2023 PIABA Annual Meeting

Written Materials

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY'S DISPUTE RESOLUTION ACTIVITIES

Revised September 5, 2023

I. BACKGROUND

The Financial Industry Regulatory Authority (FINRA) administers a dispute resolution forum for investors, brokerage firms, and their registered employees in the U.S. through its network of 69 hearing locations, including at least one in each state and Puerto Rico. FINRA administers between 3,000 and 8,500 arbitrations and numerous mediations annually. FINRA maintains a diverse roster of over 8,200 arbitrators and 230 mediators. The National Arbitration and Mediation Committee (NAMC), which is composed of investor, industry, and neutral (arbitrator and mediator) representatives, provides policy guidance to FINRA's Dispute Resolution Services (DRS) staff. A majority of the NAMC members and its chair are public. FINRA is regulated by the U.S. Securities and Exchange Commission (SEC).

FINRA's Dispute Resolution program is administered out of four regional offices: Northeast, Southeast, Midwest, and West, located in New York City, Boca Raton, Chicago, and Los Angeles, respectively, with headquarters in New York City. Contact information for the regional offices, as well as for other FINRA staff, is available on FINRA's website **here**. Below is a map showing the hearing locations and the regional offices to which they are generally assigned:



Below are highlights on: Statistics and Trends; Recent Significant Rule Changes; Proposed Rule Changes; Regulatory Notices; Significant Initiatives; FINRA Neutrals; Technology Initiatives; Mediation; and Arbitrator Selection News.

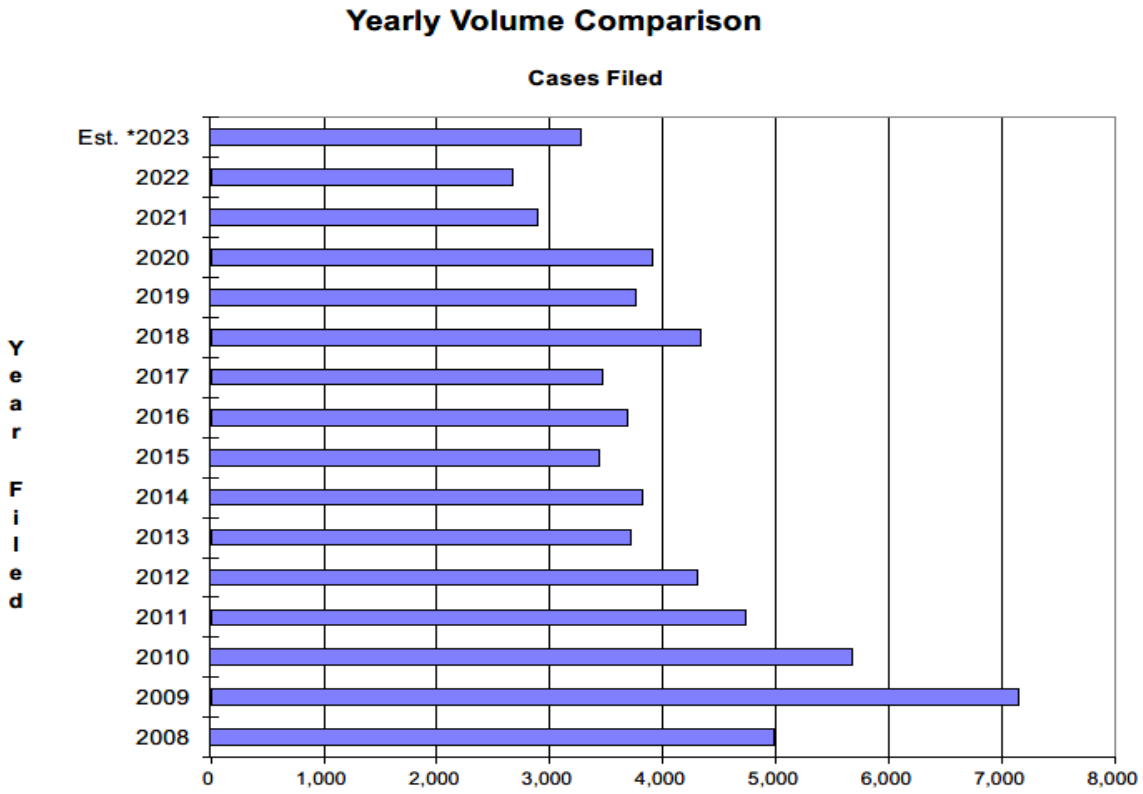
II. STATISTICS AND TRENDS

Arbitration case filings increased through July 2023 compared to July 2022. Through July 2023, parties filed 1,914 cases – a 30% increase from the 1,475 cases filed through July 2022. Customer claims increased by 19% through July 2023 compared to July 2022. Through July 2023, 43% of filed claims were intra-industry cases.

Mediation cases decreased through July 2023 compared to July 2022. Through July 2023, 407 mediation cases were filed compared to 527 through July 2022.

Case Filing Statistics for July 2023 - This section provides key filing data and trends.

Overall Arbitration Case Filings:
Through July 2023: 1,914 (30% increase compared to July 2022).



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Overall Mediation Case Filings:
Through July 2023: 407 (23% decrease compared to July 2022).

Customer Award Statistics

Awards on the Merits of Customer Claimant Cases with One or More Zoom Evidentiary Hearings[1]

Year Decided	Customer Claimant Cases Decided	Customer Claimant Cases Where Customer Awarded Damages	Customer Claimant Not Awarded Damages	Percentage of Customer Claimant Cases Where Customer Awarded Damages
2023	38	16	22	42%
2022	116	51	65	44%
2021	136	60	76	44%
2020	30	12	18	40%

Awards on the Merits of Customer Claimant Cases with In-Person Evidentiary Hearings[2]

Year Decided	Customer Claimant Cases Decided	Customer Claimant Cases Where Customer Awarded Damages	Customer Claimant Not Awarded Damages	Percentage of Customer Claimant Cases Where Customer Awarded Damages
2023	54	21	33	39%
2022	74	34	40	46%
2021	46	22	24	48%
2020	34	17	17	50%

[1] The data in this chart excludes cases dismissed prior to the hearing on the merits.
[2] The data in this chart excludes cases dismissed prior to the hearing on the merits.

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Case Processing Statistics

Processing times from service of the claim to close of the case through July 2023:

- Overall: 15.7 months (12% decrease compared to July 2022).
- Hearing cases: 18 months (10% decrease compared to July 2022).
- Special Proceeding cases: 6.5 months (14% decrease compared to July 2022).
- Paper cases (decided on the documents submitted without a hearing): 5.0 months (2% decrease compared to July 2022).

Percentage of all arbitration cases closed by award through July 2023:

- 20% (compared to 18% in 2022, 15% in 2021 and 13% in 2020).
- Through July 2023, customer cases closed by settlement approximately 72% of the time.

FINRA Dispute Resolution Services
Top 15 Security Types in Customer Arbitrations Through July

Type of Security *		2023 Cases Served	2022	2021	2020	2019
Common Stock	**Through July**	234	181	288	239	275
	Year-End	--	349	433	385	436
Corporate Bonds	**Through July**	153	106	36	46	47
	Year-End	--	239	57	79	74
Mutual Funds	**Through July**	146	78	108	111	306
	Year-End	--	159	161	177	526
Real Estate Investment Trust	**Through July**	118	123	278	177	132
	Year-End	--	211	429	421	236
Options	**Through July**	83	65	100	108	126
	Year-End	--	153	157	180	204
Private Equities	**Through July**	63	85	93	16	74
	Year-End	--	146	161	213	149
Exchange-Traded Funds	**Through July**	54	29	46	60	69
	Year-End	--	60	76	95	138
Preferred Stock	**Through July**	50	20	19	23	22
	Year-End	--	42	31	37	40
Variabe Annuities	**Through July**	48	27	48	59	64
	Year-End	--	48	75	95	109
Municipal Bond Funds	**Through July**	44	26	35	88	399
	Year-End	--	50	57	136	717
Annuities	**Through July**	39	38	50	48	47
	Year-End	--	57	98	93	97
Limited Partnerships	**Through July**	36	65	83	100	64
	Year-End	--	122	134	146	128
Business Development Company	**Through July**	31	55	127	35	14
	Year-End	--	88	177	218	26
401(k)	**Through July**	27	21	20	46	31
	Year-End	--	35	41	73	58
Structured Products	**Through July**	25	10	19	27	28
	Year-End	--	38	33	35	60

* Each case can be coded to contain multiple security types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.

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FINRA Dispute Resolution Services
Top 15 Controversy Types in Customer Arbitrations Through July

Type of Controversy *		2023 Cases Served	2022	2021	2020	2019
Breach of Fiduciary Duty	**Through July**	894	705	925	995	1,138
	Year-End	--	1,340	1,445	1,714	2,053
Negligence	**Through July**	827	641	867	914	1,021
	Year-End	--	1,261	1,371	1,592	1,826
Failure to Supervise	**Through July**	683	566	766	838	954
	Year-End	--	1,075	1,218	1,433	1,731
Breach of Contract	**Through July**	663	527	721	736	850
	Year-End	--	1,048	1,110	1,292	1,563
Misrepresentation	**Through July**	635	519	772	793	885
	Year-End	--	990	1,181	1,384	1,688
Suitability	**Through July**	549	503	651	732	836
	Year-End	--	899	1,071	1,220	1,580
Omission of Facts	**Through July**	525	421	627	699	790
	Year-End	--	825	958	1,215	1,468
Fraud	**Through July**	419	375	476	582	819
	Year-End	--	699	744	918	1,499
Violation of Blue Sky Laws	**Through July**	253	185	236	180	344
	Year-End	--	402	355	338	657
Breach of Regulation BI**	**Through July**	251	81	--	--	--
	Year-End	--	216	--	--	--
Manipulation	**Through July**	161	138	188	200	200
	Year-End	--	266	285	316	384
Elder Abuse	**Through July**	127	101	94	115	119
	Year-End	--	188	162	172	207
Unauthorized Trading	**Through July**	102	87	107	105	119
	Year-End	--	149	160	190	197
Errors-charges	**Through July**	95	60	87	55	41
	Year-End	--	99	127	102	98
Churning	**Through July**	55	47	62	81	100
	Year-End	--	81	112	115	167

* Each case can be coded to contain multiple controversy types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.
**These categories were not tracked for the years in which no data appears.

FINRA Dispute Resolution Services
Top 15 Controversy Types in Intra-Industry Arbitrations Through July

Type of Controversy *		2023 Cases Served	2022	2021	2020	2019
Breach of Contract	**Through July**	145	130	163	195	203
	Year-End	--	225	268	309	345
Promissory Notes	**Through July**	73	51	77	158	140
	Year-End	--	84	126	229	240
Libel or Slander on Form U-5	**Through July**	63	54	53	90	68
	Year-End	--	84	89	148	119
Libel, Slander, or Defamation	**Through July**	47	43	32	97	79
	Year-End	--	69	59	152	135
Compensation	**Through July**	45	51	49	88	85
	Year-End	--	77	84	135	135
Wrongful Termination	**Through July**	42	35	37	64	63
	Year-End	--	50	62	101	102
Commissions	**Through July**	19	25	31	46	45
	Year-End	--	37	55	72	82
Discrimination or Harassment**	**Through July**	17	18	21	27	29
	Year-End	--	25	36	38	46
Raiding Disputes	**Through July**	9	16	11	17	11
	Year-End	--	24	13	28	21
Indemnification	**Through July**	8	2	2	10	11
	Year-End	--	7	6	14	17
Whistleblower	**Through July**	8	4	--	--	--
	Year-End	--	5	--	--	--
Breach of Fiduciary Duty	**Through July**	4	11	13	19	23
	Year-End	--	21	23	31	30
Misrepresentation	**Through July**	3	5	4	34	26
	Year-End	--	12	12	57	29
Negligence	**Through July**	2	7	2	9	15
	Year-End	--	14	9	17	17
Partnerships	**Through July**	2	2	2	11	7
	Year-End	--	3	3	15	15

* Each case can be coded to contain multiple controversy types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.
** This category combines the following discrimination controversy types: disability, age, gender, race, sexual orientation, national origin, religion, employment discrimination, and sexual harassment. This number does not represent the number of cases served, as one case may have multiple discrimination claims.

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Comparison of Results of All-Public Panels and Majority-Public Panels in Customer Claimant Cases

Year Decided	Cases Decided by All-Public Panels	Number of Cases Decided by All-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by All-Public Panels Where Customer Awarded Damages	Cases Decided by Majority-Public Panels	Number of Cases Decided by Majority-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by Majority-Public Panels Where Customer Awarded Damages
2018	158	67	42%	58	27	47%
2019	149	79	53%	47	13	28%
2020	76	25	33%	26	6	23%
2021	139	54	39%	46	14	30%
2022	141	59	42%	51	19	37%
YTD 2023	72	25	35%	32	8	25%

Through July 2023, investors prevailed 35% of the time (25 out of 72 cases) in cases decided by all-public panels and 25% of the time (8 out of 32 cases) in cases decided by majority-public panels. To find more information on case statistics and award outcomes please visit the **Dispute Resolution Statistics** page at FINRA.org.

III. VIRTUAL HEARINGS

FINRA Dispute Resolution Services Arbitrator Resource Guide for Virtual Hearings

FINRA offers virtual hearing services (via Zoom and teleconference) to parties in all cases by joint agreement or by panel order. These services provide high-quality, secure, user-friendly options for conducting video and telephonic hearings and sharing documents remotely. Staff is available to schedule virtual hearings and provide technical support. More information about Zoom security features for arbitrations and mediations is available on **FINRA.org**.

FINRA has also released an online resource guide for arbitrators conducting hearings using Zoom, which is available on **FINRA.org**. This guide includes information about the equipment arbitrators will need, promoting fairness and impartiality throughout Zoom hearings, and best practice tips for topics like participant etiquette, when and how often to take breaks, and how to set up your Zoom background to minimize distractions. We have also released **Zoom training videos** and the **Fall 2020 Neutral Workshop** for arbitrators which offer guidance and best practice tips for virtual hearings. Arbitrators should contact their case administrator with any additional questions about virtual hearings.

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IV. RECENT SIGNIFICANT RULE CHANGES

Amendments to the Codes to Modify the Process Relating to the Expungement of Customer Dispute Information

On April 12, 2023, the SEC approved amendments to the Codes of Arbitration Procedure (Codes) to modify the process relating to the expungement of customer dispute information. The amendments impose requirements on expungement requests (a) filed by an associated person during an investment-related, customer-initiated arbitration (customer arbitration), or filed by a party to the customer arbitration on behalf of an associated person (on-behalf-of request), or (b) filed by an associated person separate from a customer arbitration (straight-in request).

The amendments: (1) require that a straight-in request be decided by a three-person panel that is randomly selected from a roster of experienced public arbitrators with enhanced expungement training; (2) prohibit parties to a straight-in request from agreeing to fewer than three arbitrators to consider their expungement requests, striking any of the selected arbitrators, stipulating to an arbitrator's removal, or stipulating to the use of pre-selected arbitrators; (3) provide notification to state securities regulators of all expungement requests and a mechanism for state securities regulators to attend and participate in expungement hearings in straight-in requests; (4) impose strict time limits on the filing of straight-in requests; (5) specify procedures for requesting expungement of customer dispute information during simplified customer arbitrations; (6) codify and update the best practices in the Notice to Arbitrators and Parties on Expanded Expungement Guidance applicable to all expungement hearings, including amendments to establish additional requirements for expungement hearings, to facilitate customer attendance and participation in expungement hearings and to codify the panel's ability to request any evidence relevant to the expungement request; (7) require the unanimous agreement of the panel to issue an award containing expungement relief; and (8) establish procedural requirements for filing expungement requests, including for on-behalf-of requests.

These amendments apply to cases filed on or after October 16, 2023. Please see **Regulatory Notice 23-12** for more information.

V. PROPOSED RULE CHANGES

Proposal to Amend the Codes of Arbitration Procedure

On December 23, 2022, FINRA filed with the SEC a proposed rule change to amend the

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Codes of Arbitration Procedure to make various clarifying and technical changes to the Codes, including in response to recommendations in the report of independent counsel Lowenstein Sandler LLP. The SEC has until September 8, 2023, to act on the rule proposal.

Request for Comment on a Proposed Rule to Accelerate Arbitration Proceedings for Seriously Ill or Elderly Parties

On March 16, 2022, FINRA filed **Regulatory Notice 22-09** seeking comment on a proposal to accelerate arbitration case processing when requested by parties who are seriously ill or are at least 75 years old. The proposal would help ensure that these parties are able to participate meaningfully in FINRA arbitration by shortening certain case processing deadlines for parties and arbitrators under the Codes. The comment period ended May 16, 2022.

Proposal to Prohibit Compensated Non-Attorney Representatives (NARs) in Arbitration and Mediation

At its **December 2018** meeting, the Board approved filing with the SEC proposed amendments to the Codes of Arbitration and Mediation Procedure to greatly limit compensated NARs from practicing in the FINRA arbitration and mediation forums. The rule proposal would also specify that a student enrolled in a law school, who is participating in a clinical program or its equivalent and is practicing under the supervision of an attorney pursuant to state law, is allowed to represent parties in arbitration and mediation. It would also include guidelines for resolving issues regarding the qualifications of NARs or law students in the forum. The proposed amendments will next be filed with the SEC.

VI. REGULATORY NOTICES

FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts

In April 2021, FINRA published **Regulatory Notice 21-16** to remind member firms about requirements when using predispute arbitration agreements for customer accounts. Where member firms use mandatory arbitration clauses in their customer agreements, FINRA rules establish minimum disclosure requirements regarding the use of such clauses and prohibit predispute arbitration agreements from including conditions that, among other things, limit or contradict FINRA rules. In addition, FINRA rules do not allow class action claims in FINRA arbitration. Accordingly, FINRA rules prohibit member firms from incorporating provisions that would prevent customers

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from bringing or participating in judicial class actions by adding waiver language into customer agreements (class action waivers) and prohibit member firms from enforcing arbitration agreements against members of a certified or putative class action. FINRA urges member firms to take prompt steps to ensure their customer agreements fully comply with FINRA rules. Member firms that fail to comply with FINRA rules related to customer agreements may be subject to disciplinary action.

VII. SIGNIFICANT INITIATIVES

Expungement Guidance for Arbitrators and Parties

Enhanced Expungement Training: On June 30, 2023, FINRA released the Enhanced Expungement Training which provides an overview of the amendments to the Codes of Arbitration Procedure relating to the expungement of customer dispute information. Experienced public chair arbitrators who meet the qualification under the amendments will be added to the Special Arbitrator Roster after completing this training. The amendments require that all expungement requests filed under the Industry Code be decided by a three-person panel randomly selected from the Special Arbitrator Roster. Arbitrators serving in simplified cases under the Customer Code are not required to be on the Special Arbitrator Roster but must complete this training before considering a request for expungement of customer dispute information. As of August 2023, nearly 480 public chair arbitrators had completed the training. Information about the **Enhanced Expungement Training** is available on FINRA.org.

General Expungement Training Workshop: On October 16, 2023, FINRA will release the General Expungement Training workshop that provides a comprehensive overview of requirements for recommending expungement under the Customer Code and the distinctions between expungement requests for non-simplified and simplified cases. There will also be a brief overview of expungement under the Industry Code and of the Central Registration Depository (CRD). The **General Expungement Training workshop** will be available on FINRA.org.

Basic Arbitrator Training Program - Module 16: Expungement: In 2020, FINRA released the Basic Arbitrator Training Program which must be successfully completed before an arbitrator candidate's application can be approved. The final module of the program, Module 16: Expungement, covers the expungement process and applies to cases filed on or before October 16, 2023. The course provides an overview of CRD, the expungement process, and FINRA rules and guidance. Information about the **Basic Arbitrator Training Program - Module 16: Expungement** is available on FINRA.org.

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Review of the Technology/System Used to Generate Arbitrator Lists

This year, a review of the FINRA DRS arbitrator selection algorithm will be conducted to determine if FINRA's current technology is the most effective means for random selection of arbitrators.

Short List Option to Reduce Extended List Appointments

To increase the parties' input into selecting replacement arbitrators, FINRA allows parties to agree to review a "short list" of potential arbitrators to find a replacement. FINRA will notify parties by letter of the option to stipulate to the use of a short list to select a replacement arbitrator in certain circumstances including: (1) during the arbitrator selection stage when no available ranked arbitrators remain on the primary list; (2) in paneled cases when an arbitrator needs to be replaced; and (3) when an arbitrator is unavailable due to a successful challenge for cause. Parties are free to use a short list by mutual agreement at all stages of the proceeding even if ranked arbitrators remain on the list.

When a hearing is scheduled within five calendar days of an arbitrator's withdrawal, removal, or unavailability, the parties also will need to stipulate to a postponement to use the short list option to select a replacement arbitrator. Parties may incur postponement fees pursuant to Customer Code Rule 12601 and Industry Code Rule 13601 when hearing dates are postponed.

As of May 2020, parties may complete the ranking and striking process for short lists by using the DR Portal. More information, along with an FAQ, about the Short List Procedure can be found on the **Short List Option to Reduce Extended List Appointments** page of FINRA.org.

List of Member Firms and Associated Persons with Unpaid Customer Arbitration Awards

In October 2018, FINRA posted a list on its website of firms and individuals responsible for unpaid customer arbitration awards. FINRA has provided this information in an effort to increase transparency regarding those firms and individuals with unpaid arbitration awards, and to make this information more readily accessible to investors. The list includes the names of firms and individuals whose FINRA registration has been terminated, suspended, canceled, or revoked, or who have been expelled from FINRA. This information will also continue to appear on the firms' or individuals' BrokerCheck reports. FINRA updates this information on a regular basis.

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The list is available on the **Member Firms and Associated Persons with Unpaid Customer Arbitration Awards** page on FINRA.org.

VIII. FINRA NEUTRALS

Arbitrator Disclosure

FINRA continually stresses to arbitrators the need to make complete and accurate disclosures. Below are recent measures we have taken to emphasize the importance of disclosing all information that may be relevant:

Arbitrator Disclosure Report Reviews

FINRA staff regularly conducts comprehensive reviews of arbitrators' disclosure reports to ensure accuracy and freshness of information.

- This review includes a search of legal databases such as PACER, detailed internet searches for new public information or publications, employment records, professional license records, etc.

- If new information is found, staff will contact the arbitrator for confirmation and add the information to the arbitrator's disclosure report.

Internet Searches

- We verify the accuracy of arbitrator disclosure by conducting internet searches of arbitrators prior to appointment to a case.

- If staff finds information during an internet search that is not disclosed in the arbitrator's disclosure report, staff contacts the arbitrator, confirms the validity of the information, and adds the information to the neutral's disclosure report.

Last Affirmation Dates

- FINRA displays the date that arbitrators last affirmed the accuracy of their disclosure reports at the top of the disclosure report documents.

- Arbitrators are advised to regularly review and affirm the accuracy of their disclosures on the DR Portal, as parties may consider the last affirmation date as a factor when selecting arbitrators for their cases.

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- Arbitrators can confirm the accuracy of their disclosures in two ways:
    - Submitting an update through the DR Portal; and
    - Submitting an Oath of Arbitrator when assigned to a case.

Attorney Information

- Disclosure reports feature the names of party representatives and the city and state in which the representative practices on each of the arbitrator's active cases. This feature helps to alert parties to potential conflicts based on legal representation.

More information on **Arbitrator Disclosure** can be found on our website at FINRA.org.

Arbitrator Recruitment

A primary goal of FINRA's arbitrator recruitment program is to identify and train a qualified pool of potential arbitrators from which parties can choose to hear their disputes. The strategic goal has been to continue to shift the balance of the arbitrator pool to include more public arbitrators and a more diverse roster nationwide. FINRA has implemented an aggressive recruitment campaign to seek individuals from diverse backgrounds from across different industries to serve as arbitrators. Ongoing recruitment initiatives thus far have included more than 100 women and minority organizations nationwide to source and recruit all types of people through on-site events, targeted recruiting advertisement, and direct marketing campaigns.

We are continuously enhancing the diversity of our arbitrator roster. Since 2016, FINRA DRS has worked with a third-party consultant to survey annually—on an anonymous and voluntary basis—the demographics of newly added and existing neutrals and have made them available on FINRA's website. In sharing the findings, FINRA strives to provide transparency about the current makeup of our arbitrator and mediator rosters.

Our 2022 demographic survey of the roster demonstrates continuing improvement in several demographic groups versus 2021. Of the new arbitrators added in 2022:

- 47% were female (45% in 2021)
- 6% were Multi-Racial (same as in 2021)
- 9% were LGBTQ (5% in 2021)
- 5% were Asian (4% as in 2021)

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We are also enhancing the diversity of our mediator roster. Of mediators (who may also be arbitrators) polled in 2022, 29% were women, 14% African American, 6% Hispanic or Latino, 5% Multi-Racial, 1% Asian, and 3% were LGBTQ.

To learn more about FINRA's efforts to diversify our arbitrator and mediator rosters visit **Our Commitment to Achieving Arbitrator and Mediator Diversity at FINRA** at FINRA.org.

Finally, to become more effective in how we communicate our message, we have begun using social media to recruit arbitrators. All FINRA Dispute Resolution Services Twitter updates can be found under FINRA's Twitter handle, **@FINRA**. We also released our first formal recruitment video on several social media platforms including Vimeo, LinkedIn and YouTube in December 2016: **https://vimeo.com/188349814**.

Arbitrator Application and Approval

Individuals interested in becoming an arbitrator can apply to our roster using the online arbitrator application available in the **Become an Arbitrator** section of our website. Applicants can complete the arbitrator application and submit it electronically along with a completed Consent to Background Search and Investigation Form and Social Security Number Verification Form. FINRA conducts a review of applications and works with applicants to ensure their submissions are complete before forwarding them to a subcommittee of the NAMC for final approval. FINRA processes applications and notifies applicants within 120 days from the date of receipt.

In 2022, we received 956 applications, well exceeding our goal of 750 applications. The average time for application process completion was 102 days. As of August 30, 2023, there were 4,059 public arbitrators on our roster.

Arbitrator Training

Arbitrator applicants are required to complete the Basic Arbitrator Training program, consisting of: (1) online basic training and (2) online expungement training. In 2022, the average time to train arbitrators was 57 days (597 candidates trained). New arbitrators are invited to participate in voluntary Arbitrator Orientation Sessions where they can ask questions and learn more about the forum in an informal setting. We are continuing to expand and improve our online training offerings.

To be considered for the chairperson roster, arbitrators must complete FINRA's online chairperson training and satisfy the case service requirement. FINRA staff has discretion to select arbitrators to serve on the chairperson roster from among those arbitrators

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who have completed the online chairperson training and: (1) have a law degree, are a member of a bar of at least one jurisdiction, and served as an arbitrator through award in at least one arbitration administered by a self-regulatory organization; or (2) if not an attorney, served as an arbitrator through award in at least three arbitrations administered by a self-regulatory organization (Customer Code Rule 12400(c) and Industry Code Rule 13400(c)).

To be considered for the Special Arbitrator Roster, candidates must complete FINRA's Enhanced Expungement Training and be public arbitrators eligible for the chairperson roster who have served on at least four customer arbitrations through to award in which a hearing was held, not including Special Proceedings.

In addition to the required trainings, FINRA offers advanced, subject-specific courses.

For more information on Basic and Advanced Arbitrator Training visit the **Arbitrator Training** page at FINRA.org.

IX. FINRA DISPUTE RESOLUTION SERVICES TECHNOLOGY INITIATIVES

Online Portals

Portal for Parties. Use of the Portal is mandatory for all parties, excluding pro se investors. This rule applies to all cases filed on or after April 3, 2017. Parties using the Portal can sign into a secure website and perform many functions online, including:

- filing a claim;
- receiving service of a claim;
- submitting an answer to a received claim;
- submitting additional case documents;
- viewing the status of a case;
- viewing case documents;
- striking and ranking arbitrators online;
- viewing and downloading disclosure reports of prospective arbitrators;
- scheduling hearing dates online;
- paying invoiced fees.
- see preliminary fee assessments in real time.
- upload various file types and multiple files at one time.

Portal for Neutrals. Neutrals are not required to use the Portal on a mandatory basis, but arbitrators and mediators must register in the Portal to take advantage of the numerous functions it provides, such as:

- viewing and printing their disclosure reports;

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- viewing and updating their personal profiles and disclosures;
- accessing information about their assigned cases, including upcoming hearings and payment information;
- viewing case documents;
- submitting documents;
- scheduling hearing dates;
- reviewing and signing awards; and
- viewing how often their names have appeared on arbitrator ranking lists sent to parties, and how often they are ranked or struck on those lists.

Portal Enhancements. FINRA DRS provides different versions of the Arbitrator and Party Experience Surveys, depending on how the case closed. We plan to expand access to the DR Portal on mobile devices by creating an app which will be accessible using biometric information. We also plan to add a DR Portal Messaging feature.

FINRA Dispute Resolution Services Website

The **FINRA Dispute Resolution Services** section of our website provides various resources for parties and neutrals regarding FINRA's arbitration and mediation processes. On the website users can find, among other things: an overview of arbitration and mediation; information on how to file a claim; forms that parties and arbitrators need in the arbitration process; arbitrator and mediator applications; the Codes; and rule filing information.

Arbitration Awards Online

FINRA's **Arbitration Awards Online** database is available without charge on our website at FINRA.org. Through the database, users can access FINRA arbitration awards from February 1989 through the present.

In addition, users can access all the New York Stock Exchange (NYSE) arbitration awards, as well as the awards of all arbitration programs absorbed over the years by FINRA (which include the American Stock Exchange, Chicago Board Options Exchange, International Stock Exchange, Philadelphia Stock Exchange, and Municipal Securities Rulemaking Board) and NYSE (which includes Pacific Exchange/NYSE ARCA).

The database provides users with access to awards and the ability to search for awards by using multiple criteria, such as by case number, keywords within awards, arbitrator names, date ranges set by the user, and any combination of these features. FINRA includes in customer awards information about the panel composition.

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Videoconferencing

Based on the successful use of Zoom in our forum, FINRA conducts all pre-hearing conferences by Zoom video, unless otherwise agreed upon by parties or panel.

All four of FINRA's regional office locations have hearing rooms that offer the latest Zoom technology videoconferencing capabilities, which is more user-friendly, has better sound and picture quality, and is easier to set up with remote locations. We also offer videoconferencing in DRS' Jersey City, NJ hearing rooms. With the consent of all parties or with the permission of the arbitration panel, parties or witnesses may appear at hearings by videoconference for hearings held in one of the regional office locations or Jersey City. There is no additional cost to use the videoconferencing equipment at FINRA. Parties are encouraged to notify their Case Administrator at least 30 days prior to the hearing to request videoconferencing services. All videoconferencing requests are honored in the order they are received.

Additionally, with the consent of all parties or with the permission of the arbitration panel, parties or witnesses may appear at hearings by videoconference for hearings held in other hearing locations not in one of the regional office locations or Jersey City. Parties are responsible for arranging and paying for audio-visual equipment, such as microphones, speakers, a recording device, screens, cameras, telephones, or other equipment required for telephonic testimony or videoconferencing.

X. MEDIATION

Mediation remains an important service that FINRA offers. Since the program's inception in 1995, FINRA's mediation staff has administered thousands of cases involving a wide variety of securities disputes with over 80 percent resulting in settlement between the parties.

Parties interested in mediation can fill out an online **Request for Mediation Form**, which is accessible from the **Initiate a Mediation** page at FINRA.org. Parties involved in current arbitration cases can also indicate their interest in mediation by checking the box on the Party Case Submission Form in the DR Portal. Both methods relay a message to mediation staff, who will follow-up with other parties regarding available mediation options. Parties may also raise their interest in mediation with their arbitration Case Administrator.

Additionally, FINRA DRS offers virtual mediation services (via Zoom with video or audio only) to parties in all cases by joint agreement of parties and mediator. These services provide high-quality, secure, user-friendly options for conducting video and telephonic

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mediation sessions and sharing documents remotely. Staff is available to schedule virtual mediations and provide technical support.

We invite you to take advantage of significantly reduced mediation prices during FINRA Mediation Settlement Month, which occurs every October. To participate in this program, parties must enter into a mediation agreement by October 31, 2023, and conduct the mediation by December 31, 2023.

Interested parties should contact the Mediation Administrator for their region.

Mediation Program for Small Arbitration Claims

FINRA expanded the Mediation Program for Small Arbitration Claims by increasing the maximum amount in controversy from $50,000 to $100,000 and making available all virtual platforms (telephonic and video) for these mediations. With these changes, the program is able to provide more parties the benefit of an expedient and cost-effective option for resolving small claims while also introducing parties to qualified, but underutilized diverse mediators on our roster.

The program offers virtual mediation at these costs:

- no cost for arbitration claims of $25,000 or less;
- $50 per hour for cases with claims between $25,000 and $50,000 to cover reduced mediator fees. (FINRA collects this fee and divides it equally between the parties); and
- $100 per hour for cases with claims between $50,000 and $100,000 to cover reduced mediator fees. (FINRA collects this fee and divides it equally between the parties).

Virtual mediation offers parties the option to participate in a mediation from their own homes. It also provides mediators with additional opportunities to mediate in hearing locations across the country, regardless of the mediator's home base. To help facilitate efficient virtual mediations, FINRA developed the **Guide for Using Breakout Rooms in Mediation**.

When parties mediate through this program, FINRA waives all mediation filing fees. Please contact FINRA's **Mediation Department** if you have any questions about this program.

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For more information on FINRA's Mediation Program visit the **Learn About Mediation** page at FINRA.org.

XI. ARBITRATOR SELECTION NEWS

Recent Court of Appeals of Georgia Decision

On January 25, 2022, a Fulton County, Ga. Superior Court vacated an arbitration award in favor of respondent Wells Fargo. The court decision found, among other things, that Wells Fargo and its counsel manipulated the arbitrator selection process through an agreement with FINRA. In February 2022, the Audit Committee of the FINRA Board of Governors **engaged Lowenstein Sandler LLP** to conduct an independent review in connection with the Fulton County, Ga. Superior Court decision. Details on the outcome of this review are discussed below.

On August 2, 2022, the Court of Appeals of Georgia reversed the Fulton County, Ga. Superior Court decision finding no evidence of an agreement between Wells Fargo and FINRA. Furthermore, the Court of Appeals of Georgia found nothing that indicated Wells Fargo manipulated the arbitrator pool in the subject arbitration. The Georgia Supreme Court declined to hear an appeal of the Georgia Court of Appeals' decision to reinstate the arbitration award.

Independent Review of Arbitrator Selection Process

On June 29, 2022, FINRA **published the report** of the independent counsel, Lowenstein Sandler LLP, which found no evidence of an improper agreement to remove certain arbitrators from arbitration cases. The report also stated that FINRA personnel generally adhered to policies and procedures and that their actions were intended to be fair and reasonable at each step of the relevant arbitration.

The independent counsel's report did make some recommendations, which FINRA is promptly implementing. The report and more information about the recommendations and the status of their implementation are available on **FINRA.org**.

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Building Diverse, Equitable, and Inclusive Legal Communities: Frameworks, Imperatives, and Opportunities

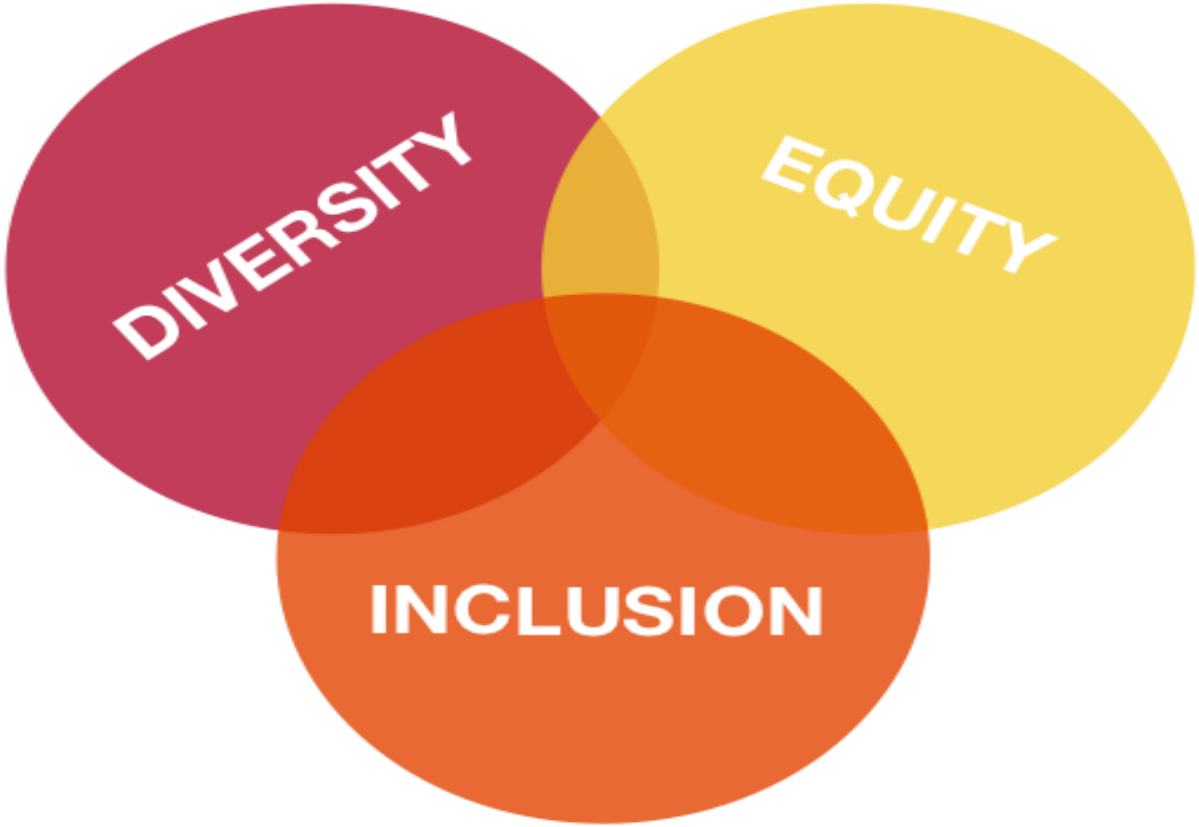
Alvin B. Tillery, Jr., Ph.D.
Director | Center for the Study of Diversity and Democracy
Northwestern University

Principal | Analytic Insights Leadership and Diversity Consulting, LLC

Email: Alvin.Tillery@protonmail.com
Twitter: @AlvinBTilleryJr

Module 1:
Key Concepts and Origins of the DEI Regime

3 Key Concepts



Diversity

- **Webster's Dictionary** defines diversity as "the condition of having or being composed of differing elements—especially the inclusion of different types of people (such as people of different races or cultures) in an organization."
- **Diversity** is the existence of variations of different characteristics in a human population. These characteristics are the traits that allow us to make distinctions between people within a group, such as ability, age, gender, race, religion, sexual orientation, etc.

Equity

- **Webster's Dictionary** defines equity as "freedom from bias."
- **Equity**: The elimination of policies, practices, attitudes and cultural messages that reinforce differential outcomes for classes of persons within an organization or fails to eliminate them.
- **Government Alliance on Race and Equity**: "Equality and equity are sometimes used interchangeably, but actually convey significantly different ideas. Equity is about fairness, while equality is about sameness. We are not interested in 'closing the gaps' by equalizing sub-par results" (p. 9).

Inclusion

- The **New American Dictionary** defines inclusion as the action of being included within a group or structure.
- The **National Association of Colleges and Employers** defines inclusion as “authentically bringing traditionally excluded individuals and/or groups into processes, activities, and decision/policy making in a way that shares power and ensures equal access to opportunities and resources.”
- The **Society for Human Resources Management** defines inclusion as “the achievement of a work environment in which all individuals are treated fairly and respectfully, have equal access to opportunities and resources, and can contribute fully to the organization’s success.”

Module 1B: Origins of the DEI Regime

Why We Focus on DEI:
The Great Transformations of the 20th Century



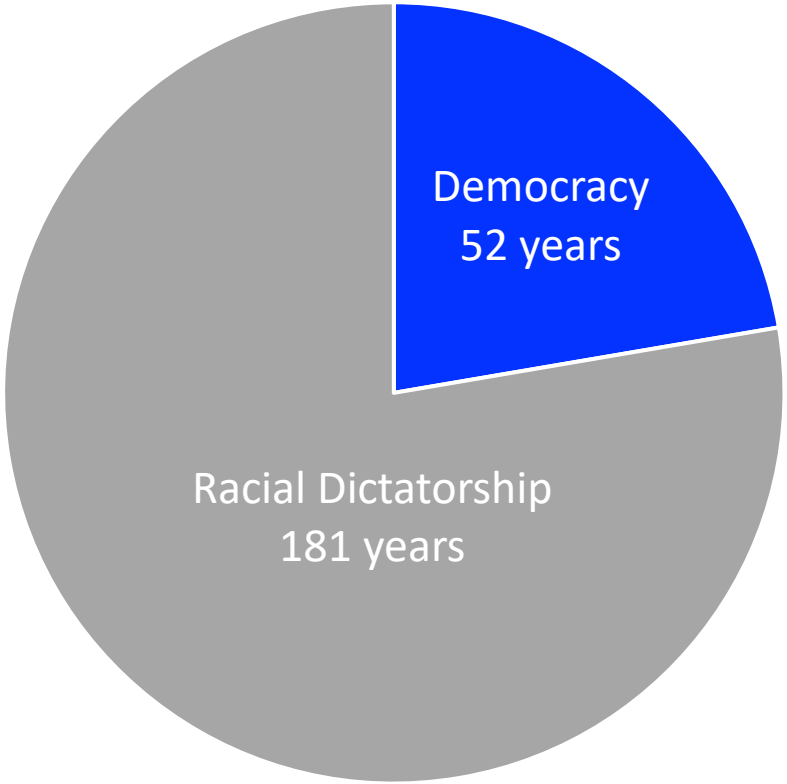
Elizabeth Eckford desegregating Little Rock Central High School in 1957



Betty Freidan leading a march in support of the Equal Rights Amendment

A Gendered-Racial Dictatorship for most of our History

America since 1787



Race:

- 1787-1870: Pro-slavery Constitution.
- 1790-1965: Racial Quotas for Immigration.
- 1896-1964: Segregation protected by federal law.
- 1863-1948: US military is segregated.
- 1876-1965: Blacks barred from voting in South.

Gender:

- 1787-1920: Women barred from voting.
- 1907-1931: Citizenship rights tied to marriage choices.
- 1787-1968: Contraceptive access is banned in most states of the union.
- 1908-1964: Professional barriers to women's entry into professions are legal.

Origins of the Affirmative Action Regime:
Lyndon Johnson's Redress Rationale

- **President Johnson** lays out a rationale for governmental action to combat the legacies of the racial dictatorship at Howard University in 1965.
- **Executive Order 11246**: Johnson makes affirmative action the official policy of the federal government.



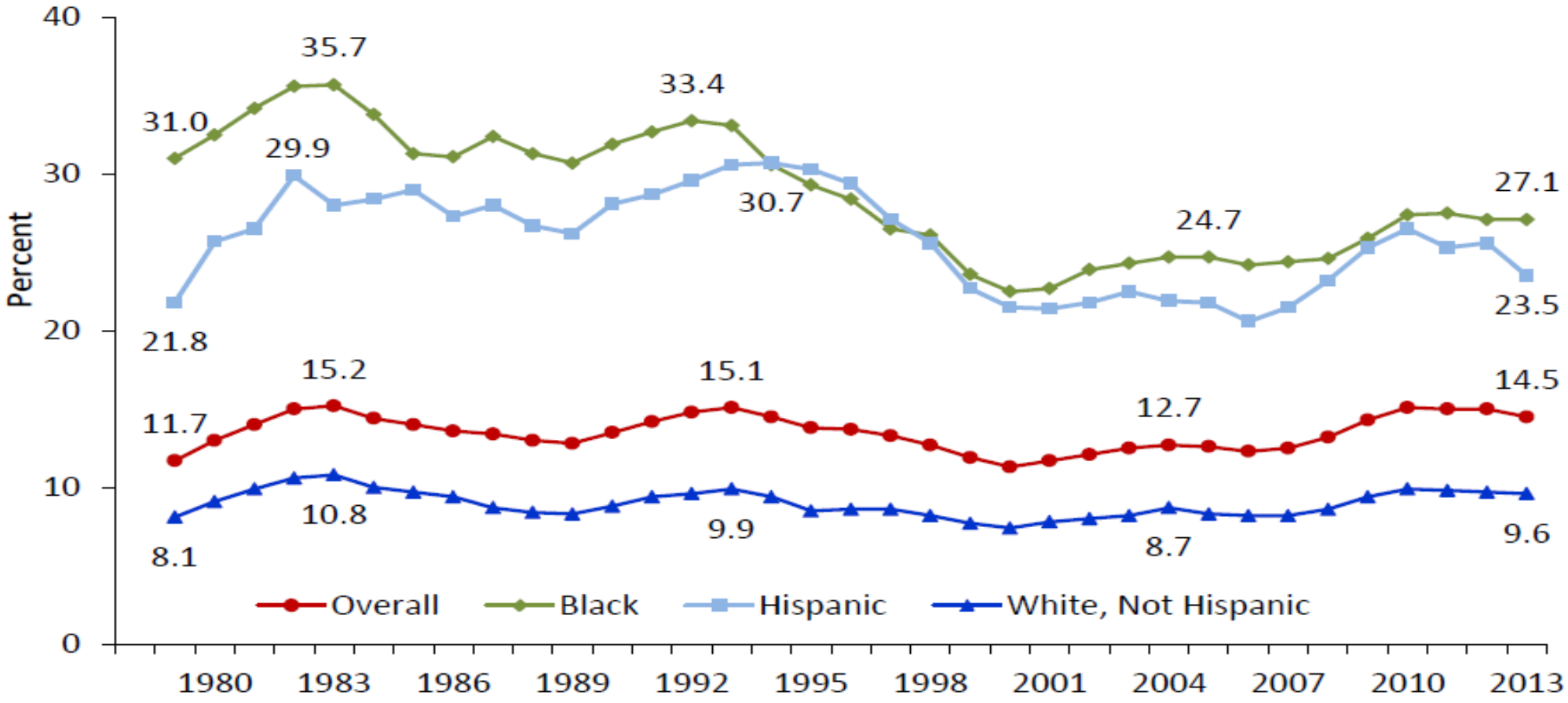
President Lyndon Johnson

Johnson's Howard University Speech:
The Logic of Redress

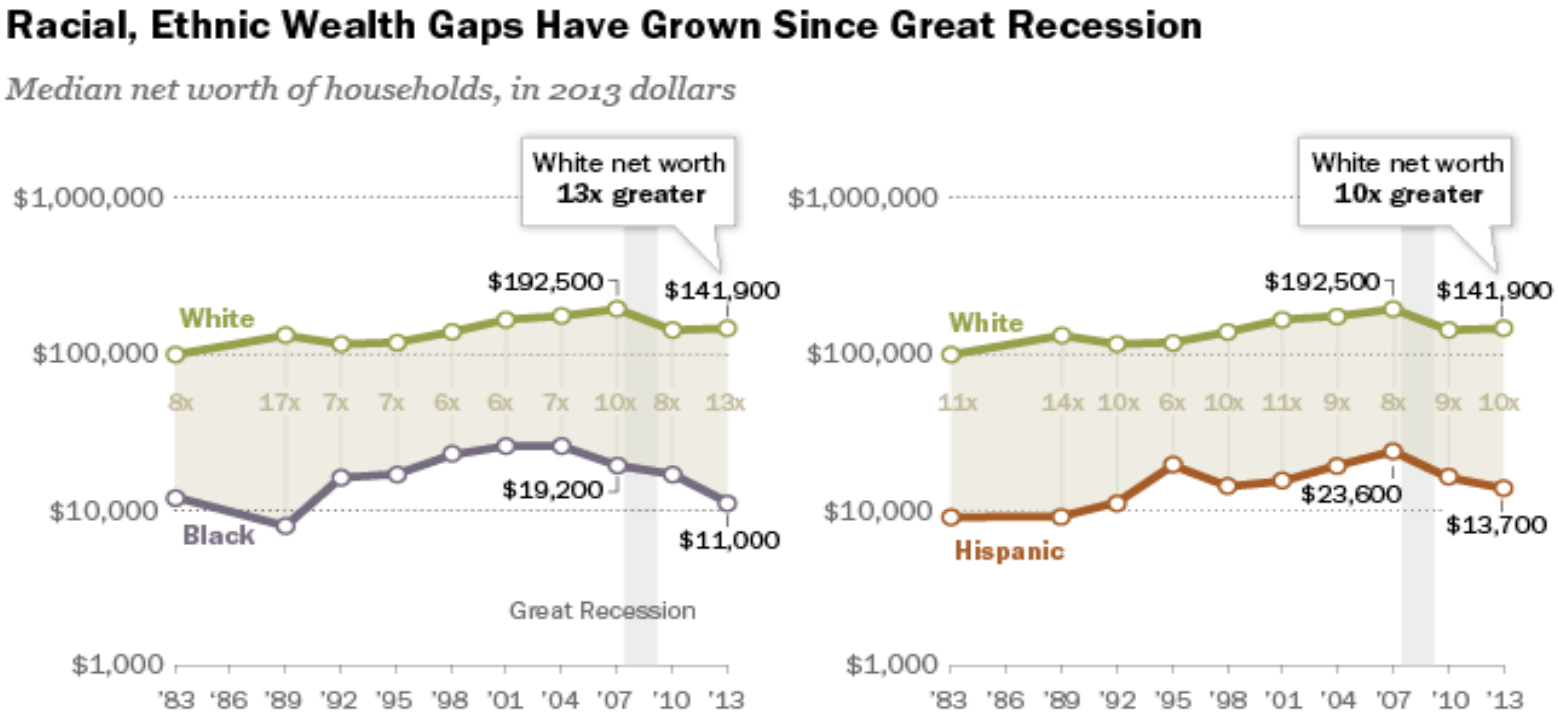
"[F]reedom is not enough. You do not wipe away the scars of centuries by saying: 'Now you are free to go where you want, and do as you desire, and choose the leaders you please.' **You do not take a person who, for years, has been hobbled by chains** and liberate him, bring him up to the starting line of a race and then say: 'You are free to compete with all others,' and believe that you have been completely fair."

---**LBJ (Howard University, 1965)**

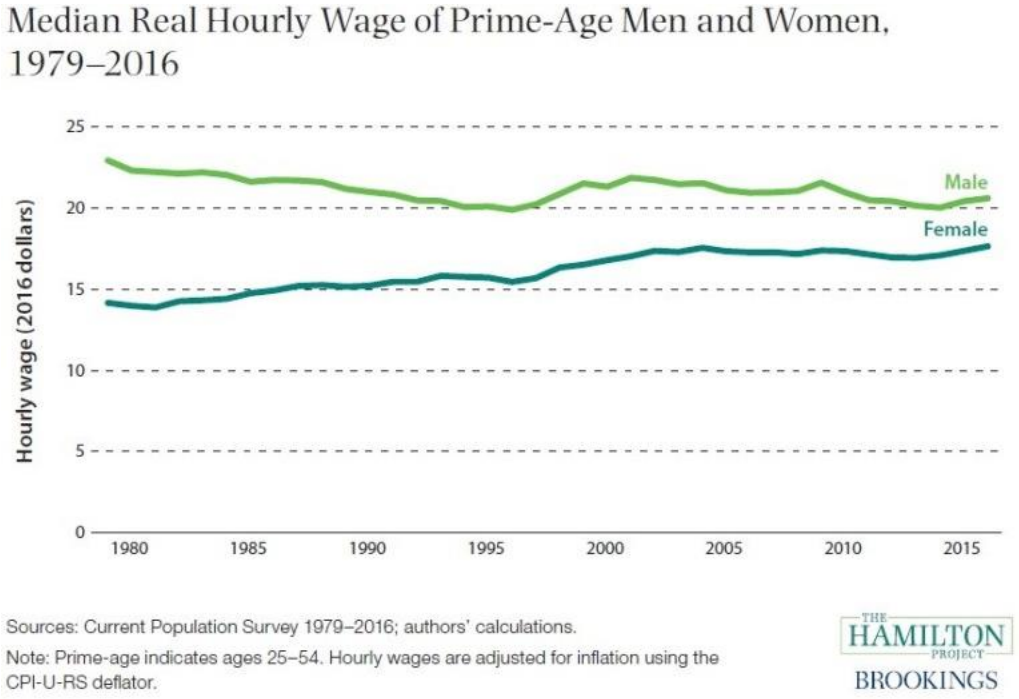
Visualizing Racial Gaps in American Life:
Poverty Rates by Race

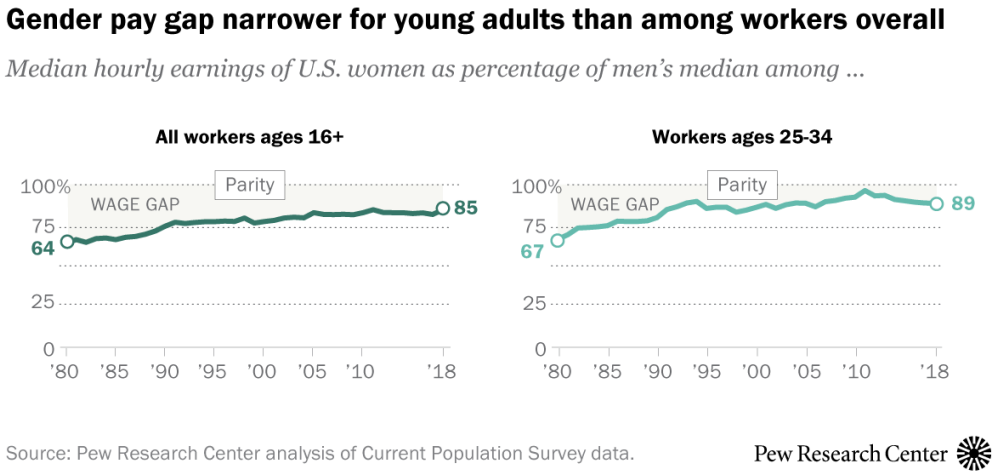


Visualizing Racial Gaps in American Life:
Wealth Distributions by Race

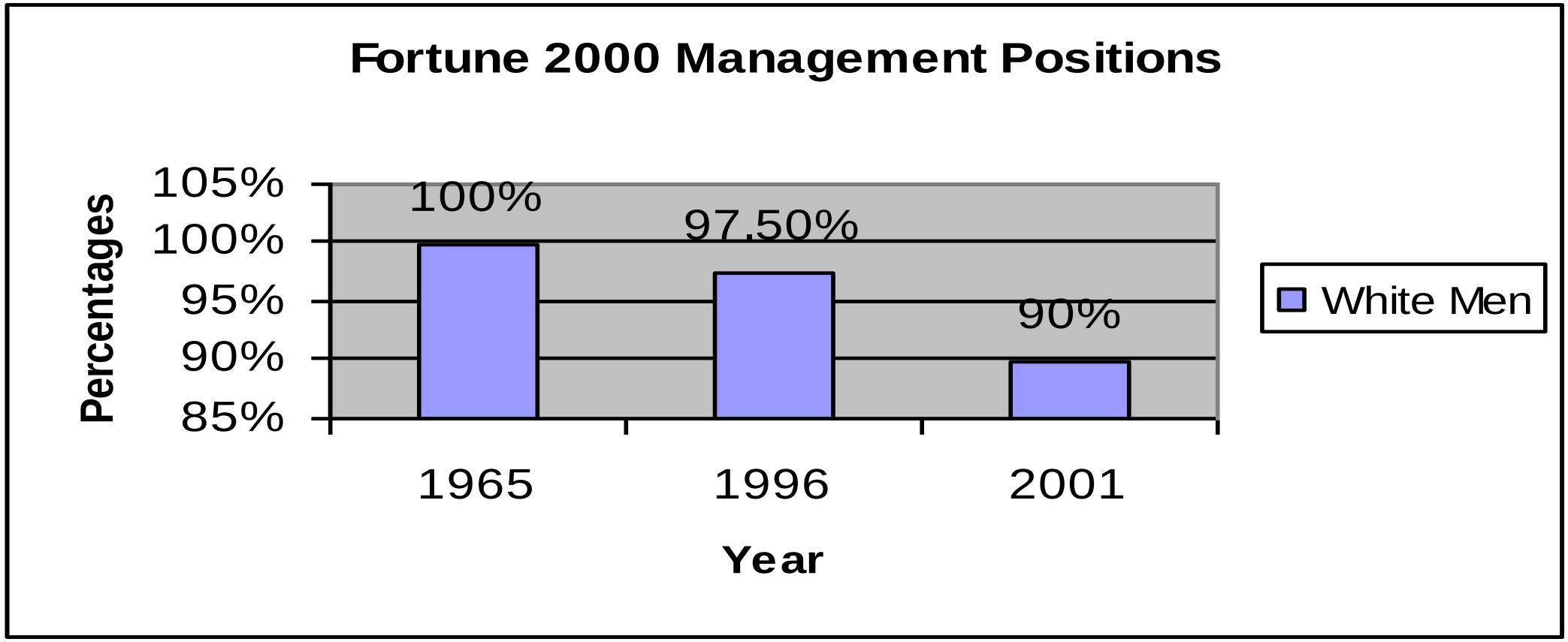


Visualizing Gender Inequalities:
The Wage Gap





Corporate America Has Been Slow to Change:
The Federal Glass Ceiling Reports



Module 2:
The Imperatives for Promoting DEI in the Legal Profession

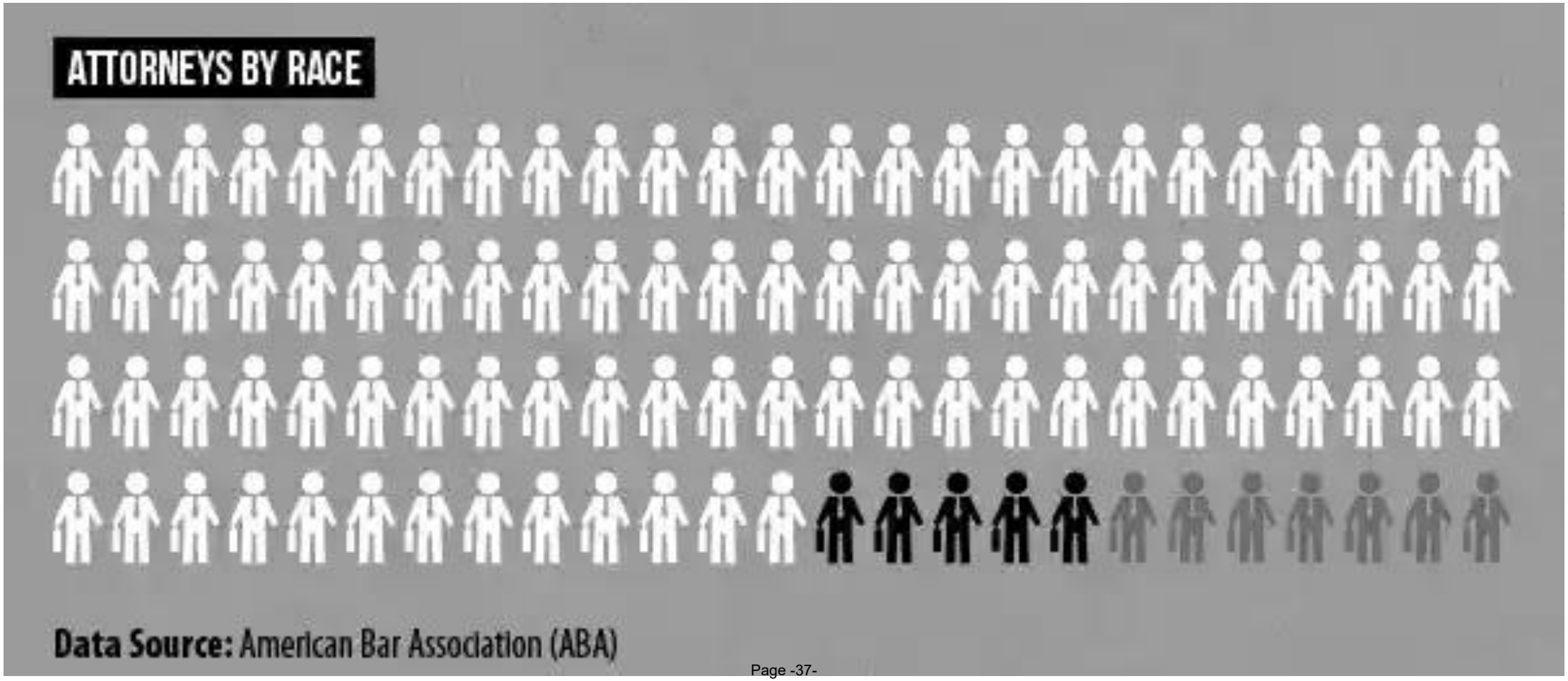
Module 2A: The Business Case for DEI in Law

America will be a Majority-Minority Nation by 2040:
The Legal Profession Remains Overwhelmingly White

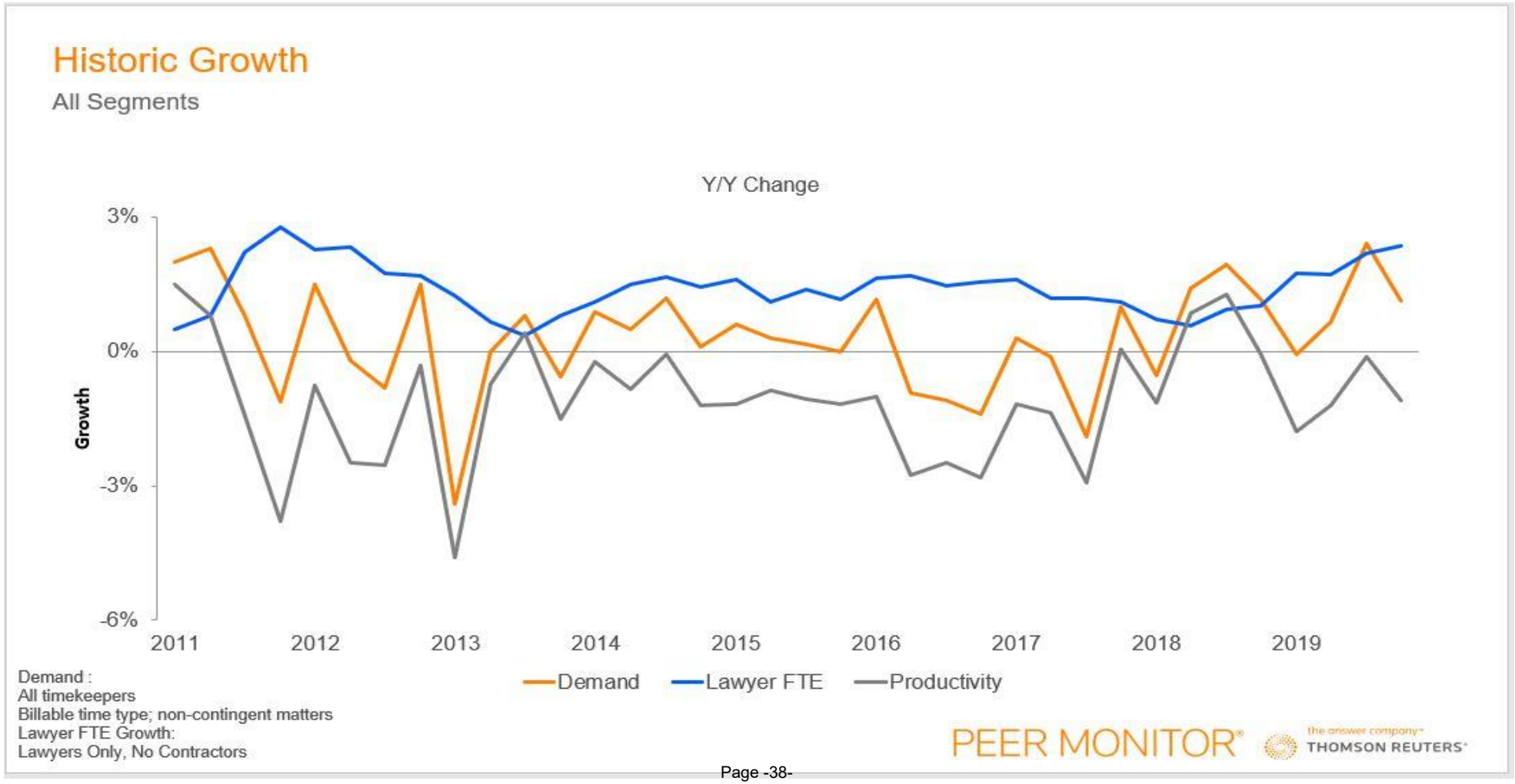
- 40 million immigrants have entered the U.S. since 1970 (**Segal et al. 2010**).
- Projections show that the U.S. will be a "majority-minority nation by 2040 (**Passel and Cohn 2008**).
- The legal profession is 86% white (**ABA 2020**); whites are 76% of the labor force.
- By 2032, whites will be 63% of the labor force (**BLS 2019**; **EPI 2018**).



Data Visualization of Racial and Ethnic Representation in the Legal Profession



Demand for Legal Services is Flat



DEI and Economic Growth:
Can the Legal Profession Grow through Equity?

Citigroup (2020): Eliminating racial gaps in the United States would…

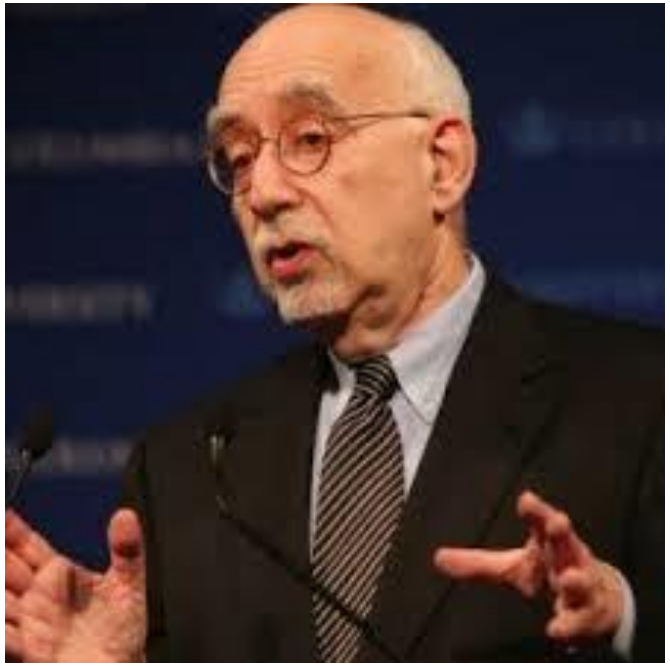
- Generate 4% annual GDP growth
- Add 5 trillion dollars to the US economy over the next 5 years.

How many lawyers would we need to service this new wealth?



Module 2B: The Moral Imperative for DEI

The US government subsidized the whiteness in the 20th Century:
This was done through Jim Crow Laws



Professor Ira Katznelson
(Columbia University)

- **Ira Katznelson** argues in his book *When Affirmative Action was White* (**Norton, 2005**) that racial gaps in housing, income, labor market participation, and education are functions of racial preferences for whites in the distribution of welfare benefits between 1934 and 1965.
- He argues that the government has a moral responsibility to fix racial inequality.

What's the GI Bill Got to Do With It?
The Color of the Recipients

- 16 million white men get the benefits of the GI bill after WW II. This figure constitutes 8 out of 10 men born in the 1920s. This legislation fundamentally transforms the American middle class (**Williams, 2003**; **Katznelson 2005**).
- Because of segregation, only 920,000 of 4.5 million eligible black men get GI bill benefits (**Bennett 1996**; **Brown 1999**).
- GI Bill benefits were moderated for those black men who did receive them because they overwhelmingly returned to segregated living and educational environments (**NBER 2004**).
- The GI Bill distribution exploded the racial gaps in educational attainment and home ownership.



GI Bill Recipients

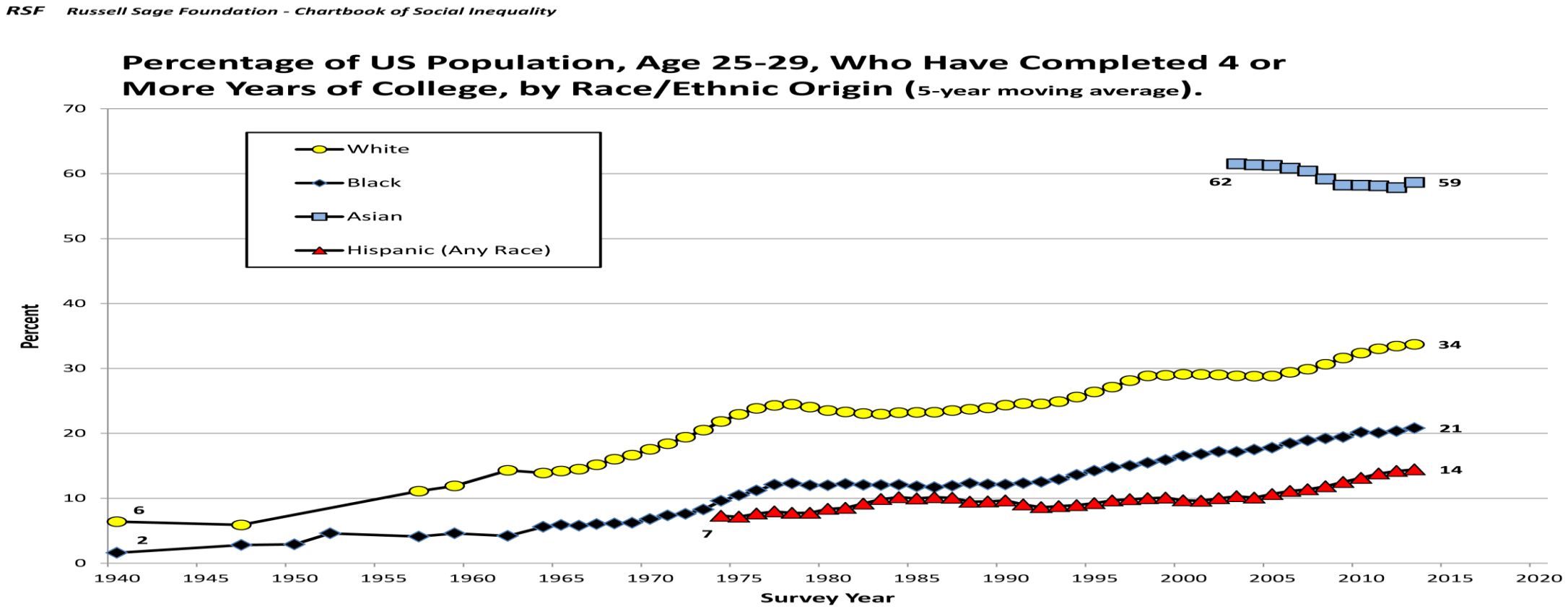
The GI Bill and the Black-White Education Gap

- In 1940, 160,000 American men a graduated from college (**Katznelson 2005**).
- By 1955, 2.5 million veterans had used GI Bill benefits to obtain college degrees (**Turner and Bound 2004**; **Katznelson 2005**).
- By 1955, 5.6 million veterans had used the GI Bill benefits to obtain vocational training in the skilled-trades (**Mettler 2005**; **Katznelson 2005**).
- The GI Bill funded unprecedented growth among American law schools and fueled the expansion of the legal profession (**Yarborough 2001**; **Bigelow 2004**).



In 1944, Don Balfour was an ex-corporal who had just enrolled at George Washington University in DC. He went to the Veterans Administration in search of a story. He got a good one. The day before the GI Bill had been signed. Don asked if he qualified. He did and became the first ex-G.I. to go to a university on the GI Bill. Source GW University.

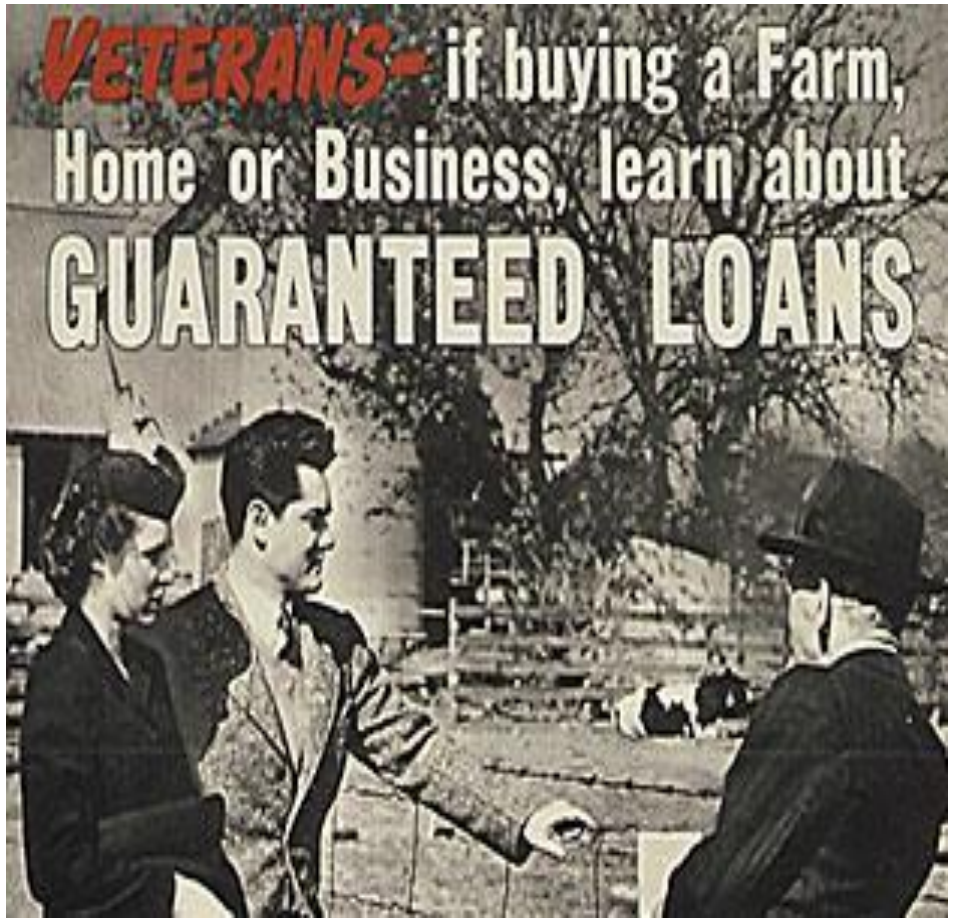
The GI Bill and the Black-White Education Gap: The Direct Impact of Segregated Opportunity Structures



Data Source: http://www.census.gov/hhes/socdemo/education/data/cps/historical/index.html. From Table A-2. Percent of People 25 Years and Over Who Have Completed High School or College, by Race, Hispanic Origin and Sex: Selected Years 1940-2013.

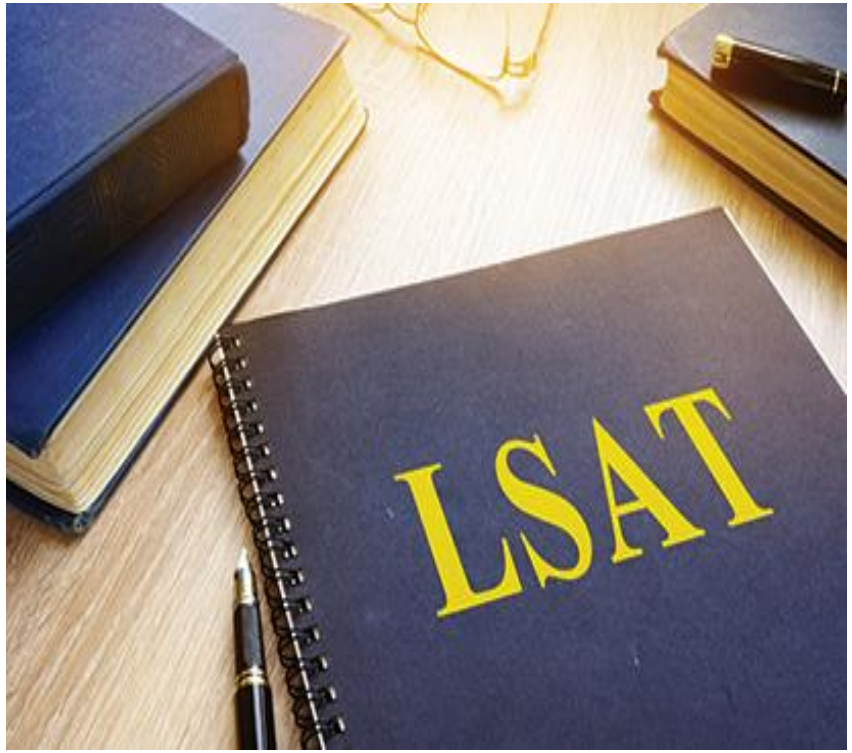
The GI Bill and the Black-White Gap in Homeownership

- The cash transfers to white veterans of World War II between 1944 and 1971 was $95 billion.
- Most of this money went to providing low-cost, guaranteed mortgages to veterans for the more than 5 million new homes that were built to accommodate them in this period.
- 43% of Americans owned homes in 1940; by 1971 that number had climbed to 64%.
- The GI Bill also fueled the growth of suburbs that generated new forms of segregation and racist exclusions that we continue to live with today.



The Racial Legacy of the GI Bill:
Are Standardized Test Reinforcing Privilege?

- There are long-standing debates about the nature of the racial gap on LSAT scores (**Sander 2004**; **Taylor 2019**).
- Both the efficacy of the test as a predictor of student performance and the dynamics of the speeded element have been challenged (**Henderson 2003**; **Austin et al., 2016**).
- Katznelson's work urges us to consider if the entire system for sourcing lawyers into the profession is reproducing previous exclusions.



Module 3:
Promoting DEI in the Legal Profession

What Can the Legal Profession Learn from Other Sectors?

The Equity Audit:
Has Your Organization Contributed to Inequalities?





- Examine the extent to which your organization has profited from and worked to sustain gender and racial inequalities.
- **Lloyd's of London (2020):** Apologized for slavery ties and invested in racial equity programs in the UK.
- **The Los Angeles Times (2020):** Apologizes for decades of racist coverage of people of color.
- **North Carolina Bar Association (2020):** Examined and apologized for its role in perpetuating Jim Crow legal institutions and other discrimination against people of color in the state of North Carolina.

Normalize Conversations about DEI:
Can your members talk about difference?

- Create environments where the members of your organization can talk about diversity and difference in productive ways.
- **ABD Insurance (2019):** Created a diversity initiative that promotes dialogues about identity; this lead them to be an early adopter of the Juneteenth holiday celebration.

Develop DEI Plans Centered on Deliverables:
Do You Have Staff, Metrics, and Training?

- Promoting racial equity requires dedicated staff, metrics, and living in the real world—meaning setting and focusing on attainable goals.
- **Living Cities (2019):** Created an internal team focused exclusively on promoting racial equity throughout the nonprofit.



LIVING CITIES

INNOVATE ▸ INVEST ▸ LEAD

Social Responsibility:
Does Your Organization Invest in Causes to Promote DEI?



- Use your market position and charitable contributions to promote DEI.
- **Intel (2019):** Announced that they will not retain law firms that have less than 10% minorities at the equity partner rank.
- **Bank of America (2020):** Announced a $1 billion pledge over four years to promote racial equity.

Thank You!

Pew Hispanic Center
a PewResearchCenter project

Report

April 14, 2009

A Portrait of Unauthorized Immigrants in the United States

Jeffrey S. Passel
Senior Demographer
Pew Hispanic Center

D'Vera Cohn
Senior Writer
Pew Research Center

The **Pew Hispanic Center** is a nonpartisan research organization that seeks to improve public understanding of the diverse Hispanic population in the United States and to chronicle Latinos' growing impact on the nation. It does not take positions on policy issues. The center is part of the Pew Research Center, a nonpartisan "fact tank" based in Washington, D.C., and it is funded by The Pew Charitable Trusts, a Philadelphia-based public charity. All of the Center's reports are available at www.pewhispanic.org. The staff of the Center is:

Paul Taylor, Director
Rakesh Kochhar, Associate Director for Research
Richard Fry, Senior Research Associate
Gretchen Livingston, Senior Researcher
Daniel Dockterman, Research Assistant
Mark Hugo Lopez, Associate Director
Jeffrey S. Passel, Senior Demographer
Ana Gonzalez-Barrera, Senior Analyst
Mary Seaborn, Administrative Manager

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Executive Summary

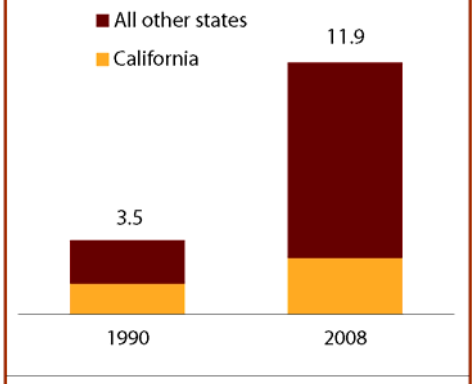
Unauthorized immigrants living in the United States are more geographically dispersed than in the past and are more likely than either U.S. born residents or legal immigrants to live in a household with a spouse and children. In addition, a growing share of the children of unauthorized immigrant parents—73%—were born in this country and are U.S. citizens.

These are among the key findings of a new analysis by the Pew Hispanic Center, a project of the Pew Research Center, which builds on previous work estimating the size and growth of the U.S. unauthorized immigrant population. A 2008 report by the Center estimated that 11.9 million unauthorized immigrants lived in the United States; it concluded that the undocumented immigrant population grew rapidly from 1990 to 2006 but has since stabilized.[1] In this new analysis, the Center estimates that the rapid growth of unauthorized immigrant workers also has halted; it finds that there were 8.3 million undocumented immigrants in the U.S. labor force in March 2008.

Based on March 2008 data collected by the Census Bureau, the Center estimates that unauthorized immigrants are 4% of the nation's population and 5.4% of its workforce. Their children, both those who are unauthorized immigrants themselves and those who are U.S. citizens, make up 6.8% of the students enrolled in the nation's elementary and secondary schools.

About three-quarters (76%) of the nation's unauthorized immigrant population are Hispanics. The majority of undocumented immigrants (59%) are from Mexico, numbering 7 million. Significant regional sources of unauthorized immigrants include Asia (11%), Central America (11%), South America (7%), the Caribbean (4%) and the Middle East (less than 2%).

Figure 1
Growth and Dispersion of Unauthorized Immigrants, 1990-2008
(millions)



Source: Pew Hispanic Center. See Table B1 for details.

State Settlement Patterns

Unauthorized immigrants are spread more broadly than in the past into states where relatively few had settled two decades ago. This is especially true in

[1] Jeffrey S. Passel and D'Vera Cohn. *Trends in Unauthorized Immigration: Undocumented Inflow Now Trails Legal Inflow.* Washington, DC: Pew Hispanic Center, October 2008.

Georgia, North Carolina and other southeastern states. Long-time immigrant destinations, including Florida, Illinois, New Jersey, New York and Texas, also have retained their appeal to undocumented migrants.

However, growth of this population has slowed in California. Although the Golden State still houses the largest number of undocumented migrants—2.7 million, or almost double the number in 1990—it is home to a markedly smaller proportion of them. Its 42% share in 1990 declined to 22% in 2008.

Table 1
States with Largest Unauthorized Immigrant Populations, 2008
(population in thousands)

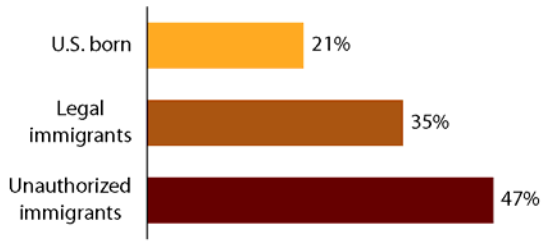
	Estimated Population	Range
U.S. Total	11,900	(11,400 - 12,400)
California	2,700	(2,500 - 2,850)
Texas	1,450	(1,300 - 1,550)
Florida	1,050	(950 - 1,150)
New York	925	(800 - 1,050)
New Jersey	550	(500 - 600)
Arizona	500	(475 - 550)
Georgia	475	(425 - 500)
Illinois	450	(375 - 525)
North Carolina	350	(300 - 400)
Virginia	300	(275 - 325)

Source: Pew Hispanic Center estimates based on augmented March Current Population Surveys for 2006-08. See Table B1

Families and Children

Most unauthorized immigrant adults reside with immediate family members—spouses or children. About half of undocumented adults live with their own children under 18. Nearly half of unauthorized immigrant households (47%) consist of a couple with children. That is a greater share than for households of U.S.-born residents (21%) or legal immigrants (35%). This difference stems in large part from the relatively youthful composition of the unauthorized immigrant population.

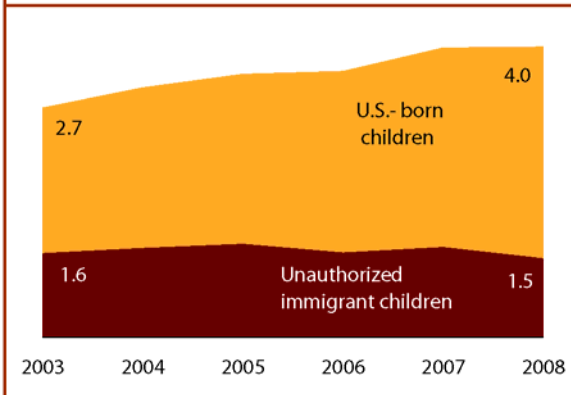
Figure 2
Nearly Half of Unauthorized-Immigrant Households Are Couples with Children
(% of households that are couples with children for each status group)



Note: Couples may be married or cohabiting
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See Figure 10.

Most children of unauthorized immigrants—73% in 2008—are U.S. citizens by birth. The number of U.S.-born children in mixed-status families (unauthorized immigrant parents and citizen children) has expanded rapidly in recent years, to 4 million in 2008 from 2.7 million in 2003. By contrast, the number of children who are unauthorized immigrants themselves (1.5 million in 2008) hardly changed in the five-year period and may have declined slightly since 2005.

Figure 3
Children with at Least One Unauthorized Immigrant Parent, by Status, 2003-08
(millions)



Note: Children are persons under age 18 who are not married.
Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

Schools

Children of unauthorized immigrants are a growing share of students in kindergarten

through grade 12. The Center, analyzing this group for the first time, estimates that 6.8% of K-12 students have at least one parent who was undocumented in 2008. In five states, about 10% or more of students are children of undocumented-immigrant parents. Most of these children, having been born in the United States, are U.S. citizens.

Labor

The nation's labor force of 154 million people includes an estimated 8.3 million unauthorized immigrants. The 5.4% unauthorized-immigrant share of the labor force in 2008 rose rapidly from 4.3% in 2003, and has leveled off since 2007. The estimate for 2008 is not significantly different from 2007, so any assessment of recent trend is inconclusive because of the margin of error in these estimates.

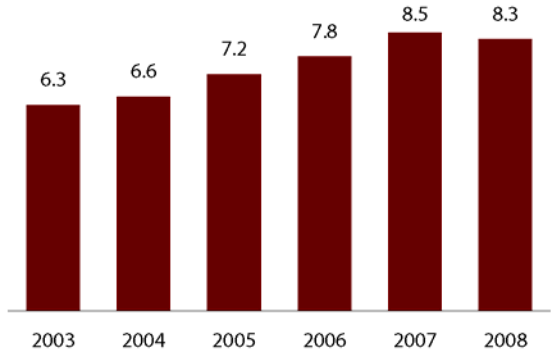
Table 2
States with Largest Share of Unauthorized Immigrants in the Labor Force, 2008
(labor force in thousands)

	Labor		
	Total	Unauthorized	
		Estimate	Share
U.S. Total	154,772	8,300	5.4%
Nevada	1,370	170	12.2%
California	18,824	1,850	9.9%
Arizona	3,103	300	9.8%
New Jersey	4,588	425	9.2%
Florida	9,231	750	8.2%
Texas	11,748	925	7.9%
District of Columbia	329	25	7.1%
New York	9,673	650	6.7%
Maryland	2,977	200	6.7%
Georgia	5,009	325	6.3%

Note: Unauthorized estimates are rounded; see Methodology appendix. Percentages computed from unrounded data.
Source: Pew Hispanic Center estimates based on augmented March Current Population Surveys for 2006-08. See Table B2

Among states, the proportion of unauthorized workers varies widely: They constitute roughly 10% or more of the labor force in Arizona, California and Nevada, but less than 2.5% in most Midwest and Plains states. They are especially likely to hold low-skilled jobs and their share of some of those occupations has grown. In 2008, 17% of construction workers were undocumented, an increase from 10% in 2003. One in four farmworkers is an unauthorized immigrant.

Figure 4
Unauthorized Immigrant Workers in U.S. Civilian Labor Force, 2003-08
(millions)

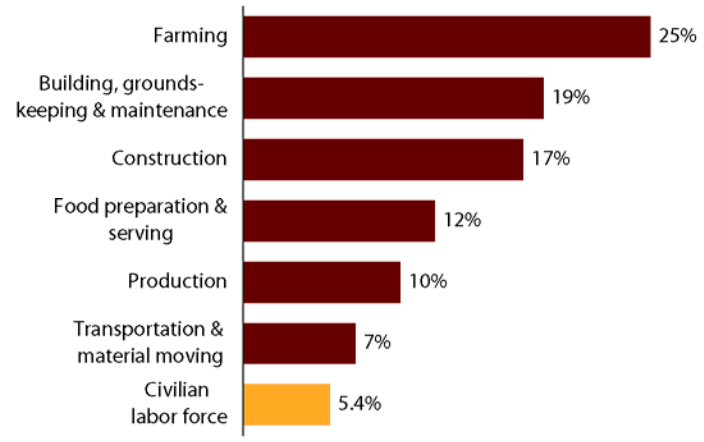


Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

The estimates reported here are based mainly on data from March Current Population Surveys, conducted by the Census Bureau, through 2008, augmented with legal status assignments and adjusted to correct for undercount; some estimates are from the 2000 and 1990 Censuses. The Census Bureau asks people where they were born but does not ask people their immigration status, so the estimate of the size of the population is derived by

employing a widely accepted methodology that has been used in previous reports on this topic. Essentially, it subtracts the estimated legal-immigrant population from the total foreign-born population and treats the residual as an estimate of the unauthorized population. The information on characteristics of status groups is developed by assigning legal statuses to individual respondents who are likely to be legal or unauthorized using probabilistic methods designed to produce results agreeing with the residual estimates. [For more details, see Methodology appendix.]

Figure 5
Occupations with High Shares of Unauthorized Immigrants, 2008
(% unauthorized immigrants of workers in occupation)



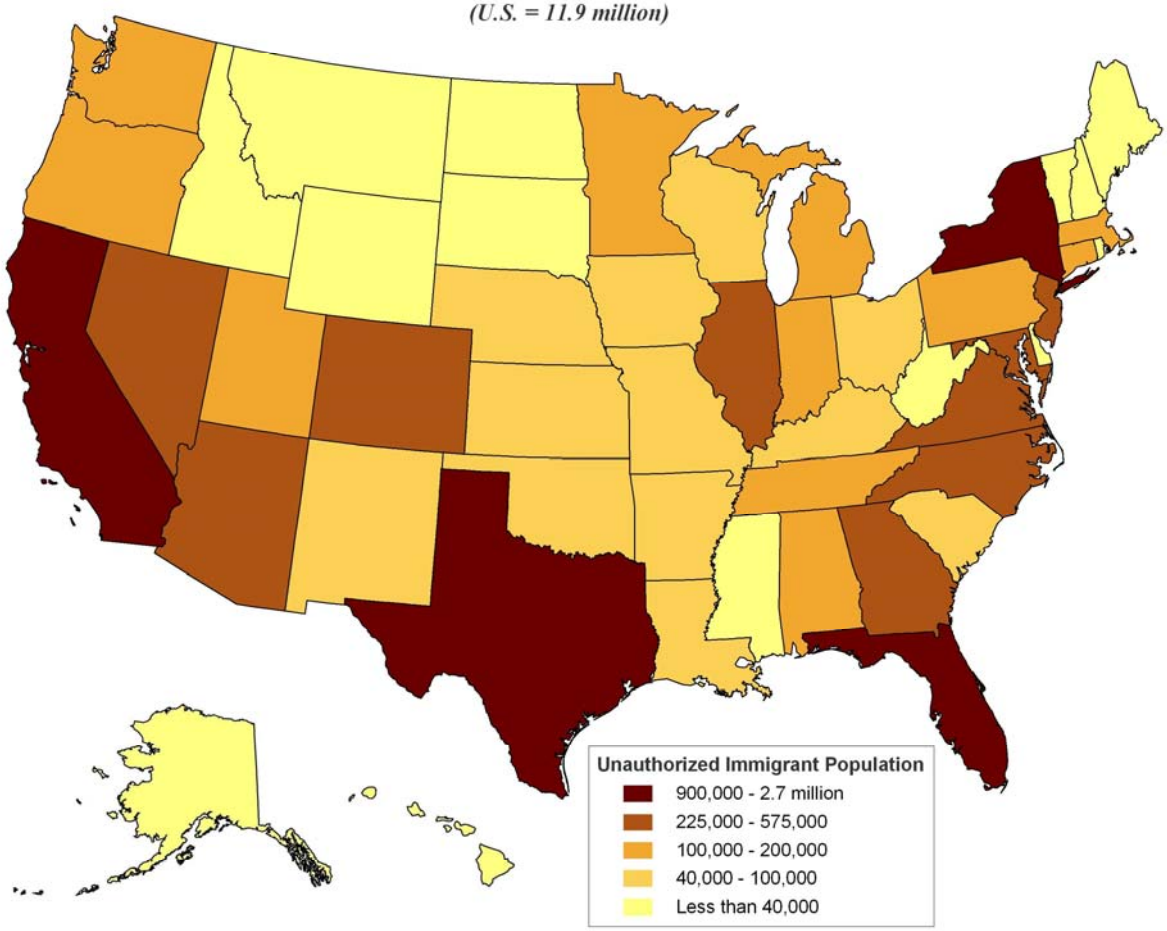
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Other Major Findings:

- Adult unauthorized immigrants are disproportionately likely to be poorly educated. Among unauthorized immigrants ages 25-64, 47% have less than a high school education. By contrast, only 8% of U.S.-born residents ages 25-64 have not graduated from high school.
- An analysis of college attendance finds that among unauthorized immigrants ages 18 to 24 who have graduated from high school, half (49%) are in college or have attended college. The comparable figure for U.S.-born residents is 71%.
- The 2007 median household income of unauthorized immigrants was $36,000, well below the $50,000 median household income for U.S.-born residents. In contrast to other immigrants, undocumented immigrants do not attain markedly higher incomes the longer they live in the United States.
- A third of the children of unauthorized immigrants and a fifth of adult unauthorized immigrants lives in poverty. This is nearly double the poverty rate for children of U.S.-born parents (18%) or for U.S.-born adults (10%).
- More than half of adult unauthorized immigrants (59%) had no health insurance during all of 2007. Among their children, nearly half of those

who are unauthorized immigrants (45%) were uninsured and 25% of those who were born in the U.S. were uninsured.

Map 1. Estimated Unauthorized Immigrant Population by State, 2008
(U.S. = 11.9 million)



Note: There are no states with unauthorized immigrant populations between 575,000 and 900,000.

About this Report

This report outlines the demographic characteristics of unauthorized immigrants living in the United States in March 2008 and offers comparisons with legal immigrants and U.S.-born residents. It also estimates the size of the unauthorized immigrant population and labor force for each state.

These unauthorized immigrants consist of residents of the United States who are not U.S. citizens, who do not hold current permanent resident visas or who have not been granted permission under a set of specific authorized temporary statuses for longer-term residence and work. The vast majority of undocumented immigrants either entered the country without valid documents or arrived with valid visas but stayed past their visa expiration date or otherwise violated the terms of their admission.

Also included in this group are some people who had entered without valid documents or violated the terms of their visas but later obtained temporary authorization to live and work in the United States. Among them are immigrants from certain countries holding temporary protected status (TPS) or people who have filed for asylum status but whose claims are unresolved. This group may account for as much as 10% of the unauthorized immigrant estimate. Many of these "quasi-legal" individuals could revert to unauthorized status.

A Note on Terminology

"Foreign born" refers to an individual who is not a U.S. citizen at birth or, in other words, who is born outside the U.S., Puerto Rico or other U.S. territories and whose parents are not U.S. citizens. The terms "foreign born" and "immigrant" are used interchangeably.

"U.S. born" refers to an individual who is a U.S. citizen at birth, including people born in the United States, Puerto Rico or other U.S. territories, as well as those born elsewhere to parents who are U.S. citizens.

The terms "unauthorized immigrants" and "undocumented immigrants" are used interchangeably.

"Children" are people under age 18 who are not married. "Adults" are ages 18 and older.

"Children of unauthorized immigrants" or "children of unauthorized immigrant parents" are foreign-born children and U.S.-born children who live with at least one unauthorized immigrant parent.

In a "U.S.-born household," both the householder and spouse or partner (if any) are born in the United States. In a "legal immigrant household," either the

householder, spouse or partner (if any) or both are legal immigrants. In an "unauthorized immigrant household," either the householder, spouse or partner (if any) or both are unauthorized immigrants.

"Spouse" includes unmarried partner unless otherwise noted; "couples" includes those both married and unmarried.

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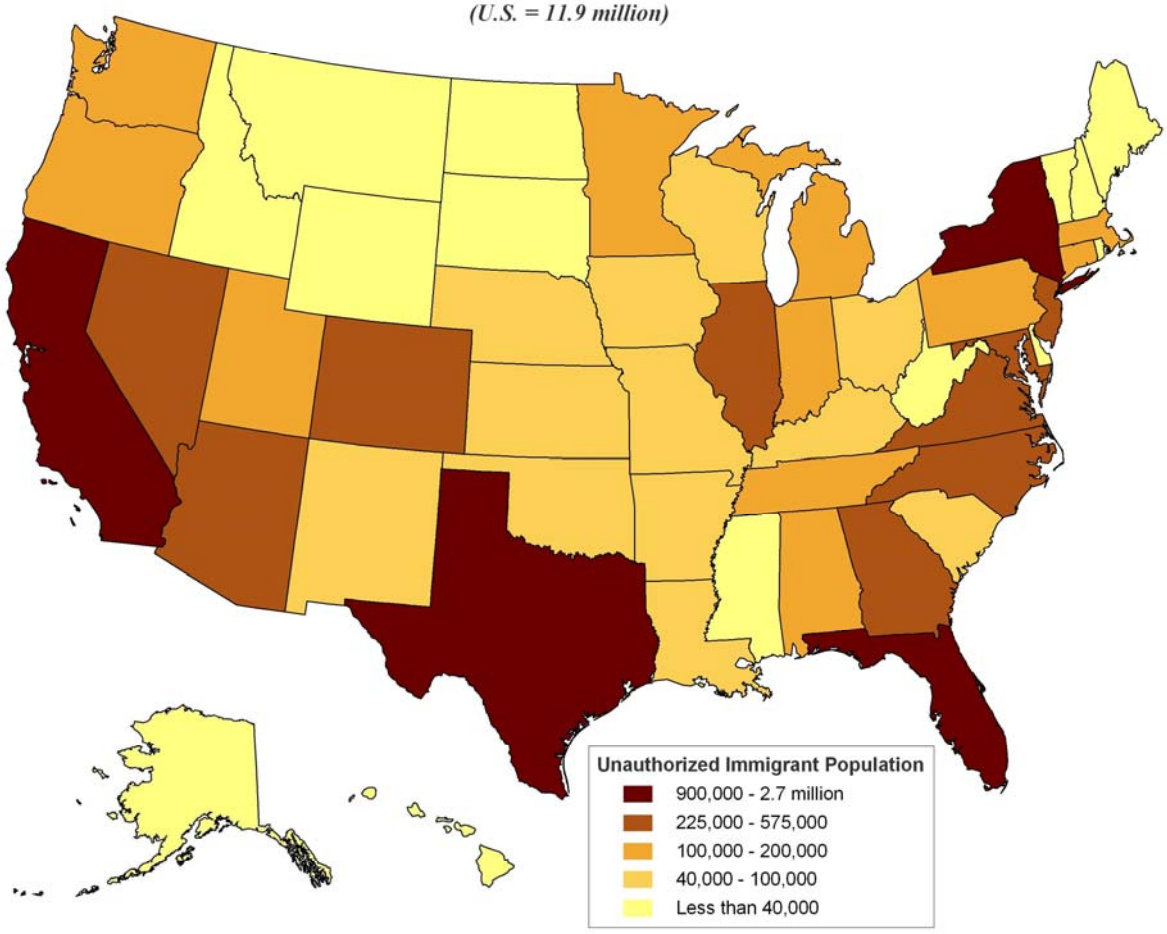
Where Do They Live?

States

About half of the nation's estimated 11.9 million unauthorized immigrants live in just four states: California, Texas, Florida and New York. Their undocumented populations range in size from about 900,000 to 2.7 million**.**

In another group of four states—New Jersey, Arizona, Georgia and Illinois—the populations of unauthorized immigrants hover around half a million. The top eight states house more than two-thirds of undocumented immigrants (68%).

Map 1. Estimated Unauthorized Immigrant Population by State, 2008
(U.S. = 11.9 million)



Note: There are no states with unauthorized immigrant populations between 575,000 and 900,000.

However, this does not tell the whole story of the geographic dispersion of the unauthorized immigrant population. In recent years, California's growth has

slowed and a group of fast-growing, new-destination states has attracted many newcomers, both legal and undocumented, from abroad.

California, where 42% of unauthorized immigrants lived in 1990, housed 22% of that population in 2008. A grouping of 28 high-growth states in the mid-Atlantic, Midwest, Mountain and Southeast regions are now home to 32% of the unauthorized immigrant population, more than double their 14% share in 1990.

Table 3
Estimated Unauthorized Immigrant Population and Range of Estimates, by State, 2008
(population in thousands)

U.S. Total	**11,900**	**(11,400 - 12,400)**			
California	2,700	(2,500 - 2,850)	New Mexico	80	(75 - 85)
Texas	1,450	(1,300 - 1,550)	South Carolina	70	(60 - 85)
Florida	1,050	(950 - 1,150)	Kansas	70	(60 - 75)
New York	925	(800 - 1,050)	Louisiana	65	(50 - 80)
			Arkansas	60	(45 - 70)
New Jersey	550	(500 - 600)	Iowa	55	(45 - 65)
Arizona	500	(475 - 550)	Oklahoma	55	(45 - 60)
Georgia	475	(425 - 500)			
Illinois	450	(375 - 525)	Nebraska	45	(40 - 55)
			Missouri	45	(35 - 60)
North Carolina	350	(300 - 400)	Kentucky	45	(35 - 60)
Virginia	300	(275 - 325)	Mississippi	35	(30 - 45)
Maryland	250	(230 - 300)	Hawaii	35	(25 - 45)
Colorado	240	(220 - 250)	Idaho	35	(25 - 40)
Nevada	230	(210 - 240)			
			Delaware	30	(25 - 35)
Massachusetts	190	(160 - 220)	Dist. of Columbia	30	(25 - 30)
Washington	180	(140 - 210)	Rhode Island	30	(20 - 35)
Tennessee	150	(130 - 170)	New Hampshire	20	(15 - 25)
Oregon	150	(130 - 160)			
Pennsylvania	140	(110 - 160)	Wyoming	<10	(0 - 10)
			South Dakota	<10	(0 - 10)
Indiana	120	(110 - 130)	Alaska	<10	(0 - 10)
Minnesota	110	(100 - 130)	Vermont	<10	(0 - 10)
Michigan	110	(85 - 140)	Maine	<10	(0 - 10)
Utah	110	(100 - 120)	Montana	<10	(0 - 10)
Connecticut	110	(100 - 120)	North Dakota	<10	(0 - 10)
Alabama	100	(85 - 120)	West Virginia	<10	(0 - 10)
Ohio	95	(80 - 120)			
Wisconsin	85	(70 - 100)			

Source: Pew Hispanic Center estimates based on augmented March Current Population Surveys for 2006-08. See Table B1

Five other large states that have been traditional immigrant destinations—Florida, Illinois, New Jersey, New York and Texas—still house 37% of the unauthorized immigrant population, little different from 1990. [See Table B1 and Table B8]

Unauthorized immigrants are 4% of the nation's population, but states in the West, Southwest and on both coasts have higher shares. In 14 states, 4% or more

of the population are unauthorized immigrants. In 21 states, they constitute less than 2% of the population. [See Table B2 and Map A1]

Unauthorized immigrants are 30% of the nation's foreign-born population of more than 39 million people. In 29 states, they are a higher share of immigrants and in eight of them the unauthorized immigrant population is about half or more of all immigrants. The states where unauthorized immigrants are an above-average share of all immigrants tend to be relatively new immigrant destinations, such as Colorado, Nevada, Georgia and North Carolina. States with low shares either have had many immigrants arriving and staying over the years, such as New York, or still have relatively few, such as West Virginia. [See Map A2]

Table 4

Foreign-born Population by Legal Status, 2008

	POPULATION	
	Millions	Percent
Total foreign born	39.9	100%
Legal immigrants	28.0	70%
Naturalized citizens	14.2	36%
Legal permanent resident aliens	12.3	31%
Legal temporary migrants	1.4	4%
Unauthorized immigrants	11.9	30%

Source: Pew Hispanic Center estimates and tabulations from augmented March 2008 Current Population Survey. See text for details.

Metropolitan Residence

A much greater share of unauthorized immigrants than of the U.S.-born population lives in metropolitan areas. Approximately 94% of unauthorized immigrants live in metropolitan areas, compared with about 80% of the U.S.-born population. This difference arises because unauthorized immigrants are more concentrated in principal cities of metropolitan areas (47% live there) than are the U.S. born (29%).

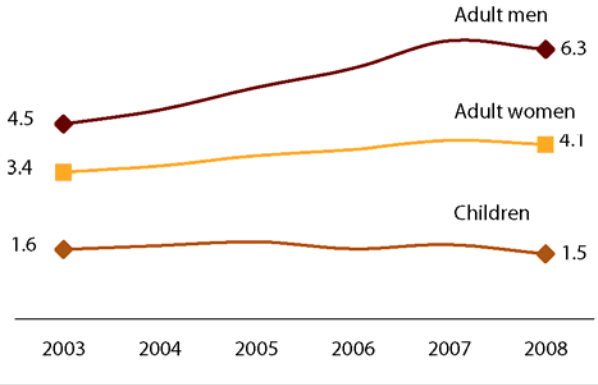
Demographic and Family Characteristics

Gender and Age

There were 6.3 million men, 4.1 million women and 1.5 million children under age 18 living in the United States as unauthorized immigrants in March 2008.

The number of men who are unauthorized immigrants has grown more rapidly than the number of women. There has been little change in the number of unauthorized immigrant children since 2003 and no discernable trend.

Figure 6
Unauthorized Immigrant Population, by Gender and Age, 2003-08
(millions)

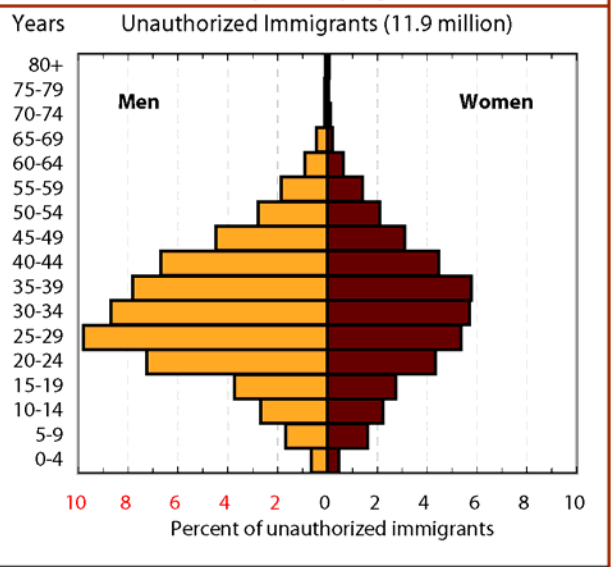


Note: Adults are ages 18 and older.
Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

The age distribution of the unauthorized immigrant population is strikingly different from that of the legal immigrant or U.S.-born population. Unauthorized immigrants are less evenly distributed by age, with considerably smaller shares of children than the U.S. born and smaller shares of the elderly than either legal immigrants or the U.S.-born population. Men ages 18-39 make up 35% of the undocumented immigrant population, compared with 14% among the U.S. born and 18% among legal immigrants.

Unauthorized immigrants are much less likely to be ages 65 and older (1.2%) than are U.S.-born residents (12%) or legal immigrants (16%).

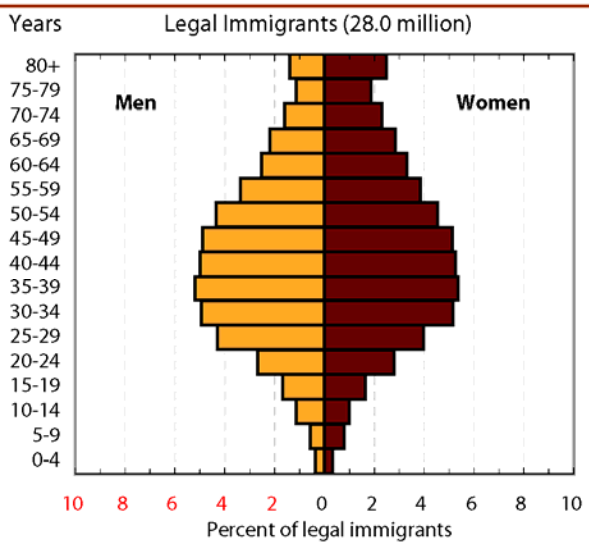
Figure 7
Unauthorized Immigrants by Age and Sex, 2008



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Children make up a smaller share of both immigrant groups than they do among the U.S. born—13% of unauthorized immigrants and 6% of legal immigrants, compared with 27% of the U.S. born. An important caveat here is that the vast majority of children of unauthorized immigrants (and legal immigrants) are born in the United States. Because most children of unauthorized immigrants are born here, a clearer picture of the demographic structure of unauthorized immigrants and their families emerges from an analysis of household/family structure and the living arrangements of individuals.

Figure 8
Legal Immigrants by Age and Sex, 2008

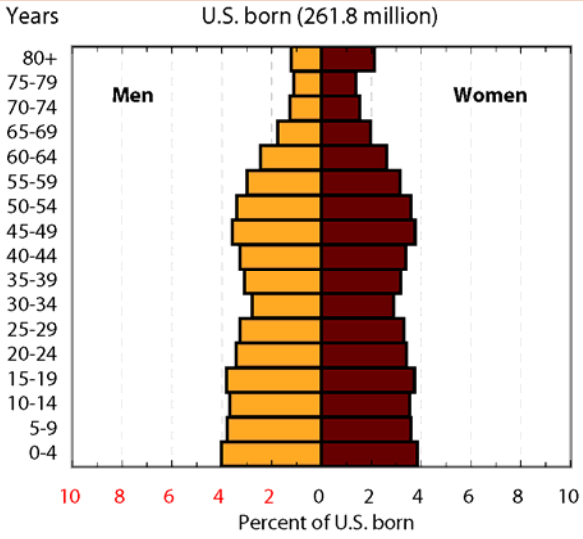


Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Household Living Arrangements

Three-quarters of the households headed by unauthorized immigrants consist of married or cohabiting couples with children; married or cohabiting couples without children; and other adults with children, mainly single parents. Compared with U.S.-born or legal immigrant households, unauthorized immigrant households are more likely to be made up of couples with children. A major reason for this difference is that the relative youth of the unauthorized immigrant adult population leads to a greater prevalence of couples as well as couples with children (notwithstanding an overrepresentation of young men).

Figure 9
U.S.-born Population by Age and Sex, 2008

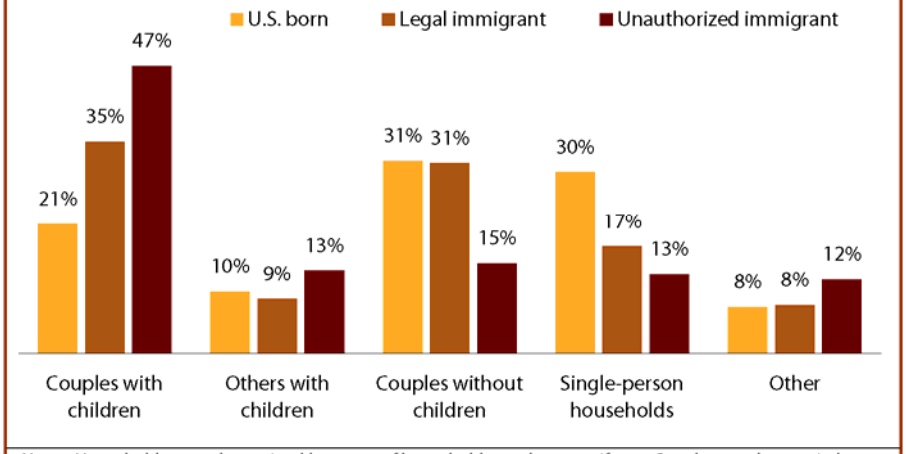


Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Nearly half (47%) of unauthorized immigrant households consist of couples with children, compared with 35% of legal immigrant households and only 21% of U.S.-born households. Couples without children account for 15% of unauthorized immigrant households and 31% of both legal immigrant and U.S.-born households. Single-person households are 13% of unauthorized immigrant

households, 17% of legal immigrant households and 30% of U.S.-born households.

Figure 10
Share of Households by Type for Status Groups, 2008
(% of total households for each status group)



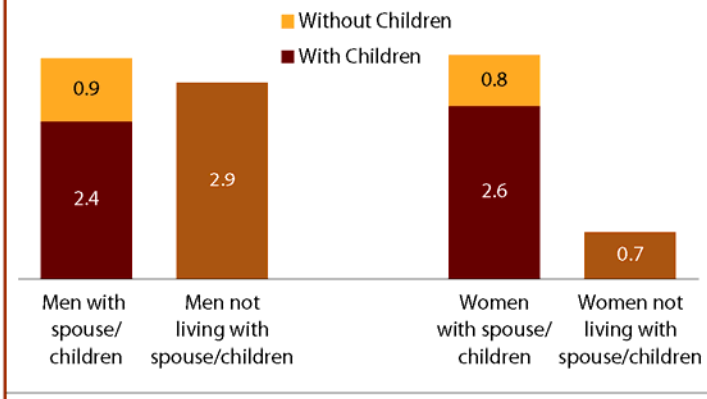
Note: Household status determined by status of householder and spouse, if any. Couples may be married or cohabiting.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Living Arrangements of Individuals

The living circumstances of individuals echo the pattern seen for households. Among adults who are unauthorized immigrants, nearly two-thirds—6.7 million—live with a spouse or a cohabiting partner (either with or without children). The share is higher for women (83%) than for men (53%). Most of this group (5.1 million) live with a spouse.

Most of these unauthorized immigrants who live with a spouse or cohabiting partner—4.3 million—also live with their children under 18. This means that nearly half of all adult unauthorized immigrants (48%) live with their children. However, the share of adult women living with their children (64%) is substantially higher than the share of men (38%) among unauthorized immigrants. Nearly all 1.5 million unauthorized

Figure 11
Unauthorized Immigrant Adults by Gender, Family Status and Presence of Children, 2008
(millions)



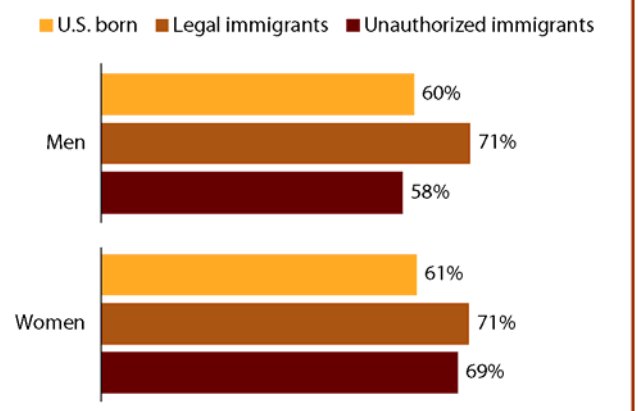
Note: Children are persons under age 18 who are not married. "Spouse" also includes unmarried partner.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

immigrant children live with their parents.

There are 3.6 million unauthorized immigrants who do not live with a spouse, partner or children.[2] These "unpartnered adults without children" are 35% of unauthorized adult immigrants, a share unchanged since 2005. Nearly half of men (47%) fit this description, as do 17% of women. The number of men in this group has increased since 2003; the number of women has not.

Comparing undocumented immigrants with others, men ages 18-64 who are unauthorized immigrants are about as likely to live with a spouse or partner (58%) as are U.S.-born men (60%), but they are less likely to do so than other foreign-born men (71%). Among women ages 18-64 who are unauthorized immigrants, 69% live with a spouse or partner, which is about the same as other foreign-born immigrants (71%) but higher than the 61% share among the U.S. born.

Figure 12
Share Married or in Cohabiting Couples, Ages 18-64, by Gender and Status, 2008
(%)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

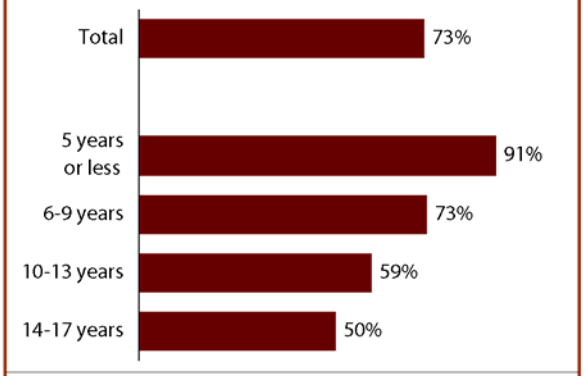
Children of Unauthorized Immigrants

The number of children of unauthorized immigrants increased by 1.2 million from 2003 to 2008, despite the fact that the number of unauthorized immigrants under age 18 has remained roughly constant. The growth has been children born in the United States.

In 2003, of the 4.3 million children of unauthorized immigrants, 2.7 million, or 63%, were born in the United States. In 2008, of the 5.5 million children of unauthorized immigrants, 4 million, or 73%, were born in the United States.

Because of the underlying dynamics of immigration and childbearing, the youngest children of unauthorized immigrants are considerably more likely than older ones to be U.S. citizens. Among children under age

Figure 13
Share Born in U.S. Among Children With at Least One Unauthorized Immigrant Parent, by Age, 2008
(%)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

[2] Some in this group have spouses or children living elsewhere.

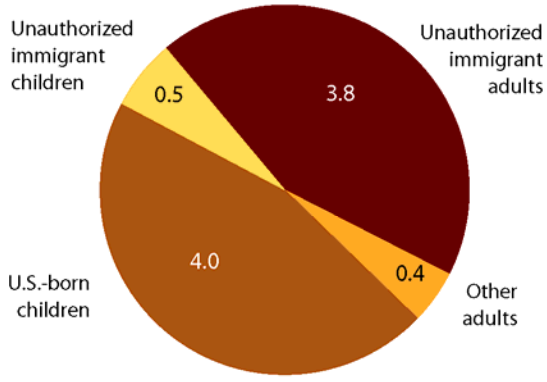
6 whose parents are unauthorized immigrants, 91% were born in the U.S.; among those ages 14 to 17, 50% are U.S. born.

The vast majority of all children with at least one unauthorized immigrant parent live in two-parent families (80%). This is similar to the share of children of other immigrants who do so (84%) and higher than the share of children with U.S.-born parents (71%).

"Mixed-Status" Families: Unauthorized Immigrant Parents and U.S. Citizen Children

Mixed-status family groups—that is, families with unauthorized immigrants and their U.S. citizen children—consist of 8.8 million people. Of these, 3.8 million are unauthorized immigrant adults and half a million are unauthorized immigrant children. The rest are U.S. citizens (mainly children) and legal immigrants.

Figure 14
People in Mixed-Status Unauthorized Immigrant Families, by Age Group and Status, 2008
(millions)



Note: A mixed-status family has at least one unauthorized immigrant parent and one U.S.-born child. Children are persons under age 18 who are not married.

Source: Pew Hispanic Center estimates and tabulations from augmented March 2008 Current Population Survey. See text for details.

Since 2003, the number of children (both U.S. born and unauthorized) in these mixed-status families has increased to 4.5 million from 3.3 million. This increase is attributable almost entirely to the increasing number of U.S. citizen children living with undocumented parents. The number of children in mixed-status families who are themselves unauthorized immigrants has remained constant.

The number of people in mixed-status families has grown in concert with the increasing unauthorized immigrant population. The 8.8 million people in these families are a slight majority (53%) of the nation's 16.6 million unauthorized immigrants and their family members. [See Figure C1] This share has hovered between 50% and 53% since 2003. The share of children of unauthorized immigrants who are in mixed-status families has increased, though. In 2008, the 4.5 million children in mixed-status families represented 82% of the 5.5 million children of unauthorized immigrants—an increase from 76% in the 2003–05 period. [See figure C1]

Looked at another way, 3.8 million unauthorized immigrants are parents of children who are U.S. citizens. They represent 37% of adult unauthorized immigrants, a figure that has remained essentially unchanged since 2003.

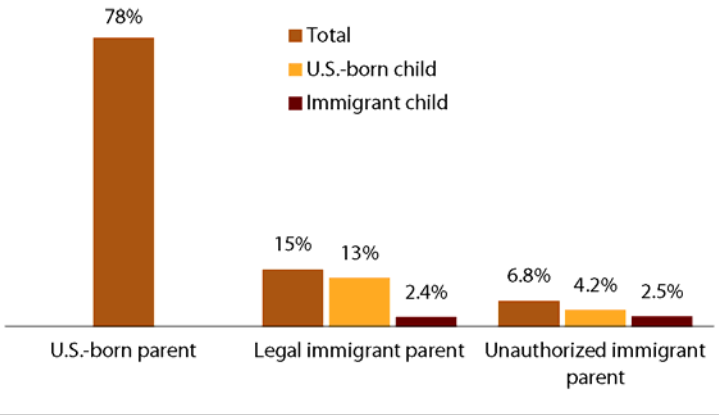
Social and Economic Characteristics

Elementary and Secondary Education (K-12)

Children of unauthorized immigrants are 6.8% of students enrolled in kindergarten through grade 12. That share has grown from 5.4% in 2003. Students with U.S.-born parents account for 78% of school-age children; those with legal immigrant parents account for the remaining 15%.

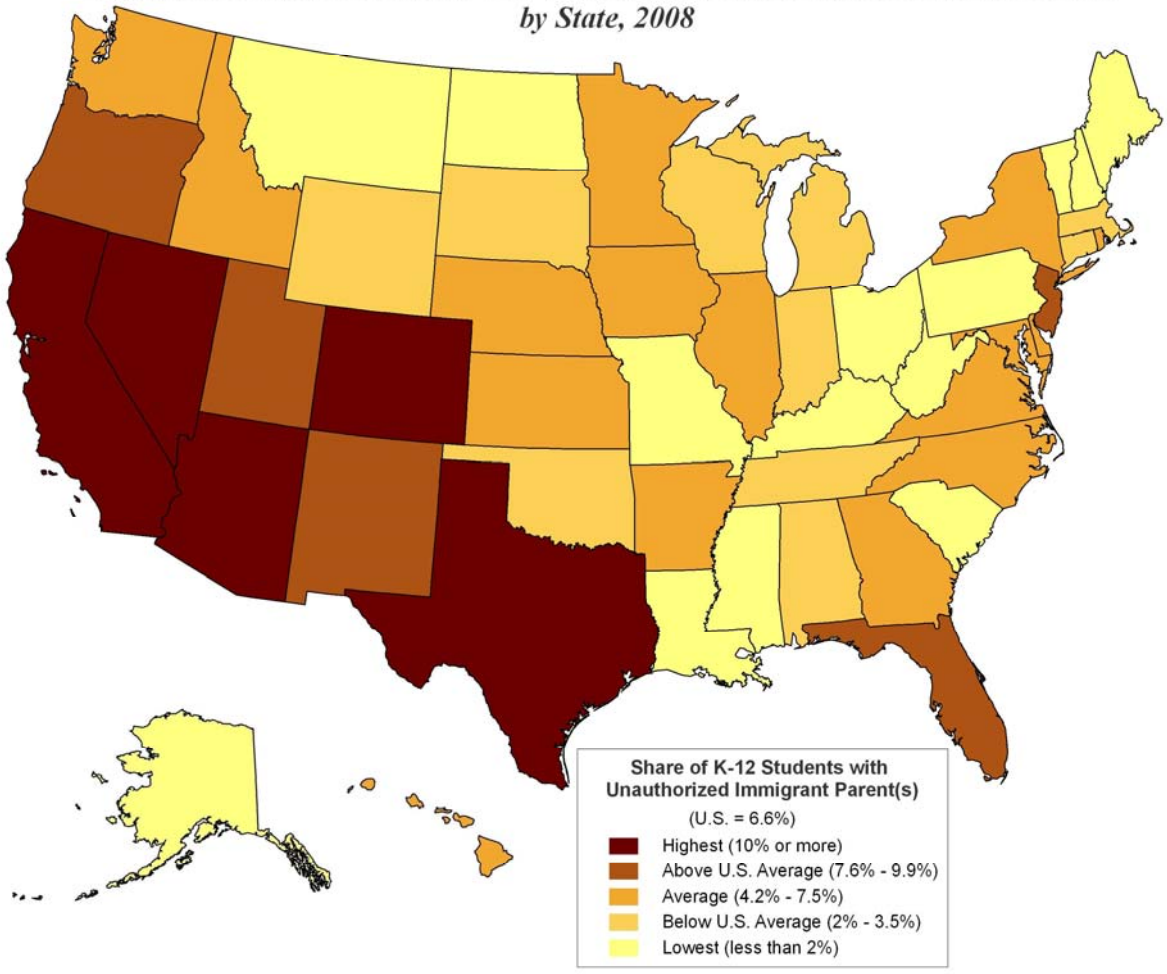
Enrollment levels of children of unauthorized immigrants vary considerably from state to state. In five states—Arizona, California, Colorado, Nevada and Texas—at least one-in-ten students in grades kindergarten through 12 have parents who are unauthorized immigrants. But in more than a dozen states, mainly those that have experienced little growth in immigration, less than one-in-fifty students (less than 2%) live with parents who are unauthorized immigrants.

Figure 15
Share of K-12 School Enrollment,
by Nativity and Status of Parents and Children, 2008
(%)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Map 2. Share of K-12 Students with at Least One Unauthorized Immigrant Parent by State, 2008

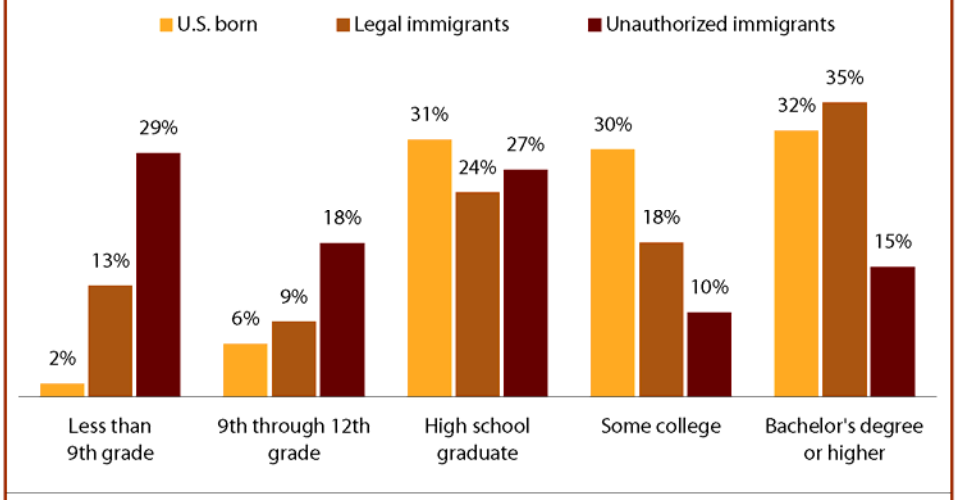


Educational Attainment

The education profile of adults who are unauthorized immigrants differs markedly from that of U.S.-born adults and from that of other immigrants because unauthorized immigrant adults ages 25-64 are disproportionately likely to have very low education levels.

Nearly three-in-ten (29%) have less than a ninth-grade education; an additional 18% have some high school education but have not completed high school. The proportion of unauthorized immigrants with either less than a ninth-grade education or less than a high school education is roughly double the share of legal foreign-born residents with those educational levels. It is far greater than the share of U.S.-born adults—only 2% of those ages 25-64 have less than a ninth-grade education, and only 6% have additional years in high school, but no diploma.

Figure 16
Educational Attainment for Ages 25-64, by Status, 2008
(% of ages 25-64 for each status group)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Unauthorized immigrants are considerably less likely than both other immigrants and U.S.-born residents to have achieved at least a high school diploma. Among adults ages 25-64 who are unauthorized immigrants, 27% have finished high school and gone no further. The corresponding figure for legal immigrants is slightly lower at 24%; the U.S. born are slightly higher at 31%. But there are very large differences among the groups in the share that go beyond high school.

Most U.S.-born adults ages 25-64 (61%) and legal immigrants (54%) have attended college or graduated from college, compared with only one-in-four unauthorized immigrants.

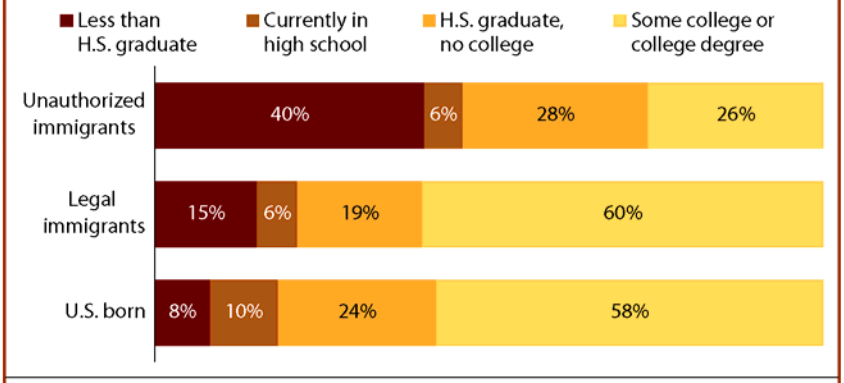
Another way to look at the education distribution is that 22% of U.S. residents ages 25-64 with less than a high school education are unauthorized immigrants—a rate that is five times the proportion of unauthorized immigrants in the adult population. The share of unauthorized immigrants is even higher—35%—among those with less than a ninth-grade education.

Educational Attainment of Younger Adults

Among unauthorized immigrants ages 18-24, a large share has not completed high school (40%)—much more than among legal immigrants (15%) or U.S.-born residents (8%).

However, closer analysis indicates that a younger age of arrival in the United States by an unauthorized immigrant increases the likelihood of higher educational attainment. Of those who arrived at age 14 or older, 46% have not completed high school, compared with 28% of those who arrived before age 14. Among high school graduates ages 18-24 who are unauthorized immigrants, 49% are in college or have attended college. But among those in this age and status group who arrived at ages 14 or older, 42% are in college or have attended college. Among those who arrived before age 14, 61% are in college or have attended college.

Figure 17
Educational Attainment by Nativity and Status for Ages 18-24, 2008
(% of ages 18-24 for each status group)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

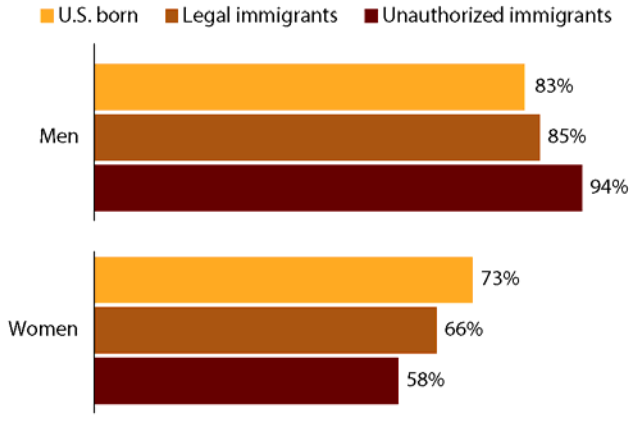
While this "college continuation rate" is higher for unauthorized immigrants who arrive as young children, it is still considerably lower than the rate for legal immigrants (76%) or U.S.-born residents (71%).

Labor Force

About 8.3 million undocumented immigrants were in the labor force in 2008, a 5.4% share. The number and share of unauthorized migrants in the workforce increased steadily through 2007. The estimate for 2008 is not significantly different from 2007, so any assessment of recent trend is inconclusive because of the margin of error in these estimates.

Among undocumented immigrants ages 18-64, men are more likely to be in the labor force than are men who are legal immigrants or who were born in the U.S. Among men of working age, 94% of undocumented immigrants are in the labor force,

Figure 18
Share in Labor Force for Ages 18-64, by Gender and Status, 2008
(%)



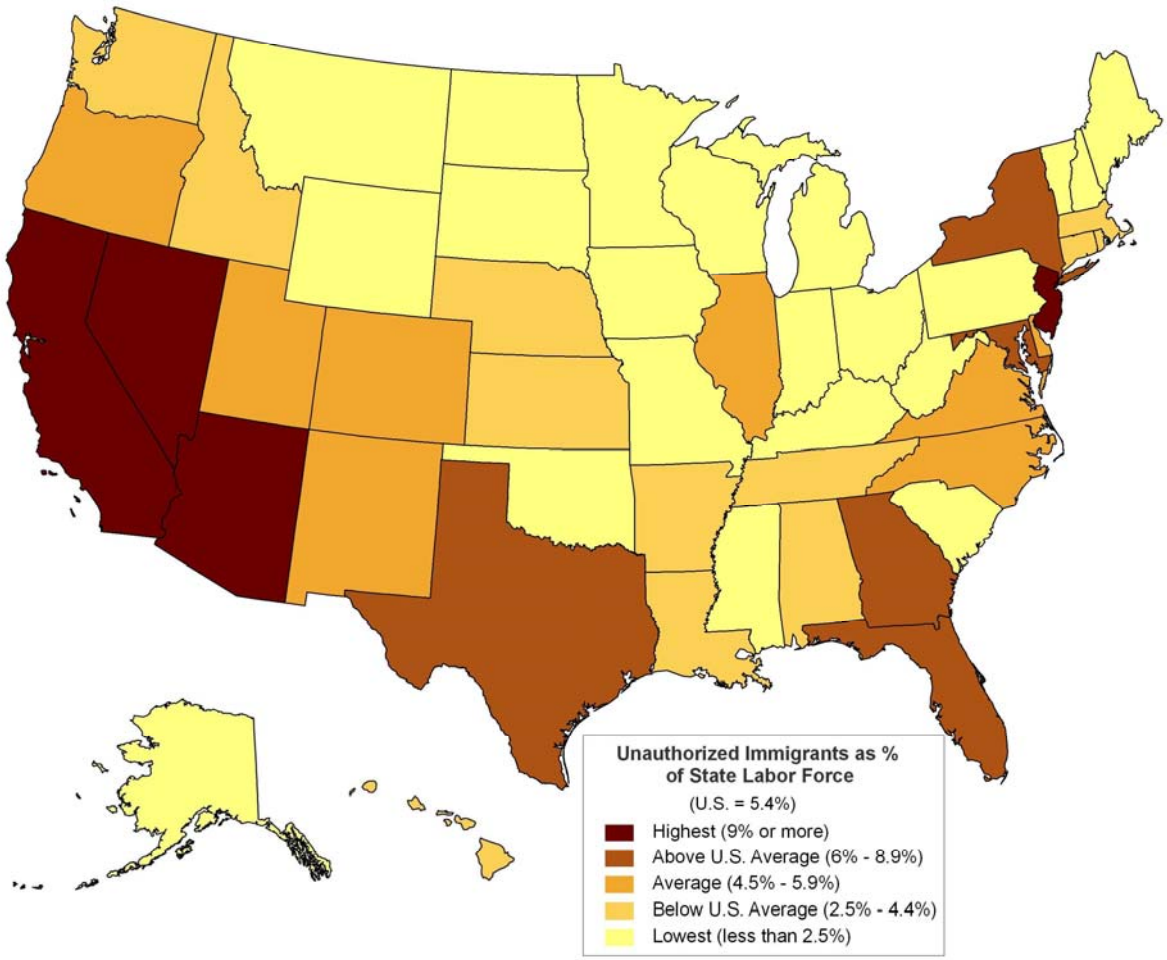
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

compared with 85% of legal immigrant men and 83% of U.S.-born men.

The opposite is true for women. Only 58% of working-age women who are undocumented immigrants are in the labor force, well below the share of women who are U.S. born (73%) or legal immigrants (66%). The major reason for this is that a higher share of women who are unauthorized immigrants say they are not working because they are raising children at home—29%, compared with 16% of other immigrants and 8% of U.S.-born women.

The unauthorized immigrant share of the labor force varies by state. At the high end, approximately one-in-ten workers in Nevada, California and Arizona is an unauthorized immigrant. Most states, however, are below average in the share of unauthorized immigrants in their labor force with 36 states having less than one-in-twenty workers who are unauthorized immigrants. In five states—Maine, Montana, North Dakota, West Virginia and Vermont—they represent less than one-in-a-hundred workers. [See Table B2]

Map 3. Unauthorized Immigrant Workers as Share of Labor Force by State, 2008



Although they are more likely to be in the labor force than other groups, undocumented immigrant men were more likely to be unemployed (6.5%) than either U.S.-born or legal immigrant workers (each 5.6%) in March 2008. This represents a change from the pattern in recent years: In March 2005, for example, unauthorized immigrant men had a lower unemployment rate (4.5%) than did U.S.-born workers (5.9%) or legal immigrant workers (4.9%).

Disproportionately likely to be less educated than other groups, unauthorized immigrants also are more likely to hold low-skilled jobs and less likely to be in white-collar occupations. Consequently, undocumented immigrants are overrepresented in several sectors of the economy, including agriculture, construction, leisure/hospitality and services.

Table 5
Comparing Occupations of U.S.-born and Unauthorized Immigrant Workers, 2008
(% of total workers for each status group)

Major Occupation Group	U.S. born	Unauthorized immigrants
Total for Status Group	100%	100%
Services	16%	**30%**
Construction and extraction	5%	**21%**
Production, installation and repair	9%	**15%**
Transportation and material moving	6%	**8%**
Farming, fishing and forestry	1%	**4%**
Sales & office and administrative support	26%	13%
Professional, management, business and finance	36%	9%

Note: Based on civilian labor force with a reported occupation; **boldface** indicates over-representation of unauthorized immigrants.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Among unauthorized immigrants in the labor force, 30% are service workers and 21% are construction workers. An additional 15% are production and installation workers. Fully two-thirds (66%) of unauthorized immigrant workers have occupations in these three broad categories; by contrast, only 31% of U.S.-born workers have such occupations.

A similar pattern appears in an analysis of the share of undocumented members of the labor force who are in particular industries—21% are in the construction industry and 20% in the services sector of the economy. An additional 17% are in the leisure and hospitality industry. The proportion of unauthorized immigrants in these industry groups (58%) is higher than the proportion of U.S.-born workers (31%) who are.

Table 6
Comparing Industries of U.S.-born and Unauthorized Immigrant Workers, 2008
(% of total workers for each status group)

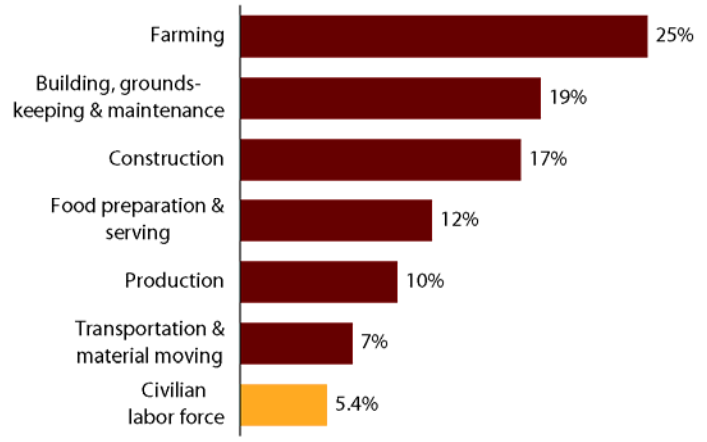
Major Industry Group	U.S. born	Unauthorized immigrants
Total for Status Group	100%	100%
Construction	7%	**21%**
Professional, business & other services	15%	**20%**
Leisure & hospitality	9%	**17%**
Manufacturing	11%	**13%**
Agriculture, forestry, etc. & mining	2%	**4%**
Wholesale & retail trade	15%	11%
Education/health services, financial activities, information & public administration	37%	10%
Transportation & utilities	5%	4%

Note: Based on civilian labor force with a reported industry; **boldface** indicates over-representation of unauthorized immigrants.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Occupation

As a result of the concentration of unauthorized immigrants working in certain occupations, there are some occupations where they also represent a high proportion of workers. For example, 25% of farmworkers are undocumented immigrants, as are 19% of building, groundskeeping and maintenance workers, and 17% of construction workers. Unauthorized immigrants also are overrepresented as a share of food preparation workers and servers (12%), production workers (10%) and transportation and material moving workers (7%). [See Table B5 for estimates by major occupation groups]

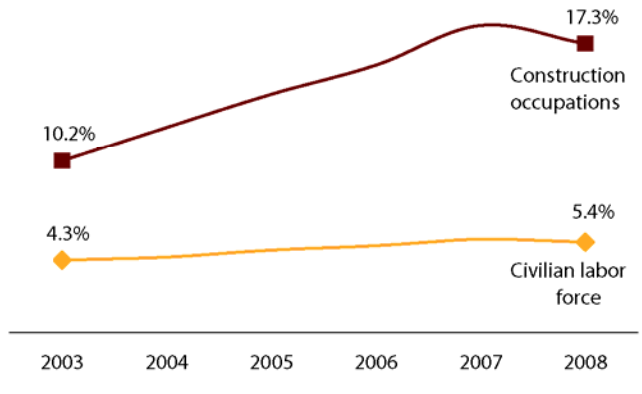
Figure 19
Occupations with High Shares of Unauthorized Immigrants, 2008
(% unauthorized immigrants of workers in occupation)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Construction occupations are a group in which the participation of unauthorized immigrants has grown substantially in recent years. The 17% share of construction occupations held by unauthorized immigrants represents a notable increase since 2003, when 10% of construction workers were unauthorized immigrants.

Figure 20
Share of Unauthorized Immigrants in Construction Occupations, 2003-08
(% unauthorized immigrants of workers in occupation or labor force)



Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

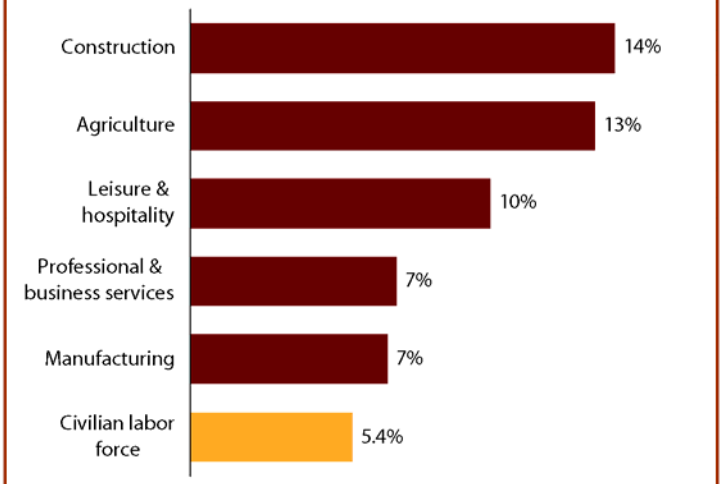
Within these broader occupation categories are specific detailed occupations in which unauthorized immigrants are highly concentrated. They are especially likely to hold certain low-skilled jobs—for example, undocumented immigrants are 40% of brickmasons, and they make up nearly that high a share of drywall installers (37%). They also are 28% of dishwashers, 27% of maids and housekeepers, and 21% of parking lot attendants**.** [See Table B3]

Industry

The concentration of unauthorized immigrants working in certain industries also means that they represent a high share of workers in those industries. They are 14% of construction industry workers, 13% of agriculture industry workers and 10% of the leisure and hospitality sector. Unauthorized immigrant workers also are a higher share of workers in the services and manufacturing sectors than they are in the civilian workforce overall. [See Table B6]

In some subsets of each major industry, unauthorized immigrant workers are an even larger share of the workforce. They represent 28% of workers in the landscaping industry, 23% of those in private household employment and 20% of those in the dry cleaning and laundry industry. [See Table B4]

Figure 21
Industries with High Shares of Unauthorized Immigrants, 2008
(% unauthorized immigrants of workers in industry)

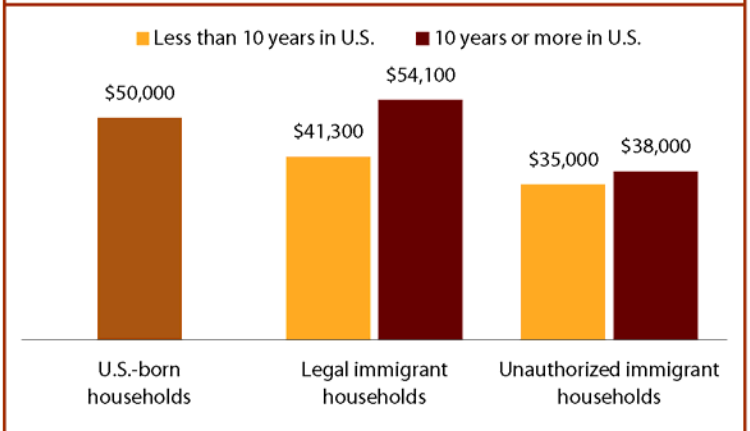


Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Income

Low levels of education and low-skilled occupations lead to undocumented immigrants having lower household incomes than either other immigrants or U.S.-born Americans. In 2007, the median annual household income of unauthorized immigrants was $36,000, compared with $50,000 for people born in the United States. These differences in household income are particularly notable because the unauthorized immigrant households have more workers per household on average (1.75) than U.S.-born households (1.23).

Figure 22
Median Household Income by Status and Time in U.S., 2007
(rounded to nearest 100 dollars)



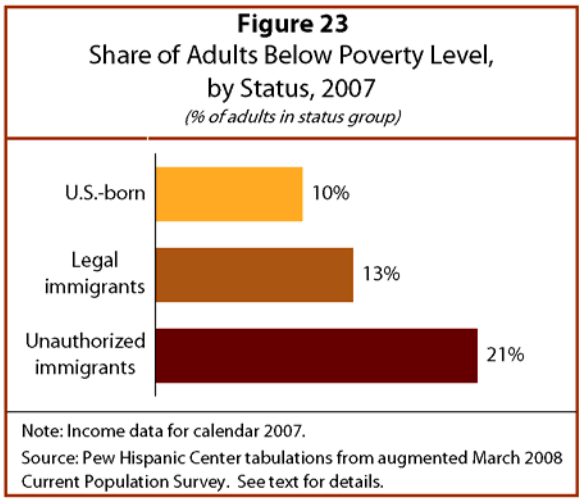
Note: Income data for calendar 2007. Household status determined by status of householder and spouse, if any.

Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Unauthorized immigrants also have lower median household incomes than do other immigrants. They do not make notable gains, as other immigrants do, the longer they have been in the United States. As a group, their median income barely rises even after they have been in the United States for more than a decade; the median income of legal immigrant households, by contrast, rises by nearly a third. [See Table B7]

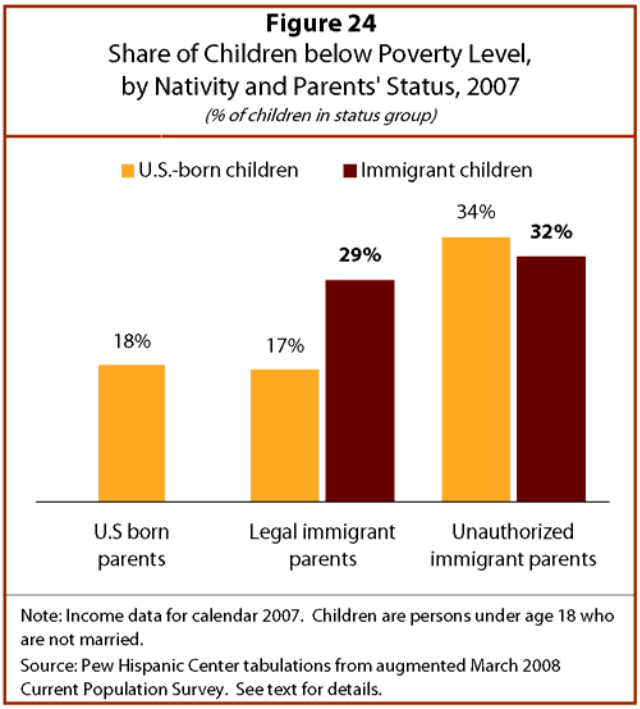
Poverty

Poverty rates are much higher among unauthorized immigrants than for either U.S.-born or legal immigrant residents. Among adults who are unauthorized immigrants, one-in-five (21%) is poor. In contrast, the poverty rate is 13% for legal immigrant adults and 10% for U.S.-born adults.



Among children whose parents are unauthorized immigrants, one-in-three is poor. The rate for children of unauthorized immigrants is similar whether the children are unauthorized immigrants (32%) or U.S. born (34%).

By contrast, there is a marked difference in poverty by nativity among children of legal immigrants. The poverty rate is higher for legal immigrant children born abroad (29%) than for the children of legal immigrants born in the United States (17%). For children of U.S.-born parents, 18% are in poverty, a figure not substantially different from the rate for U.S.-born children of legal immigrants.



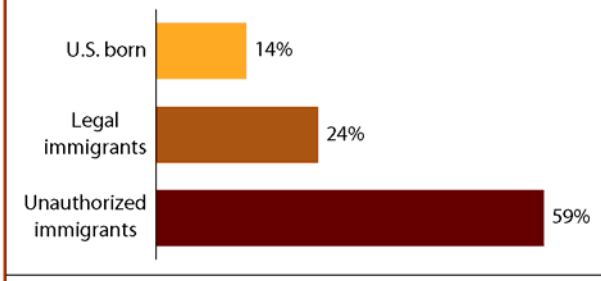
Unauthorized immigrants are notably overrepresented in the poverty population. Undocumented immigrants and their U.S.-born children account for 11% of people with incomes below the poverty level. This is twice their representation in the total population (5.5%).

Health Insurance

Most undocumented adults (59%) had no health insurance during all of 2007, more than double the uninsured share among legal immigrants and four times the uninsured share among U.S.-born adults. The children of unauthorized immigrant adults are less likely than their parents to lack insurance, but their uninsured rate is still substantially higher than that of U.S.-born children**.**

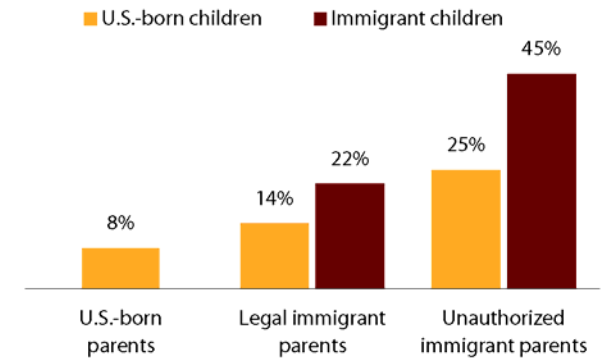
Among unauthorized immigrant children whose parents are undocumented immigrants, nearly half (45%) do not have health insurance. Among U.S.-born children whose parents are unauthorized immigrants, 25% are uninsured. These large differences by nativity for health insurance coverage contrast sharply with the similar poverty rates by nativity for children of unauthorized immigrants. By comparison, both groups are more likely to be uninsured than are children of U.S.-born parents, 8% of whom lack health insurance.

Figure 25
Share of Adults Without Health Insurance, by Status, 2008
(% of adults in status group without health insurance in previous year)



Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

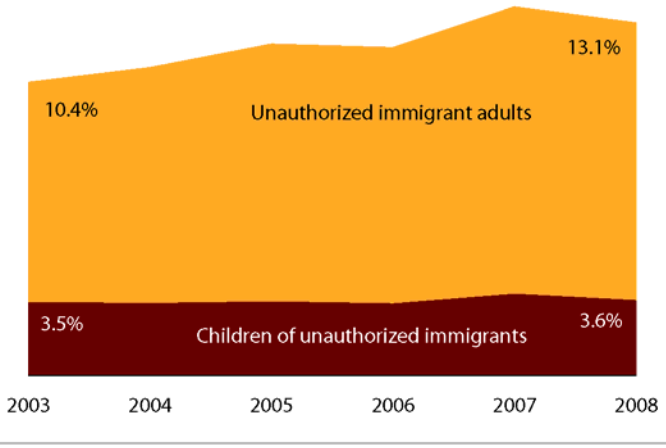
Figure 26
Share of Children Without Health Insurance, by Nativity and Parents' Status, 2008
(% of children in status group without health insurance in previous year)



Note: Children are persons under age 18 who are not married.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Because of these high proportion without health insurance, unauthorized immigrants and their children account for one-in-six Americans without health insurance (17%)—more than three times their representation in the population. This share has increased since 2003, when the undocumented and their children were about one-in-seven of the uninsured (14%).

Figure 27
Share of Population without Health Insurance Represented, by Unauthorized Immigrants and Their Children, 2003-08
(% of population without health insurance in previous year)



Note: Children are persons under age 18 who are not married.
Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

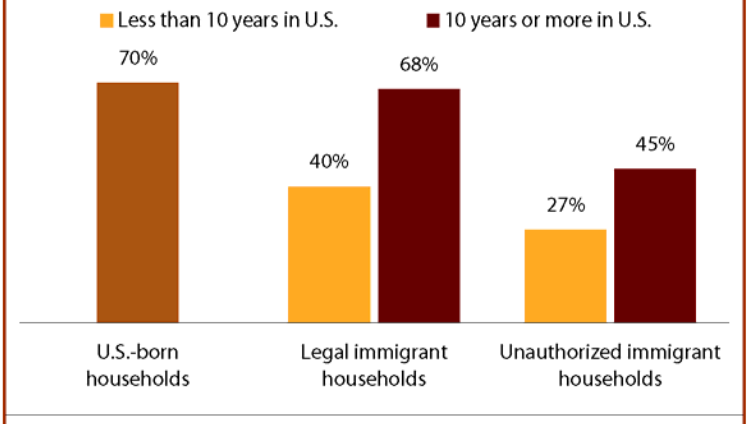
Homeownership and Mobility

Unauthorized immigrants are far less likely than other U.S. residents to own their own homes. Only 35% of unauthorized immigrant households are homeowners, half the rate of U.S.-born households. This difference is explained in part by legal status and in part by the greater affluence and older age structure of U.S.-born residents, who are better able to afford homes.

But even among undocumented immigrants who have lived in the United States for a decade or more, only 45% own their own homes. Longtime legal immigrants, on the other hand, are about as likely as U.S.-born households to be homeowners.

Undocumented immigrants are more likely to move, especially locally, than other immigrants or the U.S. born—18% of undocumented people changed residence in 2007-08, compared with 10% for other foreign-born Americans and 11% of U.S.-born residents. This difference is

Figure 28
Homeownership Rate, by Status of Household and Time in U.S., 2008
(% of households in status group owning home)

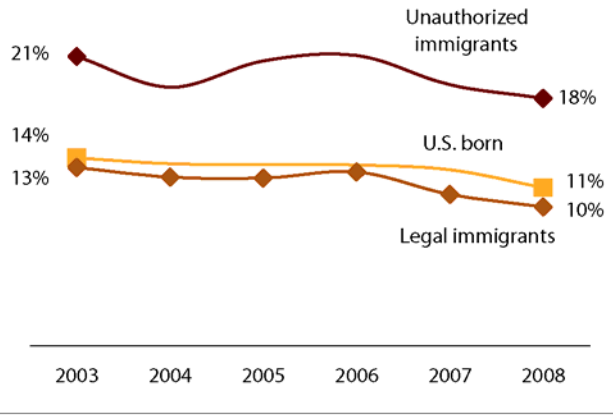


Note: Household status determined by status of householder and spouse, if any.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

mainly a function of a much greater tendency among unauthorized immigrants to move locally (within states). These short-distance moves occur with much greater frequency among renters than homeowners.

The mobility rate has been declining for all U.S. residents, including unauthorized immigrants. In 2002-03, 21% of unauthorized immigrants changed residence.

Figure 29
Share of Population Changing U.S. Residence, by Status, 2003-08
(% of status group changing residences within the U.S. in previous 12 months)

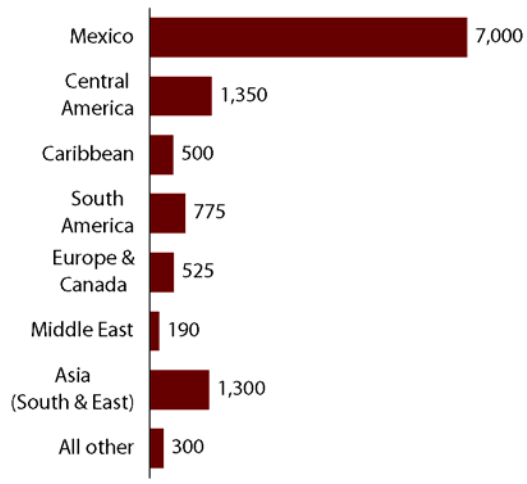


Source: Pew Hispanic Center tabulations from augmented March Current Population Surveys. See text for details.

Origins of Unauthorized Immigrants: A Focus on Mexico

Mexico is the source of by far the largest number of unauthorized immigrants, accounting for 7 million of the 11.9 million unauthorized immigrants in 2008. This 59% share has remained roughly constant over the past three decades. Other parts of Latin America send a significant share of the total, with 1.3 million (11%) coming from Central America, 775,000 (7%) from South America, and 500,000 (4%) from the Caribbean. South and East Asia is another large source, sending 1.3 million (11%), whereas the Middle East accounts for 190,000, or less than 2%.

Figure 30
Region of Birth for Unauthorized Immigrant Population, 2008
(thousands)



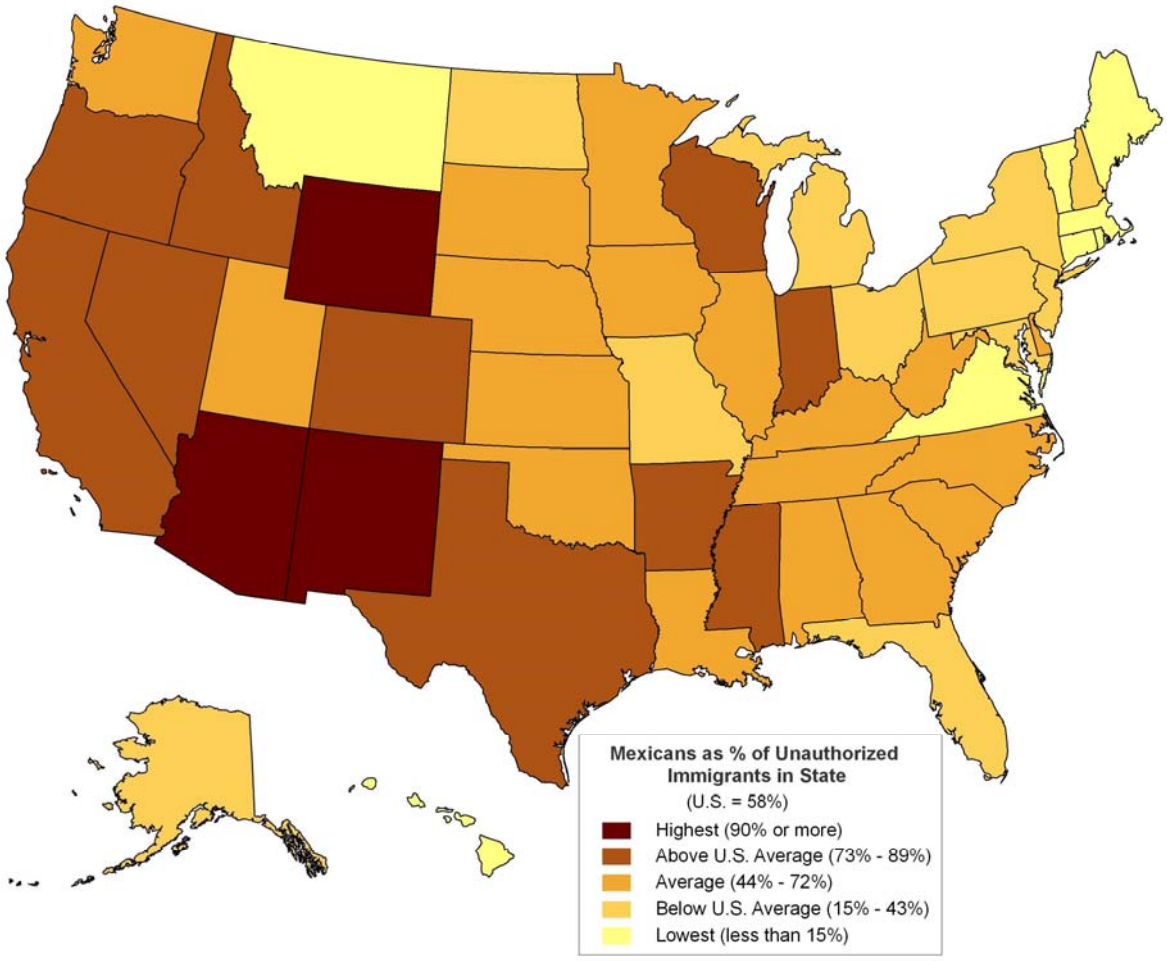
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Unauthorized Mexican immigrants are somewhat more concentrated than all unauthorized immigrants, accounting for high proportions of the unauthorized immigrant population in a few states. Thirteen states—a mix of traditional border destinations and new settlement areas, mainly in the West and Southwest—have high shares of Mexicans in the unauthorized immigrant population (73% or more). In three states (Arizona, New Mexico and Wyoming), Mexicans represent more than nine-in-ten unauthorized immigrants.

The proportion of Mexicans in the unauthorized immigrant population shrinks in the northeastern quadrant of the country. Mexicans are substantially underrepresented (less than 43% of undocumented immigrants) in 20 states and the District of Columbia. The remaining 18 states with average representation of unauthorized immigrants tend to be the new-destination states in the Southeast and Plains.

Mexicans are more likely than are other unauthorized immigrants to have children. Looking at the share of U.S.-born children of unauthorized immigrants, 74% have Mexican parents, which is greater than the 59% Mexican share of the unauthorized immigrant population. In addition, their children are more likely to be born in the United States: 77% are, compared with 62% of children of other undocumented immigrants. [See Figure C2]

Map 4. Share of Mexicans among Unauthorized Immigrants by State, 2008



Mexican-born undocumented immigrants also are less educated and have lower incomes than other unauthorized immigrants. Among adults ages 25-64, only 4% hold a college degree, compared with 30% of all other unauthorized immigrants. In addition, 64% have not completed high school, compared with 25% of other unauthorized immigrants.

The median household income for Mexican unauthorized immigrants was $32,000 in 2007, compared with $45,000 for all other unauthorized immigrants. This is explained in part by the jobs they hold, but also by the fact that only 50% of unauthorized immigrant women who were born in Mexico and are ages 18-64 are in the labor force, compared with 69% of all other women who are unauthorized immigrants. There is little difference in the labor force participation of working-age men from Mexico who are unauthorized immigrants (95%) compared with those from other countries (91%).

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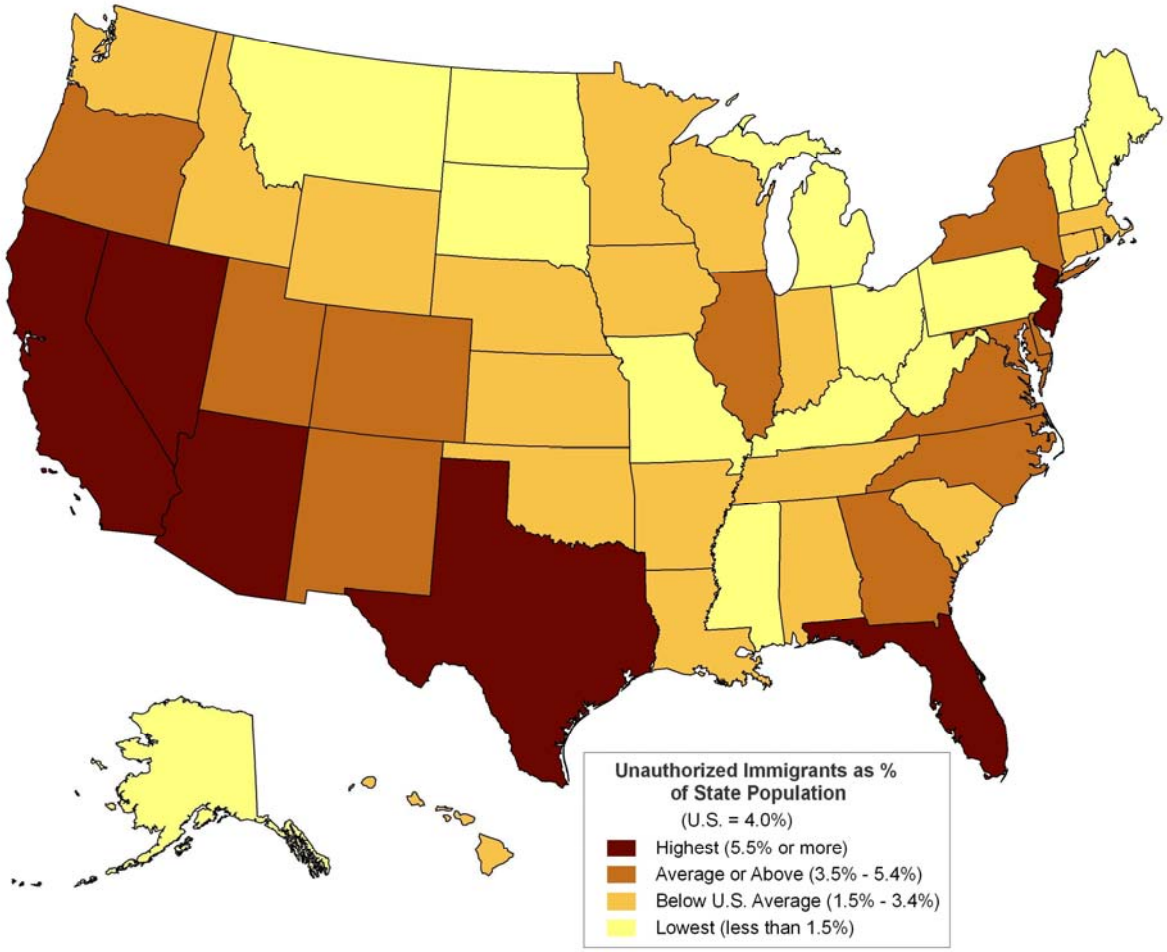
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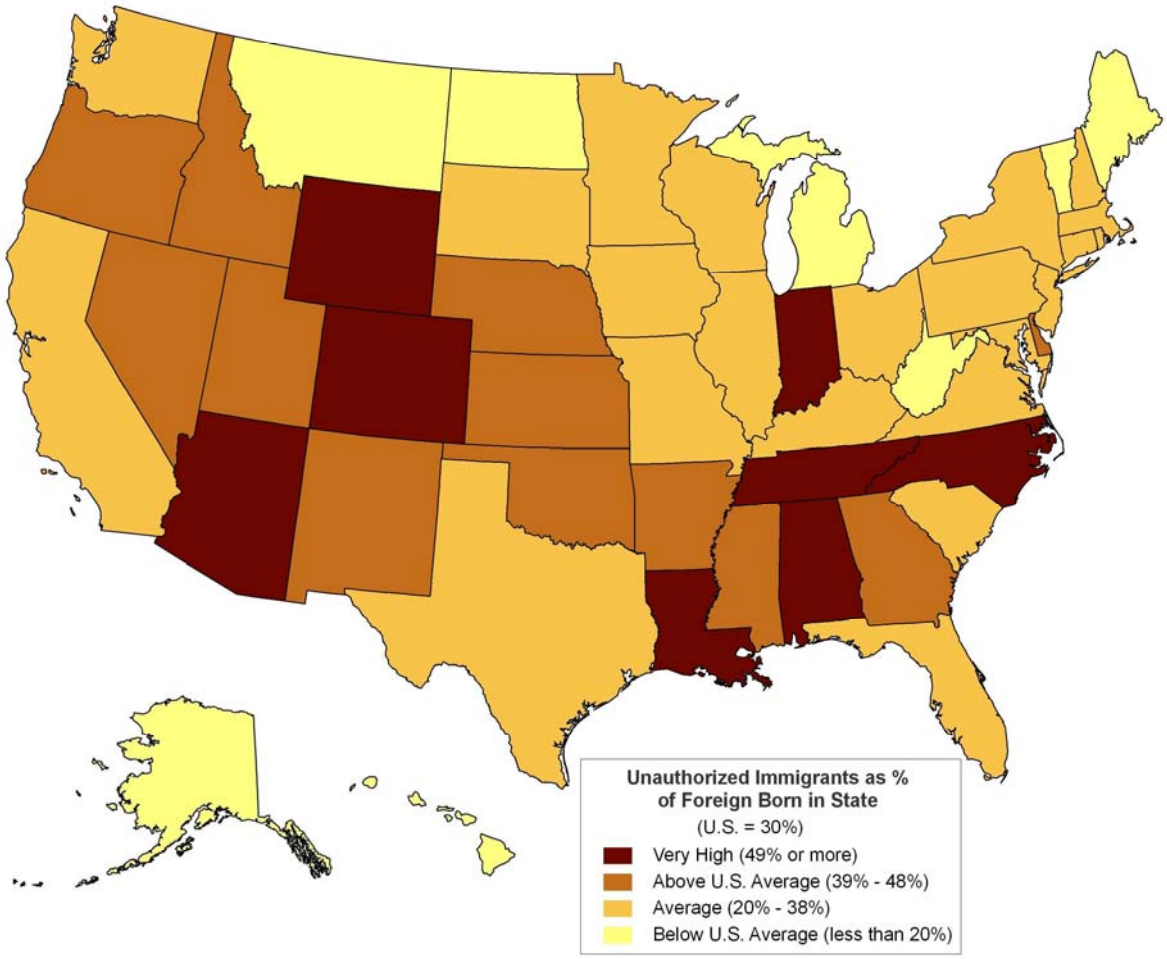
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Appendix A: Additional Maps

Map A1. Unauthorized Immigrant Share of Population by State, 2008



Map A2. Unauthorized Immigrants as Share of Foreign Born by State, 2008



Appendix B: Additional Tables

Table B1
Estimated Unauthorized Immigrant Population by State, 2008, 2005, 2000 and 1990
(population in thousands)

State	Unauthorized Immigrants in 2008		Earlier Years		
	Estimate	Range of Estimate	2005	2000	1990
Total	11,900	11,400 - 12,400	11,100	8,375	3,525
Alabama	100	85 - 120	40	25	5
Alaska	<10	<10	<10	<10	<5
Arizona	500	475 - 550	450	300	90
Arkansas	60	45 - 70	45	30	5
California	2,700	2,500 - 2,850	2,650	2,300	1,500
Colorado	240	220 - 250	240	160	30
Connecticut	110	100 - 120	90	75	20
Delaware	30	25 - 35	25	15	5
District of Columbia	30	25 - 30	25	25	15
Florida	1,050	950 - 1,150	925	575	240
Georgia	475	425 - 500	425	250	35
Hawaii	35	25 - 45	35	25	5
Idaho	35	25 - 40	40	25	10
Illinois	450	375 - 525	425	475	200
Indiana	120	110 - 130	85	65	10
Iowa	55	45 - 65	55	25	5
Kansas	70	60 - 75	60	55	15
Kentucky	45	35 - 60	50	20	5
Louisiana	65	50 - 80	35	20	15
Maine	<10	<10	<10	<10	<5
Maryland	250	230 - 300	240	120	35
Massachusetts	190	160 - 220	220	150	55
Michigan	110	85 - 140	120	95	25
Minnesota	110	100 - 130	100	55	15
Mississippi	35	30 - 45	40	10	5
Missouri	45	35 - 60	45	30	10
Montana	<10	<10	<10	<10	<5
Nebraska	45	40 - 55	45	30	5
Nevada	230	210 - 240	190	140	25
New Hampshire	20	15 - 25	15	<10	<5
New Jersey	550	500 - 600	400	325	95
New Mexico	80	75 - 85	70	55	20
New York	925	800 - 1,050	625	725	350
North Carolina	350	300 - 400	375	210	25
North Dakota	<10	<10	<10	<10	<5
Ohio	95	80 - 120	100	55	10
Oklahoma	55	45 - 60	60	50	15
Oregon	150	130 - 160	140	110	25
Pennsylvania	140	110 - 160	150	85	25
Rhode Island	30	20 - 35	35	20	10
South Carolina	70	60 - 85	55	45	5
South Dakota	<10	<10	<10	<10	<5
Tennessee	150	130 - 170	140	50	10
Texas	1,450	1,300 - 1,550	1,450	1,100	450
Utah	110	100 - 120	95	65	15
Vermont	<10	<10	<10	<10	<5
Virginia	300	275 - 325	275	150	50
Washington	180	140 - 210	210	160	40
West Virginia	<10	<10	<10	<10	<5
Wisconsin	85	70 - 100	95	50	10
Wyoming	<10	<10	<10	<10	<5

Note: Unauthorized population estimates (rounded) based on average of 2006-2008 estimates. Range is based on trend line for 2000-2008 estimates.

Sources: Pew Hispanic Center estimates for 2008 based on augmented March Current Population Surveys for 2006-08; see Passel and Cohn (2008) and text. Estimates for 1990 from Warren (2003) of the former Immigration and Naturalization Service. Estimates for 2000 based on Pew Hispanic Center tabulations from Census 2000 5-Percent Public-Use Microdata Sample (PUMS); see Passel et al. 2004. Estimates for 2005 derived from Pew Hispanic Center Factsheet, "Estimates of the Unauthorized Migrant Population for States based on the March 2005 CPS" of April 26, 2006 (http://pewhispanic.org/factsheets/factsheet.php?FactsheetID=17).

Table B2
Number and Share of Unauthorized Immigrants for Labor Force and Total Population, by State, 2008
(population in thousands)

State	Labor Force			Population		
	Total	Unauthorized Immigrants		Total	Unauthorized Immigrants	
		Estimate	Share		Estimate	Share
Total	154,772	8,300	5.4%	301,197	11,901	4.0%
Alabama	2,169	80	3.6%	4,587	100	2.3%
Alaska	361	<10	<1.5%	674	<10	<1.0%
Arizona	3,103	300	9.8%	6,455	500	7.9%
Arkansas	1,413	40	2.8%	2,836	60	2.1%
California	18,824	1,850	9.9%	36,817	2,700	7.3%
Colorado	2,770	150	5.4%	4,913	240	4.8%
Connecticut	1,893	80	4.2%	3,502	110	3.1%
Delaware	457	20	4.7%	869	30	3.6%
District of Columbia	329	25	7.1%	582	30	5.0%
Florida	9,231	750	8.2%	18,341	1,050	5.7%
Georgia	5,009	325	6.3%	9,554	475	4.9%
Hawaii	666	25	4.0%	1,265	35	2.8%
Idaho	744	25	3.1%	1,501	35	2.3%
Illinois	6,805	325	4.7%	12,755	450	3.6%
Indiana	3,217	75	2.4%	6,281	120	1.9%
Iowa	1,684	35	2.1%	2,963	55	1.9%
Kansas	1,480	40	2.8%	2,730	70	2.5%
Kentucky	1,991	25	1.3%	4,216	45	1.1%
Louisiana	1,939	60	3.1%	4,201	65	1.6%
Maine	710	<10	<0.5%	1,314	<10	<0.5%
Maryland	2,977	200	6.7%	5,611	250	4.7%
Massachusetts	3,335	140	4.3%	6,367	190	3.0%
Michigan	5,004	65	1.3%	9,917	110	1.1%
Minnesota	2,953	70	2.3%	5,208	110	2.2%
Mississippi	1,417	25	1.8%	2,914	35	1.3%
Missouri	2,993	25	0.8%	5,775	45	0.8%
Montana	507	<10	<0.5%	939	<10	<0.5%
Nebraska	1,006	30	2.8%	1,766	45	2.7%
Nevada	1,370	170	12.2%	2,581	230	8.8%
New Hampshire	766	15	1.7%	1,318	20	1.3%
New Jersey	4,588	425	9.2%	8,691	550	6.4%
New Mexico	929	40	4.5%	1,956	80	4.0%
New York	9,673	650	6.7%	19,352	925	4.8%
North Carolina	4,682	250	5.3%	9,284	350	3.8%
North Dakota	365	<10	<1.0%	615	<10	<0.5%
Ohio	5,900	65	1.1%	11,295	95	0.9%
Oklahoma	1,714	40	2.2%	3,560	55	1.5%
Oregon	1,933	100	5.4%	3,757	150	3.9%
Pennsylvania	6,336	100	1.5%	12,329	140	1.1%
Rhode Island	561	20	3.6%	1,048	30	2.8%
South Carolina	2,210	50	2.2%	4,390	70	1.6%
South Dakota	455	<10	<1.5%	789	<10	<1.0%
Tennessee	3,055	110	3.6%	6,175	150	2.4%
Texas	11,748	925	7.9%	23,867	1,450	6.0%
Utah	1,379	80	5.8%	2,680	110	4.1%
Vermont	343	<10	<0.5%	613	<10	<1.0%
Virginia	4,117	210	5.1%	7,720	300	4.0%
Washington	3,464	120	3.5%	6,540	180	2.7%
West Virginia	822	<10	<0.5%	1,796	<10	<0.5%
Wisconsin	3,081	55	1.8%	5,468	85	1.6%
Wyoming	292	<10	<2.0%	521	<10	1.5%

Note: Unauthorized population estimates (rounded) based on average of 2006-08 estimates. Total population and labor force for 2008 are the sum of the estimated unauthorized figure based on 2006-08 average plus the native-born and legal foreign-born figures from the augmented March 2008 CPS. Percentages computed from unrounded figures.

Source: Pew Hispanic Center tabulations based on augmented March Current Population Surveys for 2006-08. See Passel and Cohn (2008) and text.

Table B3
Detailed Occupations with High Shares of Unauthorized Immigrants, 2008
(thousands)

Detailed Occupation	Total Workers	Unauthorized Immigrants		U.S.-born Share	Legal Immigrant Share
		Workers	Share		
Total, Civilian Labor Force (with an occupation)	154,135	8,258	5%	84%	11%
Brickmasons, blockmasons and stonemasons (6220)	325	131	40%	45%	15%
Drywall installers, ceiling tile installers and tapers (6330)	255	94	37%	43%	20%
Roofers (6510)	246	76	31%	52%	17%
Miscellaneous agricultural workers (6050)	910	269	30%	50%	20%
Helpers, construction trades (6600)	184	52	28%	64%	8%
Dishwashers (4140)	364	101	28%	62%	10%
Construction laborers (6260)	2,055	556	27%	54%	19%
Maids and housekeeping cleaners (4230)	1,555	417	27%	49%	24%
Cement masons, concrete finishers and terrazzo workers (6250)	109	29	27%	53%	20%
Packaging and filling machine operators and tenders (8800)	369	96	26%	55%	19%
Grounds maintenance workers (4250)	1,413	356	25%	60%	15%
Packers and packagers, hand (9640)	504	119	24%	59%	18%
Butchers and other meat, poultry and fish processing workers (7810)	305	71	23%	57%	20%
Carpet, floor, and tile installers and finishers (6240)	306	68	22%	63%	14%
Painters, construction and maintenance (6420)	791	173	22%	60%	18%
Parking lot attendants (9350)	100	21	21%	60%	18%
Chefs and head cooks (4000)	377	75	20%	63%	17%
Sewing machine operators (8320)	248	49	20%	55%	26%
Refuse and recyclable material collectors (9720)	112	22	19%	71%	10%
Cooks (4020)	2,219	427	19%	69%	12%
Other "unauthorized" occupations**	34,979	3,130	9%	78%	13%
All other occupations	106,407	1,928	2%	89%	9%

Note: Occupations included in this table have at least 100,000 workers nationally and more than three times the national share of unauthorized immigrant workers. Four-digit occupation codes in parentheses.
** "Unauthorized" occupations have a higher percentage of workers who are unauthorized immigrants than the national average but do not qualify for a separate listing.

Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Table B4

Detailed Industries with High Shares of Unauthorized Immigrants, 2008

(thousands)

Detailed Industry	Total Workers	Unauthorized Immigrants		U.S.born Share	Legal Immigrant Share
		Workers	Share		
Total, Civilian Labor Force (with an industry)	154,135	8,258	5.4%	83.8%	10.3%
Landscaping services (7770)	1,412	392	28%	58%	14%
Private households (9290)	808	185	23%	53%	24%
Cut and sew apparel manufacturing (1680)	313	71	23%	46%	31%
Crop production (0170)	1,036	204	20%	62%	18%
Drycleaning and laundry services (9070)	416	81	20%	56%	24%
Animal slaughtering and processing (1180)	485	91	19%	62%	19%
Not specified manufacturing industries (3990)	219	41	19%	69%	12%
Services to buildings and dwellings (7690)	1,539	286	19%	65%	17%
Bakeries, except retail (1270)	218	38	17%	66%	17%
Support activities for agriculture and forestry (0290)	176	30	17%	70%	13%
Car washes (8780)	205	34	17%	69%	14%
Construction (0770)	12,408	1,749	14%	74%	12%
Taxi and limousine service (6190)	277	38	14%	46%	41%
Fruit and vegetable preserving and specialty food manufacturing (1090)	164	22	13%	77%	10%
Traveler accommodation (8660)	1,547	193	12%	68%	19%
Restaurants and other food services (8680)	8,992	1,088	12%	78%	10%
Sugar and confectionery products (1080)	101	12	12%	66%	23%
Specialty food stores (4980)	266	30	11%	79%	10%
Recyclable material, merchant wholesalers (4280)	148	16	11%	80%	9%
Other "unauthorized" industries **	18,124	1,372	8%	80%	12%
All other industries	105,281	2,285	2%	88%	10%

Note: Industries included in this table have at least 100,000 workers nationally and more than double the national share of unauthorized immigrant workers. Four-digit industry codes in parentheses.

** "Unauthorized" industries have a higher percentage of workers who are unauthorized immigrants than the national average but do not qualify for a separate listing.

Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

Table B5
Major Occupation Groups, by Nativity and Status, 2008
(thousands)

Major Occupation Group	Total	U.S. born	Legal Immigrants	Unauthorized immigrants
		Civilian Labor Force		
Total, Civilian Labor Force (with an occupation)	154,135	129,116	16,761	8,258
Management, business and finance	22,129	19,672	2,115	341
Professional and related	31,478	27,325	3,710	443
Services	26,108	20,434	3,200	2,474
Sales and related	17,325	15,145	1,592	588
Office and administrative support	20,604	18,524	1,632	448
Farming, fishing and forestry	1,196	682	214	300
Construction and extraction	10,200	7,086	1,351	1,763
Installation, maintenance and repair	5,299	4,576	469	255
Production	9,999	7,663	1,368	969
Transportation and material moving	9,797	8,010	1,111	677
		Percentage of Occupation		
Total, Civilian Labor Force (with an occupation)	100%	83.8%	10.9%	5.4%
Management, business and finance	100%	**88.9%**	9.6%	1.5%
Professional and related	100%	**86.8%**	**11.8%**	1.4%
Services	100%	78.3%	**12.3%**	**9.5%**
Sales and related	100%	**87.4%**	9.2%	3.4%
Office and administrative support	100%	**89.9%**	7.9%	2.2%
Farming, fishing and forestry	100%	57.0%	**17.9%**	**25.1%**
Construction and extraction	100%	69.5%	**13.2%**	**17.3%**
Installation, maintenance and repair	100%	**86.3%**	8.8%	4.8%
Production	100%	76.6%	**13.7%**	**9.7%**
Transportation and material moving	100%	81.8%	**11.3%**	**6.9%**
		Percentage of Status Group		
Total, Civilian Labor Force (with an occupation)	100%	100%	100%	100%
Management, business and finance	14.4%	**15.2%**	12.6%	4.1%
Professional and related	20.4%	**21.2%**	**22.1%**	5.4%
Services	16.9%	15.8%	**19.1%**	**30.0%**
Sales and related	11.2%	**11.7%**	9.5%	7.1%
Office and administrative support	13.4%	**14.3%**	9.7%	5.4%
Farming, fishing and forestry	0.8%	0.5%	**1.3%**	**3.6%**
Construction and extraction	6.6%	5.5%	**8.1%**	**21.3%**
Installation, maintenance and repair	3.4%	**3.5%**	2.8%	3.1%
Production	6.5%	5.9%	**8.2%**	**11.7%**
Transportation and material moving	6.4%	6.2%	**6.6%**	**8.2%**

Note: Figures in **boldface** exceed overall percentage representation.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Surveys. See text for details.

Table B6
Major Industry Groups, by Nativity and Status, 2008
(thousands)

Major Industry Group	Total	U.S. born	Legal Immigrants	Unauthorized immigrants
		Civilian Labor Force		
Total, Civilian Labor Force (with an industry)	154,135	129,116	16,761	8,258
Agriculture, forestry, fishing & hunting	2,339	1,770	255	314
Mining	755	695	41	18
Construction	12,408	9,161	1,497	1,749
Manufacturing	16,911	13,707	2,100	1,104
Wholesale & retail trade	21,894	18,846	2,102	946
Transportation & utilities	8,289	7,072	928	289
Information	3,678	3,235	370	73
Financial activities	10,523	9,243	1,053	226
Professional & business services	16,889	13,886	1,904	1,099
Education & health services	32,371	28,323	3,541	507
Leisure & hospitality	13,882	11,017	1,483	1,381
Other services	7,257	5,713	993	551
Public administration	6,942	6,447	494	(x)
		Share of Industry		
Total, Civilian Labor Force (with an industry)	100%	83.8%	10.9%	5.4%
Agriculture, forestry, fishing & hunting	100%	75.7%	**10.9%**	**13.4%**
Mining	100%	**92.1%**	5.5%	2.4%
Construction	100%	73.8%	**12.1%**	**14.1%**
Manufacturing	100%	81.1%	**12.4%**	**6.5%**
Wholesale & retail trade	100%	**86.1%**	9.6%	4.3%
Transportation & utilities	100%	**85.3%**	**11.2%**	3.5%
Information	100%	**88.0%**	10.1%	2.0%
Financial activities	100%	**87.8%**	10.0%	2.1%
Professional & business services	100%	82.2%	**11.3%**	**6.5%**
Education & health services	100%	**87.5%**	**10.9%**	1.6%
Leisure & hospitality	100%	79.4%	10.7%	**10.0%**
Other services	100%	78.7%	**13.7%**	**7.6%**
Public administration	100%	**92.9%**	7.1%	(x)
		Share of Status Group		
Total, Civilian Labor Force (with an industry)	100%	100%	100%	100%
Agriculture, forestry, fishing & hunting	1.5%	1.4%	**1.5%**	**3.8%**
Mining	0.5%	**0.5%**	0.2%	0.2%
Construction	8.0%	7.1%	**8.9%**	**21.2%**
Manufacturing	11.0%	10.6%	**12.5%**	**13.4%**
Wholesale & retail trade	14.2%	**14.6%**	12.5%	11.5%
Transportation & utilities	5.4%	**5.5%**	**5.5%**	3.5%
Information	2.4%	**2.5%**	2.2%	0.9%
Financial activities	6.8%	**7.2%**	6.3%	2.7%
Professional & business services	11.0%	10.8%	**11.4%**	**13.3%**
Education & health services	21.0%	**21.9%**	**21.1%**	6.1%
Leisure & hospitality	9.0%	8.5%	8.8%	**16.7%**
Other services	4.7%	4.4%	**5.9%**	**6.7%**
Public administration	4.5%	**5.0%**	2.9%	(x)

Note: Figures in **boldface** exceed overall percentage representation. (x) -- Not applicable.
Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Surveys. See text for details.

Table B7
Household Income Statistics, by Nativity and Status, 2008

Type of Household and Period of Entry	Median House-hold Income	Mean House-hold Size	Median Income per Person	Mean Workers per Household	Median Income per Worker	Number of Households (thousands)
Value of Measure						
All Households	50,000	2.51	22,200	1.28	34,600	117,669
U.S.-born Households	50,000	2.39	23,300	1.23	35,300	98,456
Immigrant Households	47,100	3.11	16,700	1.51	30,000	19,213
More than 10 years in the U.S.	50,100	3.10	17,800	1.48	31,800	14,602
10 years or less in the U.S.	38,000	3.13	13,500	1.60	23,700	4,611
Unauthorized Immigrant Households	36,000	3.51	11,900	1.75	22,500	4,680
More than 10 years in the U.S.	38,000	3.69	11,600	1.74	24,000	2,491
10 years or less in the U.S.	35,000	3.30	12,300	1.77	21,000	2,189
Legal Immigrant Households	52,000	2.98	18,800	1.43	33,600	14,533
More than 10 years in the U.S.	54,100	2.98	19,500	1.42	35,000	12,111
10 years or less in the U.S.	41,300	2.98	15,000	1.45	27,200	2,422
Ratio to U.S.-born Households (=100)						**Share**
All Households	100	105	95	104	98	100%
U.S.-born Households	100	100	100	100	100	84%
Immigrant Households	94	130	71	122	85	16%
More than 10 years in the U.S.	100	130	76	120	90	12%
10 years or less in the U.S.	76	131	58	130	67	4%
Unauthorized Immigrant Households	72	146	51	143	64	**4%**
More than 10 years in the U.S.	76	154	50	142	68	**2%**
10 years or less in the U.S.	70	138	53	144	59	**2%**
Legal Immigrant Households	104	125	81	116	95	12%
More than 10 years in the U.S.	108	125	84	116	99	10%
10 years or less in the U.S.	83	124	64	118	77	2%

Note: Income figures are 2007 household income. Status of household is determined by the status of the head and spouse (if any). Medians rounded to nearest $100; ratios computed from unrounded figures.

Source: Pew Hispanic Center tabulations from augmented March 2008 Current Population Survey. See text for details.

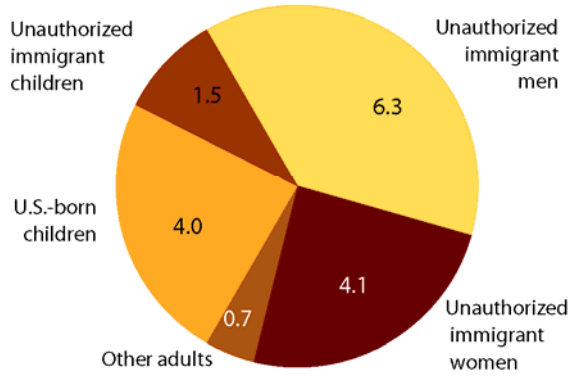
Table B8
Estimated Unauthorized Immigrant Population for State Groups, 2008, 2005, 2000 and 1990
(population in thousands)

	2008	2005	2000	1990
Total	**11,900**	**11,100**	**8,375**	**3,525**
California	**2,700**	**2,650**	**2,300**	**1,500**
Other Traditional Destinations	**4,400**	**3,850**	**3,200**	**1,350**
Recent Growth Areas	**3,850**	**3,500**	**2,150**	**500**
Southeastern States	1,350	1,200	650	110
Capital Area	600	550	300	100
Midwest/Appalachia	700	700	425	100
Mountain States	1,200	1,100	750	190
Smaller Populations	**1,000**	**1,050**	**750**	**210**
New England	350	350	275	90
Plains	275	275	190	50
Western States	350	400	300	70
Share of U.S. Total				
Total	**100%**	**100%**	**100%**	**100%**
California	**22%**	**24%**	**28%**	**42%**
Other Traditional Destinations	**37%**	**35%**	**38%**	**38%**
Recent Growth Areas	**32%**	**32%**	**25%**	**14%**
Southeastern States	11%	11%	8%	3%
Capital Area	5%	5%	3%	3%
Midwest/Appalachia	6%	6%	5%	3%
Mountain States	10%	10%	9%	5%
Smaller Populations	**8%**	**9%**	**9%**	**6%**
New England	3%	3%	3%	3%
Plains	2%	2%	2%	1%
Western States	3%	4%	4%	2%

Note: Traditional destinations: FL, IL, NJ. NY, TX;
Southeastern States: NC, SC, GA, KY, TN, AL, MS, AR, LA;
Capital Area: MD, DC, VA;
Midwest/Appalachia: OH, IN, MI, WI, MN, PA, DE, WV;
Mountain States: MT, ID, WY, CO, NM, AZ, UT, NV;
New England: ME, NH, VT, MA, RI, CT;
Plains: IA, MO. ND, SD, NE, KS, OK;
Western States: WA, OR, AK, HI.
All numbers rounded independently; percentages computed from unrounded figures.
See text for definitions, details, and rounding rules. See Table 1 for sources

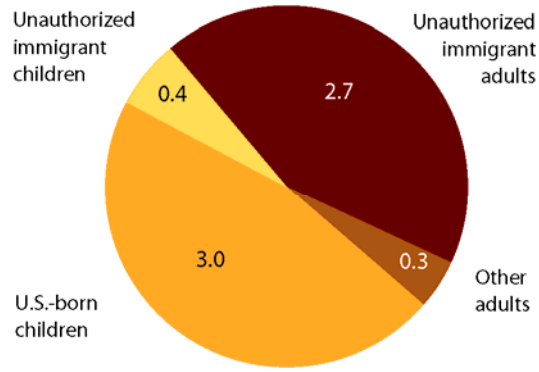
Appendix C: Additional Figures

Figure C1
Unauthorized Immigrants, Spouses and Children, 2008
(millions)



Note: Children are persons under age 18 who are not married. Includes non-partnered adults without children.
Source: Pew Hispanic Center estimates and tabulations from augmented March 2008 Current Population Survey. See text for details.

Figure C2
People in Mixed-Status Unauthorized Mexican Immigrant Families, by Age Group and Status, 2008
(millions)



Note: A mixed-status family has at least one unauthorized immigrant parent and one U.S.-born child. Children are persons under age 18 who are not married. In these families, either the head or spouse is an unauthorized immigrant born in Mexico.
Source: Pew Hispanic Center estimates and tabulations from augmented March 2008 Current Population Survey. See text for details.

Appendix D: Methodology

Unauthorized Immigrants—Overview

The data presented in this report on unauthorized and legal immigrants were developed through a multistage estimation process, principally using March Supplements to the Current Population Survey (CPS). The CPS is a monthly survey of about 55,000 households conducted jointly by the Bureau of Labor Statistics and the Census Bureau; the sample is expanded to about 80,000 households for the March supplement..

The first stage in the estimation process uses CPS data as a basis for estimating the number of legal and unauthorized immigrants included in the survey and the total number in the country using a residual estimation methodology, described in detail in previous reports and papers (especially Passel and Cohn 2008; Passel 2007).

Then, the March CPS Supplements are augmented to assign a specific legal status (one option is unauthorized immigrant) to each foreign-born survey respondent and to adjust the survey weights to account for immigrants missing from the survey. These augmented files serve as a basis for the detailed tabulations of the family, social, economic and geographic characteristics presented here. The data and methods for the overall process were developed initially at the Urban Institute by Passel and Clark (especially 1998) and were extended by work of Passel, Bean and Van Hook (2004) and by subsequent work at the Pew Hispanic Center.

The residual method compares the number of immigrants in the CPS with an independently derived demographic estimate of legal foreign-born residents. The difference between the survey total and the estimated legal foreign-born population is an estimate of unauthorized immigrants included in the survey. Variants of the residual method have been widely used and are generally accepted as the best current estimates. The initial estimates here are calculated separately for age-gender groups in six states (California, Texas, Florida, New York, Illinois and New Jersey) and the balance of the country and for 35 countries or groups of countries by period of arrival in the United States.

The next step adjusts the estimates of legal and unauthorized immigrants counted in the survey for omissions. The basic information on coverage is drawn principally from comparisons with Mexican data, U.S. mortality data and specialized surveys conducted at the time of the 2000 Census (Bean et al. 1998; Capps et al. 2002; Marcelli and Ong 2002). These adjustments increase the estimate of the legal foreign-born population, generally by 1-3%, and of the unauthorized immigrant population by 10-15%. For 2008, these procedures

yielded an estimate of 11.9 million unauthorized immigrants in the United States with 7 million from Mexico (Passel and Cohn 2008).

Status Assignments—Legal and Unauthorized Immigrants

Individual respondents are assigned a status as a legal or unauthorized immigrant based on the individual's demographic, social, economic and geographic characteristics so the resulting number of immigrants in various categories agrees with the totals from the residual estimates. The assignment procedure employs a variety of methods, assumptions and data sources.

First, all immigrants entering the U.S. before 1980 are assumed to be legal immigrants. Then, the CPS data are corrected for known over-reporting of naturalized citizenship on the part of recently arrived immigrants (Passel et al. 1997) and all remaining naturalized citizens from countries other than Mexico and those in Central America are assigned as legal. Persons entering the U.S. as refugees are identified on the basis of country of birth and year of immigration to align with known admissions of refugees and asylees (persons granted asylum). Then, individuals holding certain kinds of temporary visas (including students, diplomats and "high-tech guest workers") are identified in the survey and each is assigned a specific legal temporary migration status using information on country of birth, date of entry, occupation, education and certain family characteristics. Finally, some individuals are assigned as legal immigrants because they are in certain occupations (e.g., police officer, lawyer, military occupation, federal job) that require legal status or because they are receiving public benefits (e.g., welfare or food stamps) that are limited to legal immigrants. As result of these steps, the foreign-born population is divided between individuals with "definitely legal" status (including long-term residents, naturalized citizens, refugees and asylees, legal temporary migrants, and some legal permanent residents) and a group of "potentially unauthorized" migrants.

The number of potentially unauthorized migrants exceeds the estimated number of unauthorized migrants (from the residual estimates) by 20-35%. So, to have a result consistent with the residual estimate of legal and unauthorized immigrants, probabilistic methods are employed to assign legal or unauthorized status to these potentially unauthorized individuals. This last step also involves a check to ensure that the legal statuses of family members are consistent; for example, all family members entering the country at the same time are assumed to have the same legal status. The entire process requires several iterations to produce estimates that agree with the demographically derived population totals. At the end, the final estimates agree with the residual estimates for the six individual states noted earlier and for the balance of the country; for Mexican-born and other legal and unauthorized immigrants in each area; and for children, working-age men and working-age women within each category. Finally, the survey weights for the

foreign-born are adjusted upward so the tabulated figures agree with the analytic, demographic estimates of the total number of legal and unauthorized migrants developed in the very first step.

This methodology obviously requires a number of assumptions and is applied to survey data from a sample (albeit a large one). The resulting estimates, such as those presented here, are subject to both sampling and non-sampling error. Accordingly, small differences should not be treated as significant or substantive. Sampling error intervals have been developed for the national estimates of all unauthorized immigrants and totals by country or region of birth. These estimates were presented in Passel and Cohn (2008).

State-level Estimates

Principally because of concerns relating to the relatively small sample sizes for the foreign-born in some states, all of the state-level estimates presented in this report (total population, labor force, Mexican unauthorized immigrants and K-12 school enrollment) are based on averages from the 2006-08 surveys adjusted to agree with 2008 totals. Error ranges for the size of the unauthorized immigrant population in each state are based on both sampling variability and trend lines of the state-specific estimates for 2000-08.

All state-level estimates for unauthorized immigrant populations are presented as rounded numbers to avoid the appearance of unwarranted precision in the estimates. No estimates smaller than 10,000 are shown. Estimates in the range of 10,000-100,000 are rounded to the nearest 5,000; estimates in the range of 100,000-250,000 to the nearest 10,000; estimates smaller than 1 million to the nearest 25,000; and estimates larger than that to the nearest 50,000. The same rounding conventions are applied to estimates for 2005 (based on averages of 2004-06) and for 2000.

CPS Weights

Because of significant revisions in the Census Bureau's methods for estimating population introduced with the 2008 CPS, it was necessary to correct the population weights used in the CPS. Without this reweighting, some potentially large differences over time in both numbers and characteristics of unauthorized immigrants could be due entirely to the altered population estimates and not to any real changes in the population. To control for this source of variation, new CPS weights consistent with the revised population figures were produced for 2003-07. (Revisions for 2001 and 2002 are still in production.) See Passel and Cohn (2008) for more discussion of this weighting issue.

Country of Birth

Some modifications in the original CPS countries of birth were introduced to ensure that all foreign-born respondents could be assigned to a specific country or region of birth. See Passel and Cohn (2008) for a detailed treatment of how persons with unknown country of birth were assigned to specific countries.

The estimates of the unauthorized population shown in this report divide the world into regions. “Latin America” is defined to include Mexico, Central America, Caribbean countries and South America. “Europe” includes Russia and all of the newly independent countries that were part of the former Soviet Union, even though some of the countries are geographically in Asia. This grouping is designed to maintain maximum consistency over time and with the administrative data series used. While all of these countries are separately identified in immigration statistics since their independence, they do not appear in immigration statistics of the 1980s and most are not identified as countries of birth in the CPS.

Because more detailed information is available on country of birth than in our earlier report (Passel and Cohn 2008), the remaining groupings are slightly different from those previously published. “Middle East” as defined here includes countries of southwest Asia from Turkey and Cyprus in the north and west to Iran in the east to the Arabian Peninsula in the south; it also includes countries of North Africa (Egypt, Sudan, Libya, Tunisia, Algeria, Morocco and Western Sahara). Note that the Middle East does not include Afghanistan or Pakistan. “South and East Asia” is the rest of Asia from Afghanistan and Pakistan eastward. “Other” consists of sub-Saharan Africa and Oceania; in addition, the few respondents not assigned to any other area are categorized as being from “Other.”

K-12 School Enrollment

The March CPS collects information on school enrollment only for U.S. residents ages 16-24. The figures cited in the text for enrollment in grades kindergarten through 12 were obtained by combining the enrollment data from the CPS for ages 16-19 with new estimates for younger ages. K-12 enrollment rates, in public and private schools, were obtained from the American Community Survey (ACS), which is conducted by the U.S. Census Bureau and does collect such information. Rates specific to each state, for immigrants and the U.S. born, and for ages 3-5 and 6-15 from the ACS were applied to CPS population data by age, states, and nativity of parents and children to obtain the final estimates of K-12 enrollment.

Metropolitan-Nonmetropolitan Residence

All individuals in the country live in either a metropolitan area or a nonmetropolitan area. However, to protect the privacy of respondents who live in metropolitan or nonmetropolitan areas with small populations, the Census Bureau

does not report whether the respondent lives in a metropolitan area or a nonmetropolitan area for about 14% of the population included in the CPS. Thus, in the CPS, the entire population is divided into three area groups—metropolitan, nonmetropolitan and "not identified"—rather than just metropolitan and nonmetropolitan.

A comparison of the CPS data for people who can be identified as metropolitan or nonmetropolitan residents with the official Census Bureau population estimates for all metropolitan and nonmetropolitan areas finds that the shares of the two areas are similar. This suggests that the remaining CPS cases (those people who cannot be assigned metropolitan or nonmetropolitan residence) follow the same pattern. Thus, the vast majority of people living in "not identified" areas actually live in smaller metropolitan areas—areas that are below the population threshold that would permit them to be identified in the CPS. Accordingly, the metropolitan proportions reported in this analysis were estimated based on the 86% of CPS cases that could be assigned as either metropolitan or nonmetropolitan.

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ABA Profile of the Legal Profession 2022



Judges

Lawyer Demo-graphics





Legal Technology

Law Schools



LETTER FROM ABA PRESIDENT REGINALD TURNER


ABA President Reginald M. Turner

Last year, my hometown federal courthouse in Detroit got a new judge. Her name is Shalina Kumar and she is the first federal judge of South Asian descent in Michigan. Her father is a physician from India.

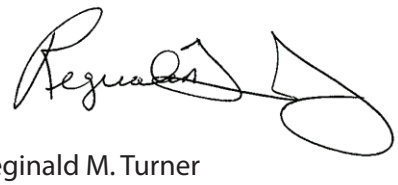
A year earlier, the western side of the state got a new federal judge named Hala Jarbou. She is the first Chaldean American federal judge in the nation. She migrated from Iraq as a child with her family.

Judge Kumar and Judge Jarbou are welcome additions to the bench. Besides their wisdom and experience, they bring a small measure of diversity to our federal judiciary, which is still largely white and largely male.

Times are changing. This 2022 ABA Profile of the Legal Profession includes a new chapter with many details about the growing diversity of the federal judiciary – and how far we still have to go. For example, consider:

- The 8th Circuit Court of Appeals, based in St. Louis, has 18 judges, but only one is female.
- Alaska's population is 40% non-white, yet all seven of its federal trial judges are white.
- Sixteen states with a combined 104 federal trial judges have no federal judges of color.

This new Profile report is a treasure trove of information about lawyers and the legal field. Take a look. I am confident you will learn something new about our profession.



Reginald M. Turner
President, American Bar Association
July 2022

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INTRODUCTION AND ACKNOWLEDGMENTS

The federal judiciary is vast, but not terribly varied. Across the nation, there are more than 1,400 sitting Article III federal judges. They are overwhelmingly male and overwhelmingly white. But times are slowly changing.

This 2022 Profile of the Legal Profession documents that gradual change. Chapter 1 is an in-depth look at the changing face of the judiciary, beyond the confirmation of the first Black female justice of the U.S. Supreme Court. It's a snapshot of the federal judiciary at a moment when new appointments are making it more diverse.

This fourth annual Profile report was produced by the ABA Media Relations and Strategic Communications Division. Our goal is to provide authoritative data for lawyers, academics and journalists. Statistics are from sources within the ABA, the federal government and nonprofit groups.

We are indebted to the following organizations and government agencies that provided information for this report:

- The Association of American Law Schools
- The Brennan Center for Justice
- The Federal Judicial Center
- The Law School Admission Council
- The National Association for Law Placement
- The National Association of Women Lawyers
- The National Conference of Bar Examiners
- Rosenblatt's Deans Database
- The U.S. Bureau of Labor Statistics
- The U.S. Census Bureau
- Courts, state bars and bar associations in every state

Within the ABA, we offer profound thanks to:

- The Center for Pro Bono
- The Center of Member Operations
- The Center for Professional Responsibility
- The Commission on Women in the Profession
- The Diversity and Inclusion Center
- The Section of Legal Education & Admissions to the Bar
- The Standing Committee on Pro Bono & Public Service
- The Standing Committee on Professional Discipline
- The Young Lawyers Division

Population statistics are from the U.S. Census Bureau and inflation figures are from the U.S. Bureau of Labor Statistics CPI Inflation Calculator.

JUDGES

- Black women on the federal bench
- Diversity on the federal bench
  - Black judges
  - Hispanic judges
  - Asian American judges
  - Female judges
- Where the judges aren't
- Firsts
- President appointments – Gender, race and ethnicity
- Education
- Where judges were born
- State Supreme Courts



ARTICLE III FEDERAL JUDGES

1,409 TOTAL

(as of July 1, 2022)

U.S. Supreme Court
- 9 justices
- 5 men, 4 women
- 6 white, 2 Black, 1 Hispanic

U.S. Courts of Appeals
- 292 judges
- 207 men, 85 women
- 233 white
- 26 Black
- 19 Hispanic
- 14 Asian American

U.S. District Courts
- 1,088 judges
- 759 men, 329 women
- 838 white
- 118 Black
- 78 Hispanic
- 32 Asian American
- 4 Native American
- 18 mixed race or ethnicity

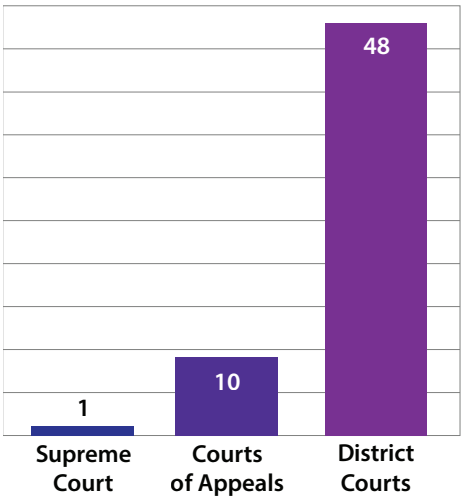
Source: Federal Judicial Center

JUDGES *

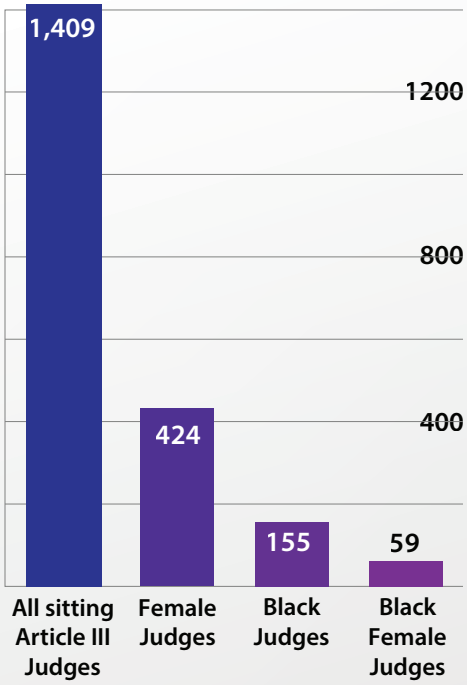
BLACK WOMEN ON THE FEDERAL BENCH

* In this chapter, all references to "federal judges" refer to Article III judges. This does not include magistrate judges and bankruptcy judges.

BLACK FEMALE FEDERAL JUDGES BY COURT *as of July 1, 2022*



BLACK FEMALE FEDERAL JUDGES IN CONTEXT *as of July 1, 2022*





Ketanji Brown Jackson, the first Black female justice of the U.S. Supreme Court

In the history of the United States, there have been 116 justices of the U.S. Supreme Court and until 2022, none of them was a Black woman. That changed on April 7, 2022, when the Senate confirmed Ketanji Brown Jackson as the first Black female justice.

Many other Black female judges serve in federal courts, although they account for just 4% of all federal judges.

Nationwide, there were 59 Black female judges among the 1,409 sitting Article III judges in the federal court system on July 1, 2022, according to the Federal Judicial Center, the education and research agency of the federal courts. That included 54 judges who identified themselves as Black or African American, and five who identified as partly Black or African American.

Most serve at the federal trial court level – the U.S. district courts. Of the 1,088 sitting judges on federal district courts, there were 48 Black women as of July 1, 2022. That's just 4.4% of all the district court judges. California had six Black female judges in district court, while Illinois and New York each had four. Twenty-seven states had none.

On the appeals court level, 10 Black female judges were among the 292 sitting judges on July 1, 2022. That's 3.4% of all appeals court judges. Two appeals courts – the Second Circuit (based in New York) and the Ninth (based in California) – each had two Black female judges. Six circuit courts had none.

The vast majority of sitting Black female federal judges were nominated by Democratic presidents – 52 out of 59, or 88%. Among the 59 currently sitting Black female judges, 25 were nominated by Barack Obama, 15 by Joe Biden, nine by Bill Clinton and three by Jimmy Carter. The remaining seven Black female federal judges were nominated by Republicans: Five by George W. Bush and one each by Donald Trump and George H.W. Bush.

In the nation's history, there have been 73 Black female federal judges. Most were appointed since 2000 – 53 from 2000 and later.

The first Black female federal judge – civil rights icon Constance Baker Motley – took office in 1966 in New York City. Twelve years passed before the next Black female federal judge (Mary Johnson Lowe, also of New York) was confirmed in 1978. Only five Black women became federal judges in the 1970s and three in the 1980s.

Source: Federal Judicial Center

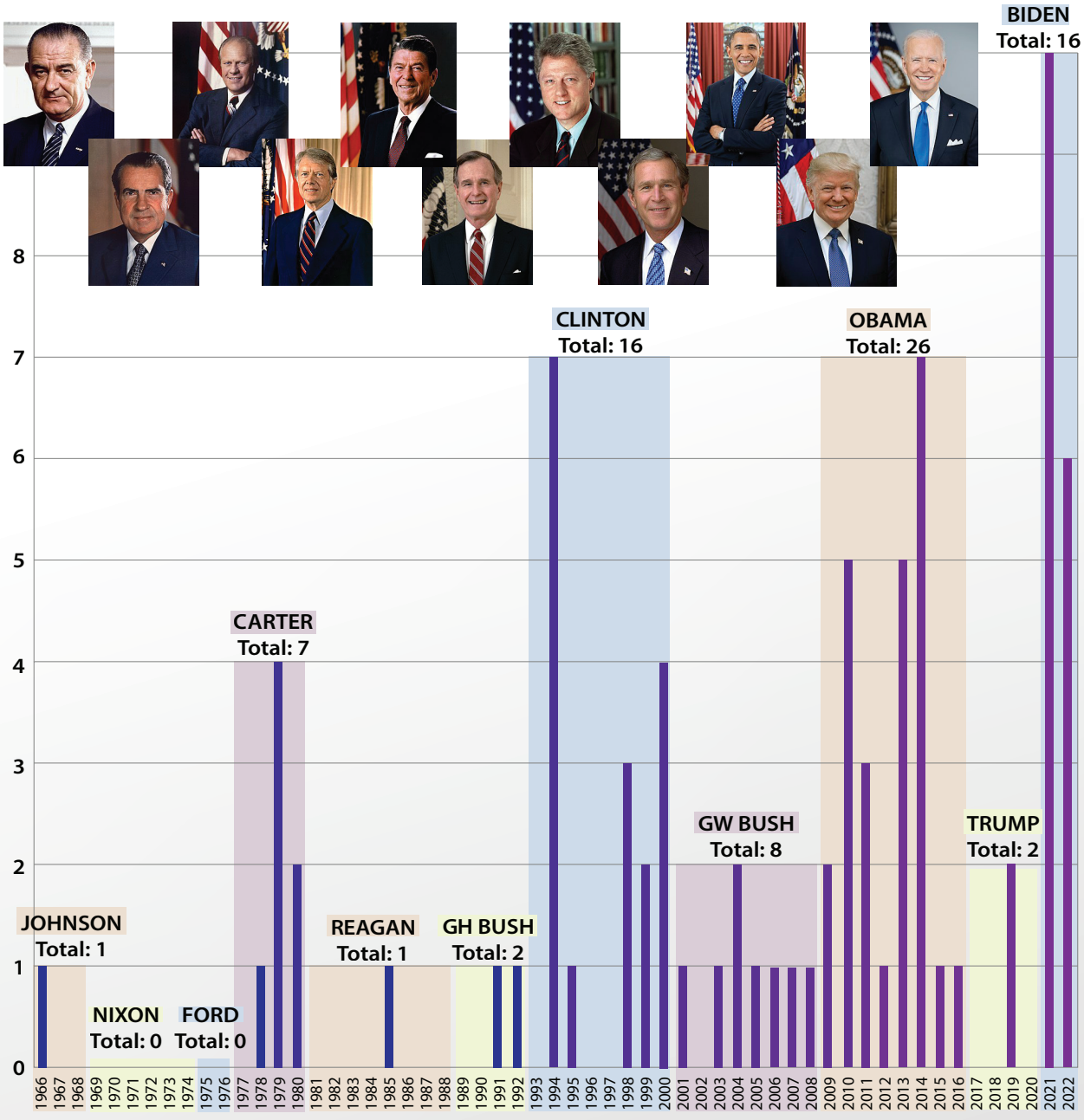
JUDGES

BLACK WOMEN ON THE FEDERAL BENCH

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BLACK FEMALE FEDERAL JUDGES BY YEAR AND PRESIDENTIAL APPOINTMENT

as of July 1, 2022



Source: Federal Judicial Center

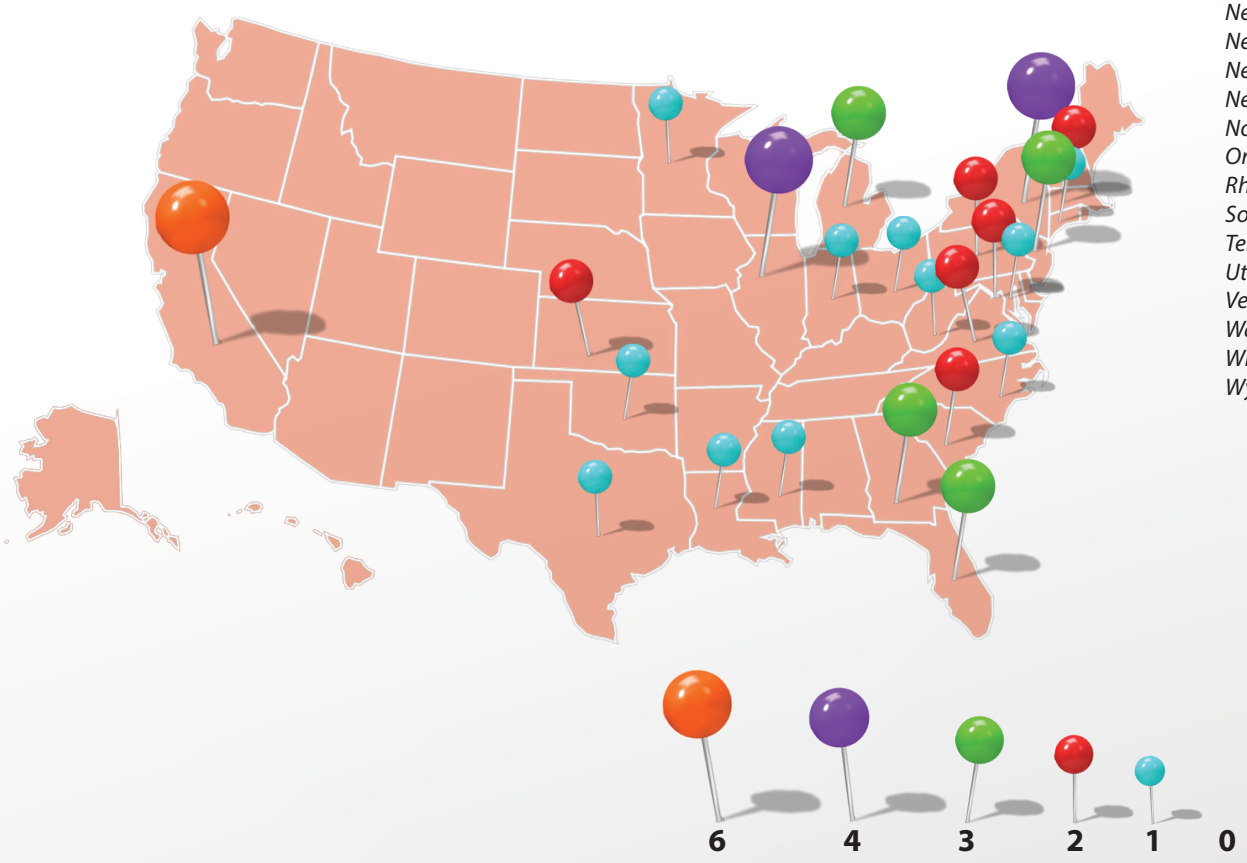
JUDGES

BLACK FEMALE FEDERAL TRIAL JUDGES BY STATE

California	*6*	*New Jersey*	*3*	*Connecticut*	*1*	*Mississippi*	*1*	*Alabama*	*0*
Illinois	*4*	*DC*	*2*	*Indiana*	*1*	*North Carolina*	*1*	*Alaska*	*0*
New York	*4*	*Masschusetts*	*2*	*Kansas*	*1*	*Ohio*	*1*	*Arizona*	*0*
Florida	*3*	*Pennsylvania*	*2*	*Louisiana*	*1*	*Oklahoma*	*1*	*Arkansas*	*0*
Georgia	*3*	*South Carolina*	*2*	*Maryland*	*1*	*Texas*	*1*	*Colorado*	*0*
Michigan	*3*	*Virginia*	*2*	*Minnesota*	*1*	*West Virginia*	*1*	*Delaware*	*0*
								Hawaii	*0*
								Idaho	*0*
								Iowa	*0*
								Kentucky	*0*
								Maine	*0*
								Missouri	*0*
								Montana	*0*
								Nebraska	*0*
								Nevada	*0*
								New Hampshire	*0*
								New Mexico	*0*
								North Dakota	*0*
								Oregon	*0*
								Rhode Island	*0*
								South Dakota	*0*
								Tennessee	*0*
								Utah	*0*
								Vermont	*0*
								Washington	*0*
								Wisconsin	*0*
								Wyoming	*0*

CURRENT BLACK FEMALE FEDERAL TRIAL JUDGES BY STATE

as of July 1, 2022



Source: Federal Judicial Center

JUDGES

DIVERSITY ON THE FEDERAL BENCH

In 2021 and 2022, the federal judiciary grew more diverse. Although the 1,409 sitting federal judges are still largely white and male, many new appointments of women and judges of color made the judiciary less homogeneous, according to the Federal Judicial Center.

From Jan. 1, 2021, to July 1, 2022, the Senate confirmed 68 new federal judges. As a group, they were very different from their predecessors. Only three of the new judges (4%) were white men. The remaining 65 new judges (96%) were a mix of women, Blacks, Hispanics, Asian Americans, two Native Americans and five lawyers of mixed race or ethnicity.

As a result, the percentage of Blacks on the federal bench rose slightly – from 9.5% in 2020 to 11% in 2022. Overall, 144 federal judges identified as Black and nine identified as partially Black. The first African American federal judge took office in 1945.

Meanwhile, 7.7% of federal judges in 2022 were Hispanic – up slightly from 6.5% in 2020. Ninety-eight federal judges identified as Hispanic and 11 others identified as partially Hispanic, as of July 1, 2022. The first Hispanic federal judge took office in 1961.

The share of Asian Americans in the federal judiciary rose from 2.6% in 2020 to 3.8% in 2022. Forty-five federal judges nationwide identified as Asian American and six others identified as partially Asian. One identified as Chaldean and one as Pakistani. The first Asian American federal judge was appointed in 1971.

Four federal judges are Native American. Two other judges identify as partially Native American. The total of six judges is just four-tenths of 1% of all federal judges. Nationally, 1.3% of the U.S. population is Native American. The first Native American federal judge took office in 1979.

The percentage of female federal judges grew from 27% in 2020 to 30% in 2022. The first female federal judge was appointed in 1928. ■

FAST FACTS:

The racial composition of the federal bench has changed gradually over the past four decades. In 1980, 91% of all federal judges were white. In 2022, that percentage was 78%.

The gender makeup of the federal bench has changed more substantially. In 1980, 5% of all federal judges were women. In 2022, that percentage was 30%.



Genevieve Rose Cline, the first female federal judge, appointed in 1928 by President Calvin Coolidge.

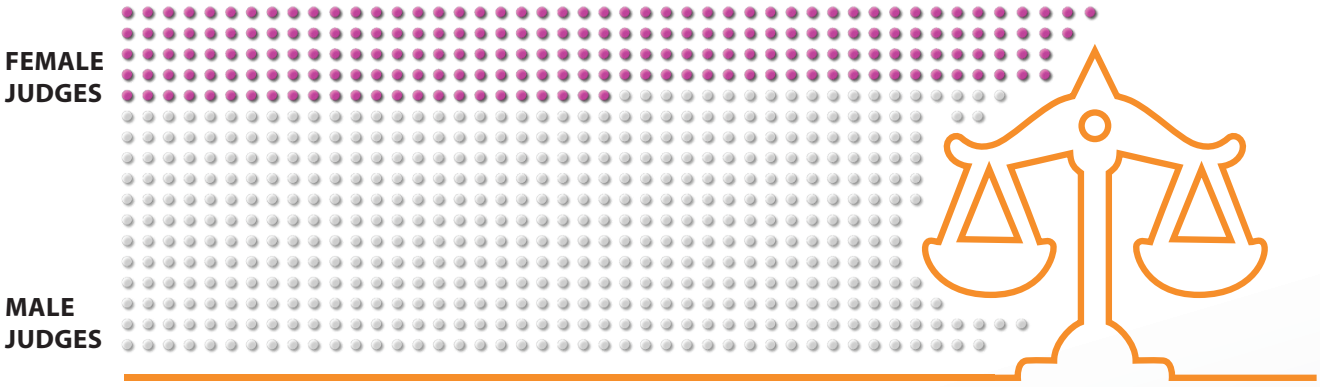
Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES BY GENDER, RACE AND ETHNICITY

FEDERAL JUDGES BY GENDER: 2022

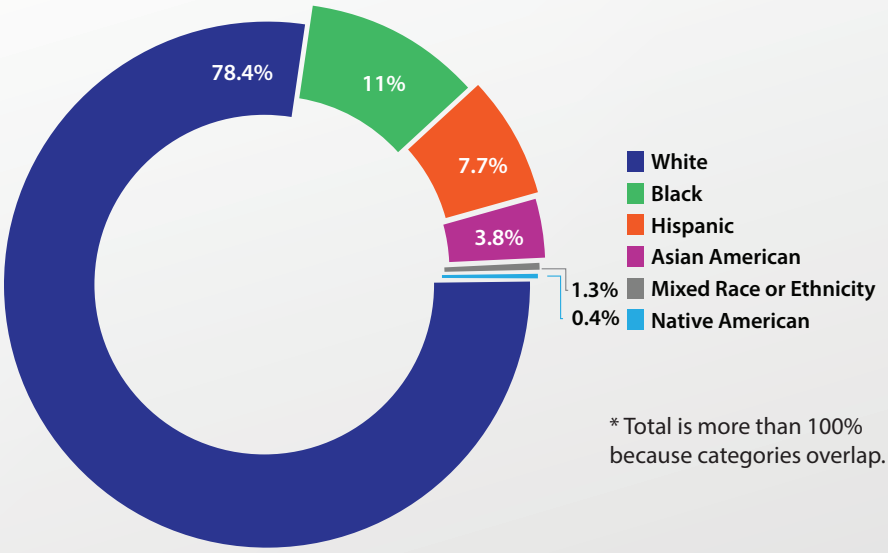
1 dot = 2 judges



TOTAL FEDERAL JUDGES: 1,409
as of July 1, 2022

GENDER of the Federal Bench: **70%** **MALE**

FEDERAL JUDGES BY RACE AND ETHNICITY: 2022



* Total is more than 100% because categories overlap.

Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES BY RACE AND ETHNICITY

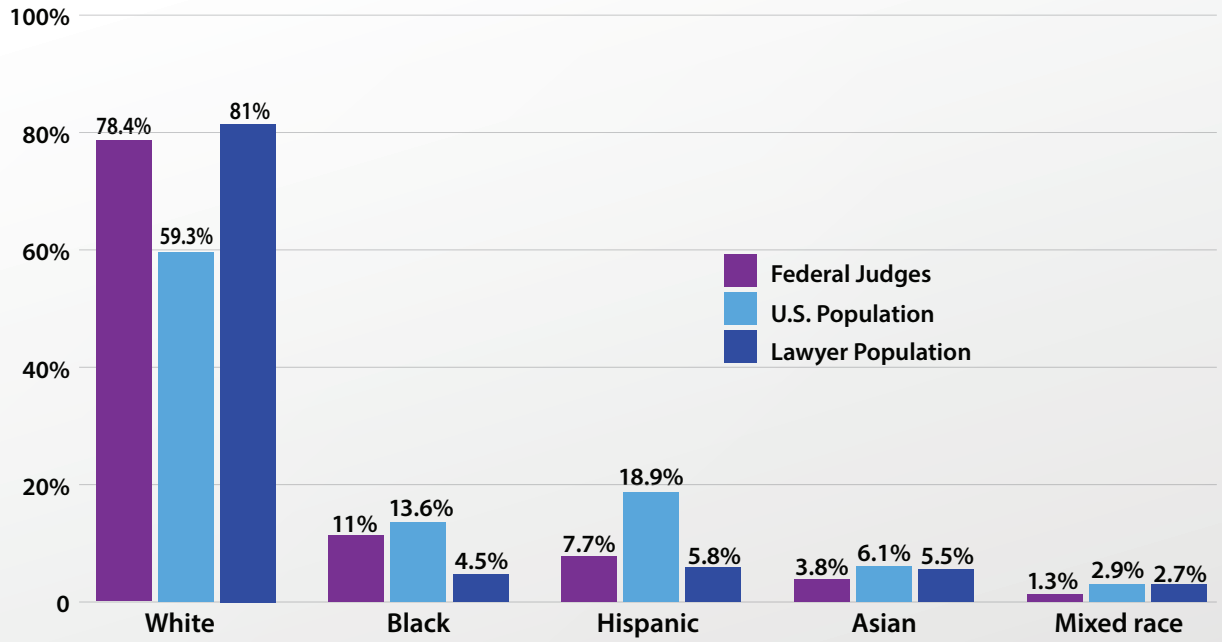
Are lawyers of color underrepresented on the federal bench? The question has more than one answer.

Compared to the U.S. population, lawyers of color are underrepresented, particularly Hispanics. For example, 7.7% of all federal judges were Hispanic as of July 1, 2022 – less than half the percentage of Hispanics in the U.S. population (18.9%).

Blacks and Asian Americans are also underrepresented compared to the U.S. population, but the difference is not as great. For example, 11.0% of federal judges were Black as of July 1, 2022, compared to 13.6% of the population. Similarly, 3.8% of federal judges were Asian American, compared with 6.1% of the population.

But compared to the pool of U.S. lawyers, from which all judges are drawn, lawyers of color are not underrepresented. For example, 7.7% of federal judges were Hispanic, but only 5.8% of all lawyers are Hispanic. Similarly, 11.0% of federal judges were Black, compared with 4.5% of all lawyers. And 3.8% of federal judges were Asian American, compared with 5.5% of all U.S. lawyers.

FEDERAL JUDGES BY RACE AND ETHNICITY
COMPARED TO U.S. POPULATION AND LAWYER POPULATION: 2022



Source: Federal Judicial Center / ABA National Lawyer Population Survey / U.S. Census Bureau

JUDGES

DIVERSITY ON THE FEDERAL BENCH / BLACK FEDERAL JUDGES

Eleven percent of the country's federal judges are Black, according to the Federal Judicial Center, the research and education arm of the federal courts. Roughly one-third of all Black federal judges (38%) are women.

Most of the 155 Black federal judges are found in the trial courts – the U.S. district courts. There were 128 Black judges in district courts throughout the country, as of July 1, 2022. They are mostly concentrated in a few large states: 17 in California, 10 in New York, eight in Florida, seven in the District of Columbia, and six each in Georgia, Illinois and Texas.

Eighteen states have no Black federal judges. Most of those states have small Black populations – for example, Montana, Idaho, Wyoming and Vermont. On the other hand, Delaware, a state whose population is 24% Black, has no Blacks among its five federal judges.

There are also 26 Black judges on the U.S. appeals courts. Every circuit court has at least one Black judge. The largest number – four each – are in the Second Circuit (based in New York City) and the Sixth Circuit (based in Ohio).

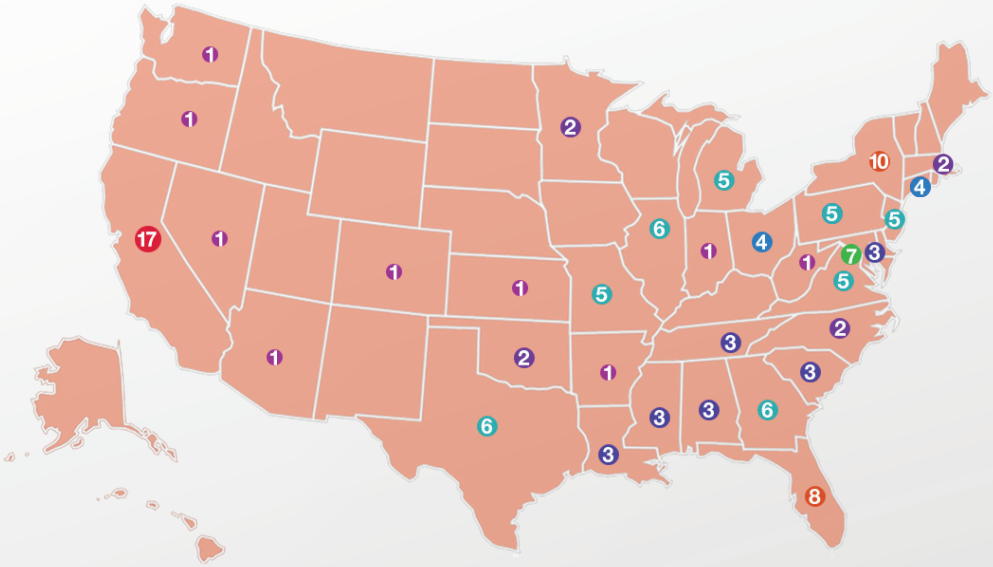
There were two Black justices on the U.S. Supreme Court as of July 1, 2022: Clarence Thomas, confirmed in 1991, and Ketanji Brown Jackson, confirmed in 2022.

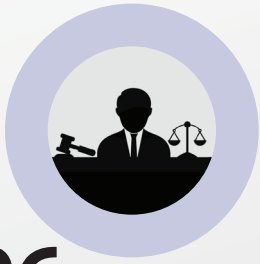
BLACK FEDERAL JUDGES

Supreme Court	2
Courts of Appeals	26
District Courts	128

BLACK FEDERAL TRIAL JUDGES IN EACH STATE: 2022

as of July 1, 2022





96 MALE



59 FEMALE

Source: Federal Judicial Center

JUDGES

DIVERSITY ON THE FEDERAL BENCH / HISPANIC FEDERAL JUDGES

Nearly 8% of the country's federal judges are Hispanic, according to the Federal Judicial Center. Roughly one-third of all Hispanic federal judges (35%) are women.

Most of the 109 Hispanic federal judges are found in the trial courts – the U.S. district courts. There were 86 Hispanic judges in district courts throughout the country, as of July 1, 2022. They are mostly concentrated in three big states with large Hispanic populations: 17 in Texas, 14 in California and 10 in Florida.

Thirty-three states have no Hispanic federal judges. Most of those states have small Hispanic populations – for example, West Virginia, Maine, Vermont and Kentucky. But Rhode Island has a population that is 17% Hispanic and none of its five federal trial judges are Hispanic.

Nineteen Hispanic judges serve on the U.S. appeals courts. The Ninth Circuit, based in California, has the most Hispanic judges: seven. Four circuit courts – the Sixth (based in Cincinnati), the Seventh (based in Chicago), the Eighth (based in St. Louis) and the District of Columbia Circuit – have no Hispanic judges.

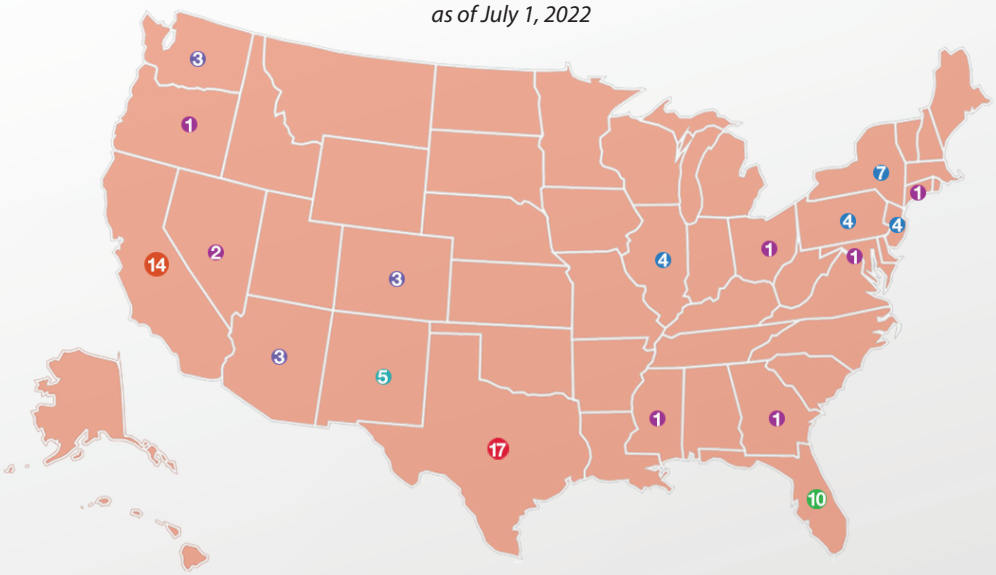
There is one Hispanic justice on the U.S. Supreme Court: Sonia Sotomayor, of Puerto Rican descent, confirmed in 2009.

HISPANIC FEDERAL JUDGES

Supreme Court	1
Courts of Appeals	19
District Courts	87

HISPANIC FEDERAL TRIAL JUDGES IN EACH STATE: 2022

as of July 1, 2022



71 MALE

38 FEMALE

Source: Federal Judicial Center

JUDGES

DIVERSITY ON THE FEDERAL BENCH / ASIAN AMERICAN FEDERAL JUDGES

Nearly 4% of the country's federal judges are Asian American, according to the Federal Judicial Center, and more than half of all Asian American federal judges (51%) are women. That's significantly higher than the national average. Nationwide, 30% of all federal judges are female.

Most of the 51 Asian American federal judges serve in the trial courts – the U.S. district courts. There were 38 Asian American judges in district courts throughout the country, as of July 1, 2022. Nearly half were in four states: California with nine, and New York, Illinois and Hawaii with four each.

Thirty-six states have no Asian American federal judges. Most of those states have small Asian American populations – for example, West Virginia, Montana, Mississippi and Wyoming. The state with the largest percentage of Asian American residents – Hawaii, whose population is 37% Asian American – has eight federal district judges. Half (four) are Asian American.

ASIAN AMERICAN FEDERAL JUDGES



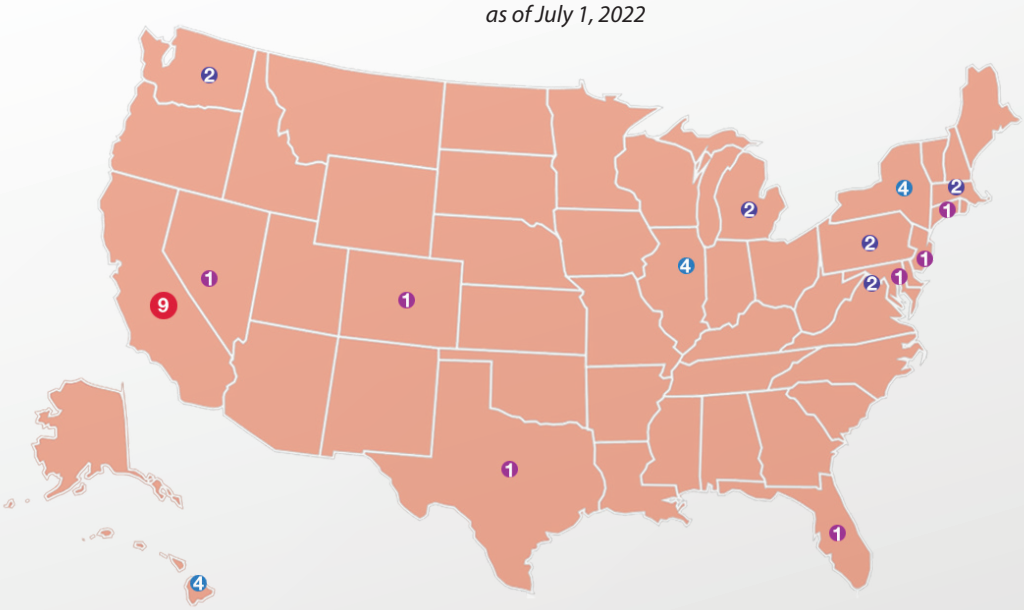
Supreme Court	0
Courts of Appeals	14
District Courts	38

Fourteen Asian American judges serve on the U.S. appeals courts. Nearly half of those judges (six) are in the huge Ninth Circuit, based in California. Seven circuits have no Asian American judges.

There has never been an Asian American justice on the U.S. Supreme Court.

ASIAN AMERICAN FEDERAL TRIAL JUDGES IN EACH STATE: 2022

as of July 1, 2022





25 MALE



26 FEMALE

Source: Federal Judicial Center

JUDGES

DIVERSITY ON THE FEDERAL BENCH / FEMALE FEDERAL JUDGES

Three out of 10 federal judges (30%) were women as of July 1, 2022, according to the Federal Judicial Center.

That corps of female federal judges was more diverse than their male colleagues: 81% of all male federal judges were white, compared with 71% of female judges. Roughly 1 in 4 female federal judges (29%) were lawyers of color – 13% Black, 8% Hispanic, 5% Asian and 2% mixed race or other.

FEMALE FEDERAL JUDGES



Supreme Court	4
Courts of Appeals	85
District Courts	328

New Jersey is the only state where a majority of federal trial judges are female: 13 of 25, or 52%. Hawaii is 50-50 male-female: four men, four women. Nine other states – Connecticut, Delaware, Maryland, Minnesota, New Hampshire, New Mexico, Rhode Island, Vermont and Wyoming – are within one judge of being majority female or 50-50 male-female.

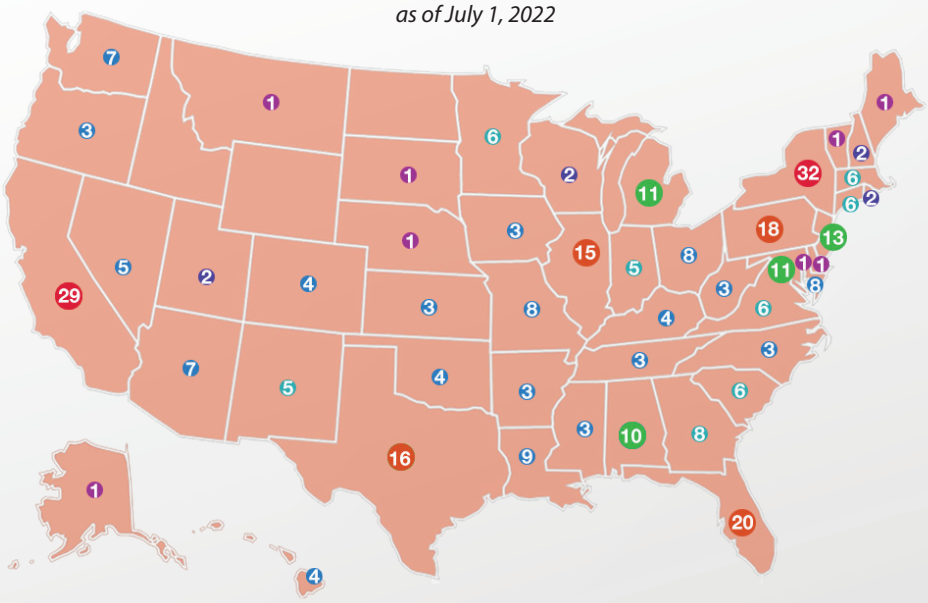
Three states have no female judges: Nebraska (six judges), North Dakota (four judges) and Idaho (three judges).

More than a quarter of the judges on the U.S. appeals courts are female – 85 women total, or 29%. No circuit has a female majority or even a 50-50 split, but the Eleventh Circuit, based in Atlanta, comes close. It has eight women among its 20 judges, or 40%. The Eighth Circuit, based in St. Louis, has the fewest female judges, with only one woman among 18 judges – or just 6% of all the circuit's judges.

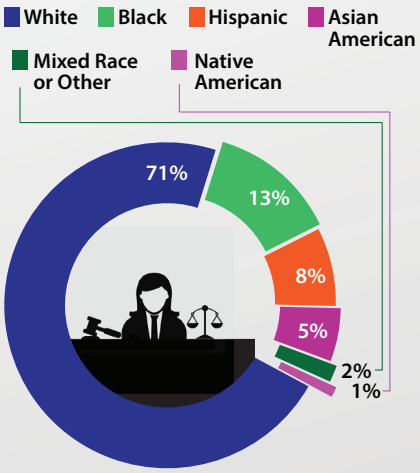
There are four female justices on the U.S. Supreme Court: Amy Coney Barrett, Ketanji Brown Jackson, Elena Kagan and Sonia Sotomayor.

FEMALE FEDERAL TRIAL JUDGES IN EACH STATE: 2022

as of July 1, 2022



FEMALE FEDERAL JUDGES BY RACE AND ETHNICITY: 2022



Source: Federal Judicial Center

JUDGES

WHERE THE JUDGES AREN'T

Sometimes, what's notable about lawyers and judges isn't where they are – it's where they aren't. Some states with large populations of Blacks, Hispanics, Asians or Native Americans have few federal trial judges of color. And some states have a surprising lack of female federal judges. For example, as of July 1, 2022:

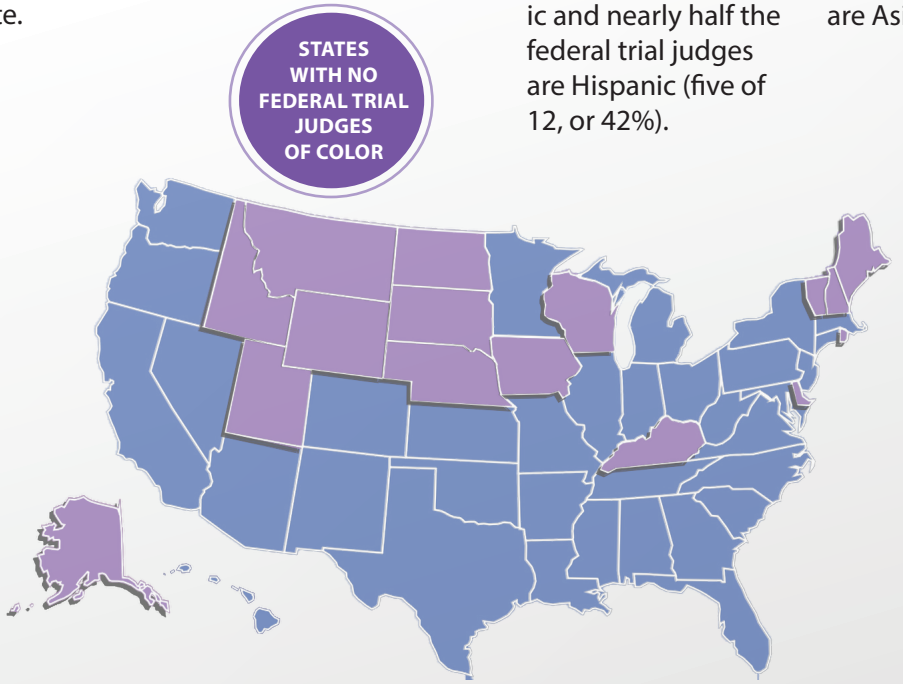
JUDGES OF COLOR: Sixteen states have no federal trial judges of color. Combined, those states have 30 million residents and 104 federal trial judges. All those judges are white. In Alaska, 41% of the population is non-white. A large portion is indigenous (16%) or mixed race (8%). Yet all seven federal trial judges in Alaska are white.

BLACK JUDGES: Delaware is 39% non-white and its largest city, Wilmington, is 57% Black. Yet all four federal trial judges in Delaware are white.

HISPANIC JUDGES: Rhode Island is 17% Hispanic, but all five federal trial judges are white. Connecticut is 18% Hispanic and only recently added its first Hispanic among 14 federal trial judges: U.S. District Judge Omar Williams, who is Black and Hispanic, took office in November 2021. However, in New Mexico, half the population is Hispanic and nearly half the federal trial judges are Hispanic (five of 12, or 42%).

ASIAN AMERICAN JUDGES: New Jersey is 10% Asian, but until last year, none of its 25 federal trial judges was Asian. That changed when U.S. District Judge Zahid Quraishi, the son of Pakistani immigrants, took office in June 2021. However, in Hawaii, where the population is 37% Asian, half of its federal trial judges (four of eight) are Asian.

FEMALE JUDGES: Three states have no female federal trial judges: Nebraska (six judges), North Dakota (four judges) and Idaho (three judges). Tennessee has 23 federal trial judges but only three are female – 13%. Only one of the 18 judges on the Eighth Circuit Court of Appeals is female. The seven states in the Eighth Circuit include such large cities as Kansas City, Minneapolis and St. Louis. One state has a female majority among its federal trial judges: New Jersey, with 13 women and 12 men. Hawaii's eight federal trial judges are 50-50 male-female.



Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES - FIRSTS

For 138 years, every judge appointed to the federal bench was white and male. From George Washington to Warren Harding, each president nominated only white men – 715 judges over nearly a century and a half. No female judges were appointed to the federal bench until 1928 and no judges of color until 1945.

- **Female judges**: President Calvin Coolidge made history in 1928 by nominating Genevieve Rose Cline to a seat on the U.S. Customs Court. She was the first female federal judge, according to the Federal Judicial Center, the research and education arm of the federal judiciary.


Cline

Cline earned a bachelor of laws degree from Baldwin-Wallace College in Ohio, had a private law practice in Cleveland and was a merchandise appraiser for the U.S. Treasury Department. She served on the Customs Court for 25 years before retiring in 1953. After Cline's appointment, only three more women were appointed to the federal bench over the next 32 years.

- **Black judges**: Just after World War II ended, President Harry Truman broke the color barrier on the federal bench in 1945 by nominating Irvin Charles Mollison to the Customs Court. Mollison became the first African American federal judge a few weeks later.


Mollison

Mollison earned a juris doctor degree from the University of Chicago and was a private practitioner in Chicago for 22 years. He served on the Customs Court for 17 years and died in office in 1962.

After Mollison's appointment, only two more Black lawyers were appointed to the federal bench in the next 15 year.

- **Hispanic judges**: Just two months after his inauguration in 1961, President John F. Kennedy nominated the first Hispanic federal judge. Reynaldo Guerra Garza was confirmed to the U.S. District Court for the Southern District of Texas three weeks later.


Garza

Garza earned a bachelor of laws degree from the University of Texas, went into private practice in Brownsville and served in the Army during World War II. He eventually became chief judge, then was named to the 5th Circuit Court of Appeals.

- **Asian American judges**: It wasn't until the 1970s that the U.S. got its first Asian American federal judge. President Richard Nixon nominated Herbert Young Cho Choy of Hawaii to the 9th Circuit Court of Appeals in 1971.


Choy

Born to Korean immigrants, Choy earned a juris doctor degree from Harvard University in 1941, served in the Army during World War II, then went into private practice in Honolulu. He was an active judge from 1971 to 1984, then took senior status.

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Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES - FIRSTS

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- **Native American judges**: President Bill Clinton nominated Billy Michael Burrage to the U.S. District Court in Oklahoma in 1994 and Burrage was confirmed three months later. At the time, it was believed that Burrage was the first Native American federal judge.

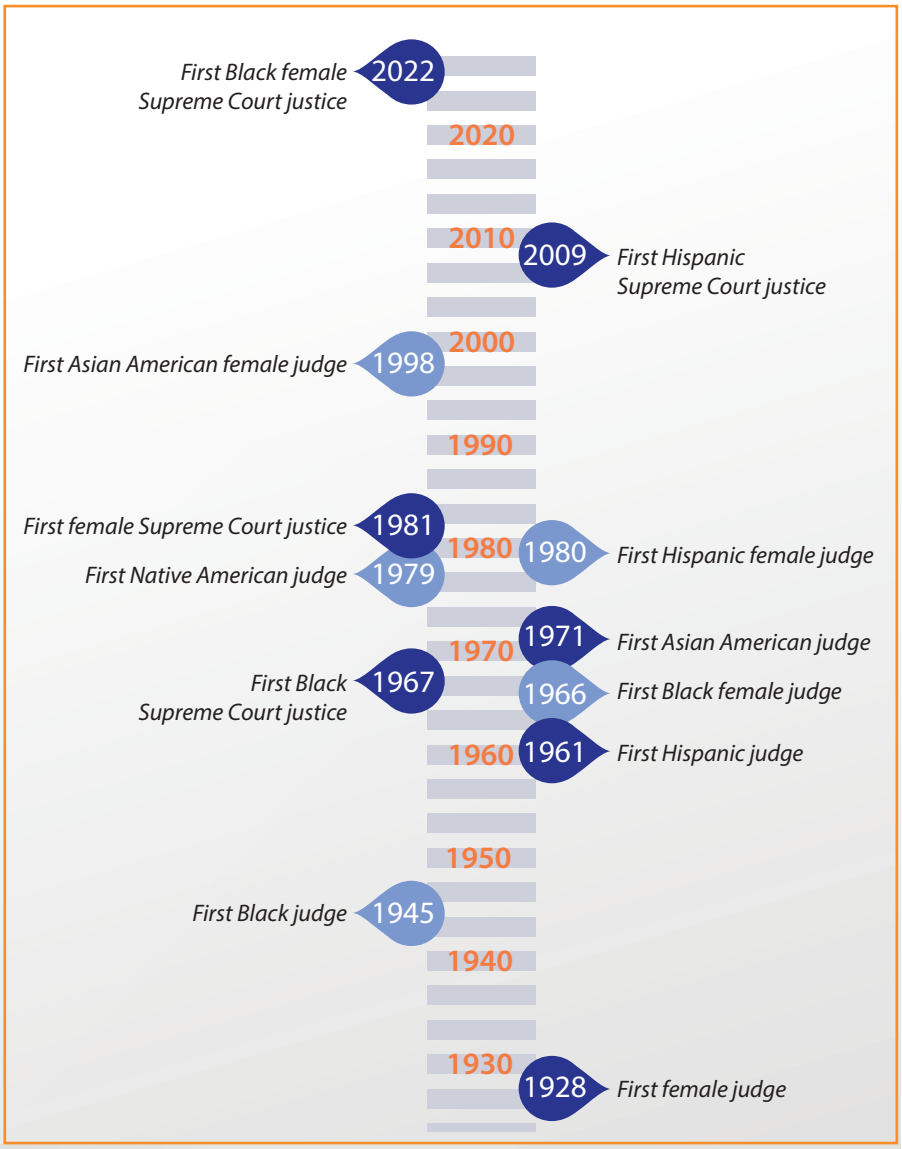


Burrage

A member of the Choctaw Nation of Oklahoma, Burrage earned a juris doctor degree from the University of Oklahoma and entered private practice in the small town of Antlers, Oklahoma. He served on the federal bench for seven years, including five years as chief judge.

Another Oklahoman, Frank Howell Seay, was partly Native American, though he didn't know about his heritage when he became a District Court judge in Oklahoma in 1979. His paternal great-grandfather was an American Indian. Seay was chief justice on the court for 16 years, from 1980 to 1996. ■

FEDERAL COURTS – TIMELINE OF FIRSTS: 1928 – 2022



Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES APPOINTED BY RECENT PRESIDENTS

The federal judiciary has become increasingly diverse over time, but the changes aren't constant. Diversity varies year by year, depending on the president and who controls the Senate.

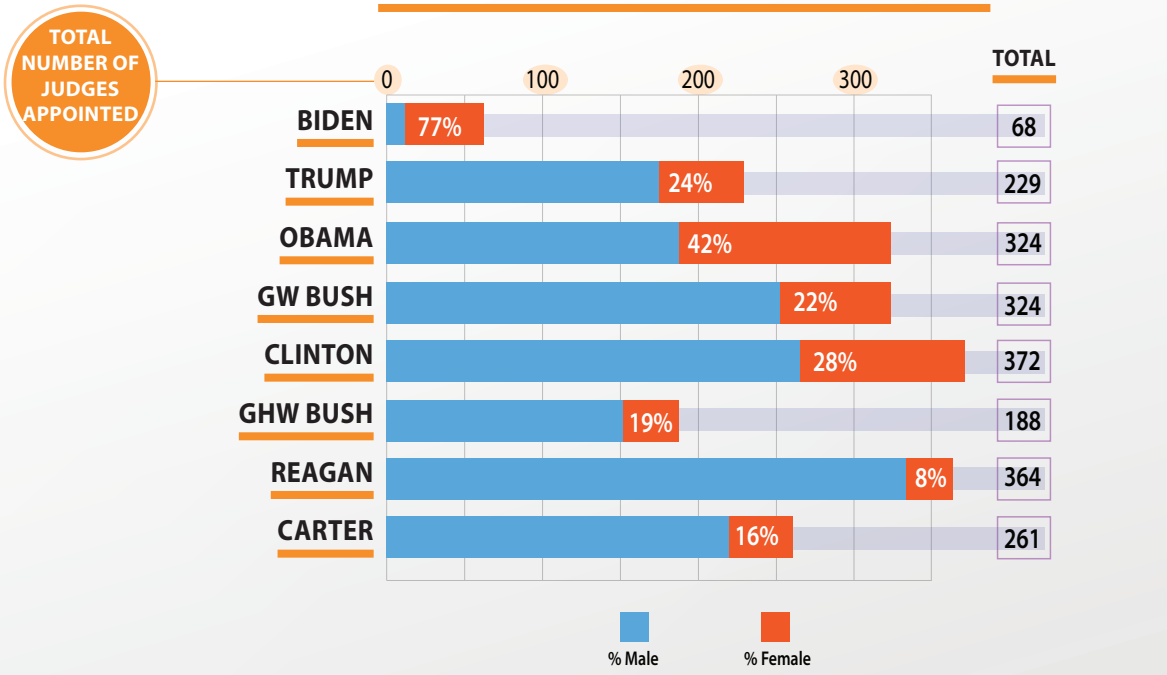
Among recent presidents, Democrats have appointed many more women and judges of color than Republicans, according to the Federal Judicial Center, the research and education arm of the federal courts.

As of July 1, 2022, more than three-quarters of President Joe Biden's confirmed judicial appointments (77%) have been women. Among other recent presidents, only Barack Obama (42%) can say that nearly half of his appointments were women. When it comes to appointing female judges, the other recent presidents are, in order: Bill Clinton (28%), Donald Trump (24%), George W. Bush (22%), George H.W. Bush (19%) and Jimmy Carter (16%). Despite the fact that Ronald Reagan appointed the first female Supreme Court justice in 1981 (Sandra Day O'Connor), only 8% of his judicial appointments were female.

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FEDERAL JUDGES BY GENDER

PRESIDENTIAL APPOINTMENTS: CARTER TO BIDEN *as of July 1, 2022*



Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES APPOINTED BY RECENT PRESIDENTS

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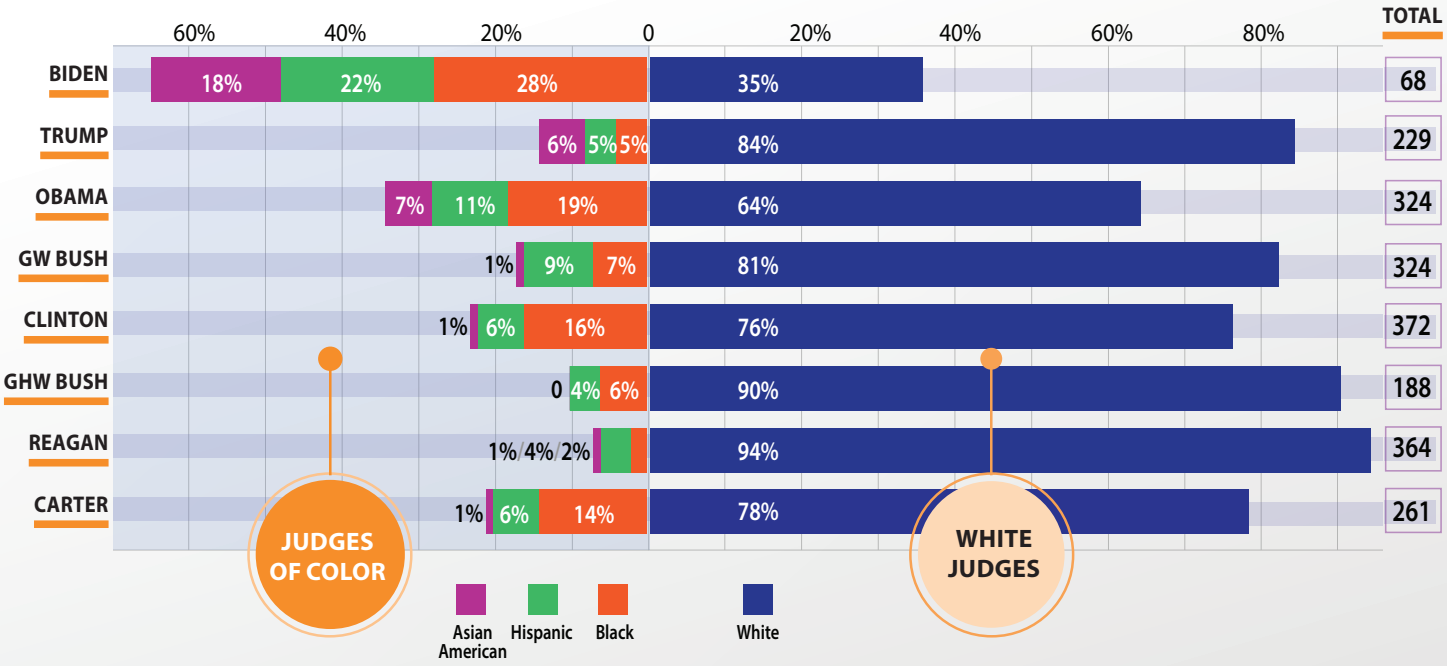
Republicans also were less likely to appoint judges of color. Among the eight most recent presidents, judicial appointments for all four Republicans were more than 80% white: Reagan 94%, George H.W. Bush 90%, Trump 84% and George W. Bush 81%.

As of July 1, 2022, Biden has been the most likely to appoint Black judges (28%), Hispanic judges (22%) and Asian judges (18%) among the eight most recent presidents.

While much was made of the large number of judges appointed by Trump (229), he actually appointed fewer than another recent one-term president, Carter (261), but more than one-termer George H.W. Bush (188). Recent two-term presidents all appointed more than 300 judges each. In order, they are: Clinton (372), Reagan (364), George W. Bush (324) and Obama (324). ■

FEDERAL JUDGES BY RACE AND ETHNICITY

PRESIDENTIAL APPOINTMENTS: CARTER TO BIDEN *as of July 1, 2022*



Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES BY EDUCATION

Ivy League law schools are heavily represented in the federal judiciary. Eight of the nine current Supreme Court justices have law degrees from Harvard or Yale. So do three of the four retired justices.

Among the rest of the federal judiciary, Harvard and Yale are the most common law schools, according to the Federal Judicial Center. As of March 25, 2022, there were 111 federal judges with juris doctor degrees from Harvard. Another 72 were from Yale.

Three other Ivy League schools are represented on the federal bench: 22 federal judges have J.D.s from Columbia, 15 from the University of Pennsylvania and 12 from Cornell. That makes 232 judges with Ivy League law degrees – 18% of the federal judiciary.

Only four other law schools have more than 30 alums on the federal bench: Georgetown 41, University of Texas 35, University of Michigan 31 and University of Virginia 31. Federal judges attended 156 different law schools, representing a large swath of educational diversity.

WHERE FEDERAL JUDGES GOT JD DEGREES

(Top 12 schools as of March 25, 2022)

Harvard	*111*
Yale	*72*
Georgetown	*41*
University of Texas	*35*
University of Michigan	*31*
University of Virginia	*31*
University of Chicago	*27*
Stanford	*25*
University of Cal, Berkeley	*23*
Columbia	*22*
New York University	*22*
University of Florida	*22*
All others	*824*

WHERE SUPREME COURT JUSTICES WENT TO LAW SCHOOL

John Roberts	Harvard
Clarence Thomas	Yale
Samuel Alito	Yale
Sonia Sotomayor	Yale
Elena Kagan	Harvard
Neil Gorsuch	Harvard
Brett Kavanaugh	Yale
Amy Coney Barrett	Notre Dame
Ketanji Brown Jackson	Harvard

Source: Federal Judicial Center

JUDGES

FEDERAL JUDGES BY NATION OF BIRTH

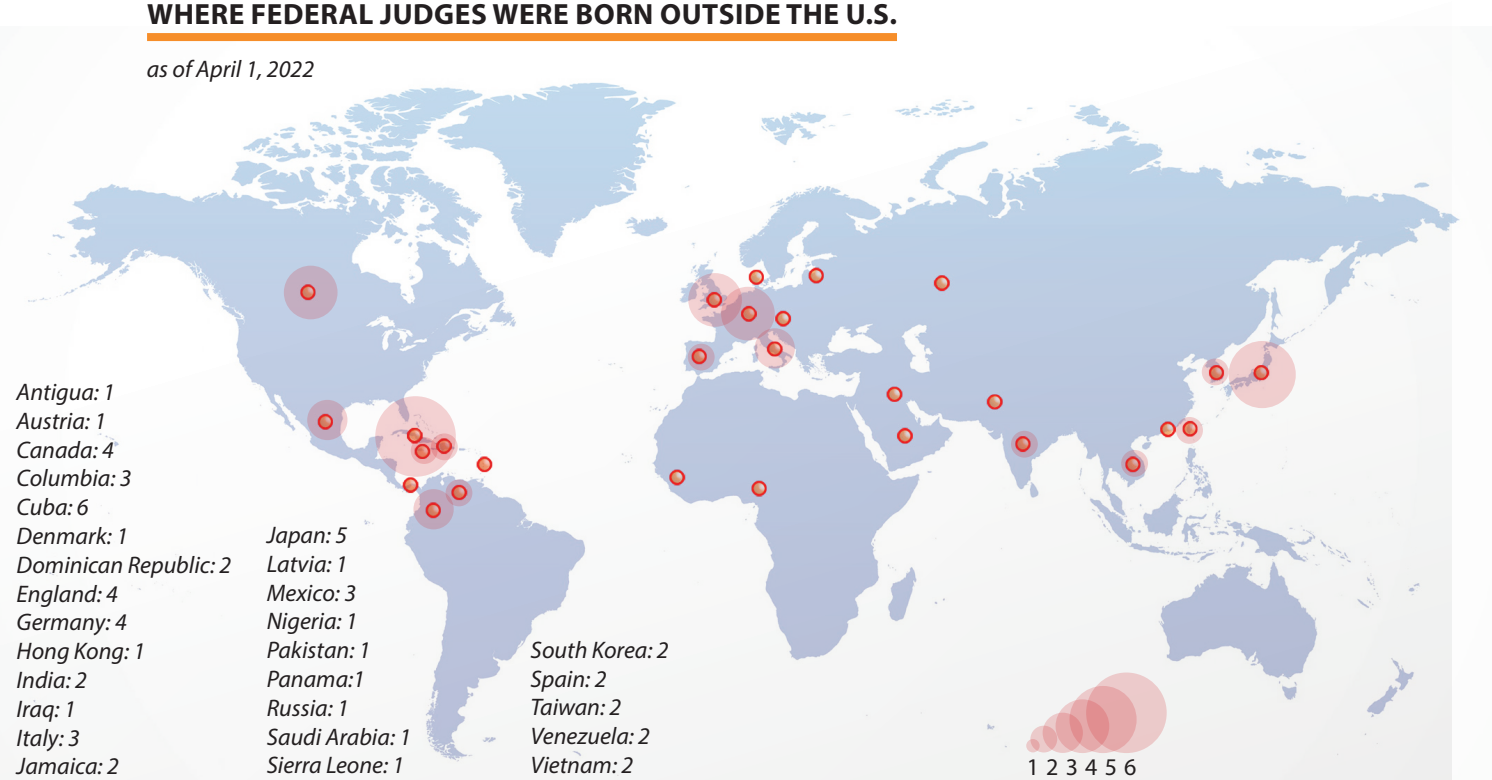
The vast majority of federal judges were born in the United States, but 61 were born in 28 foreign countries as of April 1, 2022, according to the Federal Judicial Center. They are 4.5% of the federal bench.

All told, 1,345 federal judges were born within the United States. Among those born outside the U.S., the most common countries are Cuba (six judges), Canada (five), England, Germany and Japan (four each).

Foreign-born judges are found throughout the federal judiciary, except for the Supreme Court. Forty-nine were in district courts and 12 in courts of appeals. Most are men: 61% male and 39% female. ■

WHERE FEDERAL JUDGES WERE BORN OUTSIDE THE U.S.

as of April 1, 2022



Source: Federal Judicial Center

JUDGES

DIVERSITY IN STATE SUPREME COURTS

White men are more heavily represented among justices of the 50 top state courts than they are in the population overall, according to a 2022 study by the Brennan Center for Justice at New York University.

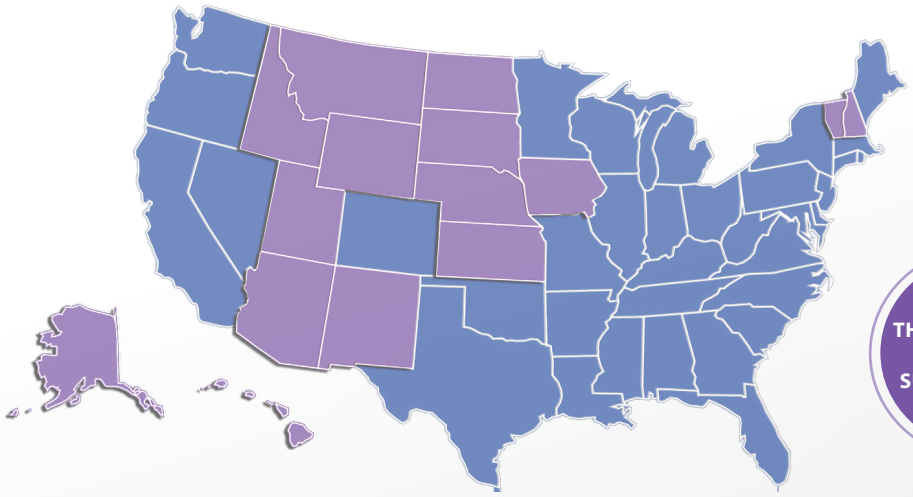
Across all state high courts, 18% percent of justices are Black, Hispanic, Asian American, Native American or multiracial. By contrast, people of color make up 40% of the U.S. population.

Also, 59% of all state supreme court justices are male, compared with 49% of the U.S. population.

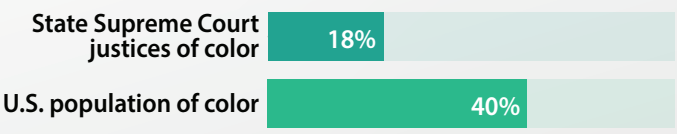
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FAST FACT:

Fifteen states have never had a Black Supreme Court justice: Alaska, Arizona, Hawaii, Idaho, Iowa, Kansas, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, South Dakota, Utah, Vermont and Wyoming



STATE SUPREME COURT JUSTICES OF COLOR: 2022



FEMALE STATE SUPREME COURT JUSTICES: 2022



Source: Brennan Center for Justice, State Supreme Court Diversity report, May 2022

JUDGES

DIVERSITY IN STATE SUPREME COURTS

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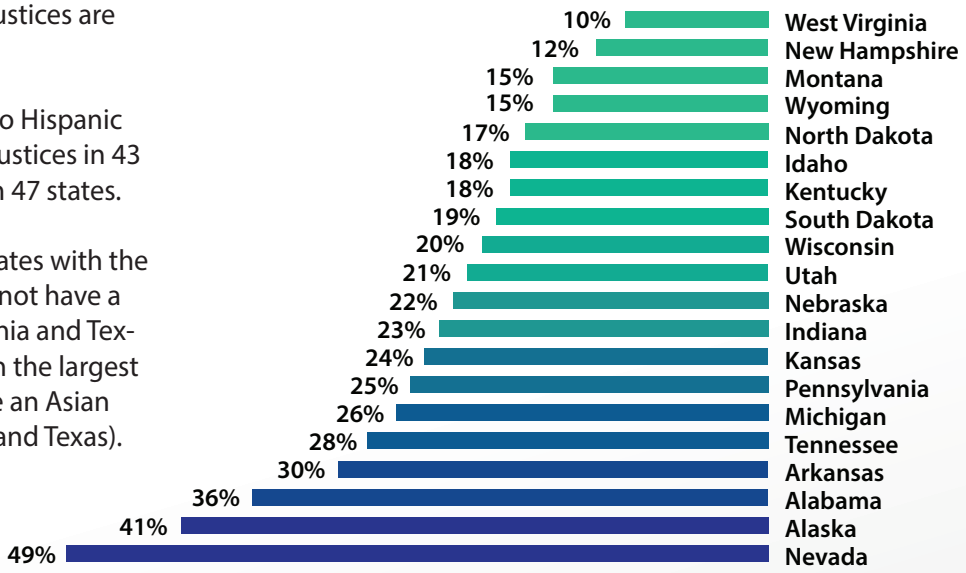
The study found 20 states have no justices that publicly identify as a person of color on their highest courts. In one state, Nevada, nearly half the population (49%) is non-white, but all seven justices are white.

There are no Black justices in 28 states, no Hispanic justices in 39 states, no Asian American justices in 43 states and no Native American justices in 47 states.

The study found that three of the four states with the largest Native American populations do not have a Native American justice (Arizona, California and Texas). Likewise, three of the four states with the largest Asian American populations do not have an Asian American justice (New Jersey, New York and Texas).

STATES WITH ALL-WHITE SUPREME COURTS: 2022

(PERCENTAGE OF RESIDENTS OF COLOR)



Over the past year (April 2021 to May 2022), 25 new state Supreme Court justices took office. As a result, the courts became more diverse. Fifteen of the 25 new justices were women, 10 were people of color and seven were women of color.

STATES WITH...



Source: Brennan Center for Justice, State Supreme Court Diversity report, May 2022

DEMOGRAPHICS

- Growth of the Legal Profession
- Lawyers by State
- Lawyers by Gender
- Lawyers by Race and Ethnicity
- Diversity in U.S. Law Firms
- LGBTQ Lawyers
- Lawyers with Disabilities
- Age
- Legal Demand in Metro Areas









DEMOGRAPHICS

GROWTH OF THE LEGAL PROFESSION

There are more than 1.3 million lawyers in the United States. To be more precise, there were 1,327,010 active lawyers as of Jan. 1, 2022, according to the ABA National Lawyer Population Survey, a tally of lawyers in every U.S. state and territory.

Over the past year, from 2021 to 2022, the number of active lawyers counted by the survey fell slightly, by one-tenth of one percent. The drop was largely because of a change in how Alabama counts its lawyers. Previously, Alabama did not distinguish between active and inactive lawyers. For 2022, Alabama tracked only active lawyers. As a result, the Alabama count dropped by 2,843. Consider that the total number of lawyers nationwide dropped by 900 in the survey, so the change in Alabama accounted for all of that drop and more.

Over the past decade, the number of lawyers nationwide has grown by more than 80,000 – an increase of 6.6% from 2012 to 2022.

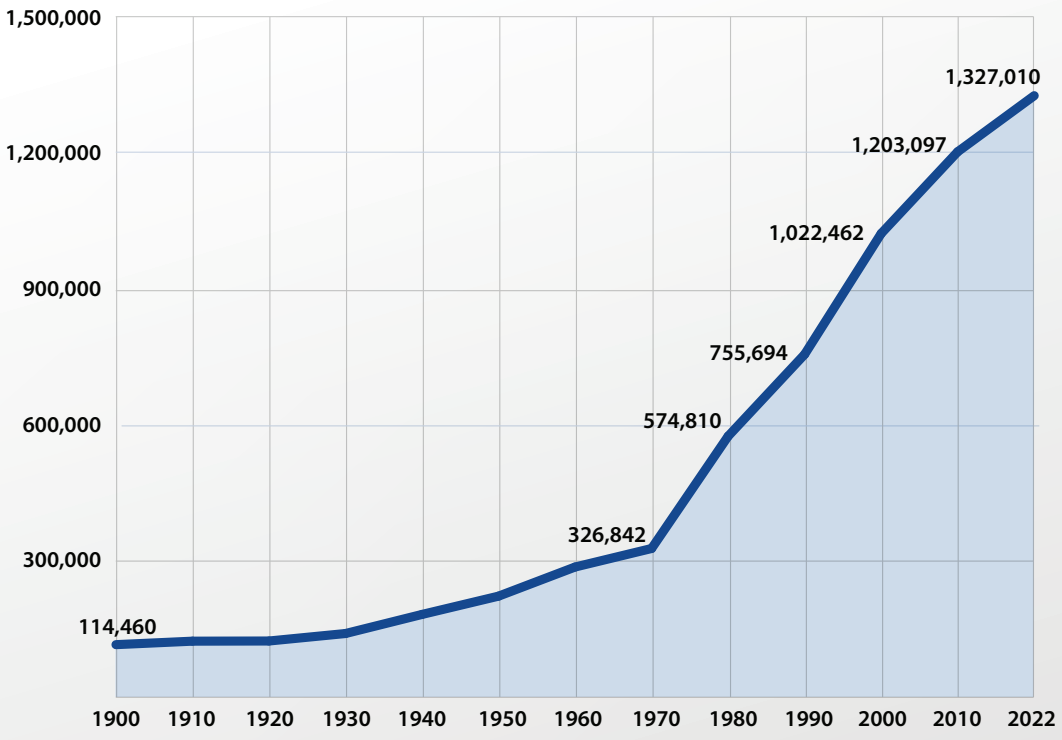
FAST FACTS:

6.6% – Increase in the number of lawyers from 2012 to 2022

1970s – Decade when the numbear of lawyers grew fastest, by 76%

In the 21st century, the growth of the legal profession has slowed. In the previous century, from 1900 to 2000, the number of lawyers rose 793% – from 114,460 to just over 1 million, an average growth of nearly 8% a year. By contrast, the number of lawyers nationwide has grown roughly 1.4% a year since 2000 – from 1,022,462 in 2000 to 1,327,010 in 2022, an increase of 30%.

LAWYER GROWTH: 1900 - 2022



The largest increase in lawyers occurred in the 1970s, a decade when the number of lawyers jumped 76% – from 326,000 in 1970 to 574,000 in 1980.

For much of the 20th century, the industry's growth was much slower: It took 50 years for the number of lawyers to nearly double – from 114,000 in 1900 to 221,000 in 1950. It took less than 30 years for that number to double again – from 221,000 in 1950 to 464,000 in 1978. ■

Source: ABA National Lawyer Population Survey

DEMOGRAPHICS

LAWYERS BY STATE

One-fourth of all the lawyers are in just two states: New York (187,246 lawyers) and California (170,306 lawyers). Combined, they have 27% of the nation's lawyers.

North Dakota has the fewest lawyers: 1,685.

Nationwide, there are four lawyers for every 1,000 residents, but some states have far more. Not surprisingly, New York tops the list with 9.3 lawyers per 1,000 residents. California is NOT second on the list; it has 4.3 lawyers per 1,000 residents – just slightly more than the national average. Maryland is No. 2 with 6.6 lawyers per 1,000 residents.

South Carolina has the fewest lawyers per capita: 2.1 lawyers for every 1,000 residents, or roughly half the national average.

Where is the lawyer population growing fastest? It's not in the largest states. Topping the list is North Carolina, where the number of active lawyers grew 21% in the past decade, followed by Georgia and Texas (both 18%) and Utah (17%).

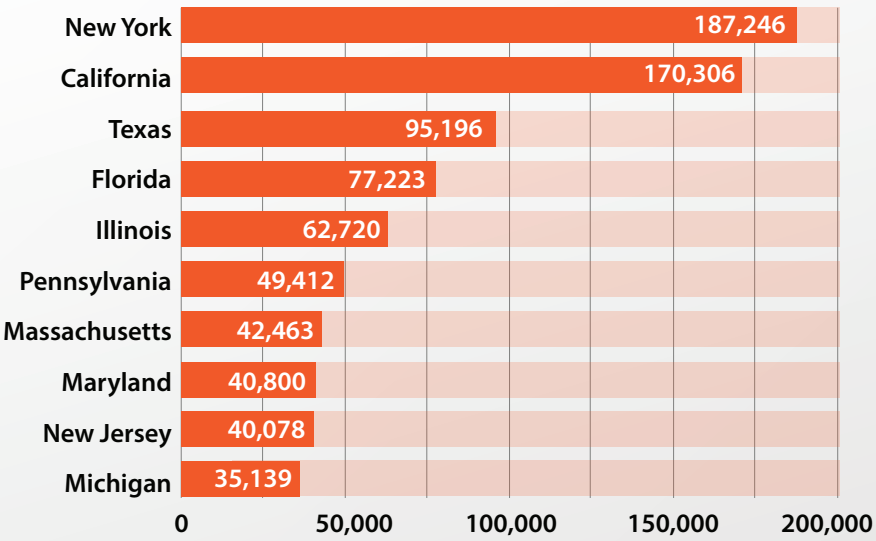
Maryland reported unusually large lawyer growth in the past decade because the state changed how it reported lawyer residents, not necessarily because it experienced large growth.

Ten states reported they lost lawyers over the past decade, led by Alabama (-15%), Alaska (-12%) and Ohio (-8%).

FAST FACT:

Where will you find the most lawyers per capita? The District of Columbia has just under 700,000 residents – less than Alaska – but it has one lawyer living in the district for every 40 residents.

10 STATES WITH THE MOST LAWYERS: 2022



Source: ABA National Lawyer Population Survey / U.S. Census Bureau

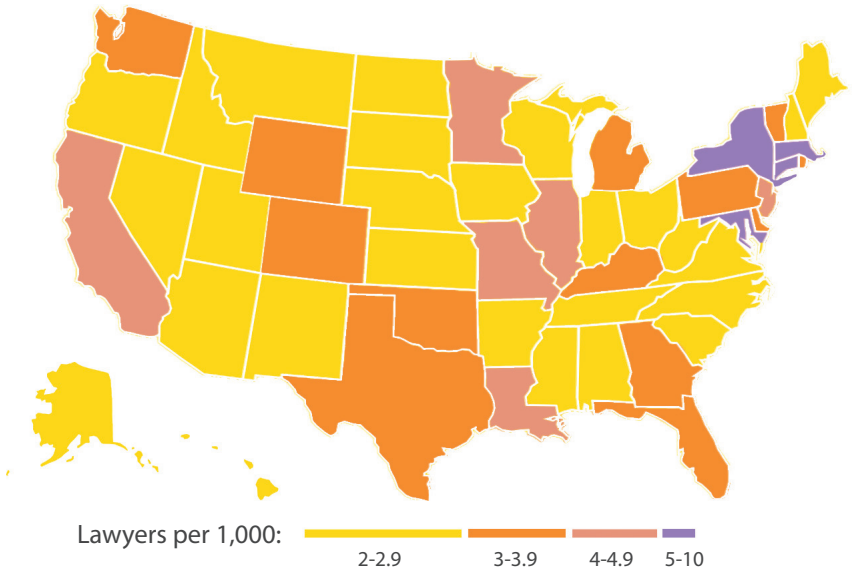
DEMOGRAPHICS

LAWYERS BY STATE

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STATE	LAWYERS	2021 POPULATION	LAWYERS PER 1,000 POPULATION
New York	187,246	20,201,249	9.3
Maryland	40,800	6,177,224	6.6
Massachusetts	42,635	7,029,917	6.1
Connecticut	21,036	3,605,944	5.8
Illinois	62,720	12,812,508	4.9
Minnesota	26,065	5,706,494	4.6
New Jersey	40,078	9,288,994	4.3
California	170,306	39,538,223	4.3
Louisiana	19,714	4,657,757	4.2
Missouri	24,674	6,154,913	4.0
Colorado	22,802	5,773,714	3.9
Pennsylvania	49,412	13,002,700	3.8
Rhode Island	4,081	1,097,379	3.7
Florida	77,223	21,538,187	3.6
Michigan	35,139	10,077,331	3.5
Washington	26,428	7,705,281	3.4
Vermont	2,198	643,077	3.4
Oklahoma	13,415	3,959,353	3.4
Texas	95,196	29,145,505	3.3
Georgia	33,729	10,711,908	3.1
Delaware	3,058	989,948	3.1
Kentucky	13,672	4,505,836	3.0
Wyoming	1,704	576,851	3.0
Montana	3,191	1,084,225	2.9
Ohio	34,692	11,799,448	2.9
Nebraska	5,689	1,961,504	2.9
Oregon	12,285	4,237,256	2.9
Alaska	2,118	733,391	2.9
Hawaii	4,184	1,455,271	2.9
Virginia	23,923	8,631,393	2.8
Tennessee	18,818	6,910,840	2.7
Kansas	7,918	2,937,880	2.7
Maine	3,669	1,362,359	2.7
New Mexico	5,634	2,117,522	2.7
Utah	8,581	3,271,616	2.6
Wisconsin	15,384	5,893,718	2.6
West Virginia	4,673	1,793,716	2.6
New Hampshire	3,495	1,377,529	2.5
North Carolina	25,735	10,439,388	2.5
Nevada	7,484	3,104,614	2.4
Alabama	12,054	5,024,279	2.4
Indiana	15,794	6,785,528	2.3
Iowa	7,405	3,190,369	2.3
Mississippi	6,814	2,961,279	2.3
South Dakota	2,026	886,667	2.3
Arkansas	6,808	3,011,524	2.3
Arizona	15,805	7,151,502	2.2
Idaho	4,047	1,839,106	2.2
North Dakota	1,685	779,094	2.2
South Carolina	11,003	5,118,425	2.1
TOTAL	**1,327,010**	**330,759,736**	**4.0**

LAWYERS PER 1,000 RESIDENTS IN EACH STATE: 2022



For number of lawyers in each U.S. county as of Jan. 1, 2020, see 2021 Profile of the Legal Profession.

Source: ABA National Lawyer Population Survey / U.S. Census Bureau

DEMOGRAPHICS

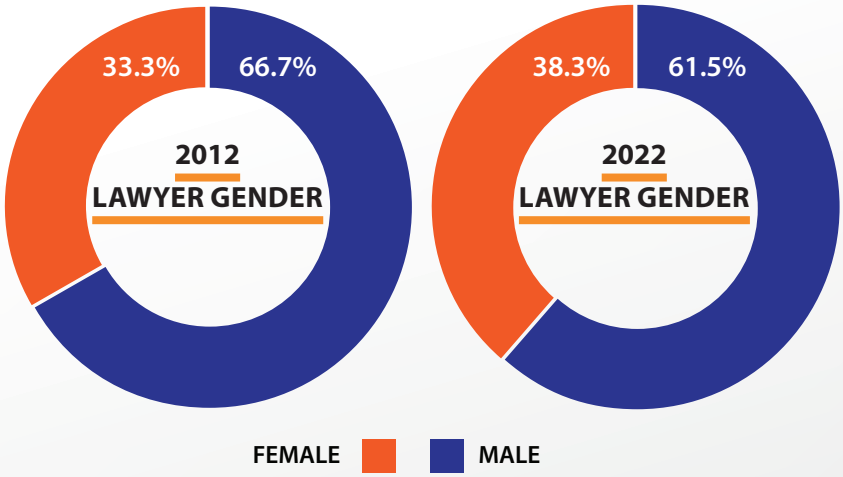
LAWYERS BY GENDER

Over the past decade, the percentage of female lawyers has increased slowly. It stood at 33% in 2012 and grew to 38% in 2022. In other words, male attorneys still greatly outnumber female attorneys – though that is gradually changing as more women, and fewer men, are enrolling in law school every year.

The gender numbers have changed drastically over the past half-century. From 1950 to 1970, only 3% of all lawyers were women. The percentage has edged up gradually since then – to 8% in 1980, 20% in 1991, 27% in 2000 and 37% in 2021.

The first female lawyer in the United States was Margaret Brent, in 1648 in Maryland. The ABA created the Margaret Brent Award in 1991 to recognize and celebrate the accomplishments of female lawyers.

The American Bar Association admitted the first two women as members in 1918 – Mary Florence Lathrop of Denver and Mary Grossman of Cleveland. The first female president of the American Bar Association was Roberta Cooper Ramo of New Mexico in 1995. There have been 10 female ABA presidents, including five of the last seven, as of 2022.



FAST FACT:

Most state bars and state licensing agencies track gender in the profession, but not all do. In 2022, 44 states reported the number of male and female lawyers – up from 42 states in 2011.

Source: ABA National Lawyer Population Survey

DEMOGRAPHICS

LAWYERS BY RACE AND ETHNICITY

The number of Asian American, Hispanic and mixed-race lawyers reported in the ABA National Lawyer Population Survey grew substantially in the past decade.

About half of all state bars and licensing agencies track race and ethnicity in the profession. In 2022, 26 states reported the race and ethnicity of lawyers.

White people are still overrepresented in the legal profession compared with their presence in the U.S. population, but that is slowly changing. Ten years ago, in 2012, lawyers of color were 12% of the profession. A decade later, in 2022, they were 19% of the profession.

The biggest change was in the number of Asian American lawyers. Last year, in 2021, the National Lawyer Population Survey found 2.5% of all lawyers were Asian American. That number more than doubled in 2022 to 5.5%. The change occurred largely because California began reporting the race and ethnicity of its lawyers in 2022. California has a huge number of lawyers – 170,000 – and 13% of them are Asian American. Asian Americans are now represented in the legal profession very close to their share of the U.S. population (5.9%).

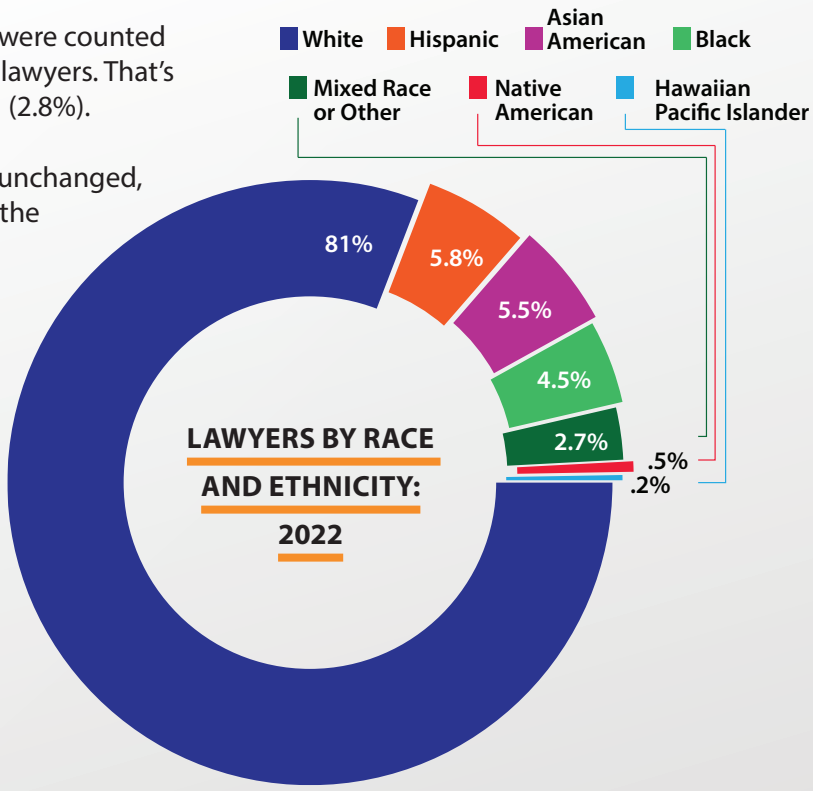
The percentage of Hispanic lawyers nationwide also rose – from 3.5% in 2012 to 5.8% a decade later in 2022, according to the survey. It rose a full percentage point in 2022 alone. Again, this was likely caused by California starting to count race and ethnicity among its lawyers. Still, Hispanics are underrepresented among lawyers compared with their share of the U.S. population (18.5%).

The number of mixed-race lawyers also grew. None were counted in 2014 and 2015, but by 2022 they were 2.7% of all lawyers. That's almost identical to their share of the U.S. population (2.8%).

Meanwhile, the number of Black lawyers is virtually unchanged, according to the survey. Black lawyers were 4.7% of the profession in 2012 and 4.5% in 2022. That's far less than the percentage of Black people in the U.S. population (13.4%).

Native Americans are the smallest racial or ethnic group among U.S. lawyers. One-half of 1% of all lawyers (0.5%) were Native American in 2022 – nearly unchanged from 0.6% a decade earlier. The U.S. population is 1.3% Native American.

Finally, the percentage of white lawyers has declined. White lawyers were 88.4% of the profession in 2012, but 81.0% in 2022. They are still overrepresented compared to the U.S. population. Non-Hispanic white people are 60.1% of the national population.



Source: ABA National Lawyer Population Survey / U.S. Census Bureau

DEMOGRAPHICS

DIVERSITY IN U.S. LAW FIRMS

For the 28th consecutive year, the percentage of law firm partners who are lawyers of color rose in 2021, according to the National Association for Law Placement Report on Diversity in U.S. Law Firms.

The increase has been slow but steady. Viewed year by year, the change is almost imperceptible. But viewed over the span of decades, it is easier to see, and it is accelerating.

In 1993, when NALP began tracking race and ethnicity of law firm partners, 2.55% of all partners were lawyers of color. The number has increased every year since then.

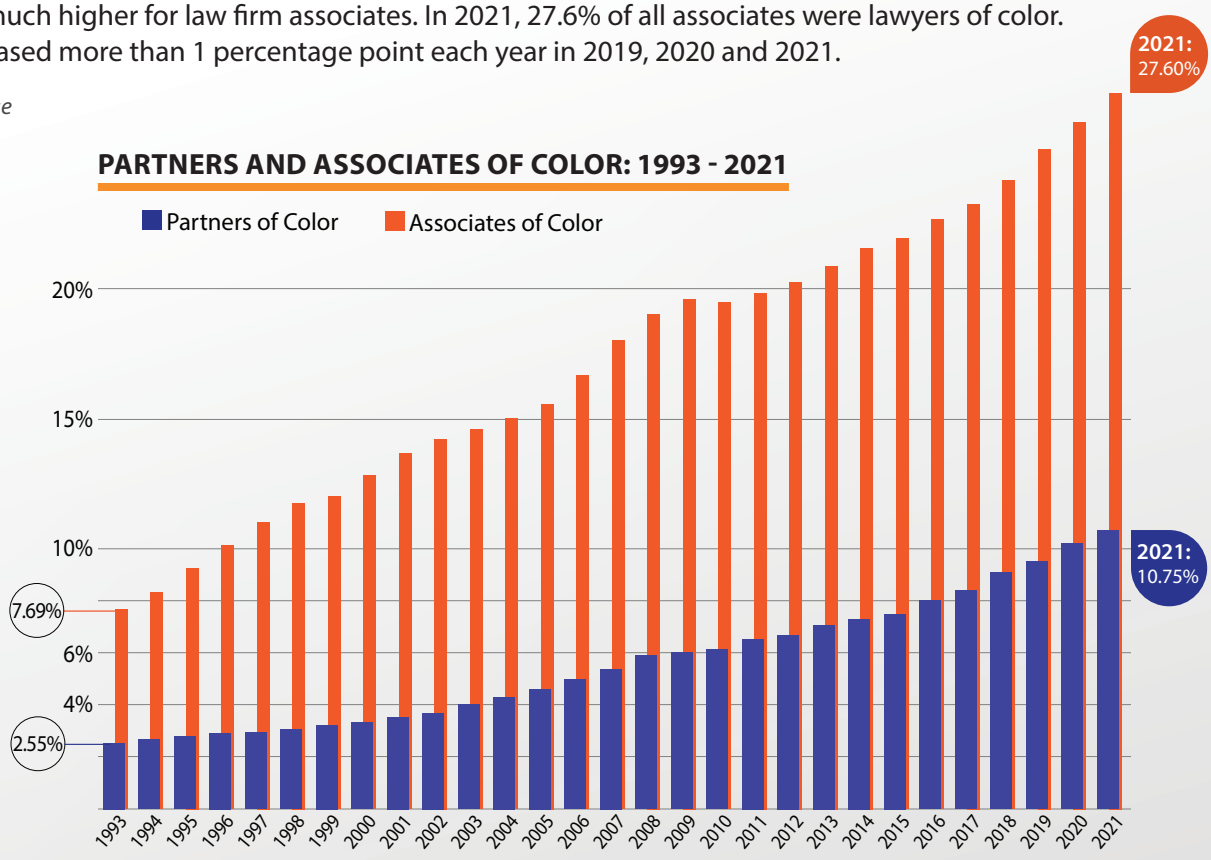
In 2021, 10.75% of all law firm partners were lawyers of color, according to the NALP report. Nearly half of those partners of color (46%) were Asian American. Another 31% were Hispanic and 24% Black.

The accelerating change from decade to decade is striking. During the 1990s and 2000s, the increase in the percentage of partners of color was very slow – usually between 0.1 and 0.3 percentage points each year. But in recent years, the change has accelerated. From 2019 to 2020, the percentage of partners who are lawyers of color increased by 0.68 percentage points. From 2020 to 2021, it increased by 0.52 percentage points.

The numbers are much higher for law firm associates. In 2021, 27.6% of all associates were lawyers of color. That number increased more than 1 percentage point each year in 2019, 2020 and 2021.

...continued on next page

PARTNERS AND ASSOCIATES OF COLOR: 1993 - 2021



Source: National Association for Law Placement 2021 Report on Diversity in U.S. Law Firms

DEMOGRAPHICS

DIVERSITY IN U.S. LAW FIRMS

continued from previous page

Law firm diversity varies dramatically across the country. At one extreme, 30% of all law firm partners in Miami are lawyers of color – the largest percentage in the country. At the other extreme, just 3% of partners in Pittsburgh are lawyers of color – the lowest percentage in the country.

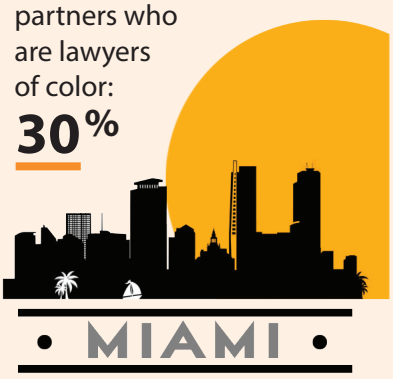
Law firm diversity is particularly strong in California. Among the top six cities and metro areas in the country for law firm diversity, all but one are in California: Silicon Valley, San Diego, Los Angeles, San Francisco and Orange County. Two more are in the Washington, D.C. metro area: Northern Virginia and the capital city itself.

On the flip side, half of the bottom 10 areas for law firm diversity are in the Midwest: Cleveland, Indianapolis, Cincinnati, Grand Rapids, Milwaukee and Kansas City.

City size appears to have no correlation to law firm diversity. For example, while Los Angeles, Houston, San Diego and San Jose are among the 10 largest U.S. cities by population and by diversity of law firms, Philadelphia – the nation's sixth-largest city – fares poorly for law firm diversity. Only 7% of all law firm partners in Philadelphia are lawyers of color.

Miami has the highest percentage of law firm partners who are lawyers of color:

30%

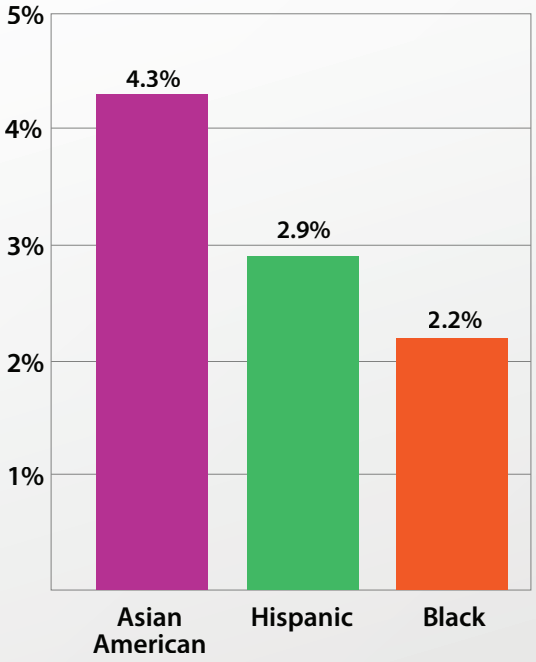


Pittsburgh has the lowest percentage of partners who are lawyers of color:

3%



LAW FIRM PARTNERS OF COLOR: 2021



Source: National Association for Law Placement 2021 Report on Diversity in U.S. Law Firms

DEMOGRAPHICS

LGBTQ LAWYERS

The number of openly lesbian, gay, bisexual, transgender or queer (LGBTQ) lawyers at American law firms continues to grow slowly, according to an annual survey by the National Association for Law Placement.

The 2021 survey found 3,653 lawyers who identify as LGBTQ at 849 law offices across the country. That represents 3.7% of the 99,606 lawyers at those firms. A decade earlier, in 2011, the same survey found 2,087 lawyers who identify as LGBTQ at American law firms, or 1.9% of all lawyers.

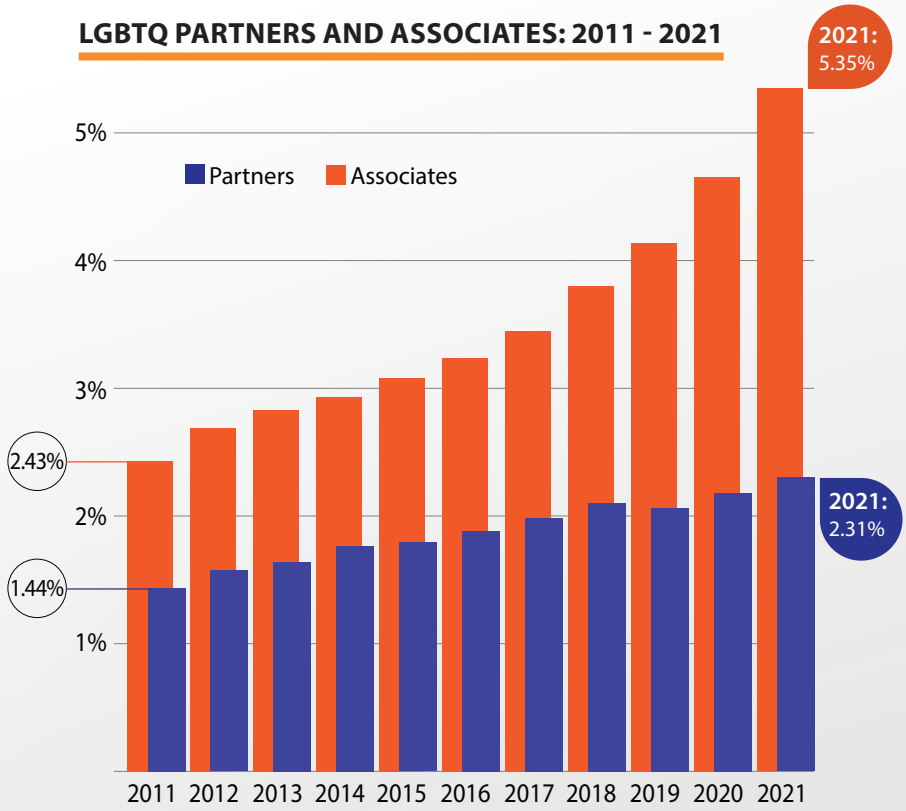
The same trend is evident among law firm associates. In 2011, 2.4% of all associates reported they were LGBTQ. In 2021, the figure was 5.4%.

The percentage of law firm summer associates who report they are LGBTQ is substantially higher. In 2021, 8.47% of all summer associates said they were LGBTQ, according to the survey.

No reliable statistics are available on the total number of lawyers who identify as LGBTQ in the legal profession overall.

FAST FACT:

Law students are much more likely to be openly LGBTQ than law firm lawyers: 8.4% of law firm summer associates describe themselves as LGBTQ – more than double the percentage of all law firm lawyers who describe themselves as LGBTQ (3.7%).



Source: National Association for Law Placement 2021 Report on Diversity in U.S. Law Firms

DEMOGRAPHICS

LAWYERS WITH DISABILITIES

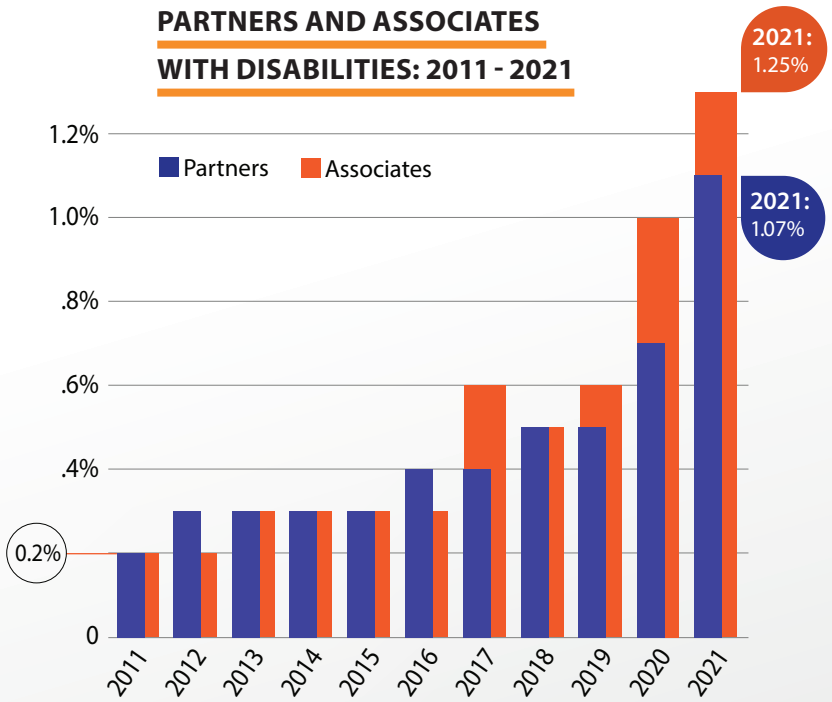
The number of lawyers at American law firms who report having disabilities remains small – just over 1% of all lawyers. Because the number is so small, it is difficult to draw any conclusions about trends, according to a 2021 survey by the National Association for Law Placement.

The survey found 865 lawyers who say they have disabilities at 641 law offices across the country. That represents 1.22% of the 70,980 lawyers in those offices.

The percentage of law firm partners who say they have disabilities is slightly lower – 1.07% – according to the 2021 survey. Still, that is more than triple the percentage for most of the past decade, when it fluctuated between 0.2% and 0.3%.

More lawyers who are associates are also reporting they have disabilities. In 2021, a little over 1% of all law firm associates (1.25%) reported having a disability. This is double the percentage of associates who reported having a disability just two years earlier (0.59%).

No reliable statistics exist on the total number of lawyers with disabilities throughout the legal profession.



Source: National Association for Law Placement 2021 Report on Diversity in U.S. Law Firms

DEMOGRAPHICS

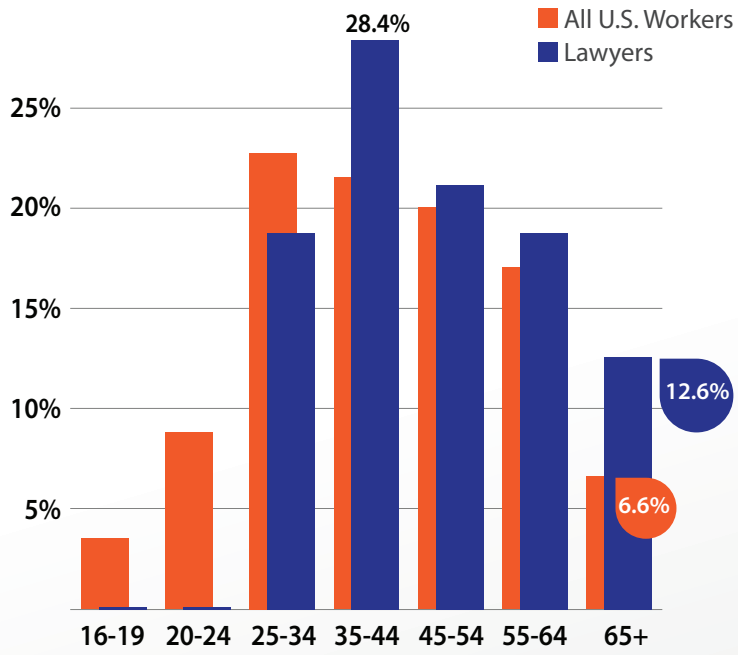
AGE

Lawyers are older than most American workers, on average, according to the U.S. Bureau of Labor Statistics. The median age for lawyers in 2021 was 46.5 years old, which means half were younger and half older. By comparison, the median age of all U.S. workers was 42.2 – four years younger than the typical lawyer.

There are two reasons. First, very few lawyers are younger than 25, but roughly 12% of all American workers are younger than 25. Second, many lawyers work past age 65. Nearly 13% of all lawyers – that's 1 in 8 – are 65 or older. Only 7% of all U.S. workers are 65 or older.

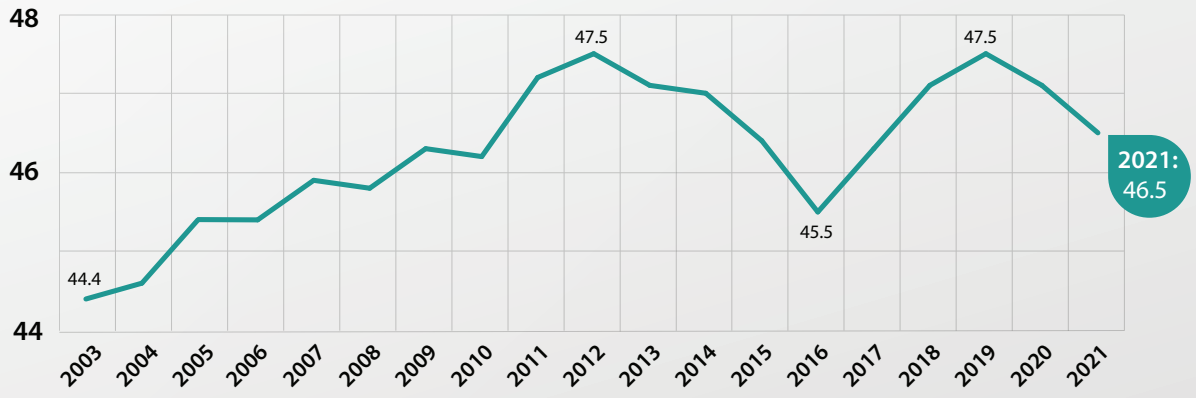
The age of a typical lawyer varies year by year. It rose steadily from 2003 to 2012, then dropped for a few years, bottoming out in 2016, then rose again. It dropped a bit again in 2020 and 2021, but it's not clear if that's an actual drop caused by, say, the retirement of older lawyers during the COVID-19 pandemic or by random variation in the small sample in the Bureau of Labor Statistics annual survey.

AGE 2021: LAWYERS COMPARED WITH ALL U.S. WORKERS



Going back several decades, the typical lawyer was younger than today. In 1980, the median age for all U.S. lawyers was 39. That's more than seven years younger than the median age of 46.5 in 2021.

MEDIAN AGE OF LAWYERS: 2003 - 2021



Source: U.S. Bureau of Labor Statistics

DEMOGRAPHICS

LEGAL DEMAND IN METRO AREAS

The demand for lawyers is high in Washington, D.C., and New York City. But did you know the demand is also high in Tallahassee and Miami, Florida, and Santa Fe, New Mexico? Those are the five metropolitan areas with the highest demand for legal services in the United States in 2021, according to the U.S. Bureau of Labor Statistics.

The bureau measures employment and wages for more than 800 occupations in more than 380 metropolitan areas. One thing the bureau measures is demand for each occupation in each metro area. It's called the "location quotient" – a single number that shows demand for an occupation in one area compared to the nation as a whole.*

For 2021 – as in all previous years – the Washington, D.C., area had the highest demand for lawyers of all metro areas. In fact, the location quotient for lawyers in the D.C. area was 3.12 – three times the national average. The demand for lawyers in the New York City area was 2.03 – double the national average.

Surprisingly, most of the other top 10 metro areas for lawyer demand in 2021 were not huge cities, but many were state capitals. They were, in order: Tallahassee (2.51), Miami (2.09), Santa Fe (1.95), Trenton, New Jersey (1.85), Charleston, West Virginia (1.85), Denver (1.60), Philadelphia (1.54) and San Francisco (1.53).

Many other state capitals have high demand for lawyers. For example, Albany, New York; Oklahoma City, Oklahoma; Cheyenne, Wyoming; Montgomery, Alabama; Hartford, Connecticut; and Sacramento, California; are all in the top 20 metro areas nationally for lawyer demand.

But not all state capitals have high location quotients for lawyers. Twelve state capitals are actually below the national average for lawyer demand, including such large cities as Phoenix, Arizona; Honolulu, Hawaii; Columbus, Ohio; and Nashville, Tennessee. ■

METROPOLITAN AREAS WITH THE HIGHEST DEMAND FOR LAWYERS

(Location Quotient)*

Washington, DC	3.12
Tallahassee, FL	2.51
Miami, FL	2.09
New York, NY	2.03
Santa Fe, NM	1.95
Trenton, NJ	1.85
Charleston, WV	1.85
Denver, CO	1.60
Philadelphia, PA	1.54
San Francisco, CA	1.53

METROPOLITAN AREAS WITH THE LOWEST DEMAND FOR LAWYERS

(Location Quotient)*

Hickory, NC	0.26
Abilene, TX	0.26
Lebanon, PA	0.26
Lima, OH	0.25
Leominster, MA	0.23
Niles, MI	0.23
Sheboygan, WI	0.23
Hot Springs, AR	0.20
Elkhart, IN	0.16
Morristown, TN	0.16

**The location quotient represents the ratio of an occupation's share of employment in a given area to that occupation's share of employment in the U.S. as a whole. For example, an occupation that makes up 10% of employment in a metro area compared with 2% of U.S. employment would have a location quotient of 5 for that area.*

Source: U.S. Bureau of Labor Statistics, Occupational Employment Statistics

WAGES

- Wage Trends over 20 Years
- Average Lawyer Wages by Metropolitan Area
- Public Service Lawyers









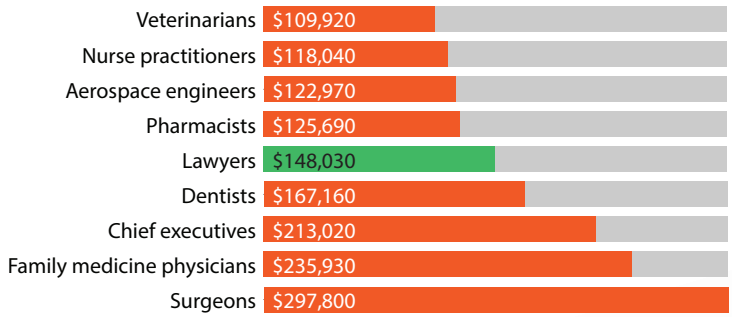
WAGES

WAGE TRENDS OVER 20 YEARS

For the first time in 20 years, the average wage for lawyers dipped in 2021, according to the U.S. Bureau of Labor Statistics. The average wage was $148,910 in 2020 and declined slightly to $148,030 in 2021 — a decrease of 0.6%, according to the BLS. Over the same period, inflation was 1.4%. (Note: BLS statistics cover wages for all lawyers but do not include profits for law firm partners and shareholders.)

Over the past 20 years, the average lawyer's salary has grown faster than inflation. From 2001 to 2021, the average lawyer's salary rose 61%. Over the same period, the inflation rate was 49%.

AVERAGE INDUSTRY WAGE BASED ON OCCUPATION: 2021

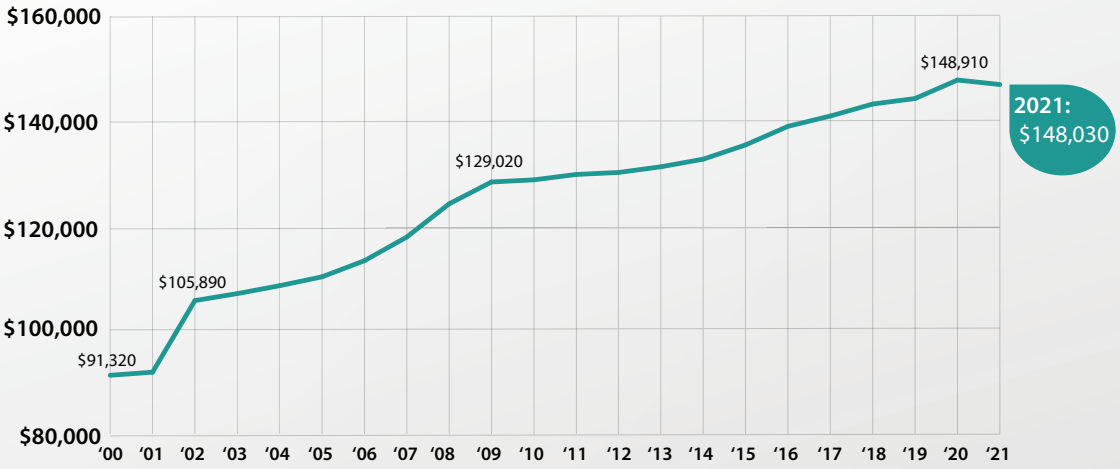


But in recent years, the increase in lawyers' wages has slowed. The fastest growth was from 1997-2002, when the average lawyer wage rose 45%. By comparison, in the most recent five-year period, the average wage rose 5.8% — from $139,880 in 2016 to $148,030 in 2021.

Lawyers who are paid wages continue to earn less, on average, than many medical professionals, according to the BLS. The average wage for family medicine physicians is $235,930. Closer to the average for lawyers are physicists at $151,580 and petroleum engineers at $145,720.

In related legal fields, the average wage for judges, magistrate judges and magistrates was $142,520 in 2021, according to the BLS. For paralegals and legal assistants, it was $58,330.

AVERAGE LAWYER WAGE: 2000 - 2021



Highest-paid job in 2021:
CARDIOLOGIST
average wage $353,970

Lowest-paid job in 2021:
SHAMPOOER
average wage $25,160

National average in 2021:
$58,260

Source: U.S. Bureau of Labor Statistics

WAGES

AVERAGE LAWYER WAGES BY METROPOLITAN AREA

The average wage for lawyers is highly dependent on geography — where the lawyer practices. Half of the 10 metropolitan statistical areas with the highest average wages for lawyers in 2021 were in California: San Jose, San Francisco, Los Angeles, San Diego and Oxnard, according to the U.S. Bureau of Labor Statistics.

At the other extreme, all five areas with the lowest average wages for lawyers are in Puerto Rico: Aguadilla, Mayaguez, Ponce, Arecibo and San Juan. In the Continental United States, four of the five areas with the lowest lawyer wages are in the Midwest and South: Pine Bluff, Arkansas; Enid, Oklahoma; Hammond, Louisiana; and Weirton, West Virginia.

The disparity between some areas is huge. The average lawyer wage in the highest-paid area (San Jose, California, at $231,200) is five times greater than the average wage in the lowest-paid area (Aguadilla, Puerto Rico, at $44,290).

FAST FACT:

Ten of the 20 highest-paid metro areas in the U.S. for lawyers are in California: San Jose, San Francisco, Los Angeles, San Diego, Oxnard, Napa, Santa Rosa, Sacramento, Vallejo and Santa Maria.

FAST FACT:

The lowest average lawyer salary in the continental U.S. is in Pine Bluff, Arkansas, at $75,030.

There is one surprise among the top 10 areas with highest lawyer wages: Midland, Michigan, near Saginaw, is No. 9 at $164,430. The BLS lists only 110 lawyers in the Midland area, so it's possible the numbers are skewed by a few high earners.

Where's the midpoint among all 384 metropolitan areas measured by the BLS? That's Santa Fe, New Mexico, at $115,640 and Bend, Oregon, at $115,580.

Source: U.S. Bureau of Labor Statistics

WAGES

AVERAGE LAWYER WAGES BY METROPOLITAN AREA

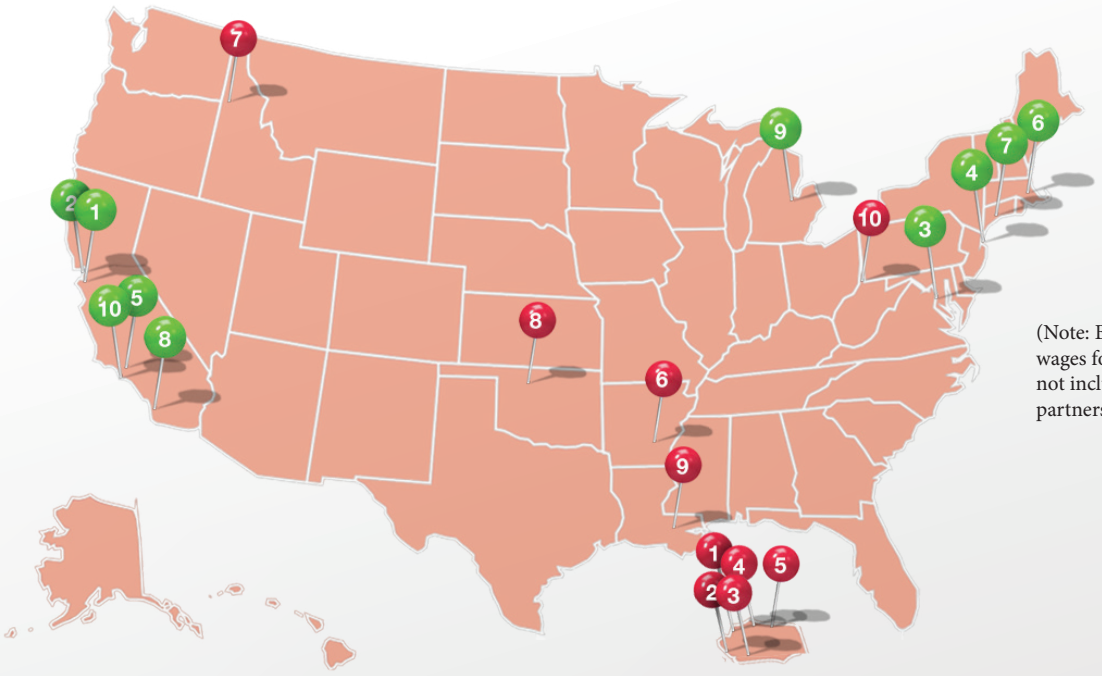
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METROPOLITAN AREAS WITH HIGHEST AVERAGE WAGE FOR LAWYERS

1. San Jose, CA	*$231,200*
2. San Francisco, CA	*$191,460*
3. Washington, DC	*$186,610*
4. New York, NY	*$183,870*
5. Los Angeles, CA	*$177,550*
6. Boston, MA	*$171,660*
7. Bridgeport, CT	*$171,100*
8. San Diego, CA	*$165,480*
9. Midland, MI	*$164,430*
10. Oxnard, CA	*$163,560*

METROPOLITAN AREAS WITH LOWEST AVERAGE WAGE FOR LAWYERS

10. Weirton, WV	*$84,380*
9. Hammond, LA	*$84.350*
8. Enid, OK	*$83,730*
7. Lewiston, ID	*$82,830*
6. Pine Bluff, AR	*$75,030*
5. San Juan, PR	*$68,450*
4. Arecibo, PR	*$55,170*
3. Ponce, PR	*$52,540*
2. Mayaguez, PR	*$52,400*
1. Aguadilla, PR	*$44,290*



(Note: BLS statistics cover wages for all lawyers but do not include profits for law firm partners and shareholders.)

Source: U.S. Bureau of Labor Statistics

WAGES

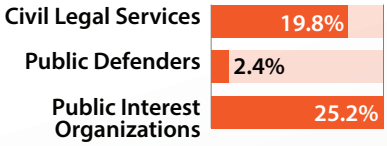
PUBLIC SERVICE LAWYERS

Entry-level pay for lawyers at nonprofits and legal aid offices rose more than inflation during the past four years, from 2018 to 2022, according to the National Association for Law Placement. But entry-level pay for public defenders remained nearly stagnant.

According to the NALP, the median entry-level salary for public service lawyers in 2022 was:

- $63,200 for lawyers at public interest organizations
- $59,700 for public defenders
- $57,500 for lawyers at civil legal services offices

MEDIAN SALARY INCREASES FOR ENTRY-LEVEL PUBLIC SERVICE LAWYERS: 2018 - 2022



That's much less than the entry-level salary at some big law firms in major cities: $215,000 in 2022. In fact, even highly experienced public service lawyers – those with 11 to 15 years in the job – earn less than half of that $215,000 for rookie lawyers at big law firms.

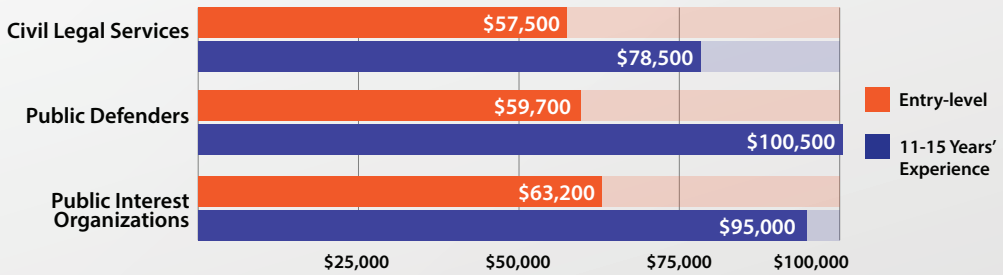
The 2022 survey shows that experienced public defenders are paid more than experienced legal aid lawyers and nonprofit lawyers. Public defenders with 11 to 15 years' experience earned a median salary of $100,500 in 2022. For nonprofit lawyers with similar experience, it was $95,000. And for legal aid lawyers with the same experience, it was $78,500.

For comparison purposes, the average salary for all lawyers – not counting law firm profit sharing – was $148,030 in 2021, according to the U.S. Bureau of Labor Statistics.

Starting pay for nonprofit lawyers rose 25.2% from 2018 to 2022, according to the NALP. That's nearly double the inflation rate of 13% over the same period. Starting pay for legal aid lawyers rose 19.8% over those four years, but starting pay for public defenders barely budged, rising just 2.4%.

The NALP Public Service Attorney Salary Survey is conducted every four years and usually includes pay data for prosecutors, but the 2022 report does not. The 2022 survey did not receive enough responses from prosecutors' offices to provide a nationally representative sample.

MEDIAN SALARIES FOR PUBLIC SERVICE LAWYERS: 2022



Source: National Association for Law Placement 2022 Public Service Attorney Salary Survey

LEGAL EDUCATION

- Law School Applicants and Enrollees
- Why Law School?
- Law School Demographics
- Employment after Graduation
- Bar Passage Rates
- Bar Passage Rates - Race, Ethnicity and Gender
- Law School Debt









LEGAL EDUCATION

LAW SCHOOL APPLICANTS AND ENROLLEES

For the fourth straight year, enrollment was up in 2021 at U.S. law schools accredited by the American Bar Association. That was a rebound after seven years of declining enrollment from 2010 to 2017.

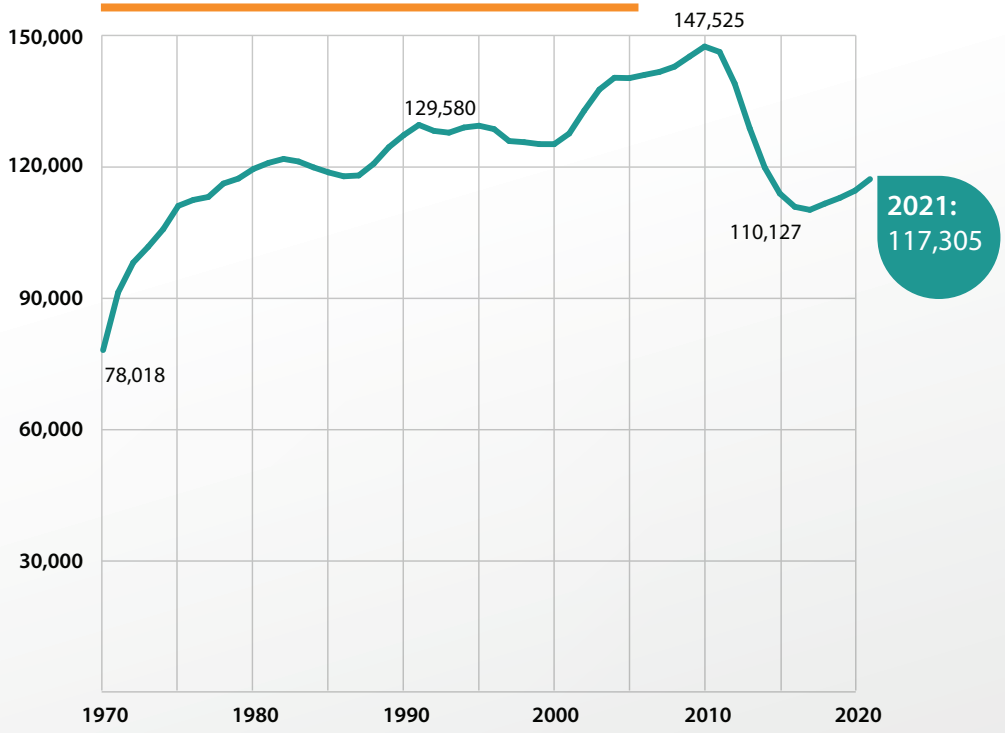
FAST FACT:

The average law school applicant applies to nearly seven law schools – 6.8 per student, to be exact.

The number of students pursuing juris doctor degrees hit 117,305 in 2021 – the highest number since 2014. That was an increase of 2,981 students (or 2.4%) over the previous year. Still, it was far below the peak of 147,525 enrolled law school students in 2010.

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LAW SCHOOL ENROLLMENT: 1970 - 2021*



** Enrollment for 1970-2013 includes all students, but for 2014 to present only JD students*

Source: ABA Section of Legal Education and Admissions to the Bar / Law School Admission Council

LEGAL EDUCATION

LAW SCHOOL APPLICANTS AND ENROLLEES

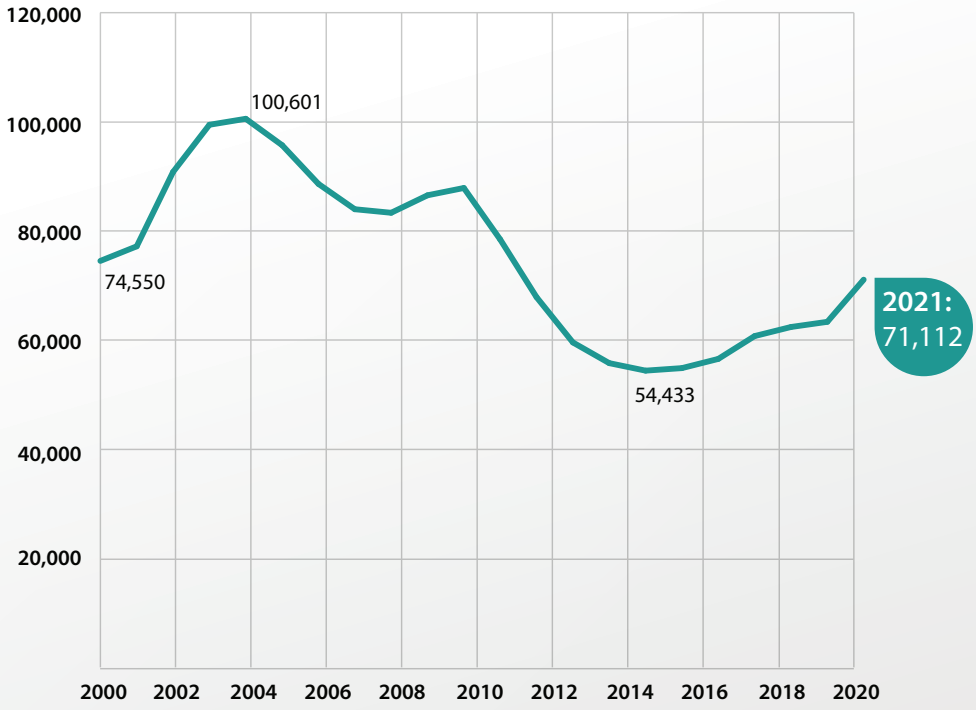
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An additional 21,044 students were in non-JD programs in U.S. law schools, pursuing master of law degrees and other degrees, as well as certificates. Participation in these non-JD programs has boomed in recent years, increasing 76% from 2014, when there were 11,973 students.

Applications to law schools rose significantly in 2021, with 71,112 students applying to law schools – an increase of 12% from 2020, according to the Law School Admission Council. Even so, the number of applicants was still far below the peak year of 2004, when more than 100,000 people applied to ABA-accredited law schools.

Roughly two-thirds (68.3%) of all applicants were accepted to at least one law school. The acceptance rate declined slightly in the past year, from 69.6% in 2020.

LAW SCHOOL APPLICANTS: 2000 - 2021



Source: ABA Section of Legal Education and Admissions to the Bar / Law School Admission Council

LEGAL EDUCATION

WHY LAW SCHOOL?

More students pursue law degrees because of their interest in public service than for high salaries, according to a 2018 national survey, "Before the JD," conducted by the Association of American Law Schools and co-sponsored by the ABA Section on Legal Education and Admissions to the Bar.

The survey evaluated responses from 22,189 undergraduates at 25 four-year institutions and from 2,727 first-year law students at 44 law schools.

The most commonly cited reasons for attending law school were as a path to careers in politics, government or public service (44%); a passion for that type of work (42%); an opportunity to be helpful (35%), and to advocate for social change (32%). About 1 in 3 students (31%) said they were motivated by access to high-paying jobs.

Most students did not enter law school immediately after college. Two-thirds (65%) delayed law school for a year or more, compared to 1 in 3 (35%) who enrolled directly after college. Of those who postponed law school, just over half (53%) waited three years or more after getting their undergraduate degree.

More than half (55%) of the law students reported that they first considered going to law school before their first year of college. Roughly one-third (35%) first considered pursuing law school before high school.

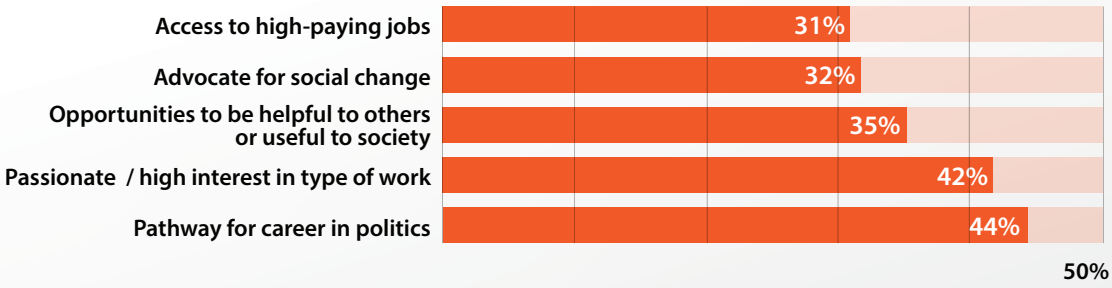
WHEN DID STUDENTS ENROLL IN LAW SCHOOL?

- **35%** Immediately after undergraduate degree
- **65%** Took time off after undergraduate degree

FOR STUDENTS WHO DELAYED LAW SCHOOL, HOW MANY YEARS?

- **25%** 1 year or less
- **21%** 2 years
- **53%** 3 years or more

WHY DO UNDERGRADUATES ASPIRE TO GO TO LAW SCHOOL?



FAST FACT:

Students with higher LSAT scores were more likely to delay law school (74%) than students with lower scores (58%).

FAST FACT:

Asian and Black students were more likely to delay law school (73% and 71%) than Hispanic and white students (69% and 64%).

Source: Association of American Law Schools "Before the JD" report

LEGAL EDUCATION

LAW SCHOOL DEMOGRAPHICS

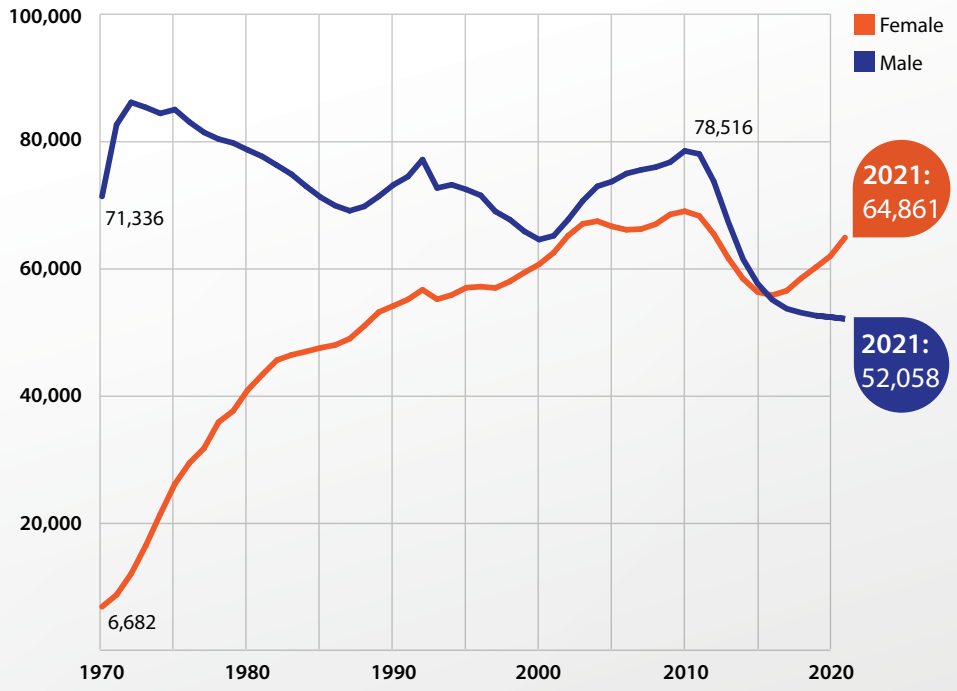
Most students at ABA-accredited law schools in 2021 were women – and the gap between the number of men and women law students grew wider for the fifth straight year.

For decades, law school students were overwhelmingly white and male, but the gender gap began to narrow markedly after 1970. That year, 91% of all law students were men. The gap came close to vanishing in 2001 and 2002, when women were 49% of all law students, but then widened again.

In 2014, for the first time, there were more first-year female students than male students. Two years later, in 2016, women made up a majority of all law students at ABA-accredited schools for the first time. That year, 50.3% of all students pursuing JD degrees were female.

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LAW SCHOOL ENROLLMENT BY GENDER: 1970 - 2021



Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

LAW SCHOOL DEMOGRAPHICS

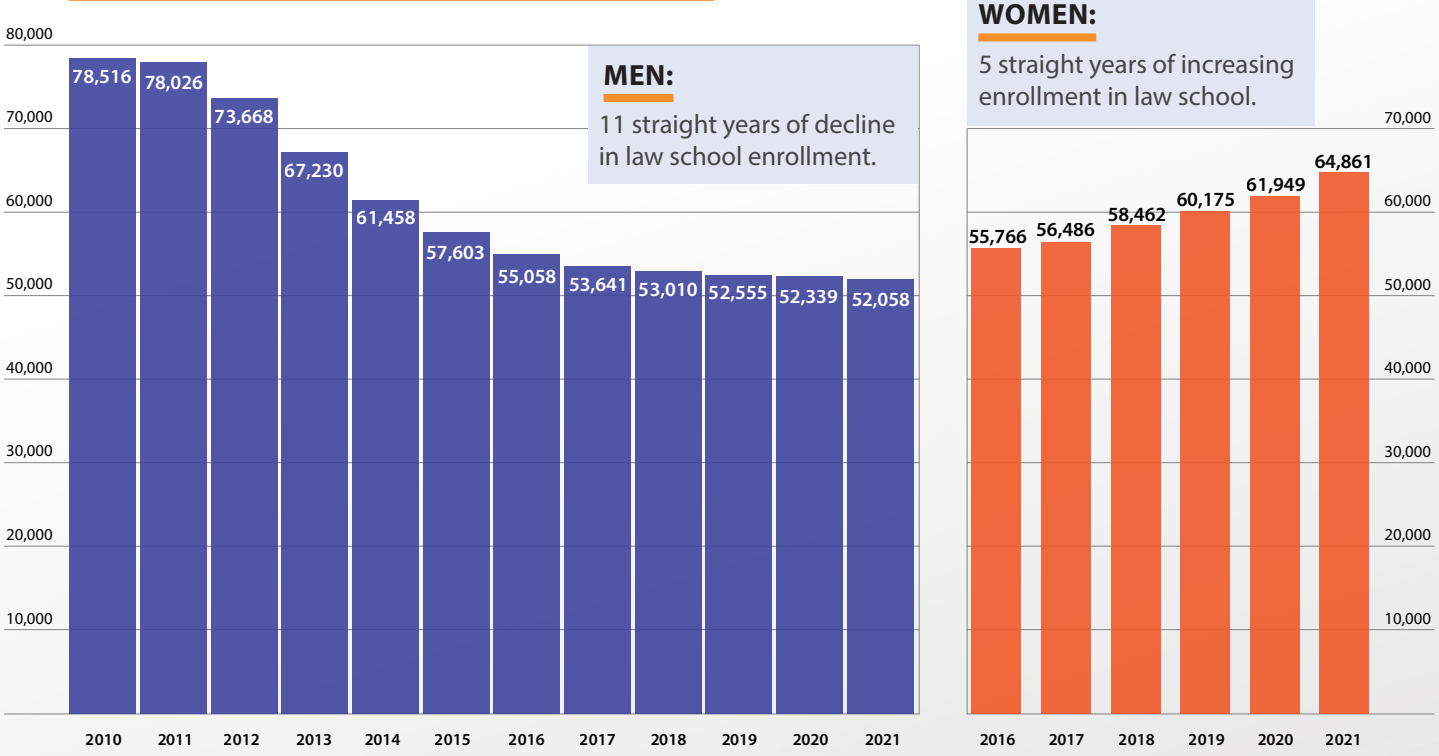
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In 2021, 55.3% of all students at ABA-accredited law schools were women. In raw numbers, for the 2021-22 academic year, there were 12,803 more women JD students than men – 64,861 women and 52,058 men. An additional 378 students said they were neither male nor female.

In fact, men are increasingly turning away from law schools while women are increasingly drawn to them. The number of men in ABA-accredited law schools has declined every year in the past 11 years -- from 78,516 in 2010 to 52,058 in 2021. Meanwhile, the number of women has increased each of the past five years – from 55,766 in 2016 to 64,861 in 2021.

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RECENT LAW SCHOOL ENROLLMENT BY GENDER



Source: ABA Section of Legal Education and Admissions to the Bar

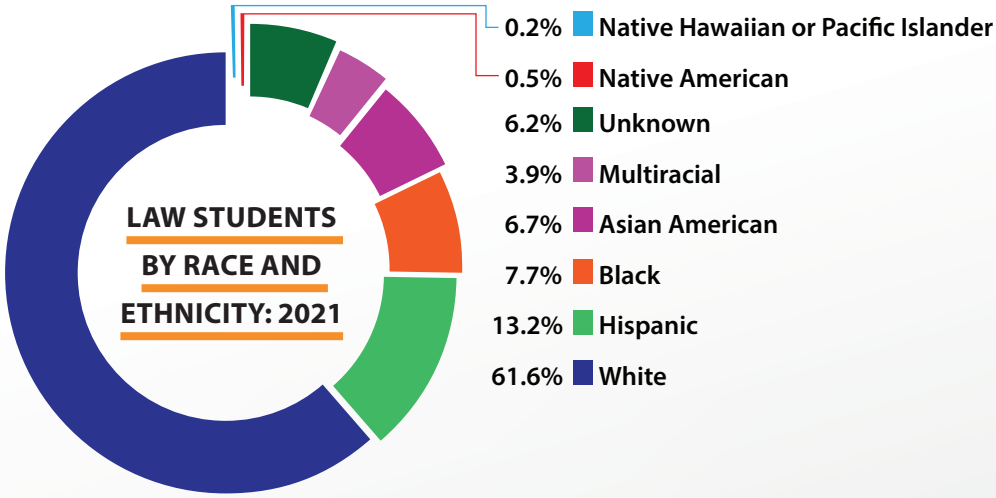
LEGAL EDUCATION

LAW SCHOOL DEMOGRAPHICS

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Meanwhile, law school classes have become gradually more diverse by race and ethnicity. In 2011, 25% of all law students were students of color. A decade later, in 2021, roughly one-third of all students pursuing a JD degree (32%) were students of color.

The demographic change is more dramatic when considering first-year law students over the past four decades. Back in 1978, students of color occupied just 9% of first-year law school seats. In 2021, that number was three times larger: 33%. Among all 1L's in 2021, 13% were Hispanic, 8% Black, 7% Asian American, 4% multiracial. An additional 7% were classified as race unknown or other.



Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

DEMOGRAPHICS FOR INDIVIDUAL LAW SCHOOLS

Highest ratio of **WOMEN TO MEN:** **72%** **FEMALE**



NORTHEASTERN

Highest ratio of **MEN TO WOMEN:** **58%** **MALE**



NEW HAMPSHIRE



Number of law schools where **WOMEN OUTNUMBER MEN 2-TO-1:** **5**

Northeastern, Howard, North Carolina Central, Florida A&M, American



Law schools* with the **HIGHEST PERCENTAGE OF STUDENTS OF COLOR:**

Howard 96%
Texas Southern 89%
St. Thomas of Florida 79%

Law schools with the **SMALLEST PERCENTAGE OF STUDENTS OF COLOR:**

Drake 11%
Nebraska 11%
West Virginia 9%

** outside Puerto Rico*

Law students in 2021 identified as **NEITHER MALE NOR FEMALE:**

378

The largest number (24) were at Columbia.

Number of law schools where **women outnumber men:** **162**

Number of law schools where **men outnumber women:** **33**

Number of law schools exactly **50-50 male-female:** **1**

MARQUETTE UNIVERSITY LAW SCHOOL

Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

EMPLOYMENT AFTER GRADUATION

Unemployment among new law school graduates fell to the lowest level in at least a decade in 2021, according to data compiled by the ABA Section of Legal Education and Admissions to the Bar.

For the law school Class of 2021, unemployment 10 months after graduation dropped three percentage points to 5.3%. A year earlier, unemployment 10 months after graduation for the Class of 2020 stood at 8.3%.

Also for the first time in at least a decade, more than half of all new law school graduates were working at law firms 10 months after graduation. That number has been climbing steadily over the past 10 years. For the Class of 2012, it was 39.3%. For the Class of 2021, it was 50.6%.

FAST FACT:

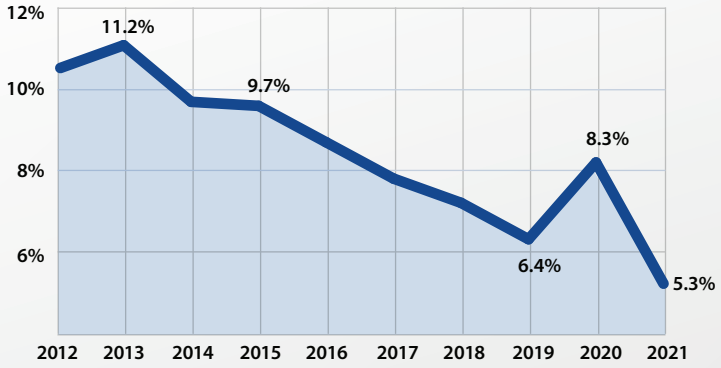
Three-quarters of new lawyers got jobs requiring bar passage within 10 months of graduation in 2021: 75.6%.

On the other hand, the number of new law graduates getting jobs in the business sector has been falling. For the Class of 2014, more than 15% worked in businesses 10 months after graduation. For the Class of 2021, it was 10%.

In almost every other sector, the numbers held roughly steady. For example, 1 in 10 graduates from the Class of 2021 (10.4%) took government jobs – up slightly from 10.2% a year earlier. It was nearly the same (10%) a decade ago.

For several years, judicial clerkships grew more popular as first jobs out of law school, but that number declined for the Class of 2020 and remained lower for the Class of 2021. Nearly 1 out of 10 graduates in the Class of 2021 (9.6%) took a clerkship after graduation.

LAW SCHOOL GRADUATES UNEMPLOYED 10 MONTHS AFTER GRADUATION: CLASS OF 2012-2021



Meanwhile, the number of graduates who went into solo practice straight out of law school continued to decline. Less than 1% of all 2021 grads (0.7%) took the solo route. A decade ago, 2.3% of the Class of 2012 practiced solo – a small number but triple the current rate.

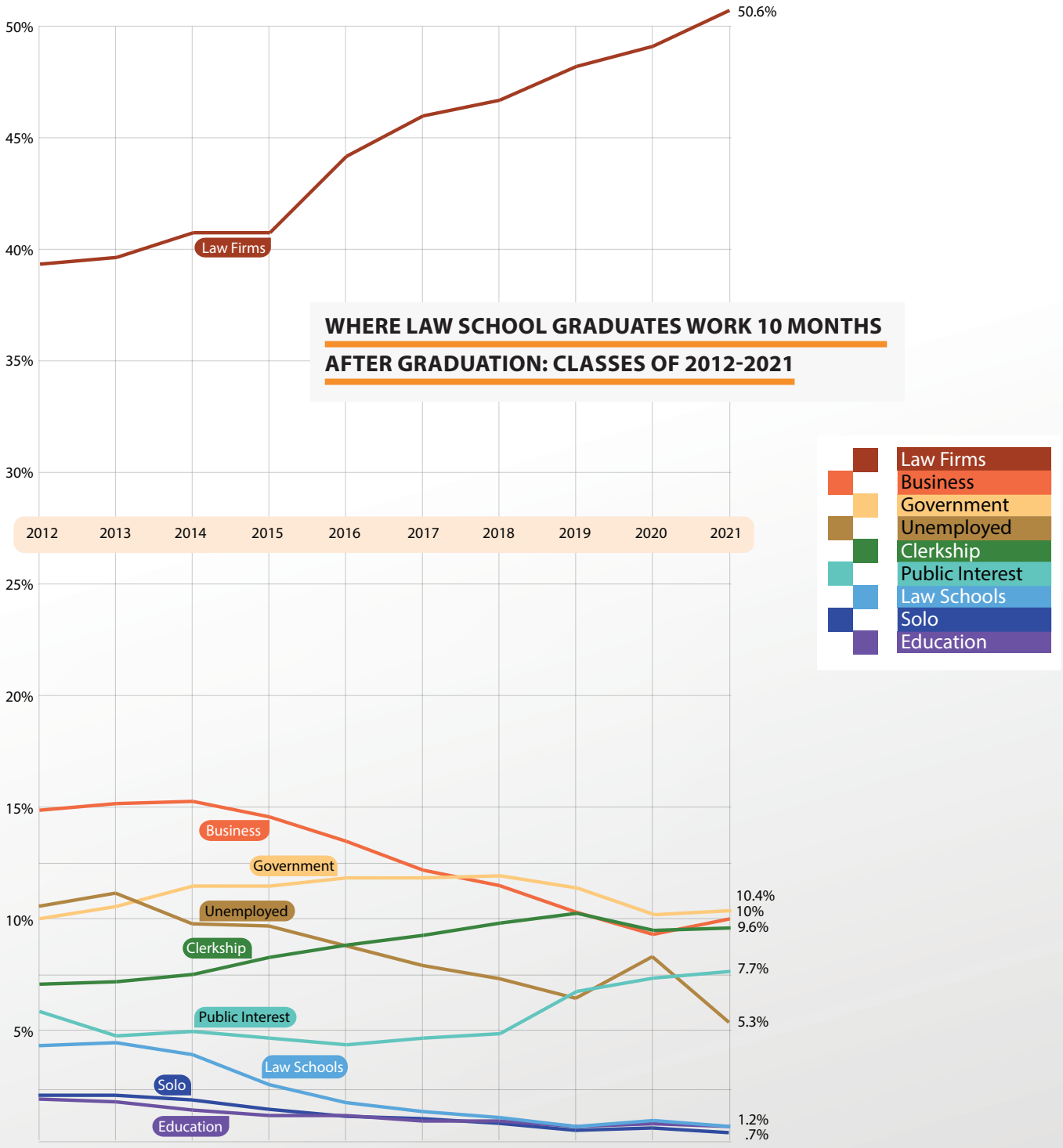
Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

EMPLOYMENT AFTER GRADUATION

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WHERE LAW SCHOOL GRADUATES WORK 10 MONTHS AFTER GRADUATION: CLASSES OF 2012-2021



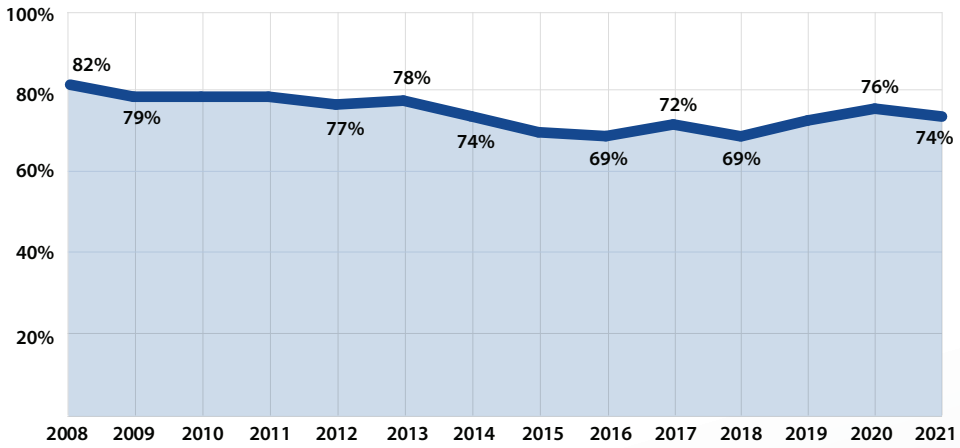
Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

BAR PASSAGE RATES

The bar exam passage rate dipped slightly in 2021, after two straight rising years, according to the National Conference of Bar Examiners, which develops the test and collects data from the states.

FIRST-TIME BAR PASSAGE RATES: 2008 - 2021

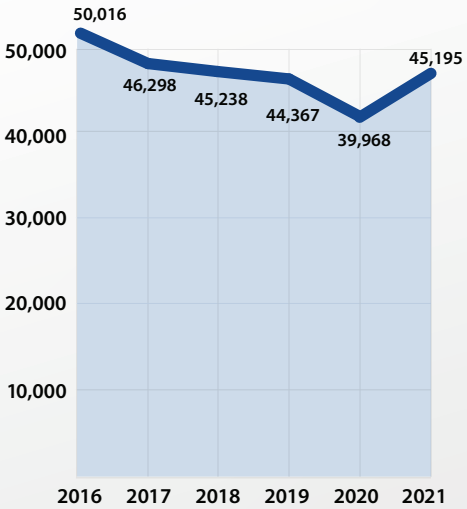


Among first-time test-takers, nearly 3 out of 4 (74%) passed the bar exam in 2021. That's the highest passage rate since 2014, except for 2020, when 76% passed the exam. The highest passage rate in recent years was 82% in 2008. The lowest was 69% in 2016 and 2018.

The number of people taking the exam for the first time rebounded in 2021, to the highest level in three years. First-time test-takers rose 13% in 2021 to 45,195, after dropping nearly 10% in 2020, most likely because of the COVID-19 epidemic.

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NUMBER OF PEOPLE TAKING THE BAR EXAM FOR THE FIRST TIME: 2016 - 2021



FAST FACT:

The vast majority of test-takers in 2021 (85%) went to ABA-accredited law schools.

FAST FACT:

Forty-eight people who took the bar exam in 2021 skipped law school and studied at law offices, which is allowed in a few states. Nearly half (23) were from Washington state. Nationwide, just 40% of those who studied in law offices passed the exam. (California did not report data in this category.)

Source: National Conference of Bar Examiners

LEGAL EDUCATION

BAR PASSAGE RATES

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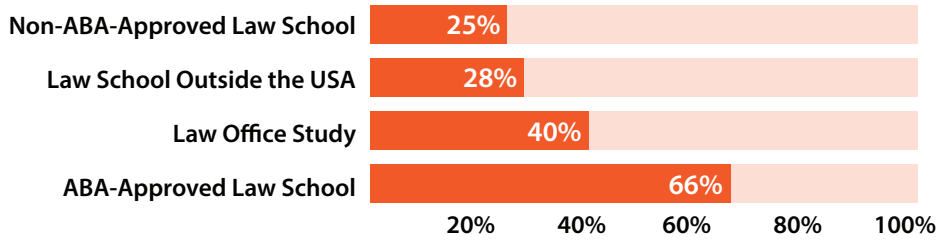
As usual, there was a significant difference in passage rates between first-time test-takers and repeat test-takers in 2021. Among first-timers, 74% passed the bar exam. Among repeaters, only 28% passed. There were more than twice as many first-time test-takers as repeaters in 2021 (45,195 versus 19,638).

BAR PASSAGE RATES FOR FIRST-TIME TEST-TAKERS AND REPEATERS: 2021



Passage rates also varied widely based on where test-takers learned the law. The passage rate for all test-takers from ABA-accredited schools — both first-timers and repeaters — was 66% in 2021. Just 25% of students who attended non-accredited law schools passed the bar.

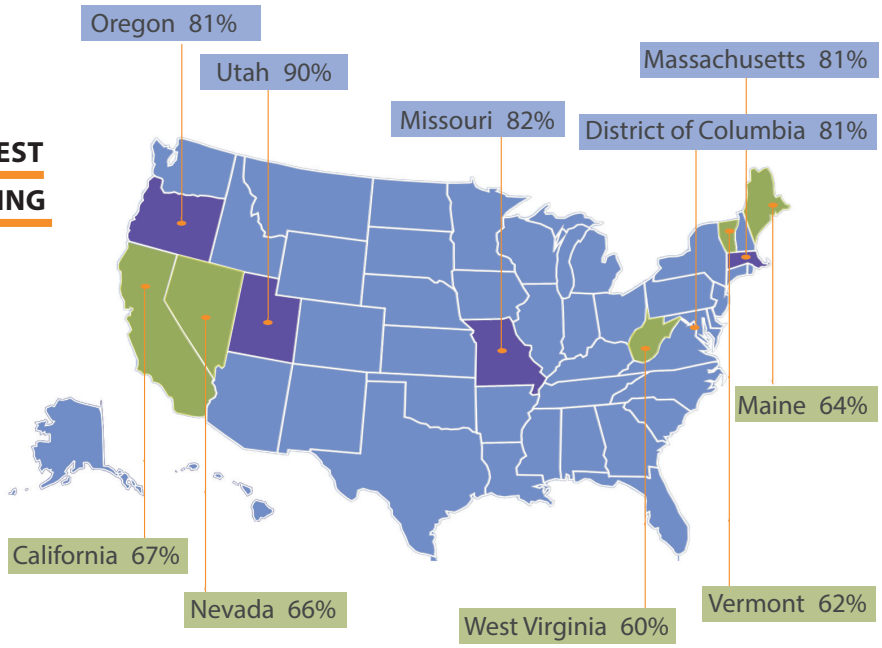
BAR PASSAGE RATES BY TYPE OF LEGAL EDUCATION: 2021



There was also a significant difference in passage rates among the 50 states. In 2021, Utah had the highest passage rate among first-time test-takers at 90%. West Virginia had the lowest passage rate at 60%.

State size doesn't seem to have any relation to passage rate. New York, with nearly 8,000 first-time bar exam takers, the most in the country, had a passage rate of 76% — slightly higher than the national 74% rate. But California, second in the nation with more than 6,000 first-time test-takers, had one of the lowest passage rates at 67%.

STATES WITH HIGHEST AND LOWEST PASSING RATES: 2021



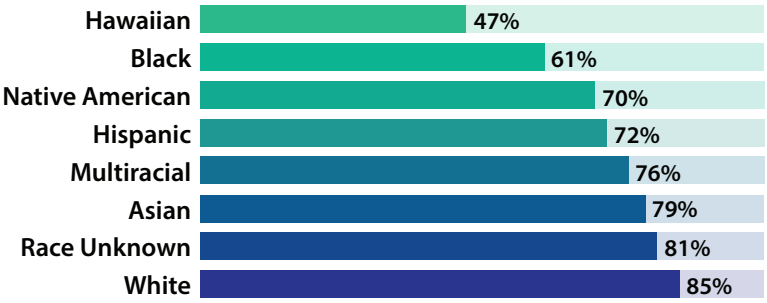
Source: National Conference of Bar Examiners

LEGAL EDUCATION

BAR PASSAGE RATES – RACE, ETHNICITY AND GENDER

To comply with ABA standards, a law school must show that three-quarters of its graduating class passes the bar exam within two years. In the most recent study, white test-takers in 2021 were more likely to pass than test-takers of other races and ethnicities, according to the ABA Section of Legal Education and Admissions to the Bar.

2021 BAR PASSAGE RATES BY RACE AND ETHNICITY FOR FIRST-TIME TEST-TAKERS



Among white graduates taking the exam for the first time, 85% passed in 2021. By comparison, 61% of Black first-time test-takers passed, 72% of Hispanics, 70% of Native Americans and 79% of Asians. Among all first-time test-takers of color, the passage rate was 71%.

The gap narrows over time. For the Class of 2019, 94% of white test-takers ultimately passed the exam within two years of graduation, as did 81% of Blacks, 87% of Hispanics, 89% of Asians and 89% of Native Americans.

There was a small difference in bar passage rates between men and women in 2021: 82% of men passed the exam on the first try, as did 79% of women.

ULTIMATE BAR PASSAGE RATE BY RACE AND ETHNICITY: CLASS OF 2019



BAR EXAM PASSAGE RATE FIRST-TIME TEST-TAKERS OF COLOR: 2021

BLACK, HISPANIC, ASIAN, NATIVE AMERICAN, HAWAIIAN AND MULTIRACIAL

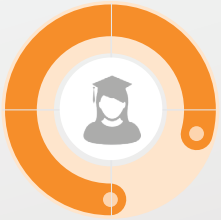
70.9%



BAR EXAM PASSAGE RATE BY GENDER: 2021 FIRST-TIME TEST-TAKERS



82.1%
MALE



79.2%
FEMALE

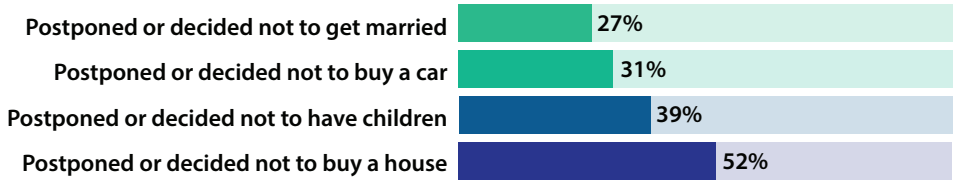
Source: ABA Section of Legal Education and Admissions to the Bar

LEGAL EDUCATION

LAW SCHOOL DEBT

Many new lawyers postpone major life decisions like marriage, having children and buying houses, or reject them outright, because they carry huge student loan debts. Those debts make many young lawyers anxious, depressed and regretful.

HOW LAW SCHOOL DEBT AFFECTED MAJOR LIFE DECISIONS



Those are the conclusions of a 2021 survey by the ABA Young Lawyers Division and AccessLex. The survey of more than 1,300 new lawyers – most in their 20s and 30s – showed that student loan debt forces the newest generation of lawyers to make major financial, personal and career sacrifices.

Nearly all law school graduates are affected. More than 90% of the lawyers surveyed took out law school loans. Their average total education debt upon graduation – money owed from law school, undergraduate school and other education expenses – was $120,000.

For many young lawyers, student debt actually increases over time. More than a quarter (27%) said they have more debt now than when they graduated from law school. The median current debt at the time of the survey was $100,000.

Participants said heavy student loan debt affected virtually every aspect of their lives, including:

Having children: More than one-third (39%) said they postponed or decided not to have children because of their debts. That was especially true for Asian lawyers (48%) and white lawyers (42%).

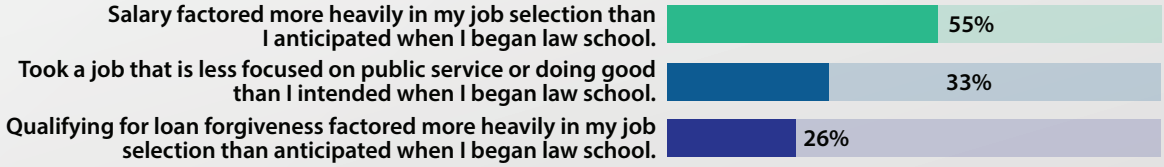
Getting married: More than 1 in 4 (27%) said they postponed or decided not to get married because of their debts. That was especially true for white and Asian lawyers (both 39%).

Housing: More than half (52%) said they postponed or decided not to buy a house because of their debts. That was especially true for Asian lawyers (64%) and Black lawyers (60%).

Transportation: Nearly one-third (31%) said they postponed or decided not to buy a car because of their debt. That was especially true for Hispanic lawyers (35%).

Career: More than half (55%) said salary factored more heavily in their job selection than they anticipated when they began law school. One-third (33%) said they took a job that is less focused on public service or doing good than they intended when they began law school because of debt.

HOW LAW SCHOOL DEBT AFFECTED CAREER DECISIONS



Source: ABA Young Lawyers Division and AccessLex, 2021 Student Loan Debt Survey

LEGAL EDUCATION

LAW SCHOOL DEBT

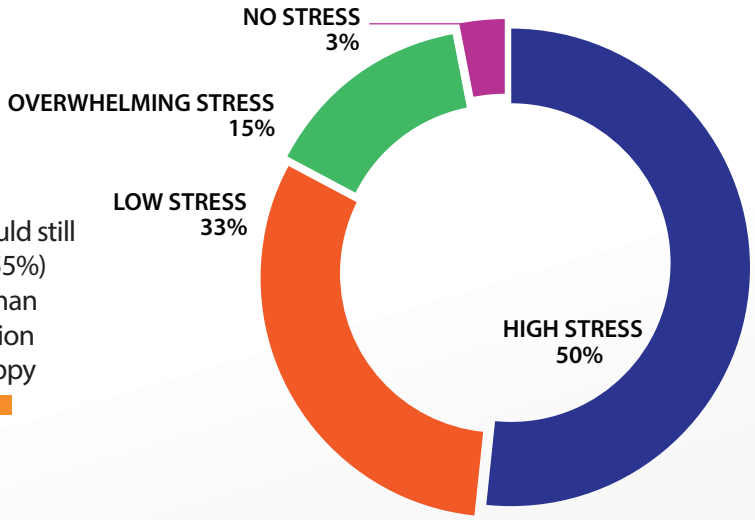
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The survey also found that student loan debt is hurting the mental health of young lawyers. Among the survey's findings:

- Nearly two-thirds (65%) said student loan debts made them feel anxious or stressed in the last month.
- More than half (53%) felt regretful or guilty.
- Nearly half (44%) felt depressed or hopeless.
- Nearly two-thirds (65%) said they felt overwhelming or high stress about their personal finances in general.

In spite of the findings, a strong majority (61%) said they would still get a J.D. degree knowing what they know now, and most (55%) said they would attend the same law school. However, less than half (47%) agreed with the statement "My law school education was worth the cost." And only 1 in 5 (22%) said they were happy with the loan counseling they received before graduation .

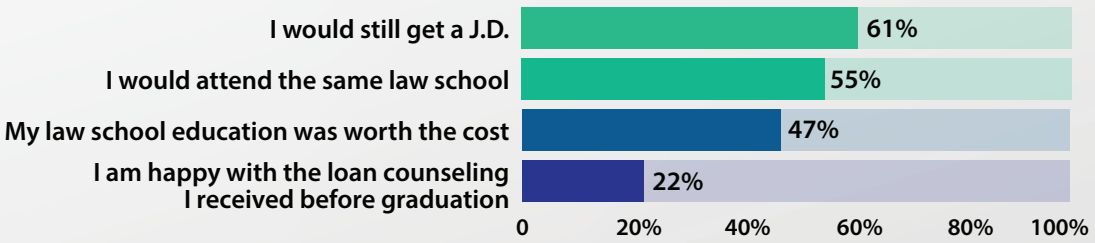
HOW STRESSED DO YOU FEEL ABOUT YOUR PERSONAL FINANCES IN GENERAL?



IN THE LAST MONTH, MY STUDENT LOAN DEBT HAS CAUSED ME TO FEEL:



KNOWING WHAT I KNOW NOW ABOUT DEBT, LAW SCHOOL AND THE LEGAL PROFESSION:



Source: ABA Young Lawyers Division and AccessLex, 2021 Student Loan Debt Survey

PRO BONO

- Hours Worked
- Type of Help
- Top States
- ABA Free Legal Answers
- Law Students





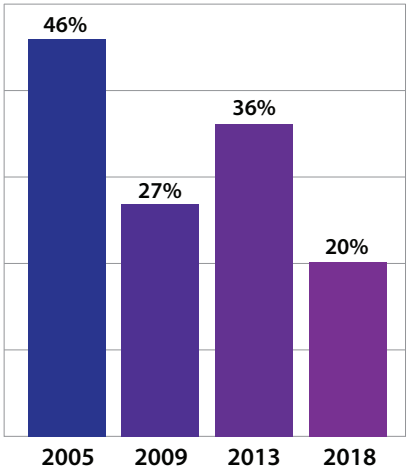




PRO BONO

HOURS WORKED

MET THE 50-HOUR ASPIRATIONAL GOAL



More than half of all American lawyers perform free pro bono services for clients who cannot afford to hire an attorney, according to a nationwide ABA survey released in 2018.

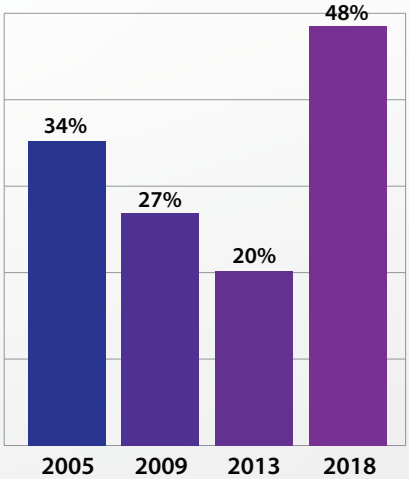
The survey of 47,000 lawyers in 24 states revealed that 52% provided pro bono services in the previous year, with the average lawyer working 37 hours. Some lawyers provide much more pro bono work. According to the survey, 9% provided 50 to 79 hours of pro bono work, and 11% provided more than 80 hours.

The ABA recommends that all lawyers perform at least 50 hours a year of pro bono services "to those unable to pay." Approximately 20% of all lawyers meet this aspirational goal, according to the survey. This is down from 36% in the last survey, released in 2013.

The survey shows that 48% of lawyers did no pro bono work in the previous year, and 19% said they have never done pro bono work.

The average hours worked fluctuates year by year, with no apparent trend. It was 39 hours in 2005, 41 hours in 2009, 56 hours in 2013 and 37 hours in 2018. Older lawyers – age 70 to 74 – perform the most hours (58 per year). Solo practitioners and lawyers from large firms and very large firms provide the most pro bono hours (45 hours, 48 hours and 73 hours, respectively).

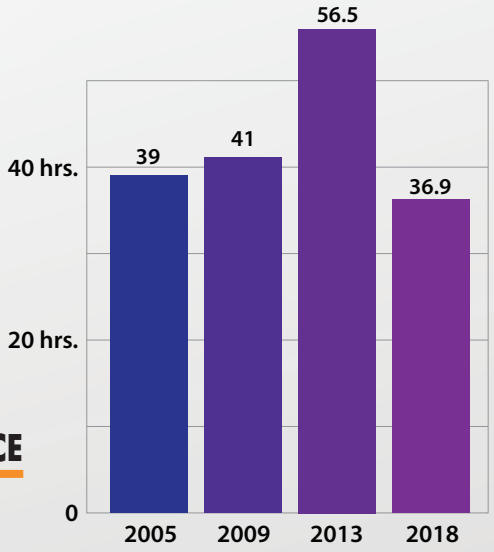
NO PRO BONO WORK IN THE PAST YEAR



FAST FACTS:

- Lawyers generally do more pro bono work later in life. On average, lawyers in their 60s did 41 to 42 hours of pro bono work per year.
- 81% of attorneys believe pro bono work is somewhat or very important.

AVERAGE HOURS OF PRO BONO SERVICE

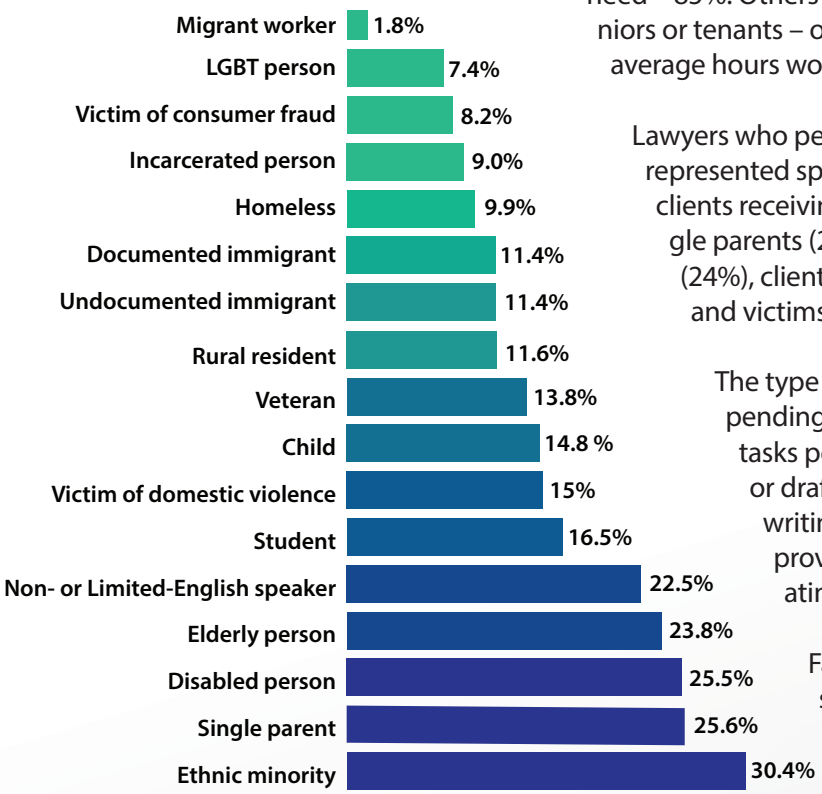


Source: "Supporting Justice: A Report on the Pro Bono Work of America's Lawyers," ABA Standing Committee on Pro Bono & Public Service, 2018, 2013, 2008 and 2004.

PRO BONO

TYPE OF HELP

PROFILE OF PRO BONO CLIENTS



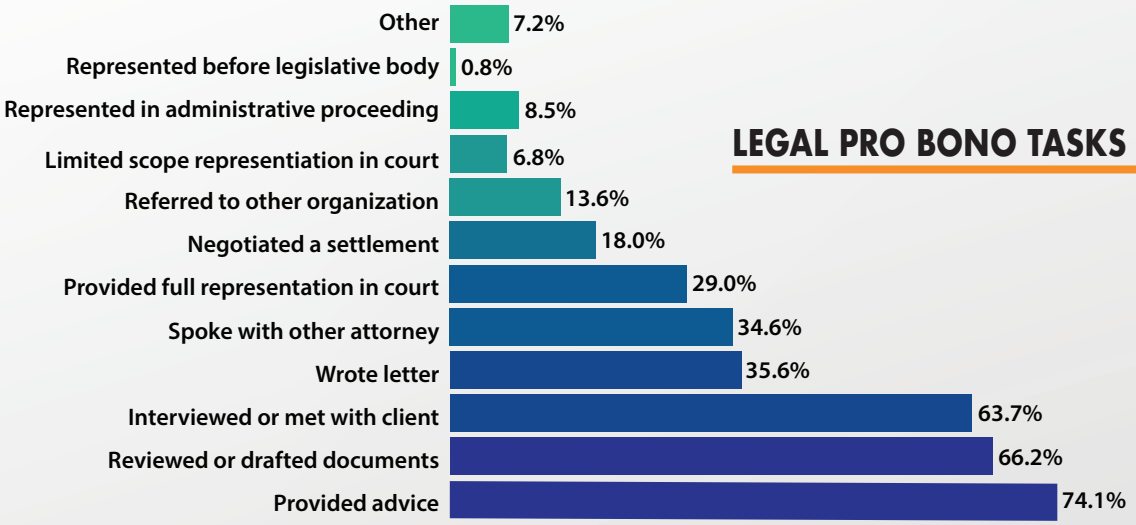
Most lawyers who provide pro bono services do so for individuals in need – 85%. Others help classes of individuals – such as a group of seniors or tenants – or organizations. For those who help individuals, the average hours worked were relatively high – 57 hours a year.

Lawyers who performed pro bono work were asked if they had represented specific types of vulnerable clients. The most common clients receiving pro bono help were ethnic minorities (30%), single parents (26%), disabled individuals (26%), elderly individuals (24%), clients with limited English abilities (23%), students (17%) and victims of domestic violence (15%).

The type of pro bono legal work performed varies widely, depending on the client and type of case. The most common tasks performed were providing advice (74%), reviewing or drafting documents (66%), interviewing clients (64%), writing letters (36%), working with other attorneys (35%), providing full representation in court (29%) and negotiating a settlement with other parties (18%).

Family law was the most common legal area of service for pro bono services, followed by criminal law, litigation, estate planning or probate, immigration and real estate law. Most lawyers tend to accept pro bono cases in their areas of expertise.

LEGAL PRO BONO TASKS PERFORMED



Source: "Supporting Justice: A Report on the Pro Bono Work of America's Lawyers," ABA Standing Committee on Pro Bono & Public Service, 2018, 2013, 2008 and 2004.

PRO BONO

TOP STATES

In the 24 states where lawyers were surveyed about their pro bono work, results in several states were notable.

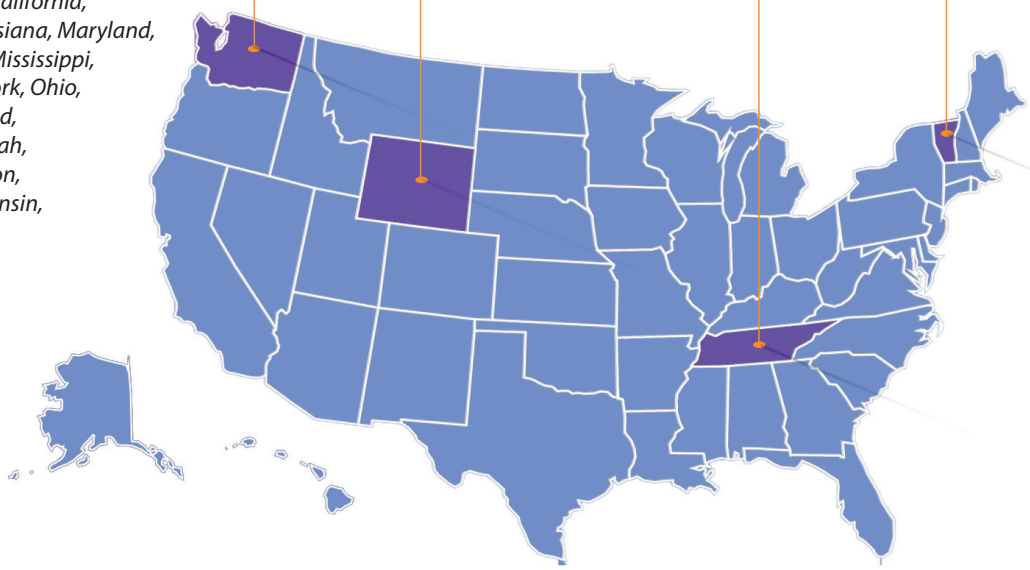
Washington state:
An average of 57 hours of pro bono service per lawyer for all lawyers – the highest among all states surveyed. Two-thirds of all lawyers in Washington (68%) reported doing at least some pro bono work. Among those, the average amount of pro bono work performed was 77 hours. Washington also had the lowest percentage of lawyers who have never performed pro bono work – 10%.

Tennessee:
Lawyers reported working an average of 53 hours of pro bono service – the second-highest among the states surveyed. Tennessee was tops among states in percentage of lawyers who provided more than 80 hours of pro bono service – 20%.

Vermont:
Three-quarters of all lawyers (78%) reported providing some type of public service – the highest among all the states surveyed.

Wyoming:
Lawyers reported working an average of 49 hours of pro bono service – the third-highest among the states surveyed.

The 24 states surveyed in the "Supporting Justice" pro bono 2018 report are Alabama, Arkansas, Arizona, California, Illinois, Kansas, Louisiana, Maryland, Maine, Minnesota, Mississippi, New Mexico, New York, Ohio, Oregon, Rhode Island, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, Wyoming.



Source: "Supporting Justice: A Report on the Pro Bono Work of America's Lawyers," ABA Standing Committee on Pro Bono & Public Service, 2018, 2013, 2008 and 2004.

PRO BONO

ABA FREE LEGAL ANSWERS

During the COVID-19 pandemic, ABA Free Legal Answers has experienced a big jump in the number of questions posed by people with legal problems, along with a dramatic increase in the number of lawyers volunteering to answer those questions.

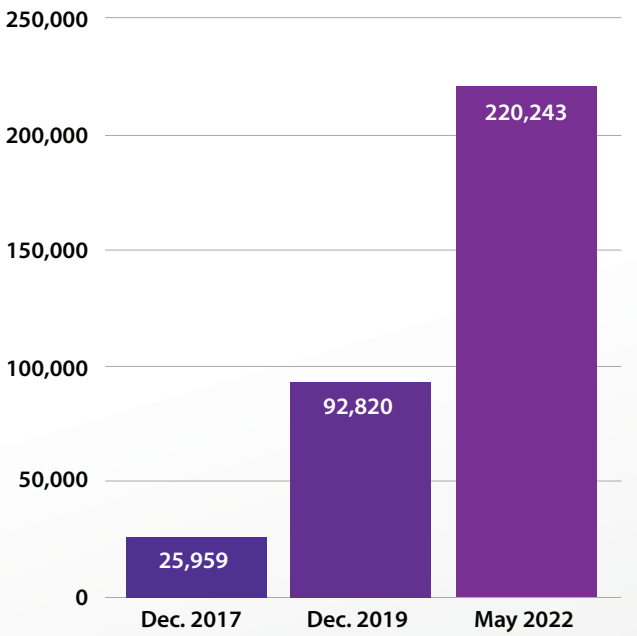
Sponsored by the ABA Standing Committee on Pro Bono and Public Service, ABA Free Legal Answers – www.abafreelegalanswers.org -- is a virtual legal clinic through which income-eligible clients can post civil legal questions, which are then answered by pro bono attorneys. Currently, lawyers in 41 states are available to answer questions. Another two have committed to participate.

Since Free Legal Answers launched in 2106, 220,000 civil legal questions have been submitted, and more than 10,600 volunteer attorneys have registered to answer those questions. The most common questions concern legal issues related to family and children (40%), housing and homelessness (15%) and consumer or financial issues (10%).

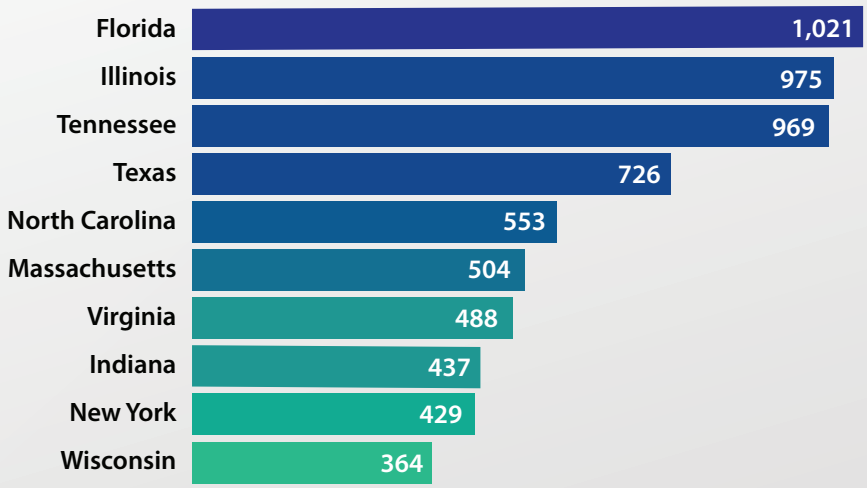
Since March 2020, when the pandemic began, Free Legal Answers has received 116,177 questions – an increase of 84% over the same pre-pandemic period. Also since March 2020, 3,685 volunteer lawyers have registered to answer civil legal questions.

In early 2021, ABA Free Legal Answers expanded to accept questions on immigration and veterans issues. The website for that service is at https://abafederal.freelegalanswers.org.

QUESTIONS SUBMITTED SINCE ABA FREE LEGAL ANSWERS LAUNCHED IN 2016



TOP 10 STATES FOR VOLUNTEERS WITH ABA FREE LEGAL ANSWERS



Source: ABA Free Legal Answers

PRO BONO

LAW STUDENTS

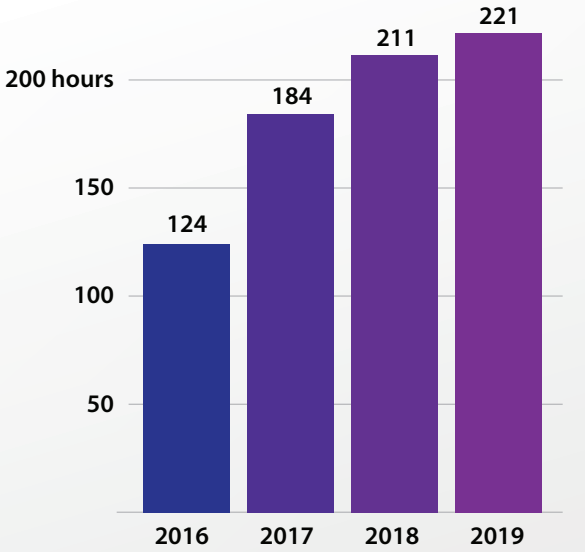
The typical third-year law student performs 221 hours of pro bono legal work through clinics, other experiential courses and pro bono activities, according to the 2019 Law Student Pro Bono Hours Survey conducted by the Association of American Law Schools.

That figure is an average of the 4.38 million hours of pro bono service performed by 19,885 law students in the Class of 2019 at 105 law schools across the country. The schools represent more than half of all students in the Class of 2019 at ABA-accredited law schools.

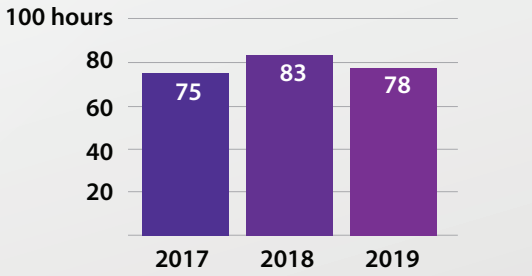
The hours worked is rising over time. AALS has conducted the survey since 2016. The 2016 survey found each graduating law student performed an average of 124 hours of pro bono work. In 2017, that figure rose to 184 hours, and in 2018 it was 211. AALS estimated that pro bono work by third-year law students in 2019 was worth $112 million.

For all students surveyed in all years of law school – not just third-year students – the number of pro bono hours worked in 2019 was 4.69 million. That's an average of about 78 hours per student.

AVERAGE HOURS OF PRO BONO WORK PER THIRD-YEAR LAW STUDENT



AVERAGE HOURS OF PRO BONO WORK BY ALL LAW STUDENTS



Source: Association of American Law Schools' Law Student Pro Bono Survey 2019

WOMEN IN THE LEGAL PROFESSION

- Demographics
- Women in Law Firms
- Women in Law Schools
- Walking out the Door









WOMEN IN THE LEGAL PROFESSION

DEMOGRAPHICS

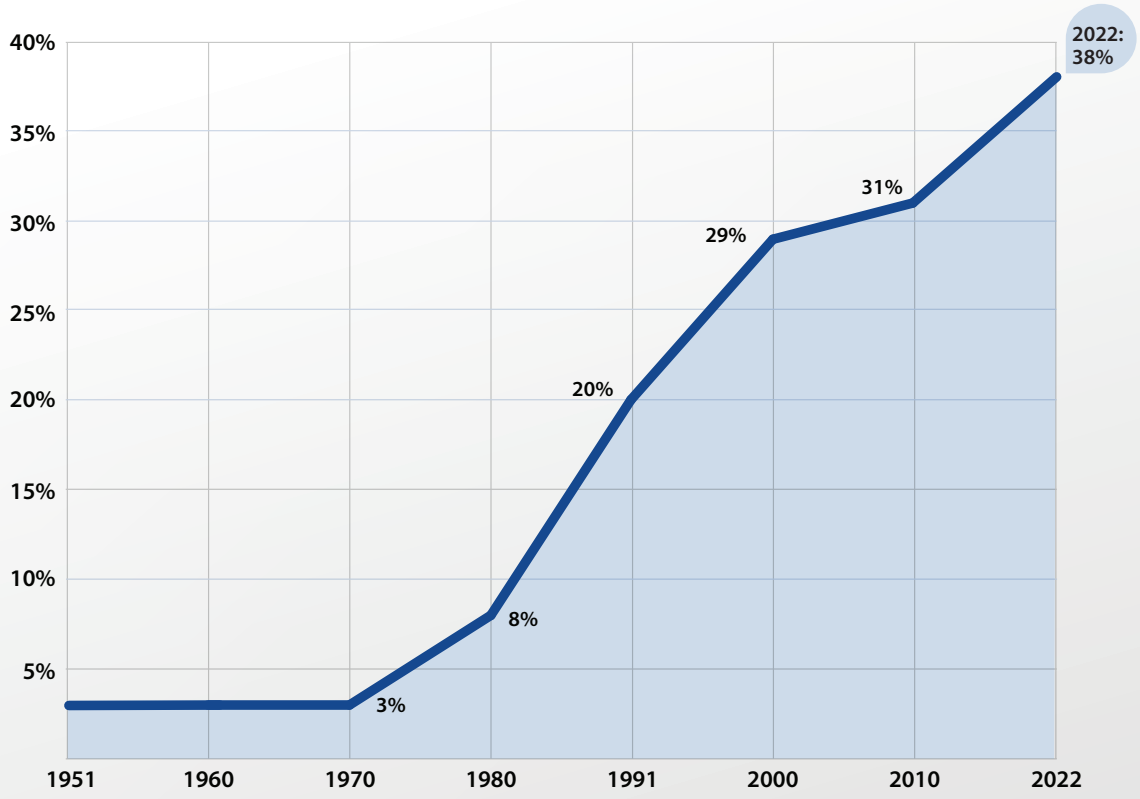
The percentage of female lawyers has slowly inched up in recent years, according to the ABA National Lawyer Population Survey, a tally of lawyers by licensing agencies in every state. In 2010, fewer than one-third of all lawyers (31%) were women. Twelve years later, in 2022, 38% of all lawyers were women.

The long-term trend is easier to see when viewed over the course of decades. The biggest growth in female lawyers came in the 1980s and '90s. From 1950 to 1970, only 3% of all lawyers were women. The percentage increased to 8% in 1980, 20% in 1991 and 29% in 2000.

The trend is also apparent at law schools. The number of male students has declined every year for the past 11 years – from 78,516 in 2010 to 52,058 in 2021. Meanwhile, the number of female law school students has increased every year for the past five years – from 55,766 in 2016 to 64,861 in 2021. Women now significantly outnumber men in U.S. law schools, and the gap is widening. In 2021, there were 12,800 more female students than male students.

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WOMEN IN THE LEGAL PROFESSION BY DECADE: 1951 - 2022



Sources: ABA National Lawyer Population Survey; American Bar Foundation Lawyer Statistical Reports; ABA Section of Legal Education and Admissions to the Bar

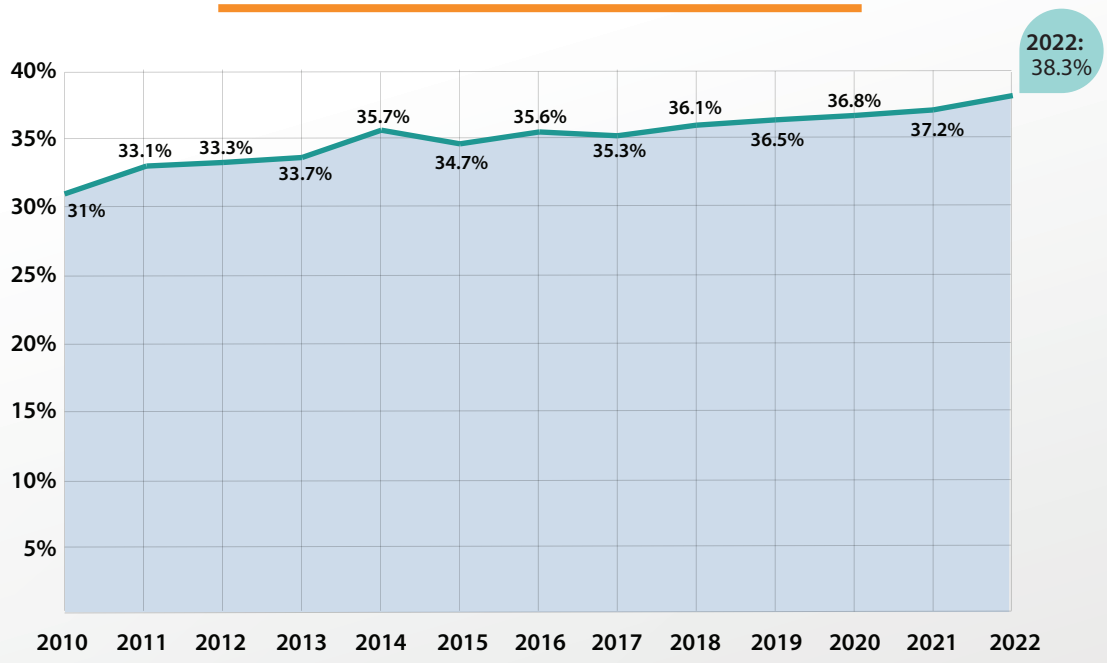
WOMEN IN THE LEGAL PROFESSION

DEMOGRAPHICS *continued from previous page*

The number of female federal judges has increased dramatically. The first woman was appointed to the federal judiciary in 1928, when 217 men held that position. By 1950, there were still only three female federal judges. That rose to 46 in 1980. And by July 1, 2022, there were 424 women on the federal bench – nearly one-third of all federal judges (30%).

Women fare better in state Supreme Courts, where they make up 41% of all high-court justices, according to a 2022 survey by the Brennan Center for Justice at New York University. That's nearly the same as the share of all lawyers who are women nationally: 38%.

WOMEN IN THE LEGAL PROFESSION: 2010 - 2022



Sources: Federal Judicial Center; Brennan Center for Justice

WOMEN IN THE LEGAL PROFESSION

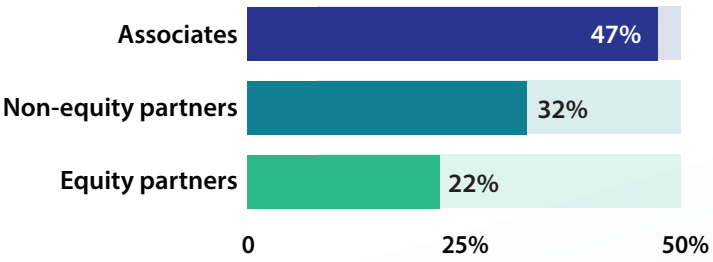
WOMEN IN LAW FIRMS

Although more than half of all law school graduates are women, the number of women in senior leadership roles at U.S. law firms is far less than half – even with the number slowly edging up in recent years.

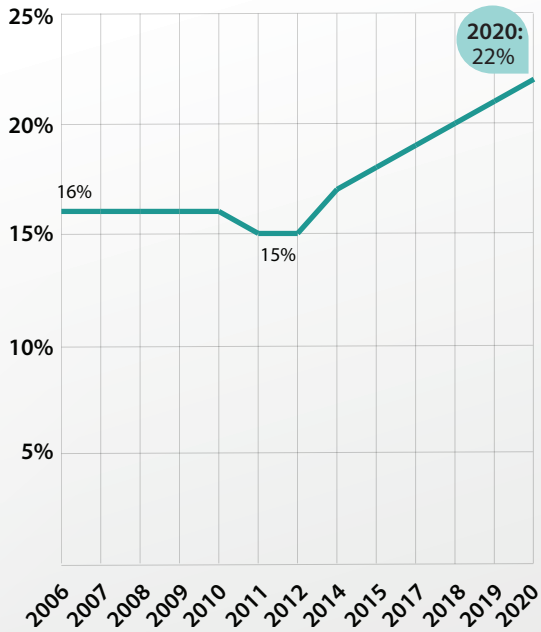
About 22% of all equity partners were female in 2020, according to the National Association of Women Lawyers. The number has risen every year since 2012, when it was 15%. Female lawyers are found in greater numbers at lower levels in the law firm hierarchy. Nearly half of all associates (47%) were women in 2020, as were nearly a third of all non-equity partners (32%).

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WOMEN IN LAW FIRMS: 2020

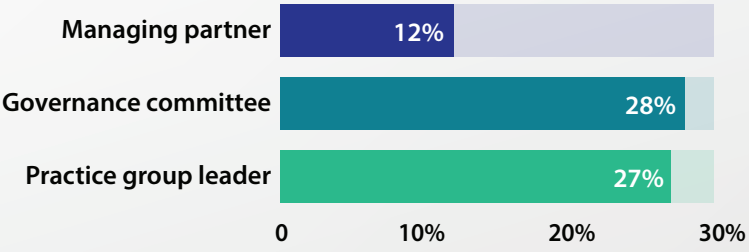


FEMALE EQUITY PARTNERS: 2006 - 2020



Women also held only a small percentage of law firm leadership jobs in 2020. They were 12% of managing partners, 28% of governance committee members and 27% of practice group leaders, according to the NAWL.

WOMEN IN LAW FIRM LEADERSHIP ROLES: 2020



Sources: National Association of Women Lawyers 2021 Survey Report

WOMEN IN THE LEGAL PROFESSION

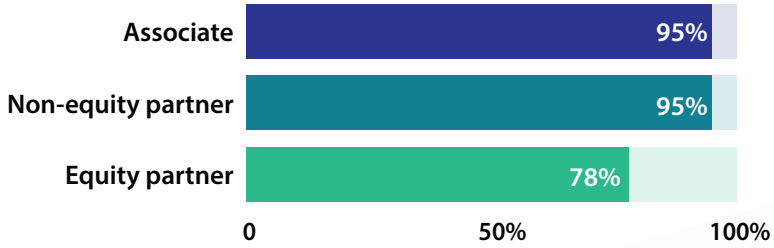
WOMEN IN LAW FIRMS

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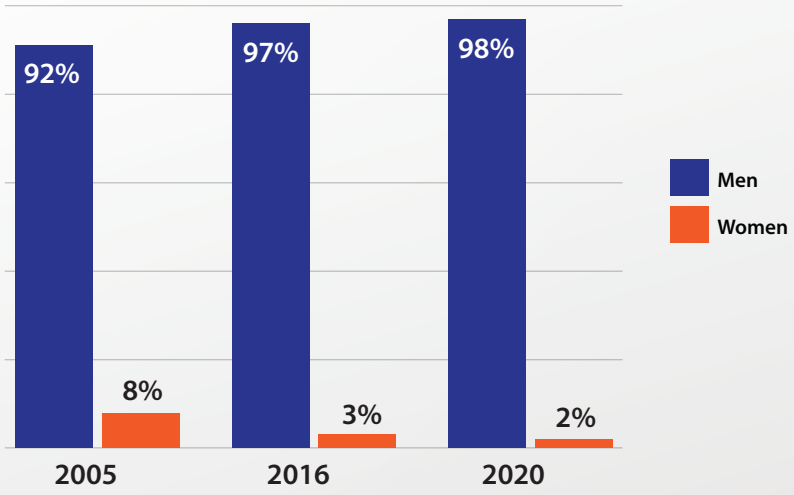
Law firm pay for women almost caught up to pay for men among associates and non-equity partners in 2020, but a sizable gap still existed at the highest levels. In 2020, female associates and female non-equity partners received, on average, 95% of the compensation of their male counterparts. But among equity partners, women received just 78% of the compensation of men, on average.

There were virtually no women among the very highest-compensated law firm attorneys in 2020. Only 2% of law firms said their highest-paid attorney is female – and that number actually dropped from 8% in 2005.

COMPENSATION OF FEMALE LAWYERS AS A PERCENTAGE OF COMPENSATION OF MALE LAWYERS: 2020



GENDER OF HIGHEST-PAID ATTORNEY IN THE FIRM: 2005 - 2020



Sources: National Association of Women Lawyers 2021 Survey Report

WOMEN IN THE LEGAL PROFESSION

WOMEN IN LAW SCHOOLS

Women make up a majority of law school students in the United States: 55.3% in 2021. That's up from 48.4% in 2000.

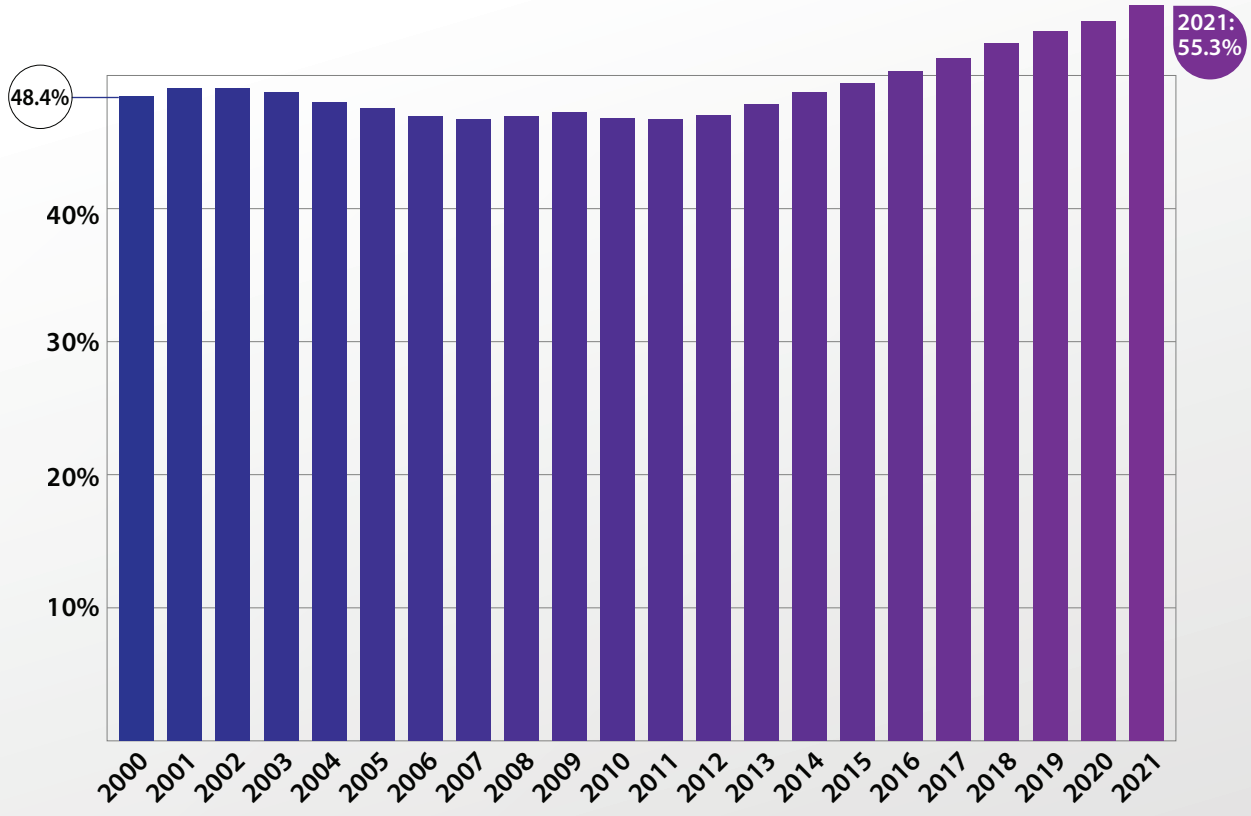
Women achieved majority status in ABA-accredited law schools only recently. The first time first-year female students outnumbered first-year male students was in 2014. Two years later, in 2016, women made up a majority of all students in law schools for the first time.

Here's another way of looking at the gender trend in law schools: In 2021, nearly five times as many law schools had female majorities (162 law schools) versus those with male majorities (33 law schools). And at five law schools in 2021 (Northeastern, Howard, North Carolina Central, Florida A&M and American), women outnumbered men by a 2-to-1 ratio.

The change came slowly over several decades. In 1963, only 4% of first-year law students were female, rising to 20% in 1973, 39% in 1983 and 44% by 1993.

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WOMEN AS A PERCENTAGE OF ALL LAW STUDENTS: 2000 - 2021



Sources: ABA Section of Legal Education and Admissions to the Bar

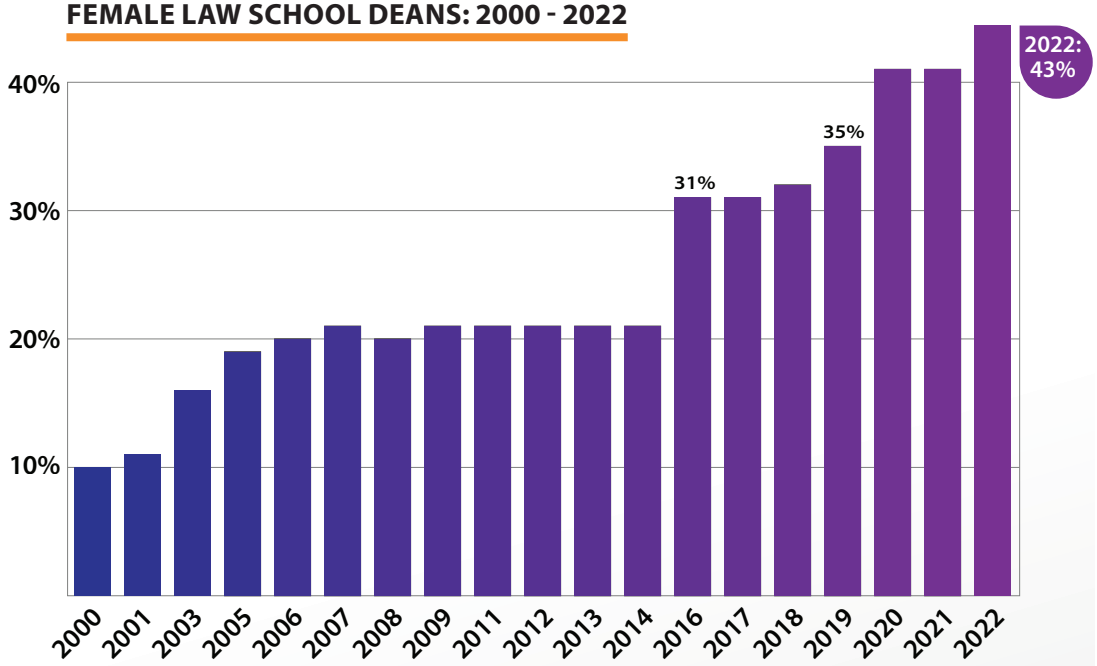
WOMEN IN THE LEGAL PROFESSION

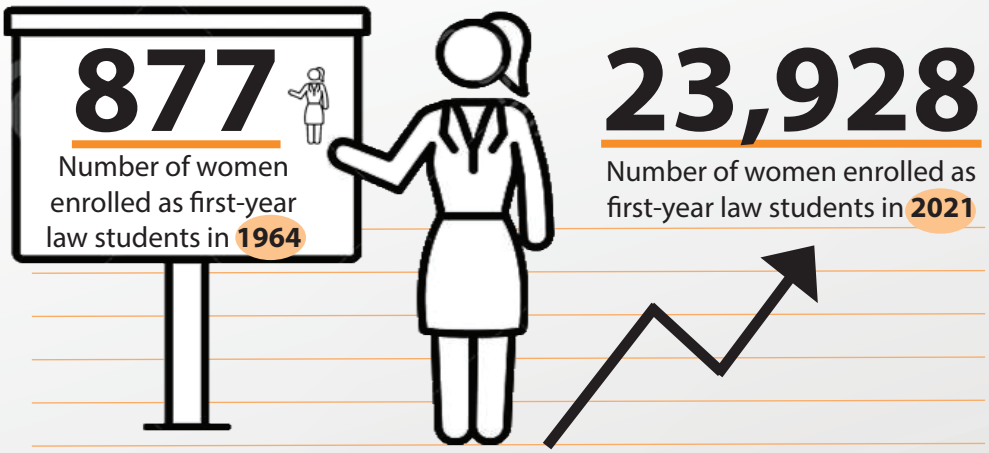
WOMEN IN LAW SCHOOLS

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More women than ever are also leading U.S. law schools. In 2000, only 10% of law school deans were women. By 2009, the percentage of female deans rose to 21%. And as of July 1, 2022, 43% of all law school deans were women, according to Rosenblatt's Deans Database at the Mississippi College School of Law.

FEMALE LAW SCHOOL DEANS: 2000 - 2022





23,928

Number of women enrolled as first-year law students in **2021**

1951



Year that Miriam Theresa Rooney became the first female dean of an ABA-approved law school, Seton Hall Law School

Sources: ABA Section of Legal Education and Admissions to the Bar and Rosenblatt's Deans Database

WOMEN IN THE LEGAL PROFESSION

WALKING OUT THE DOOR

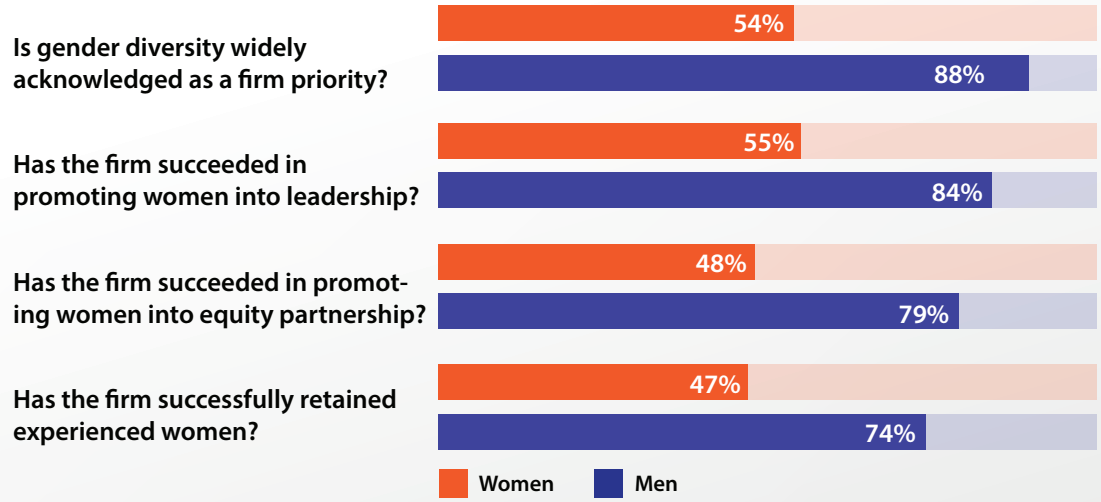
Male and female lawyers strongly disagree on how well their law firms foster long-term careers for women. That is one conclusion from a study published in October 2019 by the ABA and ALM Intelligence, which explored why experienced female lawyers are leaving law firms. The report, "Walking Out the Door," includes results from a survey of more than 1,200 senior lawyers at the nation's biggest private law firms.

Generally, men thought their law firms treated women fairly, but women disagreed. For example, the vast majority of men (88%) said gender diversity is widely acknowledged as a firm priority. Barely half of women (54%) agreed. Also, nearly 3 out of 4 men (74%) said their law firms successfully retained experienced women. Less than half of women (47%) agreed.

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HOW MEN AND WOMEN VIEW LAW FIRM POLICIES

(% WHO SAID YES)



Source: Walking Out the Door, 2019, ABA and ALM Intelligence

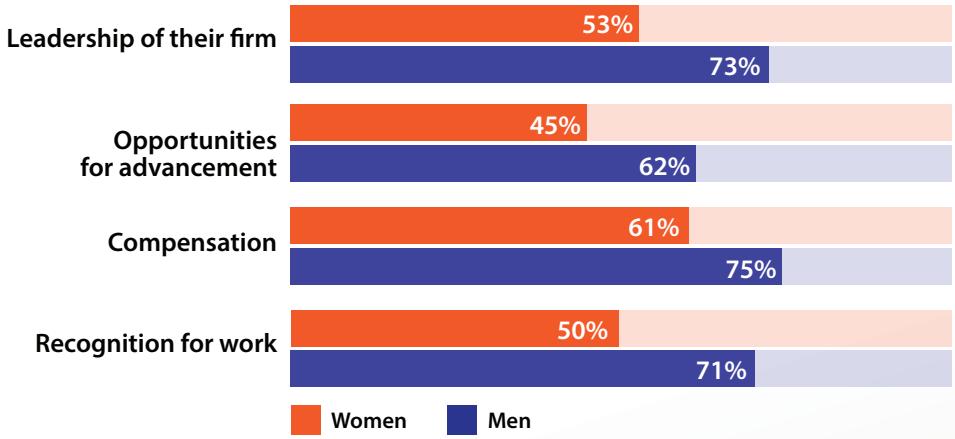
WOMEN IN THE LEGAL PROFESSION

WALKING OUT THE DOOR *continued from previous page*

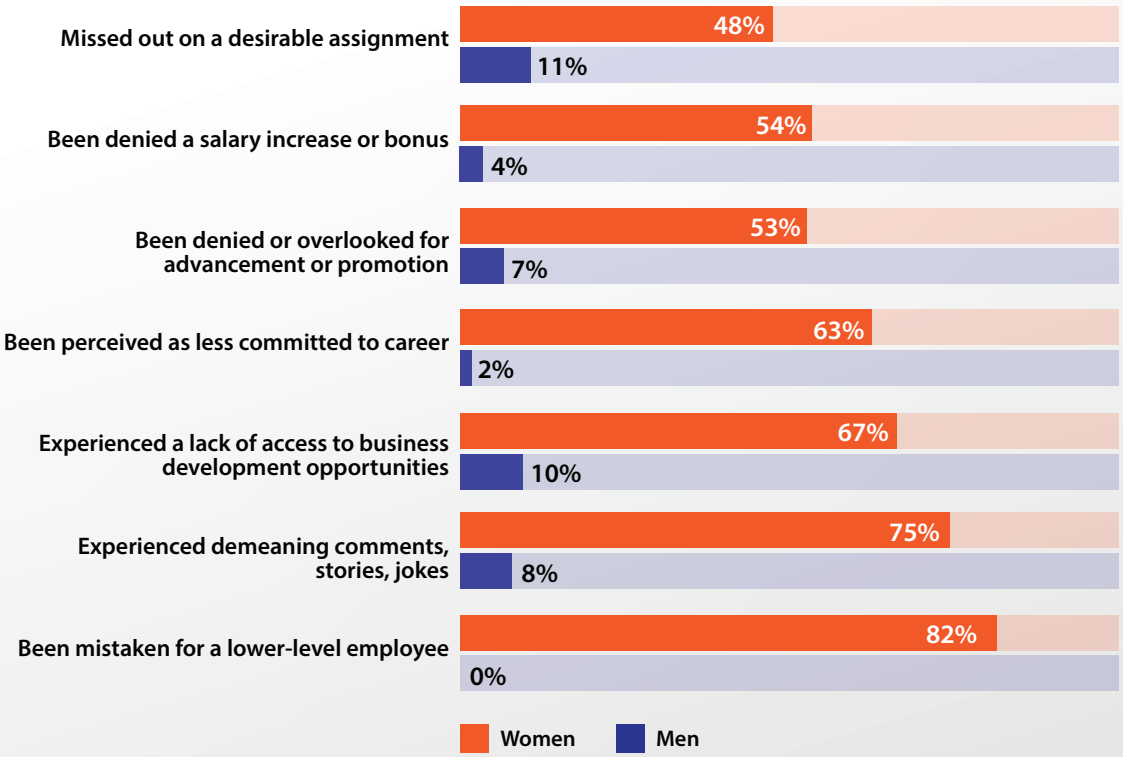
Female lawyers also reported significantly less job satisfaction than men in several important areas. For example, 71% of men said they were satisfied with the recognition they received at work, but only 50% of women said the same. Likewise, 62% of men said they were satisfied with opportunities for advancement at their law firms, but only 45% of women felt the same.

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JOB SATISFACTION (EXTREMELY OR SOMEWHAT SATISFIED)



EVERYDAY EXPERIENCES BECAUSE OF GENDER



Source: Walking Out the Door, 2019, ABA and ALM Intelligence

WOMEN IN THE LEGAL PROFESSION

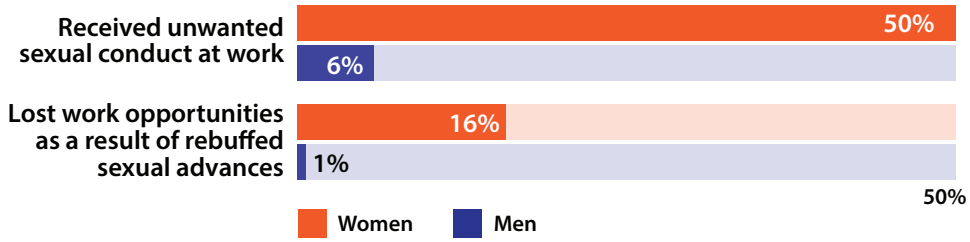
WALKING OUT THE DOOR *continued from previous page*

The survey also revealed that half of all female lawyers (50%) said they experienced unwanted sexual conduct at work, and 1 in 4 women said they avoided reporting sexual harassment due to fear of retaliation. One in six female lawyers (16%) said they lost work opportunities as a result of rebuffing sexual advances.

Finally, the women surveyed said caretaking commitments are the No. 1 reason (58%) why experienced female lawyers leave their law firms, followed by stress at work (54%) and emphasis on marketing or originating business (51%).

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SEXUAL HARASSMENT



FAST FACT:

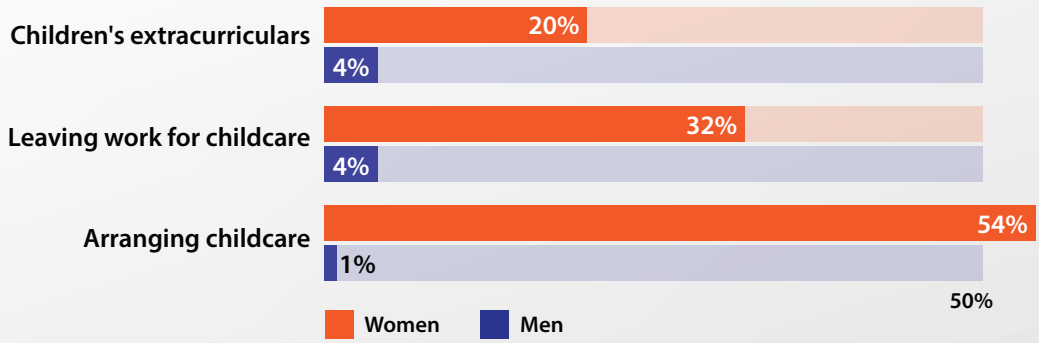
63% of female lawyers said they had been perceived as less committed to their careers.

FAST FACT:

75% of female lawyers said they experienced demeaning comments, stories or jokes.

CHILD CARE RESPONSIBILITIES

(% WHO SAY IT IS THEIR FULL RESPONSIBILITY)



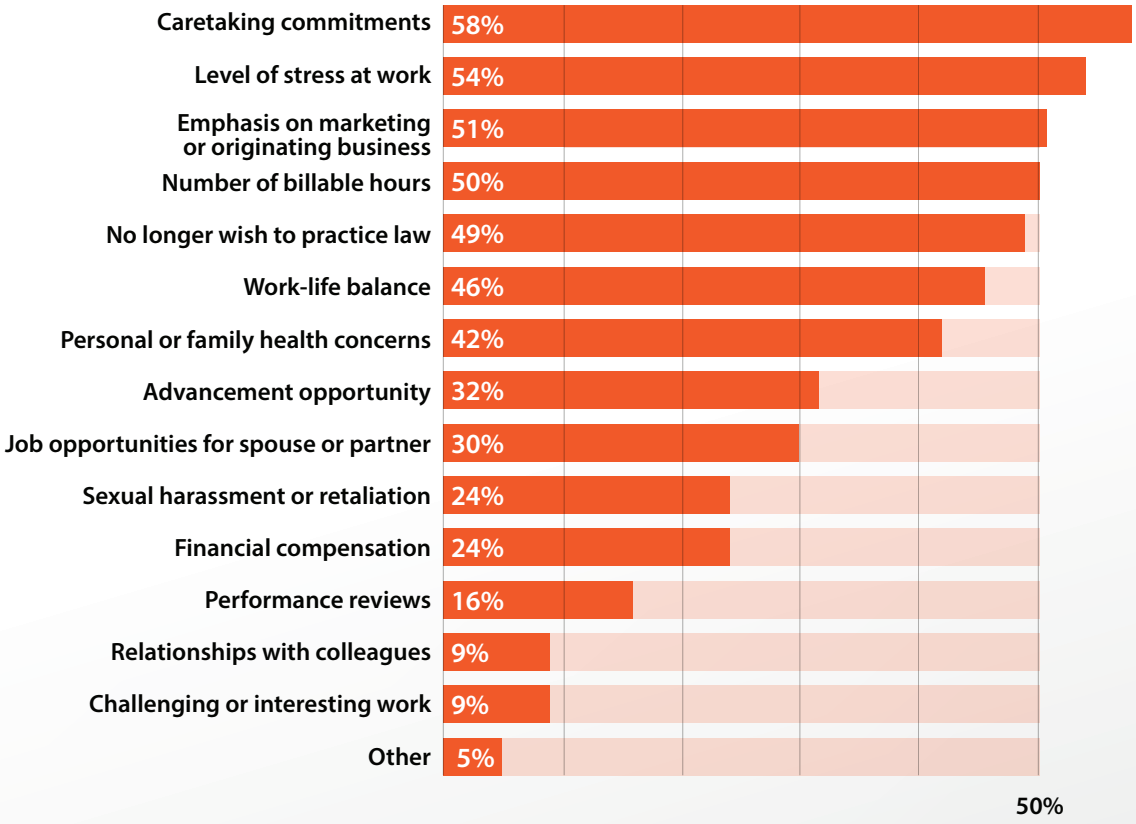
Source: Walking Out the Door, 2019, ABA and ALM Intelligence

WOMEN IN THE LEGAL PROFESSION

WALKING OUT THE DOOR *continued from previous page*

WHY DO EXPERIENCED FEMALE LAWYERS LEAVE THEIR JOBS?

(VERY OR SOMEWHAT IMPORTANT)



Source: Walking Out the Door, 2019, ABA and ALM Intelligence

LEGAL TECHNOLOGY

- Security
- Online Research
- Social Media
- Hardware and Software









LEGAL TECHNOLOGY

SECURITY

The number of computer security breaches reported by lawyers has remained relatively steady in recent years, but the number of law firms with cyber liability insurance has rapidly increased over the same period, according to the American Bar Association's 2021 Legal Technology Survey Report.

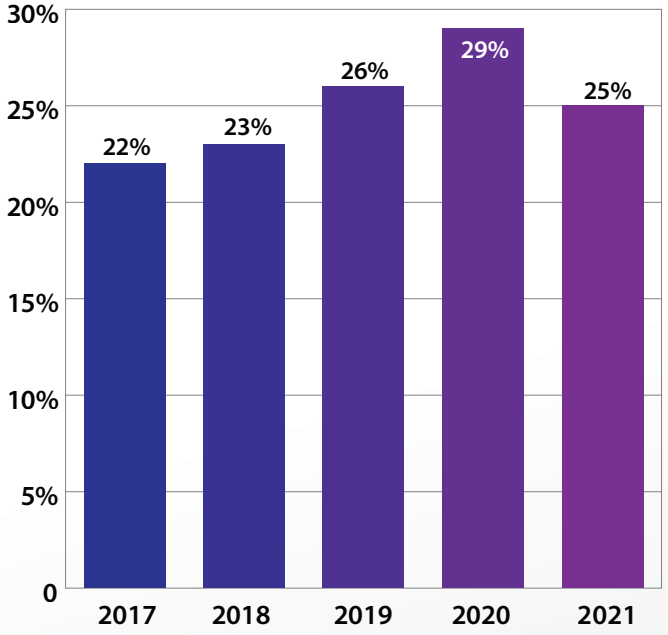
Overall, 1 in 4 lawyers (25%) in 2021 said their firms had experienced a security breach (for example, lost or stolen computer or smartphone, hack, break-in or exploited website). That's up slightly from 22% in 2017.

Nearly two-thirds of lawyers who reported a security breach (64%) said their firms suffered no significant business disruption or loss. Even so, 36% said the breach caused some down time or loss of billable hours.

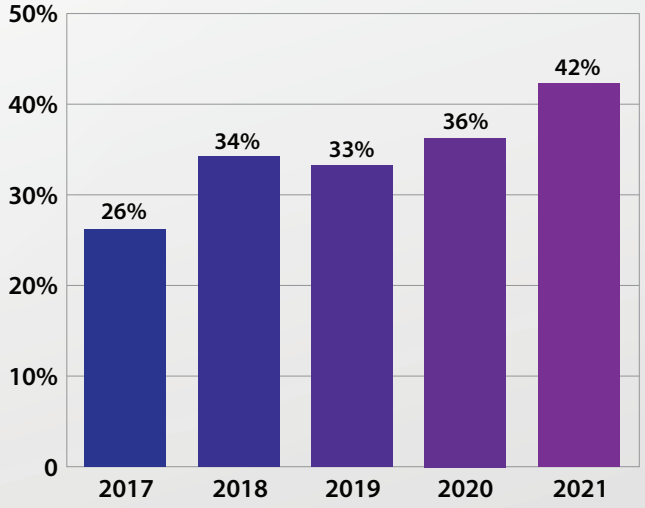
To protect from losses caused by cyber breaches, more than one-third of lawyers (42%) said their firms have cyber liability insurance. That's up significantly from 26% in 2017.

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LAW FIRMS SUFFERING SECURITY BREACHES



LAW FIRMS THAT HAVE CYBER LIABILITY INSURANCE



Source: 2021 ABA Legal Technology Survey Report

LEGAL TECHNOLOGY

SECURITY

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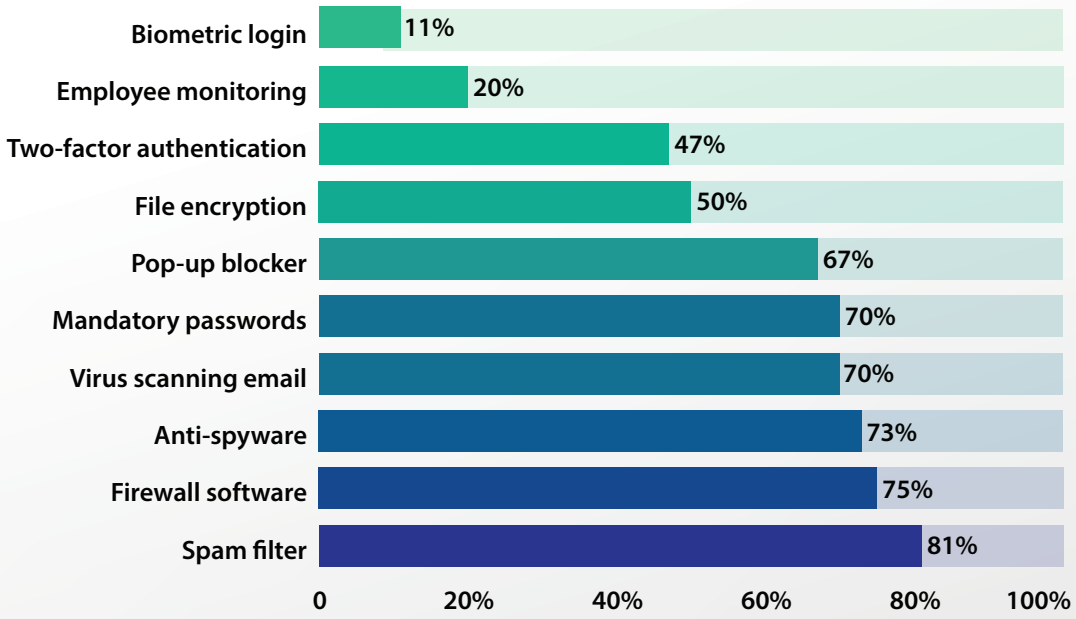
Viruses, spyware and malware were reported as common problems, but that threat appeared to be dwindling. In 2021, 29% of lawyers said their law firm technology had been infected at some point in the past. That's down from 43% in 2017.

Most lawyers said their firms used spam filters (81%), firewall software (75%), anti-spyware (73%), virus-scanning email (70%) and mandatory passwords (70%) to fight against security threats. Half (50%) said their firms encrypt files. Most lawyers said their firms do not use two-factor authentication (47%), do not monitor employees (20%) and do not use biometric login techniques (11%).

FAST FACT:

On average, solo practitioners suffered fewer security breaches than law firms with 10 lawyers or more. Only 17% of solos said they had suffered a breach compared with 35% of lawyers in firms with 10 to 49 lawyers, and 24% of lawyers in firms with 100 lawyers or more.

LAW FIRMS USING CYBERSECURITY TOOLS



Source: 2021 ABA Legal Technology Survey Report

LEGAL TECHNOLOGY

ONLINE RESEARCH

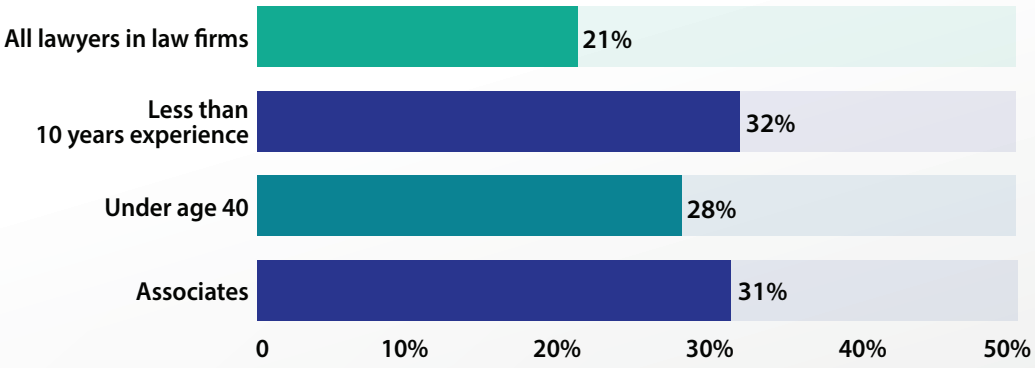
The typical lawyer spends, on average, roughly one-fifth of their time (21%) of his or her time conducting legal research, according to the ABA's 2021 Legal Technology Survey Report. That's up slightly from 2020 (18%) and 2019 (17%).

When lawyers begin a research project, nearly half (42%) say they start with a general search engine like Google. Roughly a third (34%) start with a paid online resource and 11% start with a free state bar-sponsored legal research service.

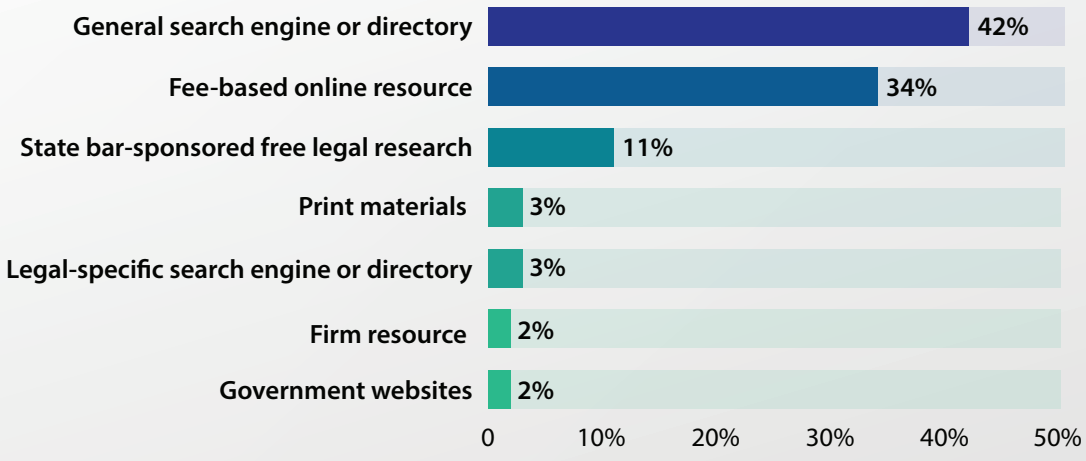
Most lawyers (60%) said they regularly use paid online resources for research and nearly as many (59%) said they use free online sources. When asked which paid online legal research service they use, nearly two-thirds (62%) said Westlaw/Westlaw Edge, followed by Lexis/Lexis+ (45%), Practical Law (17%), Bloomberg Law (15%) and Fastcase (10%).

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TIME SPENT ON LEGAL RESEARCH



WHERE LAWYERS START A RESEARCH PROJECT



FAST FACT:

Only 10% of lawyers said their law firms use artificial intelligence-based technology tools. That figure is substantially higher (19%) at law firms with 100 lawyers or more.

Source: 2021 ABA Legal Technology Survey Report

LEGAL TECHNOLOGY

ONLINE RESEARCH

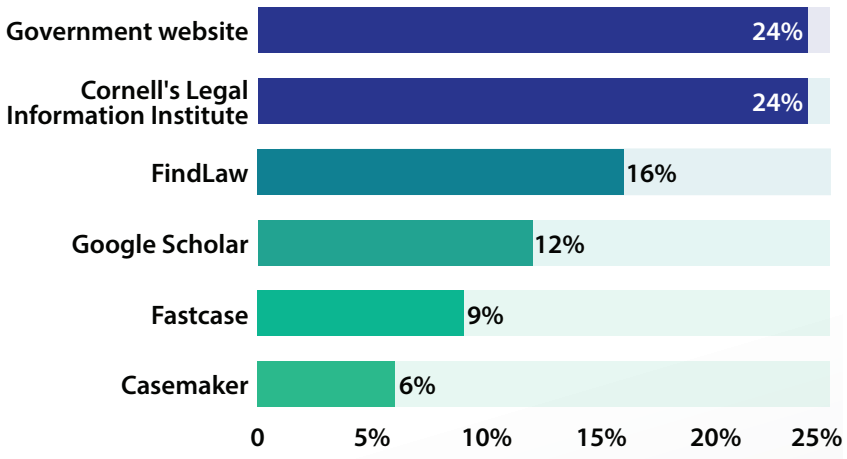
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Asked which free websites they use most often for legal research, 24% of lawyers said Cornell's Legal Information Institute and another 24% said government websites, followed by FindLaw (16%), Google Scholar (12%), Fastcase (9%) and Casemaker (6%).

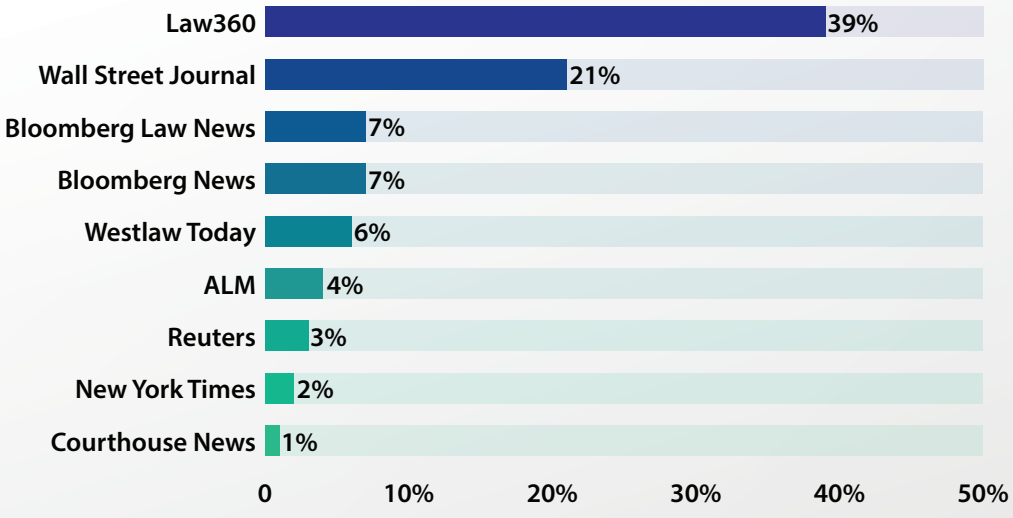
Despite the popularity of online sources, many lawyers (37%) said they still regularly use print materials for legal research. Seven percent said they never use print materials during research.

When it comes to getting legal news, the most preferred paid sources of online legal news are Law360 (39%) and the Wall Street Journal (21%).

FREE WEBSITES USED MOST OFTEN FOR LEGAL RESEARCH



PAID ONLINE SERVICE MOST PREFERRED FOR LEGAL NEWS



FAST FACT:

17% think artificial intelligence tools will become mainstream in the legal profession in the next three years. Five percent said they are already mainstream.

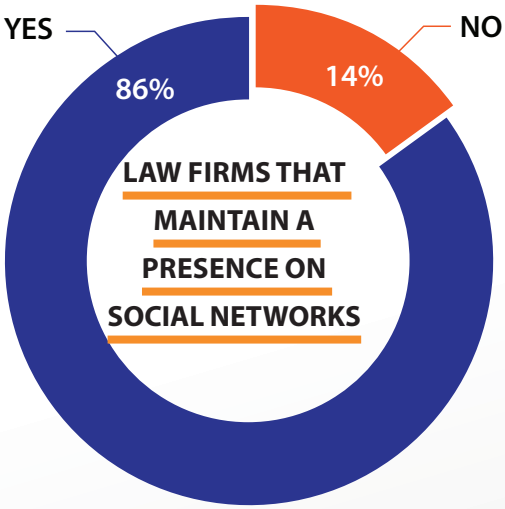
Source: 2021 ABA Legal Technology Survey Report

LEGAL TECHNOLOGY

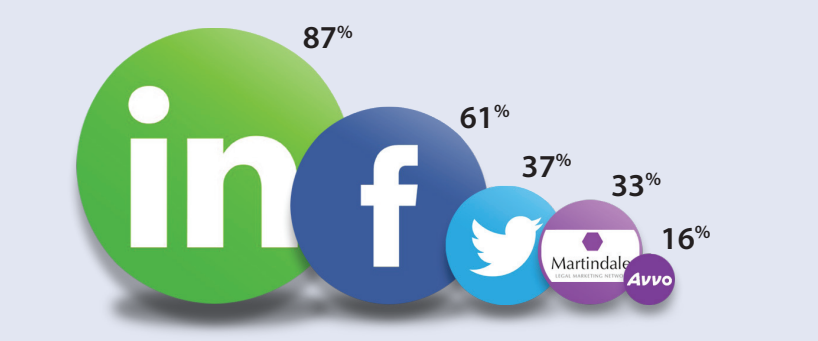
SOCIAL MEDIA

Law firms and lawyers maintain a significant presence on social media, according to the ABA's 2021 Legal Technology Survey Report. Most lawyers (86%) said their law firms are on social networks.

The most popular social network for law firms is LinkedIn. Among the lawyers who said their firms use social networks, nearly 9 out of 10 (87%) said their firms maintain a presence on LinkedIn. A majority (61%) also said their firms are on Facebook. Only one-third (37%) said their firms use Twitter.

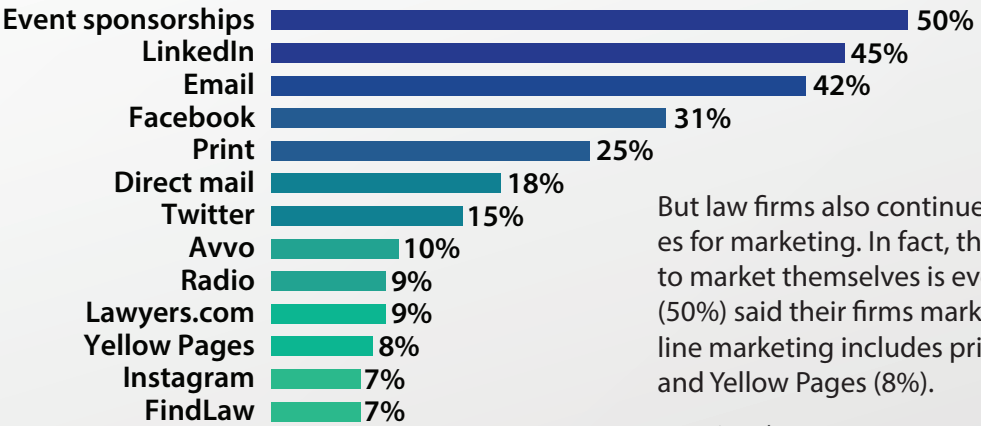


TOP SOCIAL NETWORK SITES USED BY LAW FIRMS



Law firms also use social media to market themselves, according to the survey, but no single online source is used by most firms. The most popular site for marketing purposes is LinkedIn (45%), followed by Facebook (31%), Twitter (15%) and Avvo (10%). Nearly half of all lawyers (42%) also said their firms market by email.

WHERE LAW FIRMS MARKET THEMSELVES



But law firms also continue to use traditional, non-online sources for marketing. In fact, the most common method for firms to market themselves is event sponsorships. Half of all lawyers (50%) said their firms market themselves this way. Other non-online marketing includes print (25%), direct mail (18%), radio (9%) and Yellow Pages (8%).

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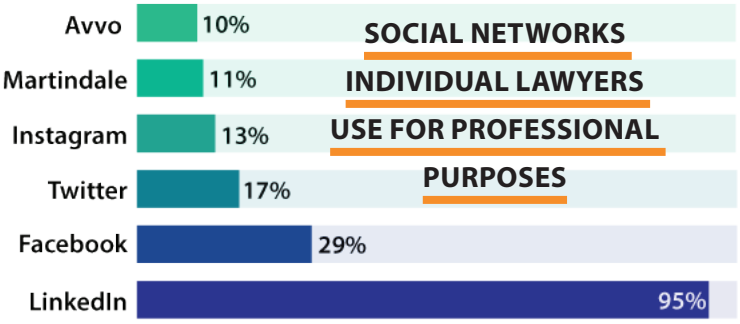
Source: 2021 ABA Legal Technology Survey Report

LEGAL TECHNOLOGY

SOCIAL MEDIA

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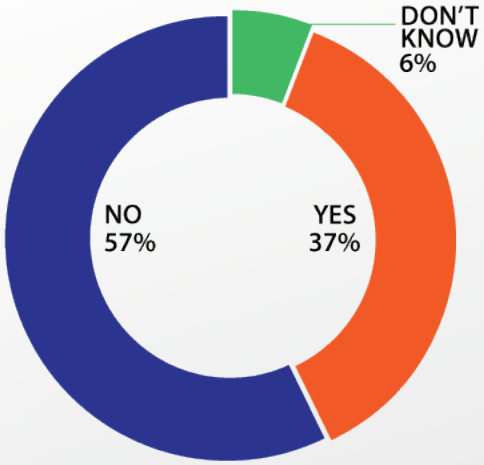
The great majority of lawyers (81%) personally maintain a presence on social media for professional purposes. Among those lawyers, virtually all (95%) are on LinkedIn. Only 29% are on Facebook professionally, followed by Twitter (17%), Instagram (13%), Martindale (11%) and Avvo (10%).



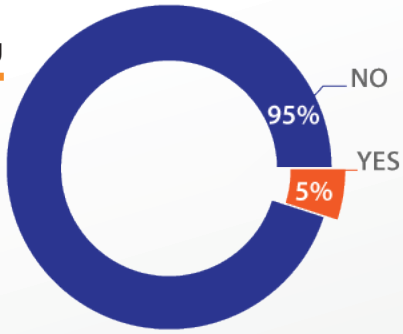
Blogging is becoming more popular among law firms. In the survey, 37% of lawyers said their firms have a blog. That's up substantially from 24% in 2018. Blogs are far more popular among big firms. The bigger the firm, the more likely it is to have a blog. Only 12% of solo practitioners blog. But among law firms with 100 lawyers or more, more than half (62%) blog. Among those lawyers whose firms blog, 1 in 4 (26%) said their firm retained a client as a result of blogging.

Very few lawyers – only 5% -- said they personally maintain a legal topic blog. Of those, nearly all (88%) said they blog for client development.

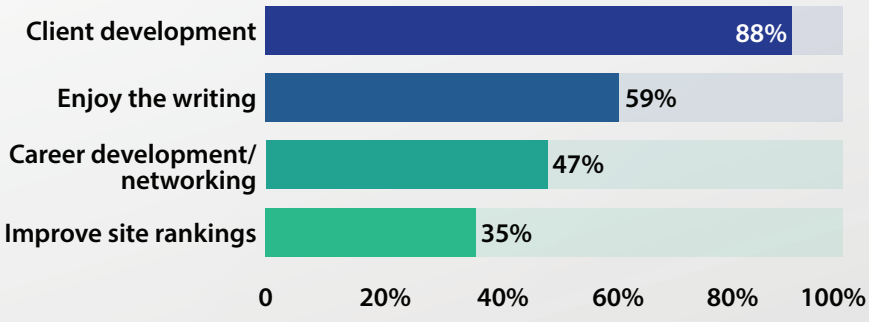
DOES YOUR FIRM HAVE A BLOG?



DO YOU PERSONALLY MAINTAIN A LEGAL TOPIC BLOG?



WHY DO YOU BLOG?



FAST FACT:

Nearly half of all lawyers (48%) said their firms have a social media policy. That increases to 91% for law firms with 500 lawyers or more.

Source: 2021 ABA Legal Technology Survey Report

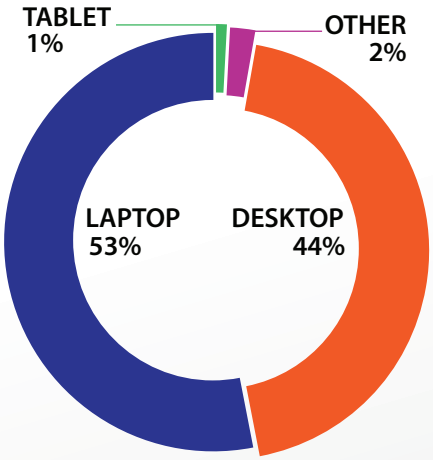
LEGAL TECHNOLOGY

HARDWARE AND SOFTWARE

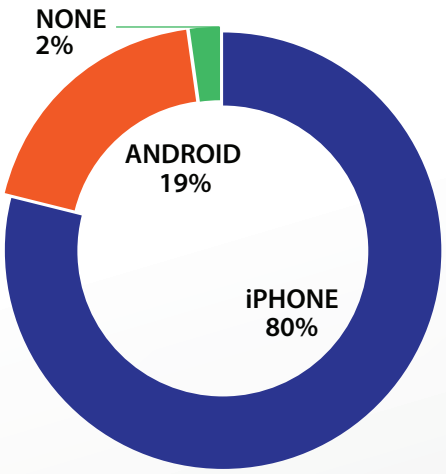
The most common smartphone for lawyers is the iPhone (80%), according to the 2021 Legal Technology Survey Report. Only 19% use an Android phone. It appears the Blackberry has finally disappeared. In 2019, 1% of lawyers said they still used Blackberries. In the 2021 survey, it was zero.

Laptop use continues to rise. For the first time in the survey, a majority of lawyers (53%) said a laptop is their primary work computer. That number has increased every year recently – from 38% in 2018, 41% in 2019 and 47% in 2020. Meanwhile, the use of desktop computers declines. Just 44% of lawyers said a desktop is their main work computer. Only 1% said a tablet is their primary work computer.

PRIMARY WORK COMPUTER

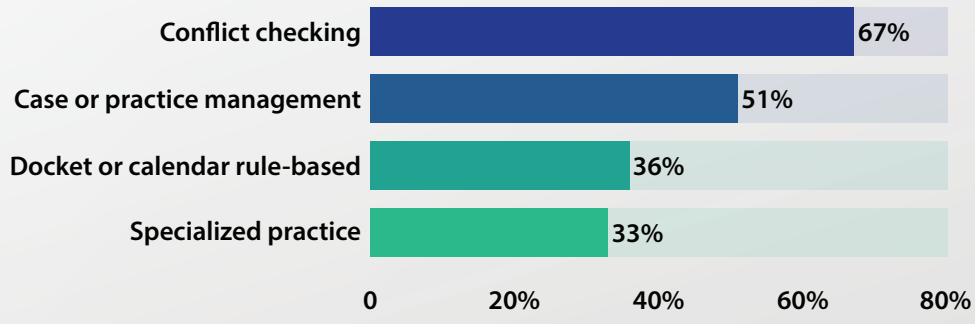


WHICH SMARTPHONE DO LAWYERS USE FOR WORK?



When it comes to legal-specific software available at law firms, software used for conflict of interest checking (67%) and case/practice management (51%) are common, but docket/calendaring rule-based software (36%) and specialized practice software (33%) are not.

TYPES OF LEGAL-SPECIFIC SOFTWARE AVAILABLE FOR USE AT LAW FIRMS



Source: 2021 ABA Legal Technology Survey Report

LAWYER WELL-BEING

- Women and Men
- Life and Practice
- Judges









LAWYER WELL-BEING

WOMEN AND MEN

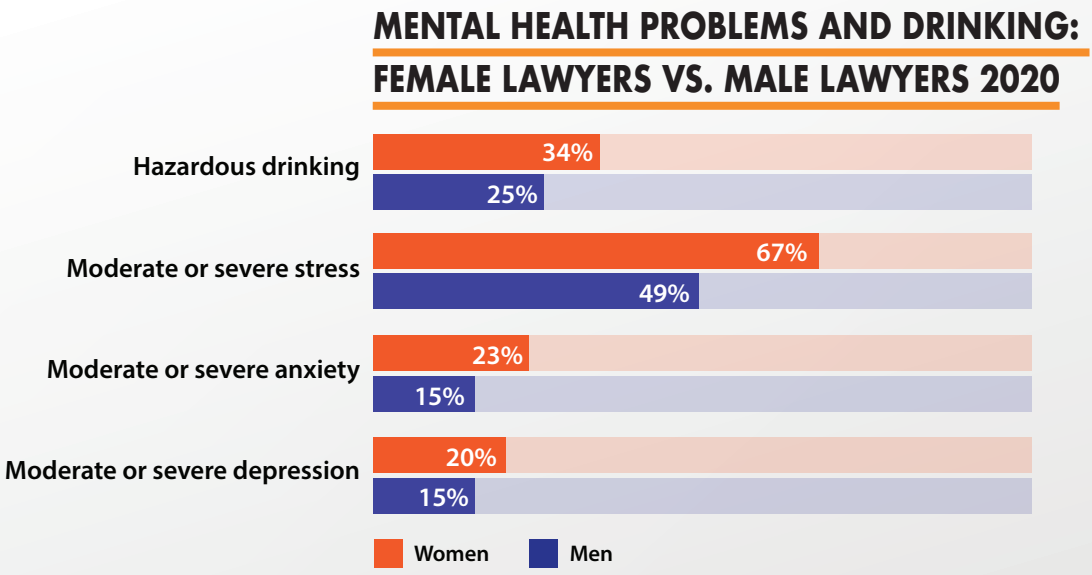
Female lawyers were more likely to experience stress, anxiety and depression in 2020 than male lawyers and were more likely to engage in hazardous drinking, according to a survey of nearly 3,000 attorneys sponsored by the California Lawyers Association and the D.C. Bar.

The survey also found that more women than men (24% versus 17%) considered leaving the legal profession due to mental health problems, burnout or stress.

According to the survey:

- Two-thirds of women (67%) reported moderate or severe stress compared with less than half of men (49%).
- Nearly one-quarter of women (23%) reported moderate or severe anxiety compared with 15% of men.
- One in five women (20%) reported moderate or severe depression compared with 15% of men.
- One-third of women (34%) reported hazardous drinking compared with 25% of men. Hazardous drinking is measured on a scale that depends on how often one drinks, how many drinks one has when one drinks and how often one has six or more drinks on one occasion.

The survey concluded that women who experienced more conflicts between work and family were four times more likely to leave the legal profession, or consider leaving, due to mental health issues, burnout and stress. Work-family conflict was also a significant factor for men, but less so, the study found.



Source: Stress, drink, leave: An examination of gender-specific risk factors for mental health problems and attrition among licensed attorneys, May 2021

LAWYER WELL-BEING

LIFE & PRACTICE

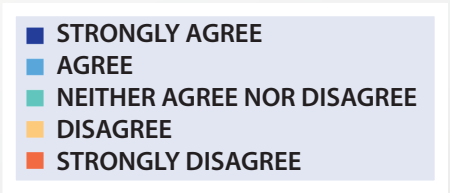
Most lawyers said their law firms support their mental health and family needs, with some caveats, according to the 2021 ABA Legal Technology Survey Report.

More than half (55%) of the lawyers surveyed agreed with the statement "My workplace is supportive of my mental health needs." Only 9% disagreed. Nearly half (46%) said their firm provides resources on substance use and addiction or other mental health services and support. One out of six lawyers (16%) said they don't know if their firms provide such services.

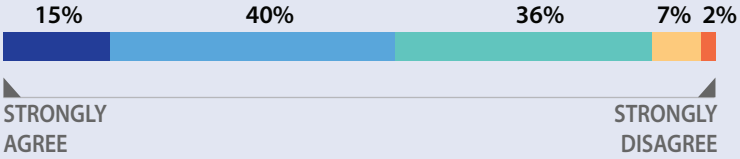
Likewise, nearly two-thirds of lawyers (65%) said they agree with the statement "My job allows me to spend adequate time with my family." Just 17% disagreed.

Views are mixed on questions about time spent at work, breaks during the day and vacations. A majority (51%) said they "take adequate breaks during the workday," but a quarter (28%) said they do not. And one-quarter of the lawyers surveyed (27%) said they feel pressure to not take vacation time.

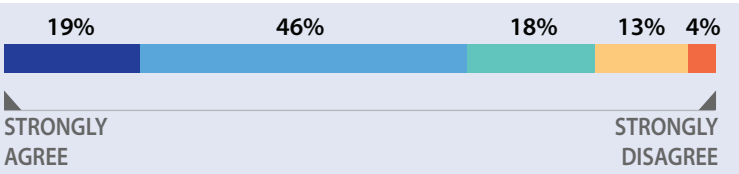
Despite that, most lawyers (63%) said they agree with the statement "I make time for myself."



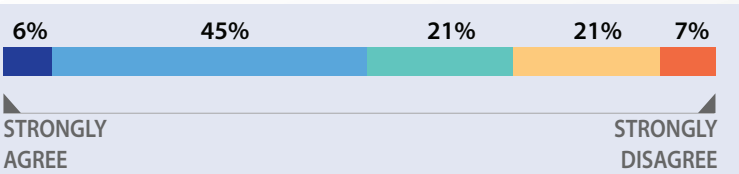
MY WORKPLACE IS SUPPORTIVE OF MY MENTAL HEALTH NEEDS



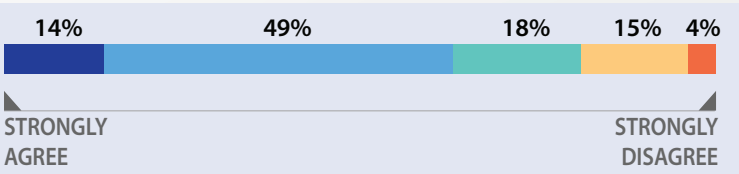
MY JOB ALLOWS ME TO SPEND ADEQUATE TIME WITH MY FAMILY



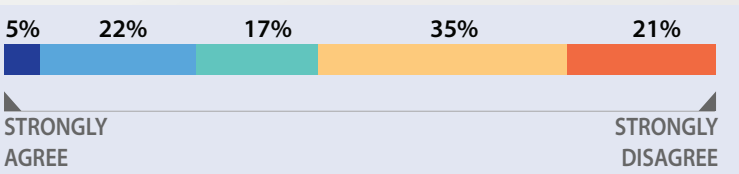
I TAKE ADEQUATE BREAKS DURING THE WORKDAY



I MAKE TIME FOR MYSELF



I FEEL PRESSURE NOT TO TAKE VACATION TIME



Source: 2021 ABA Legal Technology Survey Report

LAWYER WELL-BEING

LIFE & PRACTICE *continued from previous page*

Lawyers report nearly universal employer support for working parents. Nearly 3 out of 4 lawyers (74%) said their firm's support for working parents is good or very good. Only 5% said it is poor or very poor.

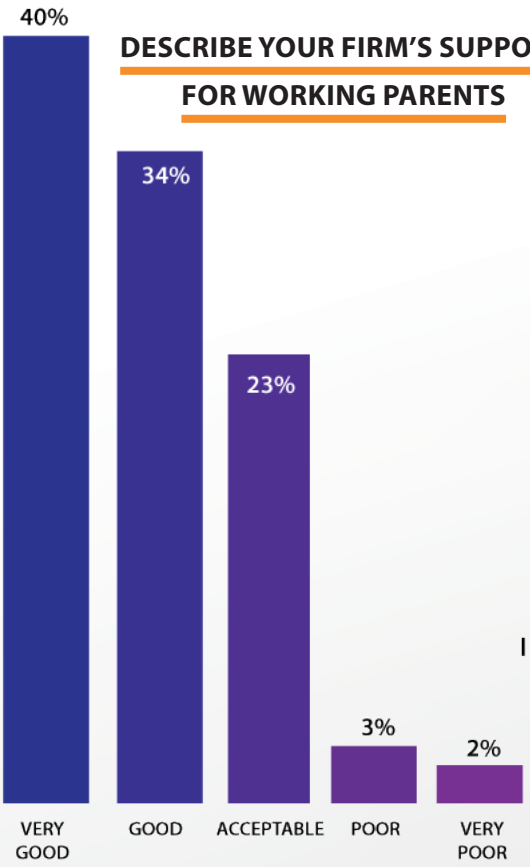
Yet more than half of all lawyers (51%) said they work long hours. Asked to "generally describe your work week," one-third of the lawyers surveyed (39%) said they often work long hours and another 12% said they "never stop working."

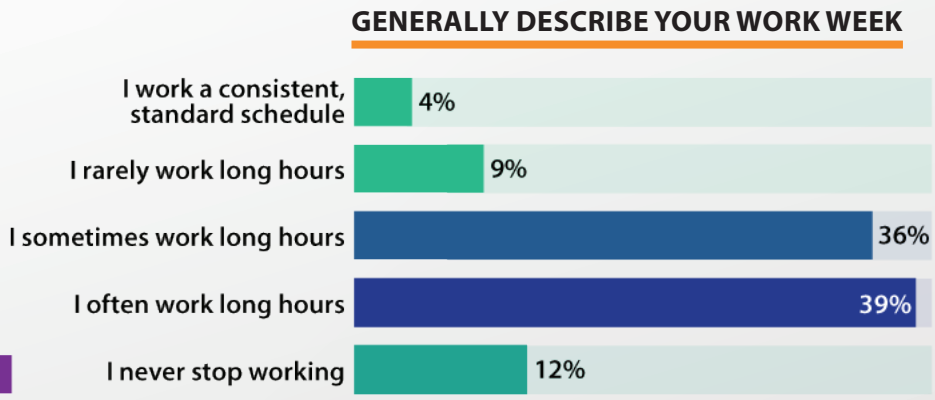
FAST FACT:

Most lawyers (82%) agree with the statement "In general, technology makes it easier to balance work and family obligations." Only 8% disagree.

FAST FACT:

The vast majority of lawyers (83%) said their firm offers flexible hours – work schedules outside the typical 9 a.m. to 5 p.m. workday.





Source: 2021 ABA Legal Technology Survey Report

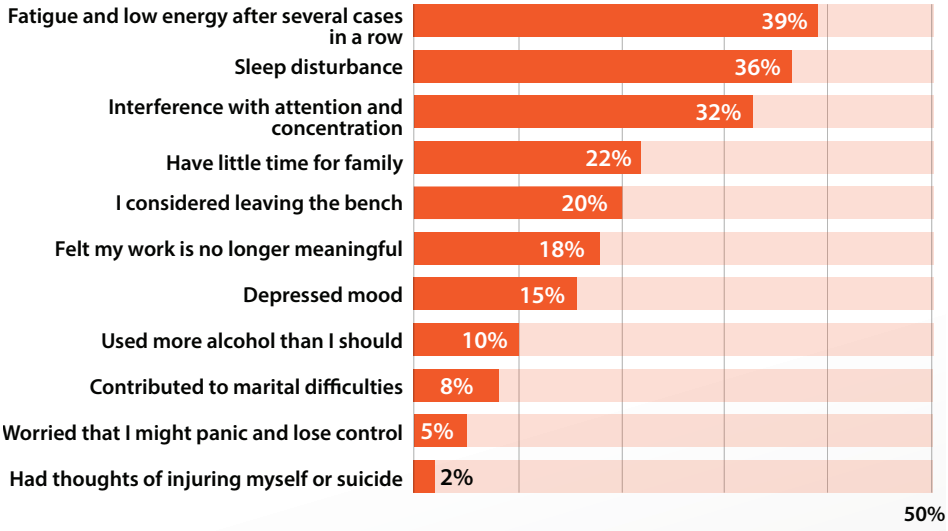
LAWYER WELL-BEING

JUDGES

Nearly one-quarter of all judges (23%) meet the criteria for experiencing stress at a level that could be debilitating, according to the National Judicial Stress and Resiliency Survey, a groundbreaking study released in December 2020 by the ABA Center for Professional Responsibility. Female judges are more likely than male judges to report one or more symptoms of stress (73% versus 54%), according to the survey.

The survey of 1,034 judges – mostly in state courts – found that 1 in 5 meet at least one criterion for depressive disorder, such as depressed mood, not having initiative, preoccupation with negative thoughts, feelings that work is no longer meaningful and feelings that they can't wait for the day's work to end.

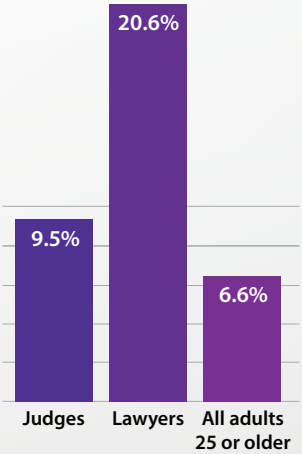
EFFECTS OF STRESS FELT BY JUDGES IN THE PREVIOUS YEAR



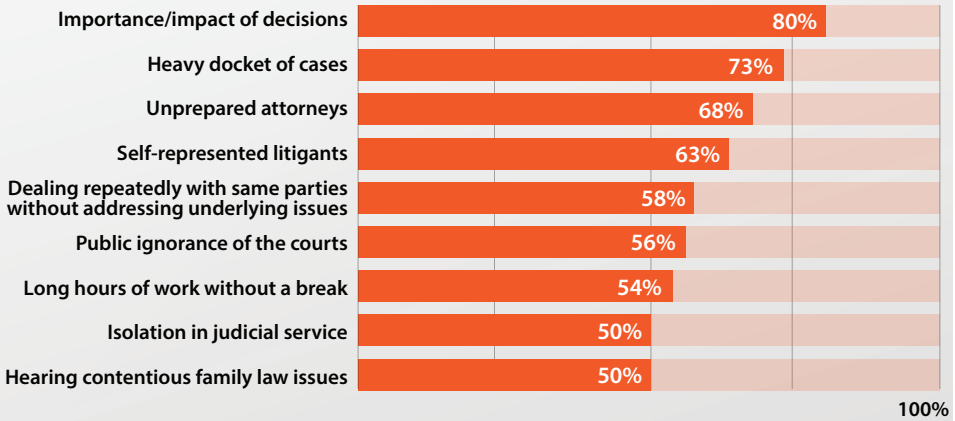
Nearly 1 in 10 judges (9.5%) reported problematic alcohol use in the past year. That's half the rate of lawyers overall who reported problematic drinking in a previous study (20.6%) and one-third the rate of young lawyers age 30 or less (32%).

Twenty-two judges who participated in the survey (2%) said they had experienced thoughts of suicide or self-injury in the previous year. The study concluded that this "is very troubling" and that "judges would benefit from increased suicide awareness." Among lawyers overall in a previous study, 11.5% reported suicidal thoughts over their entire careers.

PROBLEMATIC ALCOHOL USE IN THE PAST YEAR



SOURCES OF JUDICIAL STRESS



Source: National Judicial Stress and Resiliency Survey, 2020 ABA Journal of the Professional Lawyer

LAWYER DISCIPLINE

- Public Discipline and Disbarment
- Public Discipline by State









LAWYER DISCIPLINE

PUBLIC DISCIPLINE AND DISBARMENT

In 2019, 2,308 lawyers were publicly disciplined for misconduct in 43 states and the District of Columbia, according to the 2019 ABA Survey on Lawyer Discipline Systems. That represents roughly one-fifth of 1% (0.2%) of all practicing lawyers with active licenses in those states.

The most common form of public discipline was a suspension. Of all the lawyers who were publicly disciplined in 2019, nearly half (44%) were suspended. An additional 21% were disbarred, 11% were placed on probation and 24% received admonishments, reprimands or censures.

FAST FACT:

Lawyer discipline is a state function, usually handled by the state Supreme Court or state licensing agency. The ABA does not handle lawyer discipline.

FAST FACT:

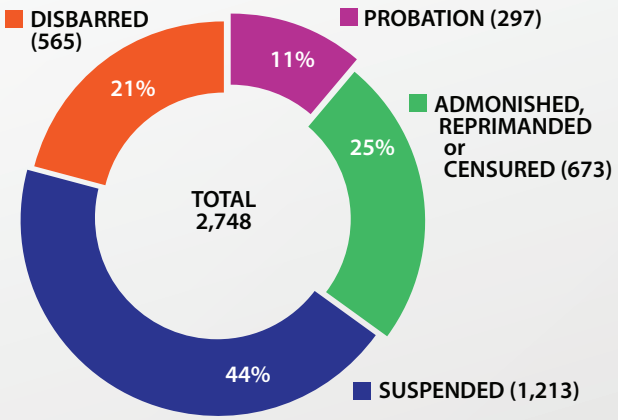
In 2019, state disciplinary agencies received 69,716 complaints in 43 states and the District of Columbia.

The ABA Center for Professional Responsibility is the only organization that collects, analyzes and compiles statistics about lawyer regulatory systems on a national basis. The numbers are collected from 56 lawyer disciplinary agencies, representing every state and the District of Columbia. However, comparisons over time can be difficult because not every agency participates in the survey every year. For the 2019 survey, all states participated except California, Massachusetts, New Jersey, South Carolina, South Dakota, Vermont, West Virginia and part of New York.

Based on the states that have participated each year since 1998, the percentage of lawyers publicly disciplined has remained relatively constant, fluctuating between 0.20% and 0.38% of all lawyers.

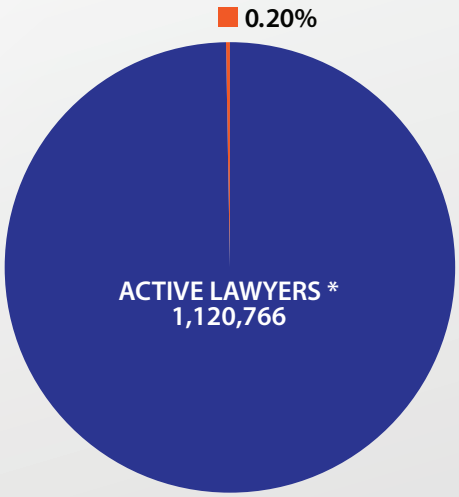
The percentage of lawyers disbarred is generally trending downward. From 1998 to 2004, roughly 0.07% to 0.08% of all active lawyers were disbarred each year. That was down in 2012 to 2019, when 0.05% to 0.06% of all lawyers were disbarred each year.

TYPES OF PUBLIC DISCIPLINE: 2019



PUBLIC DISCIPLINE: 2019

2,308 LAWYERS DISCIPLINED



** Does not include California, Massachusetts, New Jersey, South Carolina, South Dakota, Vermont, West Virginia and part of New York*

Source: 2019 ABA Survey on Lawyer Discipline Systems

LAWYER DISCIPLINE

PUBLIC DISCIPLINE BY STATE

Lawyer discipline rates vary significantly from state to state. In 2019, Alabama and Iowa had the highest rates of public disciplinary actions against lawyers. In those states, nearly 1% of all active lawyers received some form of public discipline (0.68% and 0.63%, respectively). States with the lowest rates of public disciplinary actions against lawyers in 2019 were Rhode Island and Alaska, where fewer than 1 in 1,000 active lawyers received public discipline.

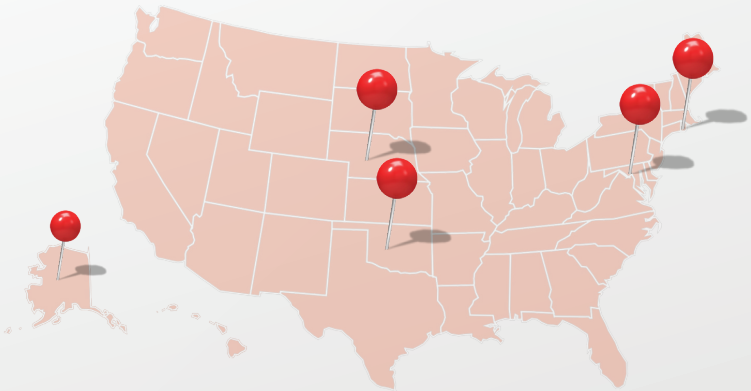
STATES WITH HIGHEST RATES OF PUBLIC DISCIPLINE: 2019

Alabama.....0.68%
Iowa.....0.63%
Arizona.....0.59%
Louisiana.....0.56%
Oregon.....0.41%



STATES WITH LOWEST RATES OF PUBLIC DISCIPLINE: 2019

Nebraska.....0.07%
District of Columbia.....0.07%
Oklahoma.....0.07%
Rhode Island.....0.06%
Alaska.....0.03%



Source: 2019 ABA Survey on Lawyer Discipline Systems

APPENDIX – JUDGES

Black Female Judges in U.S. District Courts - (as of July 1, 2022)

District Courts	Black Female Judges
N Alabama	0
S Alabama	0
Middle Alabama	0
Alaska	0
Arizona	0
E Arkansas	0
W Arkansas	0
N California	3
S California	0
Central California	3
E California	0
Colorado	0
DC	2
Connecticut	1
Delaware	0
N Florida	0
S Florida	1
Middle Florida	2
N Georgia	2
S Georgia	0
Middle Georgia	1
Hawaii	0
Idaho	0
N Illinois	3
S illinois	1
Central Illinois	0
N Indiana	0
S Indiana	1
N Iowa	0
S Iowa	0
Kansas	1
E Kentucky	0
W Kentucky	0
E Louisiana	1
W Louisiana	0
Middle Louisiana	0

District Courts	Black Female Judges
Maine	0
Maryland	1
Massachusetts	2
E Michigan	3
W Michigan	0
Minnesota	1
N Mississippi	1
S Mississippi	0
E Missouri	0
W Missouri	0
Montana	0
Nebraska	0
Nevada	0
New Hampshire	0
New Jersey	3
New Mexico	0
N New York	0
S New York	2
E New York	2
W New York	0
E North Carolina	0
W North Carolina	0
Middle North Carolina	1
North Dakota	0
N Ohio	1
S Ohio	0
E Oklahoma	0
W Oklahoma	1
N Oklahoma	0
Oregon	0

District Courts	Black Female Judges
E Pennsylvania	2
W Pennsylvania	0
Middle Pennsylvania	0
Puerto Rico	0
Rhode Island	0
South Carolina	2
South Dakota	0
E Tennessee	0
W Tennessee	0
Middle Tennessee	0
E Texas	0
W Texas	0
N Texas	1
S Texas	0
Utah	0
Vermont	0
E Virginia	2
W Virginia	0
W Washington	0
N West Virginia	0
S West Virginia	1
E Wisconsin	0
W Wisconsin	0
Wyoming	0

Source: Federal Judicial Center

Black Female Judges in U.S. Courts of Appeals - (as of July 1, 2022)

Appeals Courts - Circuits	Black female judges
First	1
Second	2
Third	0
Fourth	0
Fifth	0
Sixth	2
Seventh	1
Eighth	0
Ninth	2
Tenth	0
Eleventh	0
DC	1
Federal	1
TOTAL	10

APPENDIX – JUDGES

Federal Judges Appointed by President Joe Biden
- (as of July 1, 2022)

Gender		
Men	16	23.5%
Women	52	76.5%
TOTAL	68	

Race and Ethnicity		
Black	16	23.5%
Black/Native American	1	1.5%
Black/Asian American	1	1.5%
Black/Hispanic	1	1.5%
Native American	2	2.9%
Asian American	8	11.8%
Asian American/ Hispanic	1	1.5%
Asian American/ Hispanic/White	1	1.5%
Hispanic	12	17.6%
Pakistani	1	1.5%
White	24	35.3%
TOTAL	68	

Source: Federal Judicial Center

Sitting Article III Federal Judges by Gender, Race and Ethnicity
- (as of July 1, 2022)

Gender		
Male	985	69.9%
Female	424	30.1%
TOTAL	1,409	

Race and Ethnicity		
Black	146	10.4%
Black/Native American	2	0.1%
Black/Asian American	1	0.1%
Black/Hispanic	3	0.2%
Black/White	2	0.1%
Afro-Latino/Hispanic	1	0.1%
Native American	4	0.3%
Asian American	45	3.2%
Asian American/ Hispanic	2	0.1%
Asian American/ Hispanic/White	1	0.1%
Asian American/ Pacific Islander	1	0.1%
Asian American/ White	1	0.1%
Chaldean	1	0.1%
Hispanic	98	7.0%
Hispanic/White	4	0.3%
Pakistani	1	0.1%
White	1,096	77.8%
TOTAL	1,409	

APPENDIX – JUDGES

Federal Trial Judges of Color by State - (as of July 1, 2022)

States	Black judges	Hispanic judges	Asian American judges	Native American judges	TOTAL
ALABAMA	3	0	0	0	3
ALASKA	0	0	0	0	0
ARIZONA	1	3	0	1	5
ARKANSAS	1	0	0	0	1
CALIFORNIA	17	12	8	1	38
COLORADO	1	3	1	0	5
CONNECTICUT	4	1	1	0	6
DC	7	1	2	0	10
DELAWARE	0	0	0	0	0
FLORIDA	8	10	1	0	19
GEORGIA	6	1	0	0	7
HAWAII	0	0	4	0	4
IDAHO	0	0	0	0	0
ILLINOIS	6	4	4	0	14
INDIANA	1	0	0	0	1
IOWA	0	0	0	0	0
KANSAS	1	0	0	0	1
KENTUCKY	0	0	0	0	0
LOUISIANA	3	0	0	0	3
MAINE	0	0	0	0	0
MARYLAND	3	0	1	1	5
MASSACHUSETTS	2	0	2	0	4
MICHIGAN	5	0	2	0	7
MINNESOTA	2	0	0	0	2
MISSISSIPPI	3	1	0	0	4
MISSOURI	5	0	0	0	5
MONTANA	0	0	0	0	0
NEBRASKA	0	0	0	0	0
NEVADA	1	2	1	0	4
NEW HAMPSHIRE	0	0	0	0	0
NEW JERSEY	5	4	1	0	10
NEW MEXICO	0	5	0	0	5
NEW YORK	10	7	4	0	21
NORTH CAROLINA	2	0	0	0	2
NORTH DAKOTA	0	0	0	0	0
OHIO	4	1	0	0	5
OKLAHOMA	2	0	0	1	3

Source: Federal Judicial Center

APPENDIX – JUDGES

Federal Trial Judges of Color by State - (as of July 1, 2022) ... *continued*

States	Black judges	Hispanic judges	Asian American judges	Native American judges	**TOTAL**
OREGON	1	1	0	0	2
PENNSYLVANIA	5	4	2	0	11
RHODE ISLAND	0	0	0	0	0
SOUTH CAROLINA	3	0	0	0	3
SOUTH DAKOTA	0	0	0	0	0
TENNESSEE	3	0	0	0	3
TEXAS	6	17	1	1	25
UTAH	0	0	0	0	0
VERMONT	0	0	0	0	0
VIRGINIA	5	0	0	0	5
WASHINGTON	1	3	2	1	7
WEST VIRGINIA	1	0	0	0	1
WISCONSIN	0	0	0	0	0
WYOMING	0	0	0	0	0
TOTAL	128	80	37	6	251

Source: Federal Judicial Center

APPENDIX – JUDGES

Female Judges in U.S. District Courts - (as of July 1, 2022)

District Courts	Female Judges	% Female
Alabama N	7	53.8%
Alabama S	2	33.3%
Alabama Mid	1	20.0%
Alaska	1	14.3%
Arizona	7	29.2%
Arkansas E	2	28.6%
Arkansas W	1	20.0%
California N	9	40.9%
California S	7	33.3%
California Cen	10	29.4%
California E	3	25.0%
Colorado	4	33.3%
DC	11	39.3%
Connecticut	6	42.9%
Delaware	1	25.0%
Florida N	1	12.5%
Florida S	8	28.6%
Florida Mid	11	39.3%
Georgia N	6	30.0%
Georgia S	1	20.0%
Georgia Mid	1	14.3%
Hawaii	4	50.0%
Idaho	0	0.0%
Illinois N	11	30.6%
Illinois S	2	40.0%
Illinois Cen	2	28.6%
Indiana N	2	22.2%
Indiana S	3	42.9%
Iowa N	1	33.3%
Iowa S	2	33.3%
Kansas	3	30.0%
Kentucky E	2	22.2%
Kentucky W	2	25.0%
Louisiana E	7	50.0%
Louisiana W	1	8.3%
Louisiana Mid	1	33.3%
Maine	1	16.7%
Maryland	8	47.1%
Massachusetts	6	33.3%
Michigan E	7	33.3%
Michigan W	3	42.9%
Minnesota	6	42.9%
Mississippi N	2	40.0%
Mississippi S	1	10.0%
Missouri E	5	33.3%
Missouri W	3	23.1%
Montana	1	16.7%
Nebraska	0	0.0%
Nevada	5	38.5%
New Hampshire	2	40.0%
New Jersey	13	52.0%
New Mexico	5	41.7%
New York N	2	22.2%
New York S	14	33.3%
New York E	15	53.6%
New York W	1	12.5%
North Carolina E	1	16.7%
North Carolina W	0	0.0%
North Carolina Mid	2	40.0%
North Dakota	0	0.0%
Ohio N	5	26.3%
Ohio S	3	20.0%
Oklahoma E	0	0.0%
Oklahoma W	3	20.0%
Oklahoma N	1	16.7%
Oregon	3	30.0%
Pennsylvania E	7	20.6%
Pennsylvania W	8	47.1%
Pennsylvania Mid	3	42.9%
Puerto Rico	2	28.6%
Rhode Island	2	40.0%
South Carolina	6	40.0%
South Dakota	1	16.7%
Tennessee E	1	10.0%
Tennessee W	1	11.1%
Tennessee Mid	1	25.0%
Texas E	1	10.0%
Texas W	2	12.5%
Texas N	4	22.2%
Texas S	9	31.0%
Utah	2	18.2%
Vermont	1	25.0%
Virginia E	5	26.3%
Virginia W	1	20.0%
Washington E	2	20.0%
Washington W	5	33.3%
West Virginia N	2	40.0%
West Virginia S	1	14.3%
Wisconsin E	1	20.0%
Wisconsin W	1	33.3%
Wyoming	1	33.3%

Source: Federal Judicial Center

Female Judges in U.S. Appeals Courts - (as of July 1, 2022)

Appeals Courts - Circuits	Female Judges	% Female
First	2	20.0%
Second	9	33.3%
Third	5	21.7%
Fourth	5	29.4%
Fifth	6	23.1%
Sixth	10	34.5%
Seventh	5	35.7%
Eighth	1	5.6%
Ninth	18	35.3%
Tenth	6	27.3%
Eleventh	8	40.0%
DC	5	31.3%
Federal	5	26.3%
TOTAL	85	29.1%

APPENDIX – DEMOGRAPHICS

National Lawyer Population: 1878 - 2022

Year	Resident Active Lawyers	% Change from Prior Year
2022	1,327,010	-0.1%
2021	1,327,910	-0.1%
2020	1,328,742	-1.7%
2019	1,352,077	0.7%
2018	1,342,379	0.5%
2017	1,335,963	1.8%
2016	1,312,869	0.9%
2015	1,300,705	1.5%
2014	1,281,432	1.1%
2013	1,268,011	1.8%
2012	1,245,205	1.6%
2011	1,225,452	1.9%
2010	1,203,097	1.9%
2009	1,180,386	1.6%
2008	1,162,124	1.6%
2007	1,143,358	2.4%
2006	1,116,967	1.1%
2005	1,104,766	1.9%
2004	1,084,504	2.4%
2003	1,058,662	0.8%
2002	1,049,751	0.1%
2001	1,048,903	2.6%
2000	1,022,462	2.2%
1999	1,000,440	1.5%
1998	985,921	3.4%
1997	953,260	0.7%
1996	946,499	5.6%
1995	896,140	3.5%
1994	865,614	2.3%
1993	846,036	5.8%
1992	799,760	2.9%
1991	777,119	2.8%
1990	755,694	4.2%
1989	725,579	1.7%
1988	713,456	2.7%
1987	695,020	2.7%
1986	676,584	3.5%
1985	653,686	0.9%
1984	647,575	4.0%
1983	622,625	0.9%
1982	617,320	0.8%
1981	612,593	6.6%

Year	Resident Active Lawyers	% Change from Prior Year
1980	574,810	15.4%
1979	498,249	7.2%
1978	464,851	7.6%
1977	431,918	1.6%
1976	424,980	5.0%
1975	404,772	5.0%
1974	385,515	5.4%
1973	365,875	2.1%
1972	358,520	4.5%
1971	342,980	4.9%
1970	326,842	1.7%
1969	321,473	1.7%
1968	316,104	1.7%
1967	310,736	1.8%
1966	305,368	1.8%
1965	300,000	0.9%
1964	297,186	1.0%
1963	294,372	1.0%
1962	291,559	1.0%
1961	288,746	1.0%
1960	285,933	2.6%
1959	278,746	2.6%
1958	271,560	2.7%
1957	264,373	2.8%
1956	257,186	2.9%
1955	250,000	12.8%
1950	221,605	10.8%
1945	200,000	10.4%
1940	181,220	13.3%
1935	160,000	15.1%
1930	139,059	6.2%
1925	131,000	6.9%
1920	122,519	0.4%
1915	122,000	-0.1%
1910	122,149	3.5%
1905	118,000	3.1%
1900	114,460	27.7%
1890	89,630	39.7%
1880	64,137	0.0%
1878	64,137	N/A

* For data from 1998 forward, individual state bar associations or licensing agencies are asked to provide the number of resident and active attorneys as of December 31st of the prior year, e.g. 2022 data is as of 12/31/2021. The numbers reflected here are the best available data provided to the ABA from the respective associations or agencies.

Notes: In 2018, Indiana corrected the resident active figures for 2016; this report has been updated to reflect the new total attorney count for 2016 than was previously reported. In 2019, Maryland, Nevada, and New York provided corrected 2018 lawyer counts; this report reflects the corrected 2018 total attorney count. In 2020, the District of Columbia changed how it reports residency status, causing a decrease of more than 28,000 reported resident active attorneys in DC. In 2021, Vermont began tracking residency, causing a decrease of more than 1,400 reported resident active attorneys in VT. In 2022, Alabama began distinguishing resident active and resident inactive numbers, causing a decrease of more than 2,800 reported resident active attorneys in AL.

Data Source: 1998 forward - American Bar Association's National Lawyer Population Survey, prior to 1998 - ABA Archives, specific source unknown.

APPENDIX – DEMOGRAPHICS

Resident Lawyers by State: 2012 - 2022

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	% Change from Prior Year
Alabama (1,24,26)	14,135	14,303	14,531	14,630	14,666	14,717	14,822	14,821	14,897	14,897	12,054	-14.7%
Alaska (22)	2,418	2,442	2,469	2,456	2,439	2,402	2,311	2,324	2,324	2,340	2,118	-12.4%
American Samoa (13,22,24,27)	44	64	102	102	98	59	59	55	55	55	55	25.0%
Arizona (4,22)	14,471	16,208	15,993	16,155	15,926	14,960	15,601	15,081	15,081	15,688	15,805	9.2%
Arkansas (7,11,18,27)	5,928	5,953	5,970	5,970	7,320	6,851	7,080	6,693	6,299	6,808	6,808	14.8%
California	159,824	163,163	163,327	165,952	167,690	168,746	170,044	170,117	168,569	167,709	170,306	6.6%
Colorado (22,24,27)	20,768	21,094	21,545	21,761	21,781	22,164	21,099	22,802	22,802	22,802	22,802	9.8%
Connecticut (7,11,22,24,27)	20,842	21,150	18,655	18,655	21,517	21,341	21,111	21,036	21,036	21,036	21,036	0.9%
Delaware (22,24,27)	2,853	2,888	2,881	2,921	2,952	2,978	2,978	3,058	3,058	3,058	3,058	7.2%
Dist. of Columbia (6,20)	51,271	51,928	51,928	52,089	52,711	54,692	53,778	56,135	27,743	28,011	27,552	-46.3%
Florida (6,27)	66,556	68,464	68,464	74,258	75,697	77,008	78,244	78,448	79,328	77,223	77,223	16.0%
Georgia	28,520	28,974	30,463	31,340	31,499	31,672	32,802	32,409	32,584	33,158	33,729	18.3%
Guam (2,4,5,22,24,27)	256	256	313	313	266	266	270	262	262	262	262	2.3%
Hawaii (22,27)	4,107	4,132	4,260	4,193	4,224	4,236	4,261	4,270	4,270	4,184	4,184	1.9%
Idaho	3,627	3,725	3,705	3,736	3,714	3,836	3,882	3,911	3,967	4,029	4,047	11.6%
Illinois (2,4,22,24,27)	60,069	62,496	61,871	63,211	63,060	62,782	63,422	62,720	62,720	62,720	62,720	4.4%
Indiana (3,7,11,13)	15,512	15,646	15,883	15,883	15,854	15,826	15,826	15,845	15,761	15,802	15,794	1.8%
Iowa (22)	7,308	7,383	7,183	7,526	7,560	7,523	7,454	7,306	7,306	7,452	7,405	1.3%
Kansas (7,22)	8,156	8,199	8,261	8,266	8,234	8,218	8,131	8,045	8,045	7,932	7,918	-2.9%
Kentucky (22,24)	12,891	13,061	13,328	13,448	13,451	13,509	13,540	13,570	13,570	13,570	13,672	6.1%
Louisiana (7,18,22)	18,327	18,528	18,532	18,775	19,099	19,307	18,918	20,568	20,568	21,414	19,714	7.6%
Maine (6,22)	3,865	3,863	3,863	3,944	3,931	3,940	3,988	3,995	3,995	3,985	3,669	-5.1%
Maryland (12,17,22,24,27)	22,477	23,068	23,508	23,902	24,142	38,800	40,309	40,800	40,800	40,800	40,800	81.5%
Massachusetts	42,483	43,008	44,257	43,974	43,221	43,442	42,926	42,788	42,908	42,720	42,635	0.4%
Michigan (7,22,24)	33,692	33,995	34,739	34,739	35,087	35,236	35,362	35,453	35,453	35,453	35,139	4.3%
Minnesota (7,18,22,27)	23,774	24,091	25,272	24,522	24,952	25,483	25,252	25,823	25,823	26,065	26,065	9.6%
Mississippi (6,22)	6,955	6,955	6,955	7,059	7,094	7,067	7,007	6,886	6,886	6,845	6,814	-2.0%
Missouri (7,22,24)	24,276	24,423	25,337	25,337	24,922	24,787	24,754	24,369	24,369	24,369	24,674	1.6%
Montana	3,008	3,046	3,084	3,126	3,140	3,159	3,179	3,184	3,167	3,183	3,191	6.1%
Nebraska (6,24)	4,983	5,028	5,028	5,361	5,506	5,545	5,565	5,555	5,546	5,546	5,689	14.2%
Nevada (6,17)	6,850	7,080	7,080	6,858	7,219	7,281	7,333	7,030	7,509	7,482	7,484	9.3%
New Hampshire (19,24,27)	3,449	3,507	3,515	3,521	3,506	3,507	3,523	3,523	3,495	3,495	3,495	1.3%
New Jersey (10,22)	40,997	40,993	41,250	41,569	41,569	41,168	41,021	41,152	41,152	40,137	40,078	-2.2%
New Mexico (6,22,24)	5,513	5,468	5,468	5,547	5,581	5,524	5,428	5,612	5,612	5,612	5,634	2.2%

Data Source: American Bar Association's National Lawyer Population Survey

APPENDIX – DEMOGRAPHICS

Resident Lawyers by State: 2012 - 2022 *... continued*

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	% Change from Prior Year
New York (17)	163,798	166,317	169,756	172,630	175,195	177,035	179,600	182,296	184,662	185,076	187,246	14.3%
North Carolina (7,22,24)	21,280	21,855	23,136	23,136	23,325	23,694	24,087	24,253	24,253	24,253	25,735	20.9%
North Dakota	1,546	1,560	1,599	1,665	1,669	1,698	1,694	1,687	1,697	1,696	1,685	9.0%
North Mariana Islands (22,24,27)	135	135	210	210	126	123	128	134	134	134	134	-0.7%
Ohio (22,24)	37,745	38,541	38,234	38,849	38,237	38,623	37,873	38,189	38,189	38,189	34,692	-8.1%
Oklahoma (9,16,21)	12,978	11,970	13,465	13,465	13,431	13,470	11,695	11,768	13,549	13,713	13,415	3.4%
Oregon (5,6)	12,276	12,276	12,276	12,464	12,475	12,227	12,427	12,274	12,196	12,158	12,285	0.1%
Palau (22,25)	N/A	N/A	N/A	N/A	N/A	N/A	44	50	50	44	42	N/A
Pennsylvania	48,947	49,697	50,072	48,992	49,644	49,406	50,112	50,039	49,249	49,087	49,412	1.0%
Puerto Rico (2,4,6,11,22,24,27)	13,282	14,193	14,193	15,318	13,673	14,293	14,008	13,944	13,944	13,944	13,944	5.0%
Rhode Island (7,22,24)	4,060	4,173	4,179	4,224	4,219	4,167	4,154	4,071	4,071	4,071	4,081	0.5%
South Carolina	9,537	9,587	9,874	10,031	10,208	10,316	10,445	10,568	10,798	10,853	11,003	15.4%
South Dakota (19)	1,865	1,905	1,934	1,939	1,960	1,933	1,995	1,995	1,907	1,985	2,026	8.6%
Tennessee (6,24,27)	16,947	17,203	17,203	17,965	18,288	18,461	18,695	18,702	18,818	18,818	18,818	11.0%
Texas	80,657	82,607	84,800	86,494	87,957	89,361	90,485	91,244	92,833	93,821	95,196	18.0%
Utah (6,27)	7,309	7,840	7,840	8,413	8,468	8,204	8,285	8,362	8,473	8,581	8,581	17.4%
Vermont (6,14,18,22,23,27)	2,270	2,300	2,300	2,272	2,326	2,326	2,227	3,612	3,612	2,198	2,198	-3.2%
Virgin Islands (4,5,8,13,15,19,22,24,27)	650	650	456	456	561	372	776	776	776	776	776	19.4%
Virginia (7,22,24)	24,091	24,468	24,064	24,062	24,193	24,249	24,208	24,230	24,230	24,020	23,923	-0.7%
Washington	23,741	24,032	24,620	24,844	25,577	25,786	26,057	26,182	26,316	26,701	26,428	11.3%
West Virginia (7,22,24)	4,854	4,901	4,942	4,918	4,922	4,862	4,849	4,770	4,770	4,770	4,673	-3.7%
Wisconsin (7)	15,364	15,538	15,481	15,481	15,072	15,549	15,539	15,512	15,482	15,488	15,384	0.1%
Wyoming (7,22,24)	1,668	1,681	1,778	1,778	1,715	1,776	1,716	1,773	1,773	1,692	1,704	2.2%
TOTAL	1,245,205	1,268,011	1,281,432	1,300,705	1,312,869	1,335,963	1,342,379	1,352,077	1,328,742	1,327,910	1,327,010	6.6%

Data Source: American Bar Association's National Lawyer Population Survey

APPENDIX – DEMOGRAPHICS

Resident Lawyers by State: 2012 - 2022 *... continued*

* Individual state bar associations or licensing agencies are asked to provide the number of resident and active attorneys as of December 31st of the prior year, e.g. 2022 data is as of 12/31/2021. The numbers reflected here are the best available data provided to us from the respective associations or agencies; significant exceptions are noted below.

(1) The Alabama number reflects all resident attorneys regardless of whether they were active or not.
(2) Illinois, Guam, and Puerto Rico did not provide current data for 2011 so prior year's stats were used.
(3) During 2011, Indiana began using a new system for attorney registration leading to greater accuracy in reporting in 2012.
(4) Arizona, Illinois, Guam, Puerto Rico, and the Virgin Islands did not provide current data for 2012 so prior year's stats were used.
(5) Oregon, Guam, and the Virgin Islands did not provide current data for 2013 so prior year's stats were used.
(6) Dist. of Columbia, Florida, Maine, Mississippi, Nebraska, Nevada, New Mexico, Oregon, Puerto Rico, Tennessee, Utah, and Vermont did not provide current data for 2014 so the data from the most recent submission were used.
(7) Due to timing of the survey in 2014, the following states submitted data from Fall 2014 rather than as of December 31, 2013: Arkansas, Connecticut, Indiana, Kansas, Louisiana, Michigan, Minnesota, Missouri, North Carolina, Rhode Island, Virginia, Wisconsin, West Virginia, and Wyoming. All but Kansas, Louisiana, Minnesota, Rhode Island, Virginia, and West Virginia chose not to submit updated data for the 2015 survey.
(8) Prior to the 2014 survey, the Virgin Islands did not report on active/inactive status. The decrease in 2014 is a more accurate representation of Resident Active lawyers.
(9) Prior to the 2014 survey, Oklahoma excluded lawyers categorized as "Over 70" from their Resident Active submission. The 2014 results include this group.
(10) In 2016, New Jersey was in the process of a system conversion and was not able to provide information in time to be included in the survey. As a result, the most recent prior submission was used.
(11) In 2016, four agencies had changes in the availability of Active/Inactive status data. Arkansas, Connecticut, and Indiana were not able to provide a breakout of Active/Inactive status for Resident attorneys as they had in prior years. Puerto Rico had not provided Active/Inactive status details in prior years, but was able to provide it for the 2016 survey. In 2018, Indiana corrected the resident active figures for 2016; this report has been updated to reflect the new total attorney count for 2016 than was previously reported.
(12) In 2017, the source of the Maryland data changed from the voluntary Maryland State Bar to the Maryland Supreme Court. The Maryland Supreme Court does not track residency status, leading to larger results than prior years.
(13) In 2017, three agencies had changes in the availability of Active/Inactive status data. Indiana was not able to provide a breakout of Active/Inactive status for Resident attorneys in 2016, but was able to for 2017. American Samoa had not provided Residency or Active status details in recent years, but was able to provide it for the 2017 survey. Virgin Islands changed its classifications for the Active/Inactive status for the 2017 survey.
(14) Vermont was not able to provide current data for 2017 so the data from the most recent submission were used.
(15) Virgin Islands was not able to provide residency in 2018 due to Hurricanes Irma and Maria.
(16) In 2018, Oklahoma removed senior members from the Resident Active count (they can still practice but are over the age of 70).
(17) In 2019, Maryland, Nevada, and New York provided corrected 2018 lawyer counts; this report reflects the corrected 2018 total attorney count.
(18) In 2019, four agencies had changes in the availability of residency data. Arkansas adopted a new software system and cleaned up data; the decrease in 2019 is a more accurate representation of Resident Active Lawyers. Louisiana changed how it reports residency status, causing an increase in the reported lawyer count. Minnesota and Vermont no longer track resident/non-resident status; the counts now reflects all active lawyers.
(19) New Hampshire, South Dakota, and Virgin Islands did not provide current data for 2019, so prior year's stats were used.
(20) In 2020, the District of Columbia changed how it reports residency status to report DC addresses only and not the DC metro area.
(21) In 2020, Oklahoma returned senior members to the Resident Active count after excluding them in 2018 and 2019.
(22) Due to the COVID-19 pandemic and other reasons, not all states and territories participated in 2020; prior year responses were used for the following: Alaska, American Samoa, Arizona, Colorado, Connecticut, Delaware, Guam, Hawaii, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, North Carolina, North Mariana Islands, Ohio, Palau, Puerto Rico, Rhode Island, Vermont, Virgin Islands, Virginia, West Virginia, Wyoming.
(23) In 2021, Vermont returned to tracking resident/non-resident status; the count now reflects resident active attorneys.
(24) Due to the COVID-19 pandemic and other reasons, not all states and territories participated in 2021; prior year responses (2019 or 2020) were used for the following: Alabama, American Samoa, Colorado, Connecticut, Delaware, Guam, Illinois, Kentucky, Maryland, Michigan, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, Northern Mariana Islands, Ohio, Puerto Rico, Rhode Island, Tennessee, West Virginia. Responses from 2018 were used for Virgin Islands.
(25) Data for Palau not available prior to 2018.
(26) In 2022, Alabama began distinguishing resident active and resident inactive numbers.
(27) Not all states and territories participated in 2022; prior year responses (2019, 2020, or 2021) were used for the following: American Samoa, Arkansas, Colorado, Connecticut, Delaware, Florida, Guam, Hawaii, Illinois, Maryland, Minnesota, New Hampshire, Northern Mariana Islands, Puerto Rico, Tennessee, Utah, Vermont. Responses from 2018 were used for Virgin Islands.

APPENDIX – DEMOGRAPHICS

Lawyers by Gender: 2012 - 2022

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Change from 2012
Male	66.7%	66.3%	64.3%	65.3%	64.4%	64.7%	63.6%	63.5%	63.2%	62.8%	61.5%	-5.2
Female	33.3%	33.7%	35.7%	34.7%	35.6%	35.3%	36.1%	36.5%	36.8%	37.2%	38.3%	5
Other	N/A	N/A	N/A	N/A	0.0%	0.0%	0.3%	0.0%	0.0%	0.0%	0.2%	0.2
Count of States Reporting Statistic	44	43	43	43	45	46	46	45	44	45	44	0
% of Lawyers with Reported Statistic	59%	59%	61%	63%	66%	61%	63%	61%	60%	62%	73%	13.3 pp

Source: 2022 ABA National Lawyer Population Survey

Lawyers by Race and Ethnicity: 2012 - 2022

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Change from 2012
Black	4.7%	4.8%	4.8%	4.7%	5.3%	5.2%	4.9%	5.1%	4.7%	4.7%	4.5%	-0.2
Asian American	2.3%	1.9%	2.4%	2.5%	2.7%	2.4%	2.7%	2.5%	2.1%	2.5%	5.5%	3.1
White	88.4%	88.7%	88.1%	86.1%	85.4%	84.9%	84.8%	84.8%	85.8%	85.4%	81.0%	-7.5
Hawaiian/Pacific Islander	0.5%	0.3%	0.3%	0.6%	0.3%	0.4%	0.3%	0.4%	0.4%	0.3%	0.2%	-0.4
Hispanic	3.5%	3.7%	3.8%	5.2%	4.7%	5.0%	5.2%	4.7%	4.6%	4.8%	5.8%	2.3
Multiracial	N/A	N/A	0.0%	0.0%	1.2%	1.6%	1.5%	1.9%	1.9%	2.0%	2.7%	2.7
Native American	0.6%	0.6%	0.5%	0.8%	0.5%	0.6%	0.6%	0.5%	0.4%	0.4%	0.5%	-0.1
Count of States Reporting Statistic	16	16	17	18	19	22	21	20	21	26	26	10
% of Lawyers with Reported Statistic	20.6%	20.6%	21.5%	24.7%	30.4%	29.1%	27.8%	34.8%	31.4%	35.6%	45.3%	24.7

Source: 2022 ABA National Lawyer Population Survey

APPENDIX – DEMOGRAPHICS

Law Firm Partners and Associates Demographics: 2009 - 2021

	Partners						Associates					
	Asian		Black		Hispanic		Asian		Black		Hispanic	
	Total %	% Women	Total %	% Women	Total %	% Women	Total %	% Women	Total %	% Women	Total %	% Women
2021	4.30%	1.73%	2.22%	0.86%	2.86%	0.92%	12.49%	7.39%	5.22%	3.17%	6.11%	3.25%
2020	4.08	1.62	2.1	0.8	2.8	0.9	12.12	7.18	5.1	3.04	5.64	2.99
2019	3.89	1.46	1.97	0.75	2.52	0.8	12.17	7.17	4.76	2.8	5.17	2.7
2018	3.63	1.38	1.83	0.68	2.49	0.77	11.69	6.64	4.48	2.55	4.71	2.45
2017	3.31	1.23	1.83	0.66	2.4	0.73	11.4	6.52	4.28	2.42	4.57	2.23
2016	3.13	1.17	1.81	0.64	2.31	0.68	11.25	6.35	4.11	2.32	4.42	2.15
2015	2.89	1.07	1.77	0.64	2.19	0.63	10.93	6	3.95	2.25	4.28	2.03
2014	2.74	0.99	1.72	0.63	2.16	0.6	10.8	5.81	4.01	2.31	3.95	1.89
2013	2.67	0.91	1.78	0.6	1.99	0.54	10.48	5.64	4.1	2.43	3.82	1.89
2012	2.48	0.89	1.73	0.6	1.91	0.48	10.01	5.4	4.19	2.55	3.9	1.95
2011	2.36	0.82	1.71	0.58	1.92	0.48	9.65	5.31	4.29	2.61	3.83	1.92
2010	2.3	0.81	1.7	0.56	1.7	0.44	9.39	5.15	4.36	2.75	3.81	1.94
2009	2.2	0.76	1.71	0.57	1.65	0.41	9.28	5.12	4.66	2.93	3.89	2

Source: National Association for Law Placement, 2021 Report on Diversity in U.S. Law Firms

APPENDIX – DEMOGRAPHICS

Women and Lawyers of Color at Law Firms by Metro Area: 2021

	Partners				Associates				
	Total	% Women	% People of color	% Women of color	Total	% Women	% People of color	% Women of color	Number of offices
Atlanta	779	23.75	10.14	3.59	710	47.18	24.51	13.38	20
Austin	254	28.74	13.39	3.94	201	44.28	20.4	8.96	16
Boston	1,260	26.67	7.06	2.78	1,524	47.83	22.9	12.86	33
Charlotte	408	18.63	5.15	1.72	356	43.26	14.89	7.87	11
Chicago	2,672	25.82	9.47	3.59	2,241	45.92	22.98	12.94	45
Cincinnati	236	25.42	4.24	1.69	128	41.41	14.06	5.47	5
Cleveland	412	21.84	3.16	0.97	292	38.7	10.27	5.14	6
Columbus	386	26.17	9.07	3.37	211	47.39	16.11	8.06	10
Dallas	780	21.41	11.03	3.85	740	43.51	24.59	11.35	33
Denver	572	29.37	8.04	2.97	445	49.21	17.53	9.89	19
Detroit	528	29.17	6.82	2.46	190	46.84	15.26	9.47	9
Grand Rapids	282	23.4	4.26	1.06	101	47.52	17.82	10.89	5
Houston	786	21.12	16.41	5.34	972	43	29.22	14.81	31
Indianapolis	313	21.41	3.19	1.28	118	43.22	14.41	11.86	5
Kansas City, MO	442	27.15	4.75	1.81	228	46.49	16.23	9.21	6
Los Angeles	1,513	26.9	17.91	6.28	1,888	51.59	37.55	23.2	64
Miami	281	28.83	30.25	10.32	251	52.99	49.4	28.29	15
Milwaukee	511	25.83	4.7	2.15	263	47.91	13.31	8.37	5
Minneapolis	799	26.66	6.26	2.25	441	49.43	14.97	9.52	15
New York City	5,590	23.74	12.47	4.81	11,685	47.64	30.9	18.19	81
Northern NJ/Newark	283	23.32	6.01	1.77	178	46.63	21.91	11.24	6
Northern Virginia	111	15.32	13.51	4.5	84	46.43	26.19	15.48	6
Orange County, CA	431	20.65	16.94	6.03	348	47.13	42.82	26.15	14
Philadelphia	498	25.7	6.83	2.21	406	47.54	18.97	11.08	10
Phoenix	252	25.79	11.11	3.17	117	41.03	19.66	5.98	9
Pittsburgh	258	25.19	3.1	1.94	170	43.53	13.53	8.82	7
Portland, OR	367	27.79	7.36	2.72	161	40.37	19.88	9.94	10
Salt Lake City	115	17.39	6.09	2.61	91	36.26	9.89	5.49	5
San Diego	141	29.79	19.15	9.22	227	41.41	33.48	16.74	10
San Francisco	1,225	32.65	17.55	7.35	1,416	54.24	37.08	23.38	43
Seattle	621	30.92	11.59	4.99	475	47.37	28.42	16	19
Silicon Valley, CA	641	26.52	22.62	8.42	1,027	49.95	47.71	27.46	36
St. Louis	557	28.55	7.18	2.33	248	45.56	14.11	6.85	9
Tampa	115	15.65	7.83	0.87	75	53.33	16	10.67	6
Washington, DC	3,682	27.43	12.49	5	4,099	48.91	27.81	15.71	77
Wilmington, DE	309	26.21	5.5	2.59	325	43.38	12.92	7.08	15

Source: National Association for Law Placement, 2021 Report on Diversity in U.S. Law Firms

APPENDIX – DEMOGRAPHICS

Lawyers with Disabilities at Law Firms: 2021

	All firms		Firms of 250 Lawyers or Fewer		Firms of 251-500 Lawyers		Firms of 501-700 Lawyers		Firms of 701+ Lawyers	
	Number	% of Total	Number	% of Total	Number	% of Total	Number	% of Total	Number	% of Total
Partners	340	1.07%	81	1.19%	66	1.02%	19	0.71%	174	1.11%
Associates	361	1.25	33	0.89	67	1.42	17	0.72	244	1.34
Other Lawyers	164	1.59	24	1.35	25	1.38	13	1.33	102	1.77
All Lawyers	865	1.22	138	1.12	158	1.22	49	0.82	520	1.31

Source: National Association for Law Placement, 2021 Report on Diversity in U.S. Law Firms

LGBTQ Lawyers at Law Firms: 2021

	All firms		Firms of 100 or Fewer Lawyers		Firms of 101-2150 Lawyers		Firms of 251-500 Lawyers		Firms of 501-700 Lawyers		Firms of 701+ Lawyers	
	Number	% of Total	Number	% of Total	Number	% of Total	Number	% of Total	Number	% of Total	Number	% of Total
Partners	976	2.31%	34	2.34%	122	2.13%	170	2.08%	83	2.06%	567	2.47%
Associates	2,276	5.35	32	4.08	123	3.83	246	4.39	171	4.92	1,704	5.78
Other Lawyers	401	2.73	4	1.06	25	1.59	61	2.47	37	2.46	274	3.12
All Lawyers	3,653	3.67	70	2.67	270	2.57	477	2.94	291	3.23	2,545	4.16
Summer Associates	522	8.41	5	2.94	26	6.7	44	7.31	40	7.5	407	9.02

APPENDIX – DEMOGRAPHICS

Legal Demand by Metro Area: 2021

Metro area	Location quotient*
Washington-Arlington-Alexandria, DC-VA-MD-WV	3.12
Tallahassee, FL	2.51
Miami-Fort Lauderdale-West Palm Beach, FL	2.09
New York-Newark-Jersey City, NY-NJ-PA	2.03
Santa Fe, NM	1.95
Trenton, NJ	1.85
Charleston, WV	1.85
Denver-Aurora-Lakewood, CO	1.60
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	1.54
San Francisco-Oakland-Hayward, CA	1.53
Los Angeles-Long Beach-Anaheim, CA	1.49
Albany-Schenectady-Troy, NY	1.48
Tampa-St. Petersburg-Clearwater, FL	1.47
Oklahoma City, OK	1.47
Cheyenne, WY	1.43
New Orleans-Metairie, LA	1.41
Montgomery, AL	1.41
Hartford-West Hartford-East Hartford, CT	1.40
Sacramento--Roseville--Arden-Arcade, CA	1.39
Bridgeport-Stamford-Norwalk, CT	1.38
Boston-Cambridge-Nashua, MA-NH	1.34
Austin-Round Rock, TX	1.34
Missoula, MT	1.34
Carson City, NV	1.29
Jackson, MS	1.29
Chicago-Naperville-Elgin, IL-IN-WI	1.28
Buffalo-Cheektowaga-Niagara Falls, NY	1.27
Naples-Immokalee-Marco Island, FL	1.22
Albuquerque, NM	1.21
Harrisburg-Carlisle, PA	1.20
Topeka, KS	1.20
San Diego-Carlsbad, CA	1.18
North Port-Sarasota-Bradenton, FL	1.17
Columbia, SC	1.15
Manchester, NH	1.14
Detroit-Warren-Dearborn, MI	1.14
Atlanta-Sandy Springs-Roswell, GA	1.13
Raleigh, NC	1.13
Boulder, CO	1.12
Minneapolis-St. Paul-Bloomington, MN-WI	1.12
Springfield, IL	1.12
Pensacola-Ferry Pass-Brent, FL	1.11
Providence-Warwick, RI-MA	1.10
Portland-South Portland, ME	1.10
Richmond, VA	1.09
Baltimore-Columbia-Towson, MD	1.08
Pittsburgh, PA	1.06
San Jose-Sunnyvale-Santa Clara, CA	1.05
Bismarck, ND	1.05
Hilton Head Island-Bluffton-Beaufort, SC	1.04
Jefferson City, MO	1.04
Las Vegas-Henderson-Paradise, NV	1.03
Anchorage, AK	1.02
Burlington-South Burlington, VT	1.02
Des Moines-West Des Moines, IA	1.01
Birmingham-Hoover, AL	1.00
Madison, WI	1.00
Olympia-Tumwater, WA	1.00
Lansing-East Lansing, MI	0.98
Charleston-North Charleston, SC	0.98
Urban Honolulu, HI	0.98
Atlantic City-Hammonton, NJ	0.96
Jacksonville, FL	0.96
Lexington-Fayette, KY	0.96
Milwaukee-Waukesha-West Allis, WI	0.95
Salt Lake City, UT	0.95
St. Louis, MO-IL	0.95
Cleveland-Elyria, OH	0.94
Omaha-Council Bluffs, NE-IA	0.94
Sebastian-Vero Beach, FL	0.93
Seattle-Tacoma-Bellevue, WA	0.92
Kansas City, MO-KS	0.92
Salem, OR	0.90
Oxnard-Thousand Oaks-Ventura, CA	0.89
Little Rock-North Little Rock-Conway, AR	0.89
Brunswick, GA	0.89
Portland-Vancouver-Hillsboro, OR-WA	0.88
Phoenix-Mesa-Scottsdale, AZ	0.88
Corpus Christi, TX	0.87
Indianapolis-Carmel-Anderson, IN	0.87
Rochester, NY	0.87
Louisville/Jefferson County, KY-IN	0.87
Houston-The Woodlands-Sugar Land, TX	0.86
Great Falls, MT	0.86
Dallas-Fort Worth-Arlington, TX	0.85
Dover, DE	0.84
Durham-Chapel Hill, NC	0.84
Columbus, OH	0.83
Boise City, ID	0.83
Syracuse, NY	0.82
Gainesville, FL	0.81
Orlando-Kissimmee-Sanford, FL	0.81
Bloomington, IL	0.81
Baton Rouge, LA	0.81
Kingston, NY	0.80
New Bern, NC	0.80
Savannah, GA	0.79
Colorado Springs, CO	0.79
Lafayette, LA	0.79
Tulsa, OK	0.78
Wheeling, WV-OH	0.78
Panama City, FL	0.78
New Haven, CT	0.77
Bloomington, IN	0.77
Macon, GA	0.77
Carbondale-Marion, IL	0.77
Charlotte-Concord-Gastonia, NC-SC	0.76
Nashville-Davidson--Murfreesboro--Franklin, TN	0.76
Tucson, AZ	0.76
Palm Bay-Melbourne-Titusville, FL	0.76
Charlottesville, VA	0.74
Virginia Beach-Norfolk-Newport News, VA-NC	0.74
Billings, MT	0.74
Rapid City, SD	0.73
Fresno, CA	0.72
Coeur d'Alene, ID	0.72
Tyler, TX	0.71
Bend-Redmond, OR	0.71
Lincoln, NE	0.71
Punta Gorda, FL	0.71
Mobile, AL	0.70
San Antonio-New Braunfels, TX	0.70
Cape Coral-Fort Myers, FL	0.70
Port St. Lucie, FL	0.70
Bowling Green, KY	0.70
Parkersburg-Vienna, WV	0.70

Source: U.S. Bureau of Labor Statistics, Occupational Employment Statistics

APPENDIX – DEMOGRAPHICS

Legal Demand by Metro Area: 2021 ... *continued*

Metro area	Location quotient*
Santa Maria-Santa Barbara, CA	0.69
Ithaca, NY	0.69
Waterbury, CT	0.69
Morgantown, WV	0.69
Lake Charles, LA	0.69
Crestview-Fort Walton Beach-Destin, FL	0.68
Myrtle Beach-Conway-North Myrtle Beach, SC-NC	0.68
Midland, MI	0.67
Santa Rosa, CA	0.67
Dothan, AL	0.67
Springfield, MO	0.67
Bangor, ME	0.67
Ann Arbor, MI	0.66
Ocean City, NJ	0.66
Binghamton, NY	0.66
Muncie, IN	0.65
Reno, NV	0.65
Akron, OH	0.65
Cincinnati, OH-KY-IN	0.65
Grand Junction, CO	0.65
Alexandria, LA	0.65
Pocatello, ID	0.65
Greenville-Anderson-Mauldin, SC	0.64
Greenville, NC	0.64
Deltona-Daytona Beach-Ormond Beach, FL	0.64
Chattanooga, TN-GA	0.62
Barnstable Town, MA	0.62
Fargo, ND-MN	0.62
Spokane-Spokane Valley, WA	0.62
Enid, OK	0.62
New Bedford, MA	0.61
Las Cruces, NM	0.61
Ocala, FL	0.61
Rockford, IL	0.61
Hattiesburg, MS	0.61
Eugene, OR	0.60
Casper, WY	0.60
Danbury, CT	0.59
Knoxville, TN	0.59
Columbus, GA-AL	0.59
Prescott, AZ	0.59
Athens-Clarke County, GA	0.59
Hammond, LA	0.59
Wausau, WI	0.58
Lakeland-Winter Haven, FL	0.58
Terre Haute, IN	0.58
Asheville, NC	0.58
Flagstaff, AZ	0.58
Lake Havasu City-Kingman, AZ	0.58
Grand Rapids-Wyoming, MI	0.57
Memphis, TN-MS-AR	0.57
Fairbanks, AK	0.57
Monroe, LA	0.57
Wichita, KS	0.57
Homosassa Springs, FL	0.57
Fort Wayne, IN	0.56
California-Lexington Park, MD	0.56
Redding, CA	0.56
Elmira, NY	0.56
St. Cloud, MN	0.56
Dayton, OH	0.56
Duluth, MN-WI	0.56
Lewiston-Auburn, ME	0.56
Salinas, CA	0.55
San Luis Obispo-Paso Robles-Arroyo Grande, CA	0.55
Peoria, IL	0.55
Columbia, MO	0.55
Glens Falls, NY	0.55
Vineland-Bridgeton, NJ	0.54
Grand Forks, ND-MN	0.54
Brownsville-Harlingen, TX	0.54
Mankato-North Mankato, MN	0.54
Rome, GA	0.54
Bellingham, WA	0.54
Valdosta, GA	0.54
Napa, CA	0.53
Pittsfield, MA	0.53
Provo-Orem, UT	0.53
Davenport-Moline-Rock Island, IA-IL	0.53
Harrisonburg, VA	0.53
Williamsport, PA	0.53
Huntington-Ashland, WV-KY-OH	0.53
Sebring, FL	0.53
Lawrence, KS	0.53
Santa Cruz-Watsonville, CA	0.52
Portsmouth, NH-ME	0.52
Springfield, MA-CT	0.52
Lubbock, TX	0.52
South Bend-Mishawaka, IN-MI	0.52
Cedar Rapids, IA	0.52
Wilmington, NC	0.52
Evansville, IN-KY	0.52
Jacksonville, NC	0.52
Shreveport-Bossier City, LA	0.52
Idaho Falls, ID	0.52
Kahului-Wailuku-Lahaina, HI	0.52
Huntsville, AL	0.51
Greeley, CO	0.51
Reading, PA	0.51
Gulfport-Biloxi-Pascagoula, MS	0.51
Yakima, WA	0.51
Canton-Massillon, OH	0.51
Kokomo, IN	0.51
Salisbury, MD-DE	0.50
Sioux Falls, SD	0.50
Elizabethtown-Fort Knox, KY	0.50
Fayetteville-Springdale-Rogers, AR-MO	0.49
Utica-Rome, NY	0.49
Beaumont-Port Arthur, TX	0.49
Kingsport-Bristol-Bristol, TN-VA	0.49
Allentown-Bethlehem-Easton, PA-NJ	0.49
Saginaw, MI	0.49
Winston-Salem, NC	0.48
Norwich-New London-Westerly, CT-RI	0.48
Kalamazoo-Portage, MI	0.48
Amarillo, TX	0.48
Champaign-Urbana, IL	0.48
Racine, WI	0.48
Scranton--Wilkes-Barre--Hazleton, PA	0.48
Hagerstown-Martinsburg, MD-WV	0.48
Bay City, MI	0.47
Cape Girardeau, MO-IL	0.47
St. George, UT	0.47
The Villages, FL	0.47
Manhattan, KS	0.47
Augusta-Richmond County, GA-SC	0.47
Owensboro, KY	0.47
College Station-Bryan, TX	0.46
Yuba City, CA	0.46
Tuscaloosa, AL	0.46
Weirton-Steubenville, WV-OH	0.46

APPENDIX – DEMOGRAPHICS

Legal Demand by Metro Area: 2021 ... *continued*

Metro area	Location quotient*
Waco, TX	0.45
Greensboro-High Point, NC	0.45
Texarkana, TX-AR	0.45
San Angelo, TX	0.45
Erie, PA	0.45
Springfield, OH	0.45
Lafayette-West Lafayette, IN	0.45
Florence, SC	0.45
Youngstown-Warren-Boardman, OH-PA	0.45
Sierra Vista-Douglas, AZ	0.45
Grand Island, NE	0.45
Beckley, WV	0.45
Stockton-Lodi, CA	0.44
Medford, OR	0.44
Bremerton-Silverdale, WA	0.44
Fayetteville, NC	0.44
Farmington, NM	0.44
Pueblo, CO	0.44
Fort Collins, CO	0.43
Appleton, WI	0.43
Fond du Lac, WI	0.43
Iowa City, IA	0.43
York-Hanover, PA	0.43
Yuma, AZ	0.43
Albany, GA	0.43
Gainesville, GA	0.43
Riverside-San Bernardino-Ontario, CA	0.42
Modesto, CA	0.42
Toledo, OH	0.42
Winchester, VA-WV	0.42
McAllen-Edinburg-Mission, TX	0.42
Florence-Muscle Shoals, AL	0.42
Waterloo-Cedar Falls, IA	0.41
Ames, IA	0.41
East Stroudsburg, PA	0.41
Bakersfield, CA	0.40
Kennewick-Richland, WA	0.40
Watertown-Fort Drum, NY	0.40
Eau Claire, WI	0.40
Logan, UT-ID	0.40
Jackson, TN	0.40
Rochester, MN	0.40
Daphne-Fairhope-Foley, AL	0.40
Twin Falls, ID	0.40
Sioux City, IA-NE-SD	0.39
Green Bay, WI	0.39
Oshkosh-Neenah, WI	0.39
Hanford-Corcoran, CA	0.39
St. Joseph, MO-KS	0.39
Anniston-Oxford-Jacksonville, AL	0.39
Odessa, TX	0.38
Lancaster, PA	0.38
Lynchburg, VA	0.38
Wenatchee, WA	0.38
Mount Vernon-Anacortes, WA	0.38
Hinesville, GA	0.38
Lewiston, ID-WA	0.38
Midland, TX	0.37
El Paso, TX	0.37
Corvallis, OR	0.37
Staunton-Waynesboro, VA	0.37
State College, PA	0.37
Muskegon, MI	0.37
Decatur, IL	0.37
Gadsden, AL	0.37
Killeen-Temple, TX	0.36
Cumberland, MD-WV	0.36
Janesville-Beloit, WI	0.36
Spartanburg, SC	0.36
Warner Robins, GA	0.36
Kankakee, IL	0.36
El Centro, CA	0.35
Blacksburg-Christiansburg-Radford, VA	0.35
Albany, OR	0.35
Goldsboro, NC	0.35
Altoona, PA	0.35
Chico, CA	0.34
Sherman-Denison, TX	0.34
Visalia-Porterville, CA	0.34
Merced, CA	0.34
Joplin, MO	0.34
Johnson City, TN	0.34
Burlington, NC	0.34
Rocky Mount, NC	0.34
Clarksville, TN-KY	0.34
Johnstown, PA	0.34
Walla Walla, WA	0.33
La Crosse-Onalaska, WI-MN	0.33
Mansfield, OH	0.33
Fort Smith, AR-OK	0.33
Dubuque, IA	0.32
Monroe, MI	0.32
Cleveland, TN	0.32
Bloomsburg-Berwick, PA	0.32
Laredo, TX	0.32
Gettysburg, PA	0.32
Flint, MI	0.31
Jonesboro, AR	0.31
Lawton, OK	0.31
Dalton, GA	0.31
Auburn-Opelika, AL	0.30
Chambersburg-Waynesboro, PA	0.30
Columbus, IN	0.30
Dover-Durham, NH-ME	0.30
Ogden-Clearfield, UT	0.30
Sumter, SC	0.30
Decatur, AL	0.30
Michigan City-La Porte, IN	0.29
Pine Bluff, AR	0.29
Vallejo-Fairfield, CA	0.28
Jackson, MI	0.28
Victoria, TX	0.28
Longview, WA	0.28
Grants Pass, OR	0.27
Houma-Thibodaux, LA	0.27
Wichita Falls, TX	0.27
Battle Creek, MI	0.26
Hickory-Lenoir-Morganton, NC	0.26
Abilene, TX	0.26
Lebanon, PA	0.26
Lima, OH	0.25
Leominster-Gardner, MA	0.23
Niles-Benton Harbor, MI	0.23
Sheboygan, WI	0.23
Hot Springs, AR	0.20
Elkhart-Goshen, IN	0.16
Morristown, TN	0.16

*The location quotient represents the ratio of an occupation's share of employment in a given area to that occupation's share of employment in the U.S. as a whole. For example, an occupation that makes up 10% of employment in a metro area compared with 2% of U.S. employment would have a location quotient of 5 for that area.

APPENDIX – WAGES

Average Annual Salary for U.S. Lawyers: 2000 - 2021

	Average annual pay	% Increase
2000	$91,320	
2001	$91,920	0.7%
2002	$105,890	15.2%
2003	$107,250	1.3%
2004	$108,790	1.4%
2005	$110,520	1.6%
2006	$113,660	2.8%
2007	$118,280	4.1%
2008	$124,750	5.5%
2009	$129,020	3.4%
2010	$129,440	0.3%
2011	$130,490	0.8%
2012	$130,880	0.3%
2013	$131,990	0.8%
2014	$133,470	1.1%
2015	$136,260	2.1%
2016	$139,880	2.7%
2017	$141,890	1.4%
2018	$144,230	1.6%
2019	$145,300	0.7%
2020	$148,910	2.5%
2021	$148,030	-0.6%

Source: U.S. Bureau of Labor Statistics

APPENDIX – WAGES

Average Lawyer Wages by Metro Area: 2021

Metropolitan Area	Average Annual Lawyer Salary
San Jose-Sunnyvale-Santa Clara, CA	$231,200
San Francisco-Oakland-Hayward, CA	$191,460
Washington-Arlington-Alexandria, DC-VA-MD-WV	$186,610
New York-Newark-Jersey City, NY-NJ-PA	$183,870
Los Angeles-Long Beach-Anaheim, CA	$177,550
Boston-Cambridge-Nashua, MA-NH	$171,660
Bridgeport-Stamford-Norwalk, CT	$171,100
San Diego-Carlsbad, CA	$165,480
Midland, MI	$164,430
Oxnard-Thousand Oaks-Ventura, CA	$163,560
Napa, CA	$162,430
Midland, TX	$161,850
Dallas-Fort Worth-Arlington, TX	$161,650
Santa Rosa, CA	$160,560
Houston-The Woodlands-Sugar Land, TX	$160,120
Danbury, CT	$159,710
Sacramento--Roseville--Arden-Arcade, CA	$157,540
Chicago-Naperville-Elgin, IL-IN-WI	$153,930
Vallejo-Fairfield, CA	$153,510
Santa Maria-Santa Barbara, CA	$153,410
Leominster-Gardner, MA	$153,010
Fayetteville-Springdale-Rogers, AR-MO	$151,200
Riverside-San Bernardino-Ontario, CA	$151,180
Tyler, TX	$150,740
Portland-Vancouver-Hillsboro, OR-WA	$147,890
Milwaukee-Waukesha-West Allis, WI	$147,070
Hartford-West Hartford-East Hartford, CT	$146,540
Pittsfield, MA	$146,290
Corpus Christi, TX	$146,230
Durham-Chapel Hill, NC	$145,910
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	$145,720
Providence-Warwick, RI-MA	$145,450
Charlotte-Concord-Gastonia, NC-SC	$145,430
Santa Cruz-Watsonville, CA	$145,320
Dothan, AL	$144,830
Seattle-Tacoma-Bellevue, WA	$144,740
Provo-Orem, UT	$144,520
Charlottesville, VA	$144,440
Atlanta-Sandy Springs-Roswell, GA	$144,380
New Bedford, MA	$144,290
Denver-Aurora-Lakewood, CO	$143,890
Salinas, CA	$142,560
Richmond, VA	$142,490
Portsmouth, NH-ME	$142,450
Birmingham-Hoover, AL	$141,410
Orlando-Kissimmee-Sanford, FL	$141,250
San Luis Obispo-Paso Robles-Arroyo Grande, CA	$140,920
Austin-Round Rock, TX	$140,790
New Haven, CT	$140,560
Fresno, CA	$140,370
Baltimore-Columbia-Towson, MD	$139,660
Mobile, AL	$139,660
Dubuque, IA	$138,920
Stockton-Lodi, CA	$138,850
Sebastian-Vero Beach, FL	$138,650
Miami-Fort Lauderdale-West Palm Beach, FL	$138,390
Minneapolis-St. Paul-Bloomington, MN-WI	$138,210
Utica-Rome, NY	$137,660
Chico, CA	$137,450
Manchester, NH	$137,380
Winston-Salem, NC	$137,370
Reno, NV	$137,050
Jackson, MI	$136,960
Norwich-New London-Westerly, CT-RI	$136,960
Bakersfield, CA	$136,760
Odessa, TX	$136,510
Las Vegas-Henderson-Paradise, NV	$136,310
Atlantic City-Hammonton, NJ	$136,260
Niles-Benton Harbor, MI	$136,010
Ithaca, NY	$135,660
Chattanooga, TN-GA	$135,400
Trenton, NJ	$134,780
Syracuse, NY	$134,570
Beaumont-Port Arthur, TX	$134,450
Modesto, CA	$134,430
Indianapolis-Carmel-Anderson, IN	$134,400
Salem, OR	$134,310
San Antonio-New Braunfels, TX	$133,900
Kansas City, MO-KS	$133,880
Waterbury, CT	$132,960
Greenville-Anderson-Mauldin, SC	$132,750
Fort Collins, CO	$132,590
Springfield, MA-CT	$131,830
Salt Lake City, UT	$131,450
Sioux City, IA-NE-SD	$131,430
Huntsville, AL	$131,420
Kingsport-Bristol-Bristol, TN-VA	$131,230
Phoenix-Mesa-Scottsdale, AZ	$131,160
Peoria, IL	$130,920
Green Bay, WI	$130,670
Wausau, WI	$130,210
Waco, TX	$130,130
El Centro, CA	$130,040
Cleveland-Elyria, OH	$129,790
Fort Wayne, IN	$129,680
California-Lexington Park, MD	$129,590
Raleigh, NC	$129,430
Auburn-Opelika, AL	$129,130
St. Louis, MO-IL	$128,660
El Paso, TX	$128,430
Albany-Schenectady-Troy, NY	$128,270
Greensboro-High Point, NC	$128,060
Tulsa, OK	$127,920
Madison, WI	$127,510
Corvallis, OR	$127,380
Lakeland-Winter Haven, FL	$127,090
Appleton, WI	$127,080
Rochester, NY	$126,980
Allentown-Bethlehem-Easton, PA-NJ	$126,560
Tampa-St. Petersburg-Clearwater, FL	$126,560
Killeen-Temple, TX	$126,410
Kennewick-Richland, WA	$126,160
Nashville-Davidson--Murfreesboro--Franklin, TN	$126,130
Bloomington, IL	$126,070
Pittsburgh, PA	$125,860

Source: U.S. Bureau of Labor Statistics

APPENDIX – WAGES

Average Lawyer Wages by Metro Area: 2021 *... continued*

Metropolitan Area	Average Annual Lawyer Salary
Columbus, OH	$125,850
Kalamazoo-Portage, MI	$125,370
Sherman-Denison, TX	$125,340
Lubbock, TX	$125,250
Knoxville, TN	$125,200
Fond du Lac, WI	$125,180
Oshkosh-Neenah, WI	$124,430
Lansing-East Lansing, MI	$124,420
Longview, TX	$124,230
Des Moines-West Des Moines, IA	$124,220
Cape Coral-Fort Myers, FL	$124,110
Roanoke, VA	$123,770
Visalia-Porterville, CA	$123,750
Detroit-Warren-Dearborn, MI	$123,730
Amarillo, TX	$123,670
Iowa City, IA	$123,670
Monroe, MI	$123,500
Watertown-Fort Drum, NY	$123,460
Grand Rapids-Wyoming, MI	$123,320
Barnstable Town, MA	$122,790
Victoria, TX	$122,730
Port St. Lucie, FL	$122,620
Texarkana, TX-AR	$122,250
Savannah, GA	$122,240
Jacksonville, FL	$122,150
South Bend-Mishawaka, IN-MI	$122,060
Akron, OH	$121,940
Cincinnati, OH-KY-IN	$121,930
Eau Claire, WI	$121,930
Merced, CA	$121,750
Toledo, OH	$121,530
College Station-Bryan, TX	$121,290
Lancaster, PA	$121,280
Salisbury, MD-DE	$121,270
Cedar Rapids, IA	$121,110
Joplin, MO	$121,040
Johnson City, TN	$120,590
Staunton-Waynesboro, VA	$120,450
Greeley, CO	$120,410
Buffalo-Cheektowaga-Niagara Falls, NY	$120,390
Flint, MI	$120,360
Albuquerque, NM	$120,290
Harrisburg-Carlisle, PA	$120,270
Redding, CA	$120,020
Yuba City, CA	$119,810
Ann Arbor, MI	$119,750
Medford, OR	$119,580
Charleston, WV	$119,520
Cleveland, TN	$119,490
Carson City, NV	$119,140
Wheeling, WV-OH	$119,020
Pensacola-Ferry Pass-Brent, FL	$118,920
Kingston, NY	$118,890
Bay City, MI	$118,810
New Orleans-Metairie, LA	$118,690
San Angelo, TX	$118,310
Lynchburg, VA	$118,120
Cape Girardeau, MO-IL	$118,110
Naples-Immokalee-Marco Island, FL	$118,040
Las Cruces, NM	$117,910
Davenport-Moline-Rock Island, IA-IL	$117,750
Winchester, VA-WV	$117,460
Greenville, NC	$117,020
Hanford-Corcoran, CA	$117,020
New Bern, NC	$116,790
Reading, PA	$116,730
Vineland-Bridgeton, NJ	$116,720
Ocean City, NJ	$116,690
Abilene, TX	$116,590
Tucson, AZ	$116,560
St. George, UT	$116,420
Terre Haute, IN	$116,360
Columbia, MO	$116,340
Chambersburg-Waynesboro, PA	$116,070
Olympia-Tumwater, WA	$115,780
Morgantown, WV	$115,760
Santa Fe, NM	$115,640
Bend-Redmond, OR	$115,580
Bremerton-Silverdale, WA	$115,450
Champaign-Urbana, IL	$115,310
Fargo, ND-MN	$114,820
McAllen-Edinburg-Mission, TX	$114,670
Montgomery, AL	$114,550
Harrisonburg, VA	$114,460
Wilmington, NC	$114,240
North Port-Sarasota-Bradenton, FL	$114,120
Logan, UT-ID	$113,980
Virginia Beach-Norfolk-Newport News, VA-NC	$113,860
Cumberland, MD-WV	$113,440
Anchorage, AK	$113,260
Racine, WI	$113,100
Springfield, MO	$112,710
Deltona-Daytona Beach-Ormond Beach, FL	$112,660
Houma-Thibodaux, LA	$112,620
St. Joseph, MO-KS	$112,440
Elkhart-Goshen, IN	$112,260
Bloomsburg-Berwick, PA	$112,220
Blacksburg-Christiansburg-Radford, VA	$112,180
Memphis, TN-MS-AR	$112,160
Jackson, TN	$112,140
Florence-Muscle Shoals, AL	$112,130
Springfield, IL	$112,040
Grand Forks, ND-MN	$112,020
Baton Rouge, LA	$111,800
Gulfport-Biloxi-Pascagoula, MS	$111,700
State College, PA	$111,540
Sheboygan, WI	$111,390
Asheville, NC	$111,240
Waterloo-Cedar Falls, IA	$111,190
Lincoln, NE	$111,160
Scranton--Wilkes-Barre--Hazleton, PA	$111,070
Elmira, NY	$110,990
Columbus, IN	$110,830
Wenatchee, WA	$110,710
York-Hanover, PA	$110,640
Omaha-Council Bluffs, NE-IA	$110,610
Yakima, WA	$110,330
Flagstaff, AZ	$110,270
Rochester, MN	$110,200
Laredo, TX	$109,990
Columbus, GA-AL	$109,880
Dover-Durham, NH-ME	$109,870
St. Cloud, MN	$109,820

Source: U.S. Bureau of Labor Statistics

APPENDIX – WAGES

Average Lawyer Wages by Metro Area: 2021 *... continued*

Metropolitan Area	Average Annual Lawyer Salary
Saginaw, MI	$109,680
Spokane-Spokane Valley, WA	$109,660
Bloomington, IN	$108,870
Williamsport, PA	$108,850
Longview, WA	$108,620
Daphne-Fairhope-Foley, AL	$108,580
Panama City, FL	$108,540
Fairbanks, AK	$108,040
Burlington, NC	$107,920
Erie, PA	$107,770
Boise City, ID	$107,610
Crestview-Fort Walton Beach-Destin, FL	$107,570
Eugene, OR	$107,570
Walla Walla, WA	$107,420
Mount Vernon-Anacortes, WA	$107,340
Springfield, OH	$107,060
Yuma, AZ	$107,020
Albany, OR	$106,590
Casper, WY	$106,560
Colorado Springs, CO	$106,560
Ames, IA	$106,500
Evansville, IN-KY	$106,500
Lafayette, LA	$106,480
Portland-South Portland, ME	$106,410
Binghamton, NY	$106,380
Louisville/Jefferson County, KY-IN	$106,340
Muskegon, MI	$106,300
Tuscaloosa, AL	$106,290
Wichita Falls, TX	$106,280
Billings, MT	$105,990
Punta Gorda, FL	$105,910
Lexington-Fayette, KY	$105,820
Charleston-North Charleston, SC	$105,650
Hagerstown-Martinsburg, MD-WV	$105,330
Rocky Mount, NC	$105,310
Grand Junction, CO	$105,170
Decatur, IL	$105,130
Brownsville-Harlingen, TX	$105,050
Ogden-Clearfield, UT	$105,050
Bowling Green, KY	$104,650
Bismarck, ND	$104,640
Jacksonville, NC	$104,430
Glens Falls, NY	$104,390
Lafayette-West Lafayette, IN	$104,270
Columbia, SC	$103,710
Monroe, LA	$103,670
Dayton, OH	$103,650
Parkersburg-Vienna, WV	$103,490
Anniston-Oxford-Jacksonville, AL	$102,930
Sioux Falls, SD	$102,920
Hilton Head Island-Bluffton-Beaufort, SC	$102,870
The Villages, FL	$102,810
Morristown, TN	$102,410
Urban Honolulu, HI	$102,400
Manhattan, KS	$102,090
Rapid City, SD	$101,970
Fayetteville, NC	$101,850
Janesville-Beloit, WI	$101,830
Burlington-South Burlington, VT	$101,440
Jackson, MS	$101,330
Jefferson City, MO	$101,220
Bangor, ME	$101,160
La Crosse-Onalaska, WI-MN	$101,100
Lake Charles, LA	$101,040
Jonesboro, AR	$100,980
Shreveport-Bossier City, LA	$100,650
Huntington-Ashland, WV-KY-OH	$100,200
Macon, GA	$100,070
Great Falls, MT	$100,050
Coeur d'Alene, ID	$100,040
Sebring, FL	$99,980
Myrtle Beach-Conway-North Myrtle Beach, SC-NC	$99,870
Albany, GA	$99,830
Mankato-North Mankato, MN	$99,290
Farmington, NM	$99,240
Rome, GA	$99,240
Florence, SC	$99,180
Gainesville, GA	$99,080
Ocala, FL	$98,990
Little Rock-North Little Rock-Conway, AR	$98,940
Lebanon, PA	$98,780
Oklahoma City, OK	$98,550
Spartanburg, SC	$98,280
Palm Bay-Melbourne-Titusville, FL	$98,110
Idaho Falls, ID	$98,070
Sumter, SC	$97,870
Duluth, MN-WI	$97,840
Gadsden, AL	$97,510
Wichita, KS	$97,480
Brunswick, GA	$97,300
Goldsboro, NC	$97,180
Pueblo, CO	$97,060
Prescott, AZ	$97,040
Alexandria, LA	$96,290
Gettysburg, PA	$96,180
Lawrence, KS	$95,720
Warner Robins, GA	$94,770
Lake Havasu City-Kingman, AZ	$94,630
Kahului-Wailuku-Lahaina, HI	$94,620
Lawton, OK	$94,520
Rockford, IL	$94,350
Carbondale-Marion, IL	$94,210
Canton-Massillon, OH	$94,180
Tallahassee, FL	$93,880
Lewiston-Auburn, ME	$93,850
Youngstown-Warren-Boardman, OH-PA	$93,690
Athens-Clarke County, GA	$93,550
Mansfield, OH	$93,230
Sierra Vista-Douglas, AZ	$92,820
Dalton, GA	$92,610
Hattiesburg, MS	$92,580
East Stroudsburg, PA	$92,380
Topeka, KS	$92,170
Bellingham, WA	$92,160
Grand Island, NE	$91,730
Homosassa Springs, FL	$91,690
Missoula, MT	$91,630
Altoona, PA	$90,600
Cheyenne, WY	$90,520
Augusta-Richmond County, GA-SC	$90,320
Kankakee, IL	$90,180
Hinesville, GA	$90,160
Michigan City-La Porte, IN	$90,030
Owensboro, KY	$89,660

Source: U.S. Bureau of Labor Statistics

APPENDIX – WAGES

Average Lawyer Wages by Metro Area: 2021 *... continued*

Metropolitan Area	Average Annual Lawyer Salary
Clarksville, TN-KY	$89,040
Elizabethtown-Fort Knox, KY	$88,900
Johnstown, PA	$88,800
Pocatello, ID	$88,470
Valdosta, GA	$88,140
Twin Falls, ID	$87,920
Fort Smith, AR-OK	$86,940
Hot Springs, AR	$86,530
Decatur, AL	$86,360
Kokomo, IN	$84,920
Beckley, WV	$84,580
Lima, OH	$84,470
Weirton-Steubenville, WV-OH	$84,380
Hammond, LA	$84,350
Enid, OK	$83,730
Lewiston, ID-WA	$82,830
Pine Bluff, AR	$75,030
San Juan-Carolina-Caguas, PR	$68,450
Arecibo, PR	$55,170
Ponce, PR	$52,540
Mayaguez, PR	$52,400
Aguadilla-Isabela, PR	$44,290

Source: U.S. Bureau of Labor Statistics

Public Service Lawyer Salaries by Type and Seniority: 2004 - 2022

Years of Experience	2004	2006	2008	2010	2012	2014	2018	2022
Civil Legal Services								
Entry-level	$34,000	$36,000	$40,000	$42,000	$42,800	$44,600	$48,000	$57,500
5 years	40,000	43,300	48,000	49,400	50,200	51,000	54,800	67,100
11-15 years	51,900	55,000	60,000	62,500	64,900	65,000	69,400	78,500
Public Defenders								
Entry-level	39,000	43,300	47,400	47,500	50,500	50,400	58,300	59,700
5 years	50,000	54,700	60,000	60,300	62,800	63,000	68,000	75,700
11-15 years	65,000	65,500	75,000	76,200	78,600	84,500	96,400	100,500
Public Interest Organizations								
Entry-level	36,700	40,000	41,000	45,000	45,000	46,000	50,300	63,000
5 years	46,300	52,000	53,800	53,600	56,300	59,000	65,000	78,700
11-15 years	64,000	65,000	69,200	70,900	75,000	75,000	80,500	95,000

Source: National Association for Law Placement, 2022 Public Service Attorney Salary Survey

APPENDIX – LEGAL EDUCATION

Law School Applicants and Admissions: 2000-2021

Year	Applicants	% Change from Previous Year	Applicants Admitted	% Change from Previous Year	Applications	% Change from Previous Year
2021	71,112	12.2%	48,586	10.1%	481,584	26.0%
2020	63,384	1.5%	44,115	0.7%	382,174	0.3%
2019	62,434	2.7%	43,824	-0.4%	380,900	-1.6%
2018	60,770	7.4%	43,991	3.8%	387,034	8.5%
2017	56,583	-0.1%	42,369	-1.0%	356,762	1.6%
2016	54,897	0.9%	42,176	-0.3%	345,666	1.8%
2015	54,433	-2.5%	42,316	-2.9%	339,426	-4.2%
2014	55,808	-6.4%	43,565	-5.2%	354,368	-8.0%
2013	59,602	-12.2%	45,936	-9.3%	385,032	-17.8%
2012	67,897	-13.5%	50,645	-9.2%	468,128	-12.6%
2011	78,478	-10.7%	55,784	-7.7%	535,505	-11.4%
2010	87,916	1.5%	60,437	3.5%	604,313	6.8%
2009	86,576	3.8%	58,374	5.0%	565,656	6.2%
2008	83,371	-0.8%	55,595	-0.0%	532,580	3.0%
2007	84,021	-5.2%	55,607	-0.8%	517,110	-2.5%
2006	88,662	-7.4%	56,035	-0.2%	530,433	-3.3%
2005	95,760	-4.8%	56,135	0.4%	548,407	-1.3%
2004	100,601	1.1%	55,902	-1.7%	555,420	5.5%
2003	99,503	9.5%	56,868	0.7%	526,647	17.2%
2002	90,852	17.7%	56,475	9.1%	449,240	25.5%
2001	77,221	3.6%	51,761	3.0%	358,021	6.9%
2000	74,550		50,273		334,829	

Source: Law School Admission Council

APPENDIX – LEGAL EDUCATION

Law School Enrollment, Total and by Gender: 1970-2021

	Male	Female	Total
1970	71,336	6,682	78,018
1971	82,658	8,567	91,225
1972	86,164	11,878	98,042
1973	85,372	16,303	101,675
1974	84,425	21,283	105,708
1975	85,027	26,020	111,047
1976	83,058	29,343	112,401
1977	81,430	31,650	113,080
1978	80,375	35,775	116,150
1979	79,763	37,534	117,297
1980	78,667	40,834	119,501
1981	77,634	43,245	120,879
1982	76,252	45,539	121,791
1983	74,840	46,361	121,201
1984	72,950	46,897	119,847
1985	71,214	47,486	118,700
1986	69,893	47,920	117,813
1987	69,077	48,920	117,997
1988	69,762	50,932	120,694
1989	71,358	53,113	124,471
1990	73,164	54,097	127,261
1991	74,470	55,110	129,580
1992	77,146	56,637	133,783
1993	72,668	55,134	127,802
1994	73,181	55,808	128,989
1995	72,436	56,961	129,397
1996	71,500	57,123	128,623
1997	68,971	56,915	125,886
1998	67,675	57,952	125,627
1999	65,822	59,362	125,184
2000	64,540	60,633	125,173
2001	65,134	62,476	127,610
2002	67,706	65,179	132,885
2003	70,649	67,027	137,676
2004	72,938	67,438	140,376
2005	73,685	66,613	140,298
2006	74,946	66,085	141,031
2007	75,523	66,196	141,719
2008	75,954	66,968	142,922
2009	76,737	68,502	145,239
2010	78,516	69,009	147,525
2011	78,026	68,262	146,288
2012	73,668	65,387	139,055
2013	67,230	61,569	128,799
2014	61,458	58,360	119,818
2015	57,603	56,273	113,876
2016	55,058	55,766	110,824
2017	53,641	56,486	110,127
2018	53,010	58,462	111,472
2019	52,555	60,175	112,730
2020	52,339	61,949	114,288
2021	52,058	64,861	116,919

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Gender by Law School: 2021

School	Men	% Men	Women	% Women	Other	% Other	TOTAL
AKRON, UNIVERSITY OF	215	51.7%	200	48.1%	1	0.2%	416
ALABAMA, UNIVERSITY OF	195	47.3%	215	52.2%	2	0.5%	412
ALBANY LAW SCHOOL OF UNION UNIVERSITY	247	45.5%	296	54.5%	0	0.0%	543
AMERICAN UNIVERSITY	370	33.2%	743	66.8%	0	0.0%	1,113
APPALACHIAN SCHOOL OF LAW	89	56.3%	69	43.7%	0	0.0%	158
ARIZONA STATE UNIVERSITY	435	51.2%	410	48.2%	5	0.6%	850
ARIZONA, UNIVERSITY OF	198	50.1%	196	49.6%	1	0.3%	395
ARKANSAS, FAYETTEVILLE, UNIVERSITY OF	187	51.2%	178	48.8%	0	0.0%	365
ARKANSAS, LITTLE ROCK, UNIVERSITY OF	225	47.0%	252	52.6%	2	0.4%	479
ATLANTA'S JOHN MARSHALL LAW SCHOOL	121	40.2%	180	59.8%	0	0.0%	301
AVE MARIA SCHOOL OF LAW	135	45.2%	164	54.8%	0	0.0%	299
BALTIMORE, UNIVERSITY OF	294	42.1%	401	57.4%	3	0.4%	698
BARRY UNIVERSITY	285	39.1%	443	60.9%	0	0.0%	728
BAYLOR UNIVERSITY	217	47.0%	245	53.0%	0	0.0%	462
BELMONT UNIVERSITY	137	36.2%	238	63.0%	3	0.8%	378
BOSTON COLLEGE	405	47.0%	457	53.0%	0	0.0%	862
BOSTON UNIVERSITY	364	45.7%	432	54.3%	0	0.0%	796
BRIGHAM YOUNG UNIVERSITY	211	55.1%	172	44.9%	0	0.0%	383
BROOKLYN LAW SCHOOL	461	39.4%	700	59.8%	10	0.9%	1,171
CALIFORNIA WESTERN SCHOOL OF LAW	252	38.6%	401	61.4%	0	0.0%	653
CALIFORNIA-BERKELEY, UNIVERSITY OF	403	37.0%	671	61.7%	14	1.3%	1,088
CALIFORNIA-DAVIS, UNIVERSITY OF	257	38.5%	411	61.5%	0	0.0%	668
CALIFORNIA-HASTINGS, UNIVERSITY OF	424	39.0%	660	60.7%	3	0.3%	1,087
CALIFORNIA-IRVINE, UNIVERSITY OF	181	40.9%	254	57.3%	8	1.8%	443
CALIFORNIA-LOS ANGELES, UNIVERSITY OF	457	44.0%	574	55.3%	7	0.7%	1,038
CAMPBELL UNIVERSITY	213	40.2%	317	59.8%	0	0.0%	530
CAPITAL UNIVERSITY	218	45.4%	262	54.6%	0	0.0%	480
CARDOZO SCHOOL OF LAW	393	41.9%	540	57.5%	6	0.6%	939
CASE WESTERN RESERVE UNIVERSITY	174	43.8%	223	56.2%	0	0.0%	397
CATHOLIC UNIVERSITY OF AMERICA	164	40.4%	242	59.6%	0	0.0%	406
CHAPMAN UNIVERSITY	207	45.2%	251	54.8%	0	0.0%	458
CHARLESTON SCHOOL OF LAW	243	40.0%	364	60.0%	0	0.0%	607
CHICAGO, UNIVERSITY OF	316	50.5%	309	49.4%	1	0.2%	626
CHICAGO-KENT COLLEGE OF LAW-IIT	315	42.9%	414	56.3%	6	0.8%	735
CINCINNATI, UNIVERSITY OF	170	43.4%	221	56.4%	1	0.3%	392
CITY UNIVERSITY OF NEW YORK	223	32.0%	461	66.2%	12	1.7%	696
CLEVELAND STATE UNIVERSITY	191	45.5%	229	54.5%	0	0.0%	420
COLORADO, UNIVERSITY OF	242	47.3%	268	52.3%	2	0.4%	512
COLUMBIA UNIVERSITY	654	50.6%	615	47.6%	24	1.9%	1,293
CONNECTICUT, UNIVERSITY OF	205	41.8%	284	58.0%	1	0.2%	490
CORNELL UNIVERSITY	283	48.8%	296	51.0%	1	0.2%	580
CREIGHTON UNIVERSITY	207	53.9%	177	46.1%	0	0.0%	384
DAYTON, UNIVERSITY OF	148	41.9%	202	57.2%	3	0.8%	353

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Gender by Law School: 2021 *... continued*

School	Men	% Men	Women	% Women	Other	% Other	TOTAL
DENVER, UNIVERSITY OF	327	40.1%	488	59.8%	1	0.1%	816
DEPAUL UNIVERSITY	235	40.9%	335	58.4%	4	0.7%	574
DETROIT MERCY, UNIVERSITY OF	260	42.5%	352	57.5%	0	0.0%	612
DISTRICT OF COLUMBIA	78	34.4%	149	65.6%	0	0.0%	227
DRAKE UNIVERSITY	169	50.8%	164	49.2%	0	0.0%	333
DREXEL UNIVERSITY	176	38.9%	270	59.7%	6	1.3%	452
DUKE UNIVERSITY	309	41.6%	423	57.0%	10	1.3%	742
DUQUESNE UNIVERSITY	215	46.6%	245	53.1%	1	0.2%	461
ELON UNIVERSITY	163	38.0%	265	61.8%	1	0.2%	429
EMORY UNIVERSITY	370	45.6%	441	54.4%	0	0.0%	811
FAULKNER UNIVERSITY	114	51.4%	108	48.6%	0	0.0%	222
FLORIDA A&M UNIVERSITY	130	31.3%	286	68.8%	0	0.0%	416
FLORIDA INTERNATIONAL UNIVERSITY	243	43.3%	317	56.5%	1	0.2%	561
FLORIDA STATE UNIVERSITY	247	43.2%	325	56.8%	0	0.0%	572
FLORIDA, UNIVERSITY OF	376	53.5%	327	46.5%	0	0.0%	703
FORDHAM UNIVERSITY	603	45.3%	729	54.7%	0	0.0%	1,332
GEORGE MASON UNIVERSITY	327	54.1%	277	45.9%	0	0.0%	604
GEORGE WASHINGTON UNIVERSITY	740	44.1%	938	55.9%	0	0.0%	1,678
GEORGETOWN UNIVERSITY	911	45.2%	1093	54.2%	13	0.6%	2,017
GEORGIA STATE UNIVERSITY	312	43.8%	401	56.2%	0	0.0%	713
GEORGIA, UNIVERSITY OF	289	50.6%	281	49.2%	1	0.2%	571
GOLDEN GATE UNIVERSITY	171	40.5%	249	59.0%	2	0.5%	422
GONZAGA UNIVERSITY	204	45.4%	240	53.5%	5	1.1%	449
HARVARD UNIVERSITY	832	47.6%	909	52.0%	6	0.3%	1,747
HAWAII, UNIVERSITY OF	131	39.6%	199	60.1%	1	0.3%	331
HOFSTRA UNIVERSITY	384	46.3%	446	53.7%	0	0.0%	830
HOUSTON, UNIVERSITY OF	350	48.0%	379	52.0%	0	0.0%	729
HOWARD UNIVERSITY	134	28.7%	331	70.9%	2	0.4%	467
IDAHO, UNIVERSITY OF	243	55.6%	194	44.4%	0	0.0%	437
ILLINOIS, UNIVERSITY OF	256	52.0%	235	47.8%	1	0.2%	492
INDIANA UNIVERSITY - BLOOMINGTON	270	48.4%	285	51.1%	3	0.5%	558
INDIANA UNIVERSITY - INDIANAPOLIS	361	46.5%	415	53.5%	0	0.0%	776
INTER AMERICAN UNIVERSITY OF PUERTO RICO	248	37.9%	403	61.6%	3	0.5%	654
IOWA, UNIVERSITY OF	252	50.4%	244	48.8%	4	0.8%	500
KANSAS, UNIVERSITY OF	141	44.8%	174	55.2%	0	0.0%	315
KENTUCKY, UNIVERSITY OF	180	48.8%	189	51.2%	0	0.0%	369
LEWIS AND CLARK COLLEGE	236	40.0%	354	60.0%	0	0.0%	590
LIBERTY UNIVERSITY	165	56.5%	127	43.5%	0	0.0%	292
LINCOLN MEMORIAL	154	46.8%	175	53.2%	0	0.0%	329
LOUISIANA STATE UNIVERSITY	296	47.9%	322	52.1%	0	0.0%	618
LOUISVILLE, UNIVERSITY OF	165	48.1%	178	51.9%	0	0.0%	343
LOYOLA MARYMOUNT UNIVERSITY-LOS ANGELES	421	39.8%	635	60.1%	1	0.1%	1,057

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Gender by Law School: 2021 *... continued*

School	Men	% Men	Women	% Women	Other	% Other	TOTAL
LOYOLA UNIVERSITY-CHICAGO	350	38.1%	568	61.8%	1	0.1%	919
LOYOLA UNIVERSITY-NEW ORLEANS	230	41.5%	318	57.4%	6	1.1%	554
MAINE, UNIVERSITY OF	120	46.5%	138	53.5%	0	0.0%	258
MARQUETTE UNIVERSITY	297	50.0%	297	50.0%	0	0.0%	594
MARYLAND, UNIVERSITY OF	235	33.1%	470	66.2%	5	0.7%	710
MCGEORGE SCHOOL OF LAW	224	44.0%	283	55.6%	2	0.4%	509
MEMPHIS, UNIVERSITY OF	175	50.4%	172	49.6%	0	0.0%	347
MERCER UNIVERSITY	181	49.1%	188	50.9%	0	0.0%	369
MIAMI, UNIVERSITY OF	581	47.6%	640	52.4%	0	0.0%	1,221
MICHIGAN STATE UNIVERSITY	334	50.2%	331	49.8%	0	0.0%	665
MICHIGAN, UNIVERSITY OF	458	47.5%	496	51.5%	10	1.0%	964
MINNESOTA, UNIVERSITY OF	313	46.2%	363	53.6%	1	0.1%	677
MISSISSIPPI COLLEGE	173	47.4%	192	52.6%	0	0.0%	365
MISSISSIPPI, UNIVERSITY OF	234	47.7%	257	52.3%	0	0.0%	491
MISSOURI, UNIVERSITY OF	178	51.4%	167	48.3%	1	0.3%	346
MISSOURI-KANSAS CITY, UNIVERSITY OF	186	46.4%	215	53.6%	0	0.0%	401
MITCHELL|HAMLINE	533	43.4%	682	55.5%	14	1.1%	1,229
MONTANA, UNIVERSITY OF	120	48.4%	128	51.6%	0	0.0%	248
NEBRASKA, UNIVERSITY OF	209	47.7%	229	52.3%	0	0.0%	438
NEW ENGLAND LAW | BOSTON	374	35.3%	682	64.4%	3	0.3%	1,059
NEW HAMPSHIRE UNIVERSITY OF	299	58.4%	213	41.6%	0	0.0%	512
NEW MEXICO, UNIVERSITY OF	134	45.6%	159	54.1%	1	0.3%	294
NEW YORK LAW SCHOOL	419	37.6%	693	62.2%	2	0.2%	1,114
NEW YORK UNIVERSITY	641	45.4%	759	53.7%	13	0.9%	1,413
NORTH CAROLINA CENTRAL UNIVERSITY	141	30.7%	319	69.3%	0	0.0%	460
NORTH CAROLINA, UNIVERSITY OF	274	46.5%	311	52.8%	4	0.7%	589
NORTH DAKOTA, UNIVERSITY OF	119	50.6%	116	49.4%	0	0.0%	235
NORTHEASTERN UNIVERSITY	171	27.1%	455	72.0%	6	0.9%	632
NORTHERN ILLINOIS UNIVERSITY	157	48.8%	165	51.2%	0	0.0%	322
NORTHERN KENTUCKY UNIVERSITY	196	48.6%	207	51.4%	0	0.0%	403
NORTHWESTERN UNIVERSITY	363	47.2%	400	52.0%	6	0.8%	769
NOTRE DAME, UNIVERSITY OF	286	50.6%	279	49.4%	0	0.0%	565
NOVA SOUTHEASTERN UNIVERSITY	271	45.9%	317	53.6%	3	0.5%	591
OHIO NORTHERN UNIVERSITY	80	49.1%	83	50.9%	0	0.0%	163
OHIO STATE UNIVERSITY	254	45.4%	302	54.0%	3	0.5%	559
OKLAHOMA CITY UNIVERSITY	211	44.1%	267	55.9%	0	0.0%	478
OKLAHOMA, UNIVERSITY OF	259	47.4%	286	52.4%	1	0.2%	546
OREGON, UNIVERSITY OF	214	45.1%	257	54.2%	3	0.6%	474
PACE UNIVERSITY	282	36.9%	481	63.0%	1	0.1%	764
PENNSYLVANIA STATE - DICKINSON LAW	134	52.3%	120	46.9%	2	0.8%	256
PENNSYLVANIA STATE - PENN STATE LAW	171	43.4%	222	56.3%	1	0.3%	394
PENNSYLVANIA, UNIVERSITY OF	397	48.2%	425	51.6%	2	0.2%	824
PEPPERDINE UNIVERSITY	243	44.4%	304	55.6%	0	0.0%	547

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Gender by Law School: 2021 *... continued*

School	Men	% Men	Women	% Women	Other	% Other	TOTAL
PITTSBURGH, UNIVERSITY OF	181	46.6%	206	53.1%	1	0.3%	388
PONTIFICAL CATHOLIC UNIVERSITY OF P.R.	181	39.5%	277	60.5%	0	0.0%	458
PUERTO RICO, UNIVERSITY OF	187	37.1%	317	62.9%	0	0.0%	504
QUINNIPIAC UNIVERSITY	151	37.8%	248	62.2%	0	0.0%	399
REGENT UNIVERSITY	149	46.4%	172	53.6%	0	0.0%	321
RICHMOND, UNIVERSITY OF	162	38.5%	257	61.0%	2	0.5%	421
ROGER WILLIAMS UNIVERSITY	206	39.5%	310	59.4%	6	1.1%	522
RUTGERS UNIVERSITY	662	49.2%	677	50.3%	7	0.5%	1,346
SAINT LOUIS UNIVERSITY	265	44.1%	332	55.2%	4	0.7%	601
SAMFORD UNIVERSITY	187	41.6%	263	58.4%	0	0.0%	450
SAN DIEGO, UNIVERSITY OF	318	42.0%	439	58.0%	0	0.0%	757
SAN FRANCISCO, UNIVERSITY OF	154	40.3%	226	59.2%	2	0.5%	382
SANTA CLARA UNIVERSITY	320	45.7%	379	54.1%	1	0.1%	700
SEATTLE UNIVERSITY	249	36.8%	425	62.8%	3	0.4%	677
SETON HALL UNIVERSITY	399	47.8%	436	52.2%	0	0.0%	835
SOUTH CAROLINA, UNIVERSITY OF	321	50.7%	309	48.8%	3	0.5%	633
SOUTH DAKOTA, UNIVERSITY OF	117	51.8%	109	48.2%	0	0.0%	226
SOUTH TEXAS COLLEGE OF LAW HOUSTON	464	47.5%	512	52.5%	0	0.0%	976
SOUTHERN CALIFORNIA, UNIVERSITY OF	248	40.5%	362	59.1%	3	0.5%	613
SOUTHERN ILLINOIS UNIVERSITY-CARBONDALE	121	49.2%	125	50.8%	0	0.0%	246
SOUTHERN METHODIST UNIVERSITY	321	44.6%	398	55.4%	0	0.0%	719
SOUTHERN UNIVERSITY	265	37.1%	447	62.5%	3	0.4%	715
SOUTHWESTERN LAW SCHOOL	395	41.6%	551	58.0%	4	0.4%	950
ST. JOHN'S UNIVERSITY	362	47.2%	405	52.8%	0	0.0%	767
ST. MARY'S UNIVERSITY	319	42.7%	428	57.3%	0	0.0%	747
ST. THOMAS UNIVERSITY (FLORIDA)	312	42.4%	424	57.6%	0	0.0%	736
ST. THOMAS, UNIVERSITY OF (MINNESOTA)	186	38.6%	295	61.2%	1	0.2%	482
STANFORD UNIVERSITY	284	49.2%	289	50.1%	4	0.7%	577
STETSON UNIVERSITY	425	45.6%	505	54.1%	3	0.3%	933
SUFFOLK UNIVERSITY	447	38.0%	725	61.6%	4	0.3%	1,176
SYRACUSE UNIVERSITY	321	47.5%	355	52.5%	0	0.0%	676
TEMPLE UNIVERSITY	350	49.3%	352	49.6%	8	1.1%	710
TENNESSEE, UNIVERSITY OF	192	52.2%	172	46.7%	4	1.1%	368
TEXAS A&M UNIVERSITY	235	45.0%	286	54.8%	1	0.2%	522
TEXAS AT AUSTIN, UNIVERSITY OF	487	48.7%	514	51.3%	0	0.0%	1,001
TEXAS SOUTHERN UNIVERSITY	211	38.8%	333	61.2%	0	0.0%	544
TEXAS TECH UNIVERSITY	208	48.6%	220	51.4%	0	0.0%	428
TOLEDO, UNIVERSITY OF	176	47.4%	195	52.6%	0	0.0%	371
TOURO COLLEGE	281	48.2%	299	51.3%	3	0.5%	583
TULANE UNIVERSITY	273	44.1%	346	55.9%	0	0.0%	619

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Gender by Law School: 2021 *... continued*

School	Men	% Men	Women	% Women	Other	% Other	TOTAL
TULSA, UNIVERSITY OF	170	48.2%	183	51.8%	0	0.0%	353
UNIVERSITY OF BUFFALO-SUNY	204	43.9%	261	56.1%	0	0.0%	465
UNIVERSITY OF ILLINOIS CHICAGO SCHOOL OF LAW	390	38.7%	610	60.5%	9	0.9%	1,009
UNIVERSITY OF MASSACHUSETTS DARTMOUTH	163	44.7%	202	55.3%	0	0.0%	365
UNIVERSITY OF NEVADA - LAS VEGAS	218	48.6%	231	51.4%	0	0.0%	449
UNT DALLAS COLLEGE OF LAW	163	42.9%	217	57.1%	0	0.0%	380
UTAH, UNIVERSITY OF	135	46.9%	152	52.8%	1	0.3%	288
VANDERBILT UNIVERSITY	253	46.5%	291	53.5%	0	0.0%	544
VERMONT LAW SCHOOL	167	38.9%	259	60.4%	3	0.7%	429
VILLANOVA UNIVERSITY	243	41.9%	337	58.1%	0	0.0%	580
VIRGINIA, UNIVERSITY OF	465	50.4%	455	49.3%	2	0.2%	922
WAKE FOREST UNIVERSITY	206	44.7%	254	55.1%	1	0.2%	461
WASHBURN UNIVERSITY	157	48.3%	168	51.7%	0	0.0%	325
WASHINGTON AND LEE UNIVERSITY	186	49.1%	192	50.7%	1	0.3%	379
WASHINGTON UNIVERSITY	382	51.3%	359	48.3%	3	0.4%	744
WASHINGTON, UNIVERSITY OF	174	35.4%	309	62.8%	9	1.8%	492
WAYNE STATE UNIVERSITY	173	45.3%	209	54.7%	0	0.0%	382
WEST VIRGINIA UNIVERSITY	172	51.7%	161	48.3%	0	0.0%	333
WESTERN MICHIGAN UNIVERSITY	263	40.2%	392	59.8%	0	0.0%	655
WESTERN NEW ENGLAND UNIVERSITY	132	39.1%	206	60.9%	0	0.0%	338
WESTERN STATE COLLEGE OF LAW	96	42.5%	130	57.5%	0	0.0%	226
WIDENER UNIVERSITY-DELAWARE	313	46.0%	367	54.0%	0	0.0%	680
WIDENER-COMMONWEALTH	133	39.5%	203	60.2%	1	0.3%	337
WILLAMETTE UNIVERSITY	162	48.4%	171	51.0%	2	0.6%	335
WILLIAM AND MARY LAW SCHOOL	286	46.0%	335	53.9%	1	0.2%	622
WISCONSIN, UNIVERSITY OF	386	51.0%	371	49.0%	0	0.0%	757
WYOMING, UNIVERSITY OF	127	55.5%	102	44.5%	0	0.0%	229
YALE UNIVERSITY	307	48.3%	324	50.9%	5	0.8%	636
TOTAL	52,058	44.4%	64,861	55.3%	378	0.3%	117,297

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Law Students by Race, Ethnicity and Gender: 2021

Hispanic Men	6,351	5.4%
Hispanic Women	9,104	7.8%
Hispanic Other	32	0.0%
TOTAL Hispanic	15,487	13.2%
Native American Men	236	0.2%
Native American Women	307	0.3%
Native American Other	1	0.0%
TOTAL Native American	544	0.5%
Asian Men	2,962	2.5%
Asian Women	4,834	4.1%
Asian Other	29	0.0%
TOTAL Asian	7,825	6.7%
Black Men	3,072	2.6%
Black Women	5,944	5.1%
Black Other	20	0.0%
TOTAL Black	9,036	7.7%
Native Hawaiian or Pacific Islander Men	72	0.1%
Native Hawaiian or Pacific Islander Women	102	0.1%
Native Hawaiian or Pacific Islander Other	2	0.0%
TOTAL Native Hawaiian or Pacific Islander Men	176	0.2%
White Men	34,097	29.1%
White Women	38,011	32.4%
White Other	186	0.2%
TOTAL White	72,294	61.6%
Total Men	52,058	44.4%
Total Women	64,861	55.3%
Total Other	378	0.3%
TOTAL ALL	117,297	

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Students of Color Receiving Juris Doctor Degrees by School: 2021

School	Students of color receiving JDs	% Students of color	Total Degrees Awarded
AKRON, UNIVERSITY OF	25	18.9%	132
ALABAMA, UNIVERSITY OF	22	18.5%	119
ALBANY LAW SCHOOL OF UNION UNIVERSITY	36	21.7%	166
AMERICAN UNIVERSITY	138	33.7%	410
APPALACHIAN SCHOOL OF LAW	12	21.8%	55
ARIZONA STATE UNIVERSITY	54	19.3%	280
ARIZONA, UNIVERSITY OF	35	27.6%	127
ARKANSAS, FAYETTEVILLE, UNIVERSITY OF	18	14.9%	121
ARKANSAS, LITTLE ROCK, UNIVERSITY OF	18	14.2%	127
ATLANTA'S JOHN MARSHALL LAW SCHOOL	43	55.1%	78
AVE MARIA SCHOOL OF LAW	24	35.8%	67
BALTIMORE, UNIVERSITY OF	78	36.4%	214
BARRY UNIVERSITY	76	41.5%	183
BAYLOR UNIVERSITY	43	24.4%	176
BELMONT UNIVERSITY	16	17.2%	93
BOSTON COLLEGE	45	19.7%	228
BOSTON UNIVERSITY	88	31.3%	281
BRIGHAM YOUNG UNIVERSITY	19	18.1%	105
BROOKLYN LAW SCHOOL	81	22.9%	353
CALIFORNIA WESTERN SCHOOL OF LAW	99	45.6%	217
CALIFORNIA-BERKELEY, UNIVERSITY OF	137	41.9%	327
CALIFORNIA-DAVIS, UNIVERSITY OF	96	47.8%	201
CALIFORNIA-HASTINGS, UNIVERSITY OF	123	43.3%	284
CALIFORNIA-IRVINE, UNIVERSITY OF	97	46.0%	211
CALIFORNIA-LOS ANGELES, UNIVERSITY OF	126	36.8%	342
CAMPBELL UNIVERSITY	23	14.2%	162
CAPITAL UNIVERSITY	26	21.1%	123
CARDOZO SCHOOL OF LAW	73	22.5%	324
CASE WESTERN RESERVE UNIVERSITY	40	26.1%	153
CATHOLIC UNIVERSITY OF AMERICA	34	28.8%	118
CHAPMAN UNIVERSITY	66	45.5%	145
CHARLESTON SCHOOL OF LAW	43	23.1%	186
CHICAGO, UNIVERSITY OF	81	38.0%	213
CHICAGO-KENT COLLEGE OF LAW-IIT	66	29.7%	222
CINCINNATI, UNIVERSITY OF	29	23.0%	126
CITY UNIVERSITY OF NEW YORK	97	51.6%	188
CLEVELAND STATE UNIVERSITY	18	14.1%	128
COLORADO, UNIVERSITY OF	45	26.5%	170
COLUMBIA UNIVERSITY	134	30.0%	446
CONNECTICUT, UNIVERSITY OF	32	23.5%	136
CORNELL UNIVERSITY	70	35.9%	195
CREIGHTON UNIVERSITY	18	16.8%	107
DAYTON, UNIVERSITY OF	21	32.3%	65
DENVER, UNIVERSITY OF	50	21.5%	233
DEPAUL UNIVERSITY	66	34.6%	191
DETROIT MERCY, UNIVERSITY OF	21	11.9%	177
DISTRICT OF COLUMBIA	35	72.9%	48
DRAKE UNIVERSITY	13	13.0%	100
DREXEL UNIVERSITY	34	20.2%	168
DUKE UNIVERSITY	57	23.2%	246
DUQUESNE UNIVERSITY	19	12.1%	157
ELON UNIVERSITY	33	27.0%	122
EMORY UNIVERSITY	57	20.4%	280
FAULKNER UNIVERSITY	16	27.6%	58
FLORIDA A&M UNIVERSITY	116	75.3%	154
FLORIDA INTERNATIONAL UNIVERSITY	95	63.3%	150
FLORIDA STATE UNIVERSITY	73	33.5%	218
FLORIDA, UNIVERSITY OF	84	31.2%	269
FORDHAM UNIVERSITY	120	29.7%	404
GEORGE MASON UNIVERSITY	29	18.0%	161
GEORGE WASHINGTON UNIVERSITY	107	19.4%	552
GEORGETOWN UNIVERSITY	156	23.1%	674
GEORGIA STATE UNIVERSITY	61	31.8%	192
GEORGIA, UNIVERSITY OF	40	19.8%	202
GOLDEN GATE UNIVERSITY	92	53.8%	171
GONZAGA UNIVERSITY	16	11.2%	143
HARVARD UNIVERSITY	184	31.0%	594
HAWAII, UNIVERSITY OF	75	68.8%	109
HOFSTRA UNIVERSITY	61	22.8%	267
HOUSTON, UNIVERSITY OF	90	42.1%	214
HOWARD UNIVERSITY	137	97.2%	141
IDAHO, UNIVERSITY OF	30	21.4%	140

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Students of Color Receiving Juris Doctor Degrees by School: 2021 *... continued*

School	Students of color receiving JDs	% Students of color	Total Degrees Awarded
ILLINOIS, UNIVERSITY OF	43	35.2%	122
INDIANA UNIVERSITY - BLOOMINGTON	25	15.2%	164
INDIANA UNIVERSITY - INDIANAPOLIS	38	15.9%	239
INTER AMERICAN UNIVERSITY OF PUERTO RICO	168	97.7%	172
IOWA, UNIVERSITY OF	27	19.7%	137
KANSAS, UNIVERSITY OF	17	17.3%	98
KENTUCKY, UNIVERSITY OF	29	22.0%	132
LEWIS AND CLARK COLLEGE	39	22.2%	176
LIBERTY UNIVERSITY	15	23.8%	63
LINCOLN MEMORIAL	10	12.5%	80
LOUISIANA STATE UNIVERSITY	33	17.2%	192
LOUISVILLE, UNIVERSITY OF	11	9.6%	115
LOYOLA MARYMOUNT UNIVERSITY-LOS ANGELES	126	41.3%	305
LOYOLA UNIVERSITY-CHICAGO	71	30.1%	236
LOYOLA UNIVERSITY-NEW ORLEANS	45	29.6%	152
MAINE, UNIVERSITY OF	9	11.1%	81
MARQUETTE UNIVERSITY	42	22.0%	191
MARYLAND, UNIVERSITY OF	62	30.1%	206
MCGEORGE SCHOOL OF LAW	67	37.2%	180
MEMPHIS, UNIVERSITY OF	23	21.1%	109
MERCER UNIVERSITY	24	19.4%	124
MIAMI, UNIVERSITY OF	173	49.9%	347
MICHIGAN STATE UNIVERSITY	36	17.8%	202
MICHIGAN, UNIVERSITY OF	97	26.7%	363
MINNESOTA, UNIVERSITY OF	37	16.4%	226
MISSISSIPPI COLLEGE	20	21.7%	92
MISSISSIPPI, UNIVERSITY OF	36	25.2%	143
MISSOURI, UNIVERSITY OF	12	14.5%	83
MISSOURI-KANSAS CITY, UNIVERSITY OF	16	12.8%	125
MITCHELL|HAMLINE	69	21.3%	324
MONTANA, UNIVERSITY OF	9	12.7%	71
NEBRASKA, UNIVERSITY OF	10	9.1%	110
NEW ENGLAND LAW | BOSTON	36	23.2%	155
NEW HAMPSHIRE UNIVERSITY OF	16	18.4%	87
NEW MEXICO, UNIVERSITY OF	49	46.7%	105
NEW YORK LAW SCHOOL	91	29.4%	310
NEW YORK UNIVERSITY	131	28.4%	461
NORTH CAROLINA CENTRAL UNIVERSITY	62	70.5%	88
NORTH CAROLINA, UNIVERSITY OF	62	29.8%	208
NORTH DAKOTA, UNIVERSITY OF	2	3.7%	54
NORTHEASTERN UNIVERSITY	70	35.7%	196
NORTHERN ILLINOIS UNIVERSITY	20	26.7%	75
NORTHERN KENTUCKY UNIVERSITY	9	8.9%	101
NORTHWESTERN UNIVERSITY	73	26.7%	273
NOTRE DAME, UNIVERSITY OF	48	26.1%	184
NOVA SOUTHEASTERN UNIVERSITY	96	50.5%	190
OHIO NORTHERN UNIVERSITY	6	14.0%	43
OHIO STATE UNIVERSITY	44	24.6%	179
OKLAHOMA CITY UNIVERSITY	47	35.6%	132
OKLAHOMA, UNIVERSITY OF	53	31.0%	171
OREGON, UNIVERSITY OF	29	22.7%	128
PACE UNIVERSITY	55	26.3%	209
PENNSYLVANIA STATE - DICKINSON LAW	16	22.2%	72
PENNSYLVANIA STATE - PENN STATE LAW	21	17.9%	117
PENNSYLVANIA, UNIVERSITY OF	80	31.1%	257
PEPPERDINE UNIVERSITY	40	26.7%	150
PITTSBURGH, UNIVERSITY OF	17	12.8%	133
PONTIFICAL CATHOLIC UNIVERSITY OF P.R.	84	100.0%	84
PUERTO RICO, UNIVERSITY OF	150	100.0%	150
QUINNIPIAC UNIVERSITY	20	19.8%	101
REGENT UNIVERSITY	11	13.4%	82
RICHMOND, UNIVERSITY OF	20	14.9%	134
ROGER WILLIAMS UNIVERSITY	46	30.5%	151
RUTGERS UNIVERSITY	133	34.6%	384
SAINT LOUIS UNIVERSITY	32	18.5%	173
SAMFORD UNIVERSITY	18	13.1%	137
SAN DIEGO, UNIVERSITY OF	76	33.3%	228
SAN FRANCISCO, UNIVERSITY OF	57	50.4%	113
SANTA CLARA UNIVERSITY	106	49.1%	216
SEATTLE UNIVERSITY	63	31.7%	199
SETON HALL UNIVERSITY	53	24.0%	221
SOUTH CAROLINA, UNIVERSITY OF	40	19.9%	201

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Students of Color Receiving Juris Doctor Degrees by School: 2021 *... continued*

School	Students of color receiving JDs	% Students of color	Total Degrees Awarded
SOUTH DAKOTA, UNIVERSITY OF	7	10.9%	64
SOUTH TEXAS COLLEGE OF LAW HOUSTON	124	44.6%	278
SOUTHERN CALIFORNIA, UNIVERSITY OF	68	35.2%	193
SOUTHERN ILLINOIS UNIVERSITY-CARBONDALE	9	14.3%	63
SOUTHERN METHODIST UNIVERSITY	55	25.0%	220
SOUTHERN UNIVERSITY	124	70.1%	177
SOUTHWESTERN LAW SCHOOL	102	44.9%	227
ST. JOHN'S UNIVERSITY	58	24.3%	239
ST. MARY'S UNIVERSITY	119	59.2%	201
ST. THOMAS UNIVERSITY (FLORIDA)	123	76.4%	161
ST. THOMAS, UNIVERSITY OF (MINNESOTA)	22	15.5%	142
STANFORD UNIVERSITY	67	36.8%	182
STETSON UNIVERSITY	63	24.0%	262
SUFFOLK UNIVERSITY	59	17.5%	338
SYRACUSE UNIVERSITY	48	29.3%	164
TEMPLE UNIVERSITY	73	30.5%	239
TENNESSEE, UNIVERSITY OF	22	17.7%	124
TEXAS A&M UNIVERSITY	57	33.7%	169
TEXAS AT AUSTIN, UNIVERSITY OF	118	31.4%	376
TEXAS SOUTHERN UNIVERSITY	144	85.2%	169
TEXAS TECH UNIVERSITY	39	29.8%	131
TOLEDO, UNIVERSITY OF	8	11.9%	67
TOURO COLLEGE	35	26.1%	134
TULANE UNIVERSITY	54	26.7%	202
TULSA, UNIVERSITY OF	24	24.7%	97
UNIVERSITY OF BUFFALO-SUNY	32	23.2%	138
UNIVERSITY OF ILLINOIS CHICAGO SCHOOL OF LAW	75	26.1%	287
UNIVERSITY OF MASSACHUSETTS DARTMOUTH	28	32.6%	86
UNIVERSITY OF NEVADA - LAS VEGAS	52	31.1%	167
UNT DALLAS COLLEGE OF LAW	48	44.0%	109
UTAH, UNIVERSITY OF	22	25.0%	88
VANDERBILT UNIVERSITY	51	26.4%	193
VERMONT LAW SCHOOL	36	21.8%	165
VILLANOVA UNIVERSITY	37	21.5%	172
VIRGINIA, UNIVERSITY OF	73	23.0%	318
WAKE FOREST UNIVERSITY	32	18.6%	172
WASHBURN UNIVERSITY	15	15.0%	100
WASHINGTON AND LEE UNIVERSITY	24	20.2%	119
WASHINGTON UNIVERSITY	58	24.1%	241
WASHINGTON, UNIVERSITY OF	51	29.8%	171
WAYNE STATE UNIVERSITY	15	11.9%	126
WEST VIRGINIA UNIVERSITY	11	10.6%	104
WESTERN MICHIGAN UNIVERSITY	178	41.6%	428
WESTERN NEW ENGLAND UNIVERSITY	18	24.7%	73
WESTERN STATE COLLEGE OF LAW	48	56.5%	85
WIDENER UNIVERSITY-DELAWARE	39	21.2%	184
WIDENER-COMMONWEALTH	21	24.4%	86
WILLAMETTE UNIVERSITY	23	22.8%	101
WILLIAM AND MARY LAW SCHOOL	23	12.8%	179
WISCONSIN, UNIVERSITY OF	52	19.2%	271
WYOMING, UNIVERSITY OF	13	17.3%	75
YALE UNIVERSITY	84	38.2%	220
TOTAL	10,734	30.0%	35,728

Source: ABA Section of Legal Education and Admissions to the Bar

APPENDIX – LEGAL EDUCATION

Bar Exam Results by States: 2021

Jurisdiction	First-Time Takers/ Repeaters	Taking	Passing	% Passing
Alabama	First-Time Takers	439	297	68%
Alabama	Repeaters	334	72	22%
Alaska	First-Time Takers	82	61	74%
Alaska	Repeaters	22	3	14%
Arizona	First-Time Takers	566	435	77%
Arizona	Repeaters	220	54	25%
Arkansas	First-Time Takers	248	188	76%
Arkansas	Repeaters	75	29	39%
California	First-Time Takers	6,208	4,163	67%
California	Repeaters	4,426	978	22%
Colorado	First-Time Takers	865	654	76%
Colorado	Repeaters	189	57	30%
Connecticut	First-Time Takers	367	257	70%
Connecticut	Repeaters	196	50	26%
Delaware	First-Time Takers	351	250	71%
Delaware	Repeaters	65	27	42%
District of Columbia	First-Time Takers	1,901	1,540	81%
District of Columbia	Repeaters	964	383	40%
Florida	First-Time Takers	2,944	2,048	70%
Florida	Repeaters	1,528	452	30%
Georgia	First-Time Takers	1,060	822	78%
Georgia	Repeaters	577	123	21%
Hawaii	First-Time Takers	216	160	74%
Hawaii	Repeaters	53	32	60%
Idaho	First-Time Takers	182	132	73%
Idaho	Repeaters	57	21	37%
Illinois	First-Time Takers	1,856	1,411	76%
Illinois	Repeaters	802	199	25%
Indiana	First-Time Takers	439	333	76%
Indiana	Repeaters	139	39	28%
Iowa	First-Time Takers	236	174	74%
Iowa	Repeaters	50	20	40%
Kansas	First-Time Takers	162	126	78%
Kansas	Repeaters	28	13	46%
Kentucky	First-Time Takers	337	259	77%
Kentucky	Repeaters	89	31	35%
Louisiana	First-Time Takers	630	464	74%
Louisiana	Repeaters	195	68	35%
Maine	First-Time Takers	198	126	64%
Maine	Repeaters	39	14	36%
Maryland	First-Time Takers	859	638	74%
Maryland	Repeaters	384	113	29%
Massachusetts	First-Time Takers	1,425	1,153	81%
Massachusetts	Repeaters	459	105	23%
Michigan	First-Time Takers	675	486	72%
Michigan	Repeaters	283	80	28%
Minnesota	First-Time Takers	575	457	79%
Minnesota	Repeaters	176	64	36%
Mississippi	First-Time Takers	151	112	74%
Mississippi	Repeaters	44	18	41%
Missouri	First-Time Takers	667	545	82%
Missouri	Repeaters	166	55	33%
Montana	First-Time Takers	130	99	76%
Montana	Repeaters	24	11	46%
Nebraska	First-Time Takers	195	142	73%
Nebraska	Repeaters	30	14	47%
Nevada	First-Time Takers	439	290	66%
Nevada	Repeaters	100	38	38%
New Hampshire	First-Time Takers	97	67	69%
New Hampshire	Repeaters	20	5	25%
New Jersey	First-Time Takers	1,142	787	69%
New Jersey	Repeaters	593	132	22%
New Mexico	First-Time Takers	183	140	77%
New Mexico	Repeaters	38	17	45%
New York	First-Time Takers	7,966	6,061	76%
New York	Repeaters	3,391	784	23%
North Carolina	First-Time Takers	958	768	80%
North Carolina	Repeaters	294	107	36%
North Dakota	First-Time Takers	65	48	74%
North Dakota	Repeaters	19	5	26%
Ohio	First-Time Takers	1,006	798	79%
Ohio	Repeaters	319	106	33%
Oklahoma	First-Time Takers	357	280	78%
Oklahoma	Repeaters	73	37	51%
Oregon	First-Time Takers	438	355	81%
Oregon	Repeaters	64	24	38%
Pennsylvania	First-Time Takers	1,290	966	75%
Pennsylvania	Repeaters	438	146	33%
Rhode Island	First-Time Takers	85	63	74%
Rhode Island	Repeaters	15	8	53%
South Carolina	First-Time Takers	459	339	74%
South Carolina	Repeaters	169	64	38%
South Dakota	First-Time Takers	71	50	70%
South Dakota	Repeaters	24	17	71%
Tennessee	First-Time Takers	762	524	69%
Tennessee	Repeaters	264	64	24%
Texas	First-Time Takers	3,309	2,505	76%

Source: National Conference of Bar Examiners

APPENDIX – LEGAL EDUCATION

Bar Exam Results by States: 2021 *... continued*

Source: National Conference of Bar Examiners

Jurisdiction	First-Time Takers/ Repeaters	Taking	Passing	% Passing
Texas	Repeaters	1,002	335	32%
Utah	First-Time Takers	261	234	90%
Utah	Repeaters	45	16	36%
Vermont	First-Time Takers	138	86	62%
Vermont	Repeaters	34	9	26%
Virginia	First-Time Takers	644	502	78%
Virginia	Repeaters	136	54	40%
Washington	First-Time Takers	737	588	80%
Washington	Repeaters	125	28	22%
West Virginia	First-Time Takers	121	73	60%
West Virginia	Repeaters	75	33	44%
Wisconsin	First-Time Takers	144	107	74%
Wisconsin	Repeaters	62	17	27%
Wyoming	First-Time Takers	75	56	75%
Wyoming	Repeaters	13	10	77%
Guam	First-Time Takers	6	4	67%
Guam	Repeaters	10	4	40%
Northern Mariana Islands	First-Time Takers	3	3	100%
Northern Mariana Islands	Repeaters	0	0	—
Palau	First-Time Takers	3	3	100%
Palau	Repeaters	3	1	33%
Puerto Rico	First-Time Takers	460	155	34%
Puerto Rico	Repeaters	688	222	32%
Virgin Islands	First-Time Takers	12	12	100%
Virgin Islands	Repeaters	10	2	20%
Total for All Jurisdictions	First-Time Takers	45,195	33,396	74%
Total for All Jurisdictions	Repeaters	19,638	5,410	28%

Where Law School Graduates Work 10 Months After Graduation: 2012-2021

Source: ABA Section of Legal Education and Admissions to the Bar

Class of...	Law Firms	Business	Government	Unemployed	Clerkship	Public Interest	Solo	Education	Law Schools
2012	39.3%	14.9%	10.0%	10.6%	7.3%	5.9%	2.3%	2.2%	3.9%
2013	39.6%	15.2%	10.6%	11.2%	7.4%	4.8%	2.3%	2.1%	4.0%
2014	40.7%	15.3%	11.6%	9.8%	7.7%	5.0%	2.1%	1.8%	3.6%
2015	40.7%	14.6%	11.6%	9.7%	8.4%	4.7%	1.7%	1.6%	2.6%
2016	44.1%	13.5%	12.0%	8.8%	8.9%	4.4%	1.4%	1.6%	2.0%
2017	45.9%	12.2%	12.0%	7.9%	9.3%	4.7%	1.3%	1.4%	1.7%
2018	46.6%	11.5%	12.1%	7.3%	9.8%	4.9%	1.1%	1.4%	1.5%
2019	48.1%	10.3%	11.5%	6.4%	10.2%	6.8%	0.8%	1.2%	1.2%
2020	48.0%	9.3%	10.2%	8.3%	9.5%	7.4%	0.9%	1.3%	1.4%
2021	50.6%	10.0%	10.4%	5.3%	9.6%	7.7%	0.7%	1.2%	1.2%

APPENDIX – DISCIPLINE

Discipline by State: 2019

Source: 2019 ABA Survey on Lawyer Discipline Systems

	Active lawyers	Complaints received	Lawyers Publicly Disciplined	Disbarred	Suspended	Admonished, Reprimanded or Censured	Probation
Alabama	14,054	1,374	96	15	45	29	7
Alaska	3,096	212	1	0	0	1	0
Arizona	18,923	2,874	111	18	36	21	48
Arkansas	9,493	607	21	9	7	6	0
Colorado	27,255	3,400	65	15	41	16	18
Connecticut	33,328	810	42	1	33	13	2
Delaware	3,652	168	7	2	2	0	0
District of Columbia	80,256	1,147	55	17	73	11	6
Florida	90,784	3,557	242	82	112	63	24
Georgia	39,892	2,150	41	22	18	4	N/A
Hawaii	4,955	464	5	0	3	2	0
Idaho	5,284	428	8	1	4	14	4
Illinois	73,787	4,937	96	29	55	6	13
Indiana	18,608	1,414	38	2	30	1	8
Iowa	9,700	818	61	6	19	39	N/A
Kansas	11,094	908	22	3	4	15	1
Kentucky	18,977	1,057	22	2	17	5	1
Louisiana	22,679	1,856	126	22	62	8	33
Maine	5,357	194	16	1	4	10	1
Maryland	40,393	1,657	77	26	21	30	N/A
Michigan	42,502	NA	86	18	66	25	14
Minnesota	25,800	1,003	35	5	22	4	4
Mississippi	8,780	417	20	5	8	7	0
Missouri	30,942	1,733	54	22	22	1	10
Montana	4,035	293	12	3	3	4	0
Nebraska	6,711	422	5	4	1	0	1
Nevada	9,139	1,700	24	6	23	N/A	33
New Hampshire	5,541	186	18	3	8	11	3
New Mexico	7,572	667	8	7	6	4	4
New York (partial)	73,703	7,068	106	50	46	10	NA
North Carolina	29,267	1,258	89	17	20	84	8
North Dakota	3,101	156	5	1	1	3	0
Ohio	43,681	2,531	66	13	38	4	N/A
Oklahoma	18,240	1,041	12	5	12	0	0
Oregon	15,218	329	63	7	35	34	14
Pennsylvania	65,252	4,201	93	31	60	70	3
Rhode Island	5,085	328	3	0	3	0	0
Tennessee	23,110	1,242	58	17	27	14	11
Texas	105,125	7,505	211	30	142	39	N/A
Utah	9,870	897	29	10	8	7	7
Virginia	32,870	3,123	67	17	20	30	N/A
Washington	32,573	1,905	56	17	33	19	19
Wisconsin	25,300	1,518	30	2	20	8	N/A
Wyoming	2,999	161	6	2	3	1	0
TOTAL	1,157,983	69,716	2,308	565	1,213	673	297

On Race and Policy History: A Dialogue about the G.I. Bill

Ira Katznelson and Suzanne Mettler

We have independently analyzed the effects of the G.I. Bill's widely-utilized education and training benefits, and reached different conclusions. One of us argues that the implementation of these benefits, especially in the South, helped widen the income and wealth gaps between whites and blacks and further marginalized many African Americans; the other considers them to have been a rare example of a relatively inclusive policy, one that fostered equal citizenship. Because we are both historical institutionalists and we both share interests in matters of social policy, equality, and race, these dissimilar accounts require explanation. This dialogue first considers methodological issues, explaining our decisions about which forms of data to use and to emphasize, and how we made sense of contradictory findings. It next discusses interpretive matters, examining the processes through which we sometimes reached different conclusions even when we confronted the same evidence. Finally, the exchange considers some implications of our findings, probing the lessons they convey both about policy research and practice.

Introduction

Throughout American history, racial inequality has thwarted the democratic ideal of equal citizenship. Even today, decades after the civil rights movement achieved momentous legal and policy reforms, racial gaps persist in most indicators of social and economic well-being and in political participation and representation. As long as the status of American citizens continues to be stratified by race, democratization remains an unfinished project.

This context lends particular significance to scholarly investigations of past public policies that seek to identify those that perpetuated racial inequality and those that fostered racial equality. Such policy histories can yield valuable lessons for the present, both positive and negative.

As scholars of race, politics, and policy in American political development, we have been guided by this goal in our recent books that consider the landmark Servicemen's Readjustment Act (G.I. Bill of Rights) of 1944, which offered a bountiful package of benefits for veterans returning from World War II. Katznelson has published *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America* (Norton 2005), devoting a chapter to this subject, and Mettler has written *Soldiers to Citizens: The GI Bill and the Making of the Greatest Generation* (Oxford University Press 2005). In assessing the impact of the Bill's education and training provisions on African Americans and racial equality, we come to different conclusions. Katznelson argues that the administration of these benefits widened the gap between whites and blacks in the postwar era, often marginalizing African Americans, especially in the Jim Crow South. While he treats the G.I. Bill as a model for current interventions, he regards its racial heritage as surprisingly doleful. Mettler, by contrast, contends that the benefits proved relatively inclusive across the color line of the postwar era and helped foster equal citizenship; thus she considers them a good deal more positively as a source of historical learning. Some of these differences are stark.

How did we reach such disparate conclusions? What is at stake? We think that it is well worth grappling with these questions. They bear not only on our understanding of the G.I. Bill's impact but, more broadly, on how scholars conduct historical investigations of public policy. They have implications for how researchers proceed when making causal claims about racism or the relationship between public policies and preexisting racial barriers that affect their implementation. At the broadest level, our disagreement raises a more fundamental question. We are both historical institutionalists and students of public

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policy; generally speaking, we agree on plenty. That we have reached such different conclusions directs us to the basic matter all scholars must confront: how we know what we know. For these reasons, it seems worthwhile to engage in a dialogue about the methodological choices and interpretive decisions that led us to such different conclusions.

As a means of structuring this exchange, we have addressed issues that pertain to: (1) methods, (2) interpretation, and (3) implications. We have deliberately focused our discussion on the specific matters over which we disagree, rather than review the impact of the G.I. Bill more generally.

Regarding *methods,* some of the disparity in our conclusions results from decisions about which data, among the diversity of forms we both confronted, warranted the most emphasis. We first address how such choices shaped our analysis of the G.I. Bill's impact. We discuss which kinds of information from the historical record we count as evidence. Also, to the extent that we each confronted contradictory forms of data, we explain how we chose to weigh and assess the historical record.

In other instances, we gave equal weight to the same factual materials, but our *interpretations* of them diverged. Thus, second, we indicate how we discerned and assessed policy success and failure. In the course of this consideration, we discuss whether, or the degree to which, we think it is possible or advisable to distinguish the policy in question from other aspects of the historical social and economic context in which it was created and implemented.

We also weigh some broader *implications* concerning how contemporary policymakers and citizens should understand and respond to the lessons of the G.I. Bill. In the course of this discussion, we consider such topics as the merits and shortcomings of universal versus targeted social provision, remedies for officially-sanctioned harms, and the value of positive and negative policy lessons in today's polity. Lastly, we suggest how our studies might offer directions other scholars might wish to pursue.

Ira Katznelson
African-American Veterans and the G.I. Bill: Arguments and Evidence

When I set out to write *When Affirmative Action Was White,* I did not intend to include the G.I. Bill. Like most Americans, I considered this immense program for returning soldiers from World War II to be a nearly unqualified success. This theme of accomplishment animates *Soldiers & Citizens,* Suzanne Mettler's fine account of the program's largely positive effects on civic mobilization and democratic participation. Regarding the law's education and training benefits, she rightly observes how they altered prior circumstances in which "advanced education had been restricted primarily to the privileged, especially to white, native-born, elite Protestants."[1] On the basis primarily of utilization rates in such programs, she concluded that "the G.I. Bill's education and training benefits actually demonstrated that government does have the capacity to treat blacks and white equally and to bestow generous resources on both."[2]

Like Professor Mettler, I am particularly drawn to the G.I. Bill's comprehensive and universalistic qualities. It made all veterans eligible without any further official reference to demography or need, thus differing from more highly targeted social-welfare approaches that often have stigmatizing effects and rest on narrower coalitions of beneficiaries and supporters. Further, the immense scope of the G.I. Bill, notably including help to buy homes, start business ventures, attend college, get vocational training, and secure assistance in job placement, demonstrated that government could manage huge social programs effectively and legitimately, and, in so doing, transform opportunities and reshape the class structure and social geography of American society.

As I conducted my research, my view of the G.I. Bill's regional and racial dimensions altered. The more I learned, the more I came to understand the range and depth of differential treatment the majority of black veterans experienced. I came to grasp why, as early as 1946, the Veterans Editor for the *Pittsburgh Courier,* one of the country's leading black newspapers, could lament "the sorry plight of Negro veterans, and particularly those living in the South," and could describe how "the veterans' program had completely failed veterans of minority races."[3] I also began to appreciate the reasons a comprehensive overview in 1947 concluded that it was "as though the G.I. Bill has been earmarked 'For White Veterans Only'."[4]

What led me to an appraisal about black veterans that diverges from that of Mettler despite our shared familiarity with many of the same sources of information, notably including data on black and white participation drawn from a Veterans Administration survey?

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Usage and Its Meaning

The third chapter of *Soldiers and Citizens,* "Beyond All Expectations," announces a wish to adjudicate between what it calls "contradictory" views of the G.I. Bill as either "fostering the development of a black middle class," or having had black gains thwarted "by such formidable obstacles as persistent segregation at universities across the nation and overcrowding in historically black colleges."[5] Claiming that each position has been backed only by anecdotal evidence, Mettler turns to the Veterans Administration for "recently located evidence to assess whether usage of the education and training provisions was a commonplace among black veterans as it was among whites."[6]

In preparing *When Affirmative Action Was White,* I also consulted this source.[7] The document on which Mettler heavily relies is a 60-page mimeographed manuscript that the Veterans Administration produced for internal use to assess "benefits and services received by World War II veterans under the major Veterans Administration programs" through August 1950, including hospital care, disability compensation, outpatient dental and medical treatment, readjustment allowances, loan guarantees, and education and training. The data on usage is not an actual count. It was generated by a random sample comprising "approximately one-tenth of one percent of all veterans who had been separated from the Armed Forces to civil life between September 16, 1940 and August 31, 1950."[8] The report itself is sensitive to reliability issues. Carried out with considerable professionalism, its unnamed authors note likely ranges of error in a manner that adds confidence to their overall findings while also cautioning us to read small percentage differences with care and some skepticism, especially when sub-group samples are involved.[9]

The report is informative. Putting aside reservations about statistical accuracy and reliability, it presents interesting data about rates of participation in various aspects of the G.I. Bill. Its brief discussion of the law's education and training provisions identified black usage at 49 percent, as compared to 43 percent for whites. The respective figures for the South (the seventeen states that practiced mandatory racial segregation, plus Washington, DC) were 56 and 50 percent. These figures constitute the key data[10] Mettler deploys to argue that "the G.I. Bill's benefits reached African American service members."[11] As she notes, the types of usage under these provisions differed quite a lot by race. In the country as a whole, 28 percent of G.I. Bill beneficiaries enrolled in colleges and universities, as compared to 12 percent of black veterans.[12] Thus the higher rates of African American usage reported by the VA mainly were generated by differential black and white rates of enrollment in vocational training schools and on-the-job programs of instruction. This pattern of utilization is the central empirical support for Mettler's more general argument about black gains under the G.I. Bill, for as she rightly observes, if a bit fleetingly, there was severe discrimination in the application of the law in such other areas as home and business loans and higher education.

Good as it is to have, the information in the VA survey about percentages of involvement hardly offers a definitive evaluation of how black veterans fared in skill training and work-related programs, let alone whether such programs actually boosted significant numbers of African Americans into the middle class. As such, measurements of participation imply little—perhaps nothing—about the programs' qualities, caliber, or effects. Thus, while we might start with such data, further analysis is required to ask how such inclusion was arranged, whether it was similar across racial lines, and, if not, what were the reasons and consequences.

Rather than treat usage as a sufficient condition of fairness and mobility, my book considers the evidence presented in the VA survey as a useful point of departure. Especially in light of the far from equal treatment black veterans received in the G.I. Bill's other programs, these numbers invite us to assess more closely, with a dash of skepticism, the meaning of participation in non-collegiate vocational programs. To be sure, systematically estimated participation rates are better than mere anecdote, but they urgently demand careful estimation to gauge both their content and meaning. What was their composition in type and quality? What opportunities did they actually bestow? Did high African American utilization of vocational programs also signal the significant use of the other generous benefits offered by the G.I. Bill?

To the extent these programs are evaluated in Mettler's writing, they get high marks. Reporting results from a survey of surviving veterans from the black 92nd Infantry Division, we hear only upbeat findings: "Black veterans I interviewed found the G.I. Bill's education and training provisions to be readily available to them, and eligibility rules to be administered fairly. . . . Overall, the usage of the G.I. Bill's education and training benefits appears to have been as accessible to veterans of the 92nd Infantry Division as it was to white veterans. . . . Others turned to the sub-college programs, using them at rate that surpassed those of white veterans." Thus, she concludes, "in sharp contrast to their prior encounters with government, black veterans who used the G.I. Bill's education and training provisions experienced fair and generous treatment at the hands of government."[13]

To support this rosy picture, Mettler reports that 89 percent of African American veterans who participated in sub-college programs thought these had defined a turning point their lives.[14] This estimate does not distinguish their experience by region. Moreover, as the paragraph in which this claim appears contains no citations, I assume it is based on interviews with the 92nd, most of whose members, atypically, actually attended colleges and universities. While recognizing the problems inflicted by southern segregation, she concludes that "nonetheless . . . black

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veterans in the South utilized the education and training provisions at higher rates than black or white veterans elsewhere, and the vast majority did so in sub-college programs."[15] This assertion measures success simply, indeed exclusively, by the rate of African American participation—but participation in what?

We know quite a lot about these programs and their shocking racism. Stimulated by the availability of G.I. Bill largesse, this sector enjoyed astonishing growth. In 1944, when the Bill passed into law, the country had just 35 such private schools. By 1950, there were 10,143. Mettler stresses the positive features of this "instant emergence," emphasizing opportunity where none had existed before, correctly noting that for many veterans, the growth of these institutions was a boon.[16] Buttressing this claim, her fascinating examination of *non-black* occupational mobility demonstrates that despite the numerous fly-by-night institutions that came into being, many veterans experienced dramatic mobility as a result of this training.[17] But what about African Americans, especially the majority who still lived in the South?

Here the picture is much less pleasant. As a result of the way the law had been drafted, there was no oversight or standard setting by the federal government. With the states either providing public vocational education or regulating the great number of new private vocational schools, African American access in the Jim Crow states was confined to all-black institutions. These, in the public and private sectors, were limited to preparation for "black jobs." Private sector black institutions were most prone to fraud. Scam artists cynically took the top rate of tuition allowed by the law in exchange for little or even no actual instruction. Not surprisingly, a review of 314 private southern vocational schools for African Americans conducted in 1947 by the Urban League found most to be dreadful, noting that "it is doubtful if many of them meet minimum standards for this kind of training."[18] Another contemporary report commented that "in the absence of other opportunities, the Negro veteran may be easily exploited."[19] Likewise, the various on-the-job training programs were starkly limited by southern racist practices, with almost no white businesses willing to take on black trainees. In Georgia, in 1946, black veterans participated in only 6 of the state's 246 such programs; overall, only 1 in 12 such training venues, according to the Southern Regional Council, was open to blacks. And such training that was offered was very limited.[20] The job placement provisions of the G.I. Bill, moreover, operating through locally-staffed and almost exclusively white centers of the United States Employment Service (USES), similarly matched black workers with employers using the standards of Jim Crow.[21]

However impressive, in short, participation rates cannot produce the last word. The VA report itself explained the overall higher take-up rates for education and training in the South, and within the South by black veterans as the predictable result of high levels of economic deprivation. The poorer the region and the poorer the group, it argued, the more likely it was to be included in various vocational schools and jobs programs.[22] Moreover, the higher participation rates in the South cannot "be attributed to the relatively large nonwhite veteran population of that area." Noting that southerners utilized education and training programs in uncommonly high numbers, it observed that "the explanation can perhaps be found in the lower level in the South of educational attainment and occupational training of veterans—white and nonwhite—at time of entry into the armed forces" and "by the less favorable employment situation after VJ-day in that region compared with other more heavily industrialized areas." For the same reasons, a high percentage of individuals in training programs also received readjustment allowances, a form of unemployment insurance. Here, too, black participation was higher than white.[23]

It is one thing to be induced by deprivation into the areas of the G.I. Bill most intimately linked to being left out of labor markets and quite another to evaluate the resulting participation as necessarily successful or beneficial, let alone an instrument for movement into the middle class. We know, for example, that given their deep poverty blacks took up early New Deal relief in many southern states at higher rates than whites. But that did not mean their place in the economic and social hierarchy of the South was changed; in many respects, it was confirmed.[24] A parallel process characterized the vocational provisions of the G.I. Bill.

Mettler's larger claim about the fairness and effectiveness of the G.I. Bill has to rest on the participation levels the VA reported because, as she acknowledges, black veterans faced steep hurdles in accessing its other provisions equitably. The VA report itself highlights these barriers. By far the largest provisions for transfers of funds and for the creation of wealth via homeownership and business formation were the various loans it guaranteed. Yet, as it turns out, blacks who entered into education and training were less likely than whites to use those other resources. Tellingly, "the rate of participation in Education and Training and Loan Guaranty programs by the same veterans was considerably higher among whites than among nonwhites."[25] Mettler explains the relative absence of African Americans from home mortgage, small business, and farm loans as "*more than any other feature* of the G.I. Bill . . . vulnerable to racism because it required African American veterans to pass through a gauntlet of local banks that were often unwilling to make loans to them."[26] Such barriers certainly existed, but more here than in the other features of the law? I doubt this to be the case because *all* the provisions of the G.I. Bill made it necessary for black veterans in the South to "pass through a gauntlet" marked by white supremacy and local discretion.

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On the substance of the loan provisions, Mettler and I are in full agreement; indeed we both cite the same report by *Ebony* showing that only 2 of the 3,229 VA guaranteed loans made in 13 Mississippi cities in 1947 went to black veterans.[27] Likewise, our treatments of race and southern higher education are quite similar. We both show that the majority of returning black veterans who went home to the South faced a rigidly segregated system marked by poor funding and limited facilities; "African American veterans seeking to use the G.I. Bill for higher education in the South," she writes, "faced severely restricted options."[28]

In this area, as with lending, Mettler and I have no basic differences, only those of emphasis. For in a desire to paint a positive overarching view of the G.I. Bill, she somewhat underplays the depth of discrimination in higher education by focusing on how pre-war educational deprivations led to low post-war utilization. The most data-rich analytical study of these matters by the economists Sarah Turner and John Bound concludes that at the collegiate level "the G.I. Bill exacerbated rather than narrowed the economic and educational differences between blacks and whites."[29] They rightly note that the low number of blacks in college hardly was due simply to a lack of preparation, but to the sheer absence of places as all-white legislatures across the South refused to appropriate funds to expand black institutions at a rate sufficient to the demand, as they far more robustly did for white colleges and universities. Mettler's own interesting survey of members of the class of 1949 at eleven institutions of higher education about the usage of the G.I. Bill found that "program usage soared highest in the South, accounting for the levels of veteran enrollment at the University of Georgia and at the University of Texas at Austin," where the percentage of students who were G.I. Bill veterans reached 94 and 91 percent, respectively, well above the average for the eleven institutions of 81 percent. But right at the bottom of the group in terms of usage was Morehouse College, the only black institution in the survey, at 59 percent. She explains this disparity as having been caused by lower educational levels among blacks (and perhaps to lower life expectancy among her African American survey respondents), implicitly downplaying the structural barriers that stood in the way of finding an adequate number of places for qualified blacks at institutions that simply did not have the means to expand as quickly as the demand.[30] The vast majority of blacks who went to college under the G.I. Bill did so at historically black institutions like Morehouse where discrimination, a shortage of places, poor facilities, and modest standards were rampant.[31]

Certainly, whenever and wherever black ex-soldiers could take advantage of the G.I. Bill's provisions, they did, with gusto. Especially north of the Mason-Dixon line, despite the real discrimination they faced in its application, they gained benefits of access to parts of American institutional life—colleges, jobs, homes—they long had been denied.[32] But in the South, the G.I. Bill functioned in a manner deeply consistent with white supremacy and racial segregation across the board; as a result, for the majority of black veterans it was reprehensibly retrograde in ways that, more than any other cause, widened the gap between white and black Americans in the decade after 1945. A comprehensive evaluation, I believe, must fairly conclude just as Linda Faye Williams did in her magisterial consideration of race and social policy, that "while the conventional wisdom is that the G.I. Bill benefited black veterans enormously, in actuality their experience after World War II is in many ways reminiscent of their experience after the Civil War."[33]

Once we acknowledge how blacks fared poorly in southern higher education and in the various loan programs of the G.I. Bill, claims to the contrary about how the legislation helped level the playing field between blacks and whites must rest on how African Americans experienced vocational education and assistance. And that issue returns us to the distinction between aggregate participation and the actual character of the programs they joined.

Decentralized Bias

It makes sense, of course, to evaluate each policy feature of a law as complex as the Servicemen's Readjustment Act one at a time. Yet if we are to understand its application to African Americans, we have to come to grips with how its remarkably uneven racial and regional qualities were produced by specifications of administrative decentralization placed in the law by design. Written in committees chaired by the arch-racist Congressman John Rankin of Mississippi and the more moderate segregationist Senator Bennett Champ Clark of Missouri, the bill protected Dixie's racial order by insuring that all its provisions could, in this way, conform to southern racial practices despite its formal universalism and the absence of any specific mention of racial categories.

I am hardly the first to notice this. More than a decade ago, Hilary Herbold observed how "race was contested terrain in the very inception of the G.I. Bill."[34] A few years later, a seminal article by David Onkst chronicled the constitutive racism of the legislation as a matter of intention and implementation.[35] An excellent University of Chicago doctoral dissertation by Kathleen Hill Frydl took up these themes with much greater depth and breadth.[36] These scholars and I have underscored how the bill was authored by leading supporters of racial segregation and drafted with the keen prodding and assistance of the American Legion, which countenanced segregation, and the Veterans Administration, whose housing and hospitals were racially segregated, to create a program that could be made consistent with southern racial arrangements despite its availability to all veterans. The main means was the way massive federal funding was combined

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with state and local control of administration and implementation. Central to all the educational provisions, in particular, was a statement in the legislation, drafted by Congressman Rankin, to the effect that "no Department or Offices of the United States in carrying out the provisions of this part, shall exercise any supervision or control whatsoever over any state educational agency."[37]

With regard to the other features of the bill, Mettler concedes that such provisions opened the door to exclusion and discrimination, but in assessing education and training, just such an evaluation is disappointingly absent. It is here, with this silence, that my reading of the available evidence most differs from hers. For Jim Crow did not come to a halt at the threshold of non-collegiate education and training. To the contrary, the values and institutions of white supremacy were constitutive of how these, like the other, provisions were implemented in the South. If we stop before probing the content, organization, and inherent barriers built into these programs when they were administered by southern bureaucrats and politicians committed to white supremacy, we miss the chance to understand the apparent paradox of how high black participation could produce deeply discriminatory results.

We have seen how Mettler set out to adjudicate between the claim that the G.I. Bill moved African Americans into the middle class and the contention that the legislation severely discriminated against this group of veterans. She sees these assertions as "contradictory." I do not. As I wrote, "it is indisputable that the G.I. Bill offered eligible African Americans more benefits and more opportunities than they possibly could have imagined in the early 1940s" when they were serving in the still-segregated military.[38] In this sense, it is correct to include black veterans in the overall appraisal to the effect that "the G.I. Bill broadened educational opportunity to veterans who were Jewish or Catholic, African American, and immigrants as well as to those whose families had struggled in the American working class for generations."[39] Yet this generous assessment has to be sharply qualified because the legislation and its implementation effectively recognized the South's official and lawful system of white supremacy. For this reason, I concluded my chapter on the G.I. Bill in *When Affirmative Action Was White* by observing that "the way in which the law and its programs were organized and administered, and its ready accommodation to the larger discriminatory context within which it was embedded, produced practices that were more racially distinct and arguably more cruel than any other New Deal-era program. . . . Any celebration of postwar gains for veterans must reckon with these doleful practices and legacies."[40]

There is much about which Suzanne Mettler and I agree. The G.I. Bill made a profound contribution to modern America. It fashioned a middle class through its impact on home ownership, schooling, job placement, and business formation. It induced greater civic engagement.[41] It exhibits a model for how a modern welfare state might be shaped. We also concur that the best available data indicates that African American veterans utilized at least one program of the G.I. Bill at least as much as whites, and possibly at a higher rate. We share the view that "African American veterans were deeply committed to acquiring more education if they had the chance," that "the G.I. Bill was the means that made it possible for many to act on those inclinations," and that "they seized the opportunity" where they could.[42] But these facts are not persuasive as the basis for the larger claim that the legislation served African Americans well overall, or the assertion that they were treated fairly in the area of pre-collegiate education and training. On this, the argument turns.

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Suzanne Mettler
Fostering Equal Opportunity and Citizenship

Americans value the ideals of equal opportunity and political equality.[43] This raises the question of whether public policy might have the capacity to both mitigate social inequalities and to expand active citizenship, fostering participation by those whose voices might not otherwise be heard in the political process. As a test case for this possibility, I examined the education and training benefits of the World War II era G.I. Bill. These provisions permitted veterans to pursue, at government expense, higher education or non-college options such as vocational training, on-the-job training, or high school completion. Arguably no other U.S. policy has enjoyed such a hallowed reputation for promoting opportunity and enabling individuals to join the ranks of the middle class. I wondered whether the benefits had truly been as accessible to veterans as has been maintained by popular belief, and whether their inclusivity spanned the racial divide of the postwar era. I also wanted to know whether and how the provisions may have influenced recipients' rates of civic and political involvement, affecting the vibrancy of democracy.

My expectation, as I began the project, was that the G.I. Bill's education and training benefits may have been inclusive among white men across socio-economic classes but that African Americans were likely largely excluded. The G.I. Bill was administered at a time when legalized discrimination persisted in the South; black veterans seeking to use benefits in that region would have done so in the context of segregated institutions. Besides this obvious fact, my assumption about racial bias was based on the patterns I had observed in my previous research on New Deal social and labor policies that were established in the 1930s. Although ostensibly race-neutral, such policies initially left out most African Americans either through occupational exclusions, such as in Social Security, or as a result of the discretion left to the states for determining eligibility, as in the cases of the public assistance programs.[44] The few existing historical studies that touched on the G.I. Bill's racial legacy further buttressed my expectation.[45] In short, I anticipated that I would reach the conclusion that Ira Katznelson does in *When Affirmative Action Was White.*

What I found through my research, therefore, came as a surprise. In practice, the G.I. Bill's education and training benefits proved relatively inclusive of both black and white male veterans. A survey of 15,000 veterans conducted by the Veterans' Administration in 1950 revealed that over the first five years following the war, nonwhites utilized the provisions at *higher* rates nationwide than whites. Overall, 49 percent of nonwhites benefited compared to 43 percent of whites, and nonwhite usage rates equaled or surpassed white usage rates in each region of the country. This was the case even in the South, where 56 percent of nonwhite veterans used the benefits compared to 50 percent of white veterans.[46]

Even more striking, the G.I. Bill's education and training benefits appear to have yielded a powerful impact on male veterans' civic and political participation in the postwar era, fostering a "virtuous circle" of democratization that led to greater racial equality. Among black veterans I surveyed in the 92nd Infantry Division, G.I. Bill beneficiaries grew intensely involved, during the 1950–1964 period, in the civil rights movement: 35 percent engaged in organizing, marching, and protesting to end legalized discrimination, compared to only 8 percent of the nonbeneficiaries. Then, from 1965 to 1979, in the wake of the movement's legislative victories, these same individuals became highly active in formal politics: they participated in a wide range of activities—serving on councils or boards of local government, working on campaigns, or contacting elected officials—at rates that were, on average, twice those of the black non-G.I. Bill users. Just as the provisions had incorporated black veterans more fully as citizens, their subsequent involvement, in turn, helped make the polity become yet more inclusive.[47]

My findings challenge Katznelson's view that the G.I. Bill's education and training provisions exacerbated racial discrimination and "significantly widened the country's large racial gap."[48] This interpretation is not supported by the facts. My research clearly demonstrates that these benefits expanded opportunity in ways that departed from the prevailing discriminatory policies of their age. This constituted a remarkable and important historic development. Further, in ways overlooked by Katznelson, the benefits over time fostered intense civic engagement for social change. This finding underscores the significance of policy feedback effects for mass publics and demonstrates that policies have the potential to enhance citizenship.

It is important to note that my research on other New Deal programs generally supports Katznelson's interpretation that they were racially exclusionary at the outset.[49] Moreover, my analysis of the G.I. Bill focuses on the education and training benefits; Katznelson's assessment of the Bill's other provisions, namely the low interest mortgages and unemployment benefits, may be correct.[50]

Nonetheless, my findings regarding the G.I. Bill's education and training benefits are at odds with Katznelson's totalizing account of racial discrimination. The racial inclusivity of these parts of the G.I. Bill opens an important and new dimension of research on how public policies may, over time, transform civic involvement, with long-term effects for democracy. Indeed, the racial exclusivity of other policies during the same era further highlights both the empirical significance and the theoretical and normative importance of the G.I. Bill's education and training components.

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Methodological Matters

In conducting historical analysis, scholars must make careful assessments about which sources of data on which to rely and which to emphasize; otherwise we risk using data selectively to fit our preconceived notions of the past. This challenge emerges in assessing the central question about the racial inclusivity of the G.I. Bill's education and training benefits: how rates of usage compared between black and white veterans.

Previously, historians have surmised about black veterans' program usage by extrapolating from scattered bits of evidence drawn from individual institutions or localities, typically at particular moments in time. Both Katznelson and I had access to the far more authoritative source that I mentioned above: the national survey of 15,000 veterans conducted by the Veterans' Administration (VA) in 1950. This study revealed that nonwhites' rate of using the education and training benefits surpassed that of whites nationwide, such that by 1950 approximately 640,920 of the nation's 1,308,000 black veterans had used the benefits.[51] As I located other systematic and large-sample size studies, I found that they corroborated these patterns of usage. For example, a study of veterans in the Special Training Units, groups comprised of poorly educated soldiers who had been offered literacy training while in the army, showed that southern blacks utilized the G.I. Bill's education and training programs at the highest rate, twice that of northern whites.[52]

Yet, whereas I understand the VA study to be an authoritative source on the matter of program usage by race, Katznelson does not. He mentions its results only briefly and then proceeds to characterize my reading of it—that it indicates that the provisions were quite racially inclusive—as "not so much wrong as misleading."[53] In a footnote, Katznelson defends his choice to deemphasize the results of the VA study by saying:

> This document's data has to be read with extreme caution. That the sample size is small is not itself a problem; the margin of error is within a range of just 1 percent. But the document does not report on the demographic characteristics of the approximately fifteen thousand veterans who did respond, including the racial distribution of respondents. Further, given the upward tilt of most respondents, there is good reason to believe that the African Americans who were surveyed were disproportionately northern, better off, and more likely to have used the G.I. Bill.[54]

Katznelson's skeptical reaction about the representativeness of the VA study is surprising. No data are perfect and researchers are almost always forced to make trade-offs by using datasets that are good but have shortcomings; grappling with such limitations is the cost of being able to conduct empirical analysis, an enterprise that can yield results of considerable value. Most scholars, moreover, would consider a survey of 15,000 to constitute an unusually *large* sample and would assign to it a relatively high degree of credibility given that it was gathered according to random sampling techniques and produced such a low margin of error.[55] The particular concerns Katznelson raises are not convincing. For example, his caution that black respondents may have been "disproportionately northern" does not make sense given that the survey results are presented on a regional basis.[56]

After casting doubt on the credibility of these usage data, Katznelson proceeds to highlight instead the anecdotal evidence that historians have had to rely on previously. He offers examples of low usage rates by black veterans in specific institutions and high numbers of black veterans turned away by historically black colleges due to overcrowding.[57] I concur that these instances demonstrate obstacles encountered by black veterans as they sought to use their benefits in the context of Jim Crow segregation.[58] But Katznelson's implication that such examples undercut the evidence of the program's broad inclusivity is problematic. Unlike the VA study with its national scope, the more limited evidence on which he draws is often derived only from individual cities, states, colleges, or programs. Whereas the VA study offered usage rates across a five-year period, Katznelson's examples are based on narrower moments in time—from one month or one year. The sources from which they come, furthermore, offer no information about data collection processes or the representativeness of those studied.[59] Yet unlike Katznelson's cautious assessment of the VA study, he raises no methodological concerns about these data.

Neither does Katznelson consider how to reconcile these particularistic data with the seemingly contradictory results of the VA study. I expect that the more narrowly derived data may offer valid indications of circumstances in particular places and moments in time, but that longer-term national or regional patterns are likely captured more accurately by the VA study. Katznelson draws primarily on sources of data from the first years after the war, especially 1945 and 1946, whereas the VA study measures usage up through August 1950.[60] The disjuncture between the data may indicate that early on black southern veterans encountered greater obstacles to program usage than whites but that many prevailed in their search and eventually found spots in institutions that accommodated them.[61] Already by 1946, the rates of black enrollment at institutions in the North and West had more than doubled, and black veterans continued to migrate in large numbers to those regions where they could use the G.I. Bill away from the constraints of Jim Crow.[62] By not grappling with such issues, Katznelson appears to emphasize less representative data that support his larger argument and to deemphasize more systematic data that contradict it.

In making these criticisms, by no means do I intend to disparage qualitative approaches; historical analysis of policy outcomes benefits from the combined and appropriate use of both qualitative and quantitative approaches. For example, qualitative analysis enabled me to probe individ-

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uals' experiences of G.I. Bill usage and non-usage; I did this through in-depth, open-ended interviews with veterans across the nation. The examination of aggregate trends requires, however, that we use the most reliable quantitative data available. Scholars seeking to do this are often confronted by a dearth of broadly-derived, reputable data and a plethora of anecdotal data of uncertain quality. When more reliable sources do exist, it is essential that we take them seriously and consider how we might reasonably reconcile other forms of data with them.

Certainly obstacles abound in this kind of research; I found, for instance, that no previous surveys enabled me to examine how G.I. Bill usage influenced civic engagement. Therefore, I conducted surveys of World War II veterans, gathering data from over 1000 respondents. While I reached a nonblack male sample that permitted systematic quantitative analysis, the lower life expectancy of black males meant that I could survey only a small, more limited sample of black veterans and thus I use those data in a more cautious and qualitative fashion.[63] In sum, in analyzing the effects of past policies, scholars must often grapple with unsatisfactory data; the challenge is to make careful and reasoned decisions about how best to proceed and to move forward with a realistic understanding of the limitations we face.

Interpretive Matters

The assessment of the impact of the G.I. Bill's education and training benefits on racial inequality presents a key interpretive challenge: discerning whether the provisions themselves influenced outcomes, and if so, how. Both Katznelson and I give ample attention to the unequal circumstances that black veterans confronted in the course of program usage and afterward. He interprets many of these inequalities as if they emanated from the G.I. Bill itself. By contrast, I find them to be traceable to exogenous factors, namely the legacy of legalized segregation in the South and the pervasiveness of racial discrimination in labor markets nationwide. These laws and practices, which pre-dated the G.I. Bill by many decades, influenced the form of black veterans' program usage and curtailed its immediate socio-economic impact on their lives.[64]

Without question, Jim Crow segregation structured and restricted southern black veterans' usage of the education and training benefits. Whereas colleges across the nation experienced overcrowding during the "G.I. Bulge" and program quality was questionable in many of the nearly 5,600 new trade schools that sprang up to meet veterans' demands, southern blacks faced worse conditions than whites in the separate institutions they had to attend.[65] Katznelson treats the circumstances black veterans confronted as if they were inseparable from the G.I. Bill itself, concluding, "The performance of the G.I. Bill mocked the promise of fair treatment."[66] I understand them to be the outcome of state-level laws in the South, policies that were avoided by black veterans who used the provisions elsewhere in the nation.

We also diverge in how we interpret the different ways that black and white veterans used the education and training provisions. While the G.I. Bill is widely associated, in popular lore, with college attendance, in fact the vast majority of World War II era beneficiaries—regardless of race—used the provisions for noncollege programs. Yet whereas 28 percent of white G.I. Bill users pursued higher education, only 12 percent of black veterans did so; black beneficiaries, conversely, pursued vocational training and high school completion at higher rates than whites.[67] Katznelson treats this difference as evidence of the law's poor record among African Americans.[68] This overlooks the fact that among the Army troops during World War II, only 17 percent of black soldiers had already graduated from high school compared to 41 percent of white soldiers.[69] Because high school completion is generally regarded as a prerequisite to college attendance, it is not surprising that black veterans were less likely than whites to use their G.I. Bill benefits to attend college.[70] This disparity emanated not from the G.I. Bill but rather from pre-existing racial inequality borne of decades of legalized segregation. The G.I. Bill's education and training provisions, being available to all soldiers who had served 90 days or more, did not purport to close the racial gap that such practices had created, but they did enable all veterans to have access to more advanced study than would have been the case otherwise.

We also disagree about how to measure the G.I. Bill's impact on black and white veterans. Both of us respect a recent study by economists Sarah Turner and John Bound that shows that outside of the South, G.I. Bill usage raised college attendance rates among both blacks and whites, whereas in the South it did so for whites but not blacks.[71] Katznelson uses this study to argue that the G.I. Bill "significantly widened the country's large racial gap."[72] I contend, however, that Bound and Turner focus only on educational attainment, which is measured according to years of *formal* education. By this measure, those who went on to college gained, whereas the high proportion of black veterans who used the noncollege training programs showed no discernable improvement, no matter how extensive their training or how valuable the skills it offered. The G.I. Bill offered veterans a variety of means of acquiring a human capital investment regardless of their prior level of education; the fact that more white veterans were positioned to use the form that elevated their formal educational attainment emanated, once again, from pre-existing inequalities, not from the law itself.

We both agree that black veterans, even after achieving college degrees under the G.I. Bill, received earnings that were much less than those of whites with the same level of

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education.[73] In the postwar era, the wage gap between individuals with one to three years of college education versus those with a high school diploma was $1300 among whites but only $300 among blacks.[74] But whereas Katznelson does not explore the dynamics leading to this outcome, my analysis suggests that the widespread persistence of racial discrimination in labor markets facilitated such results. Black veterans whom I interviewed explained that when they sought jobs after graduating from college on the G.I. Bill, they often received the same low-status, low-paying positions they would have obtained beforehand. Although the data I collected from black veterans about their jobs in 1960 compared to their fathers' jobs in the 1920s does show evidence of improvement in occupational status among G.I. Bill beneficiaries, nonetheless they secured employment in a narrower range of jobs than white beneficiaries.[75] In this era prior to the passage of the Civil Rights Act of 1964, the persistence of racial occupational segregation curtailed the impact of the G.I. Bill on black veterans' socio-economic advancement.

The problem with conflating the G.I. Bill with the effects of legalized segregation and labor market discrimination is that it prevents systematic policy analysis: it becomes impossible to disentangle factors that hindered the inclusion of African Americans as first-class citizens from those that actually promoted it. Distinguishing between these factors analytically, I find that the education and training provisions yielded positive effects that transcended the postwar racial divide, fostering equal opportunity and participatory citizenship. Black veterans acquired far more education and training than they would have in the Bill's absence and they gained both greater capacity and inclination for civic engagement. At the same time, the legacy and persistence of racial bias presented formidable obstacles that attenuated the Bill's social and economic impact among black veterans. Those same factors also prompted black G.I. Bill users, with their enhanced civic capacity, to channel their subsequent civic and political involvement toward fundamental social and political change.[76]

All told, the G.I. Bill's education and training benefits represented the *most* racially inclusive policy of the era rather than, as Katznelson claims, the least so.[77] Certainly the provisions could have been more powerful still if Jim Crow policies had already been eradicated. Yet even in the segregated context in which they were administered, state and local officials lacked much capacity to divert benefits away from African Americans. The provisions' federally-defined eligibility criteria made them far more inclusive than either the New Deal federal grant-in-aid public assistance programs, wherein southern states could determine eligibility in ways that excluded African Americans, or the G.I. Bill's mortgage provisions, for which black veterans had to deal with local banks—which used red-lining procedures nationwide—to gain approval for loans. The generous monthly subsistence allowances that the G.I. Bill granted to all veterans while they underwent training or education varied neither by race, region, nor type of training; rates were determined only by veterans' marital status and by whether they had children, and those rates applied uniformly, nationwide.[78] Such hallmarks of inclusivity and generosity made the G.I. Bill's education and training benefits remarkable not only for their own time, but from a contemporary standpoint as well.

Broader Implications

The racial legacy of the G.I. Bill's education and training benefits is relevant today both because of its implications for current policy choices and because of its analytical bearing on how we make sense of the past. On the basis of what Katznelson understands to be the effects of the G.I. Bill and various New Deal policies, he promotes a new package of social policies targeted to individuals who can demonstrate a family legacy of exclusion from the benefits of such policies. His plan would "extend affirmative action in order to end it within one generation."[79] With respect to the education and training benefits of the G.I. Bill, I contend that this plan would not yield the effect that he intends.

First, Katznelson's approach would likely not reach as many African American families as he expects given that black veterans—even when they encountered more hurdles in the process—eventually gained access to the education and training benefits at comparable rates to white veterans. His plan would probably be more effective at channeling benefits to white descendents of the Merchant Marine and Women's Air Force Service Pilots, two groups that were entirely excluded from G.I. Bill coverage.[80]

Second, the targeted policy Katznelson promotes would be at odds with the G.I. Bill's universalistic format, an approach with considerably greater capacity to foster incorporation of citizens, social solidarity, and political participation. While he suggests that in his plan "the major instruments would be the same as those the federal government utilized in the G.I. Bill," the basis of eligibility would be derived far more narrowly, based on family history.[81] The education and training provisions granted benefits on an inclusive basis to individuals who had fulfilled their civic duty, recognizing and affirming their commitment to the polity. Thus, whereas segregation in the Armed Forces and in southern educational facilities "projected humiliation" on black veterans, as Katznelson rightly observes,[82] the education and training benefits actually bestowed dignity and civic status.

This basis of deservingness matters critically for the civic impact of policy receipt. Policies that are targeted to narrowly defined groups fail to incorporate beneficiaries as citizens with equal standing to others in the polity and may reinforce their second-class status. The experiences that citizens gain from such policies can undermine their

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sense of political efficacy and may thus result in lower rates of political participation. By contrast, policies that incorporate broad classes of citizens and stress the mutual obligations between them can boost recipients' political efficacy and rate of political involvement.[83]

Among black veterans, these interpretive effects of the G.I. Bill's education and training benefits combined with the policy's resource effects to facilitate active involvement in the civil rights movement. For many, the provisions were the one positive experience of government they had acquired up to that point, situated amidst numerous stigmatizing experiences. In the words of Celeste Torian, whose husband used the benefits after his service in the 92nd Infantry Division, following the war "the only good thing was the G.I. Bill."[84] The benefits provided evidence that the federal government had the capacity to fashion public policy that encompassed African Americans. In addition, by permitting black veterans to gain education and training, the provisions gave them access to the skills, resources, and networks that are widely recognized to help boost civic capacity.[85]

Thereafter, black G.I. Bill users became particularly active in the civil rights movement. After attending Northwestern University on the G.I. Bill, Henry Hervey, a Tuskegee Airman, explained that "I went to every bank in downtown Chicago and presented my credentials, and I got the same job offer I would have gotten if I had not gone into the Army: It was either a janitor or a mailroom clerk." But he continued, "By that time you learn that you can fight city hall, and you have to fight, and there are ways you can bring pressure to make changes." Together he and countless others mobilized effectively to transform the policies and practices that had so long excluded them from full inclusion in the polity. Among famous black G.I. Bill users were Medgar Evers, the NAACP leader who was assassinated in 1963; Hosea Williams, who led the march for voting rights from Selma to Montgomery until he was beaten unconscious by state troopers in a scene that appeared on national television and which prompted President Lyndon B. Johnson to send the Voting Rights Act to Congress; and Aaron Henry, who led the formation of the Mississippi Freedom Party and the Council of Federated Organizations, as well as numerous boycotts and sit-ins.[86] The United States became a more fully democratized nation due to the courageous activism of such individuals.

Today, the ideals of equal opportunity and citizenship are still stymied—now by the legacy of past racial discrimination combined with the rise, in recent decades, of economic inequality. Yet we live in an era when government solutions are suspect. I expect that if my undergraduates read Katznelson's book, they would be easily convinced of the argument that government has, in the past, played a powerful contributing role to deeply entrenched inequalities. But as a result, many would balk when, in the final pages of his book, Katznelson turns to public policy to set things right; given government's poor track record, they would favor market-based solutions instead. Yet, as market-based inequality has risen in the United States in recent decades and U.S. government has failed to mitigate its effects, the successes of the rights revolution have been curtailed as a result.[87] Today's inequalities, though not as rigidly forged along racial lines as in the past, still find African Americans profoundly disadvantaged.

The G.I. Bill, through its education and training provisions, offers an example of how government *can* succeed in making the United States more fully democratic. It did so by extending social opportunity across racial lines and then by fostering active political citizenship among beneficiaries such that they mobilized to make the polity yet more inclusive and egalitarian. Only if we can understand how American public policy once did build "a bridge over the racial divide," broadening the scope of democracy, can we begin to imagine how it could do so once again.[88]

On a theoretical level, my approach to analyzing the impact of public policies for mass publics requires that we probe their development as they unfold historically, *across time.*[89] In focusing only on the moments of policy creation and early implementation, Katznelson imposes a static analysis on phenomena that tend to be inherently dynamic. As implementation proceeds, policies may generate unanticipated results. These may emerge as effects of program administration or of the policy's interaction with concurrent social, economic, and political changes.[90] As well, a policy may transform individual lives, yielding ripple effects across time. In this manner, the G.I. Bill's first-order effects—the access it provided to education and training—generated second-order effects of heightened political involvement. By combining the analytical tools of policy feedback theory with historical analysis we can unravel effects of public policy that have long been overlooked by standard policy analysis and which are critical to understanding how policies influence democratic citizenship.

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Ira Katznelson
Reply to Suzanne Mettler

Suzanne Mettler's spirited defense of the G.I. Bill with regard to its impact on racial inequality, even in the Jim Crow South, has grown more emphatic and less qualified. The law, she insists, "did 'build a bridge over the racial divide,' broadening the scope of democracy," and yielding "positive effects that transcended the postwar racial divide, fostering equal opportunity and participatory citizenship." She characterizes the legislation's educational and training opportunities, on which she places special emphasis, as "the *most* racially inclusive policy of the era," that offered returning black soldiers "dignity and civic status" by enabling "all veterans to have access to more advanced study than would have been the case otherwise" (emphasis original). Further, she argues, the law's "federally-defined eligibility criteria" for education and training produced circumstances in which "state and local officials lacked much capacity to divert benefits away from African Americans." The G.I. Bill, she contends, is a "test case" for how "public policy might have the capacity to both mitigate social inequalities and to expand active citizenship."

Under the heading of "methodological matters," she dismisses as "scattered bits of evidence drawn from individual institutions or localities, typically at particular moments of time" the rich array of case material and statistical data on which not only I but other students of the veterans programs have relied to reach conclusions that differ substantially from hers, preferring instead what she calls "the far more authoritative" study the Veterans Administration sponsored that found the rate of black usage of G.I. Bill programs to be somewhat higher for blacks than whites.

This indeed is a useful source of data, but only when its findings are probed to get underneath the aggregate numbers to understand their composition. Because I pointed out in a footnote in *When Affirmative Action Was White* that the finding of significant black participation in that document was not a measure of actual usage but was based on research whose detailed methods we cannot access, she suggests that I dismissed this material. I did not. Based on that survey and the Ginzberg and Bray study on which she also relies, my book observed that "when they could, blacks seized the chance. . . There is ample evidence that black soldiers expected the G.I. .Bill to provide training and upward mobility, and indeed they applied for as many benefits as they could. . . Hundreds of thousands, in fact, gained resources in many cases that were simply unavailable to non-G.I.s."[91]

Mettler's methodological strictures about surveys and case research aside, the important choice is not whether to employ both types, but how to draw on the full array of existing material. Precisely because I also began with the best available quantitative data, I next did what any such evidence demands. I turned to more micro-level studies to comprehend how the summative usage numbers were composed, and which mechanisms and patterns of distribution underpinned black usage. The results are pretty startling. African Americans were significantly underrepresented in the home mortgage, business and farm loan, and college-level programs of the G.I. bill (even, for the latter, when we control for educational level and eligibility), and over-represented in its pre-collegiate schooling and training opportunities. Thus our dispute turns empirically on the meaning of high black participation in this aspect of education and training.

Perhaps it is worth underscoring that this is a contained difference. Mettler and I are in broad accord about how the G.I. Bill sharply discriminated against African American soldiers in all its other provisions. Though rhetorically downplayed in her writing, she, too, notes the deeply different ways blacks and whites were treated when they applied for loans or were placed in jobs; she, too, recognizes the vastly different kinds of college experiences open to blacks and whites who qualified under the G.I. bill (though she fails sufficiently to call attention to how southern states provided places for virtually all eligible whites without doing the same for African Americans who wished to attend the region's historically black colleges). These features of the law were crucial to upward mobility and the creation of a modern middle class. Some blacks, especially many in the North and West, gained such status as a result of their access to these programs. But even there, and far more so in the South, the region to which most black soldiers returned, the gap between whites and blacks widened not just because of Jim Crow, but because the veterans legislation was tailored to permit racism to flourish.

Mettler's singularly positive evaluation thus turns entirely on the character and meaning of vocational schooling and training at a pre-college level. But nowhere does she challenge, or produce facts to challenge, not just my findings but those of a good many other scholars who have established that these opportunities were terribly flawed. The rapid creation, very limited training, job ceilings, and other limitations of the segregated southern programs made the great majority barely adequate, if that. Many were fraudulent shells, mere excuses to collect the tuition for which all veterans, regardless of race, were entitled. Mettler's own essay also avers, if with remarkable understatement, that, in just these courses so central to her argument, "program quality was questionable."

After making too much of my cautionary words about the VA survey, Mettler's methodological discussion contrasts its "seemingly contradictory results" with "particularistic data," as if the aggregate figures somehow infirm the cumulative local experiences of repeated discrimination and poor, often non-existent, instruction in just those areas of the G.I. Bill black soldiers used the most. Clearly, there is no empirical or logical contradiction between high usage rates by African Americans in the one area of the

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law to which they were given most access and the doleful character of this opportunity. Rather, these quantitative and qualitative characteristics combining high usage with poor quality, taken together, reveal why it is misleading to focus exclusively on utilization rates. It is, moreover, something of a canard to note, as Mettler does in dismissing some mid-decade material, that black participation rose through the 1940s. Of course it did. The program's deeply flawed vocational schools, the one set of programs that sought to recruit black veterans more energetically than whites, were the fastest growing segment of the law during the second half of that decade.

Mettler is right to put most of the blame on the terrible situation of southern blacks on racist laws and practices that predated the G.I. Bill. She is right, too, to insist that the legislation did offer some resources that, in this setting, would have not been available otherwise. My book said exactly that. But she is quite wrong to treat the law in the South as somehow thwarting Jim Crow. It was deliberately crafted in southern-led congressional committees to make universal benefits consistent with racist practices. The design worked. In the political circumstances of the time, perhaps this outcome was inevitable; but it should not be let pass in our policy histories.

Mettler, in short, puts too much emphasis on summary statistics without sufficiently probing their content and meaning. But she offers a second body of evidence based on revealing interviews she conducted a half-century later with surviving members of the 92nd Infantry Division, a unit of black enlisted men and white officers based in Italy that saw combat in Europe after the invasion of Normandy. These conversations, revealing a large debt to the G.I. Bill and confirming high rates of usage, corroborate my own assertion that "to this day, many black veterans rightly credit these opportunities as turning points in their lives. There can be no doubt that . . . the G.I. Bill made a very big difference for these individuals."[92] But judging by their rates of college attendance and the location of these institutions outside the South, it is clear that the members of the 92nd were not typical black veterans. The richly appreciative quotations Mettler reports, as she says about other such materials, are interesting and revealing as anecdote, but hardly representative.

But what of the important claim, central to larger virtuous circle, policy-feedback argument of *Soldiers to Citizens,* that successful black experiences with the G.I. Bill produced a greater level of participation in the later civil rights movement? Mettler demonstrates a clear and compelling correlation. Yet in the absence of greater specification of the particular mechanisms linking the two experiences, it seems at least as plausible to believe that a combination of wartime experience in the Jim Crow army, with all the normative contradictions the fight against fascism and dictatorship entailed for black soldiers, together with the mix of opportunity and rebuff proffered by the G.I. Bill, generated a combination of skill and anger that helped southern blacks find a voice and the means to overcome formidable problems of collective action under conditions of white resistance.

Mettler worries that the full story of racism and the G.I. Bill somehow will lead her students to distrust governmental solutions. I think it is more likely they will learn to probe the difference between putative and real universalism. I would also hope they would consider how today's public policies might best address the legacy of harms that I have tried to chronicle, and how to combine broadly universal social goals with more targeted policy innovations that take this history into account. In trying to answer a question put by President Lyndon Johnson in 1965—why did the racial gap grow in the postwar years despite widespread prosperity?—*When Affirmative Action Was White* argued that public policies, notably including the G.I. Bill, played a key part. By attending to this history, in turn, it is more, rather than less, likely that we can craft a mix of policies that might make sense today. In so doing, we should take care not to simply dismiss all targeted remedies in the name of a commitment to universalism, as if past policy experience somehow had transcended race.

Like Mettler, I think the G.I. Bill offers a test case. Its racial record is a sad example of how even the best, most energetic, most egalitarian, most comprehensive, most normatively inclusive, and most liberal social policies in the New Deal-Fair Deal era were deeply injured by their encounter with Jim Crow through the willful and politically skillful defense of racism conducted by well-positioned Democratic Party members of Congress who represented the segregated South. For sure, African Americans were not excluded by the formal terms of the legislation. But its terms of administration and its pathways for participation widened the racial gap and reinforced an American tragedy.

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Suzanne Mettler
Reply to Ira Katznelson

In his essay Ira Katznelson once again attempts to use my analysis of the G.I. Bill as a foil against which to make the case that racism pervaded every aspect of the law. I suspect that his implication that I present a "rosy picture" of black veterans' experiences of the education and training provisions would strike many readers of *Soldiers to Citizens* as surprising. The book contains extensive description of the many ways in which the prevalence of legalized racism affected black veterans' form of G.I. Bill usage, their experience of its implementation, and its socio-economic effects on their lives.

By portraying my analysis as if I minimize such circumstances, Katznelson obscures how critical differences in the ways we each conducted our analysis led us to our divergent conclusions. Here, I will comment on some crucial areas of disagreement that have become more evident in this exchange.

In his essay Katznelson again deemphasizes the value of the most systematically collected and comprehensive data available for assessing the G.I. Bill's record on race. He prefaces his consideration of the results of the 1950 Veterans' Administration national survey of a random sample of 15,000 veterans with the qualification that it requires "putting aside reservations about statistical accuracy and reliability." "The data on usage is not an actual count," he warns us. Most scholars would be surprised by the demanding expectation that data should involve an "actual count" of the population in question—in this case, by Katznelson's own figure, 12 million veterans.[93] Political science research routinely uses data that are drawn from a random sample of the population in question, such as the National Election Studies, the General Social Survey, or the Citizen Participation Study of 1990. In fact, by contemporary standards, the VA study's sample of 15,000 qualifies it as a remarkably large survey for assessing a population. Ironically, however, despite Katznelson's expressed skepticism about data based on less than an "actual count" of all veterans, he then proceeds freely to make an argument that is, once again, based on scattered anecdotes that he presents in the absence of any consideration of data collection techniques or representativeness.[94]

To the extent that Katznelson acknowledges the usage data that show that more blacks than whites used the education and training provisions, particularly for noncollegiate programs, he tells readers that these numbers must be used only as a "point of departure" that "invite us to assess more closely, with a dash of skepticism, the meaning of participation" in such programs. Katznelson's major argument about the provisions' racism, therefore, rests on his contention that the programs that black veterans in the South attended were characterized by poor quality—such that the training they received was inferior to that gained by white veterans. Besides the fact that the causes of such inequality lay in the Jim Crow segregation laws of the southern states that long pre-dated the G.I. Bill's creation, this claim is problematic because it rests on an absence of any systematic evidence.[95] Contrary to Katznelson's assertion that "we know quite a lot about these programs," unfortunately we do not. What we do know is that all vocational training programs nationwide came under scrutiny by Congress and the media in the late 1940s. Of the 8,000 programs approved by the government to offer such training, fully 5,600 opened their doors after the enactment of the G.I. Bill; not surprisingly, public officials worried that many of these were "fake schools" or "fly-by-night" operations of questionable quality.[96] While Katznelson's claim of inferior quality in programs serving southern black veterans is most likely correct, he makes it in the absence of any comparative evidence indicating quality in programs that white southerners or veterans elsewhere attended.

Katznelson attributes to me one argument that is contrary to what my work suggests, that the G.I. Bill served as "an instrument for movement into the middle class" for black veterans. I found, rather, that even when black veterans attained the *same* level of training or education as white veterans, subsequently they experienced neither the same boosts in income nor in occupational status.[97] Where we actually differ with respect to this matter is how we interpret it; where Katznelson blames the G.I. Bill for such socio-economic disparities, I argue that they emanated from entrenched labor market practices that perpetuated job discrimination against African Americans. After the war black veterans experienced considerable discrimination and disadvantage, but the G.I. Bill's education and training provisions were not the source of such inequities.

Katznelson devotes attention to policymakers' intentions in creating the G.I. Bill, pointing out that segregationists purposefully designed the policy such that federal controls could not restrict state educational agencies and therefore would not disrupt Jim Crow. Such politics were standard practice in that era: an analogous story can be told for each of the other New Deal social provisions for which implementation occurred on the state level. Notwithstanding the importance of this policy history, in the case of the G.I. Bill's education and training provisions policymakers' intentions alone do not provide us with an accurate indicator of policy outcomes. Given features of the policy's design, state officials lacked the discretion to restrict black veterans' eligibility for either program usage or attainment of subsistence allowances. Furthermore, the bill's outcome that arguably became the most significant for black veterans—its impact on their civic engagement and political participation—emerged as an *unintended* consequence, one that helped to undermine the system of white supremacy and to expand democracy.

This last point reveals the most significant difference in our approaches: the socio-economic outcomes of policy

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are the endpoint of Katznelson's analysis whereas I probe beyond them to uncover civic and political consequences in individual lives. In a footnote, Katznelson takes issue with my argument, suggesting that to the extent black G.I. Bill users became more involved in the civil rights movement that it must have been because of their experience of the "unrealized promise" of the legislation and their "frustration of exclusion" from it. This does not make sense because, as we have seen, African Americans were not excluded from the policy. What set black G.I. Bill users apart from other black veterans was not an extra experience of exclusion but a single and pivotal experience of inclusion, one that gave them skills, networks, and in some cases resources—all factors that have been recognized as critical determinants of participation.[98]

Today, many decades after the achievements of the civil rights movement, our society is still plagued by inequality. To some extent, such inequality is the enduring legacy of the age of Jim Crow, red-lining, and other once-legal practices. The more proximate cause, however, is the enormous rise in economic inequality in the last three decades, trends that have transformed our social structure and, tragically, reinforced in many ways the racial stratification of the past. To combat inequality today, therefore, it is not sufficient to learn only about past policies that mandated or reinforced racial stratification. Rather, we need also to sift through our history in search of policies that successfully fostered inclusivity across both race and class. The G.I. Bill's education and training provisions constitute such an example, one that demonstrates how public policy can enable citizens themselves to claim political power and to reinvigorate democracy.

Notes

1 Mettler 2005a, 11.
2 Mettler 2005, 140.
3 Gibson 1946, 1.
4 Bolte and Harris 1947,20.
5 Mettler 2005a, 54.
6 Mettler 2005a, 55. A more extended discussion basically based on the same evidentiary base and making similar arguments can be found in Mettler 2005b.
7 We both have Michael Brown to thank for finding and providing us with a copy of this manuscript. He utilizes this material in Brown 1999.
8 U.S. Veterans Administration 1950, 1.
9 U.S. Veterans Administration 1950, 1–4.
10 The other source of information is Mettler's own survey of the black 92nd Infantry Division, the only such unit that participated in combat after joining the European theatre in 1944, after the invasion of Normandy. As Mettler notes in Appendix D, this, at best, a suggestive survey, replete with all kinds of difficulties, not least those of mortality and distance from the events. "Thus, I interpret the data on black veterans in a more cautious manner than the data on nonblack veterans, and consider it indicative only of the sample here and not as representative of the original universe of black veterans' experiences." The 104 respondents had unusual characteristics, including their very high rate of prewar schooling; of this group, fully 78 percent had completed high school before joining the Army (Mettler 2005a, 181).
11 Mettler 2005a: 54.
12 Mettler 2005a: 56.
13 Mettler 2005b: 38–39.
14 Mettler 2005a: 80.
15 Mettler 2005a, 80.
16 Mettler 2005a, 85.
17 Mettler 2005a, 95–96.
18 Cited in Onkst 1998, 531.
19 Bolte and Harris 1947, 15.
20 Bolte and Harris 1947, 14–15; Onkst 1998, 526.
21 Katznelson 2005, 138.
22 Veterans Administration 1950, 23.
23 Veterans Administration 1950, 24, 28.
24 Sterner 1943; Myrdal 1944; Brown 1999.
25 U.S. Veterans Administration 1950: 29.
26 Mettler 2005a, 102; emphasis added.
27 Katznelson 2005, 140; Mettler 2005a, 104.
28 Mettler 2005a, 76.
29 Turner and Bound 2002, 25.
30 Mettler 2005a, 67–68.
31 Mettler has criticized the study by Turner and Bound for overlooking sub-college programs where black participation was high, saying that "it fails to illuminate the fundamental question of whether the G.I. Bill's benefits proved accessible to black veterans" (Mettler 2005a, 209, n.52). Though important, this information, I have been at pains to show, is *not* the 'main issue,' which, rather, concerns the character, qualities, and results of access.
32 Cohen 2003, 171.
33 Williams 2003, 112.
34 Herbold 1994–95, 104.
35 Onkst 1998.
36 Frydl 2000.
37 Cited in Frydl 2000, 185.
38 Katznelson 2005, 140.
39 Mettler 2005a, 11.
40 Katznelson 2005, 140–141.
41 The main theme of *Soldiers & Citizens* concerns how the universalistic and comprehensive features of the G.I. Bill induced civic engagement. I am sympathetic to this argument, which builds on earlier work by Robert Putnam and Theda Skocpol, among other students of social capital (Putnam 2000; Skocpol 2003).

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But in the case of African Americans and the civil rights movement, I think the book's overly positive reading illuminates only part of the story. For it was not the bounty of the G.I. Bill that sparked black mobilization and the means with which to overcome quite deep barriers to collective action. Rather, the mix of real assets some achieved and the bitterly unrealized promise the implemented legislation offered to many more that created a brew of means, wherewithal, deprivation, and resentment that, together, by combining the taste of freedom with the frustration of exclusion, proved sufficiently powerful to motivate action that transformed the South, and, with this, the United States as a whole.

42 Mettler 2005a, 56.
43 Schlozman, Page, Verba, and Fiorina 2005, 23–25.
44 Lieberman 1998; Mettler 1998.
45 Onkst 1998; Herbold 1994–95; Brodkin 1998. For a more recent example, see Cohen 2003.
46 U.S. Congress, Committee on Veterans' Affairs 1956a, 72; U.S. Veterans Administration 1950, 27. While this latter document is not dated, it reports results of a survey conducted in 1950.
47 Analysis of World War II Veterans Survey, reported in Mettler 2005a, Chap. 8 and Appendix Table F.8.2, p. 190.
48 Katznelson 2005, 141.
49 Mettler 1998.
50 I discuss the low interest mortgages in Mettler 2005a, pp. 100–104.
51 Although a brief mention of the summary statistics of this report appears in a widely available government document, scholars have not mentioned them previously. That source is U.S. Congress, Committee on Veterans' Affairs 1956a, 72. Katznelson and I are both indebted to Michael Dawson, who in the course of archival research located the full report which offers these statistics in greater detail. See U.S. Veterans' Affairs 1950, 27, and generally, 12–13, 20–28. Also see Brown 1999, 189–90 and Table II.
52 Ginzberg and Bray 1953, 126. Also see U.S. Veterans' Administration 1980, which reports findings of a 1979 study of veterans of World War II and the Korean War, which also shows (p. 96) that black veterans were more likely than whites to use some of the non-college training programs. Interestingly, also, Turner and Bound 2002 offer a more detailed break-down of these same data which reveals (although they do not discuss it in their analysis) that black veterans from most birth years used the education and training benefits at equal or higher rates overall than white veterans. See Turner and Bound 2002, p. 32.
53 Katznelson 2005, 121.
54 Katznelson 2005, 121, note 38.
55 U.S. Veterans' Administration 1950, 1–4.
56 Also, given the composition of the World War II military and typical labels for racial classification at that time, it is reasonable to assume that the vast majority of those referred to as "nonwhite" were African Americans. And while surveys may generate an "upward tilt" among respondents, it is not clear why that bias would be more pronounced among nonwhites than the whites. Mettler 2005b, 29–30; also see Katznelson 2005, p. 128.
57 Several examples are mentioned in Katznelson 2005, 130–33, 135–37.
58 Mettler 2005a, 74–76, 80, 82.
59 For example, Katznelson cites Olson 1974, 74, who suggests that 20,000 veterans were turned away at black colleges, but in examining the source Olson cites for this point, Atkins 1948, I am unable to find that figure or to determine how Olson arrived at it. Another source that Katznelson mentions, Bolte and Harris 1947, says that 55 percent of veteran applicants had to be turned away, but they offer no source for this figure.
60 For example, see Bolte and Harris 1947, in which the bibliography includes sources mostly from 1945 and 1946; also see sources mentioned in Katznelson 2005, p. 130, note 68 and p. 132, notes 79, 80.
61 It is possible, of course, that under fully accessible conditions black usage of the education and training programs would have surpassed white usage at an even greater rate.
62 Bolte and Harris 1947, 4–5; Stouffer et al. 1949; Thompson 1946, 579; Turner and Bound 2002, 15, note 11. Besides the possibility that many black veterans moved to the north to use their benefits, it is also possible that they waited to commence their studies. Among veterans generally, use of the college benefits did not peak until 1948, and use of the vocational benefits did not peak until 1950 and then declined slowly. U.S. President's Commission on Veterans' Pensions 1956, 288. Veterans who had not previously expected to acquire more education commenced their studies under the G.I. Bill more slowly than those for whom it had already been part of long-term personal plans.
63 The black veterans' sample size is 104 individuals. Mettler 2005a, p. 181, and for greater detail see Mettler 2005b, 50–52.
64 My interpretation of the G.I. Bill's impact among African Americans is largely in accord with that of Linda Faye Williams in *The Constraint of Race,* pp. 111–114. She explains that "the nature, role, and impact of the GI Bill is complex." She points out that "some of its provisions were directly helpful to blacks" (112) but also shows how "the context of widespread racial inequality and white advantage"

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hindered its ability to foster racial equality (113). I also largely agree with her broader argument that the U.S. welfare state has tended to promote rather than to ameliorate racial stratification. Significantly, because she considered the evidence about the G.I. Bill's effects to be limited, she refrained from clearly identifying it as an example of a policy that solidified white privilege (114). For reasons that will be apparent in this essay, I do take issue, however, with her suggestion that it "sharply increased the distance between the middle and working classes . . . and blacks and white" (114).

65 U.S. Veterans' Administration 1945, 137–38; U.S. President's Commission on Veterans' Pensions 1956, 290; U.S. Committee on Veterans' Affairs 1956b, 55–61; Mettler 2005a, ch. 5, passim, for comparison between programs for black veterans and other institutions.

66 Katznelson 2005, 141.

67 Katznelson 2005, 134; Mettler 2005a, 55–57.

68 His argument follows the same logic as that of Turner and Bound 2002, but they rely upon the same limited sources that I have already criticized, such as those mentioned above in notes 17 and 18.

69 Fass 1989, 141.

70 In the survey data I collected from nonblack veterans, I found that those with less prior education were less likely to use the G.I. Bill to attend college: this pattern was by no means unique to black veterans. In fact, the black veterans' survey data I collected hints that black veterans who were poised to pursue college education may have taken advantage of the G.I. Bill even more readily than nonblacks, refusing to let obstacles like greater age and less prior education stand in their way. Mettler 2005a, 56; Mettler 2005b, Appendix C.

71 Turner and Bound 2002; Katznelson 2005, 134; Mettler 2005b, 34–35.

72 Katznelson 2005, 141.

73 Katznelson 2005, 134; Mettler 2005b.

74 Miller 1966, 145–46.

75 Mettler 2005b, 42–44.

76 Mettler 2005b, 44–49.

77 Katznelson 2005, 129, 140–41.

78 This is significant both because for the federal government, the cost of the subsistence allowances far outweighed the cost of tuition for the education and training provisions, and because veterans themselves found the payments to be extremely helpful.

79 Katznelson 2005, 172.

80 Mettler 2005a, 145–46.

81 Katznelson 2005, 171–72.

82 Katznelson 2005, 172.

83 Wilson 1987, Chap 7; Skocpol 1991; Soss 1999; Schneider and Ingram 1993.

84 Mettler 2005b, 48.

85 Verba, Schlozman, and Brady 1995; Mettler 2005a, ch. 8.

86 Mettler 2005a, 136–37, 142.

87 Hacker, Mettler, and Pinderhughes 2005, 159–63, 173–79.

88 I have borrowed this expression from Wilson 1999.

89 Pierson 2004.

90 Hacker 2005; Streeck and Thelen 2005.

91 Katznelson 2005, 121, 119.

92 Katznelson 2005, 119.

93 The U.S. Census Bureau aims for an actual population count, but social scientists in the Bureau have argued in recent years that this approach is actually *less* likely than a random sampling approach to produce an accurate count due to the fact that it typically misses large portions of segments of the population—such as racial minorities—that are harder to count.

94 Once again, Katznelson uses evidence from the early years of the Bill's implementation, 1946 and 1947. He remarks that the results of the VA survey that I emphasize come from a "60 page mimeographed manuscript." In fact most of these results also appear in a published, widely available government document—U.S. Congress, Committee on Veterans' Affairs, 1956, p. 72 and Appendix C, pp. 299–353—and the mimeographed report simply offers more disaggregrated data. The results also cohere with data from other studies that I mention in note 10 of my longer essay in this exchange.

95 As he does in his book, Katznelson offers a few data points, each from a particular state or a particular year soon after the war's end. He cites secondary sources for each of these. In an attempt to ascertain the primary sources from which such data was derived or at least some information about such data, I have examined each of these secondary sources and I have also consulted the additional secondary sources that authors of such pieces identify as evidence. In none of these instances have the sources led to information that is any more definitive.

96 Mettler 2005a, 42, 77–84. Interestingly, most veterans who used the program still considered the G.I. Bill a "turning point" in their lives, though at lower rates than higher education beneficiaries, and among non-blacks, at lower rates in the South than in the North—likely indicating lower quality in the significantly larger number of programs that opened instantly in that region. Given the small size of my sample of black veterans, unfortunately it does not make sense to report results by region. Mettler 2005a, 87–88.

97 Mettler 2005b, 42–44.

98 Verba, Schlozman, and Brady 1995.

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Closing the Gap or Widening the Divide: The Effects of the G.I. Bill and World War II on the Educational Outcomes of Black Americans

SARAH TURNER AND JOHN BOUND

The effects of the G.I. Bill on collegiate attainment may have differed for black and white Americans owing to differential returns to education and differences in opportunities at colleges and universities, with men in the South facing explicitly segregated colleges. The empirical evidence suggests that World War II and the availability of G.I. benefits had a substantial and positive impact on the educational attainment of white men and black men born outside the South. However, for those black veterans likely to be limited to the South in their educational choices, the G.I. Bill had little effect on collegiate outcomes.

Recent empirical evidence points to a substantial positive effect of the G.I. Bill and World War II service on the educational attainment of white men.[1] Left unanswered is the question of whether the G.I. Bill and World War II had a similar effect on black Americans. There are good reasons to believe that the program effects of the G.I. Bill may have differed for black Americans, who had fewer opportunities in the labor market and in higher education. In particular, black men in the South faced explicitly segregated colleges and much more limited opportunities within historically black institutions.

The related question of whether black veterans from states with *de jure* segregation demonstrated educational gains similar to black veterans in other states is significant for both the overall evaluation of the G.I. Bill and the lessons we draw from it for contemporary policy. In general, portable grant aid programs such as the G.I. Bill are expected to have large effects on collegiate investments when the supply of education is relatively elastic. Yet, limited state investment in colleges and universities open to blacks may have restricted the extent to which black veterans in the South were able to make use of G.I. benefits to attend college.

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[1] Bound and Turner, "Going to War"; and Stanley, "College Education."

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More generally, comparing the effects of the G.I. Bill on the educational outcomes of black and white Americans raises classic questions of the role of education in reproducing inequality. In principle, the portable aid available to all veterans through the G.I. Bill held the promise of significantly reducing black-white gaps in educational opportunity and long-run economic outcomes. Given the absence of other national financial-aid programs in the 1940s, one might expect the G.I. Bill to have the largest behavioral effects on men for whom financial constraints were most likely to impede college enrollment. In practice, it is less clear that economically disadvantaged and minority veterans exhibited the largest changes in college participation as a result of the financial aid provided by the G.I. Bill. These groups may have lacked the academic readiness for college programs, and supply constraints in higher education may have limited their enrollment.

Our research questions are twofold. First, we explore the extent to which World War II service and the availability of G.I. benefits had similar behavioral effects on the collegiate attainment of black and white men. Then, among blacks, we look at the extent to which state of birth, and particularly location in a southern state, led to differential collegiate outcomes. The analytic strategy in this article uses variation over time in the fraction of men serving from each birth cohort to identify the effects of military service and the availability of G.I. benefits on educational attainment.

BLACK AMERICANS, WORLD WAR II MILITARY SERVICE, AND THE G.I. BILL

Race and Military Service in World War II

The politics and practice of minority participation in the military were contentious issues as World War II approached. Before the start of the war, the black press and the NAACP launched the "Double V" campaign, urging black Americans to work toward victories over Jim Crow at home and fascism abroad. In late September 1940 President Roosevelt met with a delegation of black leaders to discuss the administration's defense policy and the utilization of blacks in the military, as well as minority-group support for the administration's policies. Shortly after that meeting, on 9 October, the Roosevelt administration released a statement reaffirming its support for the inclusion of blacks in the military in proportion to their representation in the population while continuing the segregation of black and white troops in organized military activities.[2]

[2] Smith, *When Jim Crow*. Although black leaders were unsuccessful in obtaining the changes necessary to achieve official endorsement of integration in the military in World War II, they did see passage of an amendment to the Selective Service Act of 1940 stating that "there shall be no discrimination

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As the war approached, the capacity of the military to employ black servicemen was quite limited. For example, in 1940 there were only six black units in the military, which accounted for only 4,450 soldiers.[3] To maintain segregation, the military branches were required to build additional housing, mess halls, and other facilities for black servicemen. Because of initial placement barriers, few black men were accepted to the military through voluntary enlistment in the early years of the war.

When manpower demand intensified as the war progressed, voluntary enlistment was largely eliminated and date of birth became a primary determinant of induction. All men were required to register with local draft boards at age 18, after which they were classified as "service eligible" or deferred from service. It is this classification by local draft boards that introduces the significant problem of selection in measuring the effects of World War II and the availability of G.I. benefits on the educational attainment of veterans. Reasons for deferment included mental and physical deficiencies, illiteracy, and employment in industries vital to the war effort. Differences by race in these classification rates suggest potential differences in the nature of the selection effects associated with military service. For instance, whites were much more likely to receive occupational deferments and blacks more likely to be deferred for reasons of illiteracy or "mental deficiency." Table 1 shows selective-service classification rates for black and white registrants by age in 1945. Among registrants ages 19–25, black men were 2.25 times more likely than white men to receive deferments under section IV-F for physical or mental unfitness. Of those deferred for service in 1944, 33.5 percent of blacks and 8.0 percent of whites were rejected for low scores on the reading and writing examination.[4]

Figure 1 shows the share of white and black veterans of World War II and all other U.S. conflicts by birth cohort for the first half of the twentieth century, measured at quarterly intervals. Among men designated service eligible, date of birth was significantly related to the probability of induction as the selective service drafted "oldest eligible" men first. For men turning 18 during the war, those born in the interval 1923–1925 faced a relatively high risk of induction relative to those born in later years. For black men, absolute levels of military participation were somewhat lower than for whites, with a peak share of 66 percent reached among men born in the third quarter of 1922. Among blacks and whites, the proportion of each cohort serving in the military slid rapidly after the 1926 birth cohort. Ultimately, more than 1 million black men served in the military during World War II.[5]

against any person on account of race or color" in the selection of troops and the execution of the law (MacGregor, *Integration*).

[3] Flynn, *Draft*.

[4] Selective Service System, *Quotas*, table 191, p. 664.

[5] The majority of these men served in the Army and the 885,945 black men inducted to this branch accounted for 10.9 percent of the men inducted in the Army during the war. The Navy inducted

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TABLE 1
DISTRIBUTION OF SELECTIVE SERVICE REGISTRANTS BY CLASSIFICATION AND RACE IN 1945

		Distribution by Classification						
	Number of Registrants (1)	I-C (2)	I-C D (3)	I-A (4)	Share Deferred (5)	IV-F (6)	II-A and II-B (7)	II-C, III-D, Other (8)
Black Men								
Age 18	114,890	0.222	0.011	0.449	0.318	0.216	0.027	0.075
Ages 19–25	911,222	0.508	0.070	0.038	0.384	0.265	0.059	0.060
Ages 26–29	496,495	0.367	0.071	0.076	0.486	0.292	0.107	0.087
Ages 30–33	475,568	0.241	0.054	0.057	0.648	0.295	0.236	0.117
Ages 34–37	440,656	0.179	0.047	0.055	0.719	0.317	0.271	0.131
White Men								
Age 18	637,272	0.404	0.022	0.243	0.331	0.185	0.067	0.079
Ages 19–25	6,848,970	0.687	0.065	0.018	0.230	0.118	0.060	0.052
Ages 26–29	4,107,552	0.539	0.073	0.038	0.350	0.127	0.154	0.069
Ages 30–33	4,084,599	0.316	0.051	0.018	0.615	0.133	0.385	0.097
Ages 34–37	3,911,548	0.212	0.043	0.015	0.730	0.147	0.473	0.110

Notes: Column 2, Classification I-C indicates currently enlisted or deceased; Column 3, Classification I-C D indicates discharged; Column 4, I-A indicates available for service; Column 6, IV-F indicates deferred for mental or physical unfitness; Column 7, II-A and II-B deferment for nonagricultural employment; and Column 8, II-C captures agricultural employment as well as other miscellaneous deferment categories.
Source: Selective Service System, (*Selective Service and Victory*) tables 89–93, 171–75.

G.I. Benefits and Educational Opportunities for World War II Veterans

The unprecedented support for the education of returning World War II veterans provided by the Serviceman's Readjustment Act (Public Law 346, 1944), known more generally as the G.I. Bill, was notably race-neutral in its statutory terms. Educational benefits extended from a minimum of one year to four years, depending on length of service and age, and men serving between September 1940 and July 1947 were eligible. In addition to providing annual tuition payments of up to $500, the bill also provided a monthly cash allowance.[6] A notable feature of the program was that benefits were

153,224 black men, which accounted for about 10 percent of the inductions in this branch, whereas the Marine Corp did not admit blacks until June of 1942 (Selective Service System, *Quotas*).

[6] The provisions of the G.I. Bill as signed into law by President Roosevelt on June 22, 1944, provided for a monthly stipend of $50 for single veterans and $75 for married veterans, as well as the payment of tuition, books, and supplies up to $500. All veterans serving 90 days with a record of honorable discharge were eligible for one year of educational benefits, with veterans receiving educational benefits matching years of service 1:1 up to a maximum of four years of benefit eligibility. In December of 1945, the G.I. Bill was amended to increase the length of the period over which a veteran could initiate and complete education, eliminate restrictions on educational benefits for older veterans, and increase the level of monthly stipend to $65 for single veterans and to $90 for veterans with

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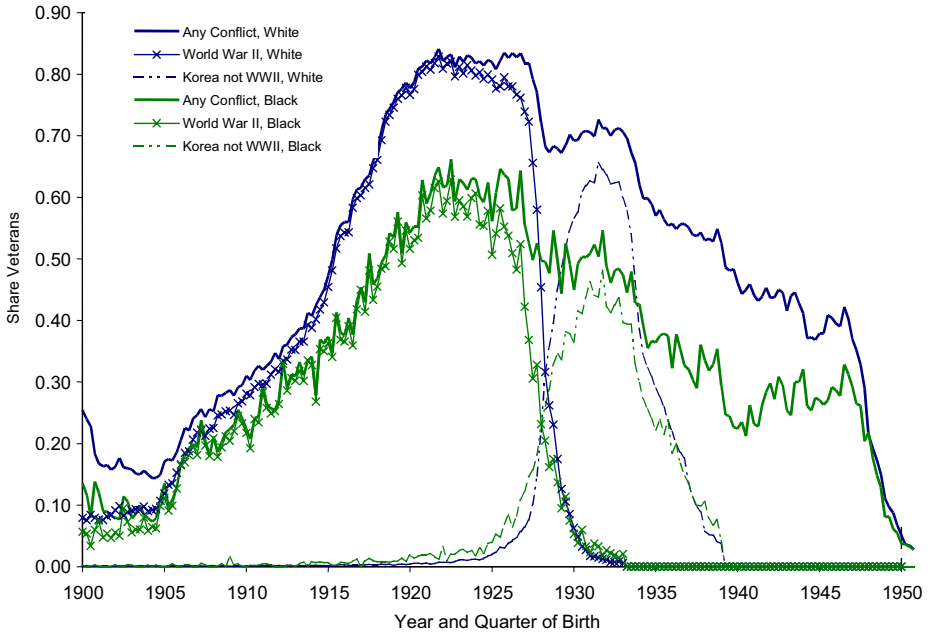


FIGURE 1
SHARE OF VETERANS AMONG MEN, 1900–1950 BIRTH COHORTS, 1970 CENSUS DATA

Source: 3-percent sample from the 1970 decennial census.

awarded to individuals rather than institutions, allowing veterans to use them for any educational or training programs to which they were accepted. G.I. benefits not only covered enrollment at colleges and universities but also provided opportunities for vocational, technical, and apprenticeship training. In fact, the majority of veterans who received training under the World War II G.I. Bill participated in noncollegiate and on-the-job programs.[7]

dependents. The nominal stipend levels were raised again in April of 1948 to $75 for single veterans, $105 for married veterans, and $120 for veterans with children.

[7] U.S. House of Representatives, *Report*. Men chose a wide array of programs beyond collegiate-level training. Overall, black men were less likely to enroll in college-level programs than whites. Data from the Survey of Veterans show more than 28 percent of whites in the 1923–1928 birth cohorts enrolled in collegiate level training, while less than 12 percent of returning black veterans chose this option. Black men were, in turn, relatively over-represented in the range of programs comprising the "other" training and schooling category as well as high school-level training.

However, there is some evidence that black men in the south had a particularly difficult time gaining access to vocational and on-the-job training programs with G.I. benefits. Southern Veterans Administration centers employed few black counselors and were generally unforthcoming in providing services to black veterans (Onkst, "First a Negro"). For example, Onkst cites evidence noting that in March of 1946 only six of the 246 on-the-job training programs in Atlanta for veterans had black participation. Another report of the period (Bolte and Harris, *Our Negro Veteran*) notes that of 102,200 veterans receiving on-the-job training in 12 southern states, only 7,700 were black, despite the fact that about one in three veterans in the area were black.

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TABLE 2
EDUCATIONAL ATTAINMENT AND USE OF G.I. BENEFITS AMONG WORLD WAR II VETERANS

	White Men							Black Men						
Year of Birth	*N*	Age at Military Discharge	Years of Education at End of Service	Used G.I. Benefits (share)	Months of G.I. Benefits	Received BA with G.I. Benefits (share)	Years of College with G.I. Benefits	*N*	Age at Military Discharge	Years of Education at End of Service	Used G.I. Benefits (share)	Months of GI Benefits	Received BA with G.I. Benefits (share)	Years of College with G.I. Benefits
1920	268	26.8	11.4	0.4	6.0	0.06	0.32	14	25.2	7.5	0.5	6.1	0.00	0.29
1921	324	25.5	11.1	0.4	6.3	0.06	0.32	22	24.9	9.8	0.6	8.9	0.00	0.45
1922	315	24.6	11.4	0.5	7.6	0.10	0.55	22	23.2	8.1	0.6	11.1	0.05	0.18
1923	295	23.9	11.5	0.5	8.4	0.13	0.69	20	22.6	9.4	0.5	8.3	0.00	0.30
1924	275	23.8	11.4	0.5	8.4	0.14	0.73	29	23.9	9.6	0.5	7.4	0.10	0.34
1925	280	22.3	11.4	0.5	9.3	0.15	0.78	19	21.1	9.3	0.6	10.1	0.05	0.42
1926	261	21.7	11.2	0.6	11.1	0.12	0.86	17	20.9	10.1	0.6	7.9	0.00	0.29
1927	256	21.8	11.4	0.6	11.9	0.12	0.99	14	22.6	10.4	0.4	7.3	0.00	0.14
1928	97	22.4	11.3	0.5	9.0	0.15	0.89	5	24.4	9.8	0.8	8.2	0.00	0.80
1929	31	24.8	11.1	0.4	3.9	0.03	0.29	3	25.8	10.0	0.3	1.7	0.00	0.00

Source: The 1979 Survey of Veterans.
Notes: The data are limited to observations for men with valid educational-attainment measures.

Very little information is available providing direct evidence on the comparative utilization rate of G.I. benefits among black and white veterans. Limited data from the Survey of Veterans presented in Table 2 suggest that black veterans turning 18 during World War II were at least as likely as white men to use G.I. benefits, although the number of months of G.I. educational benefits appears to be smaller for blacks than for whites. One study conducted by the Information and Education Division of the Army in 1944, just after the announcement of the G.I. Bill, showed the remarkable power of the benefits in changing educational aspirations. Prior to the announcement of benefits, only 7 percent of enlisted men indicated that they planned further training or education after the war. After the announcement, 29 percent of white enlisted men and 43 percent of black enlisted men expressed a definite interest in education and training after the war.[8]

It is likely that educational opportunities for veterans returning from World War II varied with race and geography. Southern states maintained explicitly segregated systems of education in the 1940s and this affected the tertiary system of education, as well as the primary and secondary levels. Moreover, access to information about veterans' benefits and advising services may have differed with racial groups. A statutory provision of the G.I. Bill was the availability of employment and education counseling services through the Veterans Administration (VA), designed to help veterans obtain education and training. To meet the high postwar demand, the VA not only maintained regional counseling centers but also contracted with educational institutions to operate an additional 300 sites.[9] It is probable that the availability of counseling services differed by race, especially in the South. David Onkst notes that the lack of black counselors was particularly marked in the deep South, with only about a dozen black counselors for all of Georgia and Alabama and none in Mississippi.[10]

At the conclusion of World War II, blacks wanting to attend college in the South were restricted in their choices to about 100 public and private institutions delineated in the Office of Education publications as "Colleges for Negroes,"[11] as segregation in public higher education remained a legal mandate in many southern states. The public institutions for blacks were founded largely under the Second Morrill Act in 1890, which specifically prohibited the distribution of federal funds to states that did not provide separate accommodation for blacks if the primary state institution denied admission to blacks.[12]

[8] Brown, *Educational Opportunities*.

[9] Ibid.

[10] Onkst, "First a Negro."

[11] With the exception of Wilberforce University in Ohio and Lincoln University in Pennsylvania, these institutions were located in southern states with legalized educational segregation. The data collected by the Office of Education during the 1940s and 1950s do not record the attendance or degree completion of students by race at integrated colleges and universities.

[12] The Second Morrill Act led to the founding of 17 Negro land-grant colleges in the southern and border states, with these institutions including Alabama A&M, University of Arkansas at Pine Bluff,

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Few of the postsecondary institutions for blacks offered education beyond the baccalaureate and 28 of the institutions reporting in academic year 1949/50 were classified as sub-baccalaureate teachers colleges or junior colleges.[13] Among the historically black colleges, those in only seven states offered postbaccalaureate training and no institution offered an accredited engineering or doctoral program. A survey of historically black colleges in 1945 found that 45 percent of institutions enrolled fewer than 250 students and 92 percent of the institutions had enrollment of less than 1,000 students.[14] Underfunded and small, these institutions were largely excluded from the "university revolution" that swept through much of public higher education in the first part of the century—a development described by Claudia Goldin and Lawrence Katz.[15]

The small scale of the historically black institutions relative to other colleges and universities merits emphasis. Whereas average enrollment at white or nonsegregated schools was nearly 1,500 in 1949/50, the average resident college enrollment at the black colleges was 729.[16] Beyond their much smaller size, colleges for blacks also had significantly fewer resources per student than their counterparts. Across all private and public institutions in the South, white institutions accounted for 92 percent of total expenditures in 1943/44; among public institutions alone, colleges and universities for whites accounted for more than 94 percent of expenditures.[17] In 1949/50, 56 percent of black men enrolled in black colleges were at public institutions, whereas 66 percent of all men attending college in southern states were at public institutions.[18] Because private schools were likely to be more limited than public institutions in their ability to expand capacity in response to demand shocks, the reliance of blacks in the South on private institutions for collegiate opportunities may have differentially affected their capacity to use G.I. benefits.

Excess demand for higher education was particularly high among black veterans in the South. Keith Olson found that an estimated 20,000 black

Southern University A&M (Louisiana), and Alcorn State (Mississippi). Many of these institutions emphasized training in crafts and trades following the "industrial education" philosophy of Booker T. Washington, rather than providing general education on the model of liberal arts colleges (Pifer, *Higher Education*).

[13] U.S. Department of Health, Education and Welfare, *Biennial Survey*.

[14] Jenkins, "Enrollment."

[15] Goldin and Katz, "Shaping."

[16] U.S. Department of Health, Education and Welfare, *Biennial Survey*.

[17] Jenkins, "Enrollment," table 1.

[18] Data for enrollment at all southern institutions are from U.S. Department of Health, Education and Welfare, *Biennial Survey of Education 1948–50*, and the data for enrollment at colleges for blacks are from Bowles and DeCosta, *Between Two Worlds*. Although the level of enrollment expanded markedly at both public and private colleges for blacks between 1939/40 and 1949/50, the growth at the public colleges was particularly marked. In 1939/40, enrollment of men at the private black colleges exceeded enrollment of men at the public black colleges, with enrollment levels of 6,724 and 6,528, respectively.

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veterans were turned away from the Negro colleges, and a survey of 21 of the southern black colleges indicated that 55 percent of all veteran applicants were turned away for lack of space, compared to about 28 percent for all colleges and universities.[19] Part of the problem was housing.[20] For example, the lack of family housing units at the Tuskegee Institute in 1945 constituted a substantial barrier to black veteran enrollment, as about a quarter of the school's veteran population were married and few were able to find alternative lodging.[21]

The historically black colleges were more limited than white colleges in their ability to accommodate returning servicemen because institutional resources were more scarce and deficiencies in physical space were often more serious than at the white institutions.[22] Although flagship universities such as the University of Wisconsin and the University of Michigan in the North and the University of Texas and the University of Alabama in the South were able to expand rapidly to meet the needs of returning veterans under the G.I. Bill, limited facilities at the segregated institutions effectively constrained the supply of places for blacks in the South. Institutions expanding most rapidly at the end of the war were the public institutions with the economies of scale, economies of scope, and funding of research universities.[23] With very few of the historically black schools maintaining graduate or professional programs, they were ill equipped to expand to meet the needs of returning veterans. Although the portability of aid under the G.I. Bill would have theoretically allowed southern blacks to attend schools in the North, the barriers to enrollment—including limited information about collegiate alternatives, the disruption of living far from home, and the potential persistence of discrimination at northern institutions—would likely have been significant.

A particularly important question concerns the extent to which urban universities in the North and West enrolled black students. Institutional enrollment counts by race were not collected at the collegiate level in the years preceding and following World War II, and there is little direct evidence of the level of integration at these schools. The available empirical evidence provides a hint that colleges in the North may have provided substantial opportunities for minorities after World War II, if not before. The concentration of northern-born blacks in urban areas may well have made it relatively easy for World War II veterans from this group to participate in

[19] Olson, *G.I. Bill*.

[20] Bolte and Harris, *Our Negro Veteran*.

[21] Onkst, "First a Negro."

[22] Recognizing the extraordinary conditions at the colleges for blacks in the South, the Federal Works Agency awarded the black colleges a disproportionate share of the institutional aid available under the Veterans' Educational Facilities Program, passed in 1946. One source suggests that the surplus war buildings and materials increased the physical plant of these institutions by 25 percent. Yet, it is less clear that this expansion in capacity benefited the black veterans returning in the mid-1940s.

[23] Stanley, World War II G.I. Bill.

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higher education given the relative concentration of colleges and universities in urban centers. In addition to changes in the racial composition of colleges in the North, southern institutions of higher education were increasingly integrated in the postwar years and, by 1952, all of the state universities in the South except those in Alabama, Florida, Georgia, Mississippi, and South Carolina allowed some black enrollment.[24] In this regard, the decade following World War II included significant changes in the range of colleges and universities attended by black Americans, as well as the level of collegiate attainment.

ESTIMATION FRAMEWORK

Our research questions focus on how World War II service, combined with the availability of G.I. benefits, changed collegiate outcomes and whether such effects differed for blacks and whites. First, even without the availability of educational benefits, veterans' postwar collegiate outcomes may have exceeded the attainment of nonveterans because veterans have had higher levels of college-preparedness in the absence of the war. Also, veterans may have acquired skills during military service that increased measured postwar educational attainment and civilian productivity. Moreover, the G.I. benefits reduced the direct cost of college through tuition payments and living stipends, thereby increasing the likelihood of college participation.

A central question of this analysis is whether the effect on collegiate attainment of military participation and the availability of educational benefits varied with race and geographic location. In fact, there is good reason to suspect that the return to education differs by race, owing to discrimination in the labor market or differences in the quality of educational opportunities available to blacks and whites. Pressing in the other direction, if blacks were more likely to face credit constraints than whites, the addition of G.I. benefits might have somewhat larger effects on the enrollment behavior of blacks.

Still, this formulation presupposes the presence of an elastic supply of enrollment places in the college market. The evidence discussed previously suggests that black men residing in the South may have faced quite limited college enrollment options. The combination of *de jure* segregation at public institutions and limited capacity at private colleges may have limited the collegiate options for the large wave of returning black veterans in southern states.

As with a wide array of efforts to measure how a public policy initiative —in this case World War II and the G.I. Bill—affect educational attainment, the key challenge is to measure a causal effect rather than to record the

[24] Johnson, "Racial Integration."

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association between eligibility and educational outcomes. Because veterans of both race groups are likely to differ systematically from nonveterans owing to the screening employed by the Armed Forces, simple comparisons of the educational attainment of veterans and nonveterans are likely to overstate the effects of military service and the availability of G.I. benefits on educational attainment. This is particularly true for black men, because a principal reason for rejection in this group was illiteracy. Thus, finding exogenous determinants of veteran status is of paramount concern.

Our strategy for estimating the effects of World War II service and the availability of G.I. benefits for black Americans is parallel to the regression discontinuity approach employed by Bound and Turner.[25] Consider a measure of collegiate attainment as a function of veteran status

$$Ed_{ij} = \alpha_j + \beta_{ij} V_{ij} + \epsilon_{ij} \quad (1)$$

where Ed_{ij} represents the educational attainment (years of college or college completion) of individual i in cohort j. V_{ij} is an indicator variable equal to one if the individual served in World War II, and ϵ_{ij} is an error term. Conceptually, α_j represents the mean educational attainment for randomly selected individuals from cohort j under the assumption that the individual did not serve in the military, and β_{ij} represents the effect of military service for individual i in cohort j. Note that the coefficient on V_{ij} is allowed to vary across individuals—there is no reason to believe that service during the war would affect all of those that served in the same way. Some individuals would have attended college regardless of service; others would not have attended regardless of service. For both of these populations $\beta_{ij} = 0$. On the other hand, some men would not have otherwise attended college except for the G.I. benefits available. For this population, the effect is positive and $\beta_{ij} > 0$. Stated in this way it should be clear that β_{ij} represents the impact on educational attainment of switching the ith individual's veteran status, while holding the veteran status of other individuals constant. To understand the (partial equilibrium) impact of the war on educational attainment, we are interested in estimating $\beta \equiv E(\beta_{ij} \mid V_{ij} = 1)$, which in the program evaluation literature has been referred to as the effect of treatment on the treated. Such a measure is, by definition, an average treatment effect and a question of this analysis is to consider the extent to which the treatment effect varies by race and place of birth.

One can imagine various strategies to estimate β. The simplest approach is to compare mean educational attainment between veterans and nonveterans for a cohort of individuals: $\beta_j^c = [\overline{Ed_{ij}} \mid V_{ij} = 1] - [\overline{Ed_{ij}} \mid V_{ij} = 0]$, where the overlines are used to represent sample means. It is clear that

[25] Bound and Turner, "Going to War."

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$$E(\beta_j^c) = E(\beta_{ij} \mid V_{ij} = 1) + [E(\varepsilon_{ij} \mid V_{ij} = 1) - E(\varepsilon_{ij} \mid V_{ij} = 0)] \qquad (2)$$

The term in the square brackets represents the difference in the propensity to go to college of those that did and did not serve in the military. As long as selection into the military is nonrandom, this term is unlikely to be zero. However, given the nature of the exemptions from the draft that existed during World War II, we would expect that for the cohorts that served in World War II, the term in brackets would be positive. As a result, the simple comparison between those who did serve and those who did not serve will exaggerate the causal effect of service on educational attainment $(E(\hat{\beta}_j^c) > \beta)$.

The primary strategy we use to try to estimate β is to compare educational attainment across cohorts employing the methodology known in the evaluation literature as a regression discontinuity design. Starting with a time-homogeneous environment, that is, the α's and the distribution of the β's are constant across cohorts, consider the comparison of cohorts across time. Define $d\overline{Ed}$ as $\overline{Ed}_{ij} - \overline{Ed}_{ij'}$ where the overlines represent averages across individuals within a specific cohort. Then

$$\begin{aligned} E(d\overline{Ed}) = {} & [E(\beta_{ij} \mid V_{ij} = 1)\Pr(V_{ij} = 1) - E(\beta_{ij'} \mid V_{ij'} = 1)\Pr(V_{ij'} = 1)] \\ & + [(\alpha_j - \alpha_{j'}) + E(\varepsilon_{ij} - \varepsilon_{ij'})] \end{aligned} \qquad (3)$$

The assumptions imply that the term in the second set of square brackets is zero. Comparing educational attainment for birth cohorts with significant service during World War II to birth cohorts that were born too late to serve [$\Pr(V_{ij'} = 1]$ yields $\dfrac{d\overline{Ed}}{d\overline{V}}$ as a consistent estimate of $E(\beta_{ij} \mid V_{ij} = 1)$, where $\Pr(V_{ij'} = 1)$ indicates the probability that an individual is a veteran in the indicated birth cohort. More generally, suppose that $\Pr(V_{ij'} = 1) > 0$, but that anyone who served in the later period would have served during the earlier period and that no one who did not serve in the earlier period would have served during the later period. Formally we are assuming that

$$\begin{aligned} V_{ij'} = 1 &\Rightarrow V_{ij} = 1 \\ V_{ij} = 0 &\Rightarrow V_{ij'} = 0 \end{aligned} \qquad (4)$$

Under this assumption, cross-cohort changes in educational attainment divided by cross-cohort changes in the fraction of the cohort serving identify the average effect of service for the population that would have served in

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one regime but not in the other—what Guido Imbens and Joshua Angrist have referred to as the *local average treatment effect* (LATE).[26]

Prior to the start of the war, collegiate attainment followed an upward trajectory for blacks and whites. In this regard, it seems natural to assume that the α_j's increased over time. The inclusion of a linear time trend, which is allowed to vary by race, accounts for such secular change. Therefore, it is deviations from a trend that identify the effects of veteran status for both blacks and whites, with the model allowing different trends by race. It is also plausible that the distribution of β's might change over time. For example, individuals from cohorts that had, for the most part, started careers before being inducted would probably be less motivated to attend college on the G.I. Bill than would individuals drawn from cohorts that were inducted immediately out of high school. We address this issue by focusing, when possible, on comparisons between closely adjacent cohorts. In particular, we focus on cohorts that likely entered military service shortly after turning 18 (or shortly before, if they volunteered).

Estimates based on the population of white men may be very different than those for the population of black men for several reasons, including different opportunity costs, returns to education in the labor market, and effects of military service.[27] Distinguishing the data by place of birth allows for the examination of the hypothesis that segregated educational institutions attenuated the impact of access to G.I. benefits for blacks from the South.[28] Yet, because there was a large migration of blacks from South to North in young adulthood during this period, a better test would be to identify outcomes of men born and residing in the South after demobilization in relation to men born and residing in the North after demobilization. Although we do not observe this classification, we do observe state of residence in 1970 as

[26] In this regard, condition 4 is exactly analogous to the monotonicity condition discussed by Imbens and Angrist ("Identification"). This empirical strategy closely follows much recent discussion of the estimation of causal effects. It has long been understood that, under suitable assumptions, comparisons over time could be used to eliminate selection bias (Heckman and Robb, "Alternative Methods"). In effect, we are using cohort dummies to form an instrument for veterans' status. The connection between instrumental variables and time aggregation has been noted by various authors (see, for example, Angrist, "Grouped Data Estimation"; and Moffitt, "Selection Bias Adjustments").

[27] Collins ("Race"), as well as Margo ("Explaining Black-White Wage Convergence"), demonstrates that black economic progress during the war years was striking and blacks made particular employment gains in the manufacturing sector, leading to a substantial narrowing in the black-white wage gap in the decade between 1940 and 1950 (Maloney, "Wage Compression").

[28] The 1970 Census data indicate state of birth and state of current residence, either of which may obviously differ from state of residence at the time of induction or demobilization. Using data from the 1940, 1950, and 1960 Census surveys, we estimate that nearly 40 percent of men born in the South from the 1923-28 birth cohorts had migrated to the North by 1960. Yet, comparisons of state of residence in 1940 (when most southern born men were still in the South) to state of residence in 1950, 1960, and 1970 makes it clear that much of the South-to-North migration for this cohort occurred in young adulthood, with roughly half occurring in the 1940s and most of the remaining migration occurring during the 1950s.

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well as state of birth. Comparing outcomes among men born and residing in the South in 1970 in relation to men born and residing in the North after 1970 produces similar outcomes to those reported in the subsequent section. However, the further stratification of the data for southern-born men, combined with the reduction in the census sample size by one-third when place of birth and place of residence are considered, leads to large increases in estimated standard errors.

EMPIRICAL RESULTS

As a starting point, it is useful to examine within-cohort differences in the educational attainment of veterans and non-veterans by race and birthplace. Tables 3 and 4 compare the educational attainment of World War II veterans to nonveterans. Using data from the 1970 Census representing 3 percent of the population, we present estimates of the relationship between service in World War II and educational attainment (see the Appendix for additional detail). These measures of educational attainment by birth year indicate substantial differences between World War II veterans and men who did not serve in the military, particularly at the collegiate level. The tables also show large educational attainment differences by veteran status between blacks and whites (Table 3). For example, among white men who turned 18 during the war (those born between 1923 and 1928), veterans received about 0.45 years more college education than nonveterans. For blacks, the differences in educational attainment between veterans and nonveterans are somewhat lower (0.29 more years of college and 4 percentage points in college completion), while the percentage differences are appreciably larger owing to the low baseline levels of educational attainment among blacks born in the 1920s. It is likely that these simple differences in education exaggerate the causal effects of World War II service and the availability of G.I. benefits on collegiate attainment. To the extent that blacks were more likely than whites to be rejected from the military for illiteracy and other attributes associated with college readiness, it is likely that this exaggeration is larger for blacks than for whites

Table 4 presents the mean level of educational attainment by World War II veteran status for blacks born in the South (here defined as Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, and Virginia) and blacks born outside this area.[29] Although the level of educational attain-

[29] A broader classification of the southern states is considered in the Appendix, with regression results included as Appendix Tables 1–3. Classifying more states as part of the South does not change the qualitative results of our analysis. In the text, we use the comparisons South/non-South and South/North interchangeably.

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TABLE 3
EDUCATIONAL ATTAINMENT OF WORLD WAR II VETERANS AND NONVETERANS, BLACK-WHITE COMPARISON

	World War II Veterans			Nonveterans			Absolute Difference		
Year of Birth	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates
				White					
1923	0.64	0.93	0.18	0.45	0.48	0.09	0.19	0.45	0.09
1924	0.64	0.99	0.19	0.43	0.46	0.09	0.22	0.54	0.11
1925	0.63	1.01	0.20	0.43	0.49	0.09	0.20	0.52	0.10
1926	0.63	1.04	0.20	0.44	0.59	0.12	0.19	0.46	0.08
1927	0.65	1.07	0.21	0.47	0.61	0.12	0.18	0.45	0.09
1928	0.63	0.96	0.18	0.55	0.73	0.14	0.08	0.22	0.04
1923–1928	0.64	1.00	0.19	0.46	0.55	0.10	0.18	0.45	0.09
				Black					
1923	0.35	0.35	0.05	0.15	0.13	0.02	0.20	0.22	0.03
1924	0.38	0.42	0.07	0.17	0.13	0.02	0.21	0.29	0.05
1925	0.38	0.44	0.07	0.18	0.13	0.02	0.21	0.30	0.05
1926	0.41	0.47	0.07	0.16	0.11	0.02	0.25	0.37	0.06
1927	0.42	0.47	0.07	0.17	0.12	0.02	0.25	0.35	0.06
1928	0.46	0.37	0.03	0.22	0.20	0.03	0.24	0.17	0.00
1923–1928	0.40	0.42	0.06	0.17	0.14	0.02	0.23	0.29	0.04

Notes: This tabulation includes observations for white and black men born between 1923 and 1928 who served in World War II and who did not serve in the military (any conflict). Annual levels represent fixed-weight averages across quarter-of-birth cohorts.
Source: 3 percent sample of the 1970 decennial census.

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TABLE 4
EDUCATIONAL ATTAINMENT OF WORLD WAR II VETERANS AND NON-VETERANS, BY REGION OF BIRTH, BLACKS ONLY

	World War II Veterans			Nonveterans			Absolute Difference		
Year of Birth	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates
				Black, Non-South					
1923	0.39	0.35	0.05	0.21	0.21	0.04	0.18	0.15	0.01
1924	0.42	0.49	0.07	0.25	0.21	0.04	0.18	0.28	0.04
1925	0.45	0.50	0.08	0.22	0.16	0.02	0.23	0.34	0.06
1926	0.47	0.57	0.09	0.21	0.13	0.02	0.26	0.44	0.07
1927	0.46	0.49	0.07	0.25	0.16	0.02	0.21	0.33	0.06
1928	0.51	0.43	0.04	0.30	0.28	0.05	0.21	0.14	-0.01
1923–1928	0.45	0.47	0.07	0.24	0.19	0.03	0.21	0.28	0.04
				Black, South					
1923	0.31	0.35	0.05	0.10	0.07	0.01	0.22	0.28	0.04
1924	0.32	0.33	0.06	0.11	0.07	0.01	0.21	0.26	0.05
1925	0.29	0.35	0.06	0.14	0.11	0.02	0.15	0.24	0.04
1926	0.33	0.35	0.06	0.11	0.08	0.01	0.22	0.27	0.04
1927	0.37	0.46	0.08	0.12	0.10	0.02	0.25	0.36	0.06
1928	0.37	0.30	0.03	0.15	0.13	0.02	0.22	0.17	0.00
1923–1928	0.33	0.36	0.06	0.12	0.09	0.02	0.21	0.27	0.04

Notes: This tabulation includes observations for black men born between 1923 and 1928 who served in World War II and who did not serve in the military (any conflict). "Non-veteran" includes men who did not serve in any military conflict. Annual levels represent fixed-weight averages across quarter of birth cohorts. "South" is defined to include the states: AL, FL, GA, MS, NC, SC, and VA.
Source: 3 percent sample of the 1970 decennial census.

ment for men born outside the South is uniformly greater than for men born in the South, the difference between veterans and nonveterans is slightly larger among black men born in the South. It is also noteworthy that blacks born in the South have much lower levels of secondary achievement than those born in other states. Among nonveterans born in the 1923–1928 interval, nonsouthern black men were about twice as likely to have graduated from high school as those born in the South. It is well established that the public education systems in the South lagged those in other states and, combined with literacy requirements for military service, it is plausible that southern- and northern-born blacks faced different likelihoods of service by educational attainment. In this regard, although the observed differences in educational attainment between veteran and nonveteran blacks born in different geographical areas are nearly identical (0.27 to 0.28 more years of college and 4 percentage points in college completion), it need not follow that the causal effects of military service and the availability of G.I. benefits were identical for blacks from the different regions.

To reduce the potential upward bias attributable to the greater selectivity of veterans relative to nonveterans, we employ a between-cohort estimation strategy that relies on the markedly different probabilities of induction faced by men from adjacent birth cohorts. Limiting the comparisons to those turning 18 during the war (born 1923–1928) mitigates the effect of potential differences in the educational response to the G.I. Bill among veterans reaching college age before and after the start of the war. Among this group of men, those with earlier birth dates stood much higher probabilities of induction in World War II. It is the variation in service participation that identifies the effect of military service and benefits for World War II participants. Essentially, we compare the educational attainment of men born during the first half of the 1920s, who would have typically been inducted into the military after finishing high school in the early 1940s, to men born in the later half of the 1920s, who would have finished high school at the conclusion of the war.

Between-cohort estimates of the effect of military service and the availability of educational benefits on collegiate outcomes are shown in Table 5. Estimates in columns 1 and 3 present the effect on years of college and college completion, respectively, for blacks and whites overall for the 1923–1928 birth cohorts.[30] Separate estimates by region of birth for blacks and whites follow in columns 2 and 4, with *p*-values corresponding to the test of the null hypothesis that the effects for those from different regions of birth effects are equal are also reported in the table. Estimates in Table 5

[30] Specification tests did not reveal evidence of serial correlation. For this reason, our standard errors are calculated under the assumption of independence of errors over time. Standard errors are also corrected for heteroskedasticity in accordance with an estimate of the variance matrix suggested by Huber -White.

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TABLE 5
BETWEEN-COHORT ESTIMATES OF THE EFFECT OF WORLD WAR II SERVICE ON COLLEGIATE ATTAINMENT, BLACKS AND WHITES, 1923–1928

	Years of College		College Completion	
	(1)	(2)	(3)	(4)
White				
Both regions	0.135		0.035	
	(0.036)		(0.009)	
Non-South		0.135		0.032
		(0.035)		(0.009)
South		0.172		0.065
		(0.097)		(0.025)
Test Non-South = South (*p* value)		0.72		0.21
Black				
Both regions	0.093		0.027	
	(0.102)		(0.026)	
Non-South		0.300		0.058
		(0.147)		(0.026)
South		–0.058		0.004
		(0.158)		(0.033)
Test Non-South = South (*p* value)		0.10		0.21
Test White = black (*p* value)	0.70		0.76	

Notes: Estimates are based on aggregates for men at the quarter-of-birth level for the indicated years. Regressions also include a constant and a linear time trend defined by year and quarter of birth, with the constant and time trend defined separately by region where applicable. *p*-values correspond to the test of the null hypothesis that the indicated coefficients are equal. "South" is defined to include the states Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, and Virginia.
Source: 3 percent sample from the 1970 decennial census; see the Appendix for information on other sample restrictions.

reflect aggregate regressions (with each observation reflecting a quarter of birth average), although the exact instrumental variables analog is a micro-level regression using quarter-of-birth dummy variables to instrument for the endogeneity of veteran status. The overall estimates are strikingly smaller than the within-birth cohort estimates for both blacks and whites. For whites, the point estimates suggest an effect of World War II and the availability of G.I. benefits of about 0.14 years of college and about 3.5 percentage points in college completions. For blacks, the estimated average effects are similar in magnitude, though the confidence intervals are quite sizable.

Within race groups, northern-born men have greater educational attainment at both the secondary and college levels than those born in the southern states, as shown in Figures 2–4 which shows educational attainment and military participation by race and region. At issue is whether deviations from the trend in collegiate attainment linked to military participation are different by region of birth for blacks and whites; for blacks, sampling variation makes inspection of the graph particularly challenging. Turning to the

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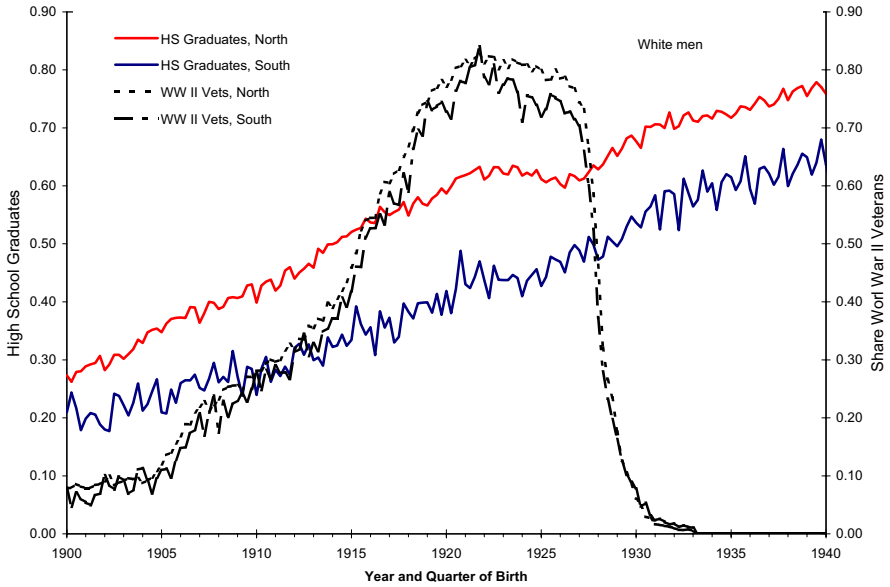


FIGURE 2A
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: HIGH SCHOOL GRADUATION, WHITE

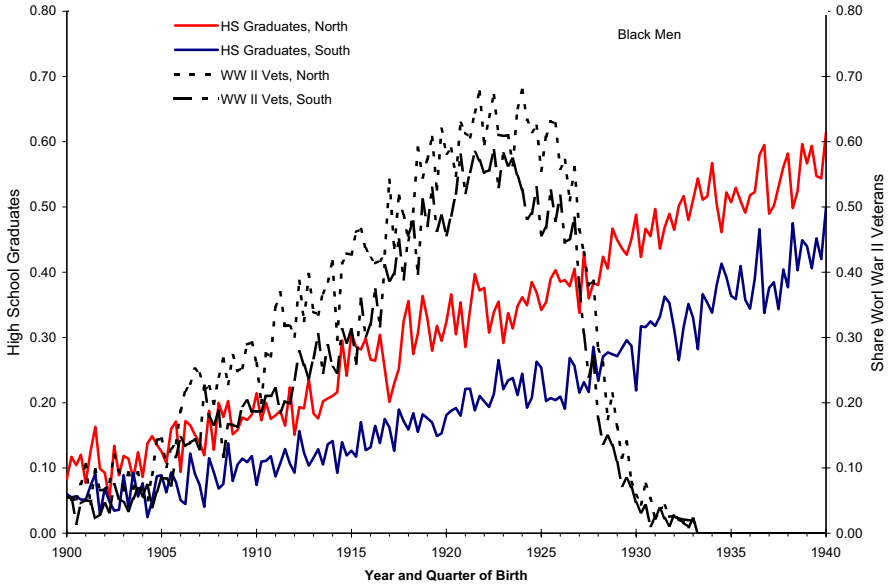


FIGURE 2B
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: HIGH SCHOOL GRADUATION, BLACK

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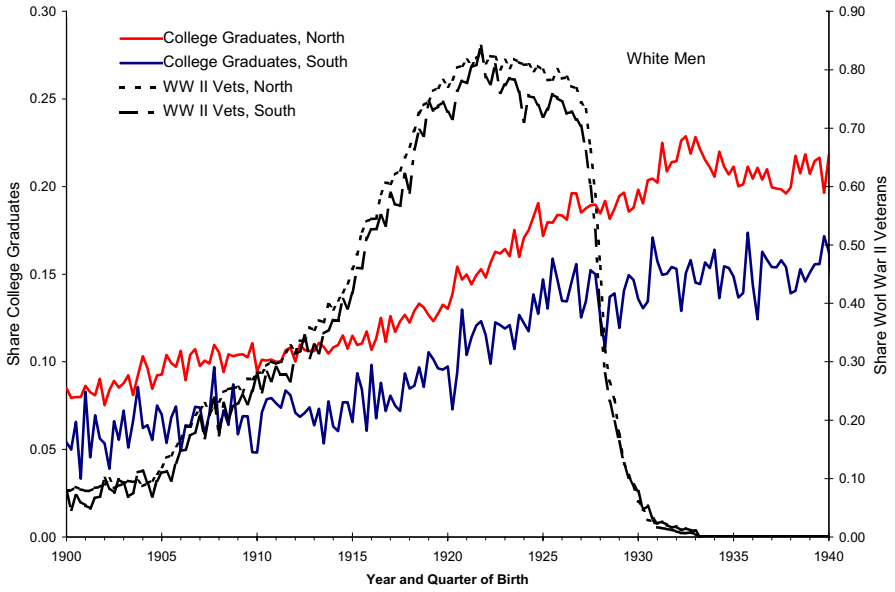


FIGURE 3A
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: COLLEGE GRADUATION, WHITE

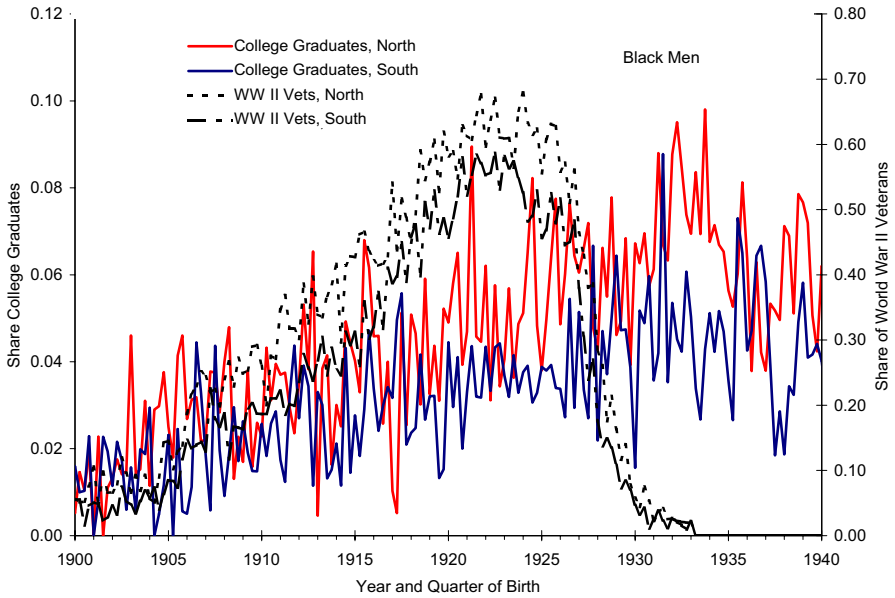


FIGURE 3B
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: COLLEGE GRADUATION, BLACK

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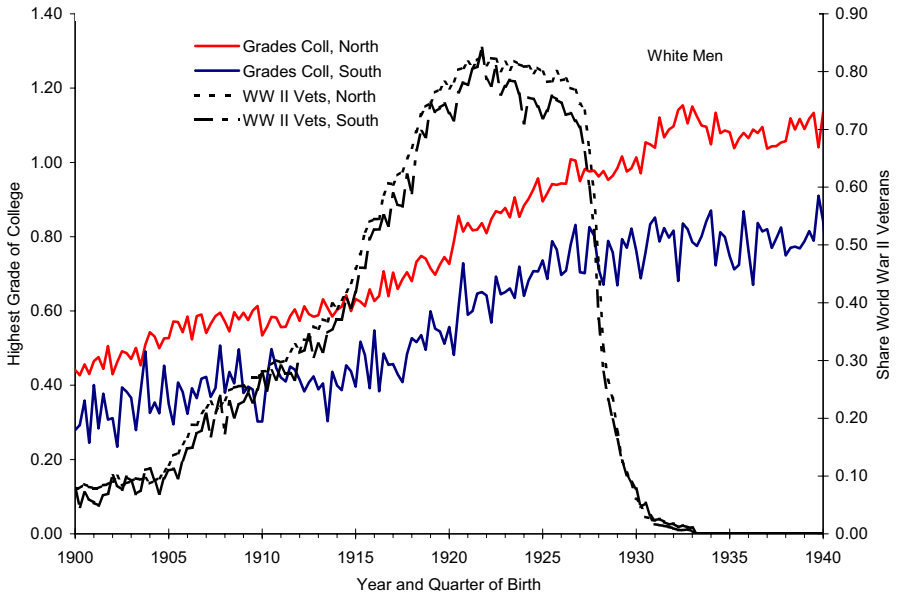


FIGURE 4A
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: HIGHEST GRADE OF COLLEGE, WHITE

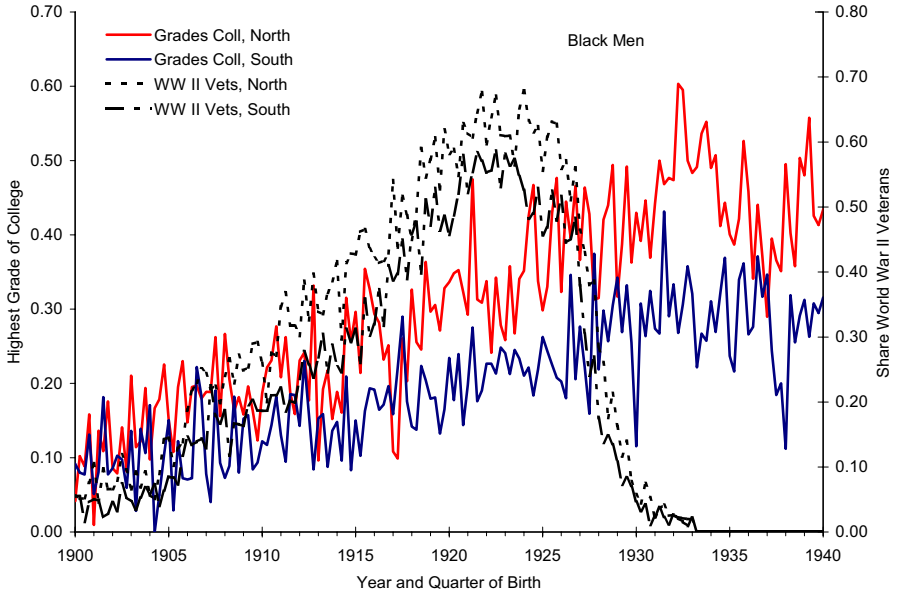


FIGURE 4B
REGIONAL DIFFERENCES IN EDUCATIONAL ATTAINMENT AND VETERAN STATUS BY RACE: HIGHEST GRADE OF COLLEGE, BLACK

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regression estimates presented in columns 2 and 4 of Table 5, it is evident that, among white veterans, those from the South gained at least as much in collegiate attainment as those from outside the South; the point estimates for white men born in the South are modestly larger though not in a statistically significant sense. For black veterans, however, those born outside the South experienced sizable gains at the collegiate level, whereas those from the South made no significant gains in educational attainment.

Expanding the range of birth cohorts used in the estimates helps to sharpen the analysis. As shown in Table 6, the point estimates of the effect of World War II participation and the availability of G.I. benefits on years of collegiate attainment do not change much with the addition of more years of observation. For nonsouthern blacks, these estimates range from 0.30 to 0.41 years of college and 6 to 8 percentage points for college completion. Moreover, the educational gains associated with World War II service and the availability of G.I. benefits are consistently indistinguishable from zero for southern-born black veterans. We are limited by the structure of the education question in the census data to using years of completed educational attainment as our outcome variable, with this measure explicitly excluding nondegree credit enrollment. To the extent that much of the G.I. Bill training took alternative forms, it is conceivable that there are other interesting and important changes in skills brought about by the G.I. Bill not captured in this analysis.

To answer the question of whether the combination of World War II service and G.I. benefits increased educational attainment, we need to compare the veterans to a "no service–no benefits" control group. Because men who did not serve in World War II were at risk for service in the Korean War and those who served in this later conflict were also eligible for educational benefits, the simple comparison of World War II veterans to non–World War II veterans will not accomplish this objective. The interval between the conclusion of World War II and the start of the Korean conflict is short and men from birth cohorts in the 1920s who did not serve in World War II were at increased risk of induction for service in Korea. For both black and white men, the manpower demands of the Korean conflict intersect the right tail of World War II service, as the youngest cohorts serving in World War II also participated in the Korean conflict (see Figure 1).[31]

To help control for the confounding effects of service in Korea on our estimates of the effect of World War II service on educational attainment,

[31] The service participation in the Korean War peaked at the last quarter of the 1931 birth cohort, as about 48 percent of black men and 65 percent of white men were veterans of this conflict. It is also the case that among men service-eligible for both conflicts, blacks were somewhat more likely to serve in Korea than whites. For example, only 8 percent of white men born in early 1927 served in the Korean conflict but not World War II, whereas about 15 percent of black men in this cohort participated in the Korean conflict but not World War II.

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TABLE 6
BETWEEN-COHORT ESTIMATES OF THE EFFECT OF WORLD WAR II SERVICE ON COLLEGIATE ATTAINMENT BY REGION OF BIRTH, BLACKS ONLY

	1923–1928 (1)	1923–1929 (2)	1923–1930 (3)	1923–1931 (4)	1923–1932 (5)
Years of College					
Non-South	0.300	0.348	0.343	0.354	0.410
	(0.147)	(0.120)	(0.114)	(0.108)	(0.104)
South	–0.058	–0.088	–0.062	–0.002	0.013
	(0.158)	(0.150)	(0.152)	(0.162)	(0.138)
Test Non-South = South (*p* value)	0.10	0.03	0.04	0.07	0.02
College Completion					
Non-South	0.058	0.077	0.070	0.070	0.081
	(0.026)	(0.022)	(0.021)	(0.021)	(0.021)
South	0.004	–0.008	–0.001	0.006	0.004
	(0.033)	(0.031)	(0.031)	(0.037)	(0.029)
Test Non-South = South (*p* value)	0.21	0.03	0.06	0.13	0.03

Notes: Estimates are based on aggregates for black men at the quarter of birth level for the indicated years. Regressions also include a constant and a linear time trend defined by year and quarter of birth for each region. *p*-values correspond to the test of the null hypothesis that the indicated coefficients are equal. "South" is defined to include the states: AL, FL, GA, MS, NC, SC, and VA.
Source: 3 percent sample from the 1970 decennial census; see the Appendix for information on other sample restrictions.

we first attempted to estimate the effects of Korean War service directly, but we found that the limitations in sample size preclude the estimation of our model with two endogenous variables. Instead, we considered a range of alternatives generated as the assumed magnitude of the Korean War effect changes. Table 7 presents results from estimates in which we have varied the Korean War service effect up to 0.5 in the case of years of college completed to 0.1 in the case of college completion. We also consider panels of alternative length, ranging from the 1923–1928 interval of birth cohorts to the 1923–1932 interval of birth cohorts. Plainly, the longer series yields more precise estimates, though the tradeoff is that the additional cohorts may have faced other appreciably different circumstances when making their educational investments.

Assuming positive effects of the Korean War on educational attainment pushes up the estimated effect of World War II service on educational attainment in a necessarily mechanical way. Yet, even at the high end of the range of predictions, the effects of World War II and the G.I. Bill on educational attainment remain more than twice as large for those born outside the South. Alternative estimates of the effect of the Korean War and the associated benefit program provide some guidance.

In suggesting a preferred estimate among the ranges presented in Table 7, one strategy is to look to alternative sources to pin down the magnitude of the Korean War effect for blacks. Although the Survey of Veterans records

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TABLE 7
BETWEEN-COHORT ESTIMATES OF THE EFFECT OF WORLD WAR II AND KOREAN SERVICE ON COLLEGIATE ATTAINMENT, 1923–1932, RESTRICTED ESTIMATES

	Years of College				College Completion			
	Korean War	World War II			Korean War	World War II		
		1923–1932	1923–1930	1923–1928		1923–1932	1923–1930	1923–1928
Non-South								
	0.10	0.47	0.40	0.35	0.02	0.09	0.08	0.07
		(0.10)	(0.11)	(0.14)		(0.02)	(0.02)	(0.03)
	0.20	0.53	0.46	0.40	0.04	0.10	0.09	0.08
		(0.10)	(0.11)	(0.14)		(0.02)	(0.02)	(0.03)
	0.30	0.59	0.51	0.46	0.06	0.12	0.10	0.09
		(0.10)	(0.11)	(0.13)		(0.02)	(0.02)	(0.03)
	0.40	0.65	0.57	0.51	0.08	0.13	0.12	0.10
		(0.10)	(0.11)	(0.13)		(0.02)	(0.02)	(0.02)
	0.50	0.71	0.63	0.56	0.10	0.14	0.13	0.11
		(0.10)	(0.11)	(0.13)		(0.02)	(0.02)	(0.02)
South								
	0.10	0.06	–0.02	–0.02	0.02	0.01	0.01	0.01
		(0.14)	(0.15)	(0.16)		(0.03)	(0.03)	(0.03)
	0.20	0.11	0.03	0.03	0.04	0.02	0.02	0.02
		(0.13)	(0.15)	(0.16)		(0.03)	(0.03)	(0.03)
	0.30	0.16	0.08	0.07	0.06	0.03	0.03	0.03
		(0.13)	(0.15)	(0.16)		(0.03)	(0.03)	(0.03)
	0.40	0.21	0.13	0.11	0.08	0.04	0.04	0.04
		(0.13)	(0.15)	(0.16)		(0.03)	(0.03)	(0.03)
	0.50	0.26	0.17	0.16	0.10	0.05	0.05	0.05
		(0.13)	(0.15)	(0.16)		(0.03)	(0.03)	(0.03)

Notes: Estimates are based on aggregates for black men at the quarter of birth level for the years in the column headings with the Korean War effect restricted to the indicated magnitude. Regressions also include a constant and a linear time trend defined by year and quarter of birth for each region. Standard errors are in parentheses.
Source: 3 percent sample from the 1970 decennial census; see the Appendix for information on other sample restrictions.

only a small number of black veterans from the Korean War, it nevertheless provides one of the few gauges of the Korean War effect. This source points to an effect of the Korean War on educational attainment of about 0.23 years of college (see Appendix Table 4), which would correspond to point estimates of 0.42 (0.14) and 0.04 (0.16) for black men born in the North and South, respectively, using data from the 1923–1928 interval. A disadvantage of the Survey of Veterans is that it is not possible to disaggregate by location. There is no reason to assume that the effects of the Korean War and associated G.I. benefits were identical for men born in and outside the South. On the one hand, the evidence from World War II points to more limited higher education opportunities for blacks from the South relative to outside the South; on the other, the wave of litigation emphasizing equal opportunities for blacks, combined with the addition to facilities at the historically black colleges after World War II, may have markedly widened opportunities for southern-born blacks in the 1950s. Within cohort estimates of the educational attainment of Korean War veterans relative to nonveterans provide an alternative set of Korean War estimates with distinction by region. These estimates, which place the Korean War effect at 0.47 years of college in the South and 0.35 years of college outside the South, effectively define an upper limit. Still, when the effect of the Korean War on educational attainment is restricted to these values, the estimated gain in collegiate attainment attributable to World War II service and the G.I. Bill is more than 0.3 years larger for black men from nonsouthern states relative to those born in the South.[32]

It is important to emphasize that the nature of our estimation strategy of using variation over time in military participation to identify deviations from a trend in collegiate attainment makes it difficult to distinguish the importance of competing interpretations. First, it is well documented that resources per student at the elementary and secondary levels were particularly low in segregated schools in southern states. As such, the low quality of schooling received by black veterans at the primary and secondary levels may have impeded opportunities to benefit from collegiate training through the G.I. Bill.[33]

[32] An additional strategy for identifying the effect G.I. benefits available to Korean veterans had on the education of blacks and whites and by region follows the approach identified by Stanley ("College Education"), which compares men commencing service before 31 January 1955 who are benefit-eligible to those who begin service thereafter and are not benefit-eligible. Data from the 1980 census identifies veterans by birth cohort, race, place of birth, and the conflict in which they participated, though these data do not have the date of service commencement or rich covariates which are available in the OCG data employed by Stanley. Nevertheless, estimates using the sharp break in benefit eligibility in 1955 to identify the effect of the Korean War G.I. Bill on educational attainment of those men turning 18 near the start of service participation (the 1934–1939 birth cohorts) suggests that this program had a somewhat larger effect on the collegiate attainment of black men from the South than those born outside the South. However, these results are not estimated precisely enough to introduce in the text.

[33] Card and Krueger ("School Quality") provide substantial evidence on the narrowing in resource differences (in measures such as the pupil-teacher ratio) between schools for blacks and whites in the

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Moreover, supply-side constraints in higher education are likely to have restricted collegiate choices among blacks in the South, also decreasing the effect of G.I. benefits. Within the South, institutions open to blacks were too few and too small to accommodate the population of black veterans with G.I. benefits.[34] If college education opportunities for southern-born blacks were limited by their preparedness to attend college or by a limited market supply, it might be expected that blacks would have pursued vocational training or other skill development with G.I. benefits. Still, regardless of the level or type of training, we find little evidence that military service and the availability of education benefits changed skill acquisition of black veterans from the South. Ideally, we would be able to do more to distinguish the hypothesis that low elementary and secondary school quality reduced the expected benefits of a college education for black veterans from the South from the hypothesis that limitations in collegiate supply restricted attainment of black veterans from the South. We have stratified the southern sample along the lines of school quality and included an interaction term for veteran status and state-level school quality measures in our estimation. There is no evidence that states with poor elementary-secondary schools have smaller educational gains associated with the G.I. Bill, but the standard errors are large enough that we are unable to put much weight on these results. Although it is hard to pin down whether the low quality of the segregated southern schools directly reduced educational gains made available by the G.I. Bill, there is ample evidence from the historical record that the limited supply response of colleges and universities in the segregated states reduced the educational gains of black veterans from the South.

DISCUSSION

How the G.I. Bill affected the level of education among men from different races and backgrounds is an important question in both educational history and public policy analysis. Models of educational investment suggest

segregated states, which started early in the twentieth century and continued through the years when the World War II cohorts were enrolled in school. Differences between black and white students from the South in the change in school resources are captured in the race-specific time trends. Card and Krueger (ibid.) also present evidence on the differential return to education for blacks and whites, with blacks from states with particularly large differences in educational resources by race also experiencing lower returns to education. Differences in elementary- and secondary-school quality combined with discrimination in the labor market may well have lowered the expected return to college for black veterans from the South.

[34] In addition to the limitations in physical capacity, the inability to expand the faculty may have severely affected the supply response of colleges for blacks in the South. Thompson ("Critical Situation") highlights this problem, noting that not only did the war itself limit the supply of prospective young faculty, but able men were often taking advantage of the G.I. Bill to obtain advanced degrees, and salaries at the black colleges were quite low, making it difficult for these institutions to compete in the faculty labor market with colleges and universities in the North and West.

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that the benefit provisions associated with the G.I. Bill might well be expected to have a larger effect on the average educational outcomes of blacks than whites, owing to lower opportunity costs and the potentially larger relative reduction in credit constraints.[35] For white men, the combination of World War II service and the availability of G.I. benefits had substantial positive effects on collegiate attainment, and these effects were similar in magnitude for men born in different geographic regions. For black men, we find that the effect of military service and the availability of the G.I. Bill differs markedly between men born in the southern states and those born elsewhere, with the former experiencing appreciably little gain in educational attainment in comparison to the latter. Beyond collegiate attainment, noncollegiate vocational and technical training was a major component of the World War II G.I. Bill, with more veterans receiving training in these institutions than in colleges. Yet, available evidence does not suggest that this avenue was a substitute for collegiate participation among black men born in the South. Rather, black men in the South also had a particularly difficult time gaining access to vocational and on-the-job training programs with G.I. benefits.[36]

The absence of behavioral effects of World War II and the G.I. Bill on black veterans from the South parallels results obtained by William Collins in association with the Fair Employment Practice Commission during World War II.[37] Collins finds that efforts to enforce complaints associated with Executive Order 8802, which barred discrimination in war-related industries, led to wage gains for black workers in the North, while political opposition to the goals of the program contributed to its ineffectiveness in the South.

The results of this analysis illustrate some of the potential pitfalls associated with decentralized federal initiatives. Contemporary advocates for choice-based reform in education have often trumpeted the success of the G.I. Bill, using its favorable effects as a motivation for vouchers.[38] Yet, this analysis indicates that state-level policies and conditions may undermine the equal distribution of such programs. The structure of the G.I. Bill ceded the responsibility for overseeing and administering many of the educational benefits to the states.[39] Congress did not create a set of uniform standards for implementation, nor was there a regulatory mechanism to ensure equal access to program benefits. As a result, the intersection of federal programs

[35] Measures of the median income for white and black men in 1948 provide an indicator of relative opportunity costs, with the median income for black men $1,363 and the median income for white men $2,510 (U.S. Census Bureau, "Table P-7").

[36] Onkst, "First a Negro."

[37] Collins, "Race."

[38] Hauptman, "Vouchers."

[39] Onkst, "First a Negro."

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such as the G.I. Bill with significantly different state policies yielded substantial interstate differences in outcomes.

The availability of benefits to black veterans had a substantial and positive impact on the educational attainment of those likely to have access to colleges and universities outside the South. Unfortunately, for those more likely to be limited to the South in their collegiate choices, the G.I. Bill exacerbated rather than narrowed the economic and educational differences between blacks and whites.

Appendix

The 1970 decennial census is the primary source for the empirical work in this analysis. Micro data files for the 1970 Census use the long-form questionnaire distributed to 15 percent of the population, with data available in three 1/100 samples.[40] (The 1/100 samples identify either state, county group, or neighborhood characteristics.) Individuals included in this analysis are those born in the continental United States. Observations for which responses were allocated for sex, age, race, veteran status, place of birth, or educational attainment are not included in the analysis. The classification of educational attainment uses information and highest grade attended as follows: "college graduate" is equal to one for all individuals completing at least 16 years of education and is zero for all other cases; "years of college completed" is equal to the maximum of zero and years of college completed (up to four).

In classifying states geographically into "non-South" and "South" in this analysis, our aim is to distinguish those states with legislatively enforced segregation. Although 17 states maintained some form of segregation in higher education at the start of World War II, such a broad classification misses substantial variation within these states in the degree to which race limited higher educational opportunities across states. In terms of empirical analysis, the capacity to make finely grained distinctions about the outcomes of blacks at the state level or several groups of states is constrained by the relatively small number of blacks observed and their geographical concentration in the southern states.

Following important judicial decisions, including *Missouri ex re. Gaines v Canada* (1938) and *McLaurin v Oklahoma State Regents* (1950)[41], many southern universities quietly opened their universities to blacks. By 1952 only five states—Alabama, South Carolina, Georgia, Florida, and Mississippi—still barred blacks from their publicly supported universities. For this reason, the primary definition of "southern" states employed in this analysis focuses on these five states plus Virginia and North Carolina, representing the states in which segregation had long historical roots and was generally supported though the local judicial process. Appendix Tables 1–3 present regression results with a broader classification of southern states that includes Alabama, Arkansas, Florida, Georgia,

[40] A somewhat different set of questions is available on the 5 percent and the 15 percent questionnaires, with the 15 percent questionnaire including the items on veteran status.

The use of data from the 1970 census in this analysis rather than data from the 1980 census is motivated by the observation that for cohorts born during the 1920s and 1930s the 1980 census shows substantially higher levels of educational attainment than does the 1970 census. These differences presumably have more to do with differential mortality, education inflation, and adult participation in college than the lingering effects of war service.

[41] *Missouri ex rel. Gaines v. Canada*, 305 U.S. 337 (1938) and *McLaurin v. Oklahoma State Regents*, 339 U.S. 637 (1950).

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APPENDIX TABLE 1
EDUCATIONAL ATTAINMENT OF WORLD WAR II VETERANS AND NONVETERANS, BY REGION OF BIRTH, BLACKS ONLY

	World War II Veterans			Nonveterans			Absolute Difference		
Year of Birth	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates	Share High School Graduates	Mean Years of College	Share College Graduates
				Black, Non-South					
1923	0.45	0.36	0.04	0.30	0.27	0.04	0.14	0.09	0.00
1924	0.49	0.56	0.09	0.30	0.27	0.04	0.19	0.29	0.05
1925	0.51	0.56	0.09	0.33	0.28	0.04	0.18	0.27	0.05
1926	0.52	0.61	0.09	0.31	0.19	0.03	0.21	0.42	0.06
1927	0.48	0.48	0.08	0.34	0.25	0.03	0.14	0.24	0.04
1928	0.53	0.46	0.03	0.41	0.35	0.06	0.13	0.12	–0.03
1923–1928	0.50	0.51	0.07	0.33	0.26	0.04	0.17	0.25	0.03
				Black, All South					
1923	0.32	0.35	0.05	0.11	0.10	0.02	0.21	0.25	0.03
1924	0.33	0.36	0.06	0.14	0.10	0.02	0.19	0.26	0.04
1925	0.32	0.38	0.06	0.14	0.10	0.01	0.18	0.28	0.04
1926	0.36	0.41	0.07	0.11	0.08	0.01	0.25	0.33	0.05
1927	0.39	0.47	0.07	0.14	0.10	0.02	0.25	0.38	0.06
1928	0.40	0.31	0.04	0.17	0.16	0.03	0.24	0.15	0.01
1923–1928	0.35	0.38	0.06	0.13	0.10	0.02	0.22	0.28	0.04

Notes: "All South" includes Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia.
Source: 3 percent sample from the 1970 decennial census.

APPENDIX TABLE 2
BETWEEN COHORT ESTIMATES OF THE EFFECT OF WORLD WAR II SERVICE ON COLLEGIATE ATTAINMENT, 1923–1928

	Years of College		College Completion	
	(1)	(2)	(3)	(4)
White				
Both regions	0.135		0.035	
	(0.036)		(0.009)	
North		0.159		0.037
		(0.046)		(0.012)
All South		0.117		0.039
		(0.108)		(0.027)
Test North = all South (*p* value)		0.72		0.96
Black				
Both regions	0.093		0.027	
	(0.102)		(0.026)	
North		0.464		0.079
		(0.271)		(0.054)
All South		–0.039		0.007
		(0.119)		(0.028)
Test North = all South (*p* value)		0.10		0.24
Test White = black (*p* value)	0.70		0.76	

Notes: "All South" includes Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia.
Source: 3 percent sample from the 1970 decennial census.

APPENDIX TABLE 3
BETWEEN-COHORT ESTIMATES OF THE EFFECT OF WORLD WAR II SERVICE ON COLLEGIATE ATTAINMENT BY REGION OF BIRTH, BLACKS ONLY

	1923–1928	1923–1929	1923–1930	1923–1931	1923–1932
Years of college					
Non-South	0.46	0.40	0.39	0.37	0.43
	(0.27)	(0.23)	(0.22)	(0.21)	(0.18)
All South	–0.04	–0.01	0.01	0.09	0.12
	(0.12)	(0.11)	(0.11)	(0.12)	(0.10)
College completion					
Non-South	0.079	0.086	0.076	0.075	0.086
	(0.054)	(0.046)	(0.046)	(0.043)	(0.037)
All South	0.007	0.008	0.013	0.021	0.024
	(0.028)	(0.024)	(0.024)	(0.026)	(0.021)

Notes: Each regression includes a linear time trend and constant for each region. "All South" includes Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia.
Source: 3 percent sample from the 1970 decennial census.

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APPENDIX TABLE 4
EDUCATIONAL ATTAINMENT AND USE OF G.I. BENEFITS AMONG KOREAN WAR VETERANS (NOT INCLUDING WORLD WAR II VETERANS), BLACKS ONLY

Year of Birth	*N*	Age at Military Discharge	Years of Education at End of Service	Used G.I. Benefits (share)	Months of G.I. Benefits	Received BA with G.I. Benefits (share)	Years of College with G.I. Benefits
1927	4	29.6	10.5	0.50	9.25	0.00	0.00
1928	11	26.6	10.0	0.45	6.18	0.00	0.45
1929	9	25.6	11.3	0.44	6.00	0.00	0.22
1930	14	23.6	9.3	0.43	8.36	0.00	0.00
1931	16	25.4	11.4	0.44	6.75	0.00	0.00
1932	17	24.9	12.2	0.61	11.22	0.00	0.50
1933	13	24.3	12.0	0.57	12.21	0.14	0.79
1934	5	22.8	11.4	0.80	18.40	0.20	1.20
1935	6	26.8	10.5	0.83	13.00	0.00	0.33
1936	6	23.8	11.8	0.50	2.00	0.00	0.17
1937	4	20.5	10.5	0.50	1.50	0.25	1.75

Notes: The measure "Years of College with G.I Benefits" is an average and takes on nonzero values for men who attended college after service and received G.I. benefits.
Source: The 1979 Survey of Veterans.
Universe: The data are limited to observations for black men born between 1927 and 1937 with valid educational-attainment measures.

Kentucky, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia. Using this classification the number of blacks in the southern states increases from 7,051 to 10,357 and the number elsewhere decreases from 6,883 to 3,577.

While the large samples of the Decennial Census provide a particular advantage in the cross-cohort estimation strategy, the 1979 Survey of Veterans provides supplemental information on the utilization of veterans benefits and the duration of military service, and more specific data on veterans serving in conflicts from World War II through the Vietnam conflict. The Survey of Veterans draws its pool of veterans from the March 1978 CPS question on military service. The primary questions of interest for this study cover information on the use of educational benefits and educational attainment before and after military service.

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Financing Legal Education

Marilyn Yarbrough

The provision of higher education to all who qualify for it intellectually has been a social ideal in this country for the last half century. Until relatively recently, attempts to provide educational opportunity for those who could not afford it took the form of tuition grants and scholarships or tuition waivers, with little reliance on educational loans. In the last twenty years, however, student loans have come to be the major method of funding students in postsecondary education. Law schools have been quite active in insuring that law students have ready access to sufficient funds to finance their legal educations and that the funds are available at favorable terms. The Law School Admission Council, an association whose membership consists of all the ABA-approved law schools in the United States and fifteen Canadian law schools with common law programs, became involved in providing federally guaranteed loans exclusively to law students in the late 1980s, a role eventually assumed by the Access Group, a not-for-profit organization that today provides private and federal loans to graduate and professional-school students, debt management materials and software, a need-analysis service, and several online services for schools and students.

Costs of Legal Education

Legal education costs vary widely. According to the most recent edition of *The Official American Bar Association Guide to Approved Law Schools,* tuition costs alone range from less than $5,000 an academic year to more than $20,000. Additional amounts for food, lodging, books, fees, and personal expenses increase the costs for three years to more than $60,000 in almost all cases and more than $100,000 in many. The geographic location of the school and whether it enjoys state subsidization contribute to the differences in costs for individual schools. The National Association of Financial Aid Administrators estimates that over 80 percent of law students require financial assistance to pay for their legal education. NASFAA reported in August 1999 that the average law student at a private college or university accumulates $63,078 of debt.

Students usually meet their expenses by a combination of personal resources, grants and scholarships, federal work-study, and loans.

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Sources of Financial Aid for Law Students

Personal resources consist of savings, earnings, and contributions from family and friends. *Grants and scholarships* are awards from the government (state or federal), the law school, or private or civic sources. Unlike loans from the same sources, they do not have to be repaid. *Federal work-study* funds are tied to employment of students who have demonstrated financial need; because of their source and their requirement for a showing of financial need, they are different from earnings that a student may derive from independent employers. *Loans* are the principal source of funding for law students. Basically, there are four types: federally guaranteed loans, state-sponsored loans, institutionally funded loans, and privately guaranteed loans offered by private lenders.

Federal Financial Aid

History

Over the years, financial aid programs have sought to achieve a number of objectives. The G.I. Bill, passed for the benefit of returning World War II veterans, and the 1947 Report of the President's Commission on Higher Education, the geneses of modern federal financial aid, sought to reward ex–service personnel for their wartime service and to restore the post–World War II economy at least to its prewar level. In addition, the notion of equal educational opportunity was embodied in the federal policy enunciated in the 1947 commission report, which addressed not just higher education in the abstract, but student financial aid as well. On that subject, it argued that equal education opportunity could not be achieved until economic, racial, ethnic, and sexual obstacles were surmounted. Adequate financial assistance to students was the agreed-upon method to overcome these inequities.

The next major federal financial aid legislation, the 1958 National Defense Education Act, had a perceived threat from the Soviet Union as its impetus. The launching of Sputnik was cited as evidence that an educated populace, especially one educated in new scientific and technological advances, justified the provision of student loans.

With the enactment in 1964 of the Equal Opportunity Act, which established the College Work Study Program and provided for Equal Opportunity Grants, and the Higher Education Act of 1965, the focus changed. Both laws addressed equal educational opportunity by means of need-based programs combining EOGs and Guaranteed Student Loans. Together, they provided grants and work opportunities for low-income students and loans for middle- and upper-income students. The Education Amendments of 1972, including Basic Education Opportunity and Pell grants, further made concrete the commitment to meet the financial need of students without regard to factors other than the economic resources available to them. A few years later, the Middle-Income Student Assistance Act of 1978 provided yet another source of federal financial aid based on economic need.

The most recent history of federal financial aid, starting around 1980, reflects continuing tension between efforts by the federal government to reduce drastically the scope and reach of existing programs and annual

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successes by opposing forces to defeat those efforts and to maintain existing programs essentially intact. Recent legislation has made Guaranteed Student Loans unavailable to students whose family income could be considered upper-middle-class, and adjustments in federal tax law have made it more attractive for those with sufficient assets to use second mortgages and equity loans for the financing of educational debt. Now those with sufficient assets are likely to make less use of Guaranteed Student Loans and Supplemental Student Loans. Economically disadvantaged students, who lack other options, undoubtedly will continue to depend on the loan programs as the primary source of financial aid for higher education.

Grants

With the exception of limited federal grant funds for ethnic minority students, primarily from the Council on Legal Education Opportunity and Patricia Roberts Harris Fellowships (formerly G*POP), grants of money to law students are financed by private donations and budgeted financial aid made possible by setting tuition at a level that allows tuition money from students who can afford it to subsidize tuition from students who cannot.

Loans

The federal loan programs are by far the largest source of student aid available. The U.S. Department of Education's student financial assistance programs include the Federal Stafford Loan and the Federal Perkins Loan programs. The Federal Stafford Loan is a low-cost loan available through the William D. Ford Federal Direct Loan Program (FDL) and the Federal Family Education Loan Program (FFEL). The former is funded directly by the U.S. government and administered by schools, while the latter is funded by commercial lenders like banks, credit unions, and organizations. Both are guaranteed by the federal government. The "guarantee" insures that lenders will receive repayment of the loan from the guarantor if the borrower does not repay it.

The Federal Stafford Loan can be subsidized or unsubsidized. If the loan is subsidized, it must be awarded on the basis of the student's financial need; the federal government pays the interest due on the loan while the borrower is in school and during approved forbearance periods. Unsubsidized loans are not based on financial need, and interest begins to accrue as soon as the funds are disbursed. The borrower can pay the interest when billed or allow it to be added to the principal amount during forbearance periods. These unsubsidized loans can be used to meet financial need not covered by other sources of financial aid or personal resources. The maximum subsidized Federal Stafford Loan is currently $8,500 per year. The combined annual maximum for subsidized and unsubsidized Federal Stafford Loans is $18,500. The cumulative maximum is $138,500, of which no more than $65,500 can be subsidized funds.

The Federal Perkins Loan is both federally guaranteed and federally subsidized; it is administered by the school of attendance. It is intended to provide low-interest loans to students demonstrating high financial need. The funds are provided by the federal government, but the school acts as lender. The

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exact amount offered to a student depends on the availability of funds and the amount of the student's financial need, but cannot exceed $5,000.

State-Funded Programs

Some states offer grants or loan programs. Eligibility for these programs is defined by state law and varies from state to state. Some may require financial need while others may be based on criteria related to academic achievement or potential.

Institutional Funds

Some law schools have institutional funds that may be offered to qualified students. As with the state-funded programs, eligibility for these funds varies from school to school. Criteria may be based on academic achievement or potential, on financial need, or in some cases on objectives, such as enrolling a diverse student body, that are peculiar to that institution. Whatever the case, it is usually up to the financial aid staff of the school to determine who is eligible to apply for these funds.

Privately Guaranteed Supplemental Loans

As I've noted, the most a borrower can receive annually through the federally guaranteed (FDL or FFEL) programs is $18,500. This amount, supplemented by personal resources, grants, and scholarships, may not meet the entire cost of attendance at private, or the most expensive public, law schools. Privately guaranteed loan programs can assist borrowers in filling this gap. There are numerous privately guaranteed student loan programs available that are not based on financial need and tend to have higher interest rates and fees than federal or state loan programs. Private loan programs, unlike the federally guaranteed programs, rely heavily on a borrower's credit history. As a result, borrowers at the same school may pay different fees and interest amounts depending on their past credit behavior and current credit standing. To be eligible for private loan programs, a borrower must meet the federal eligibility guidelines and have a favorable credit rating. In addition, some loan programs (private, state, and institutional) require that a borrower have a creditworthy cosigner in order to apply for a loan. Applying with a creditworthy cosigner can reduce the cost of a loan and provide the means for a borrower to meet a private loan program's credit requirements that otherwise could not be met.

Bar Examination Loans

Some privately guaranteed loan programs offer loans to assist law students in meeting the cost of a bar review course and other educational expenses related to preparing for the bar examination.

Repayment and Forbearance

Repayment is deferred on both the subsidized and unsubsidized Federal Stafford Loans as long as the borrower is enrolled at least half time as a student pursuing a degree or certificate. Repayment begins six months after the

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borrower graduates or ceases to be enrolled at least half time. The repayment period extends to ten years, and there is no penalty for prepayment.

A number of repayment options currently exist for Federal Stafford Loan borrowers. These include standard (level) repayment, graduated repayment, extended repayment, income-contingent repayment (FDL only), and income-sensitive repayment (FFEL only). Borrowers also have the option to refinance federal education loans though the Federal Consolidation Loan Program. Any repayment option other than the standard (level) repayment can reduce the amount that must be paid each month, at least temporarily, and typically is used when the borrower anticipates being unable to pay the minimum loan amount required under the standard plan. It also, however, will increase the total cost of the loan because of increased finance charges accruing on the loan principal. Many private loan programs also offer repayment options, and they vary by lender. While the repayment period varies among private loan programs, it typically is between fifteen and twenty-five years.

Indebtedness

With increased average indebtedness among law school graduates, and the growing disparity between private-sector and public-sector legal salaries, there is general concern about the effects of indebtedness on career choice. As indebtedness rises, fewer students can afford to take on starting positions within the lower salary strata, particularly in the area of public interest law.

A result of this growing concern is Loan Repayment Assistance Programs. LRAPs are school-sponsored programs that help repay the legal education expenses of graduates who take positions in public interest law, which typically offer lower starting salaries than positions in private law practice. Many schools will forgive the loans of graduates who serve in public interest or nonprofit positions.

* * * * *

Legal education is costly, and there is little beyond federal assistance in the form of loans. Although these programs provide funding for U.S. citizens enrolled in programs approved by the U.S. Department of Education, persons on an F1 or F2 student visa only, or on a J1 or J2 exchange-visitor visa only, can't get federal student aid regardless of where they matriculate. Also, persons with G series visas (pertaining to international organizations) are not eligible for federal student aid.

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Finding Those Assets

Michael S. Edmiston[1]

It does not matter the reasons why you find yourself considering a case or in the middle of the case where the primary wrongdoer does not appear to have any assets, the investment has evaporated (if it ever existed), and you are wondering how your client is going to get paid.

Hiring a skip tracing firm or private investigator to perform an asset search is an easy, but pricy solution. Some cases and clients may not be able to afford or merit a professional search. That leaves you to do the work, often with few tools other than the internet and some time.

It is easy to get started on Google searching the target's name, but after sorting through all the PIABAns' blog entries, the sketchy paid search tools, and filtering out all the people with the same name but no relation to the case, it is also easy to give up the task as a bad job. There is nothing wrong starting with a quick Google search, but know that it is just the beginning.

An asset search, by its very nature is conceptual and no two searches are alike. A five-step process can help organize and guide a search.

1. Identify your target
2. Build out the target's life and work
3. Start pulling each thread
4. Track each new thread found
5. Assemble the final picture

This five-step process gives structure and guidance to every search. Without structure, it is easy to get distracted, get lost in the search, miss a thread, or forget a step in the investigation, all of which can lead to incomplete or incorrect conclusions.

Step One: Identify the Target

Identify your target by name. If there are aliases, make a note of them to be searched. With first names, consider diminutives and nicknames. If possible, find the target's middle name(s). Also consider last names, particularly maiden names and married names. Every name is now a search topic. However, based on Step Two, the identification is unfinished.

Step Two: Build Out the Target's Life and Work

This step is about building out the search topics, not pursuing them, yet.

Before starting a broad Google search, review the target's website(s) and biographies. This will reveal licenses, education, alma maters, volunteer activities, hobbies, charitable activities, and more. These details can make a Google searches more effective and efficient.

---

[1] Michael S. Edmiston is an attorney with Jonathan W. Evans & Associates, a Past President of PIABA, and swears he is not a stalker.

Google searching for the target's name can be the most time intensive search. It is made more difficult if the target has a common name. Consider narrowing the searches using geographic locations, company names, middle initials, or other terms to better target the search.

Consider using other search engines with the same search terms. Different search algorithms yield different results.

Social media including LinkedIn, Twitter (now known as "X"), Facebook, and Instagram searches can be very revealing. Along with revealing employment, volunteer work, and hobbies, incautious postings expose expensive activities, vacation locations, properties, vehicles, family members, friends, business associates, lawyers, charities, and businesses. Be careful not to violate your ethical obligations vis-à-vis social media contacts if the target is represented by counsel. Keep in mind that many social media sites will reveal recent users looking at the target's pages.

Search regulatory websites with the target's name(s) and licenses for additional information, particularly about the target's business activities. Consider federal regulators, state regulators, and self-regulatory organizations.

Search the target's local area courts for filings. Criminal, civil, family, and probate courts may contain cases and importantly filings related to the target. Federal court actions are available on PACER (www.pacer.gov) and searching the target's name can be done across all civil and bankruptcy courts.

Step Three: Start Pulling the Threads

Pulling the threads means trying to connect the target to its assets.

Court cases, particularly issues related to the target's finances, can be very valuable in revealing the existence of businesses, bank and brokerage accounts, and other assets. Even criminal matters, starting with search warrants and all the way through to motions in limine may reveal assets and accounts that might not otherwise be available to civilians. Attending some of the hearings will often provide a chance to observe the target, and their clothing, footwear, jewelry, and if you happened to park in the same garage, a motor vehicle and license plate.

Search Secretary of State website(s) for the target's name and businesses. Are there new or recent filings? Review the filings for locations, properties, business associates, and attorneys. Particularly for properties, search the addresses as they may reveal yet more businesses.

Search the SEC's website (from the main page) for the target's name.

Search Edgar for company filings related to the target.

Research each volunteer activity and charitable activity. How is the target involved? Is the target giving time, talent, or treasure?

Search political donation websites to see the timing and size of donations to politicians and political parties. Search the target's name alongside any local politician to determine if there are any relationships beyond just the donation.

Use Google and other search engines to search the business associates, employees and attorneys for relationships to the target and target's businesses and activities. A business associate may have a separate business that the target has an investment or ownership interest that might not otherwise be found through searching the target.

County recorder offices will have real estate transactions that will show the targets ownership interests, mortgages, liens, and importantly, transfers of interests to spouses, children, and other family members. Similarly real estate transfers to or from a business owned by the target may reveal other businesses, partnerships, or associates.

Hobbies such as cars, boats, art, wine, hunting, flying may have more regulatory registrations which can reveal assets. Registered assets such as aircraft can be location tracked with flight tracking websites. Looking at registered asset movements may reveal the target's interests in different locations or activities, and reveal assets (e.g., vacation homes).

Step Four: Search Each New Thread

As searches reveal new details, it is necessary to search those new threads. Make a note of each new thread and be sure to give it the same degree of attention as the original searches. This will build out the target's life and work and potentially reveal assets that were not found in the direct searches.

When the searches cease to yield results or start to circle back to already known results, the search effort is nearing completion.

Step Five: Assemble the Final Picture

Once all the threads have been traced, assemble the final picture. What does the target own and where? Who is the target related to, how, and what assets are potentially recoverable based on those relationships? What assets still remain and what have been liquidated or otherwise lost?

Discovery, if it is open and available, may be used to learn more about the assets, relationships, transfers and liquidations.

State Restitution Funds as Sources of Recovery for Securities Fraud Victims

Melanie S. Cherdack[1]

History and Establishment of the Model Act

The North American Securities Administrators Association ("NASAA"), an association of state and provincial securities regulators in the United States, Canada and Mexico, drafts and promulgates various "Model Rules" for its members to promote uniformity of securities regulation. On May 17, 2021, NASAA approved Model Legislation to Create a Restitution Assistance Fund for Victims of Securities Violations ("Model Act").[2] The purpose of the Model Act is to promote state legislation that provides financial assistance to victims of securities law violations who are awarded restitution but have not receive full payment. In announcing the Model Act, NASAA outlined its parameters.[3] These include provisions establishing a securities restitution assistance fund, outlining the eligibility requirements for victims seeking restitution assistance, setting payment caps on the amounts of awards, conduct forfeiting awards, and mechanisms for award recovery. The Model Act also provides that restitution

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[2] https://www.nasaa.org/wp-content/uploads/2021/05/NASAA-Restitution-Assistance-Fund-Model-Act-Approved-May-17-2021.pdf

[3] https://www.nasaa.org/57582/nasaa-members-approve-model-act-to-create-restitution-assistance-funds-for-victims-of-securities-violations/

assistance awards be doubled for victims of securities violations who are considered vulnerable persons.[4]

The Model Act borrowed concepts from similar legislation in Indiana, Montana, Vermont, Kansas[5] and Maine. Indiana's restitution assistance program, the country's first such program, was enacted in 2010. Under the provisions of the Indiana Securities Restitution Fund ("Indiana Fund")[6], victims are eligible to receive 25% of their unpaid restitution, up to a maximum of $15,000. To be eligible for an award, a claimant must have "a final order from a state court, federal court or administrative agency which orders restitution to a victim as a result of a securities violation." For Indiana claimants, the securities violation must have occurred in Indiana or in a jurisdiction that does not offer Indiana claimants substantially similar assistance as the Securities Restitution Fund. Out-of-state claimants will only be eligible for an award from the Securities Restitution Fund if the securities violation was committed in Indiana and the jurisdiction in which the out-of-state claimant resides provides substantially similar assistance as the Securities Restitution Fund to Indiana residents who are victims of

[4] *Id.*

[5] Although Kansas proposed this legislation, it was not enacted. *See* HB 2135 https://www.kslegislature.org/li_2022/b2021_22/committees/ctte_h_insurance_and_pensions_1/documents/testimony/20210201_04.pdf

[6] Indiana Code §23-20-1

securities violations in that jurisdiction. As of 2021, Indiana had issued approximately $1 million in restitution assistance awards to 102 claimants.[7]

Montana, another early adopter of a securities restitution fund in 2012, provides for recovery where the victim has received a "final order issued by the commissioner or a final order in a legal action initiated by the commissioner." [8] Montana has increased the amount of assistance each victim may receive from its fund. Claims were originally limited to the lesser of $25,000 or 25% of unpaid restitution. However, in 2015, HB57 doubled the maximum award victims could get from the fund to $50,000 or 50 percent of their losses, whichever is less, if the victim is a senior citizen or any other Montanan defined in state law as a "vulnerable person."[9] Securities restitution payments can only go to victims of cases prosecuted or administrated by the state securities division, or in which the division initiated the investigation and referred the matter (typically to the US Attorney's office). Additionally, a person must have been a Montana resident at the time of victimization. Montana reports awarding approximately $1.8 million to 134 claimants. with 82% of restitution recipients over 60 years old.[10]

Vermont's Securities Restitution Fund, adopted in 2019, was established to enable the Vermont Department of Financial Regulation to award restitution

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[7] See *supra* n. *2*

[8] Mont. Securities Restitution Fund §6.10.7

[9] https://csimt.gov/restitution-assistance-fund/#:~:text=Upon%20the%20passing%20of%20long,they%20lost%20when%20full%20restitution

[10] See *supra* n. 2

to victims of securities law violations.[11] To recover, the victim must have a final order "issued, either by the Commissioner or in a legal action initiated by the Commissioner, which includes restitution to the victim, and the claimant shall have exhausted their appeal rights." Victims are eligible to receive 25% of their unpaid restitution, up to a maximum of $25,000, or 50% of their unpaid restitution, up to a maximum of $50,000, if they are at least 60 years old or otherwise meet the definition of "vulnerable person" under Vermont law.

In 2021, Maine established the Securities Restitution Assistance Fund ("Maine Act"). [12] To recover, the victim must have been awarded "restitution in a final order issued by the administrator under this chapter or were awarded restitution in a final order in a legal action initiated by the administrator under this chapter but did not receive the full amount of restitution ordered " The Maine Act grants the holder of an unpaid restitution award the lesser of $15,000 and 25% of the unpaid final order if the victim is not an "eligible adult," or the lesser of $30,000 and 50% of the unpaid final order of restitution if the victim is an "eligible adult." Under the Maine Act, the administrator may waive these payment caps for good cause shown.

Following NASAA's passage of the Model Act, Ohio and North Dakota established their state's restitution acts. Ohio has recently increased the amount of the award that can be claimed by eligible claimants under its Investor Recovery Act.[13] As of August 2022, Ohio victims of securities crimes and related violations

[11] 9 Vermont Securities Act § 5616

[12] Maine Uniform Securities Act §16522

[13] Ohio Revised Code §1707.471

can apply to receive up to 25% of their loss amount or 25,000, whichever is less. Eligible claims for recovery can be made from administrative, civil or criminal cases initialed by the Ohio Securities Division resulting in the issuance of a final order after Sept.30. 2021.[14]

On July 1, 2023, North Dakota passed legislation establishing its Restitution Assistance Fund.[15] To be eligible for recovery, the victims must have received a final "order issued by the commissioner under this chapter or a final order issued by the court in a legal action initiated by the commissioner under this chapter" for a violation of any provision of the state securities laws "or any rule or order issued by the commissioner under this chapter." The law provides that the commissioner may award the lesser of $50,000 or 50% of the amount of unpaid restitution awarded in the final order to a claimant. The commissioner may waive any limitations on payment upon a showing of good cause. This restitution fund seems to provide for the highest amount of recovery for victims of securities fraud violations who have been awarded restitution.

Florida has established a Securities Guaranty Fund which has been on the books since 1979.[16] While not *per se* a restitution fund, it provides for recovery by "a person who is adjudged by a court of competent jurisdiction to have suffered monetary damages as a result of [a violation of the antifraud or

[14] https://com.ohio.gov/divisions-and-programs/securities/about-securities/ohio-investor-recovery-fund

[15] See North Dakota Senate Bill 2325 (2023). https://ndlegis.gov/assembly/68-2023/regular/documents/23-1036-03000.pdf

[16] Fla Stat. 517.131

registration provisions of the Florida Securities and Investor Protection Act] ….. committed by a dealer, investment adviser, or associated person who was licensed under this chapter at the time the act was committed." This statute also allows a court-appointed receiver to apply for the funds on behalf of the victims of the securities fraud violations. This statute does not require a restitution order or commission involvement in the underlying action. There is a limit per claim of $10,000 or the unsatisfied portion of such person's judgment, whichever is less, and the amount of the judgment considered is limited to the actual or compensatory damages, excluding postjudgment interest, costs, and attorney's fees.[17] An aggregate payout cannot exceed $100,000 against any one dealer, investment adviser or associated person. Finally, there is a two-year minimum waiting period *after* an initial claim is filed during which the administrator will determine whether there are additional claims against the same dealer, investment adviser or associated person so as to pay out pro-rata if necessary.

In 2023, both Nevada[18] and West Virginia[19] had proposals to secure legislation establishing restitution funds. This legislation was not passed.

Unpaid Arbitration Awards and Civil Court Judgments Go Unanswered

[17] Fla. Stat. 517.141

[18] *See* Nevada Assembly Bill No. 67 https://www.wvlegislature.gov/Bill_Status/bills_text.cfm?billdoc=sb576%20intr.htm&yr=2023&sesstype=RS&i=576

[19] *See* West Va. Senate Bill 576 https://www.wvlegislature.gov/Bill_Status/bills_text.cfm?billdoc=sb576%20intr.htm&yr=2023&sesstype=RS&i=576

The restitution assistance statutes provide a mechanism for securities fraud victims to get some recovery where a deadbeat firm or Ponzi schemer has no money left to pay the restitution they were ordered to pay. That is the good news! Nevertheless, these acts leave out many victims of securities fraud who do not squarely fit into their state's statutory scheme. For example, victims are generally unable to recover on judgments for damages for a securities law violation in a private civil court action. Likewise, unpaid arbitration awards ordering a respondent to pay restitution or damages to a claimant for a state securities law violation are also left out. Indeed, Indiana *specifically excludes* FINRA arbitration awards from recovery under its restitution fund. The Indiana Securities Division's website specifically states that "Finra arbitration awards are not eligible for an award from the fund."[20]

The FINRA arbitration award problem is especially pernicious. By mandate, every registered brokerage firm requites that its customers arbitrate their disputes through FINRA Dispute Resolution.[21] Use of this mandatory arbitration forum often results in awards that go unpaid. FINRA has reported that during the period 2017-2022, between 21-37% of customer awards were unpaid.[22] While there are consequences for such non-payment, such as

[20] https://securities.sos.in.gov/general-information/restitution-fund/

[21] *See* https://www.finra.org/arbitration-mediation

[22] Statistics on Unpaid arbitration awards in customer arbitration https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration

expediated suspension by FINRA, the punishment does not remedy the fact that the customer has not recovered their adjudicated losses. FINRA has noted this problem and has suggested several alternatives to address it, although so far none have come to fruition.[23] And, since many investment advisers also have agreements containing mandatory arbitration in other fora such as AAA and JAMS, the unpaid awards do not even subject these respondents to license revocation for nonpayment of an award as they are not regulated by FINRA.

This lack of access to statutory recovery funds where a state securities violation has been found in an arbitration or civil court action is problematic. Where an individual is the victim of a securities fraud such as a Ponzi scheme, unregistered persons selling unregistered securities, or simply a thinly capitalized firm, dishonest broker or investment adviser, there is often nowhere for the victim to recover once they have received a final judgment or arbitration award. Having a broader pool of victims who can recover from state restitution funds can serve as a source of at least a partial recovery for these victims.

There are several hurdles to be crossed in enacting such legislation. First, is the definition of what constitutes a covered final order or judgment. The definition should be broadened to include the following types of judgments where there is a finding of a state securities law violation: 1) final arbitration awards confirmed by a court; 2) orders in bankruptcy actions; 3) orders in all types of receiverships (not just those where a securities commission is involved); and 4)

[23] *See* Discussion Paper— FINRA Perspectives on Customer Recovery (Feb. 2018) https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf

judgments in civil actions brought by the victim. These changes to the restitution acts would provide the robust safety net needed for more adequate investor protection for victims of securities fraud.

Sources of Funding

The second hurdle is funding. States have established their restitution funds in several ways. These include:

a.) Civil fines or administrative penalties assessed by the jurisdiction (*see* Montana 30-10-1004(2)(a)(i), M.C.A.; Vermont 9 V.S.A. 5616(f));

b.) Using a portion of licensing or registration fees (see Maine LD 1704 (2019-2020 legislative session); Montana 30-10-1004(2)(a)(iii), M.C.A.; Florida 517.131(1)(a));

c.) Funds received for deposit into the jurisdiction's enforcement account (see Indiana Ind. Code Ann. § 23-20-1-25(b)(1));

d.) Legislative appropriations (see Indiana Ind. Code Ann. § 23-20-125(b)(2));

e.) Gifts, grants, bequests or other donations or voluntary contributions received by the jurisdiction (see Maine LD 1704 (2019-2020 legislative session); Montana 30-10-1004(2)(a)(ii), M.C.A.; Kansas HB 2558 (20192020 legislative session)); and,

f.) Transfers from an investor education and protection fund (see Kansas HB 2558 (2019-2020 legislative session)).[24]

[24] NASAA Model Act, see *supra* n. 2

Using these sources of revenue, many of which already exist, can easily provide the necessary funding for a restitution fund. Most funds are established with a one-time funding of 1 million dollars. The statutes often provide for an amount that can be paid out from the fund and limit that amount, or require replenishment up to a certain amount as the fund dips below a watermark. Significantly, no state has reported that its fund has been depleted by victim's claims.

Conclusion

NASAA's Model Act goes a long way in helping protect investors who have been awarded restitution get paid when they cannot otherwise fully collect. With a few more provisions, however, such as including court-confirmed arbitration awards and other types of court actions where there are findings of securities law violations, investor protection would be even more enhanced.

Collecting From the Poorly Capitalized B-D



How Big is the Problem

- https://www.piaba.org/piaba-newsroom/unpaid-awards
- https://piaba.org/piaba-newsroom/piaba-report-finra-arbitrations-persistent-unpaid-award-problem-september-29-2021
- The percentage of unpaid arbitration awards in FINRA arbitration cases is approximately 30%, & the percentage of unpaid award dollars is approximately 25%.

How to identify whether the B-D can Satisfy an Award

- Focus Reports: SEC.gov | HOME
- Form B-D: BrokerCheck - Find a broker, investment or financial advisor (finra.org)
- Brokercheck: BrokerCheck - Find a broker, investment or financial advisor (finra.org)
- Insurance: FINRA NTM 18-22; Discovery Guide List 1, Request 23(a)

Potential Defendants When the Broker-Dealer Can't Pay

- Control Person Liability
- Parent Company Liability
- Clearing Firm liability
- Successor Liability
- Broker Liability
- Issuer Liability
- Third Party Professionals

Future Solutions to The Problem

- Restitution Funds
- Mandatory Insurance
- Increased Net Capital Requirements
- SIPC
- Investor Education

Discovery in Investment Advisory Disputes

2023 PIABA Annual Conference

Colorado Springs, Colorado

Ross Tulman
Trade Investment Analysis Group
Columbus, Ohio

Investment advisor dispute resolution generally falls into two categories. In matters in which a financial services firm offers both brokerage and investment advisory services, investors can bring cases at FINRA Dispute Resolution. The Discovery Guide and Document Production Lists provide investors and their counsel with access to many presumptively discoverable documents. That said, the current version of the Discovery Guide was published in 2013.[1] While the Guide can be helpful in some respects, it focuses almost exclusively on documents relevant to transactional broker-dealer disputes. The Guide is silent with respect to IA specific content.

In matters where the firm is solely registered with the SEC or a particular state (i.e. less than $100 million in assets) as an investment advisor, the venue for dispute resolution typically resides at one of the other forums such as the American Arbitration Association (Consumer or Commercial), JAMS, CPR Institute for Dispute Resolution, and either State or Federal Court as determined by the residence of the customer or advisor, or the location specified in the contract executed by the parties. None of these entities provide a "presumptively discoverable" list of documents applicable to investment advisor disputes. Discovery issues are decided by a single arbitrator or a panel of arbitrators, or by the court. Results vary materially from what most of us have become accustomed to at FINRA.

The definition of an investment advisor in Section 202(a)(11) of the Investment Advisers Act of 1940 is any person or firm that: "(1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the Advisers Act."[2] This broad definition has resulted in a wide variety of acceptable investment advisory practices. I will focus on the type of discovery that is commonly

required in cases involving investment advice on individual securities or portfolios of securities provided to retail investors.

In some respects, the cases are generally straight forward. The gravamen of investment advisor compliance is disclosure. Advisors disclose their style and methods of investment management through the provision of Form ADV, through the language of the contract agreed upon with the client, and through the provision of Form CRS, the customer relationship summary. The activity that follows is either consistent with the disclosures made at the inception of the relationship through the provision of documents, or not – keeping in mind that both the investment advisor and investment advisor representative(s) are fiduciaries that have an "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 his clients."[3]

Following is a suggested list of documents that should be considered in a discovery pleading.

1) Compliance Manual: The majority of stand-alone investment advisory firms use compliance manuals drafted by third party compliance consultants. While they are typically complete and can withstand the scrutiny of a regulatory examination, they do change over time. Sometimes the changes reflect firm activity that was noticed by an examiner or related to a client complaint. Consider asking for prior versions of the manual to track the reason(s) for modification.

2) Business Cards of Investment Advisers and Investment Advisor Representatives: Regulators look for instances where initials such as RIA or IAR are used instead of the complete spelled-out terms. The practice is prohibited since the use of initials might falsely be used to convey some form of academic achievement.

3) Form ADV Part I: The form is filed annually and amended as needed with the SEC or the State. The form acts as the primary regulatory disclosure in terms of how the firm operates the business. Part I is not required to be delivered to clients. Amendments that are in addition to the annual filing are often the result of a regulatory inquiry or client related event.

4) Form ADV Part 2A: Known as the firm's "Brochure," Part 2A is required to be given to the client at the inception of the relationship – which is typically defined as the period in which the parties can reasonably anticipate the execution of a contract. Part 2A describes in narrative form the services provided by the firm, fees charged, the style and methods of investment advice utilized, and any conflicts that might exist. Advisors must annually provide a summary of material changes to clients including an offer to provide a copy of the updated brochure. Counsel should request evidence of the dates of delivery of Form ADV Part 2A and the dates of the annual offer reflecting material changes.

5) Form ADV Part 2B: the "Brochure Supplement" provides information in narrative form about firm employees who provide investment advice for a client or make discretionary investment decisions for that client's assets, even if the supervised individual has no direct client contact. The importance of the three documents, Part 1, 2A and 2B, is to compare the contents of the disclosures to the investment activity alleged to be at issue as stated in the claim. Counsel should request evidence of the dates of delivery of Form ADV Part 2B.

6) CRS: the Form CRS discloses the nature of the relationship between the firm and the client. This includes "the types of services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those services; whether the

firm and its financial professionals have reportable legal or disciplinary history; and, how to get more information about the firm."[4]

7) Regulatory Exams: Copies of correspondence relating to any regulatory exam performed during the period at issue in the dispute.

8) Client list: Some attorneys attempt to convince the panel or the court to order production of a list of all clients of the advisor. Advisors do tend to manage accounts in the same manner; i.e. if the management of a claimant's account was negligent or evidenced a breach of fiduciary duty, it is likely that some or all the advisor's clients reflect the same characteristics. In my experience, these discovery requests are rarely granted.

9) Contracts with clients: firms do maintain standard contracts that are subject to regulatory scrutiny. However, the "standard" contract often gets modified to suit the circumstances of the client relationship. Counsel should request copies of all contracts (redacted if necessary) that the firm used during the applicable time frame.

10) Contracts with third parties: these might include sub-advisory agreements executed with other investment advisors and or investment product venders.

11) Marketing: documents regarding promotional brochures, pamphlets, newsletters, sales literature, prospectuses, private placement memoranda, offering circulars, wrap fee programs, or other materials used to educate or solicit prospective clients.

12) Private placements: copies of the operating agreement, private placement memorandum, subscription agreement and any audit reports for the fund(s).

13) Complaint File: any evidence of other client complaints, arbitrations, litigation, unsatisfied judgements, or liens involving the investment advisor, or any investment advisor representative should be requested. The custom and practice with respect to

regulatory exams is to require the advisor to affirmatively state in writing that none of these items exist (if true). This seems like a good practice to apply in discovery, rather than leave standing the inference that there have been no complaints filed if none have been acknowledged in response to the request.

14) Client file: all monthly or quarterly statements produced by the advisor for the client at issue, and or all client statements prepared by a third party clearing or custodial firm. All signed contracts, custodial account applications, correspondence, financial plans, etc. related to the claimant/plaintiff should be requested.

15) Suitability analysis: all documents including investment advisory questionnaires completed by the client and brokerage suitability forms used to determine the client investment objective and risk tolerance.

16) GIPS Analysis: investment advisors provide clients with performance and risk metrics. The preferred methodology adheres to the Global Investment Performance Standards developed by the CFA institute. The basic approach is to calculate time weighted returns and standard deviation for the client portfolio and compare the results to the time weighted returns and standard deviation of an appropriate benchmark.

17) A list of all employees and supervised persons who had contact or participation with respect to the management of claimant/plaintiff assets. The list should include job titles and duties for each identified individual.

18) Firm financial statements: these should include the firm's balance sheet, profit & loss statement, and general ledger for the time the claimant/ plaintiff maintained a relationship with the firm. In matters where theft, embezzlement, or money laundering is suspected, the request should include the cash receipts journal, cash disbursements journal or

equivalent (checkbook), bank statements**,** bank reconciliations, and credit card statements for the period at issue.

19) Trade blotter for the period at issue: this document provides a complete list of transactions in securities and other products recommended or offered by the firm for all the firm's clients. You should expect to find that most if not all clients are invested in the same manner – unlike brokerage accounts in which clients will reflect many different forms of risk tolerance and investment objectives.

20) Commission data: this applies to investment advisors and investment advisor representatives who are dually registered. Possibly the most complicated and difficult relationship issue to resolve in hybrid matters is to determine when the financial professional is acting as a broker and when they are acting in a fiduciary capacity as an advisor. The commission runs help sort that out, although replacement of the suitability standard with Reg BI further complicates the distinctions.

The records retention standard for investment advisors is slightly different than that of broker-dealers. Generally, documents that are commonly requested in a discovery pleading must be retained for five years, and for two years in any easily accessible location. It is important to secure discovery as early as possible. My experience is that the common forums in which these cases are heard require written expert reports – most often mandating the production of a Rule 26 Report consistent with that required in Federal Court. Depositions are more common as well. Your expert will need timely access to the key documents to efficiently prepare.

[1] The newsletter for FINRA Neutrals. https://www.finra.org/sites/default/files/2022-09/neutral-corner-volume-3-2022-0927.pdf.

[2] "SEC Staff No-Action Letter, Mandell Financial Group." SEC Staff No-Action Letter (Division of Investment Management): Mandell Financial Group, May 21, 1997. Accessed August 4, 2023. https://www.sec.gov/divisions/investment/noaction/mandell052197.htm.

[3] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)

[4] "Form CRS." Form CRS | Investor.gov. https://www.investor.gov/introduction-investing/investing-basics/glossary/form-crs.

The Ethics of Artificial Intelligence in Legal Advocacy

Elissa Germaine[1]

The use of AI in our personal and professional lives has entered the public consciousness over the past several months. The legal profession and the securities industry are no exception. This article begins to explore the use of open source generative AI in legal advocacy, and the related ethical implications for securities arbitration practitioners.[2]

Studies have corroborated the impact of AI on the legal profession that many of us have been seeing in practice or hearing and reading about. A Goldman Sachs study predicted that the legal profession will be one of the most likely areas to be impacted by AI, second only to the clerical and administrative sector.[3] Lawyers themselves seem to agree. A LexisNexis survey found that 39% of lawyers responding to the survey believe AI will transform the practice of law significantly.[4] Fifty one percent of lawyers surveyed had either already used it in their work or were planning on doing so. And 84% believe generative AI tools will increase the efficiency of lawyers, paralegals, or law clerks. In addition, as most lawyers are aware, the latest version of ChatGPT (ChatGPT-4) scored near the 90th percentile on the July 2022 Uniform Bar Exam.[5]

Keeping this phenomenon in mind, this article explores the ethical considerations that lawyers should consider regarding the use of AI in legal practice, focusing on advocacy in securities arbitration. The article will spotlight ethical concerns raised in the highly publicized case involving attorney use of ChatGPT in writing a legal brief submitted to the court in the Southern District of New York, consider some initial judicial responses, touch on broad ABA

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[2] This article generally focuses on the use of open source AI or large language model (LLM) tools by lawyers, which is a broad term that can be used for any AI system whose primary function is to generate new content based on learned patterns. The term large language model or LLM is often used to refer to systems that work with language, such as ChatGPT, as compared to AI models that generate images, audio, or code. *See* https://cset.georgetown.edu/article/what-are-generative-ai-large-language-models-and-foundation-models/. Generative AI differs from extractive AI, like a traditional search engine, which finds content that already exists, for example, on the internet. The term predictive AI refers to AI systems that analyze historical data patterns and existing information to make predictions and estimations about future events. *See* https://www.linkedin.com/pulse/predictive-ai-vs-generative-unveiling-distinctions-ishan-kapoor/. In addition, open source AI also can be distinguished from enterprise products being developed for use in certain industries, like the legal profession.

[3] *See* Goldman Sachs Global Economics Analyst, *The Potentially Large Effects of Artificial Intelligence on Economic* Growth (Briggs/Koldani) at Exhibit 5, March 23, 2023, available at https://www.gspublishing.com/content/research/en/reports/2023/03/27/d64e052b-0f6e-45d7-967b-d7be35fabd16.html.

[4] *See* LexisNexis Legal AI Update, *2023 Generative AI and the Legal Profession*, *Generative AI Captures Imagination of Lawyers, Law Students, and Consumers*, available at https://cert-www.lexisnexis.com/pdf/lexisnexis-legal-ai-sample-report.pdf. See also, Suzanne McGee, *Generative AI and the Law*, LexisNexis 2023, available at https://www.lexisnexis.com/html/lexisnexis-generative-ai-story/.

[5] *See* Debra Cassens Weiss, *Latest version of ChatGPT aces bar exam with score nearing 90th percentile*, ABA Journal, March 16, 2023, available at https://www.abajournal.com/web/article/latest-version-of-chatgpt-aces-the-bar-exam-with-score-in-90th-percentile.

guidance regarding AI, address comparable concerns with ethical AI in the securities industry, and then turn to the application of the Model Rules of Professional Conduct. The bottom line is that while AI may contribute to efficiency and idea generation, as with all technological tools used by lawyers, the lawyer is ultimately responsible for, and must supervise and vet, all work product generated or assisted by AI.

I. Case Example Highlighting Ethical Concerns with Using AI in Legal Advocacy

A prominent recent case highlighted many of the concerns with the use of AI in legal advocacy. Judge P. Kevin Castel in the Southern District of New York sanctioned two New York attorneys and the law firm where they worked for "abandon[ing] their responsibilities when they submitted [six] non-existent judicial opinions with fake quotes and citations created by the artificial intelligence tool ChatGPT, then continued to stand by the fake opinions after judicial orders called their existence into question."[6]

The plaintiff in the underlying personal injury case alleged that he was injured when a metal serving cart struck his knee during a flight from El Salvador to John F. Kennedy Airport.[7] The defendant airline removed the case to federal court and then filed a motion to dismiss on statute of limitations grounds under the Convention for the Unification of Certain Rules Relating to International Carriage by Air ("Montreal Convention").[8]

Plaintiff's counsel turned to ChatGPT when he found Fastcase was not helpful in preparing his response, despite having never used ChatGPT before.[9] The attorney entered various prompts that caused ChatGPT to generate descriptions of fake cases, including: "provide case law in support that statute of limitations is tolled by bankruptcy of defendant under montreal [sic] convention," "show me specific holdings in federal cases where the statute of limitations was tolled due to bankruptcy of the airline," "show me more cases," and "give me some cases where te [sic] montreal [sic] convention allowed tolling of the statute of limitations due to bankruptcy."[10]

Defendant's counsel noted that it was unable to find most of the cases cited: "although Plaintiff ostensibly cites to a variety of cases in opposition to this motion, the undersigned has been unable to locate most of the case law cited in Plaintiff's Affirmation in Opposition, and the few cases which the undersigned has been able to locate do not stand for the propositions for which they are cited."[11]

In response, the court directed plaintiff's counsel to provide copies of the case law to the court and to opposing counsel. Despite being put on notice that something was amiss, plaintiff's counsel went back to ChatGPT and entered commands such as "provide case law," "show me specific holdings," "show me more cases," and "give me some cases."[12] "The chatbot complied

[6] *Mata v. Avianca, Inc.*, 2023 WL 4114965, at *1 (S.D.N.Y. June 22, 2023).
[7] *See id.* at *2.
[8] *See id.*
[9] *See id.* at *8.
[10] *Id.*
[11] *Id*. at *3.
[12] *Id.* at *8.

by making them up."[13] Plaintiff's counsel then filed an affidavit that included purported excerpts of these bogus cases. The affidavit tried to excuse why the full decisions were not provided by explaining that the attached purported cases "may not be inclusive of the entire opinions but only what is made available by online database."[14] However, it did not identify any "online database" by name.[15]

The court noted that the "record now would look quite different" if the matter had ended with the lawyers "coming clean about their actions shortly after they received" their opponent's "brief questioning the existence of the cases" or after court orders required production of the fake cases.[16] Instead, the lawyers "doubled down and did not begin to dribble out the truth until" after an order to show cause was issued demanding why one of the lawyers should not be sanctioned.[17] During the sanction hearing, plaintiff's counsel confessed that he was operating under the false perception that ChatGPT could not possibly fabricate cases on its own.[18]

The court imposed a $5,000 sanction on the attorneys and their firm and ordered them to send letters to each of the six judges falsely identified by ChatGPT as the authors of the fake decisions. The letters were required to identify and attach the opinion imposing the sanctions, the fake opinion attributed to the recipient judge, and a copy of the false affirmation from the attorneys that continued to cite to the fake opinions.[19] In determining these sanctions, the court "weighed the significant publicity" surrounding the case and the sincerity of the lawyers "when they described their embarrassment and remorse." The lawyers had no disciplinary action history and "there was a low likelihood that they will repeat the actions" described in the case.[20]

It appears that the court's leniency in sanctioning the attorneys likely stemmed in part from the novel and first impression nature of the case – the lawyers seemed to believe that ChatGPT could not make up cases. However, after the publicity surrounding this case, a similar excuse is unlikely to be viewed in a sympathetic light moving forward.

II. Initial Judicial Responses to the Use of AI in Legal Advocacy

On May 30, 2023, in what seems to be a first for the federal courts, Judge Brantley Starr in the Northern District of Texas began requiring lawyers and pro se litigants appearing before

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[13] *Id.*
[14] *Id.* at *4.
[15] *Id.*
[16] *Id.* at *1.
[17] *Id.*
[18] *Id.* at *3.
[19] *Id.* at *17.
[20] *Id.* A somewhat similar situation occurred in Manchester County Court in England, where a pro se litigant used case citations generated by ChatGPT but which were fictitious. One case name had been completely fabricated, while the other three were real case names but with the relevant cited passages being completely different to the judgment in each. The judge accepted that the misleading submissions were inadvertent and did not penalize the pro se litigant. *See* John Hyde, *LiP presents false citations to court after asking ChatGPT*, The Law Society Gazette, May 28, 2023, available at https://www.lawgazette.co.uk/news/lip-presents-false-citations-to-court-after-asking-chatgpt/5116143.article; John Hyde, *Canadian judges demand to know if AI used in submissions,* The Law Society Gazette, June 27, 2023, available at https://www.lawgazette.co.uk/news/canadian-judges-demand-to-know-if-ai-used-in-submissions/5116452.article.

his court to make a mandatory certification regarding the use of generative artificial intelligence.[21] The requirement can be found on the court's website with a link to a template for the certification.[22] The website states the following about the mandatory certification and the reasons why Judge Starr is requiring it:

> All attorneys and pro se litigants appearing before the Court must, together with their notice of appearance, file on the docket a certificate attesting either that no portion of any filing will be drafted by generative artificial intelligence (such as ChatGPT, Harvey.AI, or Google Bard) or that any language drafted by generative artificial intelligence will be checked for accuracy, using print reporters or traditional legal databases, by a human being. These platforms are incredibly powerful and have many uses in the law: form divorces, discovery requests, suggested errors in documents, anticipated questions at oral argument. But legal briefing is not one of them. *Here's why. These platforms in their current states are prone to hallucinations and bias. On hallucinations, they make stuff up—even quotes and citations. Another issue is reliability or bias. While attorneys swear an oath to set aside their personal prejudices, biases, and beliefs to faithfully uphold the law and represent their clients, generative artificial intelligence is the product of programming devised by humans who did not have to swear such an oath. As such, these systems hold no allegiance to any client, the rule of law, or the laws and Constitution of the United States (or, as addressed above, the truth). Unbound by any sense of duty, honor, or justice, such programs act according to computer code rather than conviction, based on programming rather than principle. Any party believing a platform has the requisite accuracy and reliability for legal briefing may move for leave and explain why.* Accordingly, the Court will strike any filing from a party who fails to file a certificate on the docket attesting that they have read the Court's judge-specific requirements and understand that they will be held responsible under Rule 11 for the contents of any filing that they sign and submit to the Court, regardless of whether generative artificial intelligence drafted any portion of that filing.[23]

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[21] Jacqueline Thompson, *U.S. judge orders lawyers to sign AI pledge, warning chatbots "make stuff up,"* Reuters, June 2, 2023, available at https://www.reuters.com/legal/transactional/us-judge-orders-lawyers-sign-ai-pledge-warning-they-make-stuff-up-2023-05-31/; *see also* United States District Court, Northern District of Texas, Judge Brantley Starr, Judge Specific Requirements, Mandatory Certification Regarding Generative Artificial Intelligence, available at https://www.txnd.uscourts.gov/judge/judge-brantley-starr.

[22] United States District Court, Northern District of Texas, Judge Brantley Starr, Judge Specific Requirements, Mandatory Certification Regarding Generative Artificial Intelligence, available at https://www.txnd.uscourts.gov/judge/judge-brantley-starr.

[23] *Id.* (emphasis added).

Judge Starr clarified in a subsequent interview that he created the requirement to put "lawyers on notice, who might not otherwise be on notice, that they can't just trust those databases. They've got to actually verify it themselves, through a traditional data base."[24]

The following week, another federal district court judge, this time in the Eastern District of Pennsylvania, issued a standing order regarding AI, requiring that attorneys and pro se parties "must, in a clear and plain factual statement, disclose that AI has been used in any way in the preparation of the filing and certify that each and every citation to the law, or the record in the paper, has been verified as accurate."[25]

In addition, judges internationally are beginning to create similar rules. The Court of King's Bench of Manitoba in Canada issued a new practice direction on June 23, 2023, which states there are "legitimate concerns about the reliability and accuracy of the information generated from the use of artificial intelligence. . . . To address these concerns, when artificial intelligence has been used in the preparation of materials filed with the court, the materials must indicate how artificial intelligence was used."[26]

The concerns raised by these judges related to the use of AI in legal advocacy, including hallucinations, reliability, accuracy, and bias, will be addressed further in Section VI below.

III. American Bar Association (ABA) Task Force and Resolutions on AI

Bar associations (like PIABA) are starting to explore the ethical implications of the use of AI and how lawyers can meet their ethical obligations in the current environment. The ABA has created a Task Force on the Law and Artificial Intelligence.[27] Its mission is to "(1) address the impact of AI on the legal profession and the practice of law, (2) provide insights on developing and using AI in a trustworthy and responsible manner, and (3) identify ways to address AI risks."[28]

In August 2019, the ABA adopted a resolution urging "courts and lawyers to address the emerging ethical and legal issues related to the usage of artificial intelligence ("AI") in the practice of law including: (1) bias, explainability, and transparency of automated decisions made

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[24] Jacqueline Thompson, *U.S. judge orders lawyers to sign AI pledge, warning chatbots "make stuff up,"* Reuters, June 2, 2023, available at https://www.reuters.com/legal/transactional/us-judge-orders-lawyers-sign-ai-pledge-warning-they-make-stuff-up-2023-05-31/.

[25] United States District Court, Eastern District of Pennsylvania, Michael M. Baylson, Senior Judge, Standing Order - In Re: Artificial Intelligence ("AI") in Cases, available at https://www.paed.uscourts.gov/judges-info/senior-judges/michael-m-baylson; https://www.paed.uscourts.gov/documents/standord/Standing%20Order%20Re%20Artificial%20Intelligence%206.6.pdf (emphasis omitted).

[26] Manitoba Courts, Court of King's Bench, Pratice Direction, June 23, 2023, available at https://www.manitobacourts.mb.ca/site/assets/files/2045/practice_direction_-_use_of_artificial_intelligence_in_court_submissions.pdf; *see also* John Hyde, *Canadian judges demand to know if AI used in submissions,* The Law Society Gazette, June 27, 2023, available at https://www.lawgazette.co.uk/news/canadian-judges-demand-to-know-if-ai-used-in-submissions/5116452.article.

[27] American Bar Association (ABA) AI Task Force, available at https://www.americanbar.org/groups/leadership/office_of_the_president/artificial-intelligence/.

[28] *Id.*

by AI; (2) ethical and beneficial usage of AI; and (3) controls and oversight of AI and the vendors that provide AI."[29]

More recently, in February 2023, the ABA adopted Resolution 605 urging "organizations that design, develop, deploy, and use artificial intelligence ("AI") systems and capabilities to follow certain guidelines" and urging "Congress, federal executive agencies, the Courts, and State legislatures and regulators, to follow these guidelines in legislation, legal decisions, and standards pertaining to AI." The Executive Summary states that the "Resolution presents guidance on how the legal system and its participants, including attorneys, regulators, and stakeholders, such as developers, integrators, suppliers, and operators ("developers") of AI systems and capabilities, should assess fundamental issues with AI by addressing the principles of accountability, transparency and traceability."[30]

It also explains how the ABA believes the proposed policy position will address the issue:

> This Resolution presents guidance on how the legal system and its participants, including attorneys, regulators, and stakeholders, including developers, integrators, suppliers, and operators ("developers") of AI systems and capabilities, should assess fundamental issues with AI by addressing the principles of accountability, transparency and traceability. It states that in the context of AI individual and enterprise accountability and human authority, oversight, and control is required and it is not appropriate to shift legal responsibility to a computer or an "algorithm" rather than to responsible people and other legal entities.
>
> Further, this Resolution would ensure that courts and participants in the legal process will have the capacity to evaluate and resolve legal questions and disputes by specifying the essential information that must be included in the development, deployment and use of AI to ensure transparency and traceability.[31]

These broad guidelines have parallels to FINRA and SEC guidelines and requests for comment regarding the securities industry, as discussed in Section IV below.

IV. Ethical AI and the Securities Industry

The concerns related to the use of AI are not limited to the legal profession. The securities industry, among others, also is grappling with the issue.

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[29] American Bar Association (ABA), House of Delegates Resolution 112, adopted August 12-13, 2019, available at https://www.americanbar.org/content/dam/aba/directories/policy/annual-2019/112-annual-2019.pdf.
[30] American Bar Association (ABA), House of Delegates Resolution 604, at 21, adopted February 6, 2023, available at https://www.americanbar.org/content/dam/aba/administrative/news/2023/mym-res/604.pdf.
[31] *Id.*

In June 2020, FINRA published a Report, entitled "Artificial Intelligence (AI) in the Securities Industry."[32] This Report was the result of a request for comment regarding potential challenges associated with the use and supervision of AI applications at broker-dealers. The Report is divided into three sections, which: (1) define AI and its scope as it pertains to the securities industry; (2) provide an overview of broker-dealers' use of AI application related to communications with customers, investment processes, and operational functions, and (3) address potential regulatory considerations that securities market participants may want to consider as they develop and adopt AI-based tools.[33]

In the introduction to the Report, FINRA notes that "[f]inancial institutions are allocating significant resources to exploring, developing, and deploying AI-based applications to offer innovative new products, increase revenues, cut costs, and improve customer service." The Report touches on both the potential benefits and potential concerns that arise with the use of AI:

> AI-based applications offer several potential benefits to both investors and firms. . . . Potential benefits for investors include enhanced access to customized products and services, lower costs, access to a broader range of products, better customer service, and improved compliance efforts leading to safer markets. Potential benefits for firms include increased efficiency, increased productivity, improved risk management, enhanced customer relationships, and increased revenue opportunities.
>
> However, use of AI also raises several concerns that may be wide-ranging across various industries as well as some specific to the securities industry. Over the past few years, there have been numerous incidents reported about AI applications that may have been fraudulent, nefarious, discriminatory, or unfair, highlighting the issue of ethics in AI applications. As such, several organizations have established initiatives or developed principles to promote the ethical use of AI.[34]

FINRA views the Report as an initial contribution to an ongoing dialogue with market participants and requested further comment.

More recently, in April 2023, in response to the ethical concerns related to the use of AI in the securities industry, the SEC Investor Advisory Committee (IAC) published a letter to Chair Gensler regarding the establishment of an ethical artificial intelligence framework for investment advisors.[35] The IAC raised the importance of providing ethical guidelines for AI and algorithmic models used by investment advisers and financial institutions, and the impact on how investors make financial decisions. It continued:

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[32] FINRA, *Artificial Intelligence (AI) in the Securities Industry*, June 10, 2020, available at https://www.finra.org/rules-guidance/key-topics/fintech/report/artificial-intelligence-in-the-securities-industry.
[33] *Id.*
[34] *Id.* at 11.
[35] U.S. Securities and Exchange Commission Investor Advisory Committee, *Letter Regarding the Establishment of an Ethical Artificial Intelligence Framework for Investment Advisors*, April 6, 2023, available at https://www.sec.gov/files/20230406-iac-letter-ethical-ai.pdf.

> Accordingly, advisers have an affirmative duty of care, loyalty, honesty and utmost good faith to act in the best interests of investors when providing investment advice. As fiduciaries, advisers have a special relationship of trust and confidence with their clients. The use of technology by advisers does not change the fiduciary nature of advice or the regulatory environment in which they operate.[36]

The IAC encouraged the SEC to consider three key tenets to support better financial outcomes for all, including equity in avoiding unintended biases in algorithmic inputs, consistent and persistent testing, and governance and oversight.[37]

In July 2023, the SEC proposed new rules that would require broker-dealers and investment advisers (referred to collectively as "firms") to take certain steps to address conflicts of interest associated with their use of predictive data analytics and similar technologies to interact with investors.[38] The goal of the proposal is to prevent firms from placing their interests ahead of investors' interests.

The SEC's explanation regarding why the proposal matters has parallels to the legal profession. The SEC noted firms' accelerated use of newer technologies, such as predictive data analytics and artificial intelligence, and the potential benefits they bring in terms of in market access, efficiency and returns.[39] However, the SEC expressed its concerns that "[t]o the extent that firms use these technologies to optimize in a manner that places their interests ahead of investor interests, investors can suffer harm" that can occur "in a more pronounced fashion and on a broader scale than previously possible."[40]

Many of these potential benefits and concerns resonate in the discussion in Sections V and VI below regarding the ethical implications of AI on legal practice.

V. Proposed Rule on Ethical Guidelines for Lawyers Using ChatGPT, as Authored by ChatGPT

The author recently tried ChatGPT for the first time when starting to consider the concerns regarding the ethics of using AI in legal work. ChatGPT provided the following disclaimer language before permitting the search to start: "While we have safeguards in place, the system may occasionally generate incorrect or misleading information and produce offensive

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[36] *Id.* at 2 (noting the IAC's belief in the SEC's "authority under the Investment Advisers Act of 1940 to oversee and monitor the investment adviser industry's use of technology to provide investment advice to investors).
[37] *Id.*
[38] U.S. Securities and Exchange Commission, *SEC Proposes New Requirements to Address Risks to Investors from Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers*, Press Release, July 26, 2023, available at https://www.sec.gov/news/press-release/2023-140#:~:text="Today%27s%20predictive%20data%20analytics%20models,ahead%20of%20their%20investors%27%20interests.
[39] U.S. Securities and Exchange Commission, Fact Sheet, *Conflicts of Interest and Predictive Data Analytics*, https://www.sec.gov/files/34-97990-fact-sheet.pdf.
[40] *Id.*

or biased content. It is not intended to give advice."[41] After clicking through this disclaimer, a follow-up disclaimer on how data is collected was provided. This disclaimer read: "Conversations may be reviewed by our AI trainers to improve our systems. Please don't share any sensitive information in your conversations."[42]

After the initial sign up, follow-up usage did not prompt this same disclaimer language. Thus, attorneys or firms who may share an account or who recently have not used the service should be reminded that this language appears initially. However, the following disclaimer language does appear in fine print at the bottom of the webpage in follow-up searches: "ChatGPT may produce inaccurate information about people, places, or facts."

The author then asked ChatGPT to "draft a rule of professional conduct for attorneys on the use of ChatGPT." ChatGPT generated the following response:

> Rule of Professional Conduct: Use of ChatGPT
>
> 1. Informed Consent: Attorneys shall obtain informed consent from their clients regarding the use of ChatGPT technology, explaining the potential benefits, limitations, and risks associated with its use. Attorneys shall maintain records of such consent and provide clients with an opportunity to opt-out of the use of ChatGPT if desired.
> 2. Supervision and Responsibility: Attorneys shall exercise appropriate supervision and oversight when utilizing ChatGPT, ensuring the accuracy and reliability of the information generated. Attorneys shall be responsible for the content and consequences of any communication or advice provided by ChatGPT.
> 3. Maintaining Attorney-Client Relationship: Attorneys shall not rely solely on ChatGPT for client communication or legal advice. They should use ChatGPT as a tool to enhance their practice, but they must maintain regular and direct communication with clients to address their specific needs and provide tailored legal advice.
> 4. Bias and Discrimination: Attorneys shall be aware of and address any potential biases or discriminatory outcomes that may arise from the use of ChatGPT. They should exercise caution to prevent any unintended discriminatory impact and ensure fair and equitable treatment for all clients.
> 5. Continuing Education and Training: Attorneys shall engage in ongoing education and training to stay updated on the developments and best practices related to the use of ChatGPT. They should strive to enhance their knowledge and skills to effectively and ethically incorporate this technology into their practice.
> 6. Duty of Zealous Representation: Attorneys shall maintain their duty of zealous representation to their clients when using ChatGPT. They

[41] https://chat.openai.com (visited on June 29, 2023). The author is not aware of the dates these disclaimers came into effect.
[42] *Id.*

should use the technology responsibly and in a manner that serves their clients' best interests, advocating for their rights and objectives within the bounds of the law.

7. Professional Responsibility: Attorneys shall uphold the highest standards of professionalism, integrity, and ethical conduct when using ChatGPT. They should adhere to the rules and regulations of their respective jurisdictions and ensure that their use of ChatGPT aligns with these obligations.
8. Regular Evaluation and Quality Control: Attorneys shall regularly assess the reliability and accuracy of the ChatGPT technology they use. They should implement quality control measures to verify the output and ensure its consistency with legal standards. Attorneys must take prompt action to rectify any identified errors or deficiencies.

Note: This rule is a general framework and should be adapted and supplemented according to the specific rules and regulations of the jurisdiction where the attorney practices.[43]

ChatGPT's "Rule" was not a rule as much as list of general principles that a lawyer could use as a starting point and food for thought when considering the question presented. It did not include citations or specific references to any rules of professional conduct, but it did touch on some of the considerations that are addressed below in the discussion of the ABA Model Rules of Professional Conduct. This iteration of ChatGPT also included a "[n]ote" at the end of the response that the "rule is a general framework that should be adapted and supplemented according to the specific rules and regulations of the jurisdiction where the attorney practices" – a note that should be taken as a strong warning to attorneys considering the use of AI in their practices to heed their ethical obligations and comply with the applicable Rules of Professional Conduct in their jurisdiction.

VI. Ethical Considerations for Lawyers and Application of the ABA Model Rules of Professional Conduct

Lawyers serving as advocates in securities arbitrations and other forums must consider ethical considerations and the Rules of Professional Conduct in their jurisdiction when considering the use of AI in legal work. The discussion below focuses on the relevant ABA Model Rules of Professional Conduct.[44]

a. Terminology (Rule 1.0)

[43] *Id.*

[44] This article focuses on the most recent version of the ABA Model Rules of Professional Conduct, which are available on the ABA's website: https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents/.

Rule 1.0(m) defines the term "tribunal" to include "an arbitrator in a binding arbitration proceeding." Thus, there is no question that the Rules' ethical duties and responsibilities apply to lawyers practicing in securities arbitration, including in the FINRA Dispute Resolution Services forum.

b. Competence (Rule 1.1)

Lawyers must provide "competent representation" to clients. Rule 1.1. provides that "[c]ompetent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." Importantly, for a discussion about the use of AI, Comment 8 to Rule 1.1 provides:

> To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.

The requirement that lawyers must keep abreast of "the benefits and risks associated with relevant technology" is critical. This means that lawyers have an ethical obligation to understand the relevant technology used in their practices, which now includes the potential use of AI. This duty makes it difficult for lawyers to claim that they did not understand how AI worked or that it could create false content, particularly now that the topic has been featured heavily in legal news and thoroughly entered the public consciousness. Lawyers need to conduct a reasonable level of due diligence about the technology tools they are using, including AI tools.

Bullet 5 of ChatGPT's "Rule" itself alludes to this concept when it states: "Attorneys shall engage in ongoing education and training to stay updated on the developments and best practices related to the use of ChatGPT." This Bullet echoes the concept in Comment 8 to Rule 1.1 that lawyers must understand the benefits and risks associated with relevant technology.

c. Communication (Rule 1.4)

Lawyers must reasonably consult with the client about the means by which the client's objectives are to be accomplished, as provided by Rule 1.4(2). Therefore, lawyers should consider whether they are obligated to disclose use of this technology to their clients. There is a tension as to whether use of AI in a task like legal research is akin to choosing to use a preferred legal research platform like WestLaw or Lexis and likely not appropriate for client consultation, or whether, in these early days, use of AI is something that requires disclosure to client until such use is more universally accepted and even requested or expected.

In the current environment, where the discussion around AI is novel, exciting, and worrisome all at once, lawyers can expect to hear from clients asking about whether they are using AI in client work. Further, in a court like Judge Starr's in the Northern District of Texas or Judge Baylson's in the Eastern District of Pennsylvania, clients may learn about a lawyer's use

of AI through the mandatory certification, and then question attorneys about it if they did not proactively communicate this information.

d. Fees (Rule 1.5)

Lawyers are prohibited from making an agreement for, charging, or collecting an unreasonable fee or an unreasonable amount for expenses. Rule 1.5(1) provides that the factors to be considered in determining the reasonableness of a fee include the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly.

As discussed above, clients may approach their lawyers with questions about the use of AI in their practices, in particular related to legal fees. They may want to know how AI can be used to reduce their legal bills, perhaps via assisting with legal research, discovery searches, or performing expert analysis, among other tasks. Lawyers will need to consider how using AI to assist in these tasks affects the reasonableness of their fees, how to communicate this to clients, as well as how to explain to clients whether certain tasks cannot or should not be conducted or assisted by the use of AI even if the client believes that such use could reduce their fees. This could include explaining the ethical obligations and level of supervision lawyers must employ to ensure that the work of the AI is accurate and reliable.

e. Confidentiality (Rule 1.6)

Confidentiality is one of the key duties that lawyers owe to their clients. Rule 1.6(c) requires a lawyer to "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client." Comment 18 to Rule 1.6 provides:

> Paragraph (c) requires a lawyer to act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision.

Thus, lawyers should be cautious when using AI programs for client matters, working to ensure that they are not overtly or inadvertently providing AI firms with either explicit client confidential information or more discrete confidential information that somehow could be traced back to a client.

Lawyers must understand how entered information is treated in the AI they are using, and avoid revealing client confidences which, in some cases, could even be the fact that a lawyer known to represent a particular client is looking into a certain issue. Further, one potential use of this technology could be to input a draft document and request feedback or revisions. Lawyers must be vigilant regarding the risk of revealing client confidences through these practices.

Indeed, before conducting a search in ChatGPT, the author was confronted with the disclaimer that: "Conversations may be reviewed by our AI trainers to improve our systems.

Please don't share any sensitive information in your conversations." This warning, along with the recent press on the topic, puts lawyers on notice about the risks to client confidential information present with the use of AI. However, ChatGPT missed the mark on confidentiality as part of its generated "Rule," not including any specific mention of the concept.

f. Meritorious Claims and Contentions (Rule 3.1)

Rule 3.1 provides: "A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law." Comment 2 to Rule 3.1 provides: "The action is frivolous, however, if the lawyer is unable either to make a good faith argument on the merits of the action taken or to support the action taken by a good faith argument for an extension, modification or reversal of existing law."

As demonstrated in the case in the Southern District of New York, the use of AI in legal research and brief writing can result in reliance on cases that are fabricated, with no basis in law and made-up citations. Lawyers need to be on guard for these types of "hallucinations" when considering the use of AI. Even in a less extreme circumstance than one involving fictitious case law, lawyers should be wary of reliance on AI for legal research, and on notice that they must confirm that their legal arguments are grounded in real law. Moreover, advocates who receive an opposition brief may not know if AI was used in drafting that brief, but they must be diligent in checking their adverary's sources to ensure the arbitrator or court is properly advised of the law and that, in so doing, their clients are adequately represented.

Further, ChatGPT provides the following disclaimer upon sign up: "While we have safeguards in place, the system may occasionally generate incorrect or misleading information." It also includes the following language in fine print at the bottom of the search webpage: "ChatGPT may produce inaccurate information about people, places, or facts." Attorneys, thus, will likely to be viewed to be on notice that search results may be incorrect, misleading, or inaccurate.

Bullet 8 of ChatGPT's "Rule" touches on this concept as well, providing that "[a]ttorneys shall regularly assess the reliability and accuracy of the ChatGPT technology they use. They should implement quality control measures to verify the output and ensure its consistency with legal standards." This is good advice regarding the use of AI and any other technological tools.

g. Candor Toward the Tribunal (Rule 3.3)

Lawyers must be truthful in statements to the tribunal. Rule 3.3(a) provides that a "lawyer shall not knowingly: (1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer; (2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel . . ." Rule 1.0(f) states that the term "knowingly" "denotes actual knowledge of the fact in question" and that a "person's knowledge may be inferred by circumstances." Comment 4 to Rule 3.3 provides:

> Legal argument based on a knowingly false representation of law constitutes dishonesty toward the tribunal. A lawyer is not required to make a disinterested exposition of the law, but must recognize the existence of pertinent legal authorities. Furthermore, as stated in paragraph (a)(2), an advocate has a duty to disclose directly adverse authority in the controlling jurisdiction that has not been disclosed by the opposing party. The underlying concept is that legal argument is a discussion seeking to determine the legal premises properly applicable to the case.

Given that the definition of the term "knowingly" "denotes actual knowledge," a lawyer who uses but does not verify the results of a brief and legal citations generated by artificial intelligence might assert that they did not violate the letter of the rule, even if that brief and its legal citations were "hallucinations." However, such action on the part of counsel arguably would not comply with and would be contrary to the underlying concept in the rule that "legal argument is a discussion seeking to determine the legal premises properly applicable to the case." Such actions could also violate Rule 3.1, as discussed above.

In addition, while the FINRA Code of Arbitration Procedure does not have an equivalent provision to Rule 11 of the Federal Rules of Civil Procedure, practitioners should consider their obligations under Rule 11 as they would relate to the use of AI because proceedings related to FINRA arbitrations, such as motions to confirm or vacate an award, might end up in federal court. Among other things, Rule 11 notes that by presenting a pleading, written motion, or other paper to the court, the attorney or unrepresented party "certifies that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances: . . . (2) the claims, defenses and other legal contentions are warranted by existing law or by a nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law . . ."[45] Indeed, the court in the Southern District of New York case discussed above issued its sanctions pursuant to Rule 11.

h. Truthfulness in Statements to Others (Rule 4.1)

Lawyers also must be truthful in statements to others. Rule 4.1(a) prohibits a lawyer from knowingly "mak[ing] a false statement of material fact or law to a third person." As discussed above, reliance on a false statement of law crafted by AI in a legal argument provided to an adversary or other third party in a legal proceeding will violate this rule.

In addition, as noted above, ChatGPT's disclaimers regarding incorrect, misleading, or inaccurate information may be viewed as putting attorneys on notice of this possibility.

i. Responsibilities Regarding Nonlawyer Assistance (Rule 5.3)

Lawyers have a duty to supervise nonlawyers both inside and outside of their firm. Rule 5.3 provides: "With respect to a nonlawyer employed or retained by or associated with a lawyer: . . . (b) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable

[45] Fed. R. Civ. P. 11(b)(2).

efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer."

Comment 2 to Rule 5.3 addresses lawyers' obligations to supervise nonlawyers within their firm, such as paraprofessionals, law student interns, and investigators. "Such assistants . . . act for the lawyer in rendition of the lawyer's professional services. A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment . . . and should be responsible for their work product. The measures employed in supervising nonlawyers should take account of the fact that they do not have legal training and are not subject to professional discipline."

Comment 3 to Rule 5.3 discusses lawyers' use of nonlawyers outside the firm. Examples of these uses include investigative or paraprofessional services, but also include document management companies and internet-based services to store client information. A lawyer's ethical obligations in these circumstances include the duty "to make reasonable efforts to ensure that the services are provided in a manner that is compatible with lawyer's professional obligations." However, "the extent of this obligation will depend upon the circumstances, including the education, experience and reputation of the nonlawyer."

A lawyer's use of AI is analogous to using a nonlawyer within the firm (like a paralegal) or outside the firm (like a document management company). The lawyer is obligated to supervise the AI's work and to understand its experience, trustworthiness, and limitations. Ultimately, the lawyer is responsible for the AI's work. Lawyers must vet any results, as they would with any technology that is currently commonly used and accepted as trustworthy. For example, even with trusted technology used for legal research that has been used for decades, lawyers must still read and understand cases cited, rather than relying on headnotes summarizing parts of a decision. While this technology can speed and assist a lawyer's work, it cannot take the place of the lawyer's review and insights on the underlying case. As with the coming use of AI, the lawyer is ultimately responsible for supervision and the final work product.

At this stage, ChatGPT and other comparable tools have not had legal training and are not subject to professional discipline. However, trusted legal commercial companies have already begun to roll out AI products with certain safeguards to help the attorneys using them meet their professional obligations. Enterprise legal-specific products limit the universe from which information is gathered, using reliable sources. However, the analysis of those sources still needs to be reviewed by a lawyer. These enterprise tools may come with their own ethical issues, including with respect to reasonableness of fees, depending on how they are structured. Broader issues could include which lawyers and law firms can afford these products, which clients can afford to hire those lawyers, the impacts on pro se parties, and other issues regarding access to justice, which are beyond the scope of this article.

j. Misconduct: Bias (Rule 8.4)

Lawyers are prohibited from engaging in harassing or discriminatory conduct that leads to bias or prejudice. Rule 8.4 provides that "[i]t is professional misconduct for a lawyer to: . . . (g) engage in conduct that the lawyer knows or reasonably should know is harassment or

discrimination on the basis of race, sex, religion, national origin, ethnicity, disability, age, sexual orientation, gender identity, marital status or socioeconomic status in conduct related to the practice of law." Further, Comment 3 to Rule 8.4 expands on the rule by stating that "[d]iscrimination and harassment by lawyers in violation of paragraph (g) undermine confidence in the legal profession and the legal system. Such discrimination includes harmful verbal or physical conduct that manifests bias or prejudice towards others."

Lawyers using AI should be aware of possible biases that may be present in the underlying technology. Indeed, as noted above, ChatGPT itself concedes in its disclaimer language that it could produce biased content.

The SEC IAC letter also raises this concern, which applies across the securities and legal fields: "While technology rapidly advances, humans are still responsible for creating and selecting inputs that affect the algorithms utilized by investment advisory firms. Neurological and psychological research demonstrates that bias can manifest in human beings in a variety of ways, including in an unconscious fashion, and that these biases (unconscious or otherwise) may be replicated in the inputs selected for the algorithms."[46]

The ways in which use of AI can exacerbate bias against low income or other marginalized communities are being studied. The ABA's Section of Civil Rights and Social Justice recently established the A.I. & Economic Justice Project, an initiative to survey the legal community designed to identify the ways that AI and automation are impacting low-income and marginalized populations.[47]

In addition to the ABA, state and local bar associations, organizations like PIABA, law schools, courts, and other stakeholders also are starting to explore the ethical impacts of the use of AI in legal practice. As with all new technologies, when using AI, lawyers must abide by their ethical duties, including competence, communication, confidentiality, truthfulness, supervision, and prevention of bias.

[46] U.S. Securities and Exchange Commission Investor Advisory Committee, *Letter Regarding the Establishment of an Ethical Artificial Intelligence Framework for Investment Advisors*, at 2, April 6, 2023, available at https://www.sec.gov/files/20230406-iac-letter-ethical-ai.pdf.

[47] *See* American Bar Association (ABA), Civil Rights & Social Justice Section, available at https://www.americanbar.org/groups/crsj/projects-and-initiatives/ai-economic-justice/. You can find a link to take the survey on this webpage.

Dealing with Rogue Arbitrators: Motions to Remove and Recuse in FINRA Arbitration

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"Equity," as Anglo-American lawyers have complained for centuries, "is a roguish thing." JOHN SELDEN, THE TABLE-TALK OF JOHN SELDEN (2015) (a compilation of the private conversations of the English jurist John Selden and originally published in 1689, 35 years after his death). What it gains in the flexible justice it can provide beyond written laws, it loses in exactness and predictability. "[F]or Law, we have a measure [to] know what to trust," but in equity, it is as if "they should make the standard for the measure we call a foot, to be the Chancellor's foot . . . one Chancellor has a long foot, another a short foot, a third an indifferent foot; tis the same thing in the Chancellor's conscience." *Id.*

For this familiar reason, the composition of an arbitration panel is perhaps the most crucial factor in any FINRA case. As a forum of equity and a private commercial arbitration that creates no binding precedent and requires no reasoned ruling, differences in foot length—the background, judgment, and personal views of the panelists—can lead to completely different arbitration awards even on similar facts. In this way, FINRA arbitrators sitting in equity act like jurors: their decision is accorded substantial deference and their ultimate reasons for an award are rarely subject to scrutiny after the case, if they are known at all. But jurors, of course, are subject to extensive *voir dire* and motions to strike for cause beforehand and they must follow the instructions of the judge throughout trial. And, more akin to judges, FINRA arbitrators do not sit silent throughout the case but examine the law, decide motions, determine the procedure to be followed, and in general control the operation of the forum after the parties accept them at an Initial Pre-Hearing Conference ("IPHC"). *See generally*

Rule 12409 ("The panel has the authority to interpret and determine the applicability of all provisions under the Code. Such interpretations are final and binding upon the parties.") Because a level of roguishness comes with the territory and in arbitration there is no other judge in the room with the finders of fact—and because avenues for appeal or vacating an award are sharply limited—the process for removing an arbitrator who goes rogue or shows bias is substantially murkier than it might be in a typical courtroom.

Here, we discuss this process, the sources of authority that guide it, and strategies for ensuring a bias-free panel.

Arbitrator Disclosure & Accepting the Panel

FINRA requires its arbitrators to "be neutral in fact and appearance." *See* FINRA Dispute Resolution, Your Duty to Disclose (September 2016) ("Your Duty to Disclose"). FINRA's primary method for maintaining this neutrality is requiring broad disclosure of (1) a potential arbitrator's basic background and ten years of employment history under Rule 12403(b)(1) before parties rank and (2) any potential conflict relationships under Rule 12405, as part of the so-called Disclosure Checklist forwarded to the parties after the Director of FINRA Dispute Resolution Services (the "Director") makes appointments. Under Rule 12405, "[e]ach potential arbitrator must make a reasonable effort to learn of, and must disclose to the Director, any circumstances which might preclude the arbitrator from rendering an objective and impartial determination in the proceeding." As FINRA's training materials put it, "[d]isclosure includes any relationship, experience and background information that may affect—or even appear to affect—the arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision." Your Duty to Disclose at 8. Rule 12405(a) lists four non-exhaustive categories of potential neutrality conflicts: (1) financial or personal interests in the outcome; (2) past or present relationships with a party, party representative, or witnesses; (3)

connections through the arbitrator's family, employer, partners, or business associates; and (4) current or past service as a mediator for any of the parties.

Absent new information or a change or arbitrator, parties have at least two opportunities to ask for arbitrator disclosures of their own initiative, in a kind of FINRA *voir dire*: first, by writing to the Director at any time under Rule 12403(b)(2) and second, live at the IPHC hearing before confirming acceptance of the panel. At the IPHC, the examination is limited in scope to additional disclosures related to the arbitrator's background and potential conflict information, and the rules do not clearly require a candidate arbitrator to disclose anything further. In practice, whether wise or not, actual examination of arbitrators' backgrounds at this stage is rare and generally would occur only if some information has already come to light to raise a party's suspicions. Written questions, however, may be raised at any time—before or after the panel is accepted and whether a question of bias has been raised or not—and the Director is often willing to provide anonymity to the party who inquires.

FINRA's procedure is structured so as to head off further challenges to a panel's composition early on in a case. Near the beginning of the IPHC, the chair will ask for any further disclosures from the arbitrators, then ask the parties to confirm acceptance panel of arbitrators. *See* FINRA*,* Initial Pre-Hearing Conference Arbitrator's Script at 2 (January 28, 2022), *available at* https://www.finra.org/sites/default/files/iphc_script.pdf (last visited July 27, 2023). When a party consents to the composition of a panel, they likely waive the right to challenge an arbitrator later over information they knew or could reasonably have discovered by inquiry at the IPHC. By the same token, however, when an arbitrator says they have nothing further to disclose, the parties are entitled to rely on their statement, and anything they unreasonably failed to uncover or mention is still grounds for removal. It appears that no case law or statement from FINRA speaks explicitly to the question of whether or how a party is estopped from further challenging an arbitrator for information that might have come up at an IPHC. But because of this early-waiver procedure, where both the arbitrator

and the parties are asked to say that there is no further information to disclose and no further challenge, the scope of any challenge *after* an IPHC is generally limited to new information, or information newly relevant because of a development in the case.

Recusal and Removal

Under the FINRA rules, parties to an arbitration may for "cause" move for the recusal or removal any arbitrator empaneled in their case. In general, a movant party has two ways to challenge an empaneled arbitrator after the IPHC: first, it can file a motion to recuse in the case under Rule 12406, which reads in its entirety that "[a]ny party may ask an arbitrator to recuse himself or herself from the panel for good cause. Requests for arbitrator recusal are decided by the arbitrator who is the subject of the request." Alternatively, the movant party can submit what the Arbitrator's Guide calls a "challenge for cause" to remove an arbitrator with the Director under Rule 12407. *See* Arbitrator's Guide (the "Guide") at 19. The standard governing these requests for removal changes depending on whether the first hearing session has already begun at the time the Director decides the request.

Under Rule 12407(a), which applies before the first hearing session begins, removal is appropriate where "it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration." That interest or bias must be "definite and capable of reasonable demonstration, rather than remote or speculative." There is no exhaustive list of what shows a definite and demonstrable bias or interest, but the Director should resolve "close questions" in favor of the customer.

If parties cannot obtain a decision from the Director before the beginning of a hearing, they lose[1] the ability to challenge an arbitrator on general grounds or bias, interest, and partiality. After the

[1] While it is tempting to say parties *waive* other grounds, Rule 12407 is structured around the time of the Director's decision, not the time of the party's challenge. However, a panel that refuses to delay a hearing when there is a pending challenge runs into the teeth of the Federal Arbitration Act, which provides that a court may

hearing has begun, removal is strictly limited to cases where there is "information required to be disclosed under Rule 12405 that was not previously known by the parties." Rule 1407(b). This limitation "prevents parties from raising challenges late in the process that should have been raised at the outset." Arbitrator's Guide at 22. The rule—and the Guide—are silent as to whether the failure to disclose alone is grounds for removal or whether the information withheld must rise to the level of a definite and demonstrable bias or interest. Neither does it appear that the Director or the courts have spoken to the issue.

Challenges for Cause

Rule 12407 does not lay out what shows a definite and demonstrable bias or interest even in general terms. A few sources of authority shed light on the meaning of the rule, however. First, the Guide provides examples, grouped into seven categories:

- **Opinion and Bias**: an arbitrator's "firm opinion or belief" or "personal bias" regarding a party or their representative may be cause for removal. The Guide does not say so, but this may extend to particularly firm opinions about how the law and FINRA rules should be interpreted in a case.
- **Personal Relationships**: The Guide cites only blood or marriage relationships with parties, attorneys, or witnesses—and guardianship relationships only as to parties.
- **Business Relationships**: current and former business partnerships, customer/client relationships, or debtor/creditor relationships may be disqualifying.
- **Current Involvement**: litigation adversity may be disqualifying.

vacate an arbitration award where the arbitrators are "guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown." 9 USC § 10(a)(3).

- **Previous Involvement**: Past motions to vacate against the arbitrator, past complaints by the arbitrator against the respondent, or involvement with a law firm previously adverse to the party may be disqualifying.
- **Financial Interest**: Individually or as a fiduciary, a financial interest in the subject matter or in a party to the subject matter may be disqualifying. (But merely holding an account with a respondent member brokerage is generally not enough to create a financial interest.)
- **Expert Witnesses**: An arbitrator's past experience as an expert witness adverse to a party may be disqualifying.

Each of these categories extends to present and past relationships and interests, generally with a five-year look-back period according to the Guide.

The Guide also cites to the ABA Code of Ethics for Arbitrators in Commercial Disputes (the "Code of Ethics"), which discusses an arbitrator's ethical duty to serve impartially and independently. *See* Guide at 19; Code of Ethics Canon I. The Code of Ethics extensively discusses bias and its appearance with substantial citations to case law on vacatur. Ultimately, the Code serves as a kind of hornbook on avenues of vacatur because of arbitrator malfeasance. Because of the preoccupation with avoiding vacatur, the Code prescribes a high standard for arbitrators to follow and is a useful starting point for research in support of any challenge for cause. For example, the Code points out that even failure to truthfully answer a disclosure questionnaire may create an appearance of bias sufficient for vacatur. *See Alim v. KBR (Kellogg, Brown & Root)-Halliburton*, 331 S.W.3d 178 (Tex.App. 2011).

Finally, as discussed above, Rule 12405(a) *does* contain four categories of "circumstances which might preclude" neutrality for which disclosure is required. It might be natural to think that Rule 12405 "circumstances which might preclude [neutrality]" is no less broad a category than Rule 12407(a)'s definite and demonstrable biases—after all, most arbitrators have disclosures to make, but few are so

conflicted that they have definite biases—but the Guide contains different categories of bias than Rule 12405. At least three have no direct correlate in Rule 12405: litigation adversity, expert witness experience, and opinion and bias separate from any personal relationship. For this reason, any party bringing a late-game challenge under Rule 12407(a) might do well to argue that bias is by no means limited to the Rule 12405 disclosure categories. Even if disclosure of an arbitrator's background and experience and acceptance by the parties can cure some potential biases at an IPHC, it does not exhaust the universe of biases that amount to good cause for removal. Otherwise, Rule 12407(b) would not actually narrow the scope of challenges after the beginning of a hearing, as FINRA says it does. *See* Guide at 22.

Vacatur

Ultimately, FINRA arbitrations exist to deliver efficient and equitable final awards that are safe from vacatur under the Federal Arbitration Act, 9 U.S.C. ch. 1 *et seq*. "[E]vident partiality or corruption" among the arbitrators is one of the statutory grounds for a motion to vacate, so even if the Director denies a challenge for cause under the FINRA rules such as they are, this separate statutory standard may provide parties relief from an award issued by a rogue arbitrator. For example, the fact of an arbitrator's disclosure and the parties' acceptance of the panel at the IPHC may estop a challenge for cause within FINRA, but courts have found that evident partiality cannot be avoided by full disclosure. *See, e.g.*, *Borst v. Allstate Insurance Company*, 291 Wis.2d 361, 717 NW2d 42 (2006). In addition, courts have granted vacatur on grounds that the FINRA materials do not appear to address: even where there is no close relationship or financial interest involved, for example, a neutral arbitrator's failure to disclosure that she had considered very similar issues in a previous case involving one of the same parties—and decided for that party—was sufficient to create "evident partiality." *See Dealer Computer Services, Inc. v. Michael Motor Company, Inc.*, 2010 WL 5464266 (S.D.Tex. 2010). This is

highly relevant where, as in customer cases before FINRA, repeat arbitrators often consider allegations against repeat firms regarding the same products and legal theories.

Even where a suit for vacatur is impractical or distant, the body of case law that vacatur creates is useful authority in corralling rogue arbitrators who threaten to introduce bias to a proceeding. The last thing FINRA or any of its arbitrators should want is to face vacatur, particularly after they denied a party's reasonable challenge for cause. FINRA suffers as a forum for dispute resolution if there is doubt as to whether its awards will simply be vacated in court—and inattention to concerns of arbitrator bias creates this doubt. Unlike a court backed by the final power of the state, the equitable private forum is only as good as its reputation for certainty and fairness. A party is within its rights to speak up whenever the background or conduct of an arbitrator threatens that reputation—indeed, it does the forum a favor.

Best Practices & Conclusion

Fighting arbitrator bias begins with the diligence of the parties. Reviewing arbitrator disclosures and accepting the composition of the Panel is not a mere formality, but the beginning of an adversarial process of selecting decisionmakers that is crucial to the outcome of each case. Even if full-dress *voir dire* is not available in FINRA, an advocate should approach inquiries about a panelist's background and biases with the same level of seriousness and use all available avenues to gather information about the panelists. Once a case is underway, an arbitrator's newly evident connections to case parties or witnesses—or the arbitrator's strong views with respect to a matter—are not unavoidable bad luck, but may form the basis for a motion to remove or recuse. In many instances, it will be wise to ask for more information from the arbitrator in parallel with a challenge for cause so that even if the Director denies the challenge at first, new information may provide parties a basis to renew it. Then, only after all information has been gleaned and the Director has not provided relief, a

party may ask an arbitrator directly to recuse themselves.[2] In all events, an advocate should make their record at all stages of the arbitration and alert the panel and the Director to the risk of vacatur. Arbitrators are human and it is in the nature of FINRA arbitration that they will often be unpredictable, but the tools exist for an advocate to get the information and create the certainty they need to resolve their case.

[2] This of course will depend on whether the arbitrator appears determined to stay on the panel or not. An arbitrator concerned with reputational effects or the mere appearance of bias may be amenable to a motion to recuse before an advocate makes a challenge for cause with the Director.

THE NEW EXPUNGEMENT RULES

David E. Robbins[1]

On April 12, 2023, the Securities and Exchange Commission ("SEC") approved FINRA's major "modification" to "the current process relating to the expungement of customer dispute information."[2] This article explains what the SEC approved, the implications for financial advisers seeking such "extraordinary relief"[3] and recommendations for participation by customers and their attorneys in the process. The new rules will have an impact on brokers' publicly available Central Registration Depository (CRD) records. Throughout this article, references will be made to specific statements in FINRA's rule filings with the SEC, its training of arbitrators for these cases and the SEC's approval Release. FINRA has not yet established an effective date for the new rules, but it is anticipated that they will soon become effective in a Regulatory Notice.

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1. © 2023 David E. Robbins. of Kaufmann Gildin & Robbins LLP, is a founding member of PIABA and is the recipient of PIABA's James Beckley Golden Bowtie Award. This is his 15th Law Journal article. He represents investors, brokers and firms. He is on the Board of Editors of the *PIABA Bar Journal* and of *Securities Arbitration Alert* and is the author of the Securities Arbitration Procedure Manual (5th ed. 2022) and The New York Practitioners Guide to Securities Arbitration and Mediation, Supp. Prac. Comm., N.Y. Gen. Bus. Law Ch. 20, Art. 23-A (McKinney 2023). Mr. Robbins thanks his friend and fellow *Bar Journal* board member John Sutherland for editing this work, especially his suggestion of adding a table of contents.

2. FINRA's April 3, 2023 Rule Filing With the SEC, *available at* https://www.finra.org/sites/default/files/2023-04/sr-finra-2022-024-partial-amendment-2.pdf; FINRA's April 3, 2023 Comment Letter to the SEC ["April 3, 2023 Letter"], *available at* https://www.sec.gov/comments/sr-finra-2022-024/srfinra2022024-20163319-333785.pdf; and SEC's April 12, 2023 Approval of Rule Changes ["SEC Approval"], *available at* https://www.sec.gov/rules/sro/finra/2023/34-97294.pdf. *See also* FINRA's 2022 Discussion Paper on Expungement [Discussion Paper], *available at* https://www.finra.org/sites/default/files/2022-04/Expungement_Discussion_Paper.pdf.

3. *See* April 3, 2023 Letter at 3, *supra* note 2 ("FINRA is concerned that the current expungement process is not working as intended as a remedy that is appropriate only in extraordinary circumstances in accordance with the narrow standards in FINRA rules.").

What is in this Article?

Since many subjects are covered in this article, a table of contents of sorts is called for:

I. Overview – The five major distinctions between the process for the new expungement arbitration rules and other customer-related FINRA arbitrations.

II. The Applicable FINRA Rules – The Customer Code and the Industry Code.

III. The Three Expungement Grounds

A. The claim, allegation or information is factually impossible or clearly erroneous.

B. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds.

C. The claim, allegation or information is false.

IV. Balancing Competing Interests – Securities regulators, investors, broker-dealers and the brokerage community.

V. How Expungement Requests Began

VI. Who Decides Expungement Cases?

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XIV. Conclusion – Why the SEC Approved the New Rules

I. Overview – Major Distinctions

There are at least five major distinctions between the process for the new expungement arbitration rules and other customer-related FINRA arbitrations:

1. *Rules of Repose* – The inapplicability of the six-year arbitrability rule to expungement requests.
2. *Agency Selection* – The elimination of party selection of arbitrators for "straight-in" expungement requests.
3. *Unanimous Vote* – The requirement of a unanimous decision to grant such relief, instead of awards by majority vote.
4. *Forfeiture* – The distinct possibility of the forfeiture of an adviser's right to expungement.
5. *State Regulators* – The participation by an authorized state securities regulator in "straight-in" expungement arbitrations.

II. The Applicable FINRA Rules: The Customer Code and the Industry Code

In its April 2023 approval of the new expungement rules, the SEC made this distinction between the two arbitration codes:

- "The Customer Code, which comprises the series of rules governing customer arbitrations, governs expungement requests filed by firms or associated persons during customer arbitrations."
- "In contrast, the Industry Code comprises the series of rules governing arbitrations for disputes between or among industry parties, such as between a broker-dealer and an associated person, including straight-in [expungement] requests."

- "As a result, whether an expungement request is governed by the Customer Code or Industry Code will generally depend on whether the request is filed during a customer arbitration or is a straight-in request filed by the individual broker against the firm separately from a customer arbitration."[4]

III. The Three Expungement Grounds

Shifting Burden of Proof - While the burden of a customer is to prove to a *majority* of the arbitration panel that actionable misconduct directly gave rise to quantifiable financial damages (based on a preponderance of the evidence), for an expungement to be granted, the burden is on the financial adviser to prove a negative to a *unanimous* panel – that one of three grounds exists (and is supported by the preponderance of the evidence).

In FINRA's website *Frequently Asked Questions About FINRA Rule 2080 (Expungement)*[5] and in the training of its arbitrators, the following examples are given for the three grounds:

A. The claim, allegation or information is factually impossible or clearly erroneous.

1. The training material states: "The 'factually impossible or clearly erroneous' standard has clear meaning to regulators and public investors. For example, if the evidence shows that the broker was not even employed by the securities firm during the relevant time period, the arbitrators could find that they were erroneously named in the arbitration claim, dismiss the claim against the individual and

4. *See* SEC Approval at 3-4, *supra* note 2. *See also* FINRA, Rule 12805 (setting forth in the Customer Code the requirements arbitrators must meet to issue an expungement Award containing expungement of customer dispute information); FINRA, Rule 13805 (providing "Straight-In Request" requirements in the Industry Code); FINRA, Rule 12800(d) (handling of expungement requests in "simplified customer arbitrations"); FINRA, Rule 2080 ("Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System").

5. *See Frequently Asked Questions About FINRA Rule 2080 (Expungement), available at* https://www.finra.org/registration-exams-ce/classic-crd/faq/finra-rule-2080-frequently-asked-questions.

recommend expungement of any mention of the claim from the CRD record under this standard."

2. The online training module adds: "An example would be if a broker was not employed at the time of issue and was therefore erroneously named."

B. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds.

1. The training material provides: "The above standard would require an affirmative arbitral or judicial finding that the broker was not involved in any of the activities listed above. This list of activities is taken from Question 14 of Form U-4, which specifies the types of customer complaints that registered persons must report. Therefore, if arbitrators make the required finding, no logical basis would exist for keeping the reported claim on an individual's CRD record."
2. The online module states: "These are Form U-4 Reportable Complaints – investment related sales practice violation, forgery, theft, misappropriate or conversion of funds."[6]

C. The claim, allegation or information is false.

1. Here, arbitrators will: (a) assess the evidence in the case, (b) make an affirmative finding that the claim. allegation or information is false and (c) if warranted, order expungement relief. This is the ground customer attorneys should have the greatest trouble with since it contradicts the allegations in most Statements of Claim.
2. The training material states: "This basis for expungement is premised on a finding that the claim, allegation or information given was false. Arbitrators should make such a finding only after considering the merits of the allegations against the broker or securities firm. For example, if the customer alleged that the broker made unauthorized trades and the broker provided evidence contrary to this claim, such as a document signed by the

6. *See* FINRA, Form U-4, *available at* https://www.finra.org/sites/default/files/form-u4.pdf.

customer directing the trades, arbitrators could find that the claim or allegation was false."

3. The online module adds: "Consider the merits of the allegations and evidence contracting the claim."

IV. Balancing Competing Interests

In its SEC filing and in the Federal Register Notice,[7] FINRA stated that the expungement rules seek to balance the interests of:

1. *Securities regulators* in having accurate and relevant information to fulfill their regulatory responsibilities, what FINRA refers to throughout its filing as "maintaining the integrity of information in the CRD system;"
2. The interests of *investors* in having access to accurate and meaningful information about associated persons with whom they may entrust their money;
3. The interests of *broker-dealers* in having accurate information for use in making informed employment decisions; and,
4. The interests of the *brokerage community* in having a fair process to address inaccurate customer dispute information.

V. How Expungement Requests Began

The process of seeking expungement through FINRA began when brokers who were not found liable in a customer arbitration asked arbitration panels to expunge the underlying customer dispute from the CRD system.

Separate and apart from customer arbitrations, so-called "straight-in requests" were found by FINRA, as stated in its Initial SEC Filing, to "present inherent difficulties and panels deciding straight-in requests issue awards containing expungement relief more often than panels deciding expungement requests made in customer arbitrations."

7. *See supra*, n.2.

VI. Who Decides Expungement Cases?

A. What is the composition of the panels?

1. *Special Arbitrator Roster* – For all straight-in expungement requests, FINRA will select three arbitrators from the Special Arbitrator Roster, but the parties will not be able to strike and rank a longer list, as they do for all other FINRA arbitrations.
2. *Regular Panels* – For pending customer arbitrations, the typical customer arbitration panel will decide the expungement request unless the case settles or is withdrawn prior to the issuance of an award. If the case settles, three arbitrators from the Special Arbitrator Roster will decide the expungement request in a new, straight-in arbitration (except for Simplified Arbitrations).

B. Why can't parties select arbitrators for Straight-in Expungement cases?

"To minimize the potential for influence in the arbitrator selection process by the associated person and member firm, whose interests may be aligned, and to help ensure the development of a more complete factual record," wrote FINRA in its Initial SEC Filing, "the … rule change …. requires a NLSS to select randomly the three public chairpersons from the Special Arbitrator Roster."

"FINRA believes that the higher standards that the arbitrators must meet to serve on the Special Arbitrator Roster should mitigate the impact of the absence of party input on the selection of arbitrators. In addition. associated persons and member firms would still be permitted to challenge any arbitrator for cause."

C. Who will be on the Special Arbitrator Roster?

Public arbitrators (a) who are eligible for the chairperson roster, (b) who have successfully completed enhanced expungement training and (c) who have served as an arbitrator through award on at least four customer arbitrations in which a hearing was held.

D. What does Training Consist of?

"The public chairpersons must have evidenced successful completion of, and agreement with enhanced expungement training provided by FINRA, which will be expanded for arbitrators seeking to qualify for the Special Arbitrator Roster," wrote FINRA in its Initial SEC Filing.

FINRA added: "This would allow FINRA to further emphasize with the arbitrators on the Special Arbitrator Roster the unique, distinct role they play in determining whether to issue an award containing expungement relief and that expungement should be issued in limited circumstances and only if the arbitrators unanimously find that the information to be expunged is factually impossible, clearly erroneous or false, or that the associated person was not involved in the alleged misconduct."

VII. New Procedural Hoops

A. Request or Forfeit

In a customer arbitration in which the financial adviser is a named Respondent, the request to expunge must be contained either in the Answer (filed on the Portal within 45 days upon receiving the Statement of Claim) or by separate pleading (to be submitted on the Portal no later than 60 days before the first scheduled hearing).

Warning: Failing to do this *will* result in an adviser's forfeiture of an expungement request.

B. On-Behalf of Requests

If the person is not a named Respondent in the customer arbitration and if a party (e.g., brokerage firm) wishes to have that panel decide the expungement request, the so-called "unnamed person" (the financial adviser) must sign a FINRA Dispute Resolution Services submission form agreeing to be part of the arbitration, along with the requesting party. This "on-behalf of" request must be filed no later than 60 days before the first scheduled hearing.

C. Caveat

An "unnamed person" (the financial adviser who is not a Respondent) is not required to take part in the customer arbitration for expungement purposes and may, instead. file a separate, straight-in case before a Special Arbitrator Roster. In this instance, the "unnamed person" – unlike a "named person" – would not forfeit his/her right to seek expungement.

D. Six Things That Must Be Contained In All Expungement Requests

1. The applicable filing fee under the Codes.
2. The CRD number of the party requesting expungement.
3. Each CRD "Occurrence" number that is the subject of the request (and which appears on the adviser's FINRA Financial Professional Gateway (FinPro) report,[8] not found on the Broker Check Report.)[9]
4. The case name and docket number associated with the customer dispute information.
5. An explanation whether expungement of the same customer dispute information was previously requested and, if so, how it was decided.
6. Which of the three grounds for expungement apply and why.

E. The Seven Situations that will bar filing Straight-In Expungement Requests

1. Prior Arbitration*:* A panel held a hearing to consider the merits of the associated person's request for expungement of the same customer dispute information.
2. Res Judicata: A court of competent jurisdiction previously denied the associated person's request to expunge the same customer dispute information.
3. Pending Action*:* The customer arbitration, civil litigation or customer complaint associated with the customer dispute

8. *See* Financial Professional Gateway (FinPro), *available at* https://www.finra.org/registration-exams-ce/finpro.

9. *See* FINRA, BrokerCheck, *available at* https://brokercheck.finra.org/.

information is not closed.

4. 2 Year Rule of Repose for Actions*:* More than two years have elapsed since the customer arbitration or civil litigation associated with the customer dispute information has closed.
5. 3 Year Rule of Repose for Complaints*:* There was no customer arbitration or civil litigation associated with the customer dispute information and more than three years have elapsed since the date the customer complaint was initially reported to the CRD system.
6. Forfeiture*:* A named person is prohibited from seeking expungement because he/she did not request expungement in the customer arbitration pursuant to Rule 12805(a)(l)(A).
7. Regulatory Action – In its April 2023 amendment to the Initial Filing with the SEC, FINRA added this seventh restriction: "An associated person shall not file a claim requesting expungement of customer dispute information from the CRD system against a member firm at which the person was associated at the time the customer dispute arose if the customer dispute information involves the same conduct that is the basis of a final regulatory action taken by a securities regulator or self-regulatory organization." [10]

F. An Ironic Twist to a Time Restriction

Claimants can bring a FINRA arbitration as long as the arbitrators find that the six-year rule of arbitration eligibility has been complied with – as provided in Rules 12206 and 13206.

But not straight-in expungement Claimants; they are bound by either the two-year or three-year rules of repose.

What happens if the financial adviser brings a successful straight-in expungement case and prevails? Does that prevent the customer from thereafter bringing a case?

No, according to FINRA's Initial SEC Filing: "As a result of this six-year eligibility rule, a customer arbitration may be filed after an associated person

10. However, if the person is successful at appealing a final regulatory action, he/she may file a claim requesting expungement involving the same conduct that is the basis of the final regulatory action, provided that the request is not otherwise ineligible for arbitration, including time barred. *See* April 3, 2023 Letter at 23, *supra* note 2.

has filed and received an award in connection with a customer complaint associated with the customer arbitration."

"To avoid unfairly impacting a customer arbitration filed after a panel has issued an award on a request to expunge a customer complaint associated with the customer arbitration, the … rule change provides that a prior expungement award shall not be admissible in the customer arbitration."

VIII. Making Sure Financial Advisers Know of Arbitrations and Complaints

In FINRA's April 3, 2023 follow-up letter to the SEC ("Letter"), it recognized the possibility that financial advisers may not be aware of: (a) customer complaints and/or (b) that a customer arbitration closed in which they were not a named Respondent. This is important because under the new rules, advisers have only two years to file an expungement request from the closure of an arbitration and three years from the brokerage firm's receipt of a customer's complaint. FINRA deals with these possibilities as follows:

A. Notifying Financial Advisers About the Arbitration's Close

- "There could be instances when associated persons may not be aware that a customer arbitration has closed, and that the two-year time limit for requesting expungement of customer dispute information has begun to run."
- "Accordingly, … FINRA will update the cover letter that is provided by Dispute Resolution Services (DRS) to Respondents once a Statement of Claim has been filed ("cover letter") to explain that:
  (a) an associated person is prohibited from filing a straight-in request while a customer arbitration or civil litigation associated with the customer dispute information that is the subject of the straight-in request is pending; an associated person is permitted to file a straight-in request within two years of the close of a customer arbitration or a civil litigation associated with the customer dispute information, unless such request is barred under the Industry Code; and,
  (b) associated persons may remain apprised of the status of the customer arbitration, including case closure, by contacting the parties to the arbitration or DRS."

- "FINRA will publish guidance on its website about the changes to the Codes that will include information about how associated persons can remain apprised of the status of a customer arbitration, including through contacting DRS."[11]

B. Customer Complaints – No Notification Required

- "As a result of the three-year time limitation, an associated person may be prevented from filing a request for expungement of customer dispute information because the member firm's investigation of the customer complaint has not concluded and, therefore, the customer complaint associated with the customer dispute information has not closed."
- "FINRA believes that the three-year time limitation would generally provide sufficient time for firms to complete their investigation of the complaint, and for associated persons to develop a sense of whether the complaint may evolve into an arbitration or civil litigation and to gather the necessary resources and determine whether to request expungement."
- "In the event that an associated person is prevented from filing a request for expungement of customer dispute information in the DRS arbitration forum because of the three-year time limitation, the associated person could seek a court order directing expungement of the customer dispute information."[12]

IX. Third-Party Participants – Customers and Regulators (Since Customers Rarely Appear)

Customers have always been encouraged to participate in expungement hearings, but few do – especially after they settle. The new rules: (a) make it easier for customers to play an important role in the expungement process and (b) provide for a new person to attend, whether customers appear or not. For the first time in FINRA's arbitration history. a non-party (an "authorized representative of state securities regulators") may take an active role at straight-in hearings.

A. Customer Participation

11. *See* April 3, 2023 Letter at 9-10, *supra* note 2.

12. *Id.* at 10-11.

- *Notification to Customers:* The new rule requires the financial adviser and the Director to notify all customers whose customer arbitrations, civil litigations or customer complaints are a subject of the expungement request, of: (a) the time, (b) date and (c) place of any prehearing conferences and the expungement hearing. (It is hoped that the Director will also notify their counsel-of-record.)
- *No Compulsion* – "FINRA does not believe customers should be compelled to attend or participate in a separate proceeding to decide an expungement request after the customer has resolved [his/her] arbitration claim or civil litigation."[13]
- *The Breadth of Customer Participation* – In its Initial Filing with the SEC, FINRA stated that, at the hearing, arbitrators should allow customers and their representatives to appear, customers to testify (telephonically, in person, or other method), to introduce documents and evidence, to cross-examine the associated person or other witnesses called by the party seeking expungement and to make opening and closing statements.
- *No Intervening in Customer Arbitrations to Request Expungement*

Neither FINRA nor the SEC favor the ability of a financial adviser to intervene in a pending customer arbitration in which that adviser is not a Respondent and expungement is not sought:

- *FINRA*– "If the associated person is neither a party to the arbitration nor the subject of an on-behalf-of request by another party to the arbitration, FINRA continues to believe that the associated person should not be able to intervene in the customer's arbitration to request expungement."[14]
- *SEC* – "The rule change provides 'that if an associated person is not a party to a customer arbitration (i.e., they are an unnamed person), and no party to the customer arbitration requests expungement on their behalf, the unnamed person would be prohibited from intervening in the customer arbitration to request expungement.' Instead, the unnamed person would be able to file the request as a new claim against the member firm at which the person was associated at the time the customer dispute arose under … Rule 13805 [of] the Industry Code, and a panel from the

13. *See* April 3, 2023 Letter at 6, *supra* note 2.

14. *Id.* at 8.

Special Arbitrator Roster would decide the request."[15]

B. Securities Regulator Participation

1. *The Extent of the Regulators' Participation*

According to FINRA's Initial SEC Filing, "The authorized representative will be permitted to:

a. Introduce documentary, testimonial or other evidence;
b. Cross-examine witnesses; and,
c. Present opening and closing arguments if the panel allows any party to present such arguments.

The other persons appearing at the expungement hearing can state objections to the authorized representative's evidence and cross-examine the authorized representative's witnesses."

Here is what the SEC has to say about the involvement of state regulators in expungement proceedings:

a. *Certain Cases* – "The rule change would limit attendance and participation by an authorized representative to straight-in requests."[16]
b. *Time Limit* – "If the Director receives notification from an authorized representative no later than 30 days after the last answer is due that the authorized representative intends to attend and participate in the expungement hearing, the … rule change … requires the Director to notify the authorized representative of the time, date and place of any prehearing conferences and the expungement hearing."[17]
c. *Low-Cost Options* – "FINRA acknowledged that in-person attendance and participation by an authorized state representative may be limited given state resource constraints. FINRA pointed out that the … rule change provides low-cost options to help facilitate state participation; specifically, that it would permit the authorized representative to attend and participate via video conference or submit a state's position in writing."[18] -
d. *Why the SEC Endorsed Regulator Participation*

15. *See* SEC Approval at 19, *supra* note 2.

16. *See* SEC Approval at 46, *supra* note 2.

17. *Id.*

18. *Id.* at 91.

1. "The Commission believes that permitting attendance and participation by state securities regulators in straight-in expungement proceedings, which have a higher likelihood of proceeding unopposed, and providing state regulators low-cost options to do so, will enhance the straight-in expungement process."[19]
2. "[I]ncluding state securities regulators and providing them with access to documents relevant to the expungement request provides them the opportunity to fulfill their own regulatory obligations, while at the same time increasing the likelihood that the panel in an expungement proceeding will hear evidence from multiple viewpoints, thus allowing the panel to make more informed decisions."[20]

e. *Why FINRA is Permitting Regulator Participation*
   1. While FINRA and the SEC expanded on this issue in subsequent filings, in its Initial Filing, FINRA gave these reasons: "[A]llowing an authorized representative to attend and participate in straight-in requests may provide meaningful opposition to the expungement request, which might otherwise be unopposed, and thus help create a more complete factual record for the panel to rely upon to decide the expungement request."[21]
   2. Further, stated FINRA: "NASAA and state securities regulators have a shared interest with FINRA in protecting the integrity of the information contained in the CRD system, as it is a crucial tool in their registration and oversight responsibilities."[22]

Regulator participation will also have a chilling effect on financial advisers who are considering seeking expungement relief.

Notifications to State Securities Regulators: According to the SEC's approval Release, FINRA will be required "to notify state securities regulators, in the manner determined by the Director in collaboration with state securities regulators, of an expungement request within 15 days of receiving an expungement request. FINRA stated that the notification requirement would help ensure that state securities regulators are timely notified of expungement

19. *Id.* at 92.

20. *Id.*

21. *Id.* at 47.

22. *Id.* at 47 n.197.

requests."[23] Notification to state regulators by the Director would help – in FINRA's opinion – to ensure that they are timely notified of expungement requests.

X. The Critical Role of Customers in Expungements

In 2016, the *PIABA Bar Journal* published my article, "Challenging Expungements After Settlements."[24] It expressed the importance for customers and their counsel to participate in the expungement process. The cornerstone of that 2016 article is as relevant now as it was then: customers and their counsel can and should play a critical role in expungement proceedings.

A. Overview

Once a case has been settled on financial terms, should a broker secure expungement relief of that case without any input from the individual who had, according to the Statement of Claim, been the victim of the broker's misconduct? Should customers challenge brokers' efforts to expunge settled arbitrations? These are questions central to the integrity of FINRA's securities arbitration process.

At the October 2016 PIABA annual conference in San Diego, a panel dealt with the question of whether customer attorneys should challenge requests by brokers to expunge a settled arbitration. A number of PIABA members expressed reluctance to participate in expungement hearings to challenge expungement requests once a case was settled because, they said, their contingency retention compensation arrangements did not encompass such services after settlement. In other words, they would not receive any additional compensation for preparation or participation in an expungement hearing.

In the 2016 *PIABA Bar Journal* article, four situations were presented where a customer's attorney should consider participating in an expungement hearing after reaching a settlement, despite the fact that the customer's attendance is not mandatory under the Customer Code of Arbitration. The article suggested that the purpose of such participation is twofold:

1. To recover losses suffered by the clients.

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23. *Id.* at 45.

24. David E. Robbins, *Challenging Expungements After Settlements*, 23 PIABA B.J. 387 (2016).

2. To discourage the recurrence of the misconduct.

Deterrence is often achieved with a significant arbitration award. Should customers settle (and most do), rendering a prospective award moot, FINRA provides customers with an opportunity to discourage similar alleged misconduct against other customers. Instead of "taking the money and running," more customers should, in appropriate circumstances, show up and be heard at expungement hearings. FINRA encourages them to do so and if customers participate in such hearings, fewer expungement requests will be granted.

B. Recommendations

Premise – Your client settled the arbitration prior to the hearing and executed a settlement agreement. You deposited the settlement check into your firm's Special Account, paid the client, took your fee and moved on to the next case. Then your client receives notice from the broker and his/her brokerage firm that the broker has filed a straight-in arbitration seeking expungement relief.

Question – Should your client testify at the hearing, with or without you as counsel, recognizing that the settlement agreement will be entered into evidence and the client will be subject to questions from the broker's attorney and from the arbitrators?

Answers -

1. Broker as Respondent – Intentional Misconduct

If you named the broker as a Respondent and believe you could have met the burden of proof that intentional sales practice abuses directly resulted in your client's losses (even though now satisfied through settlement), the client should testify if the client believes the case should remain on the broker's Broker Check Report, so that other customers and potential customers will have proper warning.

2. Broker as Respondent – Unintentional Misconduct

If you named the broker as a Respondent but believe the broker's misconduct was based on negligence and the brokerage firm's failure to properly train and supervise him/her, there may be a question whether your

client would have met his/her burden of proof at the arbitration hearing. If your client wants other customers and potential customers of the broker to make similar complaints and/or move their accounts away from the broker – even if the broker's conduct was based on negligence – the client should testify because the allegations were not, in his/her opinion, false.

3. Product Cases

If you named the broker as a Respondent in a "product case" (which may have been a tactical and procedural mistake on your part) and believe the broker's misrepresentations were based on the firm's misconduct (e.g., failing to disclose to its brokers the inherent risks of the product or strategy and encouraging its brokers to nevertheless solicit the product/strategy to as many clients as possible), serious thought should be given to participating in the hearing *but* joining the broker in the expungement request. This was done as a matter of routine – with clients' authorization – in auction rate securities cases, even when the broker was not named as a Respondent (because the case was on the broker's Broker Check Report).

4. Broker Not Named as a Respondent

If you did not name the broker as a Respondent but the firm still (as is required) amended the broker's U-4 and therefore the Broker Check Report, you may want to take a pass at participating in the hearing. If you did not believe the conduct justified naming the broker as a Respondent, it may be considered hypocritical of you to now insist on the case remaining on the broker's record after your client agreed to settle the arbitration with the brokerage firm and possibly other brokers who were named as Respondents.

XI. The Unanimous Award and What Happens Next

The granting of an expungement request must now be by the unanimous vote of the arbitrators, although that is not the case for other FINRA arbitrations or FINRA disciplinary proceedings. Why is that so?

- *Other Cases* – FINRA awards are decided by majority vote in accordance with Customer Code Rule 12904 and Industry Code Rule 13904, as are all FINRA disciplinary decisions pursuant to Rule 9268. Until the new FINRA rules, that was the rule for all expungement

requests.

- *Outlier* – Now, however, arbitrators may not grant expungement requests by majority vote; the award must be unanimous. Nor can the granting of expungement request just cite one or more of the grounds for expungement; more is required.
- *How Come?* According to its Initial SEC Filing, "FINRA believes that this change would help protect the integrity of the information in the CRD system and help ensure that the expungement process operates as intended-as a remedy that is appropriate only in limited circumstances in accordance with the narrow standards in FINRA rules."

In addition, said FINRA: "The panel's explanation must be complete and not solely a recitation of one of the FINRA Rule 2080(b)(1) grounds or language provided in the expungement request. The panel's explanation should identify any specific documentary, testimonial or other evidence on which the panel relied in awarding expungement relief."

The SEC Speaks on Expungement Awards – The SEC added this justification for approving the unanimous vote rule: "Requiring a unanimous decision will help enhance the integrity of the information in the CRD system by helping ensure expungement will only be awarded when there is no disagreement among the arbitrators that the factual record supports it. The importance of the CRD system extends to all aspects of regulation of broker-dealers and registered representatives. … For these reasons, the importance of the integrity of information in the CRD system militates against awarding expungement in circumstances where there may be disagreement about the merits of a claim."[25]

The Ironic Expungement Award – While the goal of the broker is to get the arbitration and/or complaint removed permanently from the broker's public record, even if the broker is successful, the award itself remains publicly accessible on FINRA's online website.

After the Request is Granted –

1. In its April 2022 *Discussion Paper on Expungement,* FINRA dealt with the expungement process *after* a favorable award is rendered. "FINRA will not expunge customer dispute information from the CRD system based on an arbitration award unless that award is confirmed by a court of competent jurisdiction."[26]
2. Before seeking the award's confirmation in a court of law as a judgement, FINRA should be requested by the financial adviser to

25. *See* SEC Approval at 126-127, *supra* note 2.

26. *See* Discussion Paper at 4, *supra* note 2.

waive participation in the court proceeding.

3. Effective March 16, 2023, FINRA no longer accepts Rule 2080 waiver requests via email. All waiver requests and supporting documentation must be submitted via an online form that can be accessed through the Rule 2080 FAQ page.[27] Refer to the FAQs, specifically Question 7, for more information and tips on submission and for logging into the new system.

XII. Expungement Requests During Simplified Customer Arbitration

Customer arbitrations involving $50,000 or less – called simplified arbitrations – are governed by FINRA Rule 12800. The first thing one needs to know is that such customer-Claimants can request that a single arbitrator decide the case one of three ways:

1. Without a hearing (referred to as "on the papers"), where the arbitrator decides the case on the pleadings or other materials;
2. In an "Option One" full hearing. in which prehearings and hearings on the merits take place in accordance with the regular provisions of the Code; or,
3. In an "Option Two" special proceeding, where the parties present their case in a hearing to the arbitrator in a compressed timeframe, so that hearings last no longer than one day.

An associated person named as a Respondent in a simplified arbitration could, during the arbitration, make a request for the right to bring a separate straight-in arbitration before an arbitration panel from the Special Arbitrator Roster.

If named associated persons in a simplified case request expungement, they will be required to file the request in an answer or in a separate pleading requesting expungement (within 30 days after FINRA notifies the parties of the arbitrator's appointment). The request must include the same information as a request filed in a non-simplified arbitration.

As with "on-behalf-of requests" filed in customer arbitrations under Rule 12805(a)(2), the unnamed person who would benefit from the expungement request must consent to such filing by signing the same FINRA form. And to limit arbitrator shopping, the arbitrator would be required to decide an on-behalf-of request once it is filed by the requesting party.

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27. *See Frequently Asked Questions About FINRA Rule 2080 (Expungement), available at* https://www.finra.org/registration-exams-ce/classic-crd/faq/finra-rule-2080-frequently-asked-questions.

If expungement is not requested during the simplified arbitration under Rule 12800(d), the associated person would still be able to file a straight-in request under Rule 13805 and have the request decided by a three-person panel randomly selected from the Special Arbitrator Roster.

If a named associated person or party on-behalf-of an unnamed person requests expungement during a simplified arbitration, the arbitrator would be required to decide the expungement request regardless of how the simplified arbitration closes (e.g., even if the arbitration settles). If the customer chooses not to have a hearing (a paper case) or chooses an Option Two special proceeding, the arbitrator would decide the customer's dispute first and issue an award. After the customer's dispute is decided, the arbitrator must hold a separate expungement-only hearing to consider and decide the expungement request and issue a separate, subsequent award.

If the customer in a simplified case chooses to have a full "Option One" hearing on his/her claim and the hearing closes by award. the arbitrator is required to consider and decide the expungement request during the customer arbitration and include the decision on the expungement request in the same award as the decision on the customer arbitration. If, however, the customer arbitration closes other than by award or by award without a hearing (e.g., settles or is withdrawn). the arbitrator would be required to hold a separate expungement-only hearing to consider and decide the expungement request and issue a separate award containing the decision on the expungement request. This is a distinction from Special Arbitrator Roster straight-in cases.

Who are the arbitrators for simplified arbitrations in which expungements are requested? FINRA stated in its Initial Filing with the SEC that it "does not believe that it is necessary for a panel from the Special Arbitrator Roster to decide an expungement request if a simplified customer arbitration is decided on the papers, in an Option Two special proceeding or if the simplified customer arbitration closes other than by award or by award without a hearing."

XIII. An Intriguing Coda – Things to Come?

The SEC's approval of these new rules will not end FINRA's desire to continue to adapt the process to what it may see as problematic developments. In the conclusion of FINRA's April 3, 2023 letter to the SEC, it made this intriguing statement:

"FINRA will continue to evaluate whether there are other ways to further strengthen the current expungement process, including:

a) Whether a panel from the Special Arbitrator Roster should be

required to decide an expungement request in simplified arbitrations;

b) Whether to allow state securities regulators to attend and participate in separate expungement-only hearings in simplified arbitrations; and,

c) Whether to require that a panel find that the evidence presented in support of an expungement request meets a clear and convincing standard of proof in order to issue an award containing expungement relief."[28]

XIV. Conclusion - Why the SEC Approved the New Rules

In FINRA's April 3, 2023 follow-up letter to the SEC proposing minor amendments to the expungement rules, it wrote that "PIABA and PIABA Foundation stated their support for the Proposal and recommended that the SEC approve the Proposal. NASAA generally supported the Proposal, but also suggested one modification [that was thereafter contained in the amended filing]."[29]

And in its approval of these important procedural changes to the expungement process, the SEC stated it best:

- "After careful review of the proposed rule change, the comment letters, and FINRA's responses to the comments, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association."[30]
- "The Commission finds good cause to approve the proposed rule change."[31]

While it has been said that FINRA Dispute Resolution Services would prefer not to be involved in "the expungement business," with these new rules it has nevertheless done so in a carefully considered, clearly articulated and balanced manner.

28. *See* April 3, 2023 Letter at 18-19, *supra* note 2.

29. *Id*.

30. *See* SEC Approval at 55, *supra* note 2.

31. *Id.* at 156.

Regulatory Notice 23-12

Expungement of Customer Dispute Information

FINRA Adopts Amendments to the Codes of Arbitration Procedure to Modify the Process Relating to the Expungement of Customer Dispute Information

Effective Date: October 16, 2023

Summary

FINRA has adopted amendments to its Codes of Arbitration Procedure (Codes) to modify the process relating to requests to expunge customer dispute information in the FINRA Dispute Resolution Services (DRS) arbitration forum. The amendments impose requirements on expungement requests (a) filed by an associated person during an investment-related, customer-initiated arbitration (customer arbitration), or filed by a party to the customer arbitration on behalf of an associated person (on-behalf-of request), or (b) filed by an associated person separate from a customer arbitration (straight-in request). The primary changes include:

- requiring that a straight-in request be decided by a three-person panel that is randomly selected from a roster of experienced public arbitrators with enhanced expungement training (Special Arbitrator Roster);
- prohibiting parties to a straight-in request from agreeing to fewer than three arbitrators to consider their expungement requests, striking any of the selected arbitrators, stipulating to an arbitrator's removal, or stipulating to the use of pre-selected arbitrators;
- providing notifications to state securities regulators of all requests to expunge customer dispute information and a mechanism for state securities regulators to attend and participate in expungement hearings in straight-in requests;
- imposing strict time limits on the filing of straight-in requests;
- specifying procedures for requesting expungement of customer dispute information during simplified customer arbitrations;

August 11, 2023

Notice Type
- Rule Amendment

Suggested Routing
- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics
- Arbitration
- Codes of Arbitration Procedure
- Dispute Resolution
- Expungement Requests

Referenced Rules & Notices
- Exchange Act Section 15A(i)
- FINRA Rule 2080
- FINRA Rule 2081
- FINRA Rule 8312
- FINRA Rule 9216
- FINRA Rule 9270
- FINRA Rule 12000 Series (Customer Code)
- FINRA Rule 13000 Series (Industry Code)
- Regulatory Notice 09-66

- codifying and updating the best practices in the Notice to Arbitrators and Parties on Expanded Expungement Guidance (Guidance) applicable to all expungement hearings, which include establishing additional requirements for expungement hearings, facilitating customer attendance and participation in all aspects of the expungement hearings and codifying the panel's ability to request any evidence relevant to the expungement request;
- requiring the unanimous agreement of the panel to issue an award containing expungement relief; and
- establishing procedural requirements for filing expungement requests, which include on-behalf-of requests.

The amendments become effective on October 16, 2023.

- The amendments to Rules 12800 and 12805 apply to requests to expunge customer dispute information from the Central Registration Depository (CRD®) associated with a customer arbitration filed in the DRS arbitration forum on or after October 16, 2023.
- The amendments to Rules 13805 and 13806 apply to straight-in requests filed in the DRS arbitration forum on or after October 16, 2023.

The rule text is available in Attachment A. The Guidance is available in Attachment B. The Form Requesting Expungement on Behalf of an Unnamed Person is available in Attachment C.

Questions concerning this *Notice* should be directed to:

- Victoria Crane, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104 or email;
- Mignon McLemore, Associate General Counsel, Office of General Counsel, at (202) 728-8151 or email; or
- Bria Adams, Principal Counsel, Office of General Counsel, at (202) 728-8829 or email.

Background & Discussion

I. Customer Dispute Information in CRD

FINRA is mandated by federal statute to collect and maintain registration information about member firms and their associated persons. To satisfy this statutory responsibility, FINRA operates CRD, the central licensing and registration system for the benefit of FINRA, the SEC, other self-regulatory organizations (SROs), state securities regulators and firms.[1] In general, the registration information in CRD

is reported by firms, associated persons and regulatory authorities in response to questions on the uniform registration forms.[2] These forms are used to collect registration information, which includes, among other things, administrative, regulatory, criminal history, financial and other information about associated persons, such as investment-related, customer-initiated arbitrations, civil litigations or customer complaints (*i.e.*, customer dispute information). Customer dispute information maintained in CRD is reported through Forms U4 and U5.[3]

The registration information, including customer dispute information, maintained in CRD serves three important purposes. First, regulators use CRD as an important source of regulatory information to inform registrations, examinations, investigations and disciplinary actions. Second, firms use information in CRD for employment purposes. Third, FINRA makes specific registration information collected in CRD publicly available through BrokerCheck®,[4] which is a free tool available on FINRA's website to help investors make informed choices about the associated persons and firms with which they may conduct business.[5]

II. Expungement of Customer Dispute Information from CRD

If associated persons seek to remove, or "expunge," customer dispute information from CRD/ BrokerCheck, FINRA will do so only pursuant to a court order that directs expungement of the information or confirms an arbitration award that authorizes such expungement.[6]

FINRA rules specify a narrow set of circumstances in which expungement of customer dispute information from CRD is appropriate.[7] As discussed in more detail below, the amendments incorporate this narrow set of circumstances into Rules 12805 and 13805 by requiring an arbitrator considering an expungement request to make a finding that the customer dispute information to be expunged is factually impossible, clearly erroneous or false, or that the associated person was not involved in the alleged misconduct.[8] The amendments also make a number of significant enhancements to address concerns with the current expungement process[9] and to provide additional safeguards for ensuring that the information in CRD/BrokerCheck is accurate and complete.

III. Amendments to the Codes

The amendments to the Codes require an associated person seeking expungement of customer dispute information to comply with the requirements of Rules 12805 (expungement requests in a customer arbitration), 12800(d) (expungement requests in a simplified customer arbitration) or 13805 (straight-in requests).[10] The following discussion of the amendments is divided into seven areas:

- expungement requests during customer arbitrations under Rule 12805;
- expungement requests during simplified customer arbitrations under Rule 12800;
- straight-in requests under Rule 13805 and the Special Arbitrator Roster;
- requirements relating to all expungement hearings;
- notifications to customers of straight-in requests;
- notifications to state securities regulators of expungement requests and their attendance and participation in straight-in requests; and
- the Director's authority to deny the forum.

A. Expungement Requests During Customer Arbitrations Under Rule 12805

The amendments to Rule 12805 set forth requirements addressing the method and timing for, and required contents of, expungement requests filed during a customer arbitration by an associated person or as an on-behalf-of request, including the types of expungement requests that must (or cannot) be filed. The amendments provide that an associated person shall not file a request for expungement of customer dispute information if (1) a panel[11] held a hearing to consider the merits of the associated person's request for expungement of the same customer dispute information or (2) a court of competent jurisdiction previously denied the associated person's request to expunge the same customer dispute information.[12] Under such circumstances, the Director shall decline the use of the forum because the expungement request is ineligible for arbitration.[13]

1. Expungement Requests Filed by an Associated Person Named in a Customer Arbitration

The amendments require that an associated person named in a customer arbitration (named associated person) seeking to expunge customer dispute information associated with the customer's statement of claim file the expungement request during the customer arbitration.[14] If the associated person does not request expungement of the customer dispute information associated with the customer's statement of claim during the customer arbitration, the associated person forfeits the opportunity to seek expungement of the same customer dispute information in any subsequent proceeding.[15]

a. Method of Requesting Expungement

The amendments limit how and when a request for expungement may be made during the customer arbitration. If a named associated person requests expungement during the customer arbitration, the request must be included

in the answer or a separate pleading requesting expungement.[16] If the request for expungement is included in the answer, it must be filed in accordance with existing requirements under the Codes—within 45 days of receiving the customer's statement of claim.[17] If the named associated person requests expungement in a separate pleading, rather than the answer, the request must be filed no later than 60 days before the first scheduled hearing.[18] If a named associated person files the request for expungement in a separate pleading after the 60-day filing deadline, the associated person must file a motion pursuant to Rule 12503 requesting an extension, which would be decided by the panel.[19]

b. Required Contents of an Expungement Request

A request for expungement by a named associated person in a customer arbitration must include:

- the applicable filing fee under the Customer Code;
- the CRD number of the party requesting expungement;
- each CRD occurrence number that is the subject of the request;
- the case name and docket number associated with the customer dispute information; and
- an explanation of whether expungement of the same customer dispute information was (i) previously requested and, if so (ii) how it was decided.[20]

If an expungement request fails to include any of the requirements for requesting expungement, the request will be considered deficient and will not be served unless the deficiency is corrected.[21]

2. Expungement Requests Filed by a Party Named in a Customer Arbitration On Behalf Of an Unnamed Person

Prior to the amendments, the Codes did not specifically address expungement requests made by a party named in a customer arbitration on behalf of an unnamed person (*i.e.*, on-behalf-of requests).[22] The amendments to Rule 12805 permit a party to the customer arbitration to file an on-behalf-of request (requesting party) during the customer arbitration that seeks to expunge customer dispute information associated with the customer's statement of claim, provided the unnamed person consents in writing to the request and the request is eligible for arbitration under Rule 12805.[23] Filing an on-behalf-of request is permissive, not mandatory.[24]

If a named party files an on-behalf-of request, the named party must submit to the Director a signed Form Requesting Expungement on Behalf of an Unnamed Person (Form) together with the written request for expungement.[25] Rule 12805 does not

require that an on-behalf-of request be included in an answer or a separate pleading requesting expungement. However, the requesting party must file the request together with the Form, no later than 60 days before the first scheduled hearing.[26]

By filing an on-behalf-of request, the requesting party is agreeing to represent the unnamed person and the unnamed person's interests and to pursue the request for expungement on behalf of the unnamed person during the customer arbitration.[27] By signing the Form, the unnamed person is consenting to the filing of the on-behalf-of request and is agreeing to be bound by the terms of the Form and the panel's decision on the request.[28] In addition, by signing the Form, the unnamed person is acknowledging that (i) if the customer arbitration closes by award after a hearing, the unnamed person is barred from filing a request to expunge the same customer dispute information in any subsequent proceeding and (ii) if the requesting party withdraws or does not pursue the on-behalf-of request, the panel is required to deny the on-behalf-of request with prejudice.[29] The unnamed person's signature on the Form would serve as acknowledgement of these consequences.

In addition to the Form, an on-behalf-of request must include the same elements described above for a request for expungement by a named associated person during a customer arbitration.[30]

3. Deciding Expungement Requests Filed During Customer Arbitrations

The amendments to Rule 12805 specify whether a panel is required to decide an expungement request (whether filed by a named associated person or by a party on behalf of an unnamed person); specifically, whether the panel is required to decide an expungement request filed during a customer arbitration depends on how the customer arbitration closes: (1) by award after a hearing or (2) other than by award or by award without a hearing.

a. Panel Decides the Expungement Request if the Customer Arbitration Closes by Award after a Hearing

If a named associated person files an expungement request or a party files an on-behalf-of request during a customer arbitration, and the customer arbitration closes by award after a hearing, the panel must decide the expungement request during the customer arbitration in accordance with Rule 12805(c).[31] The panel's decision on the expungement request must be included in the same award as the decision on the customer arbitration.[32] If an expungement request is filed during the customer arbitration, the panel must decide the expungement request, even if the associated person or requesting party withdraws or fails to pursue the request, in which case, the panel shall deny the expungement request with prejudice.[33]

b. Panel Does Not Decide Expungement if the Customer Arbitration Closes Other than by Award or by Award without a Hearing

If, however, a named associated person files an expungement request or a party files an on-behalf-of request during the customer arbitration, and the customer arbitration closes other than by award or by award without a hearing, the panel from the customer arbitration shall not consider the expungement request.[34] Instead, the associated person may file a request for expungement of the customer dispute information as a straight-in request under Rule 13805 against the member firm at which the person was associated at the time the customer dispute arose, provided the straight-in request is not barred under Rule 13805(a)(2). A panel that is randomly selected from the Special Arbitrator Roster will decide the straight-in request.[35]

B. Expungement Requests During Simplified Customer Arbitrations Under Rule 12800

The amendments to Rule 12800 governing simplified customer arbitrations[36] establish procedures for requesting and deciding expungement requests in these types of arbitrations that are consistent with the expedited nature of the arbitrations.[37]

In a simplified customer arbitration, if a named associated person or party on behalf of an unnamed person does not submit a request for expungement, the associated person or unnamed person may file a straight-in request, provided the straight-in request is not barred under Rule 13805(a)(2). If, however, a named associated person or a requesting party submits a request for expungement in a simplified customer arbitration, the single arbitrator deciding the simplified customer arbitration must decide the expungement request, regardless of how the simplified customer arbitration closes.[38] The single arbitrator who is appointed from the public chairperson roster to decide a simplified customer arbitration must evidence successful completion of, and agreement with, enhanced expungement training provided by DRS prior to deciding any expungement request in a simplified customer arbitration.[39] Thus, the arbitrator must complete the same enhanced expungement training as the arbitrators on the Special Arbitrator Roster.[40]

1. Expungement Requests Filed by an Associated Person Named in a Simplified Customer Arbitration

If a named associated person files an expungement request during the simplified customer arbitration, the request must be included in an answer or a separate pleading requesting expungement.[41] If the associated person requests expungement in a separate pleading, the request must be filed within 30 days after the date FINRA

notifies the parties of the appointment of the arbitrator.[42] The written expungement request must include the same information as a request filed in a customer arbitration not administered as a simplified proceeding.[43]

2. Expungement Requests Filed by a Party Named in a Simplified Customer Arbitration On Behalf Of an Unnamed Person

The requirements for a party to file an on-behalf-of request during a simplified customer arbitration are the same as the requirements for a named associated person filing an expungement request during a simplified customer arbitration. As with a customer arbitration filed under Rule 12805(a)(2), a named party may only file an on-behalf-of request during a simplified customer arbitration with the written consent of the unnamed person evidenced by the requesting party's submission of the Form that is signed by the requesting party and the unnamed person.[44]

3. Deciding Expungement Requests during Simplified Customer Arbitrations

As noted above, if a named associated person or a party on behalf of an unnamed person files an expungement request during a simplified customer arbitration, the arbitrator must decide the expungement request, regardless of how the simplified customer arbitration closes (*e.g.*, even if the simplified customer arbitration settles).[45] How and when the expungement request is decided depends on which option the customer selects to decide the simplified customer arbitration. In a simplified customer arbitration, the customer has the option of having the case decided in one of three ways: (1) without a hearing (referred to as "on the papers"), where the arbitrator decides the dispute on the pleadings or other materials; (2) in an "Option One" full hearing, in which prehearings and hearings on the merits take place pursuant to the regular provisions of the Customer Code; or (3) in an "Option Two" special proceeding, whereby the parties present their case in a hearing to the arbitrator in a compressed timeframe, so that the hearings last no longer than one day.[46] If an associated person or requesting party files and then withdraws or does not pursue the expungement request, the arbitrator must deny the request with prejudice.[47]

a. No Hearing or Option Two Special Proceeding

If the customer opts not to have a hearing or chooses an "Option Two" special proceeding, the arbitrator must decide the customer's dispute first and issue an award.[48] After the arbitrator decides the customer's dispute, the arbitrator must hold a separate expungement hearing to decide the expungement request, and the arbitrator must issue a decision on the expungement request in a separate, subsequent award.[49]

b. Option One Hearing

If the customer chooses to have a full "Option One" hearing and the customer arbitration closes by award after a hearing, the arbitrator must decide the expungement request during the customer arbitration and include the decision on the expungement request in the same award as the decision on the customer's dispute.[50] (This process is the same as deciding an expungement request during a customer arbitration not administered as a simplified proceeding that closes by award after a hearing, where the customer's claim and expungement request are addressed during the customer arbitration.)

If the customer chooses to have a full "Option One" hearing and the simplified customer arbitration closes other than by award or by award without a hearing, the arbitrator must hold a separate expungement-only hearing to decide the expungement request and issue a separate award containing the decision on the expungement request.[51]

C. Straight-In Requests Under Rule 13805 and the Special Arbitrator Roster

An associated person may file a straight-in request under Rule 13805 if: (1) the associated person is named in a customer arbitration or a party submits an on-behalf-of request and the arbitration closes other than by award or by award without a hearing; (2) the associated person is the subject of a customer arbitration, but is not named in the arbitration and did not consent to an on-behalf-of request; or (3) the associated person was named in a simplified customer arbitration or was the subject of the simplified customer arbitration, but no expungement request was filed during the simplified customer arbitration.

1. Filing a Straight-in Request Under Rule 13805

a. Applicability and Required Contents of Straight-in Requests

An associated person requesting expungement of customer dispute information as a straight-in request under the Industry Code must file a statement of claim in accordance with Rule 13302 against the member firm at which the person was associated at the time the customer dispute arose, provided the straight-in request is not barred under Rule 13805(a)(2).[52] The requirement that an associated person file a straight-in request against the member firm at which the person was associated at the time the customer dispute arose is intended to help ensure that there is a connection between the respondent firm and the subject matter of the expungement request. If the associated person does not name a respondent firm with the requisite connection, the Director is authorized to deny use of the DRS arbitration forum for the request.[53] If the associated person files and then withdraws or does not pursue the request for expungement, the panel shall deny the expungement request with prejudice.[54]

The required contents of a straight-in request are the same as those required for expungement requests filed in customer arbitrations under Rule 12805.[55]

b. General Limitations on Filing Straight-in Requests

The amendments limit when straight-in requests may be filed under the Industry Code. Specifically, Rule 13805(a)(2) provides that straight-in requests are ineligible for arbitration under the Industry Code, if:

- a panel held a hearing to consider the merits of the associated person's request for expungement of the same customer dispute information;
- a court of competent jurisdiction previously denied the associated person's request to expunge the same customer dispute information;
- the customer arbitration, civil litigation or customer complaint associated with the customer dispute information has not closed;
- a panel or court of competent jurisdiction previously found the associated person liable in a customer arbitration or civil litigation associated with the same customer dispute information;
- the customer dispute information involves the same conduct that is the basis of a final regulatory action taken by a securities regulator or SRO;[56] or
- the associated person is prohibited from seeking expungement because they did not request expungement in a customer arbitration in accordance with Rule 12805(a)(1)(A).[57]

c. Time Limitations Applicable to Filing Straight-in Requests

The amendments establish time limits for filing straight-in requests under the Industry Code that are tied to when a customer arbitration or civil litigation closes, or when a customer complaint is initially reported to CRD.

i. Time Limitations Associated with Customer Arbitrations or Civil Litigations Closed, and with Customer Complaints Initially Reported to CRD, After the Effective Date

If an associated person is seeking to expunge in a straight-in request customer dispute information associated with a customer arbitration or civil litigation, including any associated customer complaint disclosures, and the customer arbitration or civil litigation closes after the effective date of the amendments, the associated person must file the straight-in request within *two years* after the close of the customer arbitration or civil litigation.[58] If an associated person is seeking to expunge a customer complaint in a straight-in request when there is no customer

arbitration or civil litigation associated with the customer complaint, and the customer complaint was initially reported to CRD after the effective date of the amendments, the associated person must file the straight-in request within *three years* after the customer complaint was initially reported to CRD.[59]

ii. Time Limitations Associated with Customer Arbitrations or Civil Litigations Closed, and with Customer Complaints Initially Reported to CRD, On or Before the Effective Date

If an associated person is seeking to expunge in a straight-in request customer dispute information associated with a customer arbitration or civil litigation that closed on or before the effective date of the amendments, the associated person must file the straight-in request within *two years* after the effective date of the amendments.[60] If an associated person is seeking to expunge in a straight-in request customer dispute information associated with a customer complaint initially reported to CRD on or before the effective date of the amendments, the associated person must file the straight-in request within *three years* after the effective date of the amendments.[61]

These straight-in requests to expunge customer dispute information are also subject to the *six-year* eligibility requirement of Rule 13206(a), which provides that no claim shall be eligible for submission to arbitration where six years have elapsed from the occurrence or event giving rise to the claim.[62] This six-year eligibility rule applies to all arbitration claims, including those requesting expungement of customer dispute information.

2. Panel from the Special Arbitrator Roster Under Rule 13806

If an associated person requests expungement under Rule 13805, the amendments require that a three-person panel randomly selected from the Special Arbitrator Roster in accordance with Rule 13806 must hold an expungement hearing, decide the straight-in request and issue an award.[63]

To help ensure that arbitrators on the Special Arbitrator Roster have the qualifications and training to decide straight-in requests under the amendments, there are several requirements. They must:

- qualify as public arbitrators[64] who are eligible for the chairperson roster;[65]
- have evidenced successful completion of, and agreement with, enhanced expungement training provided by DRS;[66] and
- have served as an arbitrator through award on at least four customer arbitrations administered by FINRA or by another SRO in which a hearing was held.[67]

The list selection algorithm[68] will select randomly the three public arbitrators from the Special Arbitrator Roster to decide a straight-in request filed by an associated person.[69] The parties are not permitted to agree to fewer than three arbitrators.[70] The parties also are not permitted to strike any arbitrators selected by the list selection algorithm or stipulate to their removal, but the parties are permitted to challenge an arbitrator selected for cause.[71] If an arbitrator is removed, the list selection algorithm randomly selects a replacement.[72]

D. Requirements Relating to All Expungement Hearings

The amendments expand the expungement hearing requirements in Rules 12805 and 13805 and incorporate relevant provisions from the Guidance:

- a panel must hold one or more recorded hearing sessions regarding the expungement request;[73]
- the associated person whose information in CRD is the subject of the expungement request must appear in person or by video conference at the expungement hearing;[74]
- all customers whose customer arbitrations, civil litigations or customer complaints are the subject of an expungement request are entitled to have a representative attend and participate in all aspects of the expungement hearing;[75]
- the panel may request from the associated person, the party filing an on-behalf-of request and the member firm at which the person was associated at the time the customer dispute arose, as applicable, any documentary, testimonial or other evidence that the panel deems relevant to the expungement request;[76]
- the panel must review any settlement documents related to the customer dispute information that is the subject of the expungement request and consider the amount of payments made to any party and any other terms and conditions of the settlement;[77]
- the panel must agree unanimously[78] that one or more of the three narrow grounds for expungement enumerated in Rules 12805(c)(8)(A)(i) or 13805(c)(9)(A)(i), as applicable, has been established to issue an award containing expungement relief;[79]
- the panel must provide a written explanation of the reason(s) for its finding that one or more of the grounds for expungement identified in Rules 12805(c)(8)(A)(i) and 13805(c)(9)(A)(i) apply to the facts of the request, and identify any specific documentary, testimonial or other evidence on which the panel relied in awarding expungement relief;[80]

- the panel must not give any evidentiary weight to a decision by a customer (or an authorized representative of the state securities regulators (authorized representative) in the case of a straight-in request) not to attend or participate in an expungement hearing when making a determination of whether expungement is appropriate;[81] and
- the panel must assess against the party or parties requesting expungement all DRS arbitration forum fees for each hearing session in which the sole topic is the determination of the appropriateness of expungement.[82]

E. Notifications to Customers of Straight-in Requests

To help facilitate customer awareness of and participation in straight-in requests, the amendments require an associated person seeking expungement relief and the Director to provide notifications to customers.

Specifically, the amendments require that the associated person serve all customers whose customer arbitrations, civil litigations or customer complaints are the subject of the expungement request with a copy of the statement of claim requesting expungement and any answer within 10 days of filing.[83] The associated person must provide a current address for the customer,[84] or the expungement request will be considered deficient and will not be served.[85] The associated person must also file with the panel proof of service to the customers of the statement of claim filed by the associated person and any answers filed by a member firm, copies of all documents provided by the associated person to the customers and copies of all communications sent by the associated person to the customers and any responses received from the customers.[86]

Furthermore, the amendments require the Director to notify all customers whose customer arbitrations, civil litigations or customer complaints are the subject of the expungement request, of the time, date and place of any prehearing conferences and the expungement hearing.[87] The Director will also provide the notified customers with access to all documents that are relevant to the expungement request that are filed in (a) the straight-in request and (b) any prior customer arbitration brought by the customer that is a subject of the expungement request.[88] This provides the notified customer with access to documents surrounding the request for expungement prior to their attendance and participation in the expungement hearing.

F. Notifications to State Securities Regulators of Expungement Requests and their Attendance and Participation in Straight-In Requests

To help ensure that state securities regulators are timely notified of expungement requests, the amendments require the Director to notify state securities regulators,

in the manner determined by the Director in collaboration with state securities regulators, of an expungement request within 15 days of receiving an expungement request that includes all of the required elements.[89]

In addition, the amendments provide a mechanism for an authorized representative to provide the state securities regulators' position(s) on an expungement request made in a straight-in request in writing or by attending and participating in the expungement hearing in person or by video conference.[90] Including states securities regulators in straight-in requests provides states the opportunity to satisfy their regulatory obligations, while at the same time increasing the likelihood that the panel in a straight-in request hears evidence from multiple viewpoints, thereby allowing the panel to make informed decisions.

The Director will also provide state securities regulators with access to all documents relevant to (a) the straight-in request and (b) any prior customer arbitration brought under the Customer Code that is associated with the customer dispute information that is a subject of the straight-in request.[91]

If an authorized representative notifies the Director no later than 30 days after the last answer is due that the authorized representative intends to attend and participate in the expungement hearing, the Director will notify the authorized representative of the time, date and place of any prehearing conferences and the expungement hearing.[92] At the expungement hearing, the authorized representative may: (1) introduce documentary, testimonial, or other evidence; (2) cross-examine witnesses; and (3) present opening and closing arguments if the panel allows any party to present such arguments.[93] The other participants appearing at the expungement hearing could state objections to the authorized representative's evidence and cross-examine the authorized representative's witnesses.[94]

G. Director's Authority to Deny the Forum

The amendments explicitly authorize the Director to decline the use of the DRS arbitration forum to request expungement if an associated person files an expungement request that the Director determines is ineligible for arbitration under Rules 12805 and 13805.[95] The amendments also provide the Director with express authority to decline the use of the DRS arbitration forum if the Director determines that the expungement request was not filed under, or considered in, the arbitration forum in accordance with Rules 12805 or 13805.[96]

Endnotes

1 The concept for CRD was developed by FINRA and the North American Securities Administrators Association (NASAA). CRD fulfills FINRA's statutory obligation to establish and maintain a system to collect and retain registration information set forth in Section 15A(i) of the Securities Exchange Act of 1934 (Exchange Act). NASAA and state securities regulators play a critical role in the ongoing development and implementation of CRD.

2 The uniform registration forms are Form BD (Uniform Application for Broker-Dealer Registration), Form BDW (Uniform Request for Broker-Dealer Withdrawal), Form BR (Uniform Branch Office Registration Form), Form U4 (Uniform Application for Securities Industry Registration or Transfer), Form U5 (Uniform Termination Notice for Securities Industry Registration) and Form U6 (Uniform Disciplinary Action Reporting Form).

3 FINRA, NASAA and state securities regulators developed Forms U4 and U5, and they were approved by the SEC. Any amendments to these uniform registration forms require collaboration with, and agreement between FINRA, NASAA and state securities regulators before being filed with the SEC for approval. Several questions on Forms U4 and U5 require associated persons to disclose certain investment-related, customer-initiated arbitrations, civil litigations or customer complaints which allege sales practice violations. *See* Form U4, Question 14I and Form U5, Question 7E.

4 BrokerCheck fulfills FINRA's statutory obligation under Section 15A(i) of the Exchange Act to establish and maintain a readily accessible electronic or other process, to receive and promptly respond to inquiries regarding registration information on, among others, firms and their associated persons. A detailed description of the information can be found at BrokerCheck.

5 As part of its statutory obligation, FINRA publishes on BrokerCheck extensive disclosure information, including customer dispute information for associated persons who are currently or were formerly registered with FINRA. Formerly registered associated persons, although no longer in the securities industry in a registered capacity, may work in other investment-related industries or may seek to attain other positions of trust with potential investors. Pursuant to FINRA rules, which are approved by the SEC, records for formerly registered associated persons are available in BrokerCheck for 10 years after an associated person leaves the brokerage industry, and records for formerly registered associated persons who were the subject of disciplinary actions and certain other disclosure events remain on BrokerCheck permanently.

6 *See* Rule 2080(a).

7 *See* Rule 2080(b)(1).

8 *See* Rules 12805(c)(8)(A)(i) and 13805(c)(9)(A)(i).

9 *See* Securities Exchange Act Release No. 95455 (August 9, 2022), 87 FR 50170, 50174 (August 15, 2022) (Notice of Filing of File No. SR-FINRA-2022-024) (Proposing Release) (discussing concerns with the current expungement process).

10 *See* Securities Exchange Act Release No. 97294 (April 12, 2023), 88 FR 24282 (April 19, 2023) (Order Approving File No. SR-FINRA-2022-024).

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11 Under the Codes, the term "panel" means the arbitration panel, whether it consists of one or more arbitrators. *See* Rules 12100(u) and 13100(s). Unless otherwise specified, this *Notice* uses the term "panel" to mean either a panel or single arbitrator.

12 *See* Rule 12805(a)(1)(B).

13 *See* Rule 12203(b).

14 *See* Rule 12805(a)(1)(A). The customer dispute information associated with a customer's statement of claim would include a written customer complaint or civil litigation brought by the same customer that addresses the same allegations.

15 *See* Rule 12805(a)(1)(A).

16 *See* Rule 12805(a)(1)(C)(i). Rules 12100(x) and 13100(v) define a "separate document requesting expungement" as a pleading under the Codes.

17 *See* Rule 12303(a) and (b).

18 *See* Rule 12805(a)(1)(C)(i).

19 *See* Rule 12805(a)(1)(C)(i). Pursuant to Rule 12503, if an associated person files a motion seeking an extension of the 60-day deadline, the opposing parties may state objections to extending the deadline, and the panel would decide the motion.

20 *See* Rule 12805(a)(1)(C)(ii)a. through e. To comply with the requirement that the request for expungement include an explanation of whether expungement of the same customer dispute information was (i) previously requested and, if so, (ii) how it was decided, the associated person should include any arbitration award or court order denying expungement of the same customer dispute information, and, if applicable, any court order modifying, vacating or otherwise setting aside an arbitration award of the same customer dispute information.

21 *See* Rules 12307(a)(8) through (11) and 12805(a)(1)(C)(ii).

22 The amendments define an unnamed person as "an associated person, including a formerly associated person, who is identified in a Form U4, Form U5, or Form U6, as having been the subject of an investment-related, customer-initiated arbitration claim that alleged that the associated person or formerly associated person was involved in one or more sales practice violations, but who is not named as a respondent in the arbitration." *See* Rule 12100(ff).

23 *See* Rule 12805(a)(2)(A) and (B).

24 *See* Rule 12805(a)(2)(A). If a party to the customer arbitration does not request expungement on behalf of the unnamed person, the unnamed person is prohibited from intervening in the customer arbitration to request expungement. *See* Rule 12805(a)(2)(E)(iii)a. The unnamed person may, however, file the request for expungement of the customer dispute information as a new claim under Rule 13805 against the member firm at which the person was associated at the time the customer dispute arose. *See* Rule 12805(a)(2)(E)(iii)b. Provided that the request for expungement is not barred, a panel from the Special Arbitrator Roster would decide the request for expungement after the customer arbitration has closed. *See* Rule 13805(a)(2)(A)(iii).

25 *See* Rule 12805(a)(2)(C)(i) and (ii); *see* also Attachment C. The unnamed person whose CRD record would be expunged and the party requesting expungement on the unnamed person's behalf must sign the Form.

26 *See* Rule 12805(a)(2)(C)(iii).

27 *See* Rule 12805(a)(2)(D)(iii).

28 *See* Rule 12805(a)(2)(D)(i). By signing the Form, the unnamed person is also agreeing to maintain the confidentiality of documents and information from the customer arbitration to which the unnamed person may be given access and to adhere to any confidentiality agreements or orders associated with the customer arbitration. *See* Rule 12805(a)(2)(D)(ii). A breach of this provision by the unnamed person could potentially subject the unnamed person to a claim for damages by an aggrieved party.

29 *See* Rule 12805(a)(2)(E)(i).

30 *See* Rules 12805(a)(1)(C)(ii) and 12805(a)(2)(C)(i); *see also supra* Section III.A.1.b (Required Contents of an Expungement Request).

31 *See* Rules 12805(a)(1)(D)(i) and 12805(a)(2)(E)(i).

32 *See* Rules 12805(a)(1)(D)(i) and 12805(a)(2)(E)(i).

33 *See* Rules 12805(a)(1)(D)(i) and 12805(a)(2)(E)(i).

34 *See* Rules 12805(a)(1)(D)(ii)a. and 12805(a)(2)(E)(ii)a.

35 *See* Rules 12805(a)(1)(D)(ii)b. and 12805(a)(2)(E)(ii)b.

36 Simplified customer arbitrations are arbitrations involving $50,000 or less.

37 *See* Rule 12800(d) and (e). Rule 12800 provides customers with expedited procedures to make the DRS arbitration forum economically feasible for these smaller claims. Simplified customer arbitrations are decided on the pleadings and other materials submitted by the parties, unless the customer requests a hearing. Further, a single arbitrator from the public chairperson roster is appointed to decide simplified customer arbitrations, unless the parties agree in writing otherwise. For ease of reference, when discussing expungement requests in simplified customer arbitrations, this *Notice* uses the term "arbitrator," unless otherwise specified, to mean either a panel or single arbitrator.

An associated person may not seek expungement in a simplified customer arbitration administered under Rule 13800 under the Industry Code. *See* Proposing Release, supra note 9 at 50186 n. 189.

38 *See* Rules 12800(d)(1)(B)(ii) and 12800(e)(1).

39 *See* FINRA DRS Arbitrator Training.

40 *See* Rule 12800(b); *see also supra* note 39; *infra* Section III.C.2. (Panel from the Special Arbitrator Roster Under Rule 13806).

41 *See* Rule 12800(d)(1)(B)(i). A respondent's answer must be submitted within 45 days of receipt of the statement of claim.

42 *See* Rule 12800(d)(1)(B)(i). When FINRA notifies the parties that an arbitrator has been appointed, FINRA informs the parties that they have 30 days from the date of notification to submit additional documents or other information before the case is submitted to the arbitrator.

43 *See* Rules 12800(d)(1)(B)(i) and 12805(a)(1)(C)(ii); *see also supra* Section III.A.1.b. (Required Contents of an Expungement Request).

44 *See* Rule 12800(d)(2). The request must also meet the same requirements as an on-behalf-of request filed under Rule 12805(a)(2). *See* Rules 12805(a)(1)(C)(ii), 12805(a)(2)(C)(ii) and 12805(a)(2)(D); *see also supra* Section III.A.1.b. (Required Contents of an Expungement Request).

45 *See* Rule 12800(e)(1).

46 *See* Rule 12800(c).

47 *See* Rule 12800(d)(1)(C).

48 *See* Rule 12800(e)(1)(A).

49 *See* Rule 12800(e)(1)(A). The arbitrator must conduct the expungement hearing pursuant to Rule 12805(c). The expungement award must meet the requirements of Rule 12805(c)(8), and the DRS arbitration forum fees will be assessed pursuant to Rule 12805(c)(9).

50 *See* Rule 12800(e)(1)(B)(i).

51 *See* Rule 12800(e)(1)(B)(ii).

52 *See* Rule 13805(a)(1). An associated person is prohibited from filing a straight-in request for expungement of customer dispute information against a customer as a new claim that is separate from the customer arbitration. *See* Rule 12805(a)(3).

53 *See* Rule 13203(b); *see also* Proposing Release, *supra* note 9 at 50179.

54 *See* Rule 13805(a)(4).

55 *See* Rule 13805(a)(3); *see also supra* Section III.A.1.b. (Required Contents of an Expungement Request).

56 A "final regulatory action" includes any final action, including any action that is on appeal, by a securities regulator or SRO. *See* Rule 8312(c); *see also* Regulatory Notice 09-66 (November 2009) (noting that "actions that are delineated in current Form U4 Questions 14C, 14D or 14E will be considered 'final regulatory actions.' Similarly, actions that are detailed in current Form U5 Question 7D, and have a status of 'final' or 'on appeal,' will be considered 'final regulatory actions' as such actions are also addressed in Form U4."). For example, a Letter of Acceptance, Waiver, and Consent and an accepted Offer of Settlement are two examples, among others, of final regulatory actions taken by FINRA. *See* Rule 9216(a)(4) and Rule 9270(g). A "final regulatory action" may also include a final action reported by a regulator on Form U6. *See Regulatory Notice 09-66* (November 2009). For purposes of Rule 13805, a "final regulatory action" does not include a final action by a securities regulator or SRO that is dismissed, vacated or withdrawn.

57 *See* Rule 13805(a)(2).

58 *See* Rule 13805(a)(2)(A)(vi).

59 *See* Rule 13805(a)(2)(A)(vii).

60 *See* Rule 13805(a)(2)(B)(i).

61 *See* Rule 13805(a)(2)(B)(ii).

62 *See* Rules 12203(a) and 13203(a); *see also* Rules 12206(a) and 13206(a). The issue of eligibility may be raised in a motion by the parties or *sua sponte* by the arbitrators. *See Horst v. FINRA, slip op.,* No. A-18-777960-C (Nev. Dist. Ct. Oct. 25, 2018) (Order Denying Motion to Vacate Arbitration Award). In addition, Rules 12409 and 13413 provide that the arbitrators have the authority to interpret and determine the applicability of all provisions under the Codes. Thus, the decision of whether to dismiss a claim pursuant to this six-year eligibility rule is within the sole discretion of the panel. *See Howsam v. Dean Witter Reynolds,* 537 U.S. 79, 85-86 (2002) (finding that an arbitrator properly decides issues of eligibility). Such interpretations and decisions are final and binding upon the parties.

63 *See* Rule 13805(a)(4).

64 Among other requirements, public arbitrators are not employed in the securities industry and do not devote 20 percent or more of their professional work to the securities industry or

to parties in disputes concerning investment accounts or transactions or employment relationships within the financial industry. *See* Rules 12100(aa) and 13100(x).

65 *See* Rule 13806(b). Arbitrators are eligible for the chairperson roster if they have completed chairperson training provided by FINRA and: (1) have a law degree and are a member of a bar of at least one jurisdiction and have served as an arbitrator through award on at least one arbitration administered by an SRO in which hearings were held; or (2) have served as an arbitrator through award on at least three arbitrations administered by an SRO in which hearings were held. Public arbitrators who are eligible for the chairperson roster would include those arbitrators who have met the chairperson eligibility requirements of Rules 12400(c) or 13400(c), regardless of whether they have already served as a chair on an arbitration case.

66 *See* Rule 13806(b)(2)(A); *see also supra* note 39.

67 *See* Rule 13806(b)(2)(B). This requirement will not be satisfied by serving on arbitrations administered under the special proceeding option of the simplified arbitration rules. *See* Rule 12800(c)(3)(B).

68 FINRA uses a list selection algorithm that generates, on a random basis, lists of arbitrators from FINRA's rosters of arbitrators. *See* Rule 13400(a); *see also* Rule 12400(a).

69 *See* Rule 13806(b)(1). The first arbitrator selected will be the chair of the panel.

70 *See* Rule 13806(b)(5). The parties also are not permitted to stipulate to the use of pre-selected arbitrators (*i.e.*, arbitrators that the parties find on their own to use in their cases). *See* Rule 13806(b)(1).

71 *See* Rule 13806(b)(4). Specifically, the Codes provide that before the first hearing session begins, the Director may remove an arbitrator for conflict of interest or bias, either upon request of a party or on the Director's own initiative. *See* Rule 13410(a).

72 *See* Rule 13806(b)(4).

73 *See* Rules 12805(c)(1) and 13805(c)(1).

74 *See* Rules 12805(c)(2) and 13805(c)(2). The panel will determine the method of appearance for the associated person. In addition, when a party files an on-behalf-of request during a customer arbitration, the requesting party or the party's representative is also required to appear in person or by video conference at the hearing, as determined by the panel. *See* Rule 12805(c)(2).

75 *See* Rules 12805(c)(3)(A), 12805(c)(4), 12800(f)(2), 13805(c)(3)(A) and 13805(c)(4). Customers can choose to attend and participate by telephone, in person or by video conference. Customers also have the option to provide their position on the expungement request in writing. In addition, all customers whose customer arbitrations, civil litigations or customer complaints are a subject of the expungement request are entitled to attend and participate in all aspects of any prehearing conferences held for straight-in requests. *See* Rule 13805(c)(3). For a list of ways in which customers can attend and participate in expungement hearings, *see* Rules 12805(c)(5)(A)-(D) and 13805(c)(5)(A)-(D).

76 *See* Rules 12805(c)(6) and 13805(c)(7). FINRA also continues to encourage arbitrators to request a current copy of the associated person's BrokerCheck report, paying particular attention to the "Disclosure Events" section of the report. It is an essential part of the arbitrator's role when determining whether expungement

is appropriate to consider the expungement request in the context of the associated person's entire securities industry record. An associated person's securities industry record may include disclosure events related to regulatory actions, investigations, criminal matters, and any other registration information that might be relevant to the expungement request.

77 *See* Rules 12805(c)(7) and 13805(c)(8). The panel must review settlement documents that are related to the customer dispute information that is the subject of the expungement request, regardless of whether the associated person was a party to the settlement. The amendments require the panel to inquire and fully consider whether a party conditioned a settlement of a customer's dispute upon any agreement, written or otherwise, not to oppose the request for expungement in cases in which the customer does not participate in the expungement hearing or the requesting party states that a customer has indicated that the customer will not oppose the expungement request. These types of conditioned settlements violate Rule 2081 and may be grounds to deny an expungement request. *See* Rules 12805(c)(7), 13805(c)(8) and 2081; *see also* Prohibited Conditions Relating to Expungement of Customer Dispute Information FAQ.

78 The unanimity requirement does not apply when deciding a customer's dispute; a majority decision of the arbitrators will continue to be sufficient.

79 *See* Rules 12805(c)(8)(A)(i) and 13805(c)(9)(A)(i). The three grounds are that (i) the claim, allegation or information is factually impossible or clearly erroneous; (ii) the associated person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or (iii) the claim, allegation or information is false. The amendments provide that the Director shall not serve an award containing expungement relief based on grounds other than those specified in Rules 12805(c)(8)(A)(i) or 13805(c)(9)(A)(i).

80 *See* Rules 12805(c)(8)(B) and 13805(c)(9)(B). The panel's explanation must be complete and not solely a recitation of one of the Rule 12805(c)(8)(A)(i) or 13805(c)(9)(A)(i) grounds or language provided in the expungement request.

81 *See* Rules 12805(c)(8)(C) and 13805(c)(9)(C).

82 *See* Rules 12805(c)(9) and 13805(c)(10).

83 *See* Rule 13805(b)(1)(A)(ii). The panel is authorized to decide whether extraordinary circumstances exist that make service on the customers impracticable. *See* Rule 13805(b)(1)(A)(i).

84 *See* Rule 13805(b)(1)(B)(i).

85 *See* Rule 13307(a)(7).

86 *See* Rule 13805(b)(1)(A)(iv).

87 *See* Rule 13805(b)(1)(B)(i). Notice to customers is not necessary for requests filed under Rules 12800 or 12805 of the Customer Code as the customer will be a named party. However, the Director will notify all customers from a simplified customer arbitration of a separate expungement-only hearing. The Director's notice serves as a reminder of the expungement request and provides the customers with timely notice of the expungement hearing so that the customers and their representatives may plan to attend and participate if they choose. *See* Rule 12800(f)(2).

88 *See* Rule 13805(b)(1)(B)(ii). DRS will provide customers with access to the documents through the DR Portal. *See* FINRA DRS, DR Portal.

89 *See* Rules 12800(f)(1), 12805(b) and 13805(b)(2)(A).

90 *See* Rule 13805(c)(6)(A).

91 *See* Rule 13805(b)(2)(B). The state securities regulators' access to the documents will be subject to confidentiality restrictions. Outside of the process provided in the rules for straight-in requests, state securities regulators can continue to seek access to documents filed in the DRS arbitration forum pursuant to their separate authority.

92 *See* Rule 13805(b)(3).

93 *See* Rule 13805(c)(6)(B).

94 *See* Rule 13805(c)(6)(C). The authorized representative will not be considered a party to the proceeding and their attendance and participation is limited to what is authorized by Rule 13805(c)(6). As such, an authorized representative is not entitled to seek discovery from the parties through the DRS arbitration forum, file motions, or seek to postpone a hearing. In addition, the panel may not allow the attendance or participation of the authorized representative to materially delay the scheduling of the expungement hearing.

95 *See* Rules 12203(b) and 13203(b).

96 *See* Rules 12203(c) and 13203(c).

The Standard of Care Applicable to CFP® professionals and Other Certified or Credentialed Securities-Industry Professionals

By Christine Lazaro, JD; Kimberly Chavers, JD; Daniel J. Broxup, JD, CFA®; and Alan Besnoff, CFP®

Securities industries professionals are increasingly seeking to gain an edge over their competition in a saturated field by obtaining industry certifications and credentials. Most notably, there are now close to 100,000 CFP® professionals operating in the United States. This proliferation of certified and credentialed industry professionals opens up a variety of opportunities and pitfalls for investor advocates, including the opportunity to hold these professionals to a heightened standard of care. In the sections that follow, we briefly address the legal framework for seeking application of a heightened standard of care, and then provide an overview of CFP Board's and CFA Institute's respective codes of ethics, practice standards, and related materials.

I. The Legal Framework

The standard of care applicable to securities industry professionals who hold themselves out as "CFPs" (CFP® professionals), "CFAs" (CFA® charterholders), or as certified or credentialed in any other manner, should arguably be the higher of (a) the standard of care established by the certifying association; or (b) the general standard of care within the industry. Note that this article does not address the debate over whether there is a private cause of action for violation of a certifying entity's internal rules or regulations. Rather, this article focuses on the certifying entity's rules or regulations as a foundation for the relevant standard of care owed to investors by a certificant.

The general issue of applying heightened standards of care to certified individuals is described in 1 The Law of Associations § 12.04 as follows:

> Liability of Certified Individuals
>
> . . .
>
> [A]nother important issue is whether a certification program can have liability implications for those who become certified.

If a person who provides services for a fee is negligent in some manner in performing those services, and thereby causes damage, he or she can be held liable. In the usual case, the determination of whether they were in fact negligent will be whether they acted in conformance with a particular standard of care. Specifically, professionals and other service providers are expected to exercise the skill and knowledge ordinarily possessed by those in the same profession or industry.

However, if one is certified in their area of practice, it may be that they will be held to a higher standard. In both medicine and law, courts have held specialists in particular areas to a higher standard of care. **That is, as specialists, they are expected to have greater expertise and skills.** As stated by one court: "One who holds himself out as specializing and as possessing greater than ordinary knowledge and skill in a particular field, will be held to the standard of performance of those who hold themselves out as specialist in that area." At least one court has held that this does not extend to the certification area. However, in lawsuit against an individual who has been certified by an organization, the plaintiffs argued that the defendant was therefore legally bound to adhere to the standards of certification, but the court disagreed: "the plaintiffs point to no evidence of an agreement to perform duties in accordance with specific standards established by the [certifying organization]." It is also possible that a company which employs certified individuals may be sought to be held responsible if those employees do not perform in a manner consistent with their certified status.

(**Tab A**, 1 The Law of Associations § 12.04) (emphasis added).

There are, of course, many examples of medical malpractice cases in which courts have held that the governing standard of care is the standard common to experts in the specific field within which the defendant was board certified. There are also numerous cases that apply heightened standards of care to lawyers who hold themselves out as specialists in a given field of the law. *See, e.g., Duffey Law Office, S.C. v. Tank Transport, Inc.*, 535 N.W.2d 91 (Wis. Ct. App. 1995) (an attorney who represents to a client that the attorney has expertise greater than that of the average Wisconsin lawyer is to be held to a standard of professional care that is consistent with that claimed expertise); *Walker v. Bangs*, 601 P.2d 1279 (Wash. 1979) (one who holds

himself out as specializing and as possessing greater than ordinary knowledge and skill in a particular field, will be held to the standard of performance of those who hold themselves out as specialists in that area).

However, there is no reason that the same approach cannot be applied to securities-industry professionals. The Restatement (Second) of Torts § 299A, comments d and e are a good starting place for arguing that a heightened standard of care should apply to CFPs and other certified or credentialed securities-industry professionals. The comments state, in pertinent part, as follows:

> *d. Special representation.* **An actor undertaking to render services may represent that he has superior skill or knowledge, beyond that common to his profession or trade. In that event, he incurs an obligation to the person to whom he makes such a representation, to have, and to exercise, the skill and knowledge which he represents himself to have.** Thus, a physician who holds himself out as a specialist in certain types of practice is required to have the skill and knowledge common to other specialists. On the other hand, the actor may make it clear that he has less than the minimum of skill common to the profession or trade; and, in that case, he is required to exercise only the skill which he represents that he has. Thus, a layman who attempts to perform a surgical operation in an emergency, in the absence of any surgeon, and who makes it clear that he does not have the skill or knowledge of a surgeon, is not required to exercise such skill or knowledge. The rule stated in this Section applies only where there is no such special representation.
>
> *e. Standard normally required.* In the absence of any such special representation, the standard of skill and knowledge required of the actor who practices a profession or trade is that which is commonly possessed by members of that profession or trade in good standing. It is not that of the most highly skilled, nor is it that of the average member of the profession or trade, since those who have less than median or average skill may still be competent and qualified. . . .

(**Tab B**, Restatement 2d of Torts, § 299A, Comments d and e) (emphasis added).

Evidently, the issue that practitioners are likely to face when seeking to invoke Restatement 2d of Torts, § 299A is whether the defendant held themself out as

having specialized knowledge or skills by virtue of a particular certification or credential. This was the critical issue in *Forester v. Servpro of Bloomfield & Livonia, et al.*, 2006 Mich. App. LEXIS 3330 (Mich. App. 2006), a copy of which is attached at **Tab C**. In that case, the Michigan court of appeals held that the plaintiff had no standing to sue a certified individual for failing to act in accordance with standards of the certifying body. However, the court hinted that the outcome might have been different had the defendant ***specifically promoted his certified status*** in soliciting the business of the plaintiffs.

Establishing that CFP Board's standard of care, or another certifying body's standard of care applies, can be a useful tool for practitioners. For one thing, these certifying bodies often have very specific standards of conduct and publish illustrative examples of conduct that runs afoul of their respective standards. The sections that follow outline CFP Board's and CFA Institute's standards, guidance, and related materials.

II. CFP Board's Standards of Care

CFP Board has instituted a *Code of Ethics and Standards of Conduct* (collectively known as the *"Code and Standards"*). According to CFP Board's website, its *Code and Standards* "benefits and protects the public, provides standards for delivering financial planning, and advances financial planning as a distinct and valuable profession."

Under CFP Board's *Code of Ethics*, a CFP® professional must:

1. Act with honesty, integrity, competence, and diligence;
2. Act in the client's best interests;
3. Exercise due care;
4. Avoid or disclose and manage conflicts of interest;
5. Maintain the confidentiality and protect the privacy of client information; and
6. Act in a manner that reflects positively on the financial planning profession and CFP® certification.

The *Standards of Conduct* are then divided into the following categories:

A. Duties Owed to Clients;
B. Financial Planning and Application of the Practice Standards for the Financial Planning Process;
C. Practice Standards for the Financial Planning Process;

D. Duties owed to Firms and Subordinates;
E. Duties Owed to CFP Board; and
F. Prohibition on Circumvention.

Within each broad category of its *Standards of Conduct*, there are a series of specific standards. For example, the following standards fall under **Duties Owed to Clients**:

1. Fiduciary Duty;
2. Integrity;
3. Competence;
4. Diligence;
5. Disclose and Manage Conflicts of Interest;
6. Sound and Objective Professional Judgment;
7. Professionalism;
8. Comply with the Law;
9. Confidentiality and Privacy;
10. Provide Information to a Client;
11. Duties When Communicating with a Client;
12. Duties When Representing Compensation Method;
13. Duties When Recommending, Engaging, and Working with Additional Persons;
14. Duties When Selecting, Using, and Recommending Technology; and
15. Refrain from Borrowing or Lending Money and Commingling Financial Assets.

A copy of the *Code and Standards* is attached at **Tab D.**

CFP Board has also developed a series of Case Studies to provide practical guidance to CFP® professionals and their firms on the *Code and Standards*. Each case study presents a hypothetical factual circumstance and then asks a question about a CFP® professional's duty in that circumstance under the *Code and Standards*. A copy of the Case Studies published (as of July 2023) is attached at **Tab E.** CFP Board also provides a helpful Q&A concerning the *Code and Standards* (as of June 2023), a copy of which is attached at **Tab F.**

CFP Board's Case Studies and Q&A tend to cover common situations that we, as investor advocates, are likely to encounter, so they can be an invaluable resource in demonstrating a violation of a particular standard.

III. **CFA** Institute's **Standards of Care**

According to CFA Institute's website, its mission "is served by generating value for investment management professionals and engaging with the investment industry to **advance ethics**, market integrity, and **professional standards of practice**, which collectively contributes value to society." (Emphasis added).

CFA Institute's Values[1] state, in relevant part:

> We believe that financial markets and services should operate in the following ways:
>
> ...
>
> - Good stewardship and **high ethical standards** are necessary for trust and confidence to be secured and for society to be served. Financial markets should afford every investor the opportunity to earn a fair return.
> - Financial markets are more effective with **knowledgeable**, diverse participants.
> - **High ethical principles and professional standards are essential to positive outcomes; rules and regulations, while necessary, are <u>not sufficient</u> by themselves.**

(Emphasis added).

To further its Mission & Vision "[t]o lead the investment profession globally by promoting the **highest standards of ethics, education, and professional excellence** for the ultimate benefit of society", CFA Institute has established and enforces a Code of Ethics and Standards of Professional Conduct ("Code and Standards"), which it describes as a "global benchmark for the professional conduct of the investment professional."[2] Importantly, all CFA Program[3] and CIPM[4]

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[1] *Available at* https://www.cfainstitute.org/en/about/vision (last visited Aug. 5, 2023).

[2] *Id.* (Emphasis added).

[3] The **Chartered Financial Analyst (CFA®)** credential sets the standard as the most highly respected designation in the investment management profession and is designed for Portfolio and wealth managers, investment and research analysts, professionals involved in the investment decision-making process, and finance students who want to work in the investment management profession.

[4] The **Certificate in Investment Performance Measurement (CIPM®)** designation is designed for Portfolio managers, investment consultants, financial advisers, sales and client service professionals, and other

charterholders/certificants and candidates are **required to follow the Code and Standards**.

A current version of its Code and Standards is attached as **Tab G**.[5] CFA Institute also provides updated guidance concerning application of the Code and Standards. In 2014, it published the 2014 Standards of Practice Handbook (11th edition), which contains the Code and Standards (effective 1 July 2014) and guidance applicable at the time of publication. A copy of the Handbook is attached hereto at **Tab H**.[6]

CFA Institute's **Standards of Professional Conduct** cover seven broad areas: (I) Professionalism; (II) Integrity of Capital Markets; (III) Duties to Clients; (IV) Duties to Employers; (V) Investment Analysis, Recommendations and Actions; (VI) Conflicts of Interest; and (VII) Responsibilities as a CFA Institute Member or CFA Candidate. Within each broad area, there are a series of specific standards. To illustrate, under Investment Analysis, Recommendations and Actions, there are standards for (A) Diligence and Reasonable Basis; (B) Communications with Clients and Prospective Clients; and (C) Record Retention.

In addition to providing the standards, the Institute also provides guidance applicable to each standard. Under Diligence and Reasonable Basis, for example, the Institute has published guidance on the following topics:

- Defining Diligence and Reasonable Basis
- Using Secondary or Third-Party Research
- Using Quantitatively Oriented Research
- Developing Quantitatively Oriented Techniques
- Selecting External Advisers and Subadvisers
- Group Research and Decision Makin

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investment professionals involved in selecting portfolio managers, evaluating portfolio performance, or communicating with clients.

[5] *Available at* https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/code-of-ethics-standards-professional-conduct.pdf (last visited Aug. 5, 2023). *See also* additional Code and Standard resources available at https://www.cfainstitute.org/en/ethics-standards/ethics/code-of-ethics-standards-of-conduct-guidance.

[6] *Available at* https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/standards-practice-handbook-11th-ed-eff-July-2014-corr-sept-2014.pdf (last visited Aug. 5, 2023). Prior edition (TENTH EDITION, 2010) *available at* https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/standards-practice-handbook-10th-ed-eff-july-2010-thru-june-2014.ashx.

In addition to guidance, the Institute publishes recommended procedures for compliance, as well as examples of applications of the standards. The examples take the form of specific fact patterns and commentary. Along with the guidance, the recommended procedures and examples are also included in the 2014 Standards of Practice Handbook.

TAB A

§ 12.04 Certification of Individuals

[1] Tax Exemption Issues

[a]— Section 501(c)(6).

The Internal Revenue Service has acknowledged that certification programs are entirely consistent with Section 501(c)(6) tax exempt status because they are designed to promote either an industry or the members of an industry or a profession.[1] Such promotion can be accomplished either by improving the employment prospects of those who have become certified, or by improving the profession or industry as a whole by raising the standards therein.

[b]— Section 501(c)(3).

The IRS has taken a harder line, however, with respect to Section 501(c)(3) organizations that wish to operate a certification program.[2] The *official* view of the IRS is that, as stated above, most certification programs are primarily designed to benefit an industry or a profession or the members thereof, and therefore the IRS does not view these programs as serving any kind of "public" purpose consistent with Section 501(c)(3) status.[3] In a Private Letter Ruling,[3.1] the IRS held that an association certification program was inconsistent with section 501(c)(3) status, saying:

> The Certification Program of [the association] consists of exam-based testing designed to demonstrate mastery of a specific body of knowledge. Participants who earn a passing grade on the exam and who have attained certain level of experience will be eligible for certification from the Certification Program. Thus, the activities of the Certification Program are designed to improve the quality of [the discipline] and maintain high standards of excellence in the [profession].

It should be pointed out, however, that the IRS did not conclude that the 501(c)(3) status of the organization in this instance be revoked. That is because the IRS found that the Certification Program represented an insubstantial part of the overall activities of the organization. This is not to say that it is impossible for an association to demonstrate some benefit (*e.g.*, improvement of health, safety, etc.) to society and, further, that such is the primary benefit and focus of the program, not the professional development of those who have become certified.[4] Clearly the burden will be on the association.

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[1] *Rev. Rul. 73-567, 1973-2 C.B. 178*, *see also*, *IRS Priv. Ltr. Rul. 9428035*.

[2] *Id. See G.C.M. 39721* ("This [certification] program is designed and operated to achieve professional standing … and to enhance the respectability of those certified"). *See also PLR 201327014, 2013 PLR LEXIS 314*, in which the IRS found that a product certification association was not eligible for exemption under Section 501(c)(3).

[3] *Rev. Rul. 73-567, 1973-2 C.B. 178*. *Cf. IRS PLR 201221023* (certification of products not a section 501(c)(3) activity). *See also*, *IRS Priv. Ltr. Rul. 201906010* ("The act of certifying [professionals] is deemed not to be in furtherance of education. Rather it is more of serving the private interests of the profession by promoting and enhancing the status of [those who practice the profession]."

[3.1] *IRS Letter Ruling 200439043*.

[4] A search of IRS records reveals that there are currently almost 50 organizations exempt under section 501(c)(3) that have the word "certification" in their name.

In another interesting situation, an organization properly determined to be exempt under Section 501(c) (3) had its status revoked due to its merger with another non-Section 501(c) (3) organization the primary activity of which is certifying medical professionals. The merger materially altered the organization's operations from what was described in its original Form 1023 application and resulting in revocation of the organization's 501(c)(3) status.[4.1]

It is also possible for a certification program to be undertaken consistent with Section 501(c)(3) if the association shows that it is "relieving the burdens of government" through operation of the program.[5] The association would have to show that the federal government, or a state or local government, has demonstrated a clear interest and desire to have a certification program of the kind that the association is operating, and that if the association did not operate the program, the government would have to do so. The evidence that the association would need to produce would perhaps be in the nature of governmental regulations, hearings, statutes, etc. It could not be simply a general interest expressed by certain government employees.

In one instance, an association that certifies medical professionals argued that it was entitled to Section 501(c)(3) status because it relieved the burdens of government. The IRS disagreed:

> Lessening the burdens of government requires that an *IRC Section 501(c)(3)* organization demonstrates a very close connection to a governmental body. This is a difficult standard to prove, as many cases and rulings relating to certification demonstrate … . [T]here needs to be evidence showing that * * * as a * * * profession should be regulated by a federal agency in order to prove that the EO is lessening the burdens of the government. It is arguable that * * * are a sub class of healthcare provider and as such, should be regulated by an authorized government body. However, as of today, there is no federal law or state law showing that the government believes * * * should be certified. Furthermore, an organization is lessening the burdens of government only if (a) its activities are activities that a governmental unit considers to be its burdens; and (b) the activities actually lessen such governmental burden. It is in our position that the EO does not qualify for *IRC Section 501(c)(3)* status base on the lessening the burdens of government argument."[5.1]

Associations that certify persons employed by a governmental agency qualify for exemption under section 501(c)(3).[6]

In one case involving an accreditation program,[7] the U.S. Tax Court rejected the argument that the program relieved the burdens of government. The association cited the fact that numerous State agencies required compliance with the program, but, on balance, the court found that the program was primarily directed at promoting the business of members than at assisting the government in any way.

If a Section 501(c)(3) organization operates a certification program that does not fit within Section 501(c)(3), then any net income from the program would be considered unrelated income, and therefore taxable. One way to avoid this result would be to create a section 501(c)(6) subsidiary.

[2] Intellectual Property

[a]— Trademark.

[4.1] *IRS Priv. Ltr. Rul. 201906010*.

[5] *E.g.*, *Indiana Crop Improvement Ass'n, Inc. v. Commissioner, 76 T.C. 394* (1981), *see also*, *IRS Tech. Adv. Mem. 199922055* (Finding that association certification program relieved burdens of government since the members of the association were themselves government officials).

[5.1] *IRS Priv. Ltr. Rul. 201906010*.

[6] *I.R.S. Tech. Adv. Mem. 99-22-055*.

[7] *Quality Auditing Co. v. Commissioner, 2000 U.S. Tax Ct. LEXIS 36, 114 T.C. No. 31*.

Certification designations (*e.g.*, "Certified _____"; "C__") can be trademarked under federal law.[8] A "certification mark" is defined as "any word, name, symbol, or device, or any combination thereof used … to certify … quality, accuracy, or other characteristics of such person's goods or services."[9] In most association programs, of course, certification marks certify that the performer of services has met certain standards or criteria.[10]

It is important for an association to act against any misuse or unauthorized use of a trademark. Failure to do so can cause the association to lose its trademark if the association is aware but fails to take any action.[11]

[b]— Copyright.

Certification materials, including examinations, are eligible for copyright registration and protection.[12] Certification exam preparation materials also are subject to copyright protection, particularly against competitors of the association.[13] Further, the U.S. Copyright Office has developed a procedure that virtually eliminates the privacy and security concerns that a certifying organization may have about the customary requirement that a copy of any work to be copyrighted must be deposited with the Copyright Office.[14]

If an association requires persons wishing to take a certification exam to agree not to disclose the content of any of the questions—orally or in writing—such commitments can be legally enforceable.[15]

[3] Antitrust Issues

It is well recognized that "certification programs can be helpful to consumers by informing them that practitioners (and establishments) meet meaningful levels of occupational competency."[16] Indeed, certification programs are generally considered to be pro-competitive because they provide "additional information or clarity" to persons making economic decisions.[17]

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[8] *See generally*, Chapter 16A, Section 16A.04.

[9] 15 U.S.C. § 1127.

[10] Trademark Manual of Examining Procedure § 1306.03.

[11] *Cf.*, National Bd. for Certification in Occupational Therapy v. American Occupational Therapy Ass'n, 24 F. Supp. 2d 494 (D. Md. 1998).

[12] Applied Innovations v. Regents of the Univ. of Minnesota, 876 F.2d 626 (8th Cir. 1989). *See also* Association of American Medical Colleges v. Mikaelian, 571 F. Supp. 144 (E.D. Pa. 1983), *aff'd*, ***734 F.2d 3 (3d Cir. 1984)***, International Kitchen Exhaust Cleaning Association v. Power Washers of North America, 81 F. Supp. 2d 70 (D.D.C. 2000). *See generally*, Chapter 16, Section 16.02.

[13] Mulcahy v. Cheetah Learning LLC, 386 F.3d 849 (8th Cir. 2004) (nonprofit that provided certification testing preparation classes and publications sued for-profit test preparation company for developing a publication that was simply a condensed version of the nonprofit's test prep book).

[14] 37 C.F.R. § 202.20(c)(2)(vi).

[15] Am. Registry of Radiologic Technologists v. Bennett, 2013 U.S. Dist. LEXIS 120548 (W.D. Tex. Aug. 26, 2013) (applicants were required to sign the following statement: "This exam is confidential and is protected by trade secret law. It is made available to you, the examinee, solely for the purpose of assessing qualifications in the discipline referenced in the title of this exam. You are expressly prohibited from disclosing, publishing, reproducing, or transmitting this exam, in whole or in part, in any form or by any means, verbal or written, electronic or mechanical, for any purpose, without the prior express written permission of [the association].").

[16] FTC Adv. Op. 783 7008, 91 F.T.C. 1204 (1978).

[17] U.S. Dept. of Justice Bus. Rev. Ltr., 2011 DOJBRL LEXIS 1 ("[T]he purpose of the certification program is to provide clarity to the film industry and the public by distinguishing those who perform what the Guild considers to be producer's duties on a work from those financiers, actors, lawyers or others in the industry who may bargain for a generic producer credit in return for their services. Providing this additional information or clarity appears to be the main pro competitive benefit of the program.").

Nevertheless, association certification programs can be vulnerable to attack on antitrust grounds. Like standards, certification programs naturally restrain trade in the sense that they may divert business from one competitor to another.[18] But that does not make such programs unlawful.

[a]— Antitrust Injury.

The first component of an antitrust challenge to an association certification program is that it harms competition. This is different from one person claiming they are economically harmed by not being able to become certified for some reason. Indeed, the mere fact that a particular plaintiff is deprived of the ability to compete is typically insufficient to establish an antitrust claim based on denial of, or ineligibility for, certified status. In many certification challenges, the plaintiffs argue that the harm they have suffered is loss of business or loss of revenue because they can make more money if they have certified status. While these allegations may be true, they do constitute a valid antitrust claim. As explained by one court:

> The Plaintiffs, who want to obtain a credential that will help them charge higher prices, have pleaded themselves out of court on the antitrust claim. Plaintiff does not specify which consumers were injured by Defendants' practices or allege any adverse effect on competition as a whole in any market … Rather, Plaintiff's alleged damages are a direct result of his inability to earn and benefit from a professional credential … with which [he] expect[s] to obtain greater compensation at a level resulting from the anticompetitive conduct [he] seek[s] to condemn. The requirement of antitrust injury and standing has been extended to plaintiffs who, as competitors in the market, seek a professional credential that will enable them to charge higher prices for their services in that market, and a request for such relief in a federal antitrust complaint negates the existence of an antitrust injury and standing requiring dismissal of the complaint. Thus, Plaintiff has alleged no cognizable injury under the antitrust laws.[19]

In one case, a group of physicians who could not meet a residency requirement for certification by an association sued the association, claiming that the residency requirement is an impermissible restraint.[20] Regarding the injury that was suffered as a result of being denied certified status, the physicians alleged that they "have been and continue to receive substantially less remuneration than certified emergency physicians" and that they are unable to "compete for the higher salaries paid to … certified emergency physicians." The average difference in compensation between certified and non-certified physicians in this instance was over $50,000 annually. But this was part of the problem with the plaintiffs' case. In essence, they were seeking the right to charge higher prices, which is not a cognizable antitrust claim. Further, even though they characterized the certification program as representing a restraint of trade, they were not seeking to put an end to the negative aspects of that program. Rather, they were simply seeking the right to become part of this "exclusive group of emergency physicians who can seek 'super-competitive' remuneration."

Nevertheless, some courts have examined in detail the claims of plaintiffs regarding economic harm. In *Austin v. Am. Ass'n of Neurological Surgeons*,[21] the plaintiff's claim failed because the court concluded that a 65% drop in earnings from the previous year's income of $220,000.00 still left a "healthy" $77,000.00 and noted also that this amount represented "income from a sideline to his primary profession, which is that of a neurosurgeon." The court found that this "is not the kind of professional body blow that the cases have in mind when they speak of an 'important economic interest' jeopardized by the action of a voluntary association." By contrast, in *Brandner v. Am. Acad. of Orthopaedic*

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[18] Lacy, *Standardizing Warhol: Antitrust Liability For Denying the Authenticity of Artwork*, 6 WASH. J.L. TECH. & ARTS 185 (2011).

[19] *Papay v. Haselhuhn, 2010 U.S. Dist. LEXIS 112272*.

[20] *Daniel v. American Bd. of Emergency Med., 428 F.3d 408 (2d Cir. N.Y. 2005)*. See also, *Shaywitz v. Am. Bd. of Psychiatry & Neurology, 675 F. Supp. 2d 376, 2009 U.S. Dist. LEXIS 119485*) ("Shaywitz … has pleaded himself out of court on the antitrust claims because he sues to show harm to producers rather than to consumers. Shaywitz seeks Board-certification in order to be admitted into the alleged antitrust conspiracy to increase his job opportunities, wages, earning potential, and the profitability of his practice.").

[21] *253 F.3d 967, 971 (7th Cir. 2001)*.

Surgeons,[22] the plaintiff was able to show sufficient harm to proceed with his claim, based on a loss of almost two-thirds of his income.

Another case[23] concerned an individual who had repeatedly sought certification by the Appraisal Institute, a private nonprofit professional association. He argued that while an appraiser does not have to be a member in order to do business, certified appraisers get over 90% of the commercial business in the county in which he works, and non-certified appraisers are left mostly with the less lucrative residential appraisals.

The court rejected the plaintiff's claim, finding that the plaintiff "competed fairly in the appraisal market," though the court acknowledged the plaintiff "was at a disadvantage compared to certified appraisers." The court added, however, that such disadvantage "is no different in principal from the disadvantage the seller of a lower quality product has against a high quality product; the seller must sell the product for less money, make its product available more conveniently, or otherwise give consumers a good reason to buy it. The plaintiff was free to compete with the certified appraisers for every job."[24]

In fact, if the only injury that a plaintiff can allege is the inability to charge higher prices or fees, then the case likely will be dismissed. Very simply, the right to charge higher prices is not a cognizable antitrust claim.[25]

[i]— Certification Required by Third Parties.

It is not unusual for some third party, such as an employer or a federal contractor, to require that certain personnel hold a certification from an association. While this certainly makes certification by the association more valuable and potentially economically necessary, it does not result in an antitrust violation. Indeed, the "mere fact" that a third party requires a particular certification "is not a sufficient allegation of an unlawful agreement."[26] As held by the US Supreme Court, "an allegation of parallel conduct and a bare assertion of conspiracy will not suffice. Without more, parallel conduct does not suggest conspiracy, and a conclusory allegation of agreement at some unidentified point does not supply facts adequate to show illegality.[27] Employers do not conspire with associations any more than graduate schools conspire with universties by requiring an undergraduate degree for admission.[28]

Further, there is nothing illegal or conspiratorial about associations encouraging employers to require certification as a condition of employment for certain positions.[29] As long as employers make "their own independent calculation" in requiring certification, there is no antitrust violation.[29.1]

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[22] *2012 U.S. Dist. LEXIS 138833*.

[23] ***McDaniel v. Appraisal Institute, 1997-1 Trade Cas. (CCH) ¶ 71,851*** (9th Cir.). *See also, Allyn v. Am. Bd. of Med. Specialties, Inc., et al., 2019 U.S. Dist. LEXIS 10805* ("Generally, voluntary certification creates fewer harms to competition than more restrictive licensing practices since non-certified providers can continue to offer their services even without the certification.").

[24] *See also* U.S. Dept. of Justice Bus. Rev. Ltr., 2011 DOJBRL LEXIS 1 (approving certification program that was voluntary and that did not prevent non-participants from still working in the profession).

[25] *Daniel v. American Board of Emergency Medicine, 428 F.3d 408 (2d Cir. 2005)*.

[26] *Ellison v. Am. Bd. of Orthopaedic Surgery, Inc., 2020 U.S. Dist. LEXIS 43993*.

[27] *Twombly, 550 U.S. at 556–57*.

[28] Id.

[29] Id. ("Lacking any actual agreement with hospitals, ABMS engaged in public marketing efforts in an attempt to expand the reach of its programs.").

[29.1] Id.

The second component of the antitrust attack is that the certification program is somehow deficient, *e.g.*, it requires knowledge or ability in areas that are not relevant to practice of the profession or employment in the industry, or it does not adequately test relevant knowledge or skills.[30]

In order to avoid or defend against charges that a certification program is unreasonable in some respect, most associations undertake formal validation of their programs. In fact, failure to do so can be a basis for a legal challenge—again typically on antitrust grounds.[31] In addition, associations should be generally prepared to defend their programs not only in terms of validation, but also in terms of all aspects of preparation, including personnel that were involved in the preparation, source of questions, etc. If a certification program is a reasonably accurate measure of knowledge and/or competency, it should be upheld as valid by a court, regardless of the protests of those who fail.[32] The requirements should not be "too indefinite" or "too subjective" such that they "lead to arbitrary limitations on certification."[33]

Another area in which programs are subject to challenge is with respect to formal education requirements. While courts often will grant associations a great deal of latitude in determining what constitutes sufficient educational requirements, especially with respect to recognized professions, it often is prudent to have a competency or experience aspect of the program.[34] For example, if an applicant for certification does not have a college degree, the association may want to provide an alternative, such as years of experience or competency testing.

Prerequisites that are unrelated to knowledge or qualifications may also be subject to challenge. For example, associations that required individuals to be members of affiliated associations in order to be eligible for certified status were successfully challenged on the basis that such memberships were irrelevant to certified status.[35]

Finally, oral examinations or other subjective elements in a certification program, while not impermissible *per se*, can be troubling and do leave an association vulnerable to charges of arbitrariness or unfairness. Ideally, exams should be objective and written, with oral interviews undertaken only for a good reason.

[b]— Test Content and Validity.

It is the goal of any certification examination to accurately test the knowledge and/or competency of those seeking to become certified. If a test is not an accurate measure, then presumably it is of little value. Most associations that administer certification examinations seek to validate the efficacy of their exams through psychometric testing. Regardless, if a test is not an accurate measure, is this a basis to sue the certifying association?

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[30] *E.g.*, *Solahart Industries v. Int'l Ass'n of Plumbing and Mech. Officials, 1996 U.S. Dist. LEXIS 19875 (S.D. Cal.)* (allegation that association adopted "unreasonable and groundless requirements for certification").

[31] *Veizaga v. Nat'l Board for Respir. Therapy, 1977-1 Trade Cas. (CCH) ¶ 61,274 (N.D. Ill.)* (program challenged on the basis that the tests "have never been validated under accepted professional standards as predictive of ability"). For a good example of an organization that undertook extensive validation to its benefit, *see Association of Mexican American Educators v. California Commission on Teacher Credentialing, 937 F. Supp. 1397 (N.D. Cal. 1996)*.

[32] *State ex rel. Scanlon v. National Ass'n of Ins. Comm'rs, 875 P.2d 340 (Mont. 1994)* (individual who failed to meet the prerequisites for certification, logically, was ineligible for certified status).

[33] FTC Adv. Op. 783 7008, *91 F.T.C. 1204 (1978)* (requirements that an applicant have "sufficient" experience and that a facility have "adequate" staff and present a "professional" appearance too vague and indefinite).

[34] *See, e.g.*, ***Daniel v. American Board of Emergency Medicine, 802 F. Supp. 912 (W.D.N.Y. 1992)*** (certification program had two paths: (1) the "residency" mode, whereby the physician was required to complete an approved three-year residency training program; and (2) a "practice track" mode, whereby the physician was required to complete 7,000 hours and 60 months of practice in emergency room medicine with 24 months of continuing practice. This latter "practice track" was eliminated in 1988. Plaintiff alleged that this elimination was an unreasonable restraint of trade).

[35] *E.g.*, *Greisman v. Newcomb Hosp., 40 N.J. 389, 192 A.2d 817 (1963)*; *Falcone v. Middlesex County Med. Soc'y, 34 N.J. 582, 170 A.2d 791 (1961)*.

One relevant case[36] involved an individual who wished to become licensed to practice dentistry in Ohio. In order to do so, he needed to pass a written examination, which he was unable to do. As a result, he sued the Northeast Regional Board of Dental Examiners for negligence for failing to administer a "psychometrically valid exam that accurately measures what it purports to, in this case dental competency." As evidence, he cited the relatively small amount of money the Board had spent to validate its test psychometrically, in violation of what the plaintiff and his paid experts claimed are the standards of the testing community regarding the provision of a valid and reliable test.

While acknowledging that a test should be a reliable measure, the court rejected the plaintiff's claims, finding that a certifying organization has no duty to develop a test with a *specified* level of validity, nor does such an organization have the burden to prove validity. In sum, said the court, there is no independent cause of action for "testing malpractice."

While the court was correct to find that there is no separate tort of "testing malpractice," this may be simply a matter of how a claim is characterized. That is, if the plaintiff had characterized his case as an antitrust suit, he might have had more success. If certification in a particular profession is vital to the successful practice of that profession, then certification must be bestowed and administered in a fair and reasonable manner. A test that does not accurately measure knowledge or competence, one could argue, is by definition unfair and unreasonable.

However, certainly a certifying association does not have to tailor a test for each applicant, and therefore the fact that a test covers areas that are not relevant to the particular work or practice of an applicant is not a basis to legally challenge the test.[37] An association is allowed to test general knowledge of relevant subject areas, even if that knowledge may not be necessary for every applicant.[38] The association may even test for knowledge in areas not required by any State or other governmental licensing agency.[39]

[c]— Restricting Certification to Members Only.

It is not unusual for an association to certify only its members. In other words, in order to become certified and to maintain certification, an individual must become a member of the association and maintain its membership in the association. This can raise legal issues, particularly under the antitrust laws. Old FTC advisory opinions take the position that membership cannot be a condition of certification,[39.1] but more recent antitrust cases hold that there is no antitrust prohibition as long as the requirements for membership are not unreasonably burdensome.[39.2] Nevertheless, a non-member may allege that a membership requirement is a so-called tying arrangement, *i.e.*, requiring a customer who wants to purchase one product or service to purchase another product or service that the customer does not want.

However, a tying arrangement is a violation of antitrust law only if a "substantial volume of commerce is *foreclosed* thereby."[40] This is because the primary concern about such arrangements is that they may allow a seller to exploit its

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[36] *Baji v. Northeast Regional Board of Dental Examiners, 2001 U.S. App. LEXIS 1825*.

[37] *Liberman v. Am. Osteopathic Ass'n, 2014 U.S. Dist. LEXIS 153012 (E.D. Mich. Oct. 29, 2014)* ("There is no requirement that a private association individually tailor a general certification examination to fit each applicant's specific practice.").

[38] *Id.*

[39] *Id.*

[39.1] *E.g.*, *78 F.T.C. 1628 (1971)* ("no applicant for certification may be denied certification [because] he is a nonmember of any association or organization").

[39.2] *E.g.*, *Pope v. Mississippi Real Estate Com., 695 F. Supp. 253 (N.D. Miss. 1988)* ("A private organization may limit its services to its members as long as there is no arbitrary exclusion from membership.").

[40] *Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2, 104 S. Ct. 1551, 80 L. Ed. 2d 2 (1984)* (emphasis added). *See also*, *Buyer's Corner Realty, Inc. v. Northern Ky. Ass'n of Realtors, 410 F. Supp. 2d 574, 578 (E.D. Ky. 2006)*, *aff'd* 198 F. App'x 485 (6th Cir. 2006) (A tying arrangement is unlawful only if it "allow[s] a seller to exploit its power in the market for the tying product to invade, and then stifle competition in, the market for the tied product.").

power in the market for the tying product to invade, and then stifle competition in, the market for the tied product. Where the buyer would not have purchased the tied product from another seller, such foreclosure is not present. Similarly, when a purchaser is "forced" to buy a product he would not have otherwise bought even from another seller in the tied product market, there can be no adverse impact on competition because no portion of the market which would otherwise have been available to other sellers has been foreclosed.[41]

An example of a tying challenge in the certification context is *Talone v. American Osteopathic Association*.[42] The plaintiffs in this care were osteopathic physicians who are board certified as medical specialists by the American Osteopathic Association ("AOA"), and who have also purchased membership in the AOA. The AOA notified the plaintiffs and all other AOA board certified physicians that their board certification would be invalidated and cancelled unless they purchased annual membership in the AOA. The plaintiffs claimed that in order to avoid the loss of their board certification, they were forced to purchase AOA membership even though it serves no purpose with respect to, and has no actual connection with, AOA board certification or their practice as physicians. They further claimed that the AOA's tying arrangement has reduced the number of physicians willing to purchase membership in other professional physician associations and has thereby foreclosed competition in the market for membership in professional physician associations. By allegedly reducing competition in the association membership market through its alleged unlawful tying arrangement, Plaintiffs claim that the AOA has been able to increase the price of its annual membership dues to almost double the price that its competitors charge for membership in their associations, and there has been a corresponding reduction in competitive offerings. Plaintiffs further claimed that there is no evidence that the AOA's tying arrangement enhances the efficiency of its product offerings, meaning there is no procompetitive business justification for its unlawful tying arrangement.

The court ruled that the plaintiffs had stated a valid cause of action under the antitrust laws:

> The Court finds at this pleading stage that plaintiffs have sufficiently stated claims for per se and 'rule of reason' antitrust violations. Plaintiffs have pleaded that 32,000 AOA board certified physicians from around the country have no choice but to purchase AOA memberships that cost significantly more than other physician association memberships with similar benefits, resulting in almost $9 million in dues since August 2012, and preventing other membership associations from competing for those physicians' business. Plaintiffs have also pleaded that they would choose a different membership association if they were not tied to the AOA membership. These allegations, when taken as true, show that the AOA ties two distinct products, it has market power in the tying product market, and it affects a substantial amount of interstate commerce. Moreover, when accepted as true, these allegations show that the AOA's tying arrangement substantially lessens the competition so that other professional association membership organizations are foreclosed from competing for AOA board certified physicians' business.[43]

This decision by the court is not on the merits; it only allowed the case to move forward to trial. The parties later settled the case.

It is important to note that an absence of foreclosure of competition in the allegedly tied market has repeatedly led courts to reject tying claims based on the forced purchase of membership in professional associations. In the real estate context, for example, plaintiffs have sued Boards of Realtors that have conditioned access to a multiple listing service on membership in such Boards. These claims alleging that purported tying arrangements violate the Sherman Act have

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[41] *See, e.g.*, *Wells Real Estate, Inc. v. Greater Lowell Bd. of Realtors, 850 F.2d 803 (1st Cir. 1988)* (rejecting tying claim because there was "no evidence that any other broker would have 'purchased' membership in any other board but for the power exerted by the lure of the defendants' MLS," and thus no evidence that "a substantial volume of 'commerce' in board membership was foreclosed by the tie-in"). *See also*, *Blough v. Holland Realty, Inc., 574 F.3d 1084, 1089 (9th Cir. 2009)* ("Zero foreclosure exists where the tied product is completely unwanted by the buyer."); *Cancall PCS, LLC v. Omnipoint Corp., 2001 U.S. Dist. LEXIS 3267 (S.D.N.Y. Mar. 26, 2001)* (dismissing tying complaint where plaintiff's allegations confirmed that the "alleged tie did not foreclose" sales in the market for the tied product).

[42] *2017 U.S. Dist. LEXIS 89395 (D.N.J.)*.

[43] *Id.* See also, In *Bogus v. Am. Speech & Hearing Ass'n, 582 F.2d 277 (3d Cir. 1978)* (holding that plaintiffs challenging a rule of a professional society that required membership as a condition of certification had standing to bring the case by virtue of the dues that they had allegedly been forced to pay to maintain membership in the society).

consistently failed where the plaintiffs' complaints were simply that they did not want to join the Realtor association.[44] Unless the tie-in has led other professional associations to lose members they otherwise would have had—i.e., unless the tie-in foreclosed competition for membership that might have occurred—there is no antitrust problem.[45]

[d]— Recertification.

Most association certification programs have some kind of recertification requirement. In fact, from a liability standpoint, that is recommended. It is the best way to confirm that a certificant is still qualified. But in recent years there have been a series of lawsuits challenging newly-imposed recertification requirements. Most of these challenges have alleged an unlawful tying arrangement. An unlawful tying arrangement is "an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier."[45.1] These arguments have failed, largely on the basis that a tying arrangement requires two products—the tying product and the tied product—and courts have concluded that recertification is not a separate product but instead is part of the same certification "product" or program.[45.2]

[4] Denial or Revocation of Certification

[a]— Rights of the Association.

Associations clearly have the right to establish meaningful criteria for certification, including a code of ethics, and apply and enforce the same. An association certification program is "only as strong as its weakest link."[46] Forcing an association to certify someone who is underserving "would cause all of [the certificants] to suffer."[47] An association "should not be forced to" certify a person "who tarnishes its reputation through his behavior."[48]

[b]— Denial of Certification.

Because certification can have economic value to those seeking to become certified, some due process must be accorded those who fail. However, there is generally considered to be a difference in the level of harm between a denial of certification as opposed to a revocation of certification, the latter generally assumed to be the more disadvantageous.[49]

The most fundamental due process is the right to reapply for certification or retake the certification exam.[50] Indeed, re-examination virtually eliminates the possibility of recurring clerical or computational errors.

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[44] See, e.g., *Wells Real Estate, Inc. v. Greater Lowell Bd. of Realtors, 850 F.2d 803, 815 (1st Cir. 1988)* (rejecting tying claim because there was "no evidence that any other broker would have 'purchased' membership in any other board but for the power exerted by the lure of the defendants' MLS," and thus no evidence that "a substantial volume of 'commerce' in board membership was foreclosed by the tie-in"); see also *O'Riordan v. Long Island Bd. of Realtors, Inc., 707 F. Supp. 111, 116 (E.D.N.Y. 1988)* ("Here, as in Wells, plaintiff has made no showing that there was any sort of market in boards of real estate dealers and has made no showing of anticompetitive results.").

[45] Cf., e.g., *In re Cox Enter., No. 12-ML-2048-C, 2015 U.S. Dist. LEXIS 152915 (W.D. Okla. Nov. 12, 2015)* (granting defendant judgment as a matter of law where plaintiff had not established that defendant "acted in a manner to prevent any other manufacturer from selling [in the product market]," and thus defendant had not "foreclosed any competition").

[45.1] *Viamedia, Inc. v. Comcast Corp., 951 F.3d 429, 468 (7th Cir. 2020)*.

[45.2] E.g. *Lazarou v. American Board of Psychiatry and Nuerology, 2020 U.S. Dist. LEXIS 167054*; *Kenney v. Am. Bd. Of Internal Med., 412 F. Supp. 3d 530 (E.D. Pa. 2019)*; *Siva v. Am. Bd. of Radiology, 418 F. Supp. 3d 264 (N.D. Ill. 2019)*.

[46] *Briggs v. BOAT/U.S., Inc., 2012 U.S. Dist. LEXIS 165610*.

[47] *Id.*

[48] *Id.*

[49] *Lincoln Memorial University Duncan School of Law v. The American Bar Association, 2012 U.S. Dist. LEXIS 46036*.

From a practical standpoint, other steps may be necessary, such as meeting with the failed candidate, reviewing the exam with the candidate, etc.

[c]— Revocation of Certification.

If a certified individual fails to meet continuing requirements to maintain the certification, or if he or she takes some action which jeopardizes the certified status, such as violating a code of ethics or engaging in misconduct, the association has a right to take disciplinary action, up to and including suspension or even revocation of certified status. Certifying organizations have great discretion in imposing such discipline, as long as they act in good faith and with a reasonable basis.[51]

On May 8, 2012, Dr. Salas-Rushford received a letter signed by Ms. Langdon, on behalf of ABIM. *Id.* at ¶¶ 47–48. The letter informed Dr. Salas-Rushford as to the result of the investigation regarding Dr. Arora, and notified him that, it had identified emails that he had sent to Dr. Arora which contained Exam [*9] questions. *Id.* According to the letter, Dr. Salas-Rushford had collected the Exam questions, and proceeded to disguise and conceal his identity in order to relay the Exam questions to Dr. Arora. *Id.* Moreover, the letter allegedly quoted from the August 2009 ABIM Policies and Procedures for Certification ("ABIM Polices & Procedures") instead of the October 2008 ABIM Policies & Procedures which are the policies and procedures that Dr. Salas-Rushford claims govern the contractual relationship that he entered into with ABIM when he registered for the Exam. *Id.* at ¶ 48. In light of this conduct, which ABIM categorized as unethical and unprofessional, the letter stated that Dr. Salas-Rushford's board certification had been recommended for revocation. *Id.* at ¶¶ 47–48. The revocation would be instituted within ten (10) days. *Id.* at ¶ 47.

After Ms. Langdon sent the May 8, 2012 letter, Dr. Salas-Rushford claims that she caused the ABIM website to show his board certification status as "Revocation Recommended". *Id.* at ¶ 50. At this point, Dr. Salas-Rushford alleges that he denied any wrongdoing, but, even then, Ms. Langdon refused to change his certification status on the ABIM website. *Id.* at [*10] ¶ 51. Moreover, he maintains that his certification status was changed in contravention of ABIM's policies of implementing such changes after having given an individual prior notification. *Id.* Shortly thereafter, Dr. Salas-Rushford submitted himself to ABIM's disciplinary process. *Id.* at ¶ 52. As claimed by Dr. Salas-Rushford, the ABIM Individuals participated in the disciplinary process which he alleges was "improvised" and did not figure in ABIM's Policies & Procedures that he argues applied to him. *Id.* The disciplinary process allegedly lasted well-over two years, during which time, Dr. Salas-Rushford claims he was denied a copy of the applicable ABIM Policies & Procedures, was not told what specific rules or policies he had violated and was denied access to the original Exam questions which would have allowed him to compare them to the questions that he received from the Arora Review and colleagues, which he believed had been independently created. *Id.* at ¶¶ 53–54. It is Dr. Salas-Rushford's understanding that such actions on behalf of ABIM and the ABIM Individuals constituted a "total disregard of contractual good faith and due process". *Id.* at ¶ 53.

On July 24, 2014, the Final [*11] Hearing of the disciplinary process was held. *Id.* at ¶ 52. The Final Hearing panel was reportedly composed by three physicians that were designated by ABIM, to wit, Dr. Coleman, Dr. Von Feldt and Dr. O'Grady. *Id.* at ¶¶ 52, 55. On October 16, 2014, the members of the Final Hearing panel, sent a letter, on behalf of ABIM, to Dr. Salas-Rushford. *Id.* at ¶ 55. The letter, which was signed by Dr. Coleman, concluded that Dr. Salas-Rushford's actions had been "unprofessional and unethical". *Id.* As such, Dr. Salas-Rushford's board certification was to be suspended for a period of seven (7) years, which would be counted retroactively, beginning on December 7, 2012. *Id.* Since the October 16, 2014 letter, Dr. Salas-Rushford's board certification status has been displayed on the ABIM website as "Not Certified", accompanied by the statement "INITIAL CERTIFICATION Internal Medicine: 2009". *Id.* at ¶ 57. In addition, Dr. Salas-Rushford has been blocked from the **Maintenance** of **Certification** process.

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[50] *See* Poats v. Givan, 651 F.2d 495 (7th Cir. 1981); Sutton v. Lionel, 585 F.2d 400 (9th Cir. 1978); Tyler v. Vickery, 517 F.2d 1089 (5th Cir. 1975).

[51] *E.g.*, ***Colorado State Board of Medical Examiners v. Ogin, 56 P.3d 1233 (Colo. Ct. App. 2002)***. See also, Bailey v. Washington Area Council of Engineering Laboratories, 2017 U.S. Dist. LEXIS 97805 ("judicial review is of limited scope," and the courts should interfere only "to keep such a [corporate] tribunal within its jurisdiction, as prescribed by the rules of the association, and will inquire whether the action taken was in bad faith, or in violation of the laws of the land, but will not investigate the merits of the tribunal's decision.").

Id. Dr. Salas-Rushford argues that the ABIM Parties' conduct was a concerted effort to destroy his "personal and professional life[.]" *Id.* at ¶ 58.

*Am. Bd. of Internal Med. v. Salas-Rushford, 2021 U.S. Dist. LEXIS 12535, *8–11, 2021 WL 214268*.

[d]— Due Process and Fundamental Fairness.

In any revocation circumstance, the association should be sure to provide sufficient due process and fair procedures to the individual prior to imposing any punishment. Chapter 9 has a full discussion of the various aspects of due process, but the elements generally include:

- Adequate advance written notice of the alleged misconduct and proposed discipline;
- A right to respond to the allegations;
- Access to all relevant evidence;
- Impartial decision makers;
- Sufficient evidence of wrongdoing;
- A punishment commensurate with the wrongdoing; and
- A right of appeal.

There should also be an overriding fairness associated with the certification process. A recent case demonstrates this point.[52] A certifying association sent a notice of renewal to a certificant via US mail but never received a response. Without taking any further steps to ensure that the certificant actually received the notice, the association revoked his certification, which ultimately resulted in the certificant losing his job. The certificant sued, and the court, clearly sympathetic, allowed the suit to proceed to trial: "The Court cannot conclude that [the plaintiff] has failed to state a claim for violation of his common law due process rights … [The association had] a fiduciary duty to be substantively rational and procedurally fair."[53] In one case, an association was found not to have provided adequate due process because the certified individual, prior to having his certifications suspended, "was not notified that his certifications were under review, nor was he afforded an opportunity to present his side of the story."[53.1]

In another case,[53.2] it was held that an association provided sufficient notice and an opportunity to respond by sending the respondent a letters. The letter informed the respondent as to the findings regarding the association's investigation and informed the respondent that if he wished for the association to consider any information regarding the matter, he should submit the same. The letter also described the appeals process.

[e]— Revocation Prior to Due Process.

There may be circumstances in which certification can be revoked prior to providing notice and an opportunity to respond to the charges. Specifically, in cases involving public safety, a pre-revocation hearing or reinstatement is not a prerequisite to fair procedure.[53.3] "[W]here [an organization] must act quickly, or where it would be impractical to

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[52] *Picard v. Am. Bd. of Family Med., 2014 U.S. Dist. LEXIS 172543 (E.D. Mich. Dec. 15, 2014)*.

[53] *Breining Inst. v. Inst. for Credentialing Excellence, 2015 Cal. App. Unpub. LEXIS 5206 (July 22, 2015)* (associations that serve a quasi-public function may be "subject to the common law fair process that requires their decisions be both substantively rational and procedurally fair").

[53.1] *Bailey v. Washington Area Council of Engineering Laboratories, 2017 U.S. Dist. LEXIS 97805*.

[53.2] *Am. Bd. of Internal Med. v. Rushford*, CIV. NO.: 19-1943 (SCC), 38–39 (D.P.R. Jan. 20, 2021).

[53.3] *Gibson v. Boy Scouts of Am., 359 F. Supp. 2d 469, 472 (E.D. Va. 2005)* (declining to reinstate plaintiff prior to his fair procedure hearing, particularly in light of the "nature of the [association's] membership involving parents, children, and church members"); *c.f. Braswell v. Haywood Reg'l Med. Ctr., 234 Fed. Appx. 47, 54 (4th Cir. 2007)* (recognizing that, in circumstances involving emergency or safety, a pre-deprivation hearing is not necessary to satisfy due process requirements so long as a post-deprivation hearing is provided).

provide predeprivation process, postdeprivation process satisfies the requirements of" due process.[53.4] This analysis typically requires courts to consider whether public safety is at risk.[53.5]

There is a key component to this approach, however, and that is a true need to act quickly. The association must be able to demonstrate that in fact exigent circumstances required action that could not wait until after full due process had been provided.[54]

[f]— Obligation to Revoke Certification.

Cases involving revocation or denial of certification understandably tend to focus on the rights of the individual seeking to maintain or secure certification. But as discussed in *Chapter 13*, a certifying association may face liability from third parties if the association does not revoke or deny certification to clearly unqualified persons or persons who have engaged in serious misconduct. This concern can be used by an association in revocation/denial situations to shift the focus from the individual certificant to the public at large.

[g]— Members Only Requirement.

One issue that arises on occasion is whether an association can require membership in order to become certified. Old FTC advisory opinions take the position that membership cannot be a condition of certification,[55] but more recent antitrust cases hold that there is no antitrust prohibition as long as the requirements for membership are not unreasonably burdensome.[56] Nevertheless, a non-member may allege that a membership requirement is an unlawful tying arrangement in violation of antitrust laws.

[h]— Relief.

While loss or denial of certification can be legally actionable, it is important to remember that in some cases any harm is temporary, specifically if the person is eligible to reapply for, or regain, certified status. This may not prevent a lawsuit claiming unfairness, bias, etc., but it should preclude injunctive relief for a plaintiff.[57]

Further, even if an association is found to have violated a procedure or engaged in other material misconduct, the proper remedy for the plaintiff is reassessment with any infirmities corrected, not bestowing of certified status.[58] And if the problems are corrected, the association is still within its rights to deny or revoke certification, if that is once again the outcome.[59] As stated by one court, "The [association's] failure to yet [revoke the plaintiff's certification] in a fundamentally fair manner does not foreclose the [association]'s right to continue to seek [revocation] based on the same circumstances."[60]

[53.4] *Gilbert v. Homar, 520 U.S. 924, 930 (1997)*.

[53.5] *See id.* (explaining that sufficient circumstances warranted the immediate action of suspending a surgeon's privileges to perform surgeries when there were numerous, legitimate concerns with his work and the surgeon rebuffed efforts to provide better care for his patients once his mistakes were uncovered).

[54] *Bailey v. Washington Area Council of Engineering Laboratories, 2017 U.S. Dist. LEXIS 97805*.

[55] *E.g.*, *78 F.T.C. 1628 (1971)* ("no applicant for certification may be denied certification [because] he is a nonmember of any association or organization").

[56] *E.g.*, *Pope v. Mississippi Real Estate Com., 695 F. Supp. 253 (N.D. Miss. 1988)* ("A private organization may limit its services to its members as long as there is no arbitrary exclusion from membership.").

[57] *Lincoln Memorial University Duncan School of Law v. The American Bar Association, 2012 U.S. Dist. LEXIS 46036*.

[58] *Levin v. Bd. of Trs. Bus. Ass'n, 2013 N.J. Super. Unpub. LEXIS 477*.

[59] *Id.*

[60] *Id.*

[5] Americans With Disabilities Act

[a]— Overview.

Examinations and courses related to certification are subject to the Americans With Disabilities Act ("ADA").[61] Specifically, the ADA states as follows:

> Any person that offers examination or courses related to applications for licensing, certification, or credentialing for secondary or post-secondary education, professional, or trade purposes shall offer such examinations or courses in a place and manner accessible to persons with disabilities or offer alternative accessible arrangements for such individuals.[62]

To show a violation of the ADA based on a failure to accommodate, a plaintiff must prove: (1) that he or she is disabled; (2) that his/her requests for accommodation are reasonable; and (3) that those requests have been denied.[63]

The U.S. Department of Justice, which enforces the ADA, has issued regulations that the purpose of the above-quoted requirement is to "best ensure" that a certification examination accurately measures "the individual's aptitude or achievement level or whatever other factor the examination purports to measure, rather than reflecting the individual's impaired sensory, manual, or speaking skills."[64] A disabled individual must have an equal opportunity to obtain the same result any other applicant, i.e., an equal opportunity to demonstrate the skills, knowledge, and achievement that the certification examination is intended to measure.

What this means from a practical standpoint is that an association is, except as noted below, required to provide appropriate auxiliary aids or make other accommodations as necessary to allow disabled individuals to take the examination in such a manner that the individual's knowledge or skill (or whatever the examination is designed to test) can be accurately measured, and so that the individual does not fail the exam because of a disability rather than because of a lack of knowledge, skill, etc.

A "disability" is generally defined as "a physical or mental impairment that substantially limits one or more of the major life activities of such individual."[65] A "major life activity" includes means functions such as caring for one's self, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning, thinking, and working.[66] The most common disability claims made in connection with certification examinations are learning disabilities and ADHD, and these are clearly impairments within the meaning of the ADA. The Department of Justice regulations specifically provide that learning disabilities are mental impairments under the Act,[67] and Federal courts likewise have consistently recognized that ADHD and learning disabilities are impairments under the ADA.[68]

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[61] *E.g.*, *Enyart v. Nat'l Conf. of Bar Examiners, Inc., 2011 U.S. Dist. LEXIS 122853 (N.D. Cal. Oct. 24, 2011)*.

[62] *42 U.S.C. § 12189*.

[63] *Rawdin v. Am. Bd. of Pediatrics, 985 F. Supp. 2d 636 (E.D. Pa. 2013)*.

[64] *28 CFR § 36.309(b)(1)(i)*. *See also Dep't of Fair Empl. & Hous. v. Law Sch. Admission Council Inc., 896 F. Supp. 2d 849, 869 (N.D. Cal. 2012)* (emphasizing the burden is on the test provider to best ensure the examination equally measures the abilities of disabled and nondisabled test-takers).

[65] *28 C.F.R. § 36.104*.

[66] *42 U.S.C. § 12102(2)(A)*.

[67] *28 C.F.R. § 35.104(1)(i)(B)* ("The phrase physical or mental impairment means … [a]ny mental or psychological disorder such as mental retardation, organic brain syndrome, emotional or mental illness, and specific learning disabilities.").

[68] *See, e.g.*, *Rothberg v. Law Sch. Admission Council, Inc., 300 F. Supp. 2d 1093 (D. Colo. 2004)*, rev'd, *2004 U.S. App. LEXIS 11824 (10th Cir. Colo. 2004)*; *Bartlett v. N.Y. State Bd. of Law Exam'rs, 2001 U.S. Dist. LEXIS 11926 (S.D.N.Y. Aug. 15, 2001)*; *Price v. National Bd. of Medical Examiners, 966 F. Supp. 419 (S.D. W.Va. 1997)*.

Not every learning disability is in fact a "disability" for ADA purposes.[69] A disability must "*substantially* limit a major life activity." Taking a test is not a "major life activity,"[70] though reading and learning are. As a result, an applicant must show more than just poor scores on similar tests. He or she must also show that their disability in fact substantially limits a major life activity.

[b]— Determining an Appropriate Accommodation.

The most common accommodation requested by and provided to disabled individuals in connection with a certification program is extra time to take the examination. With respect to "auxiliary aids," these can include any number of accommodations, including:

- a reader;
- writers;
- amanuenses;
- large print exams;
- a separate testing room;
- frequent breaks;
- the ability to take the exam in different parts.

Auxiliary aids can also include taped examination, interpreters or other effective methods of making orally delivered material available to individuals with hearing impairments, Braille or large print examination and answer sheets for individuals with visual impairments or learning disabilities, and transcribers for individuals with manual impairments.[71]

The EEOC has explained "[t]his provision does not require that an employer offer every applicant his or her choice of test format."[72] Reasonable accommodation is mandated in order to place people with disabilities on an even playing field, but "it does not authorize a preference for disabled people generally … [and it] does not extend to the provision of adjustments or modifications that are for the personal benefit of the individual with a disability."[73]

Further, no accommodation need be made if to do so "would fundamentally alter the measurement of the skills or knowledge the examination is intended to test."[74] That is, the ADA does not require associations "to lower or to effect substantial modifications of standards to accommodate a disabled person."[75] Consideration of what constitutes a

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[69] *Baer v. Nat'l Bd. of Med. Examiners, 392 F. Supp. 2d 42 (D. Mass. 2005)*.

[70] *Baer v. Nat'l Bd. of Med. Examiners, 392 F. Supp. 2d 42 (D. Mass. 2005)*.

[71] *28 CFR 36.309(b)(3)*. US v. Robin Singh Educational Services, No. CV06-3466 (C.D. Cal. 2006) (consent agreement with test prep company to provide interpreters to deaf students).

[72] 29 C.F.R. Pt. 1630, App. § 1630.11; *see also Bonnette v. D.C. Court of Appeals, 796 F. Supp. 2d 164 (D.D.C. 2011)* (acknowledging the ADA does not require an entity to provide a requested accommodation merely because it is what the test-taker prefers); *Liberty Res., Inc. v. Phila. Hous. Auth., 528 F. Supp. 2d 553, 567 (E.D. Pa. 2007)* ("[M]eaningful access does not require that the disabled receive a greater benefit but, instead, that the handicapped are provided equal access to the benefit offered by the state as provided to non-handicapped individuals." (quoting *Safe Air for Everyone v. Idaho, 469 F. Supp. 2d 884, 889–90 (D. Idaho 2006)*)).

[73] *Falchenberg v. New York State Dep't of Educ., 642 F. Supp. 2d 156, 163 (S.D.N.Y. 2008)* (quoting *Hartnett v. Fielding Graduate Inst., 400 F. Supp. 2d 570, 576 (S.D.N.Y. 2005)*, *aff'd in part and rev'd in part*, *2006 U.S. App. LEXIS 24128 (2d Cir. Sept. 21, 2006)*).

[74] *Rawdin v. Am. Bd. of Pediatrics, 985 F. Supp. 2d 636 (E.D. Pa. 2013)*, aff'd, *582 Fed. Appx. 114*; *2014 U.S. App. LEXIS 17002*. *See also* ***Jacobsen v. Tillmann, 17 F. Supp. 2d 1018, 1026 (D. Minn. 1998)*** (finding the plaintiff's request for waiver of the math portion of the Minnesota Teacher Qualification Test was an "unreasonable modification that would fundamentally alter the nature of Minnesota's certification of individuals … to teach the children of the State").

reasonable accommodation must also take into account the purpose and design of the test. An accommodation which would require an organization "to lower or to effect substantial modifications of standards to accommodate" an individual with a disability may not be reasonable.[75.1] Further, "accommodations are not reasonable if they impose 'undue financial and administrative burdens … .' "[75.2] In one case, the court found that an applicant's request to take a certification exam on an open book basis was not reasonable "because such a modification would lower or effect substantial modifications of standards."[75.3]

Similarly, "the purpose of the ADA is to guarantee that those with disabilities are not disadvantaged … the ADA was not meant to give the disabled advantages over other applicants. The purpose of the ADA is to place those with disabilities on equal footing and not to give them an unfair advantage."[76]

In one case,[77] an applicant asked that he be tested in a manner other a multiple choice exam because of a neurological condition that made it difficult for him to "pull together on command discre[te] bits of unrelated information," which is the kind of task an examinee could face on a multiple choice exam. The certifying body refused, saying that this would "fundamentally alter the nature of the certification process." The court rule in favor of the certifying body:

> ABP has shown that the Exam "best ensures" that its results will accurately reflect Rawdin's aptitude rather than his disability. *28 C.F.R. § 36.309(b)(1)(i)*. According to his experts, Rawdin's disability impairs his ability to recall information out of context. It follows, then, that ABP is required to "best ensure" that the Exam reflects Rawdin's aptitude and not his difficulty recalling information out of context. ABP provided example questions and testimony that show that it satisfies this standard since the Exam does not require an examinee to recall information out of context. Rawdin failed to present any evidence refuting ABP's characterization of the exam questions as contextual and cue- and story-based.

In another case,[77.1] an individual with dyslexia asked that, as an accommodation for his disability, he be excused from having to take the live-patient portion of an oral exam, as it is of "dubious value" anyway. The association disagreed, arguing that it is a core part of the test for certification, and the association "need not make an accommodation at all if the requested accommodation would fundamentally alter the nature of the service, program, or activity." The court found there were reasonable differences on this issue and therefore move the case forward for trial.

On a related point, a certification examination can require that a certain skill be demonstrated or knowledge shown in a particular, if necessary to the performance of the job or profession that is the subject of the certification. For example, if a particular job requires certain skills, then a certification examination can test those skills, even if an individual applicant's disability prevents that applicant from performing the demonstration successfully. In an advisory opinion to a State board of medical examiners, the Department of Justice stated as follows: "The Board is permitted to impose eligibility criteria (i.e., ask questions) that screen out, or tend to screen out, individuals with disabilities if the criteria are 'necessary' to ensure that the Board is licensing persons fit to practice medicine."[78]

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[75] *Pandazides v. Virginia Bd. of Educ., 804 F. Supp. 794 (E.D. Va. 1992)*, *rev'd on other grounds*, *13 F.3d 823 (4th Cir. 1993)*.

[75.1] *Albert v. Association of Certified Anti Money Laundering Specialists, 2021 U.S. Dist. LEXIS 106740*. See also, *Pottgen v. Missouri State High School Activities Ass'n, 40 F.3d 926, 930 (8th Cir. 1994)* (quoting *Southeastern Community College v. Davis, 442 U.S. 397, 99 S. Ct. 2361, 60 L. Ed. 2d 980 (1979)*).

[75.2] *Id.*

[75.3] *Albert v. Association of Certified Anti Money Laundering Specialists, 2021 U.S. Dist. LEXIS 106740* ("In summary, the unrebutted record evidence indicates that Defendant did not discriminate against the Plaintiff when it refused to allow him to take the CAMS examination in an "open book" format, because such an accommodation would fundamentally alter the nature of the exam.").

[76] *D'Amico v. New York State Bd. of Law Examiners, 813 F. Supp. 217 (W.D.N.Y. 1993)*.

[77] *Rawdin v. Am. Bd. of Pediatrics, 582 Fed. Appx. 114*; *2014 U.S. App. LEXIS 17002*.

[77.1] *Shaywitz v. Am. Bd. of Psychiatry & Neurology, 675 F. Supp. 2d 376, 2009 U.S. Dist. LEXIS 119485*.

[78] DOJ ADA Adv. Op. 202-PL-213 (1993).

Similarly, in a letter to an organization that certifies emergency medical technicians, Justice said: "The Board is permitted to impose eligibility criteria (i.e., require a skill be performed in a certain way) that screen out, or tend to screen out, individuals with disabilities if the criteria are 'necessary' to ensure that the Board is licensing person who can safely perform the duties of emergency medical technicians."[79]

Finally, in order to constitute a "reasonable accommodation," the requested modification must actually "accommodate" the alleged disability. Otherwise, it would constitute no more than a personal preference, which is not protected under the ADA.[80] In other words, "The obligation to make reasonable accommodation ... does not extend to the provision of adjustments or modifications that are primarily for the personal benefit of the individual with a disability."[81]

[c]— Undue Burden.

No accommodation need be provided if this would cause an "undue burden" to the association.[82] *Undue burden* means significant difficulty or expense.[83] In one case, a court held that for a certifying association to provide its exam in an open book format as requested by a disabled applicant was not a reasonable accommodation due in part to the fact that "to reprogram the exam such that it could be designed and administered in an open book format and still properly test knowledge mastery in the field of money laundering investigation would require a substantial and unreasonable outlay in terms of money and time invested."[83.1] "In summary," the court concluded, "the unrebutted record evidence indicates that Defendant did not discriminate against the Plaintiff when it refused to allow him to take the CAMS examination in an 'open book' format, because such an accommodation would ... require ACAMS' substantial allocation of funds and time to revamp."[83.2]

In determining whether an action would result in an undue burden, factors to be considered include:

(1) The nature and cost of the action needed under this part;

(2) The overall financial resources of the site or sites involved in the action; the number of persons employed at the site; the effect on expenses and resources; legitimate safety requirements that are necessary for safe operation, including crime prevention measures; or the impact otherwise of the action upon the operation of the site;

(3) The geographic separateness, and the administrative or fiscal relationship of the site or sites in question to any parent corporation or entity;

(4) If applicable, the overall financial resources of any parent corporation or entity; the overall size of the parent corporation or entity with respect to the number of its employees; the number, type, and location of its facilities; and

(5) If applicable, the type of operation or operations of any parent corporation or entity, including the composition, structure, and functions of the workforce of the parent corporation or entity.

28 C.F.R. § 36.104.

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[79] April 26, 1993 letter from DOJ to Cong. John Tanner re Tennessee EMS Board.

[80] *Hartnett v. Fielding Graduate Inst., 400 F. Supp. 2d 570 (S.D.N.Y. 2005)*.

[81] *Raffaele v. City of New York, 2004 U.S. Dist. LEXIS 17786 (E.D.N.Y. Sept. 7, 2004)*.

[82] *Id.*

[83] *Envart v. Nat'l. Conf. of Bar Examiners, Inc., 2011 U.S. Dist. LEXIS 122853 (N.D. Cal. Oct. 24, 2011)*.

[83.1] *Albert v. Association of Certified Anti Money Laundering Specialists, 2021 U.S. Dist. LEXIS 106740*.

[83.2] *Id.*

Showing an undue burden is generally a high bar.[84] For example, in *Roberts v. KinderCare Learning Centers, Inc.*,[85] the Court found accommodating a child's disability at a daycare center would cause an undue burden. Looking at the evidence, the Court found KinderCare would need to hire a full-time employee to accommodate the child's disability, at a cost of approximately $200 per week, plus benefits, while receiving $105 per week in tuition for the child's care. It was undisputed that KinderCare operated "on a shoestring budget," and plaintiff offered no evidence contrary to trial testimony indicating that the $95 per week loss would constitute a substantial financial detriment to the site, which had recently emerged from bankruptcy.

Note, however, that "Congress did not incorporate [the] 'reasonable accommodation' standard" that applies to cases arising under the employment provisions under Title I "into § 12189."[86]

[d]— Test Performance History.

Generally speaking, in determining whether an applicant for certification has a disability, or whether they are entitled to an accommodation, an association may not take into account past academic or testing success by the applicant.[87] This regulation is intended to prevent an association from denying an accommodation on the basis that the applicant's disability, or purported disability, apparently has not been a substantial obstacle in their life generally, and therefore no accommodation is necessary. In the view of the EEOC, whether or not someone has performed well in the past is irrelevant to the existence of a disability.

[e]— Facilities.

The ADA restrictions on certification programs also require that certification examinations and courses be offered at facilities that are accessible to the disabled.[88] If the particular facility is not accessible, the association may provide an alternative facility, but the location of this facility must be as convenient to the disabled individual as the normal locations, and the conditions of the examination must be comparable as well.[89] Offering a proctored examination at an individual's home is a possible accommodation in this regard.[90]

[f]— Annotation or "Flagging" of Disabled Applicant's Scores.

If an individual with a takes and passes a certification examination with an accommodation due to a disability, is he or she the exact equivalent of one who becomes certified without an examination? Some organization do believe so. They also maintain that they have an obligation to those who utilize the services of certified individuals to inform these users of the fact that certain individuals needed an accommodation to pass. For these reasons, they annotate or "flag" in some way the scores of those who became certified with an accommodation.

Flagging is a controversial issue and its legality is increasingly questionable. One early case that addressed the practice has concluded that flagging does not violate the ADA unless the plaintiff can show he or she in fact has been harmed,

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[84] *Enyart v. Nat'l Conf. of Bar Examiners, Inc., 2011 U.S. Dist. LEXIS 122853 (N.D. Cal. Oct. 24, 2011)*.

[85] *896 F. Supp. 921 (D. Minn. 1995)*.

[86] *Enyart v. Nat'l Conference of Bar Exam'rs, Inc., 630 F.3d 1153, 1162 (9th Cir. 2011)*; *Doe v. Nat'l Bd. of Med. Exam'rs, 199 F.3d 146, 155 (3d Cir. 1999)*; *Bonnette v. D.C. Court of Appeals, 796 F. Supp. 2d 164, 182 (D.D.C. 2011)*; *42 U.S.C.§ 12112(b)(5)(A)*.

[87] 26 CFR § 1630.2(j)(4)(iii). This regulation rejects older case law to the contrary, including, *e.g.*, *McClure v. GM Corp., 2003 U.S. App. LEXIS 15931 (5th Cir. 2003)* (individual with muscular dystrophy who, with the mitigating measure of "adapting," had successfully learned to live and work with his condition and was therefore not a person with a disability).

[88] *28 CFR § 36.309(b)(1)(iii)*.

[89] *28 CFR § 36.309(b)(4)*.

[90] *Id.*

e.g., lost job opportunities.[91] But more recently a large testing organization entered into a consent decree settling a lawsuit in which it agree to discontinue this practice.[92] The EEOC also discourages this practice:

> Flagging policies that impede individuals with disabilities from fairly competing for and pursuing educational and employment opportunities are prohibited by the ADA. "Flagging" is the policy of annotating test scores or otherwise reporting scores in a manner that indicates the exam was taken with a testing accommodation. Flagging announces to anyone receiving the exam scores that the test-taker has a disability and suggests that the scores are not valid or deserved. Flagging also discourages test-takers with disabilities from exercising their right to testing accommodations under the ADA for fear of discrimination. Flagging must not be used to circumvent the requirement that testing entities provide testing accommodations for persons with disabilities and ensure that the test results for persons with disabilities reflect their abilities, not their disabilities.[93]

Whether or not flagging is a problem may ultimately depend on the type of certification at issue. For example, programs and exams that measure general aptitude, such as the SAT, may not be appropriate for flagging. But for certification programs that test the ability to perform a specific job, especially one with safety concerns, flagging may be more justifiable and defensible. That is, an employer certainly may wish to know that a person who is certified had to receive an accommodation in order to pass a test before the employer allows the individual to perform a job that may pose a significant health or safety risk to that individual or to others.

[g]— Miscellaneous.

There are several additional points to keep in mind:

- the ADA applies with equal force to recertification examinations or procedures;[94]
- the ADA applies not only to examinations but also courses related to certifications exams, such as review courses;[95]
- an association can require that an applicant submit proof of the claimed disability and can require the applicant to submit to examination by a medical professional selected by the association;
- it is not a valid defense for an association to argue that the individual is capable of passing without the accommodation; if the individual has a disability, and a reasonable accommodation would be of assistance, the association must provide it.[96]

[h]— Enforcement.

Lawsuits for violation of the ADA can be brought by disabled individuals who believe the association has not followed the requirements of the law, or by the U.S. Department of Justice.[97]

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[91] *Doe v. Nat'l Bd. of Med. Exam'rs, 199 F.3d 146 (3d Cir. 1999)*. *See also*, *John Doe v. National Board of Medical Examiners, 210 Fed. Appx. 157 (3d Cir. 2006)* (plaintiff lacked standing to sue over flagging policy since he had not suffered any actual harm; therefore, his concerns were speculative).

[92] *Dep't of Fair Empl. & Hous. v. Law Sch. Admission Council Inc.*, No. CV 12-1830-EMC (N.D. Cal. May 20, 2014) ("LSAC shall permanently discontinue all forms of the practice of annotating score reports of candidates who receive the testing accommodation of extended test time due to disability. For candidates applying to law school after the Effective Date of this Decree, LSAC shall henceforth provide the same information on test score reports for all candidates for whom score reports are provided.").

[93] *https://www.ada.gov/regs2014/testing_accommodations.html*.

[94] DOJ ADA Adv. Op. 202-PL-213 (1993).

[95] 28 CFR § 36.39(c); US v. Robin Singh Educational Services, No. CV06-3466 (C.D. Cal. 2006) (consent agreement with test prep company to provide interpreters to deaf students); U.S. v. Becker CPA Review, No. 92-2879 (D.D.C. 1994).

[96] *Rothberg v. Law School Admission Council, 300 F. Supp. 2d 1093 (2004)*.

[97] *Generally* *28 CFR § 36.501–508*.

In a suit by an individual, the only relief that a court may award is injunctive relief, that is, an order by the court requiring the association to comply with the ADA, e.g., by providing a particular auxiliary aid, etc.[98] The Department of Justice, however, may seek monetary damages for individual victims of discrimination, and may ask to the court to impose a civil penalty on the association. A penalty cannot exceed $50,000 for the first violation, and $100,000 for any subsequent violation.

[i]— Limitations Period.

There is no period specified in the ADA within which claims pursuant to *42 U.S.C. § 12189* must be brought, and therefore courts will look to analogous periods under State law.[99]

[6] Tort Liability

See *Chapter 13*, Section 13.04.

[7] Liability of Certified Individuals

The focus of this Section 12.04 is, appropriately, on the legal issues that affect associations which sponsor ***certification*** programs. But another important issue is whether a ***certification*** program can have liability implications for those who become certified.

If a person who provides services for a fee is negligent in some manner in performing those services, and thereby causes damage, he or she can be held liable. In the usual case, the determination of whether they were in fact negligent will be whether they acted in conformance with a particular ***standard of care***. Specifically, professionals and other service providers are expected to exercise the skill and knowledge ordinarily possessed by those in the same profession or industry.

However, if one is certified in their area of practice, it may be that they will be held to a higher standard. In both medicine and law, courts have held specialists in particular areas to a higher ***standard of care***.[100] That is, as specialists, they are expected to have greater expertise and skills. As stated by one court: "One who holds himself out as specializing and as possessing greater than ordinary knowledge and skill in a particular field, will be held to the standard of performance of those who hold themselves out as specialist in that area."[101] At least one court has held that this does not extend to the ***certification*** area. However, in lawsuit against an individual who has been certified by an organization, the plaintiff's argued that the defendant was therefore legally bound to adhere to the standards of certification, but the court disagreed: "the plaintiffs point to no evidence of an agreement to perform duties in accordance with specific standards established by

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[98] The ADA section applicable to certification, *42 U.S.C. § 12189*, is in Title III of the ADA, and the enforcement provision for Title III, *42 U.S.C. § 12188(a)(1)*, references *42 U.S.C. § 2000a-3(a)*, which states that a "person aggrieved" may institute "a civil action for preventive relief," but there is no mention of money. Courts have confirmed that no money damages are available under Title III in a suit by a private plaintiff. E.g., *Krist v. Kolombos Rest. Inc., 688 F.3d 89, 94 (2d Cir. 2012)*; *Goodwin v. C.N.J., Inc., 436 F.3d 44, 50 (1st Cir. 2006)* ("This court has recognized that section 12188(a)(1) does not contemplate an award of money damages in suits brought by private parties. … money damages are not an option for private parties suing under Title III of the ADA"); *Dudley v. Hannaford Bros. Co., 333 F.3d 299, 304 (1st Cir. 2003)* ("Section 12188(a)(1) of the ADA incorporates the remedies set forth in *42 U.S.C. § 2000a-3(a)*. That compendium of remedies allows only injunctive relief (as opposed to money damages).

[99] *Meriwether v. ABC Training/Safety Council Tex. Gulf Coast Chapter, 2016 U.S. Dist. LEXIS 161159 (N.D. Tx.)*.

[100] *Hirschberg v. State, 398 N.Y.S.2d 470 (N.Y. Ct. Cl. 1977)* (physician); *Duffey Law Office, S.C. v. Tank Transport, Inc., 535 N.W.2d 91 (Wis. Ct. App. 1995)* (attorney).

[101] *Walker v. Bangs, 601 P.2d 1279 (Wash. 1979)*. But *see*, *Creighton E. Forester and Denise M. Forester v Servpro of Bloomfield & Livonia, et al., 2006 Mich. App. LEXIS 3330 (Mich. App. 2006)* (third party had no standing to sue certified individual for failing to act in accordance with standards of certification body). By analogy, in the accreditation area, a court strongly suggested that status of company as being "accredited" may impose heightened obligations on the company in dealing with its clients.

the [certifying organization]."[102] It is also possible that a company which employs certified individuals may be sought to be held responsible if those employees do not perform in a manner consistent with their certified status.[103]

[8] Governmental and Private Challenges to Certification Designations

Is not unusual for States to attempt to regulate the use of certain certification designations. In these situations, the State often has a concern that the public may be misled by a certification designation, either because the certification may imply certain qualifications or expertise that are not present, or the public simply may not understand the significance of the certification designation. It is important to recognize that use of a certification designation is a form of speech, albeit commercial speech, and therefore has some protections under the *First Amendment*. As a result, States do not have unfettered discretion in this regard. Writing for a unanimous court in *In re R. M. J.*[104] Justice Powell summarized the standards applicable to claims involving attorney advertising as follows:

> "Truthful advertising related to lawful activities is entitled to the protections of the *First Amendment*. But when the particular content or method of the advertising suggests that it is inherently misleading or when experience has proved that in fact such advertising is subject to abuse, the States may impose appropriate restrictions. Misleading advertising may be prohibited entirely. But the States may not place an absolute prohibition on certain types of potentially misleading information, e.g., a listing of areas of practice, if the information also may be presented in a way that is not deceptive … Although the potential for deception and confusion is particularly strong in the context of advertising professional services, restrictions upon such advertising may be no broader than reasonably necessary to prevent the deception."

The use of certification designations is considered to be commercial speech, and a State may absolutely prohibit commercial speech that is false, deceptive, or misleading.[105] Where the speech is not deceptive, the state may restrict it "only if the [s]tate shows that the restriction directly and materially advances a substantial state interest in a manner no more extensive than necessary to serve that interest."[106]

Thus, if certification designation is inherently misleading or has in actual practice misled members of the consuming public, it is not protected by the *First Amendment* and may be absolutely prohibited. However, if an advertisement is merely potentially misleading, in that the information could be presented in a different way that would not potentially mislead, then it is protected by the *First Amendment* and may not be absolutely prohibited. As to potentially misleading advertisements, the state may insist upon a presentation—typically the inclusion of additional clarifying information such as a disclaimer—that removes the potential for deception, so long as the regulation is no more extensive than necessary to directly and materially advance the state's interest.[107]

As to the advertising of professional credentials, the Supreme Court has stated that credentials issued by bona fide credentialing organizations, whose standards are rigorous, objectively clear, and verifiable, cannot be inherently or actually misleading because they are statements of objective, verifiable fact, rather than statements of opinion or about quality.[108]

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[102] *Forester v. ServPro of Bloomfield & Livonia, 2006 Mich. App. LEXIS 3330 (Nov. 16, 2006)*. Note, the outcome might have been different had the defendant specifically promoted his certified status in soliciting the business of the plaintiffs in this case.

[103] *See McLaughlin v. Dover Downs, Inc., ___ A.2d ___, 2008 Del. Super. LEXIS 251 (July 17, 2008)* (claim that employer of technicians certified by trade association should be held liable for the alleged failure of such technicians to adhere to the association's guidelines for certified technicians).

[104] *455 U.S. 191 (1982)*.

[105] *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748, 96 S. Ct. 1817, 48 L. Ed. 2d 346 (1976)*.

[106] *Ibanez v. Florida Dep't of Bus. & Professional Regulation, Bd. of Accountancy, 512 U.S. 136, 114 S. Ct. 2084, 129 L. Ed. 2d 118 (1994)*.

[107] *In re R. M. J., 455 U.S. 191, 102 S. Ct. 929, 71 L. Ed. 2d 64 (1982)*; *Am. Acad. of Pain Mgmt. v. Joseph, 353 F.3d 1099 (9th Cir. 2004)*.

[108] *Peel v. Attorney Registration & Disciplinary Comm'n, 496 U.S. 91, 110 S. Ct. 2281, 110 L. Ed. 2d 83 (1990)*.

By contrast, the Court noted that advertising of credentials "issued by an organization that had made no inquiry into [an applicant's] fitness, or by one that issued certificates indiscriminately for a price," could be inherently or actually misleading.

In the case of *American Academy of Pain Management v. Joseph*,[109] anyone with two years' experience working with patients experiencing pain who successfully completed a two-hour, 100-question multiple choice examination could become a "board certified" member of AAPM. Moreover, there was evidence indicating that more than 80% of AAPM's members had not taken that examination, but rather had been grandfathered in. AAPM apparently made little inquiry into applicants' fitness and conferred membership on applicants almost indiscriminately.

One court distinguished the AAPM situation with other more legitimate associations and certification programs.[110] The court described these, which were in the dental field, as follows:

> [These] are bona fide credentialing organizations whose standards are rigorous, objectively clear, and verifiable. In addition to attainment of a dental degree, each credential issued by AAID and ABOI/ID requires a certain number of years of practice in implant dentistry, completion of a substantial number of hours of continuing education in implant dentistry, completion of a written examination, and presentation of a certain number of cases demonstrating proficiency in performing various types of dental implants.

Moreover, mere speculation about the possibility of deception in hypothetical cases does not suffice to show that an advertisement is inherently or even potentially misleading. The state must provide evidence to show that there is a real potential that a particular advertisement or credential will mislead the public in some way.[111] In *Ibanez*, the Supreme Court held that defendants seeking to uphold the validity of a commercial speech regulation must provide concrete evidence to show that there is at least a real potential that a particular advertisement will mislead the public in a particular way.

In another case, a professional society produced sufficient evidence that the certification program of a competing professionals society is false and misleading to allow the matter to go to trial.[112] The plaintiff demonstrated that the terms "board certification" and "board certified" carry a special meaning in the fields of healthcare and medicine, and in particular imply "education, training, and experience over and above what others licensed to practice the same profession receive." Since the defendant's certification program did not include these elements, the plaintiff argued, its use of the terms "board certification" and "board certified" are misleading.

[9] Waiver of Claims and Other Contractual Protections

It is not uncommon for associations that administer certification programs to require those who wish to participate to agree to waive any future legal claims against the association. The validity of such waivers will depend in large part on the facts of a given case, and certainly not all claims are capable of being waived, such as under the Americans With Disabilities Act. Nevertheless, waivers have been upheld in connection with product[113] and individual[114] certification programs and therefore have legal legitimacy. For example, one court upheld a contractual agreement to handle internally any disagreements over the plaintiffs' failed applications for entrance into the American Board of Psychiatry and Neurology, and rejected the argument that the release was an unconscionable contract of adhesion.[115] The court noted that the Board, a

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[109] *Am. Acad. of Pain Mgmt. v. Joseph, 353 F.3d 1099 (9th Cir. 2004)*. *See also American Board of Cosmetic Surgery v. Medical Board of California, 162 Cal. App. 4th 534, 75 Cal. Rptr. 3d 574 (2008)* (certification organization denied specialty board approval by State agency due to potentially misleading nature of certification designation).

[110] *Potts v. Hamilton, 334 F. Supp. 2d 1206 (E.D. Cal. 2004)*, *rev'd*, *2007 U.S. App. LEXIS 2450 (9th Cir. Cal. Feb. 2, 2007)*.

[111] *Ibanez v. Florida Dep't of Bus. & Professional Regulation, Bd. of Accountancy, 512 U.S. 136, 145, 114 S. Ct. 2084, 129 L. Ed. 2d 118 (1994)*.

[112] *Am. Optometric Soc'y, Inc. v. Am. Bd. of Optometry, Inc., 2012 U.S. Dist. LEXIS 81379 (C.D. Cal. June 12, 2012)*.

[113] *Solahart Industries v. International Ass'n of Plumbing of Mechanical Officials, 1996 U.S. Dist. LEXIS 19875*.

[114] *Whyte v. American Board of Physical Medicine and Rehabilitation, 2005 U.S. Dist. LEXIS 6481*.

private organization, may determine its rules for membership and administration, and that removing the release would likely increase the cost of application which most applicants would oppose.

In one case, the court upheld the following waiver that all persons seeking recertification were required to sign:

> I hereby waive and release, and shall indemnify and hold harmless, the [association] ... from, against, and with respect to any and all claims, losses, costs, expenses, damages, and judgments (including reasonable attorney's fees) that arise or are alleged to have arisen, from, out of, with respect to, or in connection with this application, ... the failure of the [association to renew the registration of a certificate previously issued to me, or the [association]'s notification of legitimately interested persons of such actions taken by the [association]. I understand and agree that in the event of my breach of or default in any provision of this Application and Agreement in any respect whatsoever, the [association] shall have the absolute right, in its absolute discretion, to revoke or suspend any certificate issued to me, refuse renewal of the registration of my certificate, censure me, and/or cancel my registration with the [association] and to provide information regarding such circumstances to all legitimately interested persons without restriction.[116]

However, requiring an individual indemnify the association for legal fees incurred in defending a claim brought by the individual may be asking too much.[117]

It is also wise for a certifying association to have the application for certification to serve as a contract between the association and the individual, where the contract reserves to the association certain rights and powers. The association may reserve the right to cancel scores in the event of suspected cheating, and may impose certain obligations on the individual, such as the obligation not to cheat or share questions with others. These contractual terms are enforceable.[118]

[10] Changing Certification Requirements or Criteria

It is not unusual for an association to change from time to time the eligibility criteria for certification. If such a change is material, it may upset those who are adversely affected, such as having to satisfy new requirements. Nevertheless, the certification program is owned by the association, and the association has the authority to make whatever modifications it deems useful, and as a general rule, neither an applicant nor someone who is currently certified can reasonably object or prohibit the association from taking such action.[119] This assumes that the changes otherwise comply with the law in all respects, and it may still be prudent to include language in relevant certification materials reserving the right of the association to make changes.

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[115] *Sanjuan v. American Board of Psychiatry and Neurology, Inc., 40 F.3d 247 (7th Cir. 1994)*.

[116] *Vistein v. Am. Registry of Radiologic Technologists, 2009 U.S. App. LEXIS 18173 (6th Cir. Aug. 13, 2009)*.

[117] *Vistein v. Am. Registry of Radiologic Technologists, 2009 U.S. App. LEXIS 18173 (6th Cir. Aug. 13, 2009)*.

[118] *Fox v. The International Conference of Funeral Service Examining Boards, 2017 U.S. Dist. LEXIS 38892 (SDNY)* (non-disclosure agreement required to be signed by applicants for a certification examination upheld as valid and enforceable contract); *Doe v. Nat'l Bd. of Podiatric Med. Exam'rs, 2005 U.S. Dist. LEXIS 2021 (S.D.N.Y. 2005)*; *Peter Dalton v. Educational Testing Service, 663 N.E.2d 289, 291* (1995 N.Y.).

[119] Stratton v. American Bd. of Family Med., Inc., ___ F. Supp. 2d ___ (E.D. Ky. 2005).

TAB B

§ 299A Undertaking in Profession or Trade

Unless he represents that he has greater or less skill or knowledge, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.

COMMENTS & ILLUSTRATIONS

Comment:

a. Skill, as the word is used in this Section, is something more than the mere minimum competence required of any person who does an act, under the rule stated in § 299. It is that special form of competence which is not part of the ordinary equipment of the reasonable man, but which is the result of acquired learning, and aptitude developed by special training and experience. All professions, and most trades, are necessarily skilled, and the word is used to refer to the special competence which they require.

b. Profession or trade. This Section is thus a special application of the rule stated in § 299. It applies to any person who undertakes to render services to another in the practice of a profession, such as that of physician or surgeon, dentist, pharmacist, oculist, attorney, accountant, or engineer. It applies also to any person who undertakes to render services to others in the practice of a skilled trade, such as that of airplane pilot, precision machinist, electrician, carpenter, blacksmith, or plumber. This Section states the minimum skill and knowledge which the actor undertakes to exercise, and therefore to have. If he has in fact greater skill than that common to the profession or trade, he is required to exercise that skill, as stated in § 299, Comment *e*.

c. Undertaking. In the ordinary case, the undertaking of one who renders services in the practice of a profession or trade is a matter of contract between the parties, and the terms of the undertaking are either stated expressly, or implied as a matter of understanding. The rule here stated does not, however, depend upon the existence of an enforceable contract between the parties. It applies equally where professional services are rendered gratuitously, as in the case of a physician treating a charity patient, or without any definite understanding, as in the case of one who renders services to a patient who is unconscious, in an emergency. The basis of the rule is the undertaking of the defendant, which may arise apart from contract.

This undertaking is not necessarily a matter of the requirements of the particular task undertaken, although that task will of course have its bearing upon what is understood. A highly skilled individual, as for example, a certified public accountant, may undertake to perform services which normally require little skill, as for example to do ordinary bookkeeping, and in performing those services he may, or may not, undertake to exercise his unusually high skill. On the other hand a bookkeeper with little or no accounting skill may undertake to do work which would normally call for a certified public accountant, and he may, or may not, undertake in doing it to exercise the skill of such an accountant. It is a matter of the skill which he represents himself to have, or is understood to undertake to have, rather than of the skill which he actually possesses, or which the task requires.

d. Special representation. An actor undertaking to render services may represent that he has superior skill or knowledge, beyond that common to his profession or trade. In that event he incurs an obligation to the person to whom he makes such a representation, to have, and to exercise, the skill and knowledge which he represents himself to have. Thus a physician who holds himself out as a specialist in certain types of practice is required to have the skill and knowledge common to other specialists. On the other hand the actor may make it clear that he has less than the minimum of skill common to the profession or trade; and in that case he is required to exercise only the skill which he represents that he has. Thus a layman who attempts to perform a surgical operation in an emergency, in the absence of any surgeon, and who makes it clear that he does not have the skill or knowledge of a surgeon, is not required to exercise such skill or knowledge. The rule stated in this Section applies only where there is no such special representation.

e. Standard normally required. In the absence of any such special representation, the standard of skill and knowledge required of the actor who practices a profession or trade is that which is commonly possessed by members of that profession or trade in good standing. It is not that of the most highly skilled, nor is it that of the average member of the profession or trade, since those who have less than median or average skill may still be competent and qualified. Half of the physicians of America do not automatically become negligent in practicing medicine at all, merely because their skill is less than the professional average. On the other hand, the standard is not that of the charlatan, the quack, the unqualified or incompetent individual who has succeeded in entering the profession or trade. It is that common to those who are recognized in the profession or trade itself as qualified, and competent to engage in it.

f. Schools of thought. Where there are different schools of thought in a profession, or different methods are followed by different groups engaged in a trade, the actor is to be judged by the professional standards of the group to which he belongs. The law cannot undertake to decide technical questions of proper practice over which experts reasonably disagree, or to declare that those who do not accept particular controversial doctrines are necessarily negligent in failing to do so. There may be, however, minimum requirements of skill applicable to all persons, of whatever school of thought, who engage in any profession or trade. Thus any person who holds himself out as competent to treat human ailments must have a minimum skill in diagnosis, and a minimum knowledge of possible methods of treatment. Licensing statutes, or those requiring a basic knowledge of science for the practice of a profession, may provide such a minimum standard.

g. Type of community. Allowance must be made also for the type of community in which the actor carries on his practice. A country doctor cannot be expected to have the equipment, facilities, experience, knowledge or opportunity to obtain it, afforded him by a large city. The standard is not, however, that of the particular locality. If there are only three physicians in a small town, and all three are highly incompetent, they cannot be permitted to set a standard of utter inferiority for a fourth who comes to town. The standard is rather that of persons engaged in similar practice in similar localities, considering geographical location, size, and the character of the community in general.

Such allowance for the type of community is most frequently made in professions or trades where there is a considerable degree of variation in the skill and knowledge possessed by those practicing it in different localities. It has commonly been made in the cases of physicians or surgeons, because of the difference in the medical skill commonly found in different parts of the United States, or in different types of communities. In other professions, such as that of the attorney, such variations either do not exist or are not as significant, and allowance for them has seldom been made. A particular profession may be so uniform, in different localities, as to the skill and knowledge of its members, that the court will not feel required to instruct the jury that it must make such allowance.

REPORTER'S NOTES

This Section has been added to the first Restatement.

Comment b: In addition to physicians and surgeons, the rule stated has been applied to other professions. *United Dentists v. Bryan, 158 Va. 880, 164 S.E. 554 (1932)*, dentist; *McCullough v. Sullivan, 102 N.J.L. 381, 132 A. 102, 43 A.L.R. 928, 25 N.C.C.A. 834 (1926)*, attorney; *Humboldt Bldg. Ass'n v. Ducker's Ex'r, 111 Ky. 759, 64 S.W. 671 (1901)*, same; *Citizens Loan Fund & Sav. Ass'n v. Friedley, 123 Ind. 143, 23 N.E. 1075, 7 L.R.A. 669, 18 Am. St. Rep. 320 (1890)*, same; *Cowles v. City of Minneapolis, 128 Minn. 452, 151 N.W. 184 (1915)*, engineer; *Louisville & N. R. Co. v. Perry's Adm'r, 173 Ky. 213, 190 S.W. 1064 (1917)*, engineer; *Smith v. London Assur. Corp., 109 App. Div. 882, 96 N.Y. Supp. 820 (1905)*, accountant; *L.B. Laboratories v. Mitchell, 39 Cal. 2d 56, 244 P.2d 385 (1952)*, same; *City of East Grand Forks v. Steele, 121 Minn. 296, 141 N.W. 181, 45 L.R.A. N.S. 205*, Ann. Cas. 1914C 720 (1913), same; *Stern v Lanng, 106 La. 738, 31 So. 303 (1901)*, oculist; *Kahn v. Shaw, 65 Ga. App. 563, 16 S.E.2d 99 (1941)*, optometrist; *Allan v. State S. S. Co., 132 N.Y. 91, 30 N.E. 482, 15 L.R.A. 166, 28 Am. St. Rep. 556 (1892)*, pharmacist; *Ballance v. Dunnington, 241 Mich. 383, 217 N.W. 329, 57 A.L.R. 262 (1928)*, X-ray operator; *The Tom Lysle, 48 F. 690 (D. Pa. 1892)*, pilot; *Lane v. Calvert, 215 Md. 457, 138 A.2d 902 (1958)*, dentist; *Hurley v. Johnston, 143 Conn. 364, 122 A. 2d 732 (1956)*, same; *Wintersteen v. Semler, 197 Or. 601, 250 P.2d 420, 255 P.2d 138 (1952)*, same; *Hammer v. Rosen, 7 N.Y.2d 376, 198 N.Y.S.2d 65, 165 N.E.2d 756 (1960)*, psychiatrist; *Ward v. Arnold, 52 Wash. 2d 581, 328 P.2d 164 (1958)*, attorney; *Hodges v. Carter, 239 N.C. 517, 80 S.E.2d 144, 45 A.L.R.2d 1 (1954)*, same.

Also to skilled trades: *Jackson v. Central Torpedo Co., 117 Okla. 245, 246 P. 426, 46 A.L.R. 338 (1926)*, shooting oil well; *Van Nortwick v. Holbine, 62 Neb. 147, 86 N.W. 1057 (1901)*, thresher; *Louis Pizitz Dry Goods Co. v. Waldrop, 237 Ala. 208, 186 So. 151 (1939)*, restaurant; *Milliken v. Woodward, 64 N.J.L. 444, 45 A. 796 (1900)*, insurance agent.

Comment d: As to those holding themselves out as specialists, see *Adkins v. Ropp, 105 Ind. App. 331, 14 N.E.2d 727 (1938)*; *Rayburn v. Day, 126 Or. 135, 268 P. 1002, 59 A.L.R. 1062 (1928)*; *Rann v. Twitchell, 82 Vt. 79, 71 A. 1045, 20 L.R.A. N.S. 1030 (1909)*; *Atkins v. Clein, 3 Wash. 2d 168, 100 P.2d 1, 104 P.2d 489 (1940)*; *Worster v. Caylor, 231 Ind.*

625, 110 N.E.2d 337 (1953); Rule v. Cheeseman, 181 Kan. 957, 317 P. 2d 472 (1957); Carbone v. Warburton, 11 N.J. 418, 94 A.2d 680 (1953). As to those representing that they have less than the standard skill or knowledge, see Higgins v. McCabe, 126 Mass. 13, 30 Am. Rep. 642 (1878), midwife; Spead v. Tomlinson, 73 N.H. 46, 59 A. 376, 68 L.R.A. 432 (1904); Cummins v. Donley, 173 Kan. 463, 249 P.2d 695 (1952), osteopath; Josselyn v. Dearborn, 143 Me. 328, 62 A.2d 174 (1948), same.

Comment e: The rule stated is supported by Butler v. Rule, 29 Ariz. 405, 242 P. 436 (1926); Hesler v. California Hospital Co., 178 Cal. 764, 174 P. 654 (1918); Ries v. Reinard, 47 Cal. App. 2d 116, 117 P.2d 386 (1941); Lake v. Baccus, 59 Ga. App. 656, 2 S.E.2d 121 (1939); Howell v. Jackson, 65 Ga. App. 422, 16 S.E. 2d 45 (1941); Holtzman v. Hoy, 118 Ill. 534, 8 N.E. 832, 59 Am. Rep. 390 (1886); Comeaux v. Miles, 9 La. App. 66, 118 So. 786 (1928); Johnson v. Colp, 211 Minn. 245, 300 N.W. 791 (1941); Dunn v. Beck, 80 Mont. 414, 260 P. 1047 (1927); Buckner v. Wheeldon, 225 N.C. 62, 33 S.E.2d 480 (1945).

Comment f: As to schools of medical thought, see Force v. Gregory, 63 Conn. 167, 27 A. 1116, 22 L.R.A. 343, 38 Am. St. Rep. 371 (1893), homeopath; Nelson v. Dahl, 174 Minn. 574, 219 N.W. 941 (1928), chiropractor; Willett v. Rowekamp, 134 Ohio St. 285, 12 Ohio Op. 91, 16 N.E.2d 457 (1938), same; Atkinson v. American School of Osteopathy, 240 Mo. 338, 144 S.W. 816 (1912), osteopath; Hilgedorf v. Bertschinger, 132 Or. 641, 285 P. 819 (1930), naturopath.

As to minimum basic standards of diagnosis and treatment, see Whipple v. Grandchamp, 261 Mass. 40, 158 N.E. 270, 57 A.L.R. 974 (1927), licensing statute; Hardy v. Dahl, 210 N.C. 530, 187 S.E. 788 (1936); Spead v. Tomlinson, 73 N.H. 46, 59 A. 376, 68 L.R.A. 432 (1904); Monahan v. Devinny, 223 App. Div. 547, 249 N.Y. Supp. 60 (1928); Harris v. Graham, 124 Okla. 196, 255 P. 710 (1926); Kelly v. Carroll, 36 Wash. 2d 482, 219 P.2d 79, 19 A.L.R.2d 1174 (1950), certiorari denied, *340 U.S. 892, 71 S. Ct. 208, 95 L. Ed. 646*; Treptau v. Behrens Spa, Inc., 247 Wis. 438, 20 N.W.2d 108, 19 N.C.C.A. N.S. 1 (1945); *Dowell v. Mossberg, 226 Or. 173, 355 P.2d 624, 359 P.2d 541 (1960)*.

Comment g: The rule stated is supported by Weintraub v. Rosen, 93 F.2d 544 (7 Cir. 1937); Sinz v. Owens, 33 Cal. 2d 749, 205 P.2d 3, 8 A.L.R.2d 757 (1949); Geraty v. Kaufman, 115 Conn. 563, 162 A. 33 (1932); McGulpin v. Bessmer, 241 Iowa 1119, 43 N.W.2d 121 (1950); Michael v. Roberts, 91 N.H. 499, 23 A.2d 361 (1941); *Nation v. Gueffroy, 172 Or. 673, 142 P.2d 688, 144 P.2d 296 (1943)*; Hoover v. Goss, 2 Wash. 2d 237, 97 P.2d 689 (1940); Tvedt v. Haugen, 70 N.D. 338, 294 N.W. 183, 132 A.L.R. 379 (1940); Montgomery v. Stary, 84 So. 2d 34 (Fla. 1955); Carbone v. Warburton, 11 N.J. 418, 94 A.2d 680 (1953); Hodgson v. Bigelow, 335 Pa. 497, 7 A.2d 338 (1939).

Cross Reference

ALR Annotations:

Standard of skill and care required of medical or surgical specialist. 59 A.L.R. 1071.

Liability of physician for injury to esophagus or other internal organs occurring in course of gastroscopic examination. 88 A.L.R.2d 297.

Physician's duty to inform patient of nature and hazards of disease or treatment. *79 A.L.R.2d 1028*.

Duty to advise patient of the possibility or probability of better results from treatment by specialist or by a mode of treatment which he is not qualified to give. 132 A.L.R. 392.

Malpractice of physician or surgeon:

-- diagnosis and treatment of fractures or dislocations. 54 A.L.R.2d 200.

-- diagnosis and treatment of brain injuries, diseases, or conditions. 29 A.L.R.2d 501.

-- diagnosis and treatment of male urinary tract and related organs. 88 A.L.R.2d 309.

-- diagnosis or treatment of tuberculosis. 75 A.L.R.2d 814.

-- treatment and surgery of the ear. 76 A.L.R.2d 783.

-- leaving sponge or other foreign matter in incision. 65 A.L.R. 1023.

-- treatment and surgery of eye. 68 A.L.R.2d 426.

-- nose and throat treatment and surgery. 58 A.L.R.2d 216.

-- pregnancy and childbirth cases. 141 A.L.R. 111.

-- treatment of skin disease, disorder, blemish, or scar. 45 A.L.R.2d 1271.

-- administering medicine to which patient is unusually susceptible or allergic. *64 A.L.R.2d 1281*.

Liability of physician for permitting exposure to infectious or contagious disease. 5 A.L.R. 926.

Liability of physician who abandons case. *57 A.L.R.2d 432*.

Liability of physician for lack of diligence in attending patient. *57 A.L.R.2d 379*.

Liability for injury or death from blood transfusion. *59 A.L.R.2d 768*.

Liability for injury by *X-ray. 41 A.L.R.2d 329*.

Duty and liability of anesthetist. *53 A.L.R.2d 142*.

Liability of dentist to patient. *83 A.L.R.2d 7*.

Liability of drugless practitioner or healer for malpractice. *19 A.L.R. 2d 1188*.

Liability for results of medical or surgical treatment by one not licensed as required by law. 44 A.L.R. 1418, 57 A.L.R. 978.

Nurse's liability for her own negligence or malpractice. *51 A.L.R.2d 970*.

Veterinarian's liability for malpractice. *38 A.L.R.2d 503*.

Attorney's liability for negligence in preparing or conducting litigation. *45 A.L.R.2d 5*.

Attorney's liability for mistake or error in drafting contract, will, or the like. 43 A.L.R. 932.

Architect's liability for personal injury or death from improper plans or design. *59 A.L.R.2d 1081*.

Architect's responsibility for defects or insufficiency of work attributable to plans. *25 A.L.R.2d 1085*.

Liability of barber, beauty shop or specialist, barber college, or school of beauty culture, for injury to patron. *14 A.L.R.2d 860*.

Liability of proprietor of reducing salon, gymnasium, or other physical fitness institution for injury to patron. *88 A.L.R.2d 1112*.

Competency of physician or surgeon from one community to testify as to standard of care required of defendant practicing in another community. *8 A.L.R.2d 772*.

Digest System Key Numbers:

Negligence 1 et seq.

Restatement of the Law, Second, Torts
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TAB C

FORESTER v. SERVPRO OF BLOOMFIELD & LIVONIA

Court of Appeals of Michigan

November 14, 2006, Decided

No. 268545

Reporter
2006 Mich. App. LEXIS 3330 *; 2006 WL 3299207

CREIGHTON E. FORESTER and DENISE M. FORESTER, Plaintiffs-Appellants, v SERVPRO OF BLOOMFIELD & LIVONIA, a/k/a COLBY COMPANY, INC., and BELFOR USA, f/k/a INRECON, LLC, Defendants-Appellees, and ALLSTATE INSURANCE COMPANY, INC., Defendant.

Notice: [*1] THIS IS AN UNPUBLISHED OPINION. IN ACCORDANCE WITH MICHIGAN COURT OF APPEALS RULES, UNPUBLISHED OPINIONS ARE NOT PRECEDENTIALLY BINDING UNDER THE RULES OF STARE DECISIS.

Prior History: Oakland Circuit Court. LC No. 04-057221-NO.

Disposition: Affirmed.

Core Terms

summary disposition, plaintiffs', trial court, contractual obligation, duty to plaintiff, negligence claim, hazard, workmanlike manner, contractual duty, breached, snow, statute of limitations, further proceedings, contract claim, liable in tort, no evidence, per curiam, file suit, no duty, misfeasance, contracted, guidelines, grounds, motions, parties, steps

Judges: Before: Whitbeck, CJ., and Hoekstra and Wilder, JJ.

Opinion

PER CURIAM.

Plaintiffs appeal as of right the trial court's orders granting summary disposition in favor of defendants ServPro of Bloomfield & Livonia, a/k/a Colby Company, Inc., and Belfor USA, f/k/a Inrecon, LLC. We affirm. This appeal is being decided without oral argument pursuant to MCR 7.214(E).

In June and July 2000, a home owned by Steven Lunn sustained significant water damage when a second-story bathroom developed a leak. Allstate, Lunn's insurer, contracted with ServPro to perform cleaning and restoration services in the home. In its contract, ServPro agreed to use its best efforts to perform in a workmanlike manner and to use reasonable diligence in the execution of its duties. Subsequently, Lunn hired Belfor, a contractor approved by Allstate, to perform repairs and rehabilitation on the home. Belfor agreed to perform in a workmanlike manner in accordance **[*2]** with construction guidelines published by the National Association of Home Builders.

In 2001, plaintiffs purchased the home from Lunn. Plaintiffs determined that the flooding problem had resulted in major damage that required extensive renovation of the home. In 2003, plaintiffs filed suit against Lunn alleging, inter alia, fraudulent concealment and misrepresentation. The parties entered into a settlement agreement pursuant to which Lunn paid plaintiffs $ 35,000 in exchange for release of all claims against him. Lunn executed an assignment of claims in which he assigned all claims he had against defendants to plaintiffs.

In October 2004, plaintiffs filed suit against Allstate, ServPro, and Belfor, alleging breach of contract, negligence, and breach of contract pursuant to a valid assignment of claims. The trial court granted summary disposition in favor of all defendants, and found that plaintiffs' claim of negligence was barred by the statute of limitations.

In *Forester v Allstate Ins Co*, unpublished opinion per curiam of the Court of Appeals, issued July 26, 2005 (Docket No. 260914), another panel of this Court affirmed in part, reversed in part, and remanded for further **[*3]** proceedings. This Court reversed the trial court's grant of summary disposition of plaintiffs' negligence and breach of contract claims in favor of ServPro and Belfor on statute of limitations grounds, *id.*, slip op at 2-4, affirmed the grant of summary disposition of plaintiffs' assignment of contract claims in favor of ServPro and Belfor, *id.* at 4-5, and affirmed the grant of summary disposition of plaintiffs' negligence claim in favor of Allstate. *Id.* at 5-6. This Court remanded for further proceedings regarding plaintiffs' claim of negligence against ServPro and Belfor, only. *Id.* at 6.

ServPro and Belfor filed separate motions for summary disposition of plaintiffs' claim of negligence pursuant to MCR

2.116(C)(10) and MCR 2.116(C)(8) and (10), respectively. Both ServPro and Belfor argued that it had no duty to plaintiffs. The trial court granted the motions, finding that neither ServPro nor Belfor owed plaintiffs a duty separate and distinct from its contractual obligations.

We review a trial court's decision on a motion for summary disposition de novo. *Auto Club Group Ins Co v Burchell, 249 Mich. App. 468, 479; [*4] 642 N.W.2d 406 (2001)*.

To establish a prima facie case of negligence, a plaintiff must prove: (1) that the defendant owed a duty to the plaintiff; (2) that the defendant breached the duty; (3) that the defendant's breach of duty proximately caused the plaintiff's injuries; and (4) that the plaintiff suffered damages. *Case v Consumers Power Co, 463 Mich. 1, 6; 615 N.W.2d 17 (2000)*.

The threshold question in a negligence action is whether the defendant owed a duty to the plaintiff. There can be no tort liability unless the defendant owed duty to the plaintiff. *Fultz v Union-Commerce Assocs, 470 Mich. 460, 463; 683 N.W.2d 587 (2004)*. A tort action resulting from misfeasance of a contractual obligation must be based on the existence of a duty separate and distinct from the contractual obligation itself. *Id. at 467*.

Plaintiffs argue that the trial court erred by granting summary disposition in favor of ServPro and Belfor. Plaintiffs assert that ServPro and Belfor breached a duty separate and distinct from their contractual obligations by engaging in misfeasance that created a new hazard; therefore, they are **[*5]** liable in tort for the damage created by that hazard. We disagree.

Plaintiffs were not parties to a contract with either ServPro or Belfor. Therefore, under *Fultz, supra*, ServPro and Belfor could be liable in tort only if they owed a duty to plaintiffs that was separate and distinct from a contractual duty. Neither ServPro nor Belfor agreed to perform its duties in accordance with any specific industry guidelines. Both ServPro and Belfor agreed generally to perform contractual duties in a workmanlike manner. [1]

[1] Plaintiffs contend that Belfor was certified by the Institute of Inspection, Cleaning and Restoration, a non-profit organization of trade associations responsible for setting standards for the professional inspection, cleaning, and restoration services industries. Belfor's contract indicates that it agreed to perform duties in a workmanlike manner "in accordance with the 'Residential Construction Performance Guidelines' published by the National Association of Home Builders." Plaintiffs point to no evidence that this promise constituted an agreement to perform duties in accordance with specific standards established by the Institute of Inspection, Cleaning and Restoration.

[*6] This case is distinguishable from *Osman v Summer Green Lawn Care, Inc, 209 Mich. App. 703; 532 N.W.2d 186 (1995)*, overruled in part on other grounds in *Smith v Global Life Ins Co, 460 Mich. 446, 455 n 2; 597 N.W.2d 28 (1999)*, on which plaintiffs rely. In that case, the defendant, who had contracted to provide snow removal services to the premises owner, created a new hazard by piling snow in a location from which it knew or should have known that the snow would melt and freeze into ice on abutting sidewalks, steps, and walkways. *Id. at 704*. In this case, no evidence showed that ServProor Belfor agreed to inspect plaintiffs' home for mold or to take steps to remediate a mold problem. Thus, no evidence showed that ServPro or Belfor acted in a negligent manner that created a new hazard that resulted in harm to plaintiffs.

The trial court did not err in finding that ServPro and Belfor owed no duty to plaintiffs because neither defendant breached a duty separate and distinct from a contractual duty. *Fultz, supra at 467*. The trial court correctly granted summary disposition in favor of ServPro and Belfor. **[*7]**

Affirmed.

/s/ William C. Whitbeck
/s/ Joel P. Hoekstra
/s/ Kurtis T. Wilder

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TAB D

CFP BOARD

CODE OF ETHICS AND STANDARDS OF CONDUCT

EFFECTIVE DATE: OCTOBER 1, 2019

March 2018, as revised in November 2018

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PREAMBLE

CFP Board's *Code of Ethics and Standards of Conduct* reflects the commitment that all CFP® professionals make to high standards of competency and ethics. CFP Board's *Code and Standards* benefits and protects the public, provides standards for delivering financial planning, and advances financial planning as a distinct and valuable profession. Compliance with the *Code and Standards* is a requirement of CFP® certification that is critical to the integrity of the CFP® marks. Violations of the *Code and Standards* may subject a CFP® professional to discipline.

CODE OF ETHICS

A CFP® professional must:

1. Act with honesty, integrity, competence, and diligence.
2. Act in the client's best interests.
3. Exercise due care.
4. Avoid or disclose and manage conflicts of interest.
5. Maintain the confidentiality and protect the privacy of client information.
6. Act in a manner that reflects positively on the financial planning profession and CFP® certification.

STANDARDS OF CONDUCT

A. DUTIES OWED TO CLIENTS

1. FIDUCIARY DUTY

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. The following duties must be fulfilled:

a. **Duty of Loyalty.** A CFP® professional must:

   i. Place the interests of the Client above the interests of the CFP® professional and the CFP® Professional's Firm;

   ii. Avoid Conflicts of Interest, or fully disclose Material Conflicts of Interest to the Client, obtain the Client's informed consent, and properly manage the conflict; and

   iii. Act without regard to the financial or other interests of the CFP® professional, the CFP® Professional's Firm, or any individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the CFP® professional's.

b. **Duty of Care.** A CFP® professional must act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

c. **Duty to Follow Client Instructions.** A CFP® professional must comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

2. INTEGRITY

a. A CFP® professional must perform Professional Services with integrity. Integrity demands honesty and candor, which may not be subordinated to personal gain or advantage. Allowance may be made for innocent error and legitimate differences of opinion, but integrity cannot co-exist with deceit or subordination of principle.

b. A CFP® professional may not, directly or indirectly, in the conduct of Professional Services:

   i. Employ any device, scheme, or artifice to defraud;

   ii. Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

   iii. Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

3. COMPETENCE

A CFP® professional must provide Professional Services with competence, which means with relevant knowledge and skill to apply that knowledge. When the CFP® professional is not sufficiently competent in a particular area to provide the Professional Services required under the Engagement, the CFP® professional must gain competence, obtain the assistance of a competent professional, limit or terminate the Engagement, and/or refer the Client to a competent professional. The CFP® professional shall describe to the Client any requested Professional Services that the CFP® professional will not be providing.

4. DILIGENCE

A CFP® professional must provide Professional Services, including responding to reasonable Client inquiries, in a timely and thorough manner.

5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST

a. **Disclose Conflicts.** When providing Financial Advice, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. This obligation requires the CFP® professional to provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the CFP® professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such conflicts or reject them. A sincere belief by a CFP® professional with a Material Conflict of Interest that he or she is acting in the best interests of the Client is insufficient to excuse failure to make full disclosure.

   i. A CFP® professional must make full disclosure and obtain the consent of the Client before providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.

   ii. In determining whether the disclosure about a Material Conflict of Interest provided to the Client was sufficient to infer that a Client has consented to a Material Conflict of Interest, CFP Board will evaluate whether a reasonable Client receiving the disclosure would have understood the conflict and how it could affect the advice the Client will receive from the CFP® professional. The greater the potential harm the conflict presents to the Client, and the more significantly a business practice that gives rise to the conflict departs from commonly accepted practices among CFP® professionals, the less likely it is that CFP Board will infer informed consent absent clear evidence of informed consent. Ambiguity in the disclosure provided to the Client will be interpreted in favor of the Client.

   iii. Evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate. Written consent to a conflict is not required.

b. **Manage Conflicts.** A CFP® professional must adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests.

6. SOUND AND OBJECTIVE PROFESSIONAL JUDGMENT

A CFP® professional must exercise professional judgment on behalf of the Client that is not subordinated to the interest of the CFP® professional or others. A CFP® professional may not solicit or accept any gift, gratuity, entertainment, non-cash compensation, or other consideration that reasonably could be expected to compromise the CFP® professional's objectivity.

7. PROFESSIONALISM

A CFP® professional must treat Clients, prospective Clients, fellow professionals, and others with dignity, courtesy, and respect.

8. COMPLY WITH THE LAW

a. A CFP® professional must comply with the laws, rules, and regulations governing Professional Services.

b. A CFP® professional may not intentionally or recklessly participate or assist in another person's violation of these *Standards* or the laws, rules, or regulations governing Professional Services.

9. CONFIDENTIALITY AND PRIVACY

a. A CFP® professional must keep confidential and may not disclose any non-public personal information about any prospective, current, or former Client ("client"), except that the CFP® professional may disclose information:

   i. For ordinary business purposes:

      a) With the client's consent, so long as the client has not withdrawn the consent;

      b) To a CFP® Professional's Firm or other persons with whom the CFP® professional is providing services to or for the client, when necessary to perform those services;

      c) As necessary to provide information to the CFP® professional's attorneys, accountants, and auditors; and

      d) To a person acting in a representative capacity on behalf of the client;

   ii. For legal and enforcement purposes:

      a) To law enforcement authorities concerning suspected unlawful activities, to the extent permitted by the law;

      b) As required to comply with federal, state, or local law;

      c) As required to comply with a properly authorized civil, criminal, or regulatory investigation or examination, or subpoena or summons, by a governmental authority;

      d) As necessary to defend against allegations of wrongdoing made by a governmental authority;

      e) As necessary to present a civil claim against, or defend against a civil claim raised by, a client;

      f) As required to comply with a request from CFP Board concerning an investigation or adjudication; and

      g) As necessary to provide information to professional organizations that are assessing the CFP® professional's compliance with professional standards.

b. A CFP® professional may not use any non-public personal information about a client for his or her direct or indirect personal benefit, whether or not it causes detriment to the client, unless the client consents.

c. A CFP® professional, either directly or through the CFP® Professional's Firm, must take reasonable steps to protect the security of non-public personal information about any client, including the security of information stored physically or electronically, from unauthorized access that could result in harm or inconvenience to the client.

d. A CFP® professional, either directly or through the CFP® Professional's Firm, must adopt and implement policies regarding the protection, handling, and sharing of a client's non-public personal information and must provide a client with written notice of those policies at the time of the Engagement and thereafter not less than annually (at least once in any 12-month period) unless (i) the CFP® professional's policies have not changed since the last notice sent to a client; and (ii) the CFP® professional does not disclose non-public personal information other than as permitted without a client's consent.

e. A CFP® professional shall be deemed to comply with this Section if the CFP® Professional's Firm is subject to, and the CFP® professional complies with, Regulation S-P under the federal securities laws or substantially equivalent federal or state laws or rules.

10. PROVIDE INFORMATION TO A CLIENT

a. **When Providing Financial Advice.** When providing or agreeing to provide Financial Advice that does not require Financial Planning in accordance with the Practice Standards, a CFP® professional must provide the following information to the Client, prior to or at the time of the Engagement, and document that the information has been provided to the Client:

   i. A description of the services and products to be provided;

   ii. How the Client pays for the products and services, and a description of the additional types of costs that the Client may incur, including product management fees, surrender charges, and sales loads;

   iii. How the CFP® professional, the CFP® Professional's Firm, and any Related Party are compensated for providing the products and services;

   iv. The existence of any public discipline or bankruptcy, and the location(s), if any, of the webpages of all relevant public websites of any governmental authority, self-regulatory organization, or professional organization that sets forth the CFP® professional's public disciplinary history or any personal bankruptcy or business bankruptcy where the CFP® professional was a Control Person;

   v. The information required under Section A.5.a. (Conflict of Interest Disclosure);

   vi. The information required under Section A.9.d. (Written Notice Regarding Non-Public Personal Information);

   vii. The information required under Section A.13.a.ii. (Disclosure of Economic Benefit for Referral or Engagement of Additional Persons); and

   viii. Any other information about the CFP® professional or the CFP® Professional's Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm.

b. **When Providing Financial Planning.** When providing or required to provide Financial Planning in accordance with the Practice Standards, a CFP® professional must provide the following information to the Client, prior to or at the time of the Engagement, in one or more written documents:

   i. The information required to be provided in Sections A.10.a.i.-iv. and vi.-viii.; and

   ii. The terms of the Engagement between the Client and the CFP® professional or the CFP® Professional's Firm, including the Scope of Engagement and any limitations, the period(s) during which the services will be provided, and the Client's responsibilities. A CFP® professional is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement.

c. **Updating Information.** A CFP® professional has an ongoing obligation to provide to the Client any information that is a Material change or update to the information required to be provided to the Client. Material changes and updates to public disciplinary history or bankruptcy information must be disclosed to the Client within ninety (90) days, together with the location(s) of the relevant webpages.

11. DUTIES WHEN COMMUNICATING WITH A CLIENT

A CFP® professional must provide a Client with accurate information, in accordance with the Engagement, and in response to reasonable Client requests, in a manner and format that a Client reasonably may be expected to understand.

12. DUTIES WHEN REPRESENTING COMPENSATION METHOD

A CFP® professional may not make false or misleading representations regarding the CFP® professional's or the CFP® Professional's Firm's method(s) of compensation.

a. **Specific Representations**

i. **Fee-Only.** A CFP® professional may represent his or her or the CFP® Professional's Firm's compensation method as "fee-only" only if:

a) The CFP® professional and the CFP® Professional's Firm receive no Sales-Related Compensation; and

b) Related Parties receive no Sales-Related Compensation in connection with any Professional Services the CFP® professional or the CFP® Professional's Firm provides to Clients.

ii. **Fee-Based.** CFP Board uses the term "fee and commission" to describe the compensation method of those who receive both fees and Sales-Related Compensation. A CFP® professional who represents that his or her or the CFP® Professional's Firm's compensation method is "fee-based" or any other similar term that is not fee-only:

a) May not use the term in a manner that suggests the CFP® professional or the CFP® Professional's Firm is fee-only; and

b) Must clearly state that either the CFP® professional or the CFP® Professional's Firm earns fees and commissions, or that the CFP® professional or the CFP® Professional's Firm are not fee-only.

b. **Sales-Related Compensation.** Sales-Related Compensation is more than a *de minimis* economic benefit, including any bonus or portion of compensation, resulting from a Client purchasing or selling Financial Assets, from a Client holding Financial Assets for purposes other than receiving Financial Advice, or from the referral of a Client to any person or entity other than the CFP® Professional's Firm. Sales-Related Compensation includes, for example, commissions, trailing commissions, 12b-1 fees, spreads, transaction fees, revenue sharing, referral or solicitor fees, or similar consideration. Sales-Related Compensation does not include:

i. Soft dollars (any research or other benefits received in connection with Client brokerage that qualifies for the "safe harbor" of Section 28(e) of the Securities Exchange Act of 1934);

ii. Reasonable and customary fees for custodial or similar administrative services if the fee or amount of the fee is not determined based on the amount or value of Client transactions;

iii. Non-monetary benefits provided by another service provider, including a custodian, that benefit the CFP® professional's Clients by improving the CFP® professional's delivery of Professional Services, and that are not determined based on the amount or value of Client transactions;

iv. Reasonable and customary fees for Professional Services, other than for solicitations and referrals, the CFP® professional or CFP® Professional's Firm provides to a Client that are collected and distributed by another service provider, including under a Turnkey Asset Management Platform; or

v. A fee the Related Party solicitor receives for soliciting clients for the CFP® professional or the CFP® Professional's Firm.

c. **Related Party.** A person or business entity (including a trust) whose receipt of Sales-Related Compensation a reasonable CFP® professional would view as directly or indirectly benefiting the CFP® professional or the CFP® Professional's Firm, including, for example, as a result of the CFP® professional's ownership stake in the business entity. There is a rebuttable presumption that a Related Party includes:

i. Family Members. A member of the CFP® professional's Family and any business entity that the Family or members of the Family Control; and

ii. Business Entities. A business entity that the CFP® professional or the CFP® Professional's Firm Controls, or that is Controlled by or is under common Control with, the CFP® Professional's Firm.

d. **In Connection with any Professional Services.** Sales-Related Compensation received by a Related Party is "in connection with any Professional Services" if it results, directly or indirectly, from Client transactions referred or facilitated by the CFP® professional or the CFP® Professional's Firm.

e. **Safe Harbor for Related Parties.** Sales-Related Compensation received by a Related Party is not "in connection with any Professional Services" if the CFP® professional or the CFP® Professional's Firm adopts and implements policies and procedures reasonably designed to prevent the CFP® professional or the CFP® Professional's Firm from recommending that any Client purchase Financial Assets from or through, or refer any Clients to, the Related Party.

f. **Misrepresentations by a CFP® Professional's Firm.** A CFP® professional who Controls the CFP® Professional's Firm may not allow the CFP® Professional's Firm to make a representation of compensation method that would be false or misleading if made by the CFP® professional. A CFP® professional who does not Control the CFP® Professional's Firm must correct a CFP® Professional's Firm's misrepresentations of compensation method by accurately representing the CFP® professional's compensation method to the CFP® professional's Clients.

13. DUTIES WHEN RECOMMENDING, ENGAGING, AND WORKING WITH ADDITIONAL PERSONS

a. When engaging or recommending the selection or retention of additional persons to provide financial or Professional Services for a Client, a CFP® professional must:

   i. Have a reasonable basis for the recommendation or Engagement based on the person's reputation, experience, and qualifications;

   ii. Disclose to the Client, at the time of the recommendation or prior to the Engagement, any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for the recommendation or Engagement; and

   iii. When engaging a person to provide services for a Client, exercise reasonable care to protect the Client's interests.

b. When working with another financial or Professional Services provider on behalf of a Client, a CFP® professional must:

   i. Communicate with the other provider about the scope of their respective services and the allocation of responsibility between them; and

   ii. Inform the Client in a timely manner if the CFP® professional has a reasonable belief that the other provider's services were not performed in accordance with the scope of services to be provided and the allocation of responsibilities.

14. DUTIES WHEN SELECTING, USING, AND RECOMMENDING TECHNOLOGY

a. A CFP® professional must exercise reasonable care and judgment when selecting, using, or recommending any software, digital advice tool, or other technology while providing Professional Services to a Client.

b. A CFP® professional must have a reasonable level of understanding of the assumptions and outcomes of the technology employed.

c. A CFP® professional must have a reasonable basis for believing that the technology produces reliable, objective, and appropriate outcomes.

15. REFRAIN FROM BORROWING OR LENDING MONEY AND COMMINGLING FINANCIAL ASSETS

a. A CFP® professional may not, directly or indirectly, borrow money from or lend money to a Client unless:

   i. The Client is a member of the CFP® professional's Family; or

   ii. The lender is a business organization or legal entity in the business of lending money.

b. A CFP® professional may not commingle a Client's Financial Assets with the Financial Assets of the CFP® professional or the CFP® Professional's Firm.

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS

1. **Financial Planning Definition.** Financial Planning is a collaborative process that helps maximize a Client's potential for meeting life goals through Financial Advice that integrates relevant elements of the Client's personal and financial circumstances.

2. **Examples of Relevant Elements of the Client's Personal and Financial Circumstances.** Relevant elements of personal and financial circumstances vary from Client to Client, and may include the Client's need for or desire to: develop goals, manage assets and liabilities, manage cash flow, identify and manage risks, identify and manage the financial effect of health considerations, provide for educational needs, achieve financial security, preserve or increase wealth, identify tax considerations, prepare for retirement, pursue philanthropic interests, and address estate and legacy matters.

3. **Application of Practice Standards.** The Practice Standards set forth the Financial Planning Process. A CFP® professional must comply with the Practice Standards when:

   a. The CFP® professional agrees to provide or provides:

      i. Financial Planning; or

      ii. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or

   b. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

4. **Integration Factors.** Among the factors that CFP Board will weigh in determining whether a CFP® professional has agreed to provide or provided Financial Advice that Requires Financial Planning are:

   a. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;

   b. The portion and amount of the Client's Financial Assets that the Financial Advice may affect;

   c. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;

   d. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and

   e. The barriers to modifying the actions taken to implement the Financial Advice.

5. **CFP Board Evaluation.** In a disciplinary proceeding in which a CFP® professional denies CFP Board's allegation that the CFP® professional was required to comply with the Practice Standards, the CFP® professional must demonstrate that compliance with the Practice Standards was not required.

6. **No Client Agreement to Engage for Financial Planning.** If a CFP® professional otherwise must comply with the Practice Standards, but the Client does not agree to engage the CFP® professional to provide Financial Planning, the CFP® professional must either:

   a. Not enter into the Engagement;

   b. Limit the Scope of Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing;

   c. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or

   d. Terminate the Engagement.

C. PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS

In complying with the Practice Standards, a CFP® professional must act prudently in documenting information, as the facts and circumstances require, taking into account the significance of the information, the need to preserve the information in writing, the obligation to act in the Client's best interests, and the CFP® Professional's Firm's policies and procedures.

1. **Understanding the Client's Personal and Financial Circumstances**

   a. **Obtaining Qualitative and Quantitative Information.** A CFP® professional must describe to the Client the qualitative and quantitative information concerning the Client's personal and financial circumstances needed to fulfill the Scope of Engagement and collaborate with the Client to obtain the information.

      i. Examples of qualitative or subjective information include the Client's health, life expectancy, family circumstances, values, attitudes, expectations, earnings potential, risk tolerance, goals, needs, priorities, and current course of action.

      ii. Examples of quantitative or objective information include the Client's age, dependents, other professional advisors, income, expenses, cash flow, savings, assets, liabilities, available resources, liquidity, taxes, employee benefits, government benefits, insurance coverage, estate plans, education and retirement accounts and benefits, and capacity for risk.

   b. **Analyzing Information.** A CFP® professional must analyze the qualitative and quantitative information to assess the Client's personal and financial circumstances.

   c. **Addressing Incomplete Information.** If unable to obtain information necessary to fulfill the Scope of Engagement, the CFP® professional must either limit the Scope of Engagement to those services the CFP® professional is able to provide or terminate the Engagement.

2. **Identifying and Selecting Goals**

   a. **Identifying Potential Goals.** A CFP® professional must discuss with the Client the CFP® professional's assessment of the Client's financial and personal circumstances, and help the Client identify goals, noting the effect that selecting a particular goal may have on other goals. In helping the Client identify goals, the CFP® professional must discuss with the Client, and apply, reasonable assumptions and estimates. These may include life expectancy, inflation rates, tax rates, investment returns, and other Material assumptions and estimates.

   b. **Selecting and Prioritizing Goals.** A CFP® professional must help the Client select and prioritize goals. The CFP® professional must discuss with the Client any goals the Client has selected that the CFP® professional believes are not realistic.

3. **Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action**

   a. **Analyzing Current Course of Action.** A CFP® professional must analyze the Client's current course of action, including the material advantages and disadvantages of the current course and whether the current course maximizes the potential for meeting the Client's goals.

   b. **Analyzing Potential Alternative Courses of Action.** Where appropriate, a CFP® professional must consider and analyze one or more potential alternative courses of action, including the material advantages and disadvantages of each alternative, whether each alternative helps maximize the potential for meeting the Client's goals, and how each alternative integrates the relevant elements of the Client's personal and financial circumstances.

4. **Developing the Financial Planning Recommendation(s)**

   From the potential courses of action, a CFP® professional must select one or more recommendations designed to maximize the potential for meeting the Client's goals. The recommendation may be to continue the Client's current course of action. For each recommendation selected, the CFP® professional must consider the following information:

   a. The assumptions and estimates used to develop the recommendation;

b. The basis for making the recommendation, including how the recommendation is designed to maximize the potential to meet the Client's goals, the anticipated material effects of the recommendation on the Client's financial and personal circumstances, and how the recommendation integrates relevant elements of the Client's personal and financial circumstances;

c. The timing and priority of the recommendation; and

d. Whether the recommendation is independent or must be implemented with another recommendation.

5. **Presenting the Financial Planning Recommendation(s)**

A CFP® professional must present to the Client the selected recommendations and the information that was required to be considered when developing the recommendation(s).

6. **Implementing the Financial Planning Recommendation(s)**

a. **Addressing Implementation Responsibilities.** A CFP® professional must establish with the Client whether the CFP® professional has implementation responsibilities. When the CFP® professional has implementation responsibilities, the CFP® professional must communicate to the Client the recommendation(s) being implemented and the responsibilities of the CFP® professional, the Client, and any third party with respect to implementation.

b. **Identifying, Analyzing, and Selecting Actions, Products, and Services.** A CFP® professional who has implementation responsibilities must identify and analyze actions, products, and services designed to implement the recommendations. The CFP® professional must consider the basis for each selection, which must include:

i. How the action, product, or service is designed to implement the CFP® professional's recommendation; and

ii. The advantages and disadvantages of the action, product, or service relative to reasonably available alternatives.

c. **Recommending Actions, Products, and Services for Implementation.** A CFP® professional who has implementation responsibilities must recommend one or more actions, products and services to the Client. The CFP® professional must discuss with the Client the basis for selecting an action, product, or service, the timing and priority of implementing the action, product, or service, and disclose and manage any Material Conflicts of Interest concerning the action, product, or service.

d. **Selecting and Implementing Actions, Products, or Services.** A CFP® professional who has implementation responsibilities must help the Client select and implement the actions, products, or services. The CFP® professional must discuss with the Client any Client selection that deviates from the actions, products, and services the CFP® professional recommended.

7. **Monitoring Progress and Updating**

a. **Monitoring and Updating Responsibilities.** A CFP® professional must establish with the Client whether the CFP® professional has monitoring and updating responsibilities. When the CFP® professional has responsibilities for monitoring and updating, the CFP® professional must communicate to the Client:

i. Which actions, products, and services are and are not subject to the CFP® professional's monitoring responsibility;

ii. How and when the CFP® professional will monitor the actions, products, and services;

iii. The Client's responsibility to inform the CFP® professional of any Material changes to the Client's qualitative and quantitative information;

iv. The CFP® professional's responsibility to update the Financial Planning recommendations; and

v. How and when the CFP® professional will update the Financial Planning recommendations.

b. **Monitoring the Client's Progress.** A CFP® professional who has monitoring responsibilities must analyze, at appropriate intervals, the progress toward achieving the Client's goals. The CFP® professional must review with the Client the results of the CFP® professional's analysis.

c. **Obtaining Current Qualitative and Quantitative Information.** A CFP® professional who has monitoring responsibility must collaborate with the Client in an attempt to obtain current qualitative and quantitative information concerning the Client's personal and financial circumstances.

d. **Updating Goals, Recommendations, or Implementation Decisions.** Where a CFP® professional has updating responsibility, and circumstances warrant changes to the Client's goals, recommendations, or selections of actions, products or services, the CFP® professional must update as appropriate in accordance with these Practice Standards.

D. DUTIES OWED TO FIRMS AND SUBORDINATES

1. **Use Reasonable Care When Supervising**

   A CFP® professional must exercise reasonable care when supervising persons acting under the CFP® professional's direction, including employees and other persons over whom the CFP® professional has responsibility, with a view toward preventing violations of applicable laws, rules, regulations, and these Standards.

2. **Comply with Lawful Objectives of CFP® Professional's Firm**

   A CFP® professional:

   a. Will be subject to discipline by CFP Board for violating policies and procedures of the CFP® Professional's Firm that do not conflict with these Standards.

   b. Will not be subject to discipline by CFP Board for violating policies and procedures of the CFP® Professional's Firm that conflict with these Standards.

3. **Provide Notice of Public Discipline**

   A CFP® professional must promptly advise the CFP® Professional's Firm, in writing, of any public discipline imposed by CFP Board.

E. DUTIES OWED TO CFP BOARD

1. **Definitions.** The following definitions apply:

   a. **Felony.** A felony offense, or for jurisdictions that do not differentiate between a felony and a misdemeanor, an offense punishable by a sentence of at least one-year imprisonment or a fine of at least $1,000.

   b. **Relevant Misdemeanor.** A criminal offense, that is not a Felony, for conduct involving fraud, theft, misrepresentation, other dishonest conduct, crimes of moral turpitude, violence, or a second (or more) alcohol and/or drug-related offense.

   c. **Regulatory Investigation.** An investigation initiated by a federal, state, local, or foreign governmental agency, self-regulatory organization, or other regulatory authority. A Regulatory Investigation does not include preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.

   d. **Regulatory Action.** An action initiated by a federal, state, local, or foreign governmental agency, self-regulatory organization, or other regulatory authority.

   e. **Civil Action.** A lawsuit or arbitration.

   f. **Finding.** A finding includes an adverse final action and a consent decree in which the finding is neither admitted nor denied, but does not include a deficiency letter, examination report, memorandum of understanding, or similar informal resolution of a matter.

g. **Minor Rule Violation.** A violation of a self-regulatory organization rule designated as a minor rule violation under a plan approved by the U.S. Securities and Exchange Commission. A rule violation may be designated as "minor" under a plan if the sanction imposed consists of a fine of $2,500 or less, and if the sanctioned person does not contest the fine.

2. **Refrain from Adverse Conduct.** A CFP® professional may not engage in conduct that reflects adversely on his or her integrity or fitness as a CFP® professional, upon the CFP® marks, or upon the profession. Such conduct includes, but is not limited to, conduct that results in:

   a. A Felony or Relevant Misdemeanor conviction, or admission into a program that defers or withholds the entry of a judgment of conviction for a Felony or Relevant Misdemeanor;

   b. A Finding in a Regulatory Action or a Civil Action that the CFP® professional engaged in fraud, theft, misrepresentation, or other dishonest conduct;

   c. A personal bankruptcy or business bankruptcy filing or adjudication where the CFP® professional was a Control Person of the business, unless the CFP® professional can rebut the presumption that the bankruptcy demonstrates an inability to manage responsibly the CFP® professional's or the business's financial affairs;

   d. A federal tax lien on property owned by the CFP® professional, unless the CFP® professional can rebut the presumption that the federal tax lien demonstrates an inability to manage responsibly the CFP® professional's financial affairs; or

   e. A non-federal tax lien, judgment lien, or civil judgment that has not been satisfied within a reasonable amount of time unless the CFP® professional can rebut the presumption that the non-federal tax lien, judgment lien, or civil judgment demonstrates an inability to manage responsibly the CFP® professional's financial affairs.

3. **Reporting.** A CFP® professional must provide written notice to CFP Board within thirty (30) calendar days after the CFP® professional, or an entity over which the CFP® professional was a Control Person, has:

   a. Been charged with, convicted of, or admitted into a program that defers or withholds the entry of a judgment or conviction for, a Felony or Relevant Misdemeanor;

   b. Been named as a subject of, or whose conduct is mentioned adversely in, a Regulatory Investigation or Regulatory Action alleging failure to comply with the laws, rules, or regulations governing Professional Services;

   c. Had conduct mentioned adversely in a Finding in a Regulatory Action involving failure to comply with the laws, rules, or regulations governing Professional Services (except a Regulatory Action involving a Minor Rule Violation in a Regulatory Action brought by a self-regulatory organization);

   d. Had conduct mentioned adversely in a Civil Action alleging failure to comply with the laws, rules, or regulations governing Professional Services;

   e. Become aware of an adverse arbitration award or civil judgment, or a settlement agreement, in a Civil Action alleging failure to comply with the laws, rules, or regulations governing Professional Services, where the conduct of the CFP® professional, or an entity over which the CFP® professional was a Control Person, was mentioned adversely, other than a settlement for an amount less than $15,000;

   f. Had conduct mentioned adversely in a Civil Action alleging fraud, theft, misrepresentation, or other dishonest conduct;

   g. Been the subject of a Finding of fraud, theft, misrepresentation, or other dishonest conduct in a Regulatory Action or Civil Action;

   h. Become aware of an adverse arbitration award or civil judgment, or a settlement agreement in a Civil Action alleging fraud, theft, misrepresentation, or other dishonest conduct, where the conduct of the CFP® professional, or an entity over which the CFP® professional was a Control Person, was mentioned adversely;

i. Had a professional license, certification, or membership suspended, revoked, or materially restricted because of a violation of rules or standards of conduct;

j. Been terminated for cause from employment or permitted to resign in lieu of termination when the cause of the termination or resignation involved allegations of dishonesty, unethical conduct, or compliance failures;

k. Been named as the subject of, or been identified as the broker/adviser of record in, any written, customer-initiated complaint that alleged the CFP® professional was involved in:

   i. Forgery, theft, misappropriation, or conversion of Financial Assets;

   ii. Sales practice violations and contained a claim for compensation of $5,000 or more; or

   iii. Sales practice violations and settled for an amount of $15,000 or more.

l. Filed for or been the subject of a personal bankruptcy or business bankruptcy where the CFP® professional was a Control Person;

m. Received notice of a federal tax lien on property owned by the CFP® professional; or

n. Failed to satisfy a non-federal tax lien, judgment lien, or civil judgment within one year of its date of entry, unless payment arrangements have been agreed upon by all parties.

4. **Provide Narrative Statement.** The written notice must include a narrative statement that accurately and completely describes the Material facts and the outcome or status of the reportable matter.

5. **Cooperation.** A CFP® professional may not make false or misleading representations to CFP Board or obstruct CFP Board in the performance of its duties. A CFP® professional must satisfy the cooperation requirements set forth in CFP Board's *Procedural Rules*, including by cooperating fully with CFP Board's requests, investigations, disciplinary proceedings, and disciplinary decisions.

6. **Compliance with *Terms and Conditions of Certification and Trademark License.*** A CFP® professional must comply with the *Terms and Conditions of Certification and Trademark License*.

F. PROHIBITION ON CIRCUMVENTION

A CFP® professional may not do indirectly, or through or by another person or entity, any act or thing that the *Code and Standards* prohibit the CFP® professional from doing directly.

GLOSSARY

CFP® Professional's Firm(s). Any entity on behalf of which a CFP® professional provides Professional Services to a Client, and that has the authority to exercise control over the CFP® professional's activities, including the CFP® professional's employer, broker-dealer, registered investment adviser, insurance company, and insurance agency.

Client. Any person, including a natural person, business organization, or legal entity, to whom the CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement.

Conflict of Interest.

a. When a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client, or

b. When a CFP® professional has duties to one Client that are adverse to another Client.

Control. The power, directly or indirectly, to direct the management or policies of the entity at the relevant time, through ownership, by contract, or otherwise.

Control Person. A person who has Control.

Engagement. An oral or written agreement, arrangement, or understanding.

Family. Grandparent, parent, stepparent, father-in-law/mother-in-law, uncle/aunt, spouse, former spouse, spousal equivalent, domestic partner, brother/sister, stepsibling, brother-in-law/sister-in-law, cousin, son/daughter, stepchild, son-in-law/daughter-in law, nephew/niece, grandchild, and any other person the CFP® professional, directly or indirectly, supports financially to a material extent.

Financial Advice.

a. A communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to:

   i. The development or implementation of a financial plan;

   ii. The value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets;

   iii. Investment policies or strategies, portfolio composition, the management of Financial Assets, or other financial matters; or

   iv. The selection and retention of other persons to provide financial or Professional Services to the Client; or

b. The exercise of discretionary authority over the Financial Assets of a Client.

The determination of whether Financial Advice has been provided is an objective rather than subjective inquiry. The more individually tailored the communication is to the Client, the more likely the communication will be viewed as Financial Advice. The provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable CFP® professional would not view as Financial Advice, does not constitute Financial Advice.

Financial Assets. Securities, insurance products, real estate, bank instruments, commodities contracts, derivative contracts, collectibles, or other financial products.

Financial Planning. A collaborative process that helps maximize a Client's potential for meeting life goals through Financial Advice that integrates relevant elements of the Client's personal and financial circumstances.

Material. Information is material when a reasonable Client or prospective Client would consider the information important in making a decision.

Professional Services. Financial Advice and related activities and services that are offered or provided, including, but not limited to, Financial Planning, legal, accounting, or business planning services.

Related Party. A person or business entity (including a trust) whose receipt of Sales-Related Compensation a reasonable CFP® professional would view as benefiting the CFP® professional or the CFP® Professional's Firm, including, for example, as a result of the CFP® professional's ownership stake in the business entity. There is a rebuttable presumption that a Related Party includes:

a. **Family Members.** A member of the CFP® professional's Family and any business entity that the Family or members of the Family Control; and

b. **Business Entities.** A business entity that the CFP® professional or the CFP® Professional's Firm Controls, or that is Controlled by or is under common Control with, the CFP® Professional's Firm.

Scope of Engagement. The Professional Services to be provided pursuant to an Engagement.

CFP BOARD

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

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TAB E

CFP BOARD

CASE STUDIES APPLYING THE *CODE OF ETHICS AND STANDARDS OF CONDUCT*

July 2023

PURPOSE

CFP Board developed these case studies to provide practical guidance to CFP® professionals and their firms on the *Code of Ethics and Standards of Conduct*. Each case study presents a hypothetical factual circumstance and then asks a question about a CFP® professional's duty in that circumstance under the *Code and Standards*. The case study presents the response options, identifies the best response, and then discusses the rationale for why that response is the best and why the other response options are not the best. CFP Board intends for these and other case studies to guide CFP® professionals in their application of the *Code and Standards* to their own practice. CFP Board encourages all CFP® professionals to read the *Code and Standards*.

INDEX TO CASE STUDIES

This index identifies the page location of Case Studies for each section of CFP Board's *Code and Standards*. If there is no page number provided, then CFP Board has not released a Case Study related to that section.

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1: Information that CFP Board Requires (and Does Not Require) a CFP® Professional to Report to CFP Board 72

4. Provide Narrative Statement

5. Cooperation

6. Compliance with Terms and Conditions of Certification and Trademark License

F. PROHIBITION ON CIRCUMVENTION

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

1: THE FIDUCIARY DUTY APPLIES TO A ROLLOVER RECOMMENDATION

Sarah, a CFP® professional, is engaged by Betty, who is retiring soon, to provide Financial Advice. Betty has most of her retirement funds invested in her employer's 401(k) plan. Sarah does not obtain any information about the 401(k) plan because she assumes that there are more investment options available in an individual retirement account ("IRA") than in Betty's 401(k) plan. Based on this, Sarah believes Betty's portfolio would be better off in an IRA. Sarah properly discloses her Material Conflicts of Interest to Betty. Sarah then recommends that Betty take a distribution from her 401(k) plan and roll the assets into an IRA, which Sarah would manage. Sarah intends to analyze and recommend an investment strategy for the IRA after the funds have been distributed to the IRA.

QUESTION:

Did Sarah satisfy her Fiduciary Duty?

RESPONSE OPTIONS:

A. **Sarah satisfied her Fiduciary Duty in recommending the distribution and rollover.**

B. **Sarah did not satisfy her Fiduciary Duty in recommending the distribution and rollover.**

Best Response: Response B is the best response. This case involves the Fiduciary Duty (Standard A.1.) and the definitions of Client and Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. A Client is any person to whom a CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions.

This case study focuses on the Duty of Care, which requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

In this case, Sarah has an Engagement with Betty, and has recommended that Betty take a distribution from her 401(k) plan and roll the assets into an IRA. Therefore, Sarah has provided Financial Advice to a Client and is subject to the Fiduciary Duty, including the Duty of Care.

To satisfy the Duty of Care, Sarah should act in light of Betty's goals, risk tolerance, objectives, and financial and personal circumstances. Sarah should compare the features of the 401(k) plan and the potential IRA when making her recommendation to Betty. Sarah should apply the factors that a prudent CFP® professional would determine are relevant, including the relative features and options of the 401(k) plan compared to a rollover IRA, and determine which choice is best for Betty given her goals, risk tolerance, objectives, and financial and personal circumstances. FINRA has identified a non-exhaustive list of factors that are relevant to this analysis, such as the fees and expenses, investment options, services, availability of penalty-free withdrawals, protection from creditors and legal judgments, required minimum distributions, and issues related to investments in employer stock.

Sarah did not act with the care, skill, prudence and diligence that the Duty of Care requires because she recommended the distribution and rollover without analyzing how the features and options of the 401(k) plan compare to the potential IRA. Sarah also should have consulted her firm's policies and procedures, which may specifically address potential rollovers of 401(k) plan assets.

Response A is not the best response because Sarah did not satisfy her Fiduciary Duty (more particularly, her Duty of Care) in recommending the distribution and rollover.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); definitions of Client and Financial Advice (Glossary).

2: THE FIDUCIARY DUTY APPLIES TO AN OPINION ABOUT A FINANCIAL ASSET

Allison is a CFP® professional who is a registered representative of a broker-dealer. Allison has provided brokerage services to her Client, Mateo, several times over the past three years. Typically, Mateo wants to purchase a specific stock and asks Allison for her opinion before purchasing the stock. Mateo recently asked Allison what she "thought" about Mateo buying a specific stock he intended to purchase. Allison told Mateo that she has looked into the company and that she likes the stock and believes it is undervalued. Mateo then directed Allison to purchase the stock.

QUESTION:

Does Allison have a Fiduciary Duty?

RESPONSE OPTIONS:

A. **Allison does not have a Fiduciary Duty because Mateo identified the specific stock at issue.**

B. **Allison has a Fiduciary Duty because she provided Financial Advice when she communicated with Mateo regarding the advisability of purchasing the stock.**

C. **Allison does not have a Fiduciary Duty because Mateo ultimately directed Allison to buy the stock after Allison communicated with Mateo regarding the advisability of the purchase.**

D. **Allison has a Fiduciary Duty because she effected the stock transaction for Mateo.**

Best Response: Response B is the best response. This case study involves the Fiduciary Duty (Standard A.1.) and the definitions of Client, Financial Advice, and Financial Assets (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. A Client is any person to whom the CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement. Financial Advice includes a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to, among other things, the value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. Financial Assets include securities, insurance products, real estate, bank instruments, commodities contracts, derivative contracts, collectibles, or other financial products.

Mateo asked Allison about a specific stock before making a decision whether to purchase the stock. The content, context, and presentation of this communication makes clear that Mateo was asking for Allison's recommendation with respect to the advisability of purchasing the stock. When Allison responded to Mateo's question by saying that she likes the stock and that the stock is undervalued, she made a communication that reasonably would be viewed as a recommendation that Mateo purchase the stock. A stock is an equity security, which is a Financial Asset. Mateo is a Client because Allison provided Financial Advice and related services to Mateo pursuant to an Engagement. Therefore, because Allison made a recommendation to a Client about a Financial Asset, she has provided Financial Advice. Since a Fiduciary Duty arises when a CFP® professional provides Financial Advice to a Client, Allison has a Fiduciary Duty, and was required to act as a fiduciary, and therefore, in Mateo's best interests, when providing the Financial Advice.

Response A is not the best response. Allison has a Fiduciary Duty because she provided Financial Advice to Mateo, her Client. A CFP® professional who provides Financial Advice to a Client concerning a specific Financial Asset has a Fiduciary Duty even if it was the Client who asked for information about that Financial Asset.

Response C is not the best response because Allison's obligation to satisfy the Fiduciary Duty does not depend upon whether Mateo directed the transaction. Allison must act as a fiduciary when providing Financial Advice. Allison provided Financial Advice to Mateo because Mateo is a Client and Allison made a recommendation to Mateo about a Financial Asset.

Response D is not the best response. Allison has a Fiduciary Duty because she provided Mateo with Financial Advice.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); definitions of Client, Financial Advice, and Financial Assets (Glossary).

As revised in July 2023.

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

3: THE DUTY TO FOLLOW A CLIENT'S INSTRUCTION TO USE A SPECIFIC FIRM FOR EXECUTION

Urwa is a CFP® professional who provides asset management services to several Clients. Urwa manages assets in accordance with a standard investment management agreement that she tailors to meet each Client's investment needs. The agreement gives Urwa discretionary authority to buy or sell securities and to select broker-dealers to execute transactions. Urwa's firm charges each Client an advisory fee based on the average value of assets held in the account each quarter.

Urwa receives a call from one of her Clients, Joe, who is a novice investor. Joe tells Urwa that he wants to help advance his sister Susan's career, and he asks Urwa to begin using Susan's firm to execute trades for his non-qualified investment account. Urwa investigates and has concerns that Susan's firm may not provide Joe with best execution because the cost of execution using Susan's firm is higher than other firms where Urwa typically executes trades, and Urwa does not identify an off-setting benefit from using Susan's firm that would justify the higher fee.

QUESTION:

How should Urwa proceed?

RESPONSE OPTIONS:

A. **Tell Joe that she cannot use Susan's firm to execute trades because it would violate Urwa's Fiduciary Duty to Joe, which requires Urwa to seek the best execution of Joe's transactions.**

B. **Agree to Joe's reasonable and lawful direction, which Urwa has an obligation to follow.**

C. **Inform Joe that using Susan's firm to execute transactions may increase transaction costs or otherwise not be advantageous, and thus adversely affect Joe's investment returns. However, if after receiving this information Joe still wants to make the change, Urwa should begin to direct transactions for his account to Susan's firm.**

Best Response: Response C is the best response. This case involves the Fiduciary Duty (Standard A.1.), including the Duty of Care and the Duty to Follow Client Instructions, and the definition of Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Financial Advice includes the exercise of discretionary authority over the Financial Assets of a Client. The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances. The Duty to Follow Client Instructions requires a CFP® professional to comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

In this case, Urwa's Engagement with Joe gives Urwa discretionary authority over Joe's Financial Assets. Therefore, Urwa is providing Financial Advice to a Client and must satisfy the Fiduciary Duty. To satisfy the Duty of Care, Urwa must seek best execution of Joe's account transactions. Urwa has learned that if she uses Susan's firm, she may not be able to obtain best execution for his transactions. However, Urwa also must satisfy the Duty to Follow Client Instructions. Joe has instructed Urwa to use Susan's firm for execution because he wants to advance Susan's career.

Urwa should review her firm's policies and procedures concerning execution services to determine, for example, whether she is authorized to execute the transaction with Susan's firm. If there are no firm policies that prevent Urwa from using Susan's firm to execute the transaction, then Urwa should inform Joe that if she uses Susan's firm, he may not receive best execution, which could affect Joe's return on the account or otherwise not be advantageous. If, after being informed of these consequences, Joe still wants Urwa to use Susan's firm for execution, then Urwa should do so.

Response A is not the best response because Joe's instruction to execute trades through his sister's firm reflects his view that using a family member to execute transactions is in his best interests as he understands them. In other words, Joe may be willing to forgo some return on his account to help his sister's career. However, Urwa is required to inform Joe of the consequences of that instruction.

Response B is not the best response because, under these circumstances, Urwa's Fiduciary Duty obliges her to inform Joe of the consequences of his instruction, unless Urwa reasonably believes that Joe already knows those consequences. Since Joe is a novice investor, he likely does not have such an understanding. For that reason, Urwa should explain the issues and consequences so that Joe may make an informed decision. If, after this discussion, Joe still wants to use his sister's firm to execute the transactions, then Urwa is obligated to do so. If the basis for Joe's instruction changes, as would be the case if Urwa learns that Susan has left the firm, then Urwa's Duty of Care would require her to inform Joe of the change in facts and ask Joe to reconsider his instruction.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); definition of Financial Advice (Glossary).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

4: THE DUTY TO COMMUNICATE TEAM MEMBER RESPONSIBILITIES

Darnell, a CFP® professional, and Robert, a relationship manager who is not a CFP® professional, work as members of a team at ABC Financial Services Company. A Client has engaged ABC to provide Financial Advice. Darnell and Robert will be working together to formulate and deliver the Financial Advice. ABC does not have policies that identify the respective roles and responsibilities of the various team members.

QUESTION:

As a member of a team, what is Darnell required to do when providing Professional Services to a Client?

RESPONSE OPTIONS:

A. **Darnell's only responsibility is to follow the Financial Advice Engagement, because the Scope of Engagement is the only source of a CFP® professional's responsibilities.**

B. **Darnell must communicate with Robert about how the responsibilities will be allocated between them and determine the scope of services that each person will provide to the Client.**

C. **Darnell should tell Robert that as the relationship manager, Robert should modify the Financial Advice recommendations if he believes that the Client may want to pursue another course of action.**

Best Response: Response B is the best response. This case study involves the Fiduciary Duty (Standard A.1.).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. The Fiduciary Duty includes the Duty of Loyalty, the Duty of Care, and the Duty to Follow Client Instructions. To fulfill the Duty of Care, a CFP® professional must act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

When a CFP® professional is working as part of a team to provide Financial Advice to a Client, the Duty of Care requires the CFP® professional to communicate with the other members of the team about the scope of their respective services and the allocation of responsibility between them. This might be satisfied by a firm policy or protocol that identifies their respective responsibilities with respect to the services to be provided. In this case, Darnell, Robert, and any other members of the ABC team who may provide services to the Client will need to decide who will perform each of the services the Engagement requires. The duty that arises in this case is analogous to the Duty When Working With Additional Persons, set forth in (Standard A.13.b.i.) that applies to persons outside the firm who are providing Professional Services to the Client.

Response A is not the best response because a CFP® professional's responsibilities extend beyond those that are set forth in the Scope of the Engagement. A CFP® professional also must comply with the requirements set forth in the *Code and Standards*.

Response C is not the best response because the decision to modify a recommendation should not be based upon a "belief" that a Client "may want" to pursue another course of action. Mere speculation is not a proper basis for modifying a recommendation.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

5: THE FIDUCIARY DUTY TO OBTAIN FACTUAL INFORMATION WHEN WORKING ON A TEAM

Trinh, a CFP® professional, works in her firm's home office, developing Financial Planning recommendations based upon the information that other individuals within her firm collect from Clients. Trinh is developing recommendations for Steven's Clients, Cindy and Terry. Steven obtains from Cindy and Terry their responses to the firm's Financial Planning questionnaire and some documents that Steven requested. Steven sends the documents and questionnaire responses to Trinh and asks Trinh to provide her Financial Planning recommendation(s). Trinh reviews the information and notices that Cindy and Terry have two investment accounts at another firm that constitute a significant portion of their net worth. However, the account statements are two years old and thus are outdated. Trinh's firm does not have policies and procedures for handling this situation.

QUESTION:

What should Trinh do?

RESPONSE OPTIONS:

A. **Use the asset values from the statement Steven obtained from his Clients to develop the Financial Planning recommendation(s).**

B. **Inform a supervisor that Steven failed to explain to his Clients how to properly fill out the questionnaire and gather documents.**

C. **Inform Steven that the statements he obtained are outdated and ask him to obtain current information about the two accounts.**

D. **Use the asset values from the statements and tell Steven to disclose to the Client that the Financial Planning recommendation(s) are based upon the information that the Client provided.**

Best Response: Response C is the best response. This case study involves the Fiduciary Duty (Standard A.1.) and Step 1 of the Financial Planning Process: Understanding the Client's Personal and Financial Circumstances, Obtaining Qualitative and Quantitative Information (Standard C.1.a.).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. The Fiduciary Duty includes the Duty of Care, which requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances. When providing Financial Planning, a CFP® professional also is required to follow the Practice Standards for the Financial Planning Process. The first step in the process is Understanding the Client's Personal and Financial Circumstances, which includes Obtaining Qualitative and Quantitative Information. A CFP® professional must describe to the Client the qualitative and quantitative information concerning the Client's personal and financial circumstances needed to fulfill the Scope of Engagement and collaborate with the Client to obtain the information.

In this instance, Trinh is developing Financial Planning recommendation(s) based upon the information that other individuals in the firm have obtained from the Clients. Therefore, Trinh's ability to fulfill the Scope of Engagement, and to act in the Client's best interests in accordance with her Fiduciary Duty, depends on the work of her colleagues. When a CFP® professional is working with other individuals within a firm as part of a team that is providing services to a Client, the Fiduciary Duty requires the CFP® professional to take reasonable steps to ensure that the Client is receiving Financial Planning that is in the Client's best interests.

In this instance, the CFP® professional first should determine whether the CFP® Professional's Firm has policies and procedures that apply to the situation. In the absence of such policies and procedures, a CFP® professional should inform the other individual within the firm who is providing services to the Client that the CFP® professional believes that updated financial information may be needed for the CFP® professional to provide Financial Advice that is in the Client's best interest and explain the basis for the CFP® professional's belief. The CFP® professional should discuss with the other individual how the services may be provided in the best interests of the Client.

Here, Trinh's firm does not have policies and procedures for handling this situation. Therefore, Trinh should communicate with Steven to resolve the situation. Trinh should explain to Steven that she does not believe she can develop the Financial Planning recommendation(s) until she has reasonably current information about the two accounts, and recommend that Steven obtain more current information. She also should give Steven the opportunity to explain why it would be reasonable to use outdated statements for the services. If updated information cannot be obtained, and the Client reasonably has directed the firm to proceed with the services based on the information provided, then Trinh may proceed to do so.

Response A is not the best response because the information is outdated and the firm may be able to obtain current information. It is unclear from the fact pattern whether Trinh may provide the recommendation(s) without obtaining current information. If the information is of a type that is currently available, and this information is necessary to provide the Financial Planning recommendation(s) in accordance with the Fiduciary Duty, then Trinh must obtain reasonably current information to do so, unless the Client reasonably has instructed the firm to proceed with the information provided.

Response B is not the best response because Trinh does not know whether Steven's instructions to the Clients were improper, Trinh may ask Steven to obtain the information from the Clients or another service provider, and it is premature for Trinh to involve a supervisor.

Response D is not the best response because disclosure does not eliminate Trinh's Fiduciary Duty. To act in the best interests of the Client, Trinh must act with the care, skill, prudence, and diligence a prudent CFP® professional would exercise in these circumstances. That requires obtaining reasonably current asset values before developing the Financial Planning recommendation(s) or determining whether the existing information may be used. If Trinh is able to provide the Financial Planning recommendation(s) in accordance with the Fiduciary Duty without obtaining reasonably current values for the two accounts, then before or when providing the recommendation(s), Trinh should inform Steven that she is relying upon the information that has been provided and that the lack of current information about the value of the two accounts may limit the Financial Planning Recommendation(s).

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Step 1 of the Financial Planning Process: Understanding the Client's Personal and Financial Circumstances, Obtaining Qualitative and Quantitative Information (Standard C.1.a.).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

6: THE FIDUCIARY DUTY DOES NOT APPLY WHEN PROVIDING GENERAL FINANCIAL EDUCATIONAL MATERIALS CONCERNING EDUCATION PLANNING

Imani is expecting her first child and wants to know more about 529 savings plans. Imani decides to share her news with Jeff, the CFP® professional whom she had previously engaged solely to provide investment management. During a 30-minute meeting, Jeff provides an overview of how 529 savings plans work, addresses some of Imani's general questions about 529 savings plans, and provides a document titled "529 Plans and Other College Savings Options." Imani thanks Jeff for his time and says she will follow up with him in the next few weeks.

QUESTION:

Did Jeff provide Financial Advice when he met with Imani and gave her the 529 savings plan document?

RESPONSE OPTIONS:

A. **Yes, because he made a recommendation.**

B. **No, because Imani did not pay Jeff for the communication.**

C. **No, because Jeff provided Imani only general financial education materials.**

D. **Yes, because a 529 savings plan is an important part of the education planning process.**

Best Response: Response C is the best response. This case study involves the definition of Financial Advice (Glossary).

Financial Advice includes a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to, among other things, the value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. The determination of whether Financial Advice has been provided is an objective rather than subjective inquiry. The more individually tailored the communication is to the Client, the more likely the communication will be viewed as Financial Advice. The provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable CFP® professional would not view as Financial Advice, does not constitute Financial Advice.

Here, a reasonable CFP® professional would conclude that when Jeff provided Imani with an overview of how 529 savings plans work, addressed her general questions about 529 savings plans, and provided an educational document on 529 savings plans, Jeff was providing general financial education and not Financial Advice.

Response B is not the best response because whether Jeff provided Financial Advice does not depend upon whether he receives compensation.

Responses A and D are not the best responses because a reasonable CFP® professional would not view Jeff's communications, which were general in nature and not individually tailored to Imani, as Financial Advice. While a 529 savings plan is an important part of the education planning process, that fact does not turn Jeff's communications to Imani into Financial Advice.

Relevant Standards and Definitions: Definition of Financial Advice (Glossary).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

7: THE FIDUCIARY DUTY DOES NOT APPLY WHEN PROVIDING GENERAL FINANCIAL EDUCATIONAL MATERIALS CONCERNING RETIREMENT PLANNING

Kevin, a prospect, met Priya, a CFP® professional, at a community event. Kevin mentioned to Priya that he was planning to retire next year. Priya asked Kevin if she may send him a document her firm prepared that provides an overview of issues to consider when engaging in retirement planning. Kevin agreed. Priya sends Kevin an article titled "What will my savings cover in retirement?" Priya sends this same article to all her Clients and prospects who are within five years of their intended retirement.

QUESTION:

In this instance, does Priya have a Fiduciary Duty?

RESPONSE OPTIONS:

A. **Priya does not have a Fiduciary Duty because she provided only general financial education materials.**

B. **Priya has a Fiduciary Duty because she provided Financial Advice when she sent Kevin information regarding retirement planning.**

C. **Priya has a Fiduciary Duty even though Kevin is a prospect, not a Client to whom Priya is delivering Financial Advice.**

D. **Priya has a Fiduciary Duty because the article includes a section that describes comprehensive Financial Planning.**

Best Response: Response A is the best response. This case study involves the Fiduciary Duty (Standard A.1.), the Duty of Integrity (Standard A.2.), and the definitions of Client, Engagement, and Financial Advice (Glossary). At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. A Client is any person to whom the CFP® professional provides or agrees to provide Professional Services, including Financial Advice, pursuant to an Engagement. An Engagement is an oral or written agreement, arrangement, or understanding. Financial Advice includes a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to, among other things, the value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets.

The determination of whether Financial Advice has been provided is an objective rather than subjective inquiry. The more individually tailored the communication is to the Client, the more likely the communication will be viewed as Financial Advice. The provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable CFP® professional would not view as Financial Advice, does not constitute Financial Advice.

In this case, Kevin has not entered into an Engagement with Priya. Therefore, Kevin is not a Client and Priya does not have a Fiduciary Duty to Kevin. In addition, the article that Priya delivered to Kevin, and other prospects, describes comprehensive Financial Planning and provides an overview of issues to consider when engaging in retirement planning. The article provides financial information that is generally applicable and reasonably would be viewed as general financial education materials. Therefore, Priya has not provided Financial Advice by sending the article to Kevin. However, to satisfy the Duty of Integrity, which applies whenever a CFP® professional is performing Professional Services, the material that Priya sent to Kevin, like all communications, must not be untrue or omit a material fact that is necessary to make the statements made not misleading.

Response C is not the best response because Kevin is not a Client and Priya has not provided Financial Advice. Kevin is not a Client because there was no agreement, arrangement, or understanding for Priya to provide Professional Services to Kevin, and thus, there was no Engagement.

Responses B and D are not the best responses because an article that merely describes Financial Planning and presents an overview of issues to consider when engaging in retirement planning contains general financial education material, which does not constitute Financial Advice.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Duty of Integrity (Standard A.2.); definitions of Client, Engagement, and Financial Advice (Glossary).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

8: WHEN THE DELIVERY OF FIRM RESEARCH DOES NOT CONSTITUTE FINANCIAL ADVICE

Meghan is a CFP® professional who is a registered representative of a broker-dealer. Meghan has a longtime Client, Ted, to whom she provides episodic brokerage services with no responsibility to monitor the brokerage account. Ted contacts Meghan and asks whether Meghan's firm has a research report regarding a specific stock he is considering purchasing. Meghan provides Ted a research report on the stock that her firm prepared. The research report states that the stock is undervalued. Meghan tells Ted that she has not analyzed the stock and is not making a recommendation as to whether Ted should or should not purchase the stock. Ted reviews the research report and then directs Meghan to purchase the stock for him.

QUESTION:

Which of the following best describes Meghan's duty when purchasing the stock for Ted?

RESPONSE OPTIONS:

A. **Meghan does not have a Fiduciary Duty because Ted identified the specific stock at issue.**

B. **Meghan does not have a Fiduciary Duty with respect to Ted's decision to purchase the stock because she did not provide Financial Advice – Meghan did not recommend that Ted purchase the stock.**

C. **Meghan has a Fiduciary Duty because Ted directed Meghan to execute the transaction.**

Best Response: Response B is the best response. This case study involves the Fiduciary Duty (Standard A.1.) and the definitions of Client and Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. A Client is any person to whom the CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement. Financial Advice includes a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to, among other things, the value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. The determination of whether Financial Advice has been provided is an objective rather than subjective inquiry. The more individually tailored the communication is to the Client, the more likely the communication will be viewed as Financial Advice.

In this circumstance, Ted is Meghan's longtime Client. Meghan responded to Ted's question by providing a research report that her firm prepared. The research report was not individually tailored to Ted's personal and financial circumstances. Meghan also mentioned to Ted that she has not analyzed the stock and is not making a recommendation as to whether Ted should or should not purchase the stock. The content, context, and presentation make clear that Meghan did not recommend that Ted purchase the stock when she provided the research report to Ted. Meghan also did not provide Financial Advice to Ted when Ted requested that Meghan purchase the stock for him. The duty to act as a fiduciary arises when a CFP® professional provides Financial Advice to a Client. Since Meghan did not provide Financial Advice, she was not required to act as a fiduciary with respect to Ted's decision to purchase the stock. If, however, Meghan had a reasonable basis to believe that the transaction was not in Ted's best interests, then Meghan would have an obligation under the *Code of Ethics* to inform Ted that his suggested course of action is not in his best interests, Meghan's reasons therefore, and the possible consequences of taking the course of action.

Response A is not the best response because it does not accurately describe the reason why the Fiduciary Duty does not apply. Meghan is not required to act as a fiduciary with respect to Ted's decision to purchase the stock because she did not provide or agree to provide Financial Advice to Ted about that decision. Whether Meghan must comply with the Fiduciary Duty does not turn on whether Ted requested information regarding the Financial Asset at issue.

Response C is not the best response. Meghan did not provide or agree to provide Ted with Financial Advice as to whether to purchase the stock. A CFP® professional may purchase a stock for a Client without providing Financial Advice about the decision to make that purchase.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Definitions of Client and Financial Advice (Glossary).

As revised in July 2023.

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

9: THE FIDUCIARY DUTY WHEN A CLIENT EXHIBITS SIGNS OF LACK OF CAPACITY OR UNDUE INFLUENCE

Gillian, a CFP® professional, is an investment adviser representative of MM Advisers, Inc., a small investment advisory firm. Maria, who has a net worth exceeding $10 million, has been Gillian's Financial Planning Client for approximately 25 years. Maria has one daughter, Nina, who is named as a beneficiary for Maria's investment accounts. While Maria historically has been in good health, she recently has experienced difficulty walking and her vision is declining. Maria's husband passed away 10 years ago, and she now lives by herself. MM Advisers has account opening agreements that request the identity of and contact information for a trusted contact person. The agreements authorize the firm and its advisers to contact the trusted contact person to discuss financial matters about the Client's account, as authorized by the Client in those agreements and in a manner consistent with relevant federal laws and regulations, self-regulatory organization rules, and state and local laws and regulations. In her account opening agreements, Maria designated her friend Wilma as her trusted contact person.

Approximately one year ago, Gillian attended a dinner to celebrate Maria's 75th birthday. Maria introduced Gillian to Mick, her new companion, who is 30 years younger than Maria. Mick is a teacher whose financial resources are much more limited than Maria's. Mick attended Gillian's next Financial Planning review meeting. Mick asked many questions, and Maria authorized Gillian to respond to the questions. At the next Financial Planning review meeting held six months later, Maria attended alone, and asked Gillian an unusually large number of questions about her investments. Maria appeared to be having difficulty understanding her portfolio statements, and evidenced signs of memory lapse. At that meeting, Maria directed Gillian to change the beneficiary designation on her investment accounts from her daughter Nina to Mick. When Gillian asked why she wanted to make the change, Maria explained that she and Mick were in a serious relationship and planned to get married soon. She said that Mick had told her that he would "take care of her" in the future. Gillian gives to Maria the form that MM Advisers requires Clients to execute to effectuate a change in beneficiary.

QUESTION:

Under the circumstances, how should Gillian fulfill her Fiduciary Duty?

RESPONSE OPTIONS:

A. **Refuse to change the beneficiary on Maria's investment accounts.**

B. **Explain to Maria the risks involved in changing the beneficiary designation, document the communication, and then promptly contact Wilma, Maria's trusted contact person, to address her concerns.**

C. **Promptly call the police, because the facts suggest that Mick is exerting undue influence.**

D. **Promptly contact Maria's daughter, Nina, to discuss the matter.**

E. **Follow Maria's instructions to change the beneficiary on Maria's investment accounts to Mick.**

Best Response: Response B is the best response. This case involves the Fiduciary Duty (Standard A.1.) and the definitions of Client and Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and, therefore, act in the best interests of the Client. A Client is any person to whom a CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the development or implementation of a financial plan. The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances. The Duty to Follow Client Instructions requires a CFP® professional to comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

In this case, Gillian has a Financial Planning Engagement with Maria and is implementing Maria's Financial Plan. Therefore, Gillian is providing Financial Advice to a Client and is subject to the Fiduciary Duty.

Here, Maria has exhibited signs of diminished capacity. A Client who lacks capacity no longer is able to provide a Client instruction. A CFP® professional should be aware of and understand the CFP® Professional's Firm's policies and procedures with respect to a potential lack of capacity or undue influence, as well as any applicable laws, rules, or regulations. A CFP® professional should contact a relevant supervisor or manager to discuss such issues as they arise.

To comply with the Fiduciary Duty, Gillian should talk with Maria about the effect of changing the beneficiary on her accounts and assess whether Maria understands that such a change would mean that Mick, and not her daughter Nina, would receive the investments in her accounts after she passes away. Assuming her firm's policies and procedures allow it, Maria also should promptly contact Wilma, Maria's designated trusted contact person, to address her concerns about Maria's capacity to understand the effect of the change in beneficiary and whether Mick is exercising undue influence over Maria. Gillian also should escalate her concerns to an appropriate manager, and otherwise follow her firm's policies and procedures.

Response A is not the best response because Gillian has a duty to comply with the terms of the Engagement and Maria's reasonable and lawful directions. Gillian does not yet have enough information to determine whether Maria has capacity to provide directions in accordance with the Engagement.

Based on the facts provided, Response C is not the best response because Gillian does not have enough information to suggest that there has been undue influence. However, Gillian should consider relevant laws, rules, and regulations in determining when to contact appropriate governmental authorities.

Response D is not the best response because Nina's status as a beneficiary does not grant Gillian with authority to speak with Nina about Maria's confidential information. Gillian's obligation is to her Client, Maria, and not Maria's daughter.

Response E, which provides for Gillian to follow Maria's instructions, may become an appropriate response, depending on the results of Gillian's discussions with Maria and Wilma and within her firm, her analysis of her firm's policies and procedures, and her continued assessment of Maria's capacity.

As a best practice, a CFP® professional should consider including requests for the identity and contact information for a trusted contact person in account opening agreements or other appropriate documents that will provide authorization to contact a trusted person in appropriate circumstances. A CFP® professional also should be aware of and understand the CFP® Professional's Firm's requirements with respect to these matters, and comply with other relevant federal, self-regulatory organization, and state and local laws, rules, and regulations.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Definitions of Client and Financial Advice (Glossary).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

10: APPLYING THE FIDUCIARY DUTY TO CLIENT INSTRUCTIONS THAT CONFLICT WITH THE DUTY OF CARE

Holly, a CFP® professional, has an Engagement with Pat to provide Financial Advice addressing long-term investing for retirement and other needs later in life. Pat indicates that he is socially conscious and would be interested in investing in companies that are consistent with his views. Holly tells Pat that there are environmental, social, and corporate governance ("ESG") mutual funds that are consistent with Pat's goals. Pat responds that he would like to see what those look like.

Holly collects information about Pat's goals, risk tolerance, objectives, and financial and personal circumstances. She then develops an appropriate asset allocation and begins reviewing ESG investments that would fill the allocations for the asset classes. As she does that work, Holly discovers that, in two of the asset classes, while ESG funds are available, the ESG funds for those asset classes are not funds that Holly, based on her analysis, believes are the best available options for Pat.

QUESTION:

What should Holly do to fulfill her Fiduciary Duty?

RESPONSE OPTIONS:

A. **Recommend ESG funds for those two asset classes because Pat had indicated that he was interested in ESG funds.**

B. **Review her conclusions with Pat, explain the reasons why she would not recommend the funds, and ask Pat whether he would be interested in considering non-ESG investments.**

C. **Inform Pat that she cannot proceed with the Engagement because the only ESG funds that are available in the relevant asset classes are ESG funds that she normally would not recommend.**

Best Response: Response B is the best response. This case study involves the Fiduciary Duty (Standards A.1.) including the Duty of Care (Standard A.1.b.) and the Duty to Follow Client Instructions (A.1.c.).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Under the Duty of Care, a CFP® professional must act with the care, skill, prudence and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives and financial and personal circumstances. Under the Duty to Follow Client Instructions, a CFP® professional must comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

When a CFP® professional realizes that the Client's suggested course of action is not, in the CFP® professional's judgment, in the Client's best interests, the CFP® professional must fulfill the Duty of Care and the Duty to Follow Client Instructions by informing the Client of that conclusion, the CFP® professional's reasons therefore, and the possible consequences of taking the course of action. If the Client specifically directs the CFP® professional to follow instructions that are reasonable and lawful, then the CFP® professional is obligated to follow those instructions. When a CFP® professional cannot identify prudent recommendations due to Client restrictions, the CFP® professional must exercise due care in selecting from among the pool of investments that comply with the Client direction.

In this case, Pat merely has indicated an interest in ESG funds and has not specifically directed Holly to invest exclusively in ESG funds. Holly should review her conclusions with Pat, explain the reasons why she normally would not recommend ESG funds in this circumstance, and ask Pat whether he would prefer to invest in the ESG funds or consider non-ESG investments. If Pat directs that only ESG funds be used for his account, then Holly should follow those instructions and select the ESG funds in these categories that she reasonably believes are the best available options.

Response A is not the best response because an indication of interest is not a clear direction only to recommend ESG funds. Once Holly informs Pat that she could not identify ESG funds in certain categories that satisfy her Duty of Care, and why, Pat may provide clear and explicit instructions.

Response C is not the best response because a CFP® professional must follow a Client's reasonable and lawful directions, even if those directions might appear to require recommendations that the CFP® professional otherwise would not make. Accordingly, under these facts, a CFP® professional would not be required to resign from the Engagement.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Duty of Care (Standard A.1.b.); Duty to Follow Client

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

11: THE FIDUCIARY DUTY AND AN A SHARE CLASS RECOMMENDATION

John, a CFP® professional, works at NestEgg, a broker-dealer. John receives commissions as well as a bonus if he meets his quarterly sales goals. His Client, Emily, recently received a $75,000 inheritance. She asks John for investment recommendations. After gathering information, John determines that Emily does not need to use the funds for at least 15 years, when she expects to make a down payment on a retirement home. John recommends that Emily invest in a portfolio of mutual funds. John explains to Emily that he recommends only mutual funds that charge a sales load or bear some other type of sales charge, such as a 12b-1 distribution or marketing fee, which compensate him (and his firm) for his services. Emily tells John that she understands she will be paying such a fee in working with him.

John recommends that Emily invest in a mix of equity and bond funds from a family of mutual funds that John believes are the best match for Emily from among those available for him to recommend. Each fund has two different classes of shares that offer Sales-Related Compensation. Each class offers the identical investment experience except for the fees that investors will directly (sales load) or indirectly (12b-1 fees) bear:

- The A share class has a 4% sales load and a 0.25% 12b-1 fee.
- The C share class has no sales load but a 1% 12b-1 fee that will last as long as Emily holds the fund.

John recognizes that he and his firm have Material Conflicts of Interest because the more fees Emily pays (including the sales load and any 12b-1 fees), the greater his and his firm's compensation will be.

Because Emily intends to hold the funds for at least 15 years, the A shares likely would be the lower cost alternative. John determines that the A share class would be the better option. John recommends the A share class to Emily. There are no other professional services that John provides to Emily.

QUESTION:

When John recommended the A share class, did John fulfill his Fiduciary Duty with regard to the consideration of costs?

RESPONSE OPTIONS:

A. Yes.

B. No.

Best Response: Response A is the best response. This case involves the Fiduciary Duty (Standard A.1.) and the definition of Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets.

The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances. The Duty of Loyalty requires a CFP® professional to (a) place the interests of the Client above the interests of the CFP® professional and the CFP® Professional's Firm; (b) avoid Conflicts of Interest, or fully disclose Material Conflicts of Interest to the Client, obtain the Client's informed consent, and properly manage the conflict; and (c) act without regard to the financial or other interests of the CFP® professional, the CFP® Professional's Firm, or any individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the CFP® professional's. The Duty to Follow Client Instructions requires a CFP® professional to comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

John has an Engagement with Emily. John recommended that Emily invest in particular mutual funds. Therefore, John has provided Financial Advice to a Client and is subject to the Fiduciary Duty with respect to that advice.

John is required to fulfill the Duty of Care. John is making an investment recommendation that will affect Emily's prospective returns and her ability to meet her goals. John should evaluate the effect the different mutual fund share class fee structures would have on Emily's prospective returns. Emily is a longer-term investor. John determines, based on economic analysis, that the aggregate costs of the C class shares will be greater than the A class shares over time. Thus, absent extenuating circumstances, John fulfilled the Duty of Care when he recommended the A class shares to Emily.

John also is required to fulfill the Duty of Loyalty. John and his firm have Material Conflicts of Interest because the amount of compensation that John and his firm will receive depends on which share class Emily selects. To fulfill the Duty of Loyalty, John must disclose to Emily the compensation structure associated with the A class shares and C class shares, the incentives each compensation structure creates for John and his firm, and the costs that Emily will bear. John also must obtain Emily's informed consent to the Material Conflicts of Interest. To manage the Material Conflicts of Interest, John must make the recommendation he determined was in Emily's best interests (to invest in the A class shares) without regard to the compensation he and his firm would receive.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Definition of Financial Advice (Glossary).

12: APPLYING THE FIDUCIARY DUTY TO A RECOMMENDATION TO PURCHASE PROPRIETARY LIFE INSURANCE

Frank, a CFP® professional, has a Client, Margaret, who is a single parent of two young children. Margaret is in her early 30s and works full time at a large technology firm. Margaret became Frank's Client after they met while serving together on the Board of Trustees at the school their children attend. Margaret tells Frank that she has started saving for her children's education but needs life insurance to provide for their care and education through college if she passes away before then. She asks Frank for his advice.

Frank is an insurance agent for Old Jersey Life who is appointed only to sell life insurance and annuity products. Frank is compensated by commissions and employment benefits. His agent agreement with Old Jersey requires him to offer only Old Jersey products. Frank fully discloses his Conflicts of Interest to Margaret and obtains her informed consent to the conflicts, including the limitations on the products and services he is able to offer.

Old Jersey is a financially sound, highly rated insurer that offers a variety of life insurance products, including term and permanent life insurance. Permanent life insurance accumulates cash value over time that the policy owner may use to fund a lifetime death benefit. Term insurance provides a death benefit only for a defined period. Premiums for permanent life insurance are usually higher than premiums for term insurance. Old Jersey is known for conducting periodic due diligence to ensure that its products offer highly competitive features and prices.

Frank conducts a careful analysis of Margaret's goals, risk tolerance, objectives, and financial and personal circumstances, and determines that a life insurance product would be in Margaret's best interest. He also analyzes Old Jersey's life insurance products. Based on that analysis, Frank concludes that term insurance is the best product for Margaret. Frank recommends that Margaret purchase an Old Jersey term insurance policy that is reasonably priced compared to other similar policies.

QUESTION:

Did Frank satisfy his Fiduciary Duty of Care to Margaret? (You may assume that Frank satisfied the Duty of Loyalty, including the Duty to Disclose and Manage Conflicts of Interest.)

RESPONSE OPTIONS:

A. **Yes. The Fiduciary Duty does not apply to insurance product recommendations.**

B. **No. Frank could not satisfy his Fiduciary Duty because he was obligated to recommend only Old Jersey products and thus could not recommend the best available product.**

C. **No. Frank did not satisfy his Fiduciary Duty because he recommended a term insurance product.**

D. **Yes. Frank satisfied his Fiduciary Duty because he analyzed Margaret's goals, risk tolerance, objectives, and financial and personal circumstances and the available Old Jersey life insurance policies, and recommended an Old Jersey term insurance policy that best met Margaret's circumstances.**

Best Response: Response D is the best response. This case involves the Fiduciary Duty (Standard A.1.) and the definition of Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. "Financial Assets" include securities, insurance products, real estate, bank instruments, commodities contracts, derivative contracts, collectibles, or other financial products.

The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

Here Frank has an Engagement with Margaret, and has recommended that Margaret purchase life insurance. Therefore, Frank has provided Financial Advice to a Client and thus must satisfy the Fiduciary Duty.

Margaret told Frank that she wanted life insurance that would provide financial security for the care and education of her children through college, and not for longer term purposes. Frank determined, based on Margaret's goals, risk tolerance, objectives, and financial and personal circumstances, that term life insurance was in Margaret's best interests. Under different circumstances, Frank might reasonably determine that another type of insurance would be in Margaret's best interests.

Frank then considered whether any of the available Old Jersey term insurance offerings would be in Margaret's best interests. Frank determined that he could reasonably recommend an Old Jersey term insurance policy because Old Jersey is a financially sound insurer and the cost of the term policy was reasonable compared to other similar policies.

If Frank determined that none of the available Old Jersey would be in Margaret's best interest, Frank would not be able to recommend an Old Jersey insurance product to Margaret. Under such circumstances, he would fulfill his obligation to act as a fiduciary by informing Margaret that she should purchase insurance elsewhere.

Here, however, Frank satisfied his Duty of Care by acting with care, skill, prudence, and diligence when he followed a process that was designed to assess Margaret's goals, risk tolerance, objectives, and financial and personal circumstances, to evaluate the insurance company and the available types of policies, and to select a policy that he reasonably believed was in Margaret's best interests.

Response A is not the best response because insurance products are Financial Assets, and Frank's recommendation that Margaret purchase an insurance product is Financial Advice that is subject to the Fiduciary Duty.

Response B is not the best response because Frank's ability to offer only Old Jersey policies is not, by itself, a breach of the Fiduciary Duty. This limitation on the products and services that Frank may offer does not prevent Frank from acting in Margaret's best interests by recommending, from among the reasonably available options, the policy that is the best match for Margaret, so long as the policy has reasonable features, is reasonably priced, and is offered by a financially sound insurer. In contrast, Frank would not satisfy the Fiduciary Duty if he were to recommend the least bad option from a menu of options that are not a good match for Margaret.

Response C is not the best response because the facts and circumstances will determine whether a term insurance policy recommendation satisfies the Duty of Care. One Client's circumstances will vary from that of other Clients. Therefore, a recommendation that is in the best interest of one Client may not be in the best interest of another Client.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.) and the definition of Financial Advice (Glossary).

13: THE FIDUCIARY DUTY APPLIES TO FINANCIAL ADVICE WITH RESPECT TO THE HOLDING OF BANK DEPOSITS

Bill receives $250,000 in life insurance cash proceeds following the death of his father. Bill is a Client of Mary, a CFP® professional. Bill tells Mary that he does not intend to invest the cash for at least six months. Bill asks Mary how he should hold the cash in the meantime.

Mary recommends that Bill deposit the $250,000 in a depository account at Bank X, a well-known bank whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). Mary advises Bill that his cash will be safe in the account and that he will earn interest at a 0.15% annual rate. Mary does not consider (or discuss with Bill) other available options, such as a certificate of deposit ("CD") or a government Money Market Fund ("MMF") that would pay a higher return with minimal risk.

Bill conducts some research and asks Mary whether a MMF might be a better option. Government MMFs often have a significantly higher interest rate than depository accounts, are highly liquid, and are considered to have very low risk.

Mary confirms that that a government MMF is another option and identifies a government MMF in which Bill may hold the $250,000. Bill then directs Mary to hold the funds in the government MMF.

QUESTION:

Which is the best response?

RESPONSE OPTIONS:

A. **Mary was not required to consider alternatives to bank deposits because bank deposits do not fall within the scope of the *Code and Standards*.**

B. **Mary satisfied her Fiduciary Duty of Care because she recommended a safe product that was suitable.**

C. **Mary did not satisfy her Fiduciary Duty of Care because she did not consider all reasonably available options before making her recommendation.**

Best Response: C is the best response. This case involves the Fiduciary Duty (Standard A.1.) and the definitions of Financial Advice and Financial Assets (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. A Client is any person to whom a CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets. "Financial Assets" include securities, insurance products, real estate, bank instruments, commodities contracts, derivative contracts, collectibles, or other financial products." Bank deposits are "Financial Assets."

This case involves the Duty of Care, which requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

In this case, Mary did not satisfy the Duty of Care. Mary failed to consider, as an alternative to the deposit account, other products (including MMFs) that were reasonably available for her to recommend. Mary should have compared the features, risks and benefits of the deposit account to other available alternatives, and made a recommendation based upon the results of that comparison and Bill's goals, risk tolerance, objectives, and financial and personal circumstances. Among the factors that Mary should have considered are liquidity, transparency, rate of return, withdrawal limits, insurance coverage, record of safety, regulation, and the features of the different types of deposits (such as checking accounts, savings accounts, and certificates of deposit) and MMFs (such as government MMFs, prime MMFs, and municipal MMFs) that are reasonably available. Mary also should have considered Bill's six-month time horizon and compared the features of a six-month CD to an MMF.

A is not the best response because bank deposits are "Financial Assets" and a recommendation concerning the value of or the advisability of holding a Financial Asset is Financial Advice that is subject to CFP Board's Fiduciary Duty.

B is not the best response because Mary did not satisfy her Fiduciary Duty of Care when she made a suitable recommendation to deposit the cash in a deposit account. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise. Here a prudent professional would have determined which of the reasonably available options is the best option for the Client. (There may more than one option that is the best option.) Mary did not do so.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); definitions of Financial Advice and Financial Assets (Glossary).

A. DUTIES OWED TO CLIENTS, 1. FIDUCIARY DUTY:

14: THE FIDUCIARY DUTY TO TAKE REASONABLE STEPS WHEN PROVIDING PROFESSIONAL SERVICES AS PART OF A TEAM WITHIN A FIRM

Larry, a CFP® professional, works at a small registered investment adviser where he provides Professional Services to Clients as part of a team. Larry's role on the team is to develop Financial Planning recommendations utilizing information that other members of the team have collected from Clients. Larry has no responsibility for implementing the Financial Planning recommendations, monitoring progress, or updating.

Richard, a non-CFP® professional, has collected information from a couple, Salma and Rina, who are Clients of Larry and Richard. Salma is a freelance writer whose income varies each month, with the result that her ability to save is sporadic.

After understanding Salma and Rina's financial and personal circumstances, identifying and selecting goals, and analyzing Salma and Rina's current course of action and potential alternatives, Larry recommends that the Clients take three actions, in the following order of priority: (1) establish an emergency fund, (2) reallocate their existing Roth IRAs to long-term growth investment vehicles, and (3) increase funding to their existing Roth IRAs. Salma and Rina were informed that Larry is responsible for developing the recommendations and Richard is responsible for working with the Clients on implementation, monitoring progress, and updating. At a meeting with Larry and Richard, Salma and Rina agree with Larry's recommendations and agree to work with Richard on implementing the recommendations.

One month later, Larry sees Richard at the firm's annual meeting and Richard tells Larry that Salma and Rina have increased funding to their Roth IRAs and rebalanced their Roth IRA investments. However, Salma and Rina have not implemented the recommendation to establish an emergency fund. Richard tells Larry that he did not recommend any actions, products, or services that are designed to implement the recommendation to establish an emergency fund. Instead, Richard tells Larry he recommended that the Clients purchase a variable life insurance policy, and that they currently are in underwriting for the policy. Larry's analysis had indicated that both Salma and Rina were adequately insured. Larry is concerned that Richard did not act in the Client's best interests in recommending life insurance rather than moving forward with Larry's recommendation that the Clients establish an emergency fund. Larry's firm does not have policies and procedures for handling this situation.

QUESTION 1:

What, if anything, should Larry do when he learns that Richard did not help the Clients implement the emergency fund and instead recommended the Clients purchase a variable life insurance policy?

RESPONSE OPTIONS:

A. **Larry is not required to take any action because his responsibilities ended when he delivered the Financial Planning recommendations.**

B. **Larry should escalate this matter to a supervisor.**

C. **Larry should contact the Clients and tell them that they should implement the recommendation to establish an emergency fund.**

D. **Larry should ask Richard why he did not recommend to the Clients any actions, products, or services that are designed to implement the recommendation to establish an emergency fund, and whether Richard plans to do so.**

Best Response: Response D is the best response. This case study involves the Fiduciary Duty (Standard A.1.) and Steps 6 and 7 of the Financial Planning Process: Implementing the Financial Planning Recommendation(s) (Standard C.5.) and Monitoring Progress and Updating (Standard C.6.).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. The Fiduciary Duty includes the Duty of Loyalty, the Duty of Care, and the Duty to Follow Client Instructions. When providing Financial Planning, a CFP® professional is required to follow the Practice Standards for the Financial Planning Process. The sixth step in the process is Implementing the Financial Planning Recommendations. The seventh step in the process is Monitoring Progress and Updating.

The *Code and Standards* does not include a duty to monitor or supervise another person within a firm who is providing Professional Services to a Client as part of a team. However, when a CFP® professional is working as part of a team within a firm to provide Professional Services to a Client and the CFP® professional has actual knowledge that another member of the team may have failed to provide the Professional Services that were assigned to that team member, the Fiduciary Duty requires the CFP® professional to take reasonable steps to help ensure that the Professional Services provided to the Client are in the Client's best interests.

When a CFP® professional does not have responsibility for supervising the other team member, the CFP® professional should determine whether the CFP® Professional's Firm has policies and procedures, such as an escalation path or a hotline that may be used to communicate with appropriate personnel about concerns related to the delivery of Professional Services, and then follow those policies and procedures. In the absence of such policies and procedures, a CFP® professional should inform the other team member that the CFP® professional believes that the Professional Services were not performed in the Client's best interests, explain the basis for the CFP® professional's belief, and request that the other team member either demonstrate that the Professional Services were provided in the Client's best interests or take action to ensure that the Professional Services are provided in the best interests of the Client.

In this instance, Larry has actual knowledge of the Clients' agreement to implement Larry's recommendations and that Richard did not recommend to the Clients any actions, products, or services that are designed to implement the recommendation to establish an emergency fund. Since Larry's firm does not have policies and procedures for handling this situation, Larry should address his concern with Richard. Larry should ask Richard to explain his reasons for not recommending to the Clients any actions, products, or services that are designed to implement the recommendation to establish the emergency fund. Richard may have good reasons. For example, the Clients' circumstances may have changed, such that another recommendation should take priority over establishing an emergency fund. Alternatively, Richard might have simply forgotten to implement the recommendation to establish the emergency fund and may welcome the opportunity to rectify that oversight.

Response A is not the best response because when a CFP® professional knows that another team member is providing or has provided Professional Services to the Client that may not be in the Client's best interests, the Fiduciary Duty requires a CFP® professional to take action to ensure that the Professional Services are in the Client's best interests.

Responses B and C are not the best responses. While Larry is concerned that Richard has not recommended that the Clients implement the recommendation to establish an emergency fund, Larry does not have sufficient facts to know that Richard has failed to act in the Clients' best interests. Larry should not involve a supervisor or the Clients until he has had an opportunity to discuss his concern with Richard.

QUESTION 2:

What, if anything, should Larry do if Richard is not able to demonstrate either that he already acted in the Clients' best interests or that he will help the Clients implement the emergency fund and terminate the underwriting for a variable life insurance policy?

RESPONSE OPTIONS:

A. **Larry is not required to take any action because his responsibilities ended when he delivered the Financial Planning recommendations.**

B. **Larry should escalate the matter to a supervisor.**

C. **Larry should contact the Clients and tell them that they should implement the recommendation to establish an emergency fund.**

Best Response: Response B is the best response.

In this instance, Larry has actual knowledge that Richard recommended and selected for implementation a product that was contrary to Larry's recommendation, and the Client's agreement with Larry's recommendation, to establish an emergency fund. Since Larry's firm does not have policies and procedures for handling this situation, Larry should address his concern with Richard. Larry should ask Richard to explain his reasons for not assisting the Clients with establishing the emergency fund and instead recommending a variable life insurance policy. Richard may have good reasons. For example, the Clients' circumstances may have changed, such that establishing an emergency fund is no longer in the Clients' best interests.

However, if Richard is not able to demonstrate either that he already has acted in the Clients' best interests or that he will do so now, then Larry should request that Richard discuss the recommendation with the Clients. If Richard refuses to discuss the recommendation with the Clients, then after advising Richard of his intent to do so, Larry should inform his supervisor about his concerns, or escalate the matter to another appropriate person or channel within the firm. Larry can work with the firm and the Clients to make sure the actions taken are in the Clients' best interest.

A and C are not the best responses for the reasons provided above in response to question 1.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); Steps 6 and 7 of the Financial Planning Process: Implementing the Financial Planning Recommendation(s) (Standard C.5.) and Monitoring Progress and Updating (Standard C.6.).

A. DUTIES OWED TO CLIENTS, 5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST:

1: THE DUTY TO DISCLOSE MATERIAL CONFLICTS OF INTEREST WHEN MAKING A ROLLOVER RECOMMENDATION

Bruce, a CFP® professional, is a representative of XYZ Advisors, Inc., a registered investment adviser. XYZ does not permit its investment adviser representatives to charge a fee for managing assets in a 401(k) plan. Bruce is engaged by Heather, who is retiring, to provide Financial Planning. After obtaining information about and understanding Heather's personal and financial circumstances, Bruce helps Heather develop a goal of having adequate income during her retirement. Bruce analyzes Heather's existing account in the 401(k) plan and the plan's investment options, fees and expenses, services, and other features. Bruce concludes that the management fees Heather will pay if she rolls over the assets into an individual retirement account ("IRA") will be higher than if she leaves the assets in her account in the 401(k) plan. Nevertheless, based on his review of Heather's circumstances and analysis of the relevant factors, Bruce determines that such a rollover is in Heather's best interest. Bruce presents that recommendation to Heather and tells Heather that he would receive an ongoing fee for managing the assets in the IRA. Bruce does not tell Heather that she would not have to pay Bruce a fee if she continues to invest her assets in the account in the 401(k) plan, as he would not be advising on those assets.

QUESTION:

With respect to Bruce's Duty to Disclose Conflicts of Interest, which of the following is the best response?

RESPONSE OPTIONS:

A. **Bruce has no Material Conflict of Interest because Heather understands that Bruce will be paid for his services.**

B. **Bruce satisfied his disclosure obligation when he disclosed his fee for managing the IRA.**

C. **Bruce did not fully disclose to Heather the Material Conflict of Interest that his recommendation presented.**

D. **Since Bruce sincerely believed that his recommendation was in Heather's best interest, he was excused from making full disclosure to Heather.**

Best Response: Response C is the best response. This case involves the Duty to Disclose Conflicts of Interest (Standard A.5.a.) and the definitions of Conflict of Interest and Material (Glossary).

A CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. A CFP® professional must provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the CFP® professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such conflicts or reject them. One way that a Conflict of Interest occurs is when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. Information is Material when a reasonable Client or prospective Client would consider the information important in making a decision. A CFP® professional must make full disclosure and obtain the informed consent of the Client before providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.

In this case, Bruce has a Material Conflict of Interest that could affect his professional relationship with Heather because of how he is compensated for his services. To provide sufficiently specific facts for Heather to understand this Material Conflict of Interest, Bruce must explain to Heather that he will receive an ongoing fee for managing Heather's assets only if she accepts the recommendation and the assets are invested in an IRA; Bruce will receive no compensation if Heather keeps the assets in the account in the 401(k) plan because he will not be providing Financial Advice on those assets. A reasonable Client, like Heather, would consider that information important in making a decision whether to follow or reject Bruce's Financial Advice. Because Bruce did not fully disclose that information to Heather, he did not satisfy his Duty to Disclose Material Conflicts of Interest.

Response A is not the best response because Bruce has a Material Conflict of Interest.

Response B is not the best response because the Duty to Disclose Conflicts of Interest requires Bruce to do more than disclose that he would receive a fee for managing the assets in the IRA. Bruce also is required to explain to Heather that he will receive a fee only if she accepts his recommendation.

Response D is not the best response because a sincere belief by a CFP® professional that he or she is acting in the Client's best interests is insufficient to excuse a failure to make full disclosure of a Material Conflict of Interest.

While the Duty to Disclose Conflicts of Interest does not require disclosure of Material Conflicts of Interest in writing, evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate. As a best practice, CFP Board recommends that a CFP® professional disclose the Conflict of Interest in writing before or when providing the Financial Advice.

Relevant Standards and Definitions: Disclose and Manage Conflicts of Interest (Standard A.5); definitions of Conflict of Interest and Material (Glossary).

A. DUTIES OWED TO CLIENTS, 5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST:

2: THE DUTY TO DISCLOSE MATERIAL CONFLICTS OF INTEREST WHEN RESPONDING TO A CLIENT'S INVESTMENT INQUIRY

Emma, a CFP® professional, receives a call from her Client, David, who is approaching retirement age. David asks Emma whether he should invest in a real estate investment trust (REIT) to fund his retirement income. To invest in the REIT, David would need to liquidate a portion of the assets held in his investment account, which Emma manages, and purchase the REIT through another account. Emma conducts her analysis and concludes that investing in the REIT is a bad idea because, among other reasons, the account she is managing likely will achieve better returns than an investment in the REIT. Emma analyzes David's investment time horizon and concludes that the commission she would receive on the purchase of a REIT investment would be less than the management fee she would earn if the assets remained in David's investment account. The account that would hold the REIT would not pay Emma a management fee.

QUESTION:

What should Emma do?

RESPONSE OPTIONS:

A. **Explain to David that, in her professional judgment, he should not invest in the REIT.**

B. **Fully disclose to David her Material Conflict of Interest, obtain informed consent to the conflict, and provide David with her advice.**

C. **Explain to David that she must decline to provide David the advice he is seeking. Emma has a Material Conflict of Interest because she will earn more compensation if David keeps the assets in the investment account than if David invests in the REIT, and Emma cannot provide disinterested Financial Advice.**

Best Response: B is the best response. This case involves the Duty to Disclose Conflicts of Interest (Standard A.5.a.) and the definitions of Conflict of Interest and Material (Glossary).

A CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. The Duty to Disclose Conflicts of Interest requires the CFP® professional to provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the CFP® professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and to either give informed consent to such conflicts or reject them. One way in which a Conflict of Interest occurs is when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. Information is Material when a reasonable Client or prospective Client would consider the information important in making a decision. A CFP® professional must make full disclosure and obtain the consent of the Client before providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.

In this case, Emma has a Material Conflict of Interest because she will earn more compensation if David accepts her recommendation. The fee that Emma would receive if she continued to manage David's investment account will be greater than the commission she would receive if he purchased the REIT. Emma must make full disclosure to David of the compensation conflict before or when making the recommendation and obtain David's informed consent to the conflict.

While the Duty to Disclose Conflicts does not require written disclosure, evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate. As a best practice, CFP Board recommends that a CFP® professional disclose the Conflict of Interest in writing before or when providing the Financial Advice.

Response C is not the best response because the Fiduciary Duty that Emma, as a CFP® professional, has when providing Financial Advice does not require her to decline to provide the Financial Advice because she has a conflict. Emma may provide full disclosure of the Material Conflict of Interest, obtain David's consent, and properly manage the Material Conflict of Interest by adopting and following business practices reasonably designed to prevent the Material Conflict of Interest from compromising her ability to act in David's best interests.

Response A is not the best response because it does not address Emma's Material Conflict of Interest.

Relevant Standards and Definitions: Disclose and Manage Conflicts of Interest (Standard A.5.); definitions of Conflict of Interest and Material (Glossary).

A. DUTIES OWED TO CLIENTS, 5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST:

3: THE DUTY TO DISCLOSE MATERIAL CONFLICTS OF INTEREST WHEN RECOMMENDING A PRODUCT ISSUED BY AN AFFILIATE

Olivia, a CFP® professional, identifies three single premium annuities that will best meet the needs of her Client, Michael. One of the three annuities Olivia identified is issued by a life insurance company (DEF Mutual, Inc.) that is affiliated with Olivia's firm (DEF Advisers, Inc.). While Olivia will receive the same compensation if Michael purchases any of the three annuities, her firm and her firm's affiliate will receive an additional economic benefit if Michael purchases the DEF Mutual annuity.

QUESTION:

How should Olivia proceed?

RESPONSE OPTIONS:

A. **Olivia should disclose to Michael that one of the insurance companies is affiliated with her firm and that if Michael purchases an annuity from that insurance company, Olivia's firm and an affiliate of Olivia's firm will receive an additional economic benefit on that transaction.**

B. **Olivia should assume that, because the insurance company and Olivia's firm have the same name, Michael recognizes that they are affiliated and that Olivia's firm or the affiliate will receive an additional economic benefit, with the result that no further disclosure is required.**

C. **Olivia should avoid recommending annuity contracts that are issued by the affiliated company.**

Best Response: Response A is the best response. This case involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.) and the definitions of Conflict of Interest and Material (Glossary).

A CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. The Duty to Disclose a Conflict of Interest requires the CFP® professional to provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the CFP® professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and either give informed consent to such conflicts or reject them. One way in which a Conflict of Interest occurs is when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. Information is Material when a reasonable Client or prospective Client would consider the information important in making a decision.

In this case, the affiliation between Olivia's firm and the insurance company that issued the annuity, and the fact that Olivia's firm and an affiliate of Olivia's firm will receive an additional economic benefit if Michael purchases an annuity from that insurance company, are Material Conflicts of Interest. As a result, Olivia must make full disclosure of the potential additional economic benefit that will result if Michael purchases the annuity from the affiliate and obtain Michael's informed consent to the Material Conflict of Interest before or when recommending the annuity issued by the affiliate.

Response B is not the best response because it is not reasonable to assume that Michael understands the conflict solely from the fact that the names of the firm and the affiliate are similar.

Response C is not the best response because if DEF Advisers' affiliation with DEF Mutual, and the additional economic benefit, are fully disclosed and informed consent is obtained, Olivia may manage the conflict through business practices reasonably designed to prevent the Material Conflict of Interest from compromising her ability to act in the Client's best interests. Here, for example, Olivia has analyzed the annuities that are available to Michael, and she may recommend the annuity issued by DEF Mutual if she concludes that the annuity is in Michael's best interests.

Relevant Standards and Definitions: Disclose and Manage Conflicts of Interest (Standard A.5.); definitions of Conflict of Interest and Material (Glossary).

A. DUTIES OWED TO CLIENTS, 5. DISCLOSE AND MANAGE CONFLICTS OF INTEREST:

4: THE DUTY TO DISCLOSE AND MANAGE MATERIAL CONFLICTS OF INTEREST INVOLVING PROPRIETARY PRODUCTS

Frank, a CFP® professional, has a Client, Margaret, a single parent of two young children who is in her early 30s and works full time. Margaret became Frank's Client after they met while serving together on the Board of Trustees at the school their children attend. Margaret tells Frank that she needs life insurance to protect her children and that she wants advice on how to save for retirement and her children's college education. Frank agrees to provide Financial Advice on these issues.

Frank is an insurance agent for Old Jersey Life who only is licensed to sell life insurance and fixed annuity products. Under his agent agreement with Old Jersey, Frank is required only to offer Old Jersey products. Old Jersey offers a variety of life insurance products, including term and permanent life insurance. Permanent life insurance accumulates cash value over time that the policy owner may use to fund a lifetime death benefit or for other purposes, such as supplemental retirement income. Term insurance provides a death benefit only for a defined period. Premiums usually are higher for permanent life insurance than for term insurance.

Frank receives commissions and certain employment benefits from Old Jersey. Frank earns commissions from selling insurance products that are based on a percentage of the premium that the Client pays. Frank receives a commission that is a higher percentage of the premium that the Client pays for some Old Jersey products than other Old Jersey products. Frank conducts a careful analysis of the Client's needs and the available Old Jersey products and recommends a product that is in Margaret's best interests. Assume that Frank fulfilled his Duty of Care and Duty of Loyalty in making his recommendation.

QUESTION 1:

Which of the following are <u>not</u> Material *Conflicts of Interest* under the *Code and Standards*?

RESPONSE OPTIONS:

A. **Frank's contract with Old Jersey requires Frank exclusively to offer Old Jersey products to his Clients.**

B. **Frank and Margaret met while serving on the Board of Trustees of their children's school.**

C. **Frank receives compensation only for providing Financial Advice on the sale of insurance products.**

D. **The premiums of permanent life insurance are higher than the premiums for term insurance, which means that Frank receives more compensation when he sells a Client permanent life insurance than when he sells a Client term life insurance.**

Best Response: Response B. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.), and the definitions of Conflict of Interest and Material (Glossary).

When providing Financial Advice, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. A Conflict of Interest occurs when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. A Conflict of Interest is Material when a reasonable Client or prospective Client would consider the information important in making a decision.

As described in the fact pattern, Response B is not a Conflict of Interest. The fact that Frank met Margaret while serving on the Board of Trustees at the school does not make Frank's interests adverse to his duties to Margaret.

Response A is a Material Conflict of Interest. Frank has a financial incentive to sell Old Jersey products to Margaret. The Old Jersey products may be more expensive than other products available in the marketplace. Frank's interests are adverse to Margaret's interest in obtaining objective Financial Advice and paying less for the products that she purchases. The Conflict of Interest is Material because a reasonable Client would consider important in deciding whether to accept Frank's recommendation the fact that Frank may offer only Old Jersey products.

Response C is a Material Conflict of Interest. Frank has an interest in selling insurance products to Margaret, as opposed to other types of investment products, because he receives compensation only for selling insurance. This creates a Conflict of Interest because Frank's interest in receiving compensation is adverse to his duty to provide Margaret with objective Financial Advice about whether she needs insurance, and if so, how much. The Conflict of Interest is Material because a reasonable Client or prospective Client would consider it important to know, in deciding whether to accept Frank's recommendation about which products to purchase, how and when Frank is compensated when he provides Financial Advice regarding the products that Margaret should purchase. Margaret is particularly likely to consider the information Material because the Financial Advice concerns her retirement and her children's college education, and thus may affect her personal and financial circumstances for a long time.

Responses D and E are Material Conflicts of Interest. Frank's interest in receiving greater compensation (for selling permanent life insurance and for selling certain types of policies) is adverse to his duty to provide Margaret with objective Financial Advice. These Conflicts of Interest are Material because a reasonable Client or prospective Client would find the information important in making a decision about whether to accept Frank's recommendations.

QUESTION 2:

What must Frank do to address these Material Conflicts of Interest?

RESPONSE OPTIONS:

A. **Frank must disclose his Material Conflicts of Interest to Margaret, obtain her informed consent, and manage the conflicts in Margaret's best interests.**

B. **Frank must obtain Margaret's informed consent to any Material Conflicts of Interest in writing.**

Best Response: Response A. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.).

When providing Financial Advice to a Client, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship, obtain the Client's informed consent, and manage the conflict in the Client's best interests.

In making the disclosure, the CFP® professional must provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such Conflicts of Interest or reject them. Ambiguity in the disclosure provided to the Client will be interpreted in favor of the Client. The Duty to Disclose and Manage Conflicts of Interest does not require a CFP® professional to disclose Conflicts of Interest in writing, but CFP Board recommends written disclosure as a best practice. Evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate.

A CFP® professional also must obtain the Client's informed consent. Written consent to a conflict is not required. In determining whether the disclosure about a Material Conflict of Interest provided to the Client was sufficient to infer that a Client has consented to a Material Conflict of Interest, a CFP® professional should consider whether a reasonable Client receiving the disclosure would have understood the Conflict of Interest and how it could affect the advice the Client will receive from the CFP® professional.

A CFP® professional also must manage Material Conflicts of Interest by adopting and following business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests.

In this case, one way that Frank may make full disclosure of all Material Conflicts of Interest that could affect the professional relationship would be by providing Margaret with the following information:

- That his agent agreement with Old Jersey requires him exclusively to offer Old Jersey products, even if other products available in the marketplace might have a lower cost or have features that would make them a better fit for Margaret's circumstances.
- That he only is authorized to sell insurance products and that he receives compensation only on the sale of insurance products, and that this provides him with a financial incentive to recommend insurance products even if other types of products that he is not permitted to sell might be a better fit for Margaret's circumstances.
- That there is a difference between permanent and term life insurance, and explain that difference.
- That Margaret will pay higher premiums for permanent life insurance and that Frank will receive more compensation for the sale of permanent life insurance, and that this provides Frank with an incentive to sell permanent life insurance.
- That Frank expects to earn more compensation over the term of certain insurance products than others, and the types of products that will pay him more compensation.
- That this provides him with a financial incentive to recommend those insurance products over others where he will earn a lower aggregate amount of compensation.

For Frank to sell Margaret the policy, Margaret also must provide her informed consent to the Material Conflicts of Interest. Margaret's informed consent may be inferred if Frank's disclosures are sufficiently specific.

Frank also must manage the Material Conflicts of Interest by adopting and following business practices that are reasonably designed to prevent the Material Conflicts of Interest from compromising his ability to act in Margaret's best interest.

B is not the best response because a CFP® professional is not required to obtain the Client's informed consent in writing. Obtaining the Client's informed consent in writing is a best practice, but informed consent may be inferred if the disclosures are sufficiently specific.

QUESTION 3:

Which of the following is the best statement with respect to Frank's management of the Material Conflicts of Interest?

RESPONSE OPTIONS:

A. **Frank is required to eliminate Material Conflicts of Interest from his planning process.**

B. **Frank satisfies his duty when he discloses his Material Conflicts of Interest to Clients and they provide their informed consent.**

C. **In addition to disclosing Material Conflicts of Interest and obtaining the Client's informed consent, Frank must adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising his ability to act in the Client's best interests.**

Best Response: Response C is the best response. This question involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.).

A CFP® professional has a duty to adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests.

Here Frank has Material Conflicts of Interest because he may sell only proprietary products, he receives compensation only for the sale of certain products, and he receives more compensation for selling some products than others. Frank must take steps to ensure that his recommendation is based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances, and not his potential compensation. As a best practice, Frank should consider documenting the basis for making the recommendation.

Response A is not the best response because the *Code and Standards* does not require a CFP® professional to eliminate all Material Conflicts of Interest.

Response B is not the best response because disclosing Material Conflicts of Interest and obtaining the Client's informed consent is not all that the *Code and Standards* requires when a CFP® professional is providing Financial Advice and has a Material Conflict of Interest. A CFP® professional also must properly manage the conflict.

Relevant Standards and Definitions: Duty to Disclose and Manage Conflicts of Interest (Standard A.5.); Definitions of Conflict of Interest and Material (Glossary).

5: THE DUTY TO DISCLOSE AND MANAGE CONFLICTS OF INTEREST AND A DISCRETIONARY PURCHASE OF NO TRANSACTION FEE FUNDS

Michelle, a CFP® professional who is a principal of a mid-sized registered investment adviser, begins working with Theresa, a new Client. Theresa is 40 years old and recently left a large company to start her own business. Theresa's objective is long-term investing for retirement. Her Financial Assets include a rollover IRA, a startup Keogh plan (covering Theresa and her two employees), and mutual funds held in a non-qualified brokerage account.

Theresa would like to transfer the Financial Assets she currently holds in her non-qualified brokerage account into an advisory account. To accomplish that, Michelle opened a fully discretionary advisory account for Theresa that will pay Michelle ongoing advisory fees. Michelle's firm requires its clients to select a particular clearing broker for investment accounts. Michelle is not affiliated with the clearing broker. The clearing broker has a "no transaction fee" ("NTF") program, through which investors can purchase and sell a specific share class of certain mutual funds without paying a transaction fee. It also offers a "transaction fee" program, through which investors can pay a transaction fee to purchase and sell either (1) mutual funds that aren't offered in the NTF program, or (2) the same mutual funds that are offered in the NTF program but a different share class of those funds.

To avoid transaction costs, Michelle purchased a fund in the NTF program for Theresa's account. However, the fund in the NTF program that Michelle purchased was also offered in the transaction fee program as a different share class of the same fund with a lower expense ratio. Class G of the fund, which was available through the clearing broker's NTF program (and which Michelle used) had an expense ratio of .75%, while Class M, which was part of the transaction fee program, had an expense ratio of .53%. The funds were otherwise the same. Taking into account (1) the size of the position in the fund that Michelle purchased and (2) her expectation that the need to rebalance or otherwise liquidate the position would be minimal within the next several years, Michelle could have determined that, due to the higher expense ratio of the share class offered in the NTF program over the expected holding period, the cost to Theresa of owning the NTF share class of the fund would be expected to exceed the costs that Theresa would have incurred if she had paid a transaction fee to purchase the share class of the fund that was available in the transaction fee program.

The clearing broker makes revenue sharing payments to Michelle's firm for the sale of the funds (limited to the specified share class) in the NTF program, which are compensation to Michelle's firm in addition to the advisory fee that Theresa will pay. Michelle's firm does not receive revenue sharing payments for sales of the different funds or share classes of funds in the transaction fee program. Michelle provides Theresa with a website link to her firm's Form ADV, including Part 2A or the "brochure," which disclosed only the advisory fee, that her firm offered both an NTF program and a transaction fee program through its clearing broker, and that the firm's clearing broker would share with Michelle's firm revenue it received from mutual fund sponsors who pay a fee to participate in the NTF program. Michelle makes no other disclosures to Theresa about the impact of the revenue sharing arrangement, including that the mutual funds that were part of the NTF program for which it received revenue sharing were generally more expensive for clients or that there were instances in which a mutual fund in the NTF program otherwise had a lower-cost share class available in the transaction fee program, for which Michelle's firm would receive no revenue sharing compensation.

QUESTION:

Which two of the statements about Michelle's Fiduciary Duty and her Duty to Disclose and Manage Conflicts of Interest are best?

RESPONSE OPTIONS:

A. **Michelle has satisfied her duty to act in Theresa's best interests by purchasing the NTF fund, which will be costlier for Theresa over time, because Michelle's total compensation is reasonable.**

B. **Michelle fully satisfied her duty to disclose conflicts of interest because her firm's Form ADV disclosed that the firm would receive revenue sharing.**

C. **Michelle has not satisfied her duty to act in Theresa's best interests by purchasing the NTF fund because the use of NTF funds will be costlier for Theresa.**

D. **Michelle has not satisfied her duty to disclose conflicts of interest because she did not disclose that she and her firm had economic incentives to purchase the NTF fund, which were more expensive for Theresa.**

Best Response: Both C and D are the best responses. This case involves the Fiduciary Duty (Standard A.1), the Duty to Disclose and Manage Conflicts of Interest (Standard A.5), and the definitions of Conflict of Interest, Material, and Financial Advice (Glossary).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Financial Advice includes communications that, based on their content, context, and presentation, would reasonably be viewed as a recommendation to take or refrain from taking a particular course of action with respect to the development or implementation of a financial plan; the value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets; investment policies or strategies, portfolio composition, the management of Financial Assets, or other financial matters; or the selection and retention of other persons to provide financial or Professional Services to the Client. Financial Advice also includes the exercise of discretionary authority over the Financial Assets of a Client.

The Fiduciary Duty includes a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. The Duty of Care requires a CFP® professional to act with the care, skill, prudence, and diligence that a prudent professional would exercise considering the Client's goals, risk tolerance, objectives, and financial and personal circumstances. The Duty of Loyalty requires a CFP® professional to (a) place the interests of the Client above the interests of the CFP® professional and the CFP® Professional's Firm; (b) avoid Conflicts of Interest, or fully disclose Material Conflicts of Interest to the Client, obtain the Client's informed consent, and properly manage the conflict; and (c) act without regard to the financial or other interests of the CFP® professional, the CFP® Professional's Firm, or any individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the CFP® professional's.

A CFP® professional must make full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship. The Duty to Disclose Conflicts of Interest requires the CFP® professional to provide the Client with sufficiently specific facts so that a reasonable Client would be able to understand the CFP® professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and to either give informed consent to such conflicts or reject them. One way a Conflict of Interest occurs is when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. Information is Material when a reasonable Client or prospective Client would consider the information important in making a decision. A CFP® professional must make full disclosure and obtain the consent of the Client before providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.

Michelle exercised discretionary authority over Theresa's Financial Assets. Therefore, Michelle has provided Financial Advice to a Client and is required to act as a fiduciary with respect to that Financial Advice.

In this case, the NTF share class purchased by Michelle was not the best reasonably available option for Theresa because it would result in higher costs to her over time than the transaction fee share class of the same fund. Michelle's firm, however, would receive more compensation from the selection of the NTF funds because of the revenue sharing payments to her firm. Michelle failed to satisfy the Duty of Care because she did not act with the care, skill, prudence, and diligence that a prudent professional would exercise when she selected the product that would be more expensive for Theresa. Further, in selecting the NTF funds, Michelle also failed to satisfy the Duty of Loyalty because she (1) placed her own interests and the interests of her firm above the interests of Theresa, and (2) did not act without regard to her own financial interests or the financial interests of her firm. For these reasons, Response C is one of the best responses.

Michelle and her firm have a Material Conflict of Interest because of the revenue sharing payments the firm will receive when Michelle makes the purchase of NTF funds. Although Michelle provided Theresa with a link to her firm's Form ADV 2A brochure, which disclosed the revenue sharing payments, the disclosure did not state that the mutual funds that were part of the NTF program (for which it received revenue sharing compensation) were generally more expensive for clients. Michelle also did not disclose that there were instances in which a mutual fund in the NTF program otherwise had a lower-cost share class available in the transaction fee program (for which Michelle's firm would receive no revenue sharing compensation). As a result, the disclosure was not sufficient for Theresa to give informed consent to the conflict or reject it. For these reasons, Response D is one of the best responses.

A is not the best response because the reasonableness of Michelle's compensation is not determinative of whether Michelle acted in Theresa's best interest in purchasing the NTF fund that is costlier to Theresa.

B is not the best response because the disclosure was not sufficient for the reasons described above.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1), Duty to Disclose and Manage Conflicts of Interest (Standard A.5) and the definitions of Financial Advice, Conflict of Interest, and Material (Glossary).

6. MANAGING CONFLICTS OF INTEREST ARISING FROM DIFFERENT PRODUCT RECOMMENDATIONS

Gabriella is a CFP® professional who is a registered representative with a broker-dealer. She provides comprehensive financial planning to her Clients Santiago and Renata, a couple in their mid-40s who recently received a $50,000 inheritance. Santiago and Renata have no immediate need for the money, and asked Gabriella to invest the funds for them as supplemental retirement income.

Gabriella is considering recommending that Santiago and Renata add to their existing modest portfolio by investing the $50,000 in a mutual fund portfolio. Gabriella has identified two possible mutual fund portfolios that would meet the couple's needs. Specifically, Gabriella determined that the benefits of both portfolios are the same and will meet Santiago and Renata's goals, risk tolerance, objectives, and financial and personal circumstances. Further, with respect to both portfolios, Gabriella's firm would earn a 5.5% initial commission (or load) on the sale of the mutual funds, with a 25-basis point trailing 12b-1 fee. However, the expense ratio of one mutual fund portfolio is a little lower than the other. Furthermore, Gabriella's firm will receive revenue sharing payments from the mutual fund company that has the lower expense ratio. Gabriella's firm does not allow its individual representatives to receive additional direct or indirect compensation or benefits resulting from revenue sharing payments paid to the firm.

Gabriella recommends that Santiago and Renata purchase the mutual fund portfolio that would result in revenue sharing payments paid to Gabriella's firm (and has the lower expense ratio).

QUESTION:

Which of the following is the best statement(s) with respect to Gabriella's obligation to manage conflicts of interest?

RESPONSE OPTIONS:

A. **Gabriella may make the recommendation of the lower cost mutual fund portfolio without any disclosure or other management steps because the payment of revenue sharing payments to Gabriella's Firm is not a Material Conflict of Interest.**

B. **Gabriella can recommend the mutual fund portfolio that would pay revenue sharing so long as she discloses the firm's conflict of interest and receives the Clients' informed consent because the expense ratio of that mutual fund portfolio is lower than the other and the recommendation is less expensive for Santiago and Renata.**

C. **Gabriella must recommend the mutual fund portfolio that does not pay Gabriella's firm revenue sharing because the payment of revenue sharing is a Material Conflict of Interest that cannot be adequately disclosed or otherwise managed.**

Best Response: Response B is the best response. This case study involves the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.) and the definitions of Conflict of Interest and Material (Glossary).

A Conflict of Interest exists when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. A Conflict of Interest is Material when a reasonable Client or prospective Client would consider the information important in making a decision. When providing Financial Advice to a Client, a CFP® professional must avoid conflicts or make full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship, obtain the Client's informed consent, and manage the conflict in the Client's best interests.

To manage conflicts, CFP® professionals must adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests. As described in CFP Board's Guide to Managing Material Conflicts of Interest, in developing business practices for conflicts management for identified conflicts, a CFP® professional should review and evaluate the CFP® Professional's Firm's conflict management or mitigation practices and any additional conflict management practices that the CFP® professional follows. The CFP® professional then should consider and implement any additional steps the CFP® professional needs to take to properly manage conflicts in accordance with the CFP® professional's Duty of Care, in a manner that is reasonably designed to result in Financial Advice that is in the Client's best interests despite the conflict of interest. The CFP® professional's process must reflect the practices of a prudent CFP® professional and must be proportional to the size of the conflict. The greater the conflict of interest, the more carefully CFP Board will scrutinize the conflict management process. A CFP® professional also should consider documenting the basis for the recommendations, including the conflict management process that the CFP® professional followed. A CFP® professional should keep in mind that a Material Conflict of Interest may be so great that it cannot be reasonably managed and therefore must be avoided.

In this scenario, Gabriella's firm will earn more compensation if she recommends that Santiago and Renata purchase shares of the mutual fund company that pays revenue sharing. This is a Material Conflict of Interest under CFP Board's *Code of Ethics and Standard of Conduct (Code and Standards)* because Gabriella is incented to recommend the mutual fund portfolio that will generate revenue sharing payments to her firm. Therefore, Response A is not the best response. Gabriella must ensure the conflict is adequately disclosed to Santiago and Renata and obtain their informed consent to the conflict prior to providing Financial Advice to the couple.

A CFP® professional might be able to manage a Material Conflict of Interest such as this one through a process, consistent with the CFP® professional's Duty of Care, that is reasonably designed to result in Financial Advice that is in the Clients' best interests despite the conflicts of interest. Here, Gabriella can manage the Material Conflict of Interest created by the payment of revenue sharing payments to her firm by relying on the type of prudent process described above to determine which alternative is in the best interests of Renata and Santiago based on their goals, risk tolerance, objectives, and financial and personal circumstances. As noted above, Gabriella has already determined that the benefits of investing in the two mutual fund portfolios are the same and the cost to Renata and Santiago is less if they invest in the mutual fund portfolio that pays revenue sharing. Therefore, under these circumstances, the payment of revenue sharing to the firm is not compromising Gabriella's ability to act in Santiago and Renata's best interests if she recommends the mutual fund portfolio that has the lower expense ratio. Response B is the best response.

Response C is not the best response because, in addition to relying on her firm's disclosures, she can manage the conflict of interest resulting from the recommendation of the fund that pays revenue sharing through a process, consistent with the CFP® professional's Duty of Care, that is reasonably designed to result in Financial Advice that is in the Clients' best interests despite the conflicts of interest. If she could not act in the Client's best interests, then she may need to limit the Scope of Engagement or decline to provide the Financial Advice.

Relevant Standards and Definitions: Disclose and Manage Conflicts of Interest (Standard A.5); definitions of Conflict of Interest and Material (Glossary).

7. THE DUTY TO MANAGE MATERIAL CONFLICTS OF INTEREST WHEN MAKING AN ACCOUNT TYPE RECOMMENDATION

Ann, a CFP® professional, works for a large dually registered broker-dealer/investment adviser firm. Ann has a new client, Sam, who is in his late-20s and never has invested in the market. Sam has $100,000 in a savings account, and he has asked Ann to help him invest the assets in mutual funds. Sam hopes to use the investment to pay for a vacation home but does not plan to use the funds for at least 10 years. Sam has a moderate risk tolerance. Sam believes he will have approximately $10,000 in additional funds to invest each year, probably all at once because of anticipated annual bonus payments. Since Sam is new to investing, he wants Ann to provide ongoing assistance with his investments; however, he does not want to give Ann discretion in his account.

As a representative of a dually registered firm, Ann could recommend that Sam open either a non-discretionary advisory account or a brokerage account. If Sam opens a brokerage account, he will pay a commission (or transaction-based fee) to Ann (and her firm) every time he buys or sells an investment. If he opens an advisory account, he will pay Ann (and her firm) an annual fee of 1.25% of the assets in the account. Over time, Ann and her firm likely would receive more compensation through the advisory account than the brokerage account. However, advisory accounts provide clients with additional services, including ongoing advisory services, as compared to brokerage accounts.

Ann identifies the Material Conflict of Interest that arises from her account type recommendation and the compensation she may receive. She sufficiently discloses the conflict to Sam and obtains his informed consent to the conflict prior to providing Financial Advice.

QUESTION:

Which of the following is the best statement(s) with respect to Ann's management of her Material Conflict of Interest?

RESPONSE OPTIONS:

A. **Ann could manage the conflict by recommending that Sam open a brokerage account and purchase front-end load mutual funds with the initial $100,000 investment, but then transfer the existing mutual funds and make new purchases in an advisory account the following years.**

B. **Ann could recommend either account type so long as her fees are competitive with other firms.**

C. **Ann should make her recommendation of account type using a process reasonably designed to result in a determination of which account is in Sam's best interest.**

D. **Ann must recommend the brokerage account to Sam because it likely will result in him paying less over time.**

Best Response: Response C is the best response. This case study involves the Fiduciary Duty (Standard A.1.), the Duty to Disclose and Manage Conflicts of Interest (Standard A.5.), and the definitions of Conflict of Interest and Material (Glossary).

A Conflict of Interest exists when a CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client. A Conflict of Interest is Material when a reasonable Client or prospective Client would consider the information important in making a decision. When providing Financial Advice to a Client, a CFP® professional must make full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship, obtain the Client's informed consent, and manage the conflict in the Client's best interests. In this case, the likelihood that Ann will receive greater compensation over time if Sam opens an advisory account than a brokerage account is a Material Conflict of Interest. As noted, Ann adequately disclosed the Material Conflict of Interest and obtained Sam's informed consent to the conflict.

To manage conflicts, CFP® professionals must adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests. As described in CFP Board's Guide to Managing Material Conflicts of Interest, in developing business practices for conflicts management for identified conflicts, a CFP® professional should review and evaluate the CFP® Professional's Firm's conflict management or mitigation practices and any additional conflict management practices that the CFP® professional individually uses. The CFP® professional should then consider and implement any additional steps the CFP® professional needs to take to properly manage conflicts in accordance with the CFP® professional's Duty of Care, in a manner that is reasonably designed to result in Financial Advice that is in the Client's best interests despite the conflict of interest. The CFP® professional's process must reflect the practices of a prudent CFP® professional and must be proportional to the size of the conflict. The greater the conflict of interest, the more carefully CFP Board will scrutinize the conflict management process. A CFP® professional also should consider documenting the basis for the recommendations, including the conflict management process that the CFP® professional followed. CFP® professionals should keep in mind that a Material Conflict of Interest may be so great that it cannot be reasonably managed and therefore must be avoided.

In this case study, Ann likely will receive more compensation over time if Sam invests through a fee-based (advisory) account as compared to a commission-based (brokerage) account. As a result, Ann has a greater incentive to recommend a fee-based advisory account than the commission-based brokerage account. However, fee-based accounts provide clients with additional services, including ongoing advisory services, as compared to commission-based accounts. Sam has indicated that, although he may only invest funds once per year, he intends to continue making investments and, because he is a novice investor, he needs ongoing assistance with his investments.

To manage this conflict, Ann should look first to her firm's conflicts management or mitigation policies and procedures to ensure that the recommended account type is and remains appropriate, including with respect to the account type selection process and any required periodic review of accounts. If these firm policies and procedures do not adequately address the management of Ann's conflict of interest, then she also can manage the Material Conflict of Interest by relying on her own process for determining which alternative is in the best interest of her Client based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances, in a manner that reflects the practices of a prudent CFP® professional. Therefore, Response C is the best response.

Response A is not the best response because any recommendation that Sam purchase a mutual fund that is subject to a front-end sales load and, shortly thereafter, move those mutual fund shares into an investment advisory account that is subject to an asset-based advisory fee would result in Sam effectively paying twice for the same recommendation. Under the facts as described, this is a conflict that cannot be managed under the *Code and Standards*.

Response B is not the best response because the obligation of the CFP® professional is to make a recommendation in the best interest of the Client. The fact that Ann's fees are in line with another financial professional's does not satisfy Ann's Duty of Care. As described above, Ann must use a process to determine which alternative is in her Client's best interest based on the Client's goals, risk tolerance, objectives, and financial and personal circumstances. For example, the facts stated above indicate that Ann may determine that the advisory account and the associated ongoing monitoring that the advisory account will provide are in Sam's best interest even though it will likely provide more compensation to her over time. For that reason, Response D also is not the best response.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.), Disclose and Manage Conflicts of Interest (Standard A.5); definitions of Conflict of Interest and Material (Glossary).

1. THE DUTY OF CONFIDENTIALITY AND PRIVACY REQUIRES REASONABLE STEPS TO PROTECT CLIENT INFORMATION

Mei is a CFP® professional who works for a financial services firm. She is the financial professional for Clients Jin and Fen.

Mei meets with Jin and Fen to discuss updates to their financial plan. Based upon the meeting, Mei needs to send documents to Jin and Fen. Mei uses her firm's e-mail system to share documents with Jin and Fen. However, the firm was experiencing a system error and the firm's email system was inoperative.

Because some of the documents were time-sensitive, including documents that required a same-day response, Mei does not believe she can wait for the firm's systems to come back online. Instead of waiting, Mei emailed the relevant documents to her personal email, which is a commercially available email software that does not include the same level of protection as her firm's email system. Mei then used her personal email to send the documents to Jin and Fen.

QUESTION:

Did Mei's actions violate the *Code of Ethics and Standards of Conduct*?

RESPONSE OPTIONS:

A. **No. Mei did not violate CFP Board's Duty of Confidentiality and Privacy because she believed her personal email was secure.**

B. **Yes. Mei violated CFP Board's Duty of Confidentiality and Privacy by not informing the clients that she would be using her personal email.**

C. **Yes. Mei violated CFP Board's Duty of Confidentiality and Privacy by using her personal email to send documents to Jin and Fen.**

D. **No. Mei did not violate CFP Board's Duty of Confidentiality and Privacy because her clients needed to sign time-sensitive documents and her only recourse was using her personal email.**

Best Response: Response C is the best response. This case involves the Duty of Confidentiality and Privacy (Standard A.9.).

A CFP® professional, either directly or through the CFP® Professional's Firm, must take reasonable steps to protect the security of non-public personal information about any client, including the security of information stored physically or electronically, from unauthorized access that could result in harm or inconvenience to the client.

Mei's failure to ensure that she took prudent steps to protect this client information is demonstrated by the fact that this information was sent to or stored on a personal email inbox that did not have the same level of protection the information would have had if it had remained on the firm's email system.

Response A is not the best response. While Mei may have believed that her personal email was secure, that is not enough by itself to meet the standard.

Response B is not the best response. Mei's disclosure to the clients is irrelevant to the issue of whether the use of personal email violated CFP Board's Duty of Confidentiality and Privacy.

Response D is not the best response. The clients' needs to receive documents does not negate the responsibility to ensure the transfer of those documents is secure.

Relevant Standard: Confidentiality and Privacy (Standard A.9.).

2. APPLYING THE DUTY OF CONFIDENTIALITY AND PRIVACY TO THE SHARING OF NON-PUBLIC PERSONAL INFORMATION

Becky Smith, CFP® has worked with Jeff and Susan Barnes for almost fifteen years in a financial planning relationship. The Barnes are very philanthropic – Becky has assisted the Barnes with numerous charitable donations and other charitable projects. The Barnes let Becky know that if there are potential opportunities to donate to charity in the future, Becky should let them know.

Becky has recently been nominated to serve on the steering committee for a well-known charitable organization. Becky wants to provide a good impression, so she provides the names, ages, and income levels for the Barnes so the charity could solicit donations from the clients. She believes that they would be happy to be involved with her charity due to their prior philanthropy and their statements to Becky about potential charitable opportunities.

QUESTION:

Did Becky violate the duty of confidentiality and privacy under CFP Board's *Code and Standards* when she provided the clients' names and income levels to the charity?

RESPONSE OPTIONS:

A. **No. The Barnes told Becky that they were interested in future opportunities to donate to charity and Becky was just acting on that request.**

B. **Yes. While the Barnes requested that Becky inform them of any charitable opportunities, Becky shared the Barnes' non-public personal information with the charity without first receiving permission from the Barnes.**

C. **No. Becky only provided the Barnes' names, ages, and general income levels.**

D. **Yes. But only if the charity acts on the information.**

Best Response: Response B is the best response. This case involves the Duty of Confidentiality and Privacy (Standard A.9.).

A CFP® professional must keep confidential and may not disclose any non-public personal information about any prospective, current, or former Client ("client"), except that the CFP® professional may disclose information:

1. For ordinary business purposes:
    a. With the client's consent, so long as the client has not withdrawn the consent;
    b. To a CFP® Professional's Firm or other persons with whom the CFP® professional is providing services to or for the client, when necessary to perform those services;
    c. As necessary to provide information to the CFP® professional's attorneys, accountants, and auditors; and
    d. To a person acting in a representative capacity on behalf of the client;
2. For legal and enforcement purposes:
    a. To law enforcement authorities concerning suspected unlawful activities, to the extent permitted by the law;
    b. As required to comply with federal, state, or local law;
    c. As required to comply with a properly authorized civil, criminal, or regulatory investigation or examination, or subpoena or summons, by a governmental authority;
    d. As necessary to defend against allegations of wrongdoing made by a governmental authority;
    e. As necessary to present a civil claim against, or defend against a civil claim raised by, a client;
    f. As required to comply with a request from CFP Board concerning an investigation or adjudication; and
    g. As necessary to provide information to professional organizations that are assessing the CFP® professional's compliance with professional standards.

Here, while the Barnes requested that Becky inform them of any charitable opportunities, Becky shared the Barnes' non-public personal information with the charity without first receiving permission from the Barnes. Becky did not share the information for ordinary business purposes or for legal and law enforcement purposes. Although Becky shared the information to gain stature at the charity she had just joined, Becky's disclosure without the Barnes' consent is improper.

Response A is not the best response because the statement from the Barnes about a future charitable opportunity would not constitute consent to provide non-public personal information to a third party.

Response C is not the best response because the clients' names, ages, and income levels constitute non-public personal information and cannot be shared with third parties without consent.

Response D is not the best response because there is no requirement under the *Code and Standards* for the third party to take action with the non-public personal information that they receive.

Relevant Standard: Confidentiality and Privacy (Standard A.9.).

1: A CFP® PROFESSIONAL FIRM'S SALES-RELATED COMPENSATION

Mildred is a CFP® professional employed by Alpha Advisory Services, Inc. ("Alpha"), a registered investment adviser. Mildred tells Thomas, a client of Alpha, that her compensation method is "fee-only." Thomas asks Mildred for investment recommendations. Mildred gathers the information that she needs, conducts an appropriate analysis, and recommends that Thomas invest in an Alpha-approved family of mutual funds after making the required disclosures. Thomas is pleased with Mildred's recommendation and directs her to make the investment. The only compensation that Mildred receives is a salary from Alpha. Mildred does not receive any additional compensation when Thomas invests in the mutual fund. Although her firm discloses the information to Clients, Mildred does not realize that Alpha receives revenue sharing payments from the mutual funds she recommends, including the Alpha-approved family of mutual funds in which Thomas has invested.

QUESTION:

Has Mildred complied with the Duties When Representing Compensation Method?

RESPONSE OPTIONS:

A. **Yes. Mildred accurately informed Thomas that she is "fee-only" because her only source of compensation is her salary and she does not receive any additional compensation when Thomas invests in the mutual fund.**

B. **No. Mildred may not refer to her compensation method as "fee-only" because her firm, Alpha, receives revenue sharing payments from mutual funds.**

C. **Yes. Mildred may refer to her compensation method as "fee-only" because she is not aware that Alpha receives revenue sharing payments from mutual funds, and thus she has no incentive to recommend the mutual funds to Clients.**

Best Response: Response B is the best response. This case involves the Duties When Representing Compensation Method (Standard A.12.).

A CFP® professional may not make false or misleading representations regarding the CFP® professional's or the CFP® Professional's Firm's method(s) of compensation. A CFP® professional may represent his or her or the CFP® Professional's Firm's compensation method as "fee-only" if:

(a) The CFP® professional and the CFP® Professional's Firm receive no Sales-Related Compensation; and

(b) Related Parties receive no Sales-Related Compensation in connection with any Professional Services the CFP® professional or the CFP® Professional's Firm provides to Clients.

Sales-Related Compensation is defined as more than a *de minimis* economic benefit, including any bonus or portion of compensation, resulting from a Client purchasing or selling Financial Assets, from a Client holding Financial Assets for purposes other than receiving Financial Advice, or from the referral of a Client to any person entity other than the CFP® Professional's Firm.

Here the revenue sharing payments are Sales Related Compensation because they are more than a de minimis economic benefit that results from the Client purchasing an investment in the mutual fund. Mildred may not refer to her compensation method as "fee-only" because her firm will receive Sales-Related Compensation. Mildred's failure to know that her firm receives Sales-Related Compensation does not excuse her representation that her compensation method is "fee-only." Whether a CFP® professional may represent his or her compensation as "fee-only" depends on the objective facts, not on his or her subjective beliefs. Mildred is responsible for knowing whether she or her firm receives Sales-Related Compensation, and whether any Related Parties receive Sales-Related Compensation in connection with any Professional Services she or her firm provides to Clients.

Response A is not the best response because Mildred may not represent her compensation method as "fee-only." While Mildred does not receive any additional compensation when her Clients invest in the mutual funds, her personal compensation is only one factor that she must consider in determining whether she may represent her compensation method as "fee-only." Mildred also must consider the compensation that her firm and any Related Parties receive. Because her firm receives Sales-Related Compensation in the form of revenue sharing payments, Mildred may not refer to her compensation method as "fee-only."

Response C is not the best response because Mildred's duty when representing her compensation method depends upon the objective facts, not her subjective understanding of the facts. A CFP® professional who decides to represent his or her compensation method as "fee-only" has a duty to know the objective facts and make truthful and non-misleading representations about those facts.

Relevant Standards and Definitions: Duties When Representing Compensation Method (Standard A.12.) Instructions (A.1.c.).

1: DUTIES WHEN RECOMMENDING ADDITIONAL PERSONS TO PROVIDE FINANCIAL OR PROFESSIONAL SERVICES TO A CLIENT

Marie is a CFP® professional who works for a financial services firm. She is the relationship manager for Clients Seth and Jennifer, who intend to retire in ten years and are looking for a financial advisor who lives locally and is able to help them address their wealth management needs. More specifically, the Clients seek a financial advisor to provide customized, active portfolio management. Marie's firm does not have a financial advisor who lives locally and is available to help them.

Several local registered investment advisors (RIAs) custody their assets with Marie's firm. The firm established requirements that an RIA must meet for the firm to recommend Clients to the RIA. The requirements set reasonable standards for the reputation, experience, and qualifications of the RIA firm and its investment adviser representatives. Marie's firm recently developed a list of RIA firms that meet the requirements after interviewing RIA firms and evaluating the reputation (including disciplinary history), experience, and qualifications of the firms and their investment adviser representatives. Marie receives a fee for each recommendation that she makes to a Client of a firm-approved RIA. In this instance, Marie arranges for Seth and Jennifer to meet with a local investment adviser representative of the firm-approved RIA who she determines will be the best fit for the Clients given the desire for customized, active portfolio management.

QUESTION:

What is Marie required to do when recommending to the Clients the RIA firm's investment adviser representative?

RESPONSE OPTIONS:

A. **Marie is not required to take any action because the Clients are not paying her firm a referral fee.**

B. **Marie may rely on her firm's vetting process for approving the RIA firm, and must disclose to the Client, at the time of the recommendation, the compensation that she, her firm, and any Related Party will receive for the recommendation if the Clients retain the local RIA.**

C. **Marie is required to independently investigate at least three local RIA firms on the firm-approved list to determine the best fit for the Clients.**

D. **Marie must enter into a written Engagement with the Clients before recommending an RIA firm.**

Best Response: Response B is the best response. This case study involves the Duties When Recommending, Engaging, and Working with Additional Persons (Standard A.13.a.).

When recommending the retention of additional persons to provide financial or Professional Services for a Client, a CFP® professional must: (1) have a reasonable basis for the recommendation based on the person's reputation, experience, and qualifications; and (2) disclose to the Client, at the time of the recommendation, any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for the recommendation.

A CFP® professional may rely on the CFP® Professional's Firm's list of approved firms if the CFP® professional understands the process the CFP® Professional's Firm used to develop the list and determines that it is reasonably designed and implemented. If a CFP® professional becomes aware of other information that makes the recommendation unreasonable, then the CFP® professional must refrain from making the recommendation.

In this instance, Marie has recommended to the Clients an investment adviser representative of a local RIA firm. Marie has a reasonable basis to make the recommendation because the RIA was on her firm's approved list of RIA referral firms, and she has a reasonable basis to believe that her firm engaged in a diligent process of selecting the RIA firms after conducting an investigation and evaluating the reputation (including disciplinary history), experience, and qualifications of the firm and its professionals against the firm's reasonable standards. Since the RIA firm will pay Marie's firm a referral fee, when Marie recommends the RIA firm to the Clients, she must disclose to the Clients the compensation arrangement that her firm has with the RIA firm.

A is not the best response because a CFP® professional has a duty when recommending an additional person to provide Professional Services for a Client that includes disclosing to the Client any arrangement by which the RIA firm will compensate Marie, Marie's firm, or a Related Party for the recommendation.

C is not the best response because Marie has a reasonable basis for relying on her firm's approved list of RIA referral firms. In selecting RIA firms for the approved list, Marie's firm developed and applied reasonable standards for the reputation (including disciplinary history), experience, and qualifications of the RIA firm and its investment adviser representatives.

D is not the best response because Marie may make the recommendation without entering into a written Engagement with the Clients.

Relevant Standards and Definitions: Duties When Recommending, Engaging, and Working with Additional Persons (Standard A.13.a.).

2: DUTIES WHEN RECOMMENDING ANOTHER SERVICE PROVIDER

Maggie, a CFP® professional, provides Financial Advice to her Client, Ryan, a small business owner. Ryan asks Maggie to recommend an accountant to provide tax and accounting services for both Ryan's business and for him personally.

Maggie's Clients work with a variety of accountants, and Maggie has communicated with them about their services. Based upon that personal experience, Maggie develops a list of four certified public accountants (CPAs) she considers recommending. Maggie had a positive experience working with each of these individuals. Maggie talks to Clients about their experiences with those accountants and receives additional feedback about the kinds of services they offer and the quality of their services. Maggie also reviews a publicly available database that contains information about licensed CPAs in the United States to determine if any of the accountants on her list have been disciplined or have other negative information. Based on those conversations and her research, Maggie recommends one of the four accountants on her list to Ryan.

The accountant Maggie recommends to Ryan once recommended a Client to Maggie; however, Maggie and the accountant currently do not have, and never have had, an arrangement by which the accountant would recommend Clients to Maggie or by which Maggie would recommend Clients to the accountant.

QUESTION:

Did Maggie satisfy her duties when recommending the accountant?

RESPONSE OPTIONS:

A. **Maggie did not satisfy her duties when recommending the accountant because her due diligence was inadequate.**

B. **Maggie did not satisfy her duties when recommending the accountant because she failed to inform Ryan that she previously received a Client recommendation from the accountant.**

C. **Maggie has no duties when recommending other service providers.**

D. **Maggie satisfied her duties when recommending the accountant to Ryan.**

Best Response: Response D is the best response. This case study involves the Duty of Care (Standard A.1.b.) and the Duties When Recommending, Engaging, and Working With Additional Persons (Standard A.13.).

At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. Under the Duty of Care, a CFP® professional must act with the care, skill, prudence and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives and financial and personal circumstances. Financial Advice includes a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to the selection and retention of other persons to provide financial or Professional Services to the Client.

When recommending persons to provide Professional Services to a Client, a CFP professional must, in relevant part:

i. Have a reasonable basis for the recommendation based on the person's reputation, experience, and qualifications; and

ii. Disclose to the Client, at the time of the recommendation or prior to the Engagement, any arrangement by which someone who is not the Client will compensate or provide other material economic benefit to the CFP professional, the CFP® Professional's Firm, or a Related Party for the recommendation or Engagement.

Here, Maggie's due diligence with respect to the accountant she recommended was adequate to provide her with a reasonable basis for the recommendation, based on the accountant's reputation, experience and qualifications. Maggie had personal experience working with the accountant, she consulted with Clients of the accountant to determine whether they believed that the accountant provided quality services, and she researched the accountant in a publicly-available database maintained by the state's Board of Accountancy.

Response A is not the best response because, based upon the facts provided, Maggie's due diligence provided a reasonable basis for making the recommendation.

Response B is not the best response because there is no obligation to report prior Client recommendations when recommending another service provider. However, if there was an arrangement that provided a financial benefit to Maggie for the recommendation (for example, a mutual-referral agreement), then Maggie would have been required to disclose the arrangement, obtain the Client's informed consent, and properly manage the Conflict of Interest in the Client's best interests. Whether there is an "arrangement for a financial benefit" depends on the factual circumstances. However, the more recommendations that the CFP® professional and the other service provider make to each other, the more likely it is that there is an "arrangement for financial benefit." It is a best practice to disclose recommendations that subjectively may be viewed as being the result of an arrangement. In addition, a CFP® professional should comply with the CFP® Professional's Firm's policies and procedures regarding these matters.

Response C is not the best response because a CFP® professional has duties when recommending other persons to provide Professional Services to a Client.

Relevant Standards and Definitions: Duty of Care (Standard A.1.b.); Duties When Recommending, Engaging, and Working With Additional Persons (Standard A.13.).

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 3. APPLICATION OF PRACTICE STANDARDS:

1: FINANCIAL ADVICE THAT REQUIRES FINANCIAL PLANNING

Bob is 50 years old. He is divorced with no children and rents his home. His only significant assets are $300,000 invested in a bank savings account and $200,000 that has accumulated in his firm's 401(k) plan. He asks Gina, a CFP® professional, to manage the assets currently held in his bank savings account, manage his cash flow, and plan for his retirement. Bob also tells Gina that he wants to focus on his long-term financial outlook. They agree that Gina will develop recommendations for the assets currently invested in the bank savings account, make cash flow recommendations, and develop long-term planning scenarios that include retirement projections. Gina and Bob enter into an investment advisory agreement so that Gina can manage the assets currently invested in Bob's bank savings account.

QUESTION 1:

Is Gina providing Financial Advice that requires Financial Planning?

RESPONSE OPTIONS:

A. **Yes, Gina is providing Financial Advice that Requires Financial Planning.**

B. **No, Gina is not providing Financial Advice that Requires Financial Planning.**

Best Response: Response A is the best response. Gina is providing Financial Advice that Requires Financial Planning. This case study involves the Application of the Practice Standards (Standard B.3.) and the Integration Factors (Standard B.4.). A CFP® professional must comply with the Practice Standards for the Financial Planning Process, and therefore, provide Financial Planning, when:

a. The CFP® professional agrees to provide or provides:

   i. Financial Planning; or

   ii. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or

b. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

In this case, there are insufficient facts to conclude that the written Engagement contains language requiring Gina to provide Financial Planning, or that Bob has a reasonable basis to believe that Gina will provide Financial Planning. Therefore, whether Gina must comply with the Practice Standards for Financial Planning Process depends on whether Gina's Financial Advice requires integration of relevant elements of Bob's personal and/or financial circumstances.

CFP Board has established the following Integration Factors that CFP Board will weigh in determining whether a CFP® professional has agreed to provide or provided Financial Advice that Requires Financial Planning:

a. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;

b. The portion and amount of the Client's Financial Assets that the Financial Advice may affect;

c. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;

d. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and

e. The barriers to modifying the actions taken to implement the Financial Advice.

CFP Board would weigh the Integration Factors in this case as follows:

- Gina is addressing Bob's need for or desire to develop goals, manage assets and liabilities, manage cash flow, achieve financial security, preserve or increase wealth, and prepare for retirement. Therefore, Gina's Financial Advice may affect several relevant elements of Bob's personal and financial circumstances.
- Gina will be managing the funds currently invested in Bob's bank savings account, which has a higher value than any of Bob's other assets. Therefore, Gina's advice will affect a significant portion and amount of Bob's assets.
- Bob has asked Gina to focus on his long-term financial outlook, and to prepare long-term planning scenarios. Therefore, Gina's Financial Advice likely will affect Bob's personal and financial circumstances for a long time.
- Gina will recommend that Bob reallocate the assets currently held in the bank savings account, thereby altering the risk return profile of his holdings and exposing Bob to increased risk.
- Based upon the facts provided, it is unclear what barriers to modifying the actions taken to implement the Financial Advice may exist.

Based upon a weighing of the Integration Factors, Gina will be providing Bob with Financial Advice that Requires Financial Planning. Gina's Financial Advice (a) will affect a significant portion of Bob's Financial Assets, (b) will affect Bob's personal and financial circumstances for a long time, and (c) may affect several relevant elements of Bob's personal and financial circumstances. Because Gina is providing Bob with Financial Advice that Requires Financial Planning, she must follow the Practice Standards for the Financial Planning Process. In addition, since Gina is required to provide Financial Planning to Bob, some of the information that she may have provided to Bob orally when providing Financial Advice now must be delivered to Bob in writing.

The *Code and Standards* does not require an explicit agreement to provide Financial Planning for Financial Planning to be required. Where, as here, a CFP® professional provides or agrees to provide Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances to act in the Client's best interests, the CFP® professional is required to provide Financial Planning.

QUESTION 2:

Is Gina required to comply with the Practice Standards for the Financial Planning Process if Bob does not agree to engage her for Financial Planning?

RESPONSE OPTIONS:

A. Yes, Gina is required to comply with the Practice Standards for the Financial Planning Process.

B. No, Gina is not required to comply with the Practice Standards for the Financial Planning Process.

Best Response: Response B is the best response. If a CFP® professional otherwise must comply with the Practice Standards, but the Client does not agree to engage the CFP® professional to provide Financial Planning, the CFP® Professional must either:

a. Not enter into the Engagement;

b. Limit the Scope of Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing;

c. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or

d. Terminate the Engagement.

If Bob decides that he does not want to engage Gina for Financial Planning, Gina may provide Bob with the requested Financial Advice after informing Bob how Financial Planning would benefit him and how the decision not to engage her to provide Financial Planning may limit her Financial Advice.

Relevant Standards and Definitions: Application of Practice Standards (Standard B.3.); Integration Factors (Standard B.4.); No Client Agreement to Engage for Financial Planning (Standard B.6.).

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 3. APPLICATION OF PRACTICE STANDARDS:

2: WHEN A CLIENT HAS A REASONABLE BASIS TO BELIEVE A CFP® PROFESSIONAL WILL PROVIDE FINANCIAL PLANNING

Kimani, a CFP® professional, distributes a flyer inviting prospects to attend a Financial Planning Seminar. At the event, Kimani places a sign at the entrance that states: "What Financial Planning Can Do For You." Daniel, a prospect, attends the event. At an in-person meeting the following week, Daniel tells Kimani that he wants to be a Financial Planning Client, with a specific focus on retirement planning. Kimani asks Daniel to complete an investment risk profile questionnaire. Kimani does not clearly inform Daniel that she would not be providing Financial Planning. Kimani reviews Daniel's answers and, rather than providing Financial Planning, Kimani solely makes an investment recommendation.

QUESTION:

Is Kimani required to comply with the Practice Standards for the Financial Planning Process, and therefore, provide Financial Planning?

RESPONSE OPTIONS:

A. **Kimani is not required to comply with the Practice Standards for the Financial Planning Process because Kimani only provided investment planning to Daniel.**

B. **Kimani is required to comply with the Practice Standards for the Financial Planning Process because Kimani provided Financial Advice to Daniel when she conducted investment planning.**

C. **Kimani is required to comply with the Practice Standards for the Financial Planning Process because Daniel has a reasonable basis to believe that Kimani will provide or has provided Financial Planning.**

D. **Kimani is not required to comply with the Practice Standards for the Financial Planning Process because Kimani only engaged in a brokerage transaction.**

Best Response: Response C is the best response. This case study involves the Application of Practice Standards (Standard B.3.). A CFP® professional must comply with the Practice Standards for the Financial Planning Process, and therefore, provide Financial Planning, when:

a. The CFP® professional agrees to provide or provides:

   i. Financial Planning; or

   ii. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or

b. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

Although Daniel's Engagement does not specify that Kimani will provide Financial Planning, Daniel has a reasonable basis to believe that Kimani will provide or has provided Financial Planning: Kimani invited Daniel to a Financial Planning seminar; Daniel told Kimani that he wanted Financial Planning; Kimani advised Daniel how to invest; and Kimani did not clearly inform Daniel that she would not be providing Financial Planning. Under other facts or circumstances, the application of the Practice Standards for the Financial Planning Process may produce a different result. In addition, since Kimani is required to provide Financial Planning to Daniel, some of the information that she may have provided to Daniel orally when providing Financial Advice now must be delivered to Daniel in writing.

Response A is not the best response because Daniel had a reasonable basis to believe that Kimani would be providing Financial Planning, and thus Kimani was required to provide Financial Planning. Where Financial Planning is required, the Practice Standards for the Financial Planning Process apply even if the CFP® professional does not actually provide Financial Planning.

Response B is not the best response. The reason that the Practice Standards for the Financial Planning Process apply is not because Kimani provided Financial Advice to Daniel when she conducted investment planning. Not all Financial Advice requires Financial Planning, and the facts here are insufficient to determine whether Kimani has provided Financial Advice that requires Financial Planning. The reason that the Practice Standards for the Financial Planning Process apply is because based on the facts, Daniel has a reasonable basis to believe that Kimani will provide or has provided Financial Planning.

Response D is not the best response. The standard for determining whether the Practice Standards for the Financial Planning Process apply is not whether the Client engaged in a brokerage transaction. Where there is no explicit agreement regarding Financial Planning, the Practice Standards for the Financial Planning Process apply if the Client has a reasonable basis to believe the CFP® professional will provide Financial Planning, or if the CFP® professional provides or agrees to provide Financial Advice that Requires Financial Planning.

Relevant Standards and Definitions: Application of Practice Standards (Standard B.3.).

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 4. INTEGRATION FACTORS:

1: DETERMINING WHETHER FINANCIAL PLANNING IS REQUIRED WHEN AN ENGAGEMENT EXPANDS OVER TIME

Pedro, a CFP® professional, has a new client, Napoleon, who is 28 years old. Napoleon is engaged to be married and has a two-year old child from a previous marriage. At their first meeting, Napoleon informs Pedro that he recently received a $20 million inheritance. Napoleon asks Pedro for advice on how to invest his inheritance. Napoleon and Pedro's firm enter into an Engagement to provide investment management for the inheritance funds. Pedro's firm sends Napoleon a document stating that "the only time an Advisor is providing Financial Planning is if the engagement explicitly provides for Financial Planning."

Over time, Pedro and Napoleon's professional relationship expands, with Pedro providing "modular" Financial Advice over successive meetings:

- Prior to his wedding, Napoleon tells Pedro that he wants to purchase a home for his family. He also wants to know if he has enough money to quit his job and live off his inheritance for the rest of his life. Pedro determines, based on Napoleon's net worth, cash flow, retirement projections, and risk tolerance, that a moderate growth portfolio likely will provide Napoleon with a comfortable lifestyle and a new home. Pedro tells Napoleon that he can quit his job and advises Napoleon to continue his employer-sponsored health insurance coverage. Pedro also helps Napoleon determine how much he should spend on his new home.
- Two months after he is married, Napoleon and Pedro discuss Napoleon's need for new health insurance coverage. Pedro compares several private health insurance policies with those from the insurance marketplace, and recommends Napoleon purchase a private policy. Pedro incorporates this new expense into the cash flow analysis.
- Four months later, Napoleon tells Pedro that he would like to begin saving for his son's college. Pedro presents an education funding analysis for Napoleon's son and recommends that Napoleon front-load a 529 savings plan with a $75,000 one-time contribution. Pedro factors this expense into Napoleon's cash flow analysis.
- Sometime later, Napoleon tells Pedro he is concerned that his ex-wife and other family members may try to make a claim on his inheritance. Pedro prepares an estate planning analysis and recommends that Napoleon create Wills, Trusts, Powers of Attorney, and Health Care Directives. Pedro provides the names of three experienced, qualified, and reputable attorneys who are available to help Pedro implement the recommendation.
- At their most recent meeting, Napoleon discusses his desire to provide for his child and second wife. Pedro recommends the gifting of certain assets to an Irrevocable Trust, changing beneficiary designations, and annual gifting strategies that would benefit Napoleon's mother and his two-year old son. Pedro includes the annual gifting expense in the cash flow analysis.

QUESTION:

Is Pedro providing Financial Advice that Requires Financial Planning?

RESPONSE OPTIONS:

A. **Yes, because Pedro's Financial Advice requires integration of relevant elements of Napoleon's personal and/or financial circumstances.**

B. **No, because Pedro did not create a comprehensive financial plan, but instead delivered modular Financial Advice over the course of several meetings.**

C. **No, because Pedro did not specifically state that he was performing Financial Planning.**

D. **No, because Pedro's firm's disclosure document states that "the only time an Advisor is providing Financial Planning is if the Advisor and client explicitly agree to the engagement."**

Best Response: A is the best response. Pedro is providing Financial Advice that requires Financial Planning. This case study involves the Application of the Practice Standards for the Seven-Step Financial Planning Process (Standard B.3.) ("Practice Standards"), the Integration Factors (Standard B.4.), and the Duty to Provide Information to a Client (Standard A.10.).

A CFP® professional must comply with the Practice Standards, and therefore, provide Financial Planning, when:

a. The CFP® professional agrees to provide or provides:

   i. Financial Planning; or

ii. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or

b. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

Pedro's firm does not have an explicit agreement for Pedro to provide Financial Planning to Napoleon. Pedro also has not discussed Financial Planning with Napoleon, and Napoleon has no reasonable basis to believe that Pedro will be providing Financial Planning. Therefore, the issue is whether Pedro's Financial Advice requires integration of relevant elements of Napoleon's personal and/or financial circumstances in order to act in Napoleon's best interests, such that Pedro is required to provide Financial Planning to Napoleon. CFP Board has established the following Integration Factors that CFP Board will weigh in making that determination:

a. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;

b. The portion and amount of the Client's Financial Assets that the Financial Advice may affect;

c. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;

d. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and

e. The barriers to modifying the actions taken to implement the Financial Advice.

CFP Board would weigh the Integration Factors in this case as follows:

- Pedro is addressing Napoleon's need for or desire to develop goals, manage assets and liabilities, manage cash flow, identify and manage the financial effect of health considerations, provide for educational needs, preserve or increase wealth, prepare for retirement, and address estate and legacy matters. Therefore, Pedro's Financial Advice may affect several relevant elements of Napoleon's personal and financial circumstances, which weighs in favor of a finding that Financial Planning is required.
- Pedro will be managing Napoleon's $20 million inheritance, which is a significant portion of Napoleon's Financial Assets and a significant amount of Financial Assets. Therefore, this factor weighs in favor of a finding that Financial Planning is required.
- Napoleon has asked Pedro to focus on his long-term financial outlook, and to prepare long-term planning scenarios. Therefore, Pedro's Financial Advice likely will affect Napoleon's personal and financial circumstances for a long time, which weighs in favor of a finding that Financial Planning is required.
- It is not clear how Pedro's analysis, including the assumptions he uses and the recommendations he makes, will impact Napoleon's overall risk exposure. Therefore, this factor does not weigh for or against a finding that Financial Planning is required.
- Pedro is recommending a large deposit in a 529 savings plan ($75,000). If Napoleon needs to access the money in the 529 savings plan for something other than qualified education expenses, he may have to pay taxes and a penalty. In addition, Pedro is recommending that Napoleon gift assets to an Irrevocable Trust, as well as to Napoleon's mother and son. These facts weigh in favor of a finding that Financial Planning is required because, if implemented, these recommendations would be difficult to modify.

Based upon a weighing of the Integration Factors, Pedro will be providing Napoleon with Financial Advice that Requires Financial Planning. Most significantly, Pedro's Financial Advice (a) will affect most of Napoleon's Financial Assets; (b) may affect several relevant elements of Napoleon's personal and financial circumstances; (c) will affect Napoleon's personal and financial circumstances for a long time; and (d) may be difficult to modify, if implemented.

Where, as here, a CFP® professional provides or agrees to provide Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances to act in the Client's best interests, then the CFP® professional has additional duties to the Client, unless the Client does not want to engage the CFP® professional to provide Financial Planning.

If the Client does not agree to engage the CFP® professional to provide Financial Planning, then the CFP® professional must either:

a. Not enter into the Engagement;

b. Limit the Scope of Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing;

c. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or

d. Terminate the Engagement.

In this case, Pedro's and Napoleon's professional relationship has expanded over time and is not limited to the provision of investment advice. There is no indication that Napoleon does not want to engage Pedro to provide Financial Planning. Therefore, Pedro is required to provide Financial Planning to Napoleon.

When Pedro's Financial Advice expands to the point that the Financial Advice requires Financial Planning, Pedro has additional duties to Napoleon. Pedro is required to provide Financial Planning and to comply with the Practice Standards. In addition, under the Duty to Provide Information to a Client, most of the information that Pedro may have provided to Napoleon orally (or in writing) when providing Financial Advice now must be delivered to Napoleon in writing, in one or more written documents. This includes the following information, which must be provided prior to or at the time of Engagement:

- A description of the services and products to be provided;
- How the Client pays for the products and services, and a description of the additional types of costs that the Client may incur;
- How the CFP® professional, the CFP® Professional's Firm's, and any Related Party are compensated for providing the products and services;
- The existence of any public discipline and bankruptcy, and the locations of the webpages of certain public websites that sets forth the CFP® professionals' public disciplinary history or any personal or business bankruptcy when the CFP® professional was a Control Person;
- Full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship, including sufficiently specific facts so that a reasonable Client would be able to understand the CFP professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such conflicts or reject them;
- A written notice at the time of the Engagement identifying policies regarding the protection, handling, and sharing of a client's non-public personal information that were adopted and implemented by the CFP® professional's Firm, and thereafter not less than annually except under certain enumerated circumstances.
- Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for engaging or recommending the selection or retention of additional persons to provide financial or Professional Services for a Client; and
- Any other information about the CFP® professional or the CFP® Professionals' Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm.

Pedro also must provide to Napoleon the terms of the Engagement, including the Scope of Engagement and any limitations, the periods during which the services will be provided, and Napoleon's responsibilities. Pedro is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement.

Response B is not the best response because Pedro is not required to provide one document called a "financial plan" to be required to provide Financial Planning. Pedro provides Financial Advice to Napoleon in modules, with the breadth of the Financial Advice expanding over time. The scope of the Financial Advice is such that Pedro is required to integrate relevant elements of Napoleon's personal and/or financial circumstances in order to act in Napoleon's best interests. Therefore, Pedro is providing Financial Advice that requires Financial Planning.

Responses C and D are not the best responses because they offer reasons that do not determine whether Pedro must provide Financial Planning. Instead, that determination depends on whether Pedro's Financial Advice requires integration of relevant elements of Napoleon's personal and/or financial circumstances. A CFP® professional who does not explicitly state that he or she is providing Financial Planning still may be required to provide Financial Planning and comply with the duties that apply when Financial Planning is required.

Relevant Standards and Definitions: Application of Practice Standards (Standard B.3.); Integration Factors (Standard B.4.); Duty to Provide Information to a Client (Standard A.10.).

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 4. INTEGRATION FACTORS:

2: WHEN FINANCIAL ADVICE DOES NOT REQUIRE FINANCIAL PLANNING

Juan, a CFP® professional, receives a call from prospective clients Cristabella and Miguel. They are expecting their first child and want to begin to save for the child's education. Juan sends Cristabella and Miguel a questionnaire, which they complete and return to Juan, requesting personal information such as their names, ages, net worth, income, and risk profile. Juan schedules a meeting to better understand their personal and financial circumstances. After the meeting, Juan uses his education funding calculator to prepare an education funding analysis applying a balanced risk tolerance that is consistent with Cristabella and Miguel's answers on the questionnaire. Juan agrees to examine in-state and out-of-state college costs and determine the monthly amount they would need to save to fund the education goal for either an in-state or out-of-state educational institution.

QUESTION 1:

Is Juan required to provide Financial Planning to Cristabella and Miguel?

RESPONSE OPTIONS:

A. Yes, Juan is required to provide Financial Planning to Cristabella and Miguel.

B. No, Juan is not required to provide Financial Planning to Cristabella and Miguel.

Best Response: Response B is the best response. This question involves the Application of the Practice Standards for the Seven-Step Financial Planning Process (Standard B.3.) ("Practice Standards"), the Integration Factors (Standard B.4.), and the Duty to Provide Information to a Client (Standard A.10.).

A CFP® professional must comply with the Practice Standards, and therefore, provide Financial Planning, when:

a. The CFP® professional agrees to provide or provides:
   i. Financial Planning; or
   ii. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or
b. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

In this circumstance, there is no explicit agreement for Juan to provide Financial Planning to Cristabella and Miguel. In addition, Cristabella and Miguel do not have a reasonable basis to believe Juan will provide or has provided Financial Planning. Therefore, the issue is whether Juan's Financial Advice requires integration of relevant elements of Cristabella and Miguel's personal and/or financial circumstances in order to act in Cristabella and Miguel's best interests, such that Juan is required to provide Financial Planning to Cristabella and Miguel. CFP Board has established the following "Integration Factors" that CFP Board will weigh in making that determination:

a. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;
b. The portion and amount of the Client's Financial Assets that the Financial Advice may affect;
c. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;
d. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and
e. The barriers to modifying the actions taken to implement the Financial Advice.

In this circumstance, Cristabella and Miguel have requested education planning. CFP Board would weigh the Integration Factors as follows:

- Juan's Financial Advice will not affect many relevant elements of Cristabella's and Miguel's personal and financial circumstances. Cristabella and Miguel have not asked Juan to help them manage assets and liabilities, identify and manage risks, preserve or increase wealth, prepare for retirement, or address other long-term goals. Moreover, the Financial Advice that Juan provided was limited. Juan was able to provide Financial Advice using an education funding calculator that enabled him to determine the amount of money Cristabella and Miguel would need to save each month to fund their education goal. This factor weighs against a finding that Financial Planning is required.
- The portion and amount of Cristabella and Miguel's Financial Assets that may be affected by Juan's Financial Advice is limited, given that Juan only would be providing Finance Advice on a saving strategy for the account (such as a 529 savings plan) that they will use to meet their education goal. Therefore, this factor also weighs against a finding that Financial Planning is required.
- Cristabella's and Miguel's personal and financial circumstances may be affected for a lengthy period of time, given that the education goal will span a 22-year time frame (i.e., 18 years of saving prior to college plus 4 years of spending during college). This weighs in favor of a finding that Financial Planning is required.
- The effect on Cristabella and Miguel's overall exposure to risk should be limited since they will be adding money on a monthly basis in a balanced portfolio. This factor weighs against a finding that Financial Planning is required.
- The barriers to modifying the actions taken to implement Financial Advice to fund a 529 plan weigh in favor of a finding that Financial Planning is required because there are barriers to taking funds out of a 529 savings plan. If Cristabella and Miguel need to access the money in the 529 savings plan for something other than for qualified education expenses, then they may have to pay taxes and a penalty.

Based upon a weighing of the Integration Factors, Juan is not providing Cristabella and Miguel with Financial Advice that requires Financial Planning. Therefore, Juan is not responsible for providing Financial Planning, complying with the Practice Standards, or providing the additional information that the Duty to Provide Information to a Client requires a CFP® professional to provide to a Client when providing or required to provide Financial Planning. Nevertheless, Juan is required to comply with the Fiduciary Duty that applies when providing Financial Advice to a Client as well as the Duties that apply at all times, such as the Duties of Integrity, Competence, and Diligence.

QUESTION 2:

Would Juan be required to provide Financial Planning to Cristabella and Miguel if they requested Financial Advice with respect to both education and retirement savings?

RESPONSE OPTIONS:

A. Yes, Juan may be required to provide Financial Planning to Cristabella and Miguel.

B. No, Juan will not be required to provide Financial Planning to Cristabella and Miguel.

Best Response: Response A is the best response. This question involves the same standards that applied to Question 1.

In this circumstance, Juan may be required to provide Financial Planning if Cristabella and Miguel request additional Financial Advice beyond the education analysis that they already requested.

CFP Board would weigh the Integration Factors in this case as follows:

- Juan is addressing several additional relevant elements of Miguel and Cristabella's personal and financial circumstances, including their need for or desire to manage cash flow in order to provide for retirement needs, insurance needs, and educational needs, which weighs in favor of a finding that Financial Planning is required.
- The Financial Advice will affect most, if not all, of Miguel's and Cristabella's Financial Assets, which also weighs in favor of a finding that Financial Planning is required.
- Since Juan will be providing Cristabella and Miguel with retirement projections for their life expectancy, an insurance need analysis to life expectancy, and a 22-year education analysis, the Financial Advice may affect Cristabella's and Miguel's personal and financial circumstances for a long time. This weighs in favor of a finding that Financial Planning is required.

- Cristabella's and Miguel's overall exposure to risk may increase because Juan will be reviewing all of their Financial Assets, including their 401k plans and insurance policies, and may recommend changes to their retirement contributions, asset allocation, and insurance coverage. This also weighs in favor of a finding that Financial Planning is required.
- The barriers to modifying the actions taken to implement the Financial Advice also may increase. Juan may recommend changes to life insurance coverage that may be difficult to modify if Cristabella and Miguel's health changes or as they age. In addition, Juan may provide Financial Advice regarding a Roth IRA conversion, the purchase of a deferred annuity, and maximizing 401k plan contributions. Each of these actions may be difficult to modify in the future, and thus would weigh in favor of a finding that Financial Planning is required.

Based upon a weighing of the Integration Factors, Juan would be providing Miguel and Cristabella with Financial Advice that requires Financial Planning. Most significantly, Juan's Financial Advice likely will: (a) affect several relevant elements of Cristabella's and Miguel's personal and financial circumstances; (b) affect Cristabella's and Miguel's personal and financial circumstances for a long time; and (c) be difficult to modify, if implemented. Therefore, Juan would be required to provide Financial Planning to Cristabella and Miguel.

Because Juan is required to provide Financial Planning, Juan has additional duties to Cristabella and Miguel. Juan is required to comply with the Practice Standards. In addition, under the Duty to Provide Information to a Client, most of the information that Juan may have provided to Miguel and Cristabella orally (or in writing) when providing Financial Advice now must be delivered to them in writing, in one or more written documents. This includes the following information, which must be provided prior to or at the time of Engagement:

- A description of the services and products to be provided;
- How the Client pays for the products and services, and a description of the additional types of costs that the Client may incur;
- How the CFP® professional, the CFP® Professional's Firm's, and any Related Party are compensated for providing the products and services;
- The existence of any public discipline and bankruptcy, and the locations of the webpages of certain public websites that sets for the CFP® professionals' public disciplinary history or any personal or business bankruptcy when the CFP® professional was a Control Person;
- Full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship, including sufficiently specific facts so that a reasonable Client would be able to understand the CFP professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such conflicts or reject them;
- A written notice at the time of the Engagement identifying policies regarding the protection, handling, and sharing of a client's non-public personal information that were adopted and implemented by the CFP® professional's Firm, and thereafter not less than annually except under certain enumerated circumstances.
- Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for engaging or recommending the selection or retention of additional persons to provide financial or Professional Services for a Client; and
- Any other information about the CFP® professional or the CFP® Professionals' Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm.

Juan also must provide to Cristabella and Miguel the terms of the Engagement, including the Scope of Engagement and any limitations, the periods during which the services will be provided, and Cristabella and Miguel's responsibilities. Juan is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement.

QUESTION 3:

If Juan determines that it is in Cristabella and Miguel's best interests to deliver Financial Planning to Cristabella and Miguel, but Cristabella and Miguel confirm that they do not want Financial Planning, is Juan still required to comply with the Practice Standards?

RESPONSE OPTIONS:

A. **Yes, Juan is required to comply with the Practice Standards if Cristabella and Miguel do not want Financial Planning.**

B. **No, Juan is not required to comply with the Practice Standards if Cristabella and Miguel do not want Financial Planning.**

Best Response: Response B is the best response. This question involves the standard "No Client Agreement to Engage for Financial Planning" (Standard B.6.).

If a CFP® professional otherwise must comply with the Practice Standards, but the Client does not agree to engage the CFP® professional to provide Financial Planning, then the CFP® professional must either:

a. Not enter into the Engagement;

b. Limit the Scope of Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing;

c. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or

d. Terminate the Engagement.

In this circumstance, Juan is not required to comply with the Practice Standards. Although Juan believes it is in Cristabella's and Miguel's best interests to engage in Financial Planning, Cristabella and Miguel decide they only want Financial Advice on education funding and retirement savings. Therefore, Juan and the Clients agree that Juan will provide them only educational and retirement planning, after Juan informs Cristabella and Miguel how Financial Planning would benefit them and how the decision to not engage him to provide Financial Planning may limit his Financial Advice.

Consequently, because Juan is not providing Financial Planning to Cristabella and Miguel, Juan is not required to comply with the Practice Standards. Juan also is not required to comply with the additional requirements set forth in the Duty to Provide Information to a Client that apply when a CFP® professional is providing or required to provide Financial Planning in accordance with the Practice Standards, nor is he required to provide the terms of their Engagement in writing. Nevertheless, Juan is required to comply with the Fiduciary Duty that applies when providing Financial Advice to a Client as well as the Duties that apply at all times, such as the Duties of Integrity, Competence, and Diligence.

Relevant Standards and Definitions: Application of Practice Standards (Standard B.3.); Integration Factors (Standard B.4.); No Client Agreement to Engage for Financial Planning (Standard B.6.); Duty to Provide Information to a Client (Standard A.10.).

3. WHEN CASH FLOW PLANNING DOES (AND DOES NOT) REQUIRE FINANCIAL PLANNING

Cindy, a CFP® professional, manages three portfolios for Greg and Marcia, her long-time clients. Greg and Marcia describe to Cindy the cash flow that they anticipate needing from these portfolios over the next 24 months to fund other planned investments. They ask Cindy to develop a cash flow plan that illustrates the income projections from each portfolio, the account from which they should withdraw cash to meet their cash flow needs, and how they should allocate the investments in each portfolio in view of the anticipated timing of the withdrawals from each account. Cindy provides Greg and Marcia no other Financial Advice. Greg and Marcia have additional investment accounts, including a retirement account, that Cindy does not manage. While the amounts in the portfolios Cindy manages are significant, the other accounts hold the majority of Greg and Marcia's Financial Assets. Greg and Marcia direct Cindy not to include these other accounts in her illustration.

QUESTION:

Is Cindy providing Financial Advice that Requires Financial Planning?

RESPONSE OPTIONS:

A. **Yes, because Cindy's Financial Advice requires integration of relevant elements of Greg and Marcia's personal and financial circumstances in order to act in the Client's best interests.**

B. **No, because Cindy's Finance Advice is limited to managing three portfolios and providing cash flow planning on the portfolios that she manages.**

C. **No, because the engagement does not specifically provide for Financial Planning.**

D. **Yes, because Financial Advice on investment cash flow planning is difficult to modify should Greg and Marcia change their minds about their cash flow needs.**

Best Response: B is the best response. Cindy is providing Financial Advice that does not require Financial Planning. This case study involves the Integration Factors (Standard B.4).

Peter, a CFP® professional, provides Financial Advice to Jan and Bobby, his long-time clients, on all their investment accounts, including their retirement plan. Peter meets with Jan and Bobby to discuss their retirement goals and engage in retirement planning. Peter develops a cash flow plan for Jan and Bobby's retirement that identifies their retirement dates and includes estimates for income and expenses, social security payments, required minimum distributions from their retirement plans, and pension payments. The cash flow plan illustrates the income projections from each account in their portfolio, the account from which they should withdraw cash to meet their cash flow needs, and how they should allocate the investments in each portfolio in view of the anticipated timing of withdrawals from each account. The plan illustrates how their income may support their monthly retirement expenses until they both reach age 95. Peter never specifically states that he is providing Financial Planning to Jan and Bobby.

QUESTION:

Is Peter providing Financial Advice that Requires Financial Planning?

RESPONSE OPTIONS:

A. **Yes, because Peter's Financial Advice requires integration of relevant elements of Jan and Bobby's personal and financial circumstances in order to act in the Client's best interests.**

B. **No, because Peter's Financial Advice is limited to investment advice and cash flow planning.**

C. **No, because the engagement does not specifically provide for Financial Planning.**

D. **Yes, because Jan and Bobby have a reasonable basis to believe that Peter will be performing Financial Planning.**

Best Response: A is the best response. Peter is providing Financial Advice that does requires Financial Planning. This case study involves the Integration Factors (Standard B.4).

A CFP® professional must comply with the Practice Standards when:

1. The CFP® professional agrees to provide or provides:
   a. Financial Planning; or
   b. Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or
2. The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

Here neither firm has an explicit agreement to provide Financial Planning to clients. The CFP® professional does not discuss Financial Planning with the clients and the clients have no reasonable basis to believe that the CFP® professional will be providing Financial Planning. Therefore, the issue is whether the CFP® professional's Financial Advice requires integration of relevant elements of the clients personal and/or financial circumstances in order to act in their best interests, such that the CFP® professional is required to provide Financial Planning to the clients. CFP Board has established the following Integration Factors that CFP Board will weigh in making that determination:

- The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;
- The portion and amount of the Client's Financial Assets that the Financial Advice may affect;
- The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;
- The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and
- The barriers to modifying the actions taken to implement the Financial Advice.

CFP Board would weigh the Integration Factors in this case as follows:

• In managing the three portfolios and preparing a cash flow analysis, Cindy is addressing a component of Greg and Marcia's need for or desire to manage cash flow, achieve financial security, and preserve or increase wealth. Therefore, Cindy's Financial Advice will affect some relevant elements of Greg and Marcia's personal and financial circumstances. However, Cindy is not addressing Greg and Marcia's need or desire to develop goals, manage other significant assets (including their retirement accounts, which have been specifically excluded from the Scope of Engagement), manage other aspects of their cash flow (including their other assets, income, and expenses), manage liabilities, identify or manage risks other than those related to the management of the three portfolios, identify or manage the financial effect of health considerations, provide for educational needs, prepare for retirement, identify tax considerations, pursue philanthropic interests, or address estate and legacy matters. Therefore, this factor does not weigh in favor of a finding that Financial Planning is required.	• Peter is managing all of Jan and Bobby's investment accounts (including their retirement accounts), preparing a long-term cash flow analysis, and preparing Jan and Bobby for retirement. Peter's Financial Advice is addressing several relevant elements of Jan and Bobby's personal and financial circumstances, including Jan and Bobby's need for or desire to develop retirement goals, manage cash flow in order to provide for their retirement needs, achieve financial security, preserve or increase wealth, and prepare for retirement. Therefore, this factor weighs in favor of a finding that financial planning is required.
• Cindy is providing Finance Advice to Greg and Marcia on three portfolios, but not on their other investment accounts, including their retirement accounts, which hold the majority of Greg and Marcia's Financial Assets. While the amount of assets that Cindy manages are significant, warranting cash flow planning and the services of a separate financial services professional, Greg and Marcia hold most of their assets in other accounts. Therefore, the portion and amount of Greg and Marcia's Financial Assets does not weigh in favor of a finding that Financial Planning is required.	• Peter's Financial Advice will address most of Jan's and Bobby's Financial Assets, including all of their investment accounts and estimates for their social security and pension income. Therefore, this factor weighs in favor of a finding that Financial Planning is required.
• Greg and Marcia have asked Cindy to prepare cash flow plans for the next 24 months and to manage three accounts that contain assets that may be traded quickly at a relatively low cost. Therefore, Cindy's Financial Advice likely will not affect Greg and Marcia's personal and financial circumstances for a long time, which weighs in favor of a finding that Financial Planning is not required.	• Peter is providing Jan and Bobby with a long-term cash flow analysis that identifies their retirement dates and projects income and expenses until the age of 95. These long-term planning scenarios will affect Jan's and Bobby's personal and financial circumstances for a long time. This factor weighs in favor of a finding that Financial Planning is required.

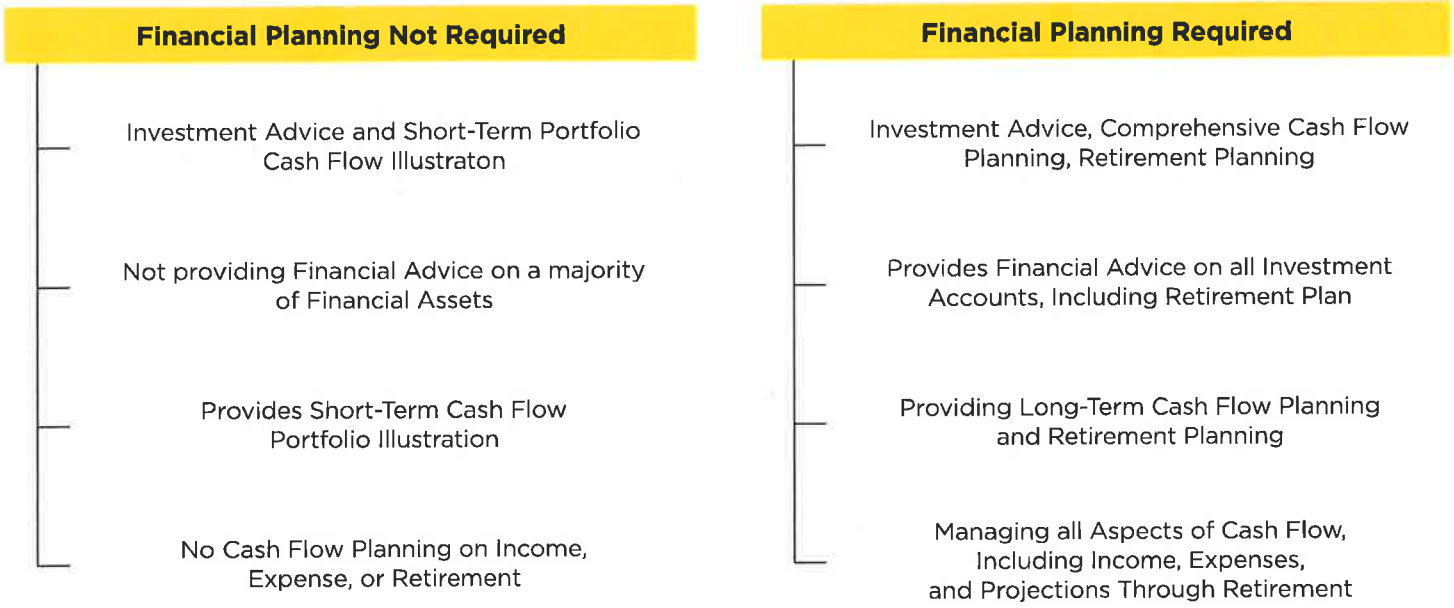
- The effect on Greg and Marcia's overall exposure to risk is low. While Cindy's management of the three portfolios involves risk, these accounts do not hold Greg and Marcia's retirement accounts or the majority of Greg and Marcia's Financial Assets. Moreover, Cindy's cash flow planning is designed to enable Greg and Marcia to make additional investments within the next two years. If the cash flow does not materialize as expected, Greg and Marcia may adjust their investment plans or utilize other assets for those investments. This weighs against a finding that Financial Planning is required.
- The barriers to modifying the actions taken to implement the Financial Advice do not weigh in favor of a finding that Financial Planning is required because Cindy's investment allocations and cash flow plan may be modified quickly and at a low cost if the circumstances warrant such a change.

Based on the weighing of the Integration Factors, Cindy is not providing Financial Advice that requires Financial Planning. Therefore, Cindy is not responsible for providing Financial Planning, complying with the Practice Standards, providing the information in one or more written documents, or the additional information that the Duty to Provide Information to a Client requires when providing or required to provide Financial Planning. Nevertheless, Cindy is required to comply with the Fiduciary Duty that applies when providing Financial Advice to a Client as well as other Duties that apply at all times, such as the Duties of Integrity, Competence, and Diligence.

- The Financial Advice identifies when Jan and Bobby may be able to retire and meet their retirement goals and allocates investments in their accounts to support those retirement goals. While their overall exposure to risk would increase significantly if Jan and Bobby were to retire in accordance with this plan, or if Peter's allocations were inconsistent with Jan and Bobby's risk profile, neither of those risk factors are present. Therefore, this factor does not weigh for or against a finding that Financial Planning is required.
- The retirement cash flow plan and investment allocations may be changed easily and without great cost if the circumstances warrant such a change. As a result, the barriers to modifying the actions taken to implement the Financial Advice is not a factor that weighs in favor of a finding that Financial Planning is required.

Based on the weighing of the Integration Factors, Peter is providing Jan and Bobby with Financial Advice that requires Financial Planning. Most significantly, Peter's Financial Advice (a) affects most of Jan and Bobby's Financial Assets, including all their retirement accounts, (b) affects several relevant elements of Jan and Bobby's personal and financial circumstances, and (c) will affect Jan's and Bobby's personal and financial circumstances for a long time.

Based upon the facts as set forth above, in one circumstance the cash flow planning requires financial planning, and in the other circumstance the cash flow planning does not require financial planning. Some facts that are present in the circumstance where financial planning is required, but not the other circumstance, are that the CFP® professional (a) is providing Financial Advice to the Clients on all of their investment accounts, including their retirement plan, (b) is providing retirement planning, and (c) is managing all aspects of their cash flow, including income, expenses, and long-term projections through retirement. The combination of these additional facts is what necessitates the different conclusion.



A is not the best response because a weighing of the integration factors reveals that Cindy's Financial Advice does not require integration of relevant elements of Greg and Marcia's personal and financial circumstances in order to act in the Clients' best interests.

C is not the best response because it offers a reason that does not determine whether Cindy must provide Financial Planning. Where there is no explicit agreement regarding Financial Planning, the Practice Standards for the Financial Planning Process apply if the Client has a reasonable basis to believe the CFP® professional will provide Financial Planning or if the CFP® professional provides or agrees to provide Financial Advice that Requires Financial Planning.

D is not the best response because it presents only one of the five integration factors that CFP Board will weigh in determining whether Financial Advice requires Financial Planning.

Responses B and C are not the best responses because they offer reasons that do not determine whether Peter must provide Financial Planning. Instead, that determination depends on whether Peter's Financial Advice requires integration of relevant elements of Jan and Bobby's personal and/or financial circumstances in order to act in the Clients' best interests. A CFP® professional who does not explicitly state that he or she is providing Financial Planning still may be required to provide Financial Planning and comply with the duties that apply when Financial Planning is required.

Response D is not the best response because Jan and Bobby have no reasonable basis to believe that Financial Planning will be provided. For example, Peter's Engagement does not specify that Peter will be providing Financial Planning, Peter has not marketed Financial Planning to Jan and Bobby, and Jan and Bobby have not told Peter that they want Financial Planning.

Where, as with respect to Peter, Bobby and Jan, a CFP® professional provides or agrees to provide Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests, then the CFP® professional has additional duties to the Client, unless the Client does not agree to engage the CFP® professional to provide Financial Planning. If the Client does not agree to engage the CFP® professional to provide Financial Planning, then the CFP® professional must either:

a. Not enter into the Engagement;

b. Limit the Scope of Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing;

c. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or

d. Terminate the Engagement.

In this case, Jan and Bobby have asked Peter for long-term Financial Advice concerning their retirement. There is no indication that Jan and Bobby do not want to engage Peter to provide Financial Planning. Therefore, Peter is required to provide Financial Planning to Jan and Bobby.

For this reason, Peter has additional duties to Jan and Bobby. Peter is required to provide Financial Planning and to comply with the Practice Standards. In addition, under the Duty to Provide Information to a Client, most of the information that Peter may have provided to Jan and Bobby orally (or in writing) when providing Financial Advice now must be delivered to Jan and Bobby in writing, in one or more written documents. This includes the following information, which must be provided prior to or at the time of Engagement:

- A description of the services and products to be provided;
- How the Client pays for the products and services, and a description of the additional types of costs that the Client may incur;
- How the CFP® professional, the CFP® Professional's Firm's, and any Related Party are compensated for providing the products and services;
- The existence of any public discipline and bankruptcy, and the locations of the webpages of certain public websites that sets forth the CFP® professionals' public disciplinary history or any personal or business bankruptcy when the CFP® professional was a Control Person;
- Full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship, including sufficiently specific facts so that a reasonable Client would be able to understand the CFP professional's Material Conflicts of Interest and the business practices that give rise to the conflicts, and give informed consent to such conflicts or reject them (this information may be provided orally);

- A written notice at the time of the Engagement identifying policies regarding the protection, handling, and sharing of a client's non-public personal information that were adopted and implemented by the CFP® professional's Firm, and thereafter not less than annually except under certain enumerated circumstances.
- Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for engaging or recommending the selection or retention of additional persons to provide financial or Professional Services for a Client; and
- Any other information about the CFP® professional or the CFP® Professionals' Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm.

Peter also must provide to Jan and Bobby the terms of the Engagement, including the Scope of Engagement and any limitations, the periods during which the services will be provided, and Jan and Bobby's responsibilities. Peter is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement.

Relevant Standards and Definitions: Application of Practice Standards (Standard B.3); Integration Factors (Standard B.4); Duty to Provide Information to a Client (Standard A.10).

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 6. NO CLIENT AGREEMENT TO ENGAGE FOR FINANCIAL PLANNING:

1: DUTIES WHEN A CLIENT DOES NOT AGREE TO ENGAGE FOR FINANCIAL PLANNING

Susan is dissatisfied with her investment manager's performance and costs and wants to work with a CFP® professional. She is referred to Blaine. After meeting with Susan and reviewing the information she provided, Blaine determines that Susan needs investment management and retirement planning. Financial Advice in these areas would affect almost all of Susan's Financial Assets. To provide Susan with investment management and retirement planning, Blaine also determines that he would need to perform cash flow and budgeting, estate planning, and insurance planning to act in Susan's best interests. Under those circumstances, Blaine would be agreeing to provide Financial Advice that Requires Financial Planning, and thus would be required to comply with the Practice Standards for the Financial Planning Process. However, Susan tells Blaine that she does not want to engage Blaine to provide Financial Planning. Blaine determines that if he were to limit the Scope of the Engagement to investment management, he would not be required to provide Financial Planning.

QUESTION:

Which is the best course of action?

RESPONSE OPTIONS:

A. **Blaine must do what Susan wants and provide investment management and retirement planning.**

B. **Blaine may Limit the Scope of the Engagement to investment management and inform Susan that he will not be performing retirement planning.**

C. **Blaine may provide investment management and retirement planning after making Susan sign a waiver indicating that Susan does not want Financial Planning.**

D. **Blaine must comply with the Practice Standards and provide Susan with Financial Planning.**

Best Response: B is the best response. This case involves the Application of the Practice Standards (Standard B.) and No Client Agreement to Engage in Financial Planning (Standard B.6).

The Practice Standards set forth the Financial Planning Process. A CFP® professional must comply with the Practice Standards (1) when the CFP® professional agrees to provide or provides (a) Financial Planning, or (b) Financial Advice that requires integration of relevant elements of the Client's personal and/ or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"), or (2) the Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

The *Code and Standards* recognizes that a Client has the right to choose which services to receive from a CFP® professional. If a Client does not agree to engage the CFP® professional to provide Financial Planning, a CFP® professional must either: (1) Not enter into the Engagement; (2) Limit the Scope of the Engagement to services that do not require application of the Practice Standards, and describe to the Client the services the Client requests that the CFP® professional will not be performing; (3) Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the Practice Standards; or (4) Terminate the Engagement (if applicable).

In this case Blaine has determined that Susan had requested Financial Advice that Requires Financial Planning, but Susan does not want to engage Blaine for Financial Planning. Therefore, there are four options available to Blaine. One of those options is to limit the Scope of the Engagement to services that do not require application of the Practice Standards and describe to the Client the services the Client requests that the CFP® professional will not be performing. Therefore, Blaine may Limit the Scope of the Engagement to investment management and inform Susan that he will not be performing retirement planning.

A and C are not the best responses because they do not describe Blaine's duty in this circumstance. While Blaine may provide the requested services without complying with the Practice Standards, he may do so only after informing Susan how Financial Planning would benefit Susan and how Susan's decision not to engage Blaine to provide Financial Planning may limit Blaine's Financial Advice. C also is not the best response because Blaine is not required to obtain a signed waiver from Susan.

D is not the best response because Blaine is not required to provide services for which Susan does not want to engage Blaine.

Relevant Standard: Standard B.6 (No Client Agreement to Engage in Financial Planning)

C. PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS, 2. IDENTIFYING AND SELECTING GOALS:

1: INTERPRETING THE PRACTICE STANDARD FOR IDENTIFYING AND SELECTING GOALS

Tania (age 43) and Bonnie (age 45) engage with Scott, a CFP® professional, for Financial Planning. In accordance with step 1 of the Practice Standards for the Financial Planning Process, Scott obtains and analyzes the qualitative and quantitative information necessary to fulfill the Scope of the Engagement and assess Tania and Bonnie's personal and financial circumstances. Tania and Bonnie rent an apartment, have modest savings in low-yielding savings accounts ($50,000) and retirement assets ($100,000), are cash flow positive with moderate expenses, and are carrying high interest credit card debt ($15,000). For the last 11 years, Tania and Bonnie have invested for retirement in conservative Financial Assets, with most of their retirement assets allocated to fixed income and cash equivalent investments. They sold their more growth-oriented portfolio at market lows.

Tania and Bonnie indicate their two primary goals are (1) to save the funds that they will need in approximately 5 years to make a 20% down payment ($70,000) on the purchase of a $350,000 small beach condo on the South Carolina coast that they will use for vacations while working and then in retirement, and (2) to retire at age 65 with a net retirement income of $75,000 in today's dollars.

QUESTION:

What actions must Scott take to address Tania and Bonnie's goals, in accordance with step 2 of the Practice Standards for the Financial Planning Process?

RESPONSE OPTIONS:

A. **Scott must assist Tania and Bonnie in planning to accomplishing their stated goals, without considering how they may impact other potential goals.**

B. **Scott must help Tania and Bonnie identify their goals, and the impact that a particular goal may have on other goals. Scott also must help Tania and Bonnie select and prioritize goals.**

C. **Scott must provide Tania and Bonnie with Financial Advice concerning the goals to include in their financial plan without regard to their expressed goals.**

Best Response: Response B is the best response. This case involves the Practice Standards for the Financial Planning Process, Identifying and Selecting Goals (Standard C.2.).

The second step of the Financial Planning Process involves identifying and selecting goals. A CFP® professional must discuss with the Client the CFP® professional's assessment of the Client's financial and personal circumstances, and help the Client identify goals, noting the effect that selecting a particular goal may have on other goals. In helping the Client identify goals, the CFP® professional must discuss with the Client, and apply, reasonable assumptions and estimates. These may include life expectancy, inflation rates, tax rates, investment returns, and other Material assumptions and estimates. A CFP® professional also must help the Client select and prioritize goals. The CFP® professional must discuss with the Client any goals the Client has selected that the CFP® professional believes are not realistic.

Here Scott must discuss with Tania and Bonnie his assessment of their financial and personal circumstances, including their high interest credit card debt, current investment allocation, and stated goals. Scott also must discuss with Tania and Bonnie the assumptions and estimates that he is making, such as their life expectancy, current and future tax and inflation rates, and anticipated investment returns and expenses. Scott must use this information to help Tania and Bonnie identify other potential goals, including how each goal may affect the other goals. Here, for example, if Tania and Bonnie prioritize the goal of saving for a vacation home down payment and making ongoing mortgage payments and maintenance costs, then that goal may affect the funds that will be available for retirement at age 65, and such other potential goals that they may identify.

Response A is not the best response because the goals that a Client identifies when a CFP® professional is assessing the Client's financial and personal circumstances during the first step of the Financial Planning process may be different from the goals that the Client selects during the second step of Financial Planning process. A CFP® professional must help the Client identify potential goals and then select and prioritize the Financial Planning goals, taking into account the effect that selecting a particular goal may have on other goals. This may require the CFP® professional to discuss goals that the Client has selected that the CFP® professional believes are not realistic.

Response C is not the best response because the goals that a Client identifies when a CFP® professional is assessing the Client's financial and personal circumstances during the first step of the Financial Planning process are a component of the qualitative information that a CFP® professional must consider in helping the Client select and prioritize goals during the second step of Financial Planning process.

Relevant Standards and Definitions: Practice Standards for the Financial Planning Process, Identifying and Selecting Goals (Standard C.2.).

1. INTERPRETING THE PRACTICE STANDARD FOR ANALYZING THE CLIENT'S CURRENT COURSE OF ACTION

Joe, a CFP® professional, meets with Martha and Dan Miller, who are 32 years old and have a newborn daughter. Joe learns the following about the Millers:

Age, Income, Dependents

- Martha and Dan have annual salaries of $120,000 and $110,000, respectively.

Savings, Assets, Liabilities, Education and Retirement Accounts

- The Millers contribute $12,600 annually to a savings account that has a balance of $70,000, which includes $30,000 for emergencies, $30,000 targeted for the purchase of a lake cabin, and $10,000 earmarked for college savings.
- They have a taxable investment account with a $10,000 value.
- The allocation in their accounts is 50% equities and 50% fixed income.

Expenses, Cash Flow, Liquidity

- Marth and Dan have $34,500 in unallocated cash flow each year.

Insurance, Employee Benefits

- Martha and Dan contribute 10% of their salaries (with a 6% employer match) to their 401(k) plan accounts, which collectively have a value of $150,000.
- They have employer-provided life insurance coverage that is equal to two times their salaries.

Estate Plans

- Marth and Dan's home value is $300,000 with $60,000 of equity.
- They have not created any estate planning documents.

Miller's Current Annual Personal Balance Sheet and Cash Flow Report

Assets		Liabilities	
Taxable Investment Account	$10,000	Mortgage Debt	$240,000
Current Market Home Value	$300,000		
Low-Yield Savings Account	$70,000		
401(k) - Martha	$80,000		
401(k) - Dan	$70,000		
Net Worth			
Total Assets	$530,000	Total Liabilities	$240,000
Net Worth	$290,000		

Income		Expenses	
Martha's Income	$120,000	Fixed Expenses	
Dan's Income	$110,000	Income Taxes	$48,000
		Mortgage	$15,000
		Health and Other Insurances	$15,000
		Utilities and Household Maintenance	$11,900
		Food and Clothing	$10,000
		Transportation	$10,000
		Fixed Expenses	
		Vacations and Travel	$15,000
		Recreation and Entertainment	$20,000
		Gifts and Charitable Constributions	$15,000
		Low-Yield Savings Account Contributions	$12,600
		401(k) Contributions	$23,000
Cash Flow			
Total Income	$230,000	Total Expenses	$195,500
Unallocated Cash Flow	$34,500		

Joe helps Martha and Dan identify and select five goals:

1. Accumulate adequate retirement assets to retire at age 67 and live a comfortable life during retirement.
2. Acquire a cabin at the lake within approximately six years.
3. Have adequate insurance coverage.
4. Create an estate plan.
5. Accumulate assets to cover their daughter's elite private university costs.

QUESTION:

In analyzing the current course of action under Step 3 of the Financial Planning Process, what else must Joe do?

RESPONSE OPTIONS:

A. **Determine whether the interest rate on Martha and Dan's mortgage is higher than the existing market rate, and if so, recommend that they refinance their mortgage.**

B. **Evaluate their investment allocations against their risk tolerance.**

C. **Develop recommendations based upon the selected goals.**

D. **Analyze their savings rate, liabilities, investment allocation, and retirement projections to determine whether the Millers are maximizing the potential to meet their goals.**

Best Response: Response D is the best response. This case study involves Step 3 of the Financial Planning Practice Standards (Standard C.3.)

Step 3 of the Financial Planning Practice Standards has two components: (1) analyzing the Client's current course of action and (2) analyzing potential alternative courses of action. In fulfilling the first component, a CFP® professional must analyze the Client's current course of action, including the material advantages and disadvantages of the current course and whether the current course maximizes the potential for meeting the Client's goals.

Response A-B are not the best response because each present only one material advantage or disadvantage of their current course of action. There is additional analysis that Joe must perform to satisfy this step of the Financial Planning process. Response A also addresses a component of Step 4 of the Financial Planning process; namely, the development of a recommendation. A CFP® professional, however, does not develop recommendations until Step 4 of the Financial Planning process. Before developing recommendations, a CFP® professional must analyze potential alternative courses of action.

Response C is not the best response. As discussed in the analysis of Responses A and B, a CFP® professional does not develop recommendations until Step 4 of the Financial Planning process.

Response D is the best response because it presents a more comprehensive list of the additional analysis that Joe must perform than that which is presented in Responses A and B. In analyzing their savings rate, liabilities, investment allocation, and retirement projections, Joe would need to consider the material advantages and disadvantages to determine whether the Millers are maximizing the potential to meet their goals. After performing this analysis, Joe determines as follows:

Joe identifies advantages of their current course of action. The Millers:

☐ Have a cash reserve in the event of an emergency.	☐ Do not have significant liabilities and have no credit card debt.
☐ Are contributing approximately 15.5% of their gross income annually to a savings account and to their 401(k) plan accounts (does not include employer match).	☐ Have some insurance coverage (Martha's short- and long-term disability policies though her employer, Dan's short-term disability through his employer, and Martha and Dan's life insurance policies through their employers.
☐ Are building equity in their home.	☐ Have established an excellent credit rating.

Joe identifies disadvantages of their current course of action and potential opportunities. The Millers:

☐ Should be allocating their assets in alignment with their risk tolerance.	☐ Have an interest rate on their existing mortgage that is high compared to current market rates.
☐ Have mutual fund investments that have high costs and are not tax-efficient.	☐ Are using a low-interest savings account with taxable interest for college savings.
☐ Do not have adequate insurance coverage (Dan and Martha lack appropriate liability and life insurance coverage and Dan lacks long-term disability coverage).	☐ Have no estate planning documents and have outdated beneficiary designations on their retirement accounts and life insurance policies.
☐ Are not planning for the additional costs of owning a second home, such as property taxes, insurance, and maintenance costs.	

Joe's analysis of the Millers' current course shows a low likelihood of meeting all their targeted goals. Joe begins to analyze potential alternative courses of action, each of which helps maximize the potential for the Millers to meet their goals and integrates the relevant elements of the Millers' personal and financial circumstances.

Relevant Standards and Definitions: Practice Standards for the Financial Planning Process, Step 3: Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action (Standard C.3.)

1: INTERPRETING THE PRACTICE STANDARD FOR IMPLEMENTING THE FINANCIAL PLANNING RECOMMENDATION(S)

Rick, a CFP® professional, has presented his Financial Planning recommendations to his Clients Mike and Sofia. He previously informed the Clients of his Material Conflicts of Interest, explained how he will manage the conflicts, and obtained the Clients' informed consent. His Financial Planning recommendations include obtaining additional term life insurance and reallocating their retirement savings to investment products that are designed to maximize their potential to meet long-term goals. Rick explains to his Clients that he implements recommendations relating to investment products, for which he charges an ongoing management fee. For the implementation of other recommendations, Rick communicates with his Clients their responsibility and the responsibilities of any third-party.

QUESTION:

What should Rick do next to comply with the Practice Standards for the Financial Planning Process?

RESPONSE OPTIONS:

A. **Instruct his clients to complete an online account application to begin implementing the recommendations.**

B. **Provide his clients with the historical track record of his investment recommendations to establish that he is competent to recommend investment products.**

C. **Discuss with his clients the basis for selecting an action, product, or service, and the timing and priority of implementing the action, product, or service.**

D. **Recommend an insurance agent from a referral network that provides Rick with referral compensation.**

Best Response: Response C is the best response. This case involves the Practices Standards for the Financial Planning Process, Implementing the Financial Planning Recommendations (Standard C.6).

The Practice Standards provide, in step 6, that a CFP® professional must establish with the Client whether the CFP® professional has implementation responsibilities. When the CFP® professional has implementation responsibilities, the CFP® professional must communicate to the Client the recommendation(s) being implemented and the responsibilities of the CFP® professional, the Client, and any third-party with respect to implementation.

A CFP® professional who has implementation responsibilities must identify and analyze actions, products, and services, designed to implement the recommendations. The CFP® professional must consider the basis for each selection, which must include:

i. How the action, product, or service is designed to implement the CFP® professional's recommendation; and

ii. The advantages and disadvantages of the action, product, or service relative to reasonably available alternatives.

A CFP® professional who has implementation responsibilities must recommend one or more actions, products, and services to the Client. The CFP® professional must discuss with the Client the basis for selecting an action, product, or service, the timing and priority of implementing the action, product, or service, and disclose and manage any Material Conflicts of Interest concerning the action, product, or service.

A CFP® professional who has implementation responsibilities must help the Client select and implement the actions, products, or services. The CFP® professional must discuss with the Client any Client selection that deviates from the actions, products, and services the CFP® professional recommended.

In this case, Rick has already disclosed his Material Conflicts of Interest and how he will manage those conflicts. Therefore, the next step is for Rick to discuss with his Clients the basis for selecting an action, product, or service, and the timing and priority of implementing the action, product, or service.

Response A is not the best response because Rick must first discuss with his Clients the basis for selecting an action, product, or service, and the timing and priority of implementing the action, product, or service. After those discussions, Rick may instruct the Clients to compete an online account application to begin implementing the recommendations.

Response B is not the best response because the Practice Standards does not require providing to a Client the CFP® professional's track record for investment recommendations. In fact, in isolation only showing past performance may be misleading.

Response D is not the best response because Rick is not required to provide the Clients with an insurance agent recommendation. However, when providing a recommendation, Rick must have a reasonable basis for the recommendation based on the agent's reputation, experience, and qualifications. Rick must also disclose to the Clients any arrangement by which Rick would receive any additional compensation. Rick should also check his firm's policies and procedures which could require that Rick provide to the Clients the names of at least several qualified insurance agents.

Relevant Standards and Definitions: Implementing the Financial Planning Recommendations (Standard C.6.).

1: INTERPRETING THE PRACTICE STANDARD FOR MONITORING PROGRESS

Sally and George are 50 years old and have a goal of retiring in 16 years. They engaged Jim, a CFP® professional, to provide Financial Planning, including with respect to their intended retirement. After understanding their financial and personal circumstances, identifying and selecting goals, and analyzing their current course of action and potential alternative courses of action, Jim develops and then presents the Financial Planning recommendations. Jim determined that it would be in their best interests to reallocate their retirement investments with broader diversification to the equity markets. In addition, while Sally and George had accumulated significant savings for retirement, Jim determined that they needed to increase their annual savings contribution and optimize their asset allocation to maximize the potential of retiring in 16 years.

Jim communicates and fulfills his implementation responsibilities and establishes that he will have full monitoring progress and updating responsibilities. Jim also informs Sally and George of their responsibility to inform him of any Material changes to their information. Sally and George agree to pay Jim an annual fee.

QUESTION:

How often must Jim monitor Sally and George's progress?

RESPONSE OPTIONS:

A. **Sally and George are responsible for determining how frequently Jim must monitor progress towards their goal.**

B. **Jim must monitor Sally and George's progress towards their goal on at least an annual basis.**

C. **The Practice Standards for the Financial Planning Process indicate that a CFP® professional must analyze progress toward achieving a Client's goals at appropriate intervals.**

Best Response: Response C is the best response. This case involves the Monitoring Progress and Updating standard of the Practices Standards for the Financial Planning Process (Standard C.7.).

The Practice Standards provide that a CFP® professional must establish with the Client whether the CFP® professional has monitoring and updating responsibilities. When the CFP® professional has responsibilities for monitoring and updating, the CFP® professional must communicate to the Client:

i. Which actions, products, and services are and are not subject to the CFP® professional's monitoring responsibility;

ii. How and when the CFP® professional will monitor the actions, products, and services;

iii. The Client's responsibility to inform the CFP® professional of any Material changes to the Client's qualitative and quantitative information;

iv. The CFP® professional's responsibility to update the Financial Planning recommendations; and

v. How and when the CFP® professional will update the Financial Planning recommendations.

The Practice Standards further provide that a CFP® professional who has monitoring responsibilities must analyze, at appropriate intervals, the progress toward achieving the Client's goals. The CFP® professional must review with the Client the results of the CFP® professional's analysis. A CFP® professional who has monitoring responsibility also must collaborate with the Client in an attempt to obtain current qualitative and quantitative information concerning the Client's personal and financial circumstances. Where circumstances warrant changes to the Client's goals, recommendations, or selections of actions, products or services, the CFP® professional must update as appropriate in accordance with the Practice Standards. A CFP® professional also must comply with applicable federal and state laws, rules, and regulations that apply to monitoring services.

In this case Jim needs to determine what interval is appropriate for analyzing Sally and George's progress towards retirement. In making that determination, he might consider, among other factors, Sally and George's demonstrated ability to stick to the plan, the consequences to Sally and George of deviating from the plan, and the probability that Sally and George will achieve their goals, taking into account their investment portfolio, retirement date, life expectancy, and expenses. Jim may need to reevaluate the monitoring interval should the market experience significant volatility or if Sally and George experience other material qualitative or quantitative changes to their financial or personal circumstances.

Response A is not the best response because a CFP® professional must communicate to the Client how and when the CFP® professional will monitor progress toward the Client's goals.

Response B is not the best response because monitoring progress on an annual basis may not be an appropriate interval for some Clients.

Relevant Standards and Definitions: Monitoring Progress and Updating standard of the Practices Standards for the Financial Planning Process (Standard C.7.).

2: INTERPRETING THE PRACTICE STANDARD FOR UPDATING THE FINANCIAL PLANNING RECOMMENDATIONS

Kayla, a CFP® professional at a small registered investment adviser (RIA) firm, provides financial planning (including ongoing monitoring and updating services) to Isis, a new client, who has a moderate risk tolerance. On June 15 of Year 1, Kayla met with Isis. Isis wants to retire in twelve years and buy a new house. Kayla evaluates Isis's situation and explains that if she wants to retire in twelve years and buy a new home, then under her present standard of living she needs to increase her ongoing savings to make up for some bad investment choices in the past, invest in a more aggressive manner, or retire a few years later. Currently, the equity markets are performing exceptionally well, and Isis has become comfortable with investing in them again. Isis agrees with Kayla's recommendation of increasing her exposure to risk in her investment allocation.

On January 15 of Year 2, Isis tells Kayla that she wants to retire in only seven years, five years earlier than originally planned. Kayla views the equity markets and economy as being exceptionally strong and does not recommend making any changes until they meet at their regular meeting in August.

In February of Year 2, the equity markets experience a deep decline and Isis's portfolio suffers a significant loss.

QUESTION:

In accordance with the Practice Standards, what steps should Kayla have taken in monitoring and updating Isis's plan? Choose the most complete response.

RESPONSE OPTIONS:

A. **Kayla should have predicted that a steep decline in the equity markets was coming soon.**

B. **Kayla should have discussed with Isis in January whether the modification of her retirement goal warranted any updates to the Financial Planning recommendations.**

C. **Isis is responsible for telling Kayla to modify her portfolio to meet the change in retirement date.**

D. **Kayla is responsible for monthly monitoring per Standard C.7 of the *Code and Standards*.**

Best Response: Response B is the best response. This case involves the Practice Standards for the Financial Planning Process, Monitoring Progress and Updating (Standard C.7).

A CFP® professional must establish with the Client whether the CFP® professional has monitoring and updating responsibilities. When the CFP® professional has responsibilities for monitoring and updating, the CFP® professional must communicate to the Client:

i. Which actions, products, and services are and are not subject to the CFP® professional's monitoring responsibility;

ii. How and when the CFP® professional will monitor the actions, products, and services;

iii. The Client's responsibility to inform the CFP® professional of any Material changes to the Client's qualitative and quantitative information;

iv. The CFP® professional's responsibility to update the Financial Planning recommendations; and

v. How and when the CFP® professional will update the Financial Planning recommendations.

A CFP® professional who has monitoring responsibilities must analyze, at appropriate intervals, the progress toward achieving the Client's goals. The CFP® professional must review with the Client the results of the CFP® professional's analysis. A CFP® professional who has monitoring responsibility must also collaborate with the Client in an attempt to obtain current qualitative and quantitative information concerning the Client's personal and financial circumstances. Where a CFP® professional has updating responsibility, the CFP® professional must determine whether circumstances warrant changes to the Client's goals, recommendations, or selection of actions, or products or services. Information is Material when a reasonable Client or prospective Client would consider the information important in making a decision.

Isis informed Kayla of a Material change in her circumstances when she modified her retirement timeline. Therefore, when Isis notified Kayla of the accelerated retirement date, Kayla should have re-run her projections in Isis's financial plan and discussed with Isis any changes to the financial planning recommendations. For example, the accelerated retirement timeline will effect Isis's income needs in retirement, requiring a larger pool of assets to distribute from given the earlier termination of her employment income. Kayla should have reevaluated Isis's portfolio and evaluated the probability of success given the five additional years of retirement. This may have changed Kayla's financial planning recommendations. Kayla might have advised Isis to reduce expenses, increase pre-retirement savings, or possibly develop a phased retirement approach. Laruen may have needed to advise Isis that she is unable to retire early given her existing portfolio, income level, and risk profile.

Response A is not the best response because a CFP® professional would not be able to predict a steep decline in the market.

Response C is not the best response because Isis is not responsible for directing Kayla to update her portfolio.

Response D is not the best response because the Practice Standards do not require monthly monitoring. The Practice Standards require a CFP® professional who has monitoring responsibilities to analyze, at appropriate intervals, the progress toward achieving the Client's goals. The CFP® professional must review with the Client the results of the CFP® professional's analysis.

Relevant Standards and Definitions: Monitoring Progress and Updating (Standard C.7.) and Material (Glossary).

E. DUTIES OWED TO CFP BOARD, 3. REPORTING

1: INFORMATION THAT CFP BOARD REQUIRES (AND DOES NOT REQUIRE) A CFP® PROFESSIONAL TO REPORT TO CFP BOARD

Bob Stewart, a CFP® professional, is working late at night when he receives news that Shirley Taylor, a long-time client, filed a complaint (the "Customer Complaint") with his firm, alleging that Bob's recommendations were not in the client's best interest. Ms. Taylor alleges losses greater than $150,000. Bob leaves work and begins his long commute home. Along the way, Bob's car veers into another lane and collides with a police cruiser. Luckily, no one was hurt, but Bob receives a ticket for reckless driving (the "Traffic Ticket") and will have to attend a driver education course. Two months later, Ms. Taylor files a FINRA arbitration (the "FINRA Arbitration") against Bob's firm, but not Bob, that raises the same allegations as set forth in the Customer Complaint. Later that day, Bob's firm terminates his employment (the "Termination") because the firm determined that Bob sold products to another client that were not in the client's best interests. When Bob arrives home, he opens the mail and finds a notice that the IRS imposed a tax lien on his personal residence (the "Tax Lien") because of Bob's failure to pay federal taxes in the amount of $5,000.

QUESTION

Which of these events does the *Code of Ethics and Standards of Conduct* require Bob to report to CFP Board within 30 days?

RESPONSE OPTIONS:

A. **Customer Complaint**

B. **Traffic Ticket**

C. **FINRA Arbitration**

D. **Termination**

E. **Tax Lien**

Best Response: Responses A, C, D, and E are all correct responses. This case involves the Duties Owed to CFP Board and Reporting. (Standard E.3.).

As set forth in Standard E.3 of CFP Board's *Code and Standards*, a CFP® professional must provide written notice to CFP Board within thirty (30) calendar days after the CFP® professional, or an entity over which the CFP® professional was a Control Person, has:

a. Been charged with, convicted of, or admitted into a program that defers or withholds the entry of a judgment or conviction for, a Felony or Relevant Misdemeanor;

b. Been named as a subject of, or whose conduct is mentioned adversely in, a Regulatory Investigation or Regulatory Action alleging failure to comply with the laws, rules, or regulations governing Professional Services;

c. Had conduct mentioned adversely in a Finding in a Regulatory Action involving failure to comply with the laws, rules, or regulations governing Professional Services (except a Regulatory Action involving a Minor Rule Violation in a Regulatory Action brought by a self-regulatory organization);

d. Had conduct mentioned adversely in a Civil Action alleging failure to comply with the laws, rules, or regulations governing Professional Services;

e. Become aware of an adverse arbitration award or civil judgment, or a settlement agreement, in a Civil Action alleging failure to comply with the laws, rules, or regulations governing Professional Services, where the conduct of the CFP® professional, or an entity over which the CFP® professional was a Control Person, was mentioned adversely, other than a settlement for an amount less than $15,000;

f. Had conduct mentioned adversely in a Civil Action alleging fraud, theft, misrepresentation, or other dishonest conduct;

g. Been the subject of a Finding of fraud, theft, misrepresentation, or other dishonest conduct in a Regulatory Action or Civil Action;

h. Become aware of an adverse arbitration award or civil judgment, or a settlement agreement in a Civil Action alleging fraud, theft, misrepresentation, or other dishonest conduct, where the conduct of the CFP® professional, or an entity over which the CFP® professional was a Control Person, was mentioned adversely;

i. Had a professional license, certification, or membership suspended, revoked, or materially restricted because of a violation of rules or standards of conduct;

j. Been terminated for cause from employment or permitted to resign in lieu of termination when the cause of the termination or resignation involved allegations of dishonesty, unethical conduct, or compliance failures;

k. Been named as the subject of, or been identified as the broker/adviser of record in, any written, customer-initiated complaint that alleged the CFP® professional was involved in:

   i. Forgery, theft, misappropriation, or conversion of Financial Assets;

   ii. Sales practice violations and contained a claim for compensation of $5,000 or more; or

   iii. Sales practice violations and settled for an amount of $15,000 or more.

l. Filed for or been the subject of a personal bankruptcy or business bankruptcy where the CFP® professional was a Control Person;

m. Received notice of a federal tax lien on property owned by the CFP® professional; or

n. Failed to satisfy a non-federal tax lien, judgment lien, or civil judgment within one year of its date of entry, unless payment arrangements have been agreed upon by all parties.

A CFP® professional must provide written notice to CFP Board within thirty (30) calendar days of both the initiation and conclusion of the Reportable Matter and include a narrative statement that completely and accurately describes the material facts and the outcome or status of the Reportable Matter.

Response (A) is a correct response. Bob must report the Customer Complaint because the client alleged that Bob made recommendations that were not in the client's best interests. See Standard E.3(k).

Response (B) is not a correct response. The Traffic Ticket does not fall within any of the categories of information that Standard E.3. of the *Code and Standards* requires Bob to report to CFP Board. The Traffic Ticket is not a misdemeanor or felony. The Traffic Ticket also is not a civil judgment alleging failure to comply with the laws, rules, or regulations governing Professional Services.

Response (C) is a correct response. Although the FINRA Arbitration involves the same customer who filed the Customer Complaint that Bob reported to CFP Board, the FINRA arbitration is a separate Reportable Matter. While Bob is not a respondent in the FINRA Arbitration, Bob has a duty to report the FINRA arbitration because his alleged conduct, the recommendations that allegedly were not in the client's best interest, was adversely mentioned in the FINRA Arbitration statement of claim. See Standard (E.3(e).

Response (D) is a correct response. Bob must report the Termination because the firm terminated Bob for making recommendations that were not in the best interests of several clients. The cause of the Termination was allegations of unethical conduct and compliance failures. See Standard E.3(j).

Response (E) is a correct response. Bob must report the Tax Lien to CFP Board because it is a federal tax lien on property owned by Bob. See Standard E.3(m).

Relevant Standards and Definitions: Duties Owed to CFP Board - Reporting. (Standard E.3.)

CFP Board has developed resources to help CFP® professionals understand and comply with the new *Code and Standards*. Access compliance resources like the Roadmap to the *Code and Standards*, videos, FAQs, and other documents on CFP Board's website **(CFP.net/compliance)**.

CFP BOARD

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TAB F

CFP BOARD

FREQUENTLY ASKED QUESTIONS

CODE OF ETHICS AND STANDARDS OF CONDUCT

UPDATED JUNE 2023 WITH A NEW FAQ (PAGE 9)

INDEX TO FAQS

This index identifies the page location of answers to the Frequently Asked Questions (FAQs) for each section of CFP Board's *Code of Ethics and Standards of Conduct*. If there is no page number provided, then CFP Board has not released an FAQ related to that section. CFP Board has collected the FAQs that concern miscellaneous subjects at the end of the document.

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FREQUENTLY ASKED QUESTIONS

CFP Board provides answers to the following Frequently Asked Questions (FAQs) concerning CFP Board's *Code of Ethics and Standards of Conduct* (the "*Code and Standards*"). CFP Board may provide answers to additional FAQs on a periodic basis.

A. DUTIES OWED TO CLIENTS

A.1 FIDUCIARY DUTY

Question A.1.1: The *Financial Planning Practice Standards* that apply through September 30, 2019 requires a CFP® professional to act as a fiduciary when providing Financial Planning or material elements of Financial Planning. The new *Code and Standards* requires a CFP® professional to act as a fiduciary when providing Financial Advice to a Client. What is the difference between Financial Planning and Financial Advice? (Standards A.1., B.4., and C., and Glossary.)

Answer A.1.1: Financial Advice has a much broader scope than Financial Planning. The new *Code and Standards* states that a CFP® professional provides Financial Planning "through" Financial Advice. While Financial Planning requires Financial Advice, not all Financial Advice requires Financial Planning.

The new *Code and Standards* sets forth separate definitions for Financial Advice and Financial Planning. The Glossary defines Financial Advice as:

A. A communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action with respect to:

   1. The development or implementation of a financial plan;
   2. The value of or the advisability of investing in, purchasing, holding, gifting, or selling Financial Assets;
   3. Investment policies or strategies, portfolio composition, the management of Financial Assets, or other financial matters;
   4. The selection and retention of other persons to provide financial or Professional Services to the Client; or

B. The exercise of discretionary authority over the Financial Assets of a Client.

The determination of whether Financial Advice has been provided is an objective rather than subjective inquiry. The more individually tailored the communication is to the Client, the more likely the communication will be viewed as Financial Advice. The provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable person would not view as Financial Advice, does not constitute Financial Advice.

The new *Code and Standards* defines Financial Planning in the Glossary as follows:

Financial Planning is a collaborative process that helps maximize a Client's potential for meeting life goals through Financial Advice that integrates relevant elements of the Client's personal and financial circumstances.

The new *Code and Standards* also identifies factors (See Standard B.4.) that CFP Board will weigh in determining whether a CFP® professional providing Financial Advice is required to provide Financial Planning, and thus is required to comply with the *Practice Standards*. These integration factors are discussed in another FAQ. Where application of those factors to a particular situation leads to the conclusion that Financial Planning is not required, the new *Code and Standards* does not require a CFP® professional to comply with the *Practice Standards*. (See Standard C.) In that circumstance, the CFP® professional remains obligated to act as a fiduciary when providing Financial Advice to a Client. (See Standard A.1.) As noted above, since Financial Planning requires Financial Advice, a CFP® professional also must act as a fiduciary at all times when providing Financial Planning to a Client.

Question A.1.2: What does CFP Board's fiduciary duty require? (Standard A.1.)

Answer A.1.2: The new *Code and Standards* sets forth an objective standard requiring a CFP® professional providing Financial Advice to act in the best interests of the Client. In order to act in the best interests of the Client, a CFP® professional must fulfill a Duty of Loyalty, a Duty of Care, and a Duty to Follow Client Instructions. Standard A.1 of the new *Code and Standards* defines each of these duties using language that was drawn from the common law of fiduciaries.

The Duty of Loyalty requires a CFP® professional to:

i. Place the interests of the Client above the interests of the CFP® professional and the CFP® Professional's Firm;

ii. Avoid Conflicts of Interest, or fully disclose Material Conflicts of Interest to the Client, obtain the Client's informed consent, and properly manage the conflict; and

iii. Act without regard to the financial or other interests of the CFP® professional, the CFP® Professional's Firm, or any other individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the CFP® professional's.

Disclosure of Material Conflicts of Interest by itself is not sufficient to fulfill the Duty of Loyalty.

The Duty of Care requires a CFP® professional to act with the care, skill, prudence and diligence that a prudent professional would exercise in light of the Client's goals, risk tolerance, objectives, and financial and personal circumstances.

The Duty to Follow Client Instructions requires a CFP® professional to comply with all objectives, policies, restrictions, and other terms of the Engagement and all reasonable and lawful directions of the Client.

Question A.1.3: A CFP® professional must act as a fiduciary when providing Financial Advice to a Client. Will a CFP® professional have a fiduciary duty when she:

1) Makes a passing statement about a financial issue to someone she just met at a cocktail party; or

2) Provides general advice to a relative who asks her for her general opinion, for example, about a particular company or about the benefits of opening a 529 college savings plan for a newborn child?

(Standard A.1. and Glossary.)

Answer A.1.3: No. The new *Code and Standards* requires a CFP® professional to act as a fiduciary when providing "Financial Advice to a Client." (See Standard A.1.) The Glossary defines a "Client" as any person to whom the CFP® professional "provides or agrees to provide Professional Services pursuant to an Engagement." An "Engagement" is an "oral or written agreement, arrangement or understanding." Therefore, unless there is an agreement, arrangement or understanding that the CFP® professional will be providing professional services, the person receiving the information is not a "Client," and the CFP® professional does not have a fiduciary duty to that person.

In addition, the Glossary defines "Financial Advice" as "a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action." In the scenarios outlined in this question, it would be unreasonable for the CFP® professional, the cocktail party guest, or the relative to assume that they have established a client relationship, or that the information was a purposefully directed recommendation to take a specific action.

Furthermore, the definition of Financial Advice indicates that the "more individually tailored the communication" is to the information recipient, the "more likely the communication will be viewed as Financial Advice." A CFP® professional's general opinions about a particular company or the benefits of opening a 529 college savings plan would not be viewed as being tailored to the specific needs of that particular information recipient, and thus, would not constitute Financial Advice.

Finally, CFP Board applies an objective standard, not a subjective standard, to determine whether a particular communication constitutes Financial Advice. Therefore, in determining whether a CFP® professional has a fiduciary duty, CFP Board will consider whether "a reasonable CFP® professional" would conclude that the communication constituted Financial Advice, and will not defer to the opinion of either that particular information recipient or the CFP® professional who made that communication.

Question A.1.4: Does the Fiduciary Duty in the *Code and Standards* apply to a one-time recommendation (either a brokerage or insurance recommendation)?

Answer A.1.4: Yes. When a CFP® professional provides Financial Advice to a Client, the CFP® professional is required to act as a fiduciary regardless of whether the advice is one time or ongoing. A CFP® professional who provides a one-time recommendation and has no ongoing duty to monitor or provide other Financial Advice concerning the recommendation does not have an ongoing Fiduciary Duty with respect to that recommendation. A CFP® professional who provides ongoing Financial Advice is subject to an ongoing Fiduciary Duty. The Fiduciary Duty in the *Code and Standards* provides that a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client, at all times when providing Financial Advice to a Client. Financial Advice includes, among other things, a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking action with respect to the value of or advisability of investing in, purchasing, holding, gifting, or selling assets.

A.5 DISCLOSE AND MANAGE CONFLICTS OF INTEREST

Question A.5.1: Whenever a CFP® professional is providing Financial Advice to a Client, CFP Board's *Code and Standards* requires "full disclosure of all Material Conflicts of Interest." What does this entail, and in what format does the CFP® professional need to convey that disclosure to the Client? (Standard A.5.)

Answer A.5.1: CFP Board's Duty to Disclose and Manage Conflicts of Interest, which is set forth in Standard A.5 of the new *Standards of Conduct* requires a CFP® professional to fully disclose all Material Conflicts of Interest that could affect the professional relationship and provide sufficiently specific facts so that a reasonable Client would be able to understand the Material Conflicts of Interest and the business practices that give rise to the conflicts and give informed consent to such conflicts or reject them. As indicated in the Glossary, a "Conflict of Interest" arises when:

1. A CFP® professional's interests (including the interests of the CFP® Professional's Firm) are adverse to the CFP® professional's duties to a Client; or
2. A CFP® professional has duties to one Client that are adverse to another Client.

A Conflict of Interest becomes "Material" when a "reasonable Client or prospective Client would consider the information" about the conflict to be "important in making a decision" about the engagement with the CFP® professional, such as whether to retain, or continue to retain, a CFP® professional or whether to implement a recommendation.

In determining whether the disclosure about a Material Conflict of Interest provided to the Client was sufficient to infer that a Client has consented to a Material Conflict of Interest:

> CFP Board will evaluate whether a reasonable Client receiving the disclosure would have understood the conflict and how it could affect the advice the Client will receive from the CFP® professional. The greater the potential harm the conflict presents to the Client, and the more significantly a business practice that gives rise to the conflict departs from commonly accepted practices among CFP® professionals, the less likely it is that CFP Board will infer informed consent absent clear evidence of informed consent. Ambiguity in the disclosure provided to the Client will be interpreted in favor of the Client.

Whether a Client has provided informed consent depends on the facts and circumstances and may be inferred when not explicit. For example, silence after disclosure may constitute informed consent if the disclosure contains sufficiently specific facts that are understandable to a reasonable Client, but may not constitute informed consent if that is not the case. CFP Board intends for its "informed consent" standard to be interpreted in a manner that is consistent with interpretations of the Investment Advisers Act of 1940. A CFP® professional may refer to regulatory guidance and case law interpretations to gain a deeper understanding of "informed consent."

CFP Board recognizes that, in some circumstances, there are logistical challenges to providing written disclosure of Material Conflicts of Interest. Therefore, the standard does not require either the CFP® professional's disclosure or the Client's consent to be in writing. However, the standard also makes clear that evidence of oral disclosure of a conflict will be given such weight as CFP Board in its judgment deems appropriate.

In view of the fact-intensive nature of an inquiry into whether a CFP® professional orally disclosed a conflict, and whether a Client provided informed consent, a CFP® professional operating under a Material Conflict of Interest may want to consider, among other things, (a) avoiding business practices that create Material Conflicts of Interest that are difficult to manage, (b) describing all Material Conflicts of Interest to a Client clearly and in a manner that will allow the Client to understand the conflict, and (c) obtaining written consent to those Conflicts of Interest that a reasonable CFP® professional would consider adverse to the Client's interests.

A CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the interests of the CFP® professional.

Disclosure of Material Conflicts of Interest does not eliminate the Duty of Loyalty or the Duty of Care.

A.10 PROVIDE INFORMATION TO A CLIENT

Question A.10.1: What are a CFP® professional's disclosure requirements under the new *Code and Standards*?

Answer A.10.1: A CFP® professional has a Duty to Provide Information to a Client. Whether the information may be provided orally or must be provided in writing depends upon whether the Financial Advice that the CFP® professional is providing requires Financial Planning.

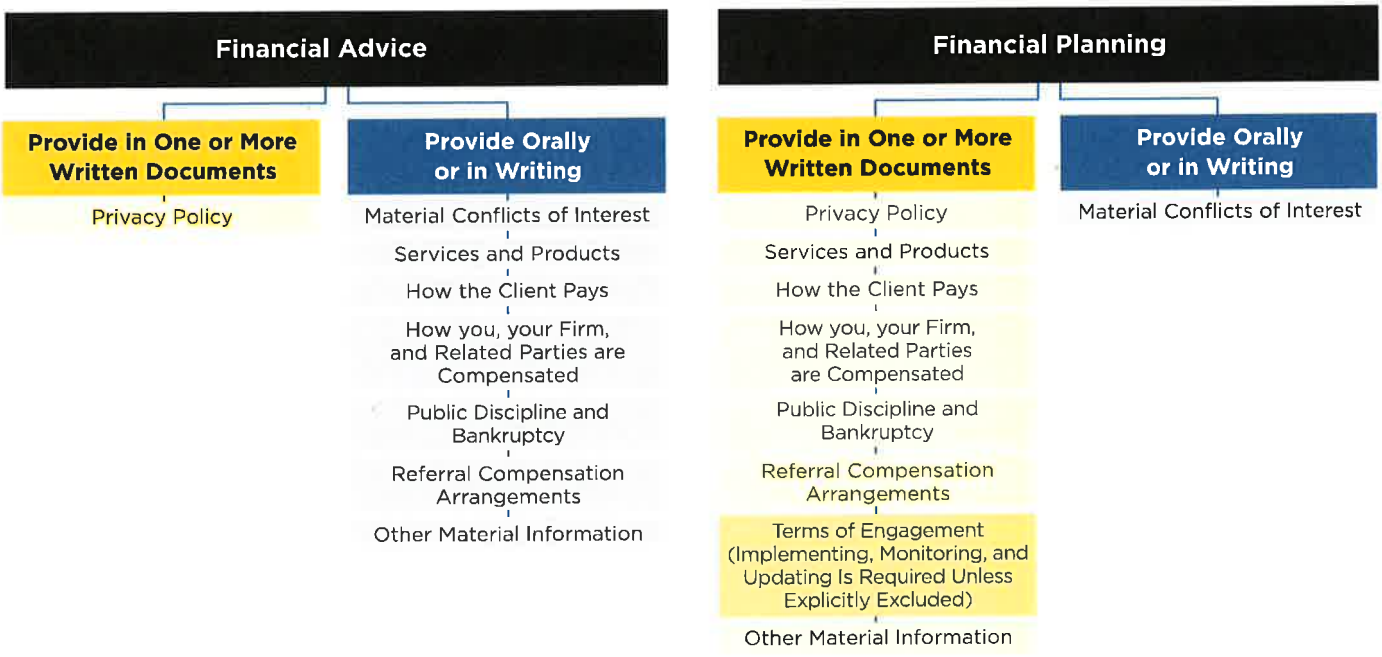
There are eight categories of information that a CFP® professional is required to provide to a Client when providing Financial Advice. There is an additional category of information that a CFP® professional must provide to a Client when providing or required to provide Financial Planning in accordance with the *Practice Standards*. (Standard A.10.) The requirement to provide information to a Client set forth in CFP Board's *Code and Standards* is in addition to any requirements that apply under applicable law, rule, or regulation and the CFP® Professional's Firm's policies and procedures.

When Providing Financial Advice: When providing Financial Advice, a CFP® professional is required to provide the following information to the Client:

1. A description of the services and products to be provided;
2. How the Client pays for the products and services, and a description of the additional types of costs that the Client may incur, including product management fees, surrender charges, and sales loads;
3. How the CFP® professional, the CFP® Professional's Firm, and any Related Party are compensated for providing the products and services;
4. The existence of any public discipline or bankruptcy, and the location(s), if any, of the webpages of all relevant public websites of any governmental authority, self-regulatory organization, or professional organization that sets forth the CFP® professional's public disciplinary history or any personal bankruptcy or business bankruptcy where the CFP® professional was a Control Person;
5. Full disclosure of all Material Conflicts of Interest with the CFP® professional's Client that could affect the professional relationship (a CFP® professional also must obtain the Client's informed consent and adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP® professional's ability to act in the Client's best interests);
6. Written notice of policies regarding the protection, handling, and sharing of a client's non-public personal information (Privacy Policies);
7. Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to the CFP® professional, the CFP® Professional's Firm, or a Related Party for engaging or recommending the selection or retention of additional persons to provide financial or Professional Services for a Client; and
8. Any other information about the CFP® professional or the CFP® Professional's Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm.

When Providing Financial Planning: When providing or required to provide Financial Planning in accordance with the *Practice Standards*, in addition to the information described above, a CFP® professional must provide to the Client the terms of the Engagement between the Client and the CFP® professional or the CFP® Professional's Firm. The terms of the Engagement include the Scope of Engagement and any limitations, the period(s) during which the services will be provided, and the Client's responsibilities. (Note that a CFP® professional is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement.)

Orally or in Writing? The chart set forth below summarizes the categories of information that a CFP® professional must provide a Client, and whether a CFP® professional must provide the information orally or in writing:



A CFP® professional must document that the information has been provided to the Client. CFP Board does not require any particular form of documentation. For example, a CFP® professional may document the information in a CRM or by maintaining a copy of an email sent to the Client. A CFP® professional also has an ongoing obligation to provide the Client with any information that is a Material change or update. Material changes and updates to public disciplinary history or bankruptcy information must be disclosed to the Client within 90 days, together with the location(s) of any relevant webpages. (Standard A.10.c.)

Question A.10.2: Does a CFP® professional investment adviser representative satisfy the Duty to Provide Information to a Client (Standard A.10.) when the CFP® professional provides a Client with the U.S. Securities and Exchange Commission's Form ADV Brochure and Brochure Supplement?

Answer A.10.2: Maybe. A CFP® professional investment adviser representative who provides a Form ADV Brochure and Brochure Supplement that contains only the information that the Brochures require would not fully satisfy the Duty to Provide Information to a Client. However, a CFP® professional investment adviser representative may satisfy the Duty to Provide Information to a Client by providing a Client a Form ADV Brochure and Brochure Supplement (including Form CRS) that contains all the information that the standard requires.

Question A.10.3: Will a CFP® professional providing investment advisory services satisfy the Updating Information component of the Duty to Provide Information to a Client, set forth in Standard A.10. of the *Code and Standards*, when the CFP® Professional's Firm follows the SEC's rules for providing and updating the Brochure Supplement?

Answer A.10.3: Maybe. A CFP® professional investment adviser representative who provides a Form ADV Brochure and Brochure Supplement that contains only the information that the Brochures require would not fully satisfy the Updating Information component of the Duty to Provide Information to a Client. However, a CFP® professional will satisfy the Duty to Provide Information to a Client by delivering to a Client a Brochure (and/or Brochure Supplement) that contains all the required information listed in Standard A.10. To satisfy the Updating Information requirement, a CFP® professional must provide to the Client any information that is a Material change or update to the information that the *Code and Standards* requires a CFP® professional to provide to the Client. Between annual updating amendments to Form ADV, the SEC requires disclosure of Material changes to such information to Clients even if those changes do not trigger delivery of an interim amendment.

However, Material changes and updates to public disciplinary history or bankruptcy information, which a CFP® professional must provide to the Client under the *Code and Standards*, but which Form ADV does not require to be disclosed, must be provided within ninety (90) days of the public discipline or bankruptcy, together with the location(s) of relevant webpages.

Question A.10.4: What information must CFP® professionals provide to existing and new clients now that the new *Code and Standards* became effective on October 1, 2019?

Answer A.10.4: A CFP® professional is required to satisfy the Duty to Provide Information to a Client set forth in Standard A.10. of the new *Code of Ethics and Standards of Conduct*. As part of the transition to the new *Code and Standards*, CFP Board is taking into consideration the fact that CFP® professionals already have provided information to existing Clients that is similar to the information that is required under the new *Code and Standards*. Therefore, a CFP® professional will not be required to make new disclosures to current Clients to the extent the CFP® professional has made all required disclosures under the previous *Standards of Professional Conduct* and there are no material changes or updates to the information required to be provided to the Clients. However, material changes and updates to disciplinary history or bankruptcy information must be disclosed to existing Clients within 90 days, together with the location(s) of the relevant webpages. With respect to new clients, the CFP® professional must provide the information identified in Standard A.10. of the new *Code and Standards* prior to or at the time of the Engagement.

Question A.10.5: The *Code and Standards* requires a CFP® professional to provide information to a Client, prior to or at the time of the Engagement, as set forth in Standard A.10. May a CFP® professional provide that information by email and by posting the information on the CFP® Professional's Firm's website?

Answer A.10.5: Maybe. Where the Client has indicated a preference for a particular form of delivery, the CFP professional must provide the information using the form of delivery the Client has requested. Where the client has not indicated a preference and if the Client has an email address that the CFP® Professional uses to communicate with the Client, then the CFP® professional may deliver the information to the Client using that email address. However, a Client must explicitly consent to the email delivery of personal financial data. A CFP® professional also should review the CFP® Professional's Firm's policies and procedures, which may address the delivery of information to a Client by email.

If the CFP® professional communicates with the Client by email, then a CFP® professional may satisfy the delivery requirement by electronically delivering to a Client an email that contains a location to the webpage link or URL to the information that has been posted on a website. The email must describe the information the Client may obtain by clicking on the link.

On the other hand, simply posting the information on a website, without taking these additional steps to direct the client to the information, would not satisfy the requirement that information be "provided to" a Client.

A CFP® professional who uses email delivery also must have reason to believe that information was successfully delivered to the Client.

The Duty to Provide Information to a Client requires a CFP® professional to document that the information was provided to the Client. For example, a CFP® professional may document the information in a CRM or by maintaining a copy of an email sent to the Client.

Question A.10.6: The Paycheck Protection Program ("PPP") established by the U.S. Small Business Administration ("SBA") allows eligible individuals and small businesses to obtain loans that can be used during the Covid-19 crisis. A PPP loan is eligible for forgiveness, provided the terms of the loan forgiveness are satisfied. If a CFP® professional or an entity over which the CFP® professional is a Control Person obtains a PPP loan and the loan or part of the loan is forgiven, will the CFP® professional be required to notify Clients about the loan or loan forgiveness under the *Code and Standards*?

Answer A.10.6: CFP Board's Duty to Provide Information to a Client is set forth in Standard A.10. of the *Code and Standards*. Standard A.10.a. requires CFP® professionals to provide certain information to a Client, prior to or at the time of the Engagement, when providing or agreeing to provide Financial Advice, and to document that the information has been provided to the Client. Among the information required to be provided pursuant to Standard A.10.a. is any "information about the CFP® professional or the CFP® Professional's Firm that is Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm." *See* Standard A.10.a.viii.

With respect to investment adviser firms and their reporting obligations regarding PPP loans under the Investment Advisers Act of 1940, the staff of the U.S. Securities and Exchange ("SEC") stated:

> As a fiduciary under federal law, you must make full and fair disclosure to your clients of *all material facts relating to the advisory relationship*. If the circumstances leading you to seek a PPP loan or other type of financial assistance constitute material facts relating to your advisory relationship with clients, it is the staff's view that your firm should provide disclosure of, for example, the nature, amounts and effects of such assistance. If, for instance, you require such assistance to pay the salaries of your employees who are primarily responsible for performing advisory functions for your clients, it is the staff's view that you would need to disclose this fact. In addition, if your firm is experiencing conditions that are reasonably likely to impair its ability to meet contractual commitments to its clients, you may be required to disclose this financial condition in response to Item 18 (Financial Information) of Part 2A of Form ADV (brochure), or as part of Part 2A, Appendix 1 of Form ADV (wrap fee program brochure).

See Question II.4., (Posted April 27, 2020), SEC, Division of Investment Management Coronavirus (COVID-19) Response FAQs, available at t sec.gov/investment/covid-19-response-faq (emphasis added).

Whether a CFP® professional is required to provide information about a PPP loan or loan forgiveness to Clients under the *Code and Standards* depends on the facts and circumstances. If information about a PPP loan or loan forgiveness would be Material to a Client's decision to engage or continue to engage the CFP® professional or the CFP® Professional's Firm, it must be provided to the Client, prior to or at the time of the Engagement, pursuant to Standard A.10.a.viii.

CFP Board also reminds CFP® professionals that proceeds of PPP loans should only be used for the limited purposes enumerated by the SBA.

Question A.10.7: A CFP® Professional's Firm has an Engagement with a Client. A CFP® professional is providing Financial Planning to the Client as part of a team. The CFP® professional reasonably believes that the Client is not aware that the CFP® professional is participating in the development of Financial Planning in support of the Engagement. Must the CFP® professional satisfy the Duty to Provide Information to a Client (Standard A.10 of the *Code and Standards*)?

Answer A.10.7: No. Standard A.10 sets for the Duty to Provide Information to a Client When Providing Financial Advice and When Providing Financial Planning. A CFP® Professional's Firm may have an Engagement with a Client to provide Financial Advice or Financial Planning. In this circumstance, the Client's communications with the CFP® Professionals Firm were solely with other financial professionals. The CFP® professional may reasonably believe that the Client is not aware that the CFP® professional is participating in the development of Financial Planning in support of the Engagement. In that circumstance, the CFP® professional is not required to satisfy the Duty to Provide Information to a Client (Standard A.10 of the *Code and Standards*). The CFP® professional continues to be subject to the other Duties to Clients set forth in the *Code and Standards*, including the Fiduciary Duty.

Question A.10.8: A CFP® Professional's Firm has an Engagement with a Client to provide Financial Advice. Other financial professionals at the CFP® Professional's Firm are developing the Financial Advice. The CFP® professional is supporting the Client relationship but not providing Financial Advice or Financial Planning. Must the CFP® professional satisfy the Duty to Provide Information to a Client (Standard A.10 of the *Code and Standards*)?

Answer A.10.8: No. Standard A.10 sets for the Duty to Provide Information to a Client When Providing Financial Advice and When Providing Financial Planning. If a CFP® professional is supporting the Client relationship but is not participating in the development of any part of the Financial Advice or Financial Planning, then the CFP® professional is not providing Financial Advice or Financial Planning and therefore is not required to satisfy the Duty to Provide Information to a Client (Standard A.10 of the *Code and Standards*). This type of support may arise, for example, when a CFP® professional is providing marketing materials or general financial education to the Client that does not constitute Financial Advice or Financial Planning.

A.12 DUTIES WHEN REPRESENTING COMPENSATION METHOD

Question A.12.1: What is a CFP® professional's duty under the new *Code and Standards* when representing compensation method? (Standard A.12.)

Answer A.12.1: When a CFP® professional provides Financial Advice, the CFP® professional must inform the client how the CFP® professional, the CFP® Professional's Firm, and any Related Party are compensated for providing the products and services. A CFP® professional also must not make false or misleading representations regarding the method of compensation of the CFP® professional or the CFP® Professional's Firm. Standard A.12 of the new *Code and Standards* addresses two specific compensation representations (fee-only and fee-based), defines important terms, provides a safe harbor for related parties, and sets forth a standard that applies to misrepresentations by a CFP® Professional's Firm.

Question A.12.2: How does CFP Board define Fee-only? (Standard A.12.a.)

Answer A.12.2: The standard with respect to when a CFP® professional may use the term fee-only remains largely the same. The standard defines the term fee-only by exclusion, and identifies individuals and entities whose compensation should be considered in determining whether fee-only is an appropriate compensation representation. A CFP® professional may describe his or her or the CFP® Professional's Firm's compensation method as fee-only only where: (a) the CFP® professional and the CFP® Professional's Firm receive no Sales-Related Compensation; and (b) Related Parties receive no Sales-Related Compensation in connection with any Professional Services the CFP® professional or the CFP® Professional's Firm provides to Clients. "Sales-Related Compensation" and "Related Parties" are defined terms that are discussed in other FAQs. CFP Board replaced the term "commissions" with Sales-Related Compensation because there are some fees that, like commissions, provide an incentive for the purchase or sale of Financial Assets (such as 12b-1 fees).

Question A.12.3: How does CFP Board address "Fee-Based" in the *Code and Standards*? (Standard A.12.a.)

Answer A.12.3: The new *Code and Standards* sets a new standard for the use of fee-based – a term that is equivalent to "fee and commission," but is often confused with fee-only. The standard provides that a CFP® professional who represents his or her compensation method as fee-based must not use the term in a manner that suggests the CFP® professional or the CFP® Professional's Firm is fee-only. Moreover, a CFP® professional using fee-based must clearly state either that the CFP® professional earns both fees and commissions, or is not fee-only. This standard also applies to other similar terms that, like fee-based, may be confused with a fee-only compensation method.

Question A.12.4: Who does CFP Board consider to be a Related Party? (Standard A.12.c.)

Answer A.12.4: CFP Board has defined the previously undefined term "Related Party" as including anyone whose receipt of Sales-Related Compensation reasonably would be viewed as directly or indirectly benefiting the CFP® professional or the CFP® Professional's Firm. CFP Board will presume that family members and controlled business entities are Related Parties, but a CFP® professional may show otherwise. Sales-Related Compensation received by a Related Party only is relevant for purposes of fee-only if the compensation is received "in connection with any Professional Services the CFP® professional or CFP® Professional's Firm provides to Clients." This connection exists when the compensation results, directly or indirectly, from Client transactions referred (or facilitated) by the CFP® professional or the CFP® Professional's Firm. For example, if a CFP® professional's father is a broker who receives Sales-Related Compensation, but there is no connection between the father's business and the CFP® professional's business, the father's Sales-Related Compensation is not being received "in connection with" the CFP® professional's Professional Services. In this circumstance, the father's Sales-Related Compensation would not prevent the CFP® professional from having a fee-only compensation method.

CFP Board also has a standard for using the term "fee-based." A CFP® professional's duty when using the term "fee-based" is discussed in another FAQ.

Question A.12.5: What is Sales-Related Compensation? (Standard A.12.b.)

Answer A.12.5: Sales-Related Compensation is more than a de minimis economic benefit, including any bonus or portion of compensation, resulting from a Client purchasing or selling Financial Assets. To account for compensation that is based on a Client's decision to hold an asset, such as an incentive to advise a Client to annuitize a pension rather than take a lump sum, the Sales-Related Compensation definition also includes compensation resulting from a Client "holding" Financial Assets for purposes other than receiving Financial

Advice. Sales-Related Compensation also includes compensation for the referral of a Client to any person or entity other than the CFP® Professional's Firm, as the referral constitutes a Professional Service provided to a Client. The standard sets forth common examples of Sales-Related Compensation, and explicitly excludes five types of compensation from the definition.

Question A.12.6: When does the Safe Harbor for Related Party compensation apply and what does it require? (Standard A.12.e.)

Answer A.12.6: The new *Code and Standards* includes a Related Party compensation "safe harbor" for a CFP® professional who adopts and implements policies and procedures (including through a CFP® Professional's Firm) reasonably designed to prevent recommendations that a Client purchase Financial Assets from or through, or refer any Clients to, a Related Party.

Question A.12.7: How does the *Code and Standards* address misrepresentation of compensation method by a CFP® Professional's Firm? (Standard A.12.f.)

Answer A.12.7: Standard 12.f provides a standard for when the CFP® Professional's Firm makes compensation representations that are inconsistent with CFP Board's *Code and Standards*. If the CFP® professional Controls the firm, the CFP® professional must not allow the firm to make a representation of compensation method that would be false or misleading if made by the CFP® professional. For example, when a CFP® professional is the sole owner of a firm that refers to its compensation method as fee-only, but the CFP® professional personally sells insurance and securities in exchange for Sales-Related Compensation, the *Code and Standards* would not permit the CFP® professional to allow the CFP® Professional's Firm, which the CFP® professional Controls, to use fee-only because the CFP® professional earns Sales-Related Compensation.

If the CFP® professional does not Control the firm, the CFP® professional does not have an obligation to prevent the firm from making a false or misleading misrepresentation of compensation method. Instead, the CFP® professional must correct any misrepresentation of compensation method by accurately representing the CFP® professional's compensation method to the CFP® professional's Clients. For example, assume a CFP® professional is an employee at a corporation that refers to its compensation method as fee-only even though the CFP® professional and others in the corporation refer commission-earning insurance business to a Related Party. In this instance, the CFP® professional could not use the term fee-only. Therefore, the CFP® professional must inform Clients that his or her compensation method is fee and commission.

Question A.12.8: When will CFP Board not consider trailing commissions to be Sales-Related Compensation? (Standard A.12.a.iii.)

Answer A.12.8: Standard A.12 of the *Code and Standards* provides that a CFP® professional may not make false or misleading representations regarding the CFP® professional's or the CFP® Professional's Firm's method(s) of compensation. A CFP® professional may represent his or her or the CFP® Professional's Firm's compensation method as "fee-only" only if:

1. The CFP® professional and the CFP® Professional's Firm receive no Sales-Related Compensation; and
2. Related Parties receive no Sales-Related Compensation in connection with any Professional Services the CFP® professional or CFP® Professional's Firm provides to Clients.

Sales-Related Compensation is more than a de minimis economic benefit resulting from, among other things, a Client purchasing or selling Financial Assets. Trailing commissions are Sales-Related Compensation that would prevent a CFP® professional from representing his or her or the CFP® Professional's Firm's compensation method as "fee-only."

However, there is a limited circumstances where CFP Board would find that a CFP® professional who refers to his or her or the CFP® Professional's Firm's compensation method as fee-only is not in violation of Standard A.12. notwithstanding the receipt of trailing commission. More specifically, if there is no other Sales-Related Compensation, and the CFP® professional:

a. Requests a transfer or assignment of the Financial Assets paying trailing commission to a person or entity that is not a Related Party;
b. Contacts the entities paying the trailing commission that may not be so transferred and requests that these entities discontinue paying any trailing commission; and
c. Donates any and all remaining trailing commission to one or more 501(c)(3) organizations.

In that circumstance, CFP Board would find that a CFP® professional who refers to his or her or the CFP® Professional's Firm's compensation method as fee-only is not making a false or misleading representation about compensation method.

A.13 DUTIES WHEN RECOMMENDING, ENGAGING, AND WORKING WITH ADDITIONAL PERSONS

Question A.13.1: What does the *Code and Standards* require of a CFP® professional who recommends the selection of additional persons to provide financial or Professional Services for a Client?

Answer A.13.1: The Fiduciary Duty in the *Code and Standards* provides that at all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client. A recommendation that a Client select and retain another financial or Professional Services provider for a Client, such as an accountant or attorney, is Financial Advice. To fulfill that Fiduciary Duty, the Duties When Recommending, Engaging, and Working with Additional persons, set forth in Standard A.13.a.i. of the *Code and Standards*, requires a CFP® professional to have a reasonable basis for the recommendation based on the person's reputation, experience, and qualifications.

A CFP® professional may obtain such a reasonable basis through appropriate due diligence to support the recommendation. The necessary amount of research and analysis will depend upon the facts and circumstances. A CFP® professional's reliance upon a personal relationship with the other financial or Professional Services provider, by itself, ordinarily would be insufficient justification for the recommendation. Some of the information that a CFP® professional may consider reviewing when conducting due diligence includes information about the individual that is contained in FINRA's BrokerCheck, the Investment Adviser Public Disclosure database, CFP.net/verify, CPAverify.org, and a Google search result. A CFP® professional also may rely upon the CFP® Professional's Firm's recommendation if the CFP® professional has a reasonable basis to believe that the firm developed the recommendation after conducting appropriate due diligence.

B. FINANCIAL PLANNING AND APPLICATION OF THE PRACTICE STANDARDS FOR THE FINNAICAL PLANNING PROCESS

B.1 FINANCIAL PLANNING DEFINITION

Question B1.1: How does CFP Board define Financial Planning? (Standard B.1. and Glossary.)

Answer B.1.1: In the new *Code and Standards*, CFP Board incorporates a shorter Financial Planning definition that is more user-friendly, without sacrificing clarity. The revised Financial Planning definition, which is set forth in both the Glossary and Standard B.1 of the new *Standards of Conduct*, consists of 30 carefully chosen words:

Financial Planning is a collaborative process that helps maximize a Client's potential for meeting life goals through Financial Advice that integrates relevant elements of the Client's personal and financial circumstances.

To best understand this new definition, it is helpful to consider each element in succession:

- "Financial Planning is a collaborative process": CFP Board is committed to the fundamental principle that Financial Planning is a "process," not a document or product. The *Practice Standards* provide the roadmap. (See Standard C.) Collaboration between the CFP® professional and the Client, and potentially others, is critical to the process.
- "That helps maximize a Client's potential": The goal of Financial Planning is to help maximize the Client's potential. In developing the definition, CFP Board carefully considered a long list of alternatives to "maximize," including achieve, advance, enhance, foster, further, improve, increase, optimize, realize, and support. CFP Board determined that "maximize" is the word that best fits the definition because the goal of a CFP® professional providing Financial Planning is to make the most out of the Client's potential. Maximize is qualified by "helps" and modifies the Client's "potential," but does not guarantee any specific financial performance.
- "For meeting life goals": The purpose of Financial Planning is to develop and meet goals. The goal is to obtain what the Client wants in life. Financial goals are one means to that end, not the end itself. Therefore, defining the goals as "financial goals" would be too narrow.
- "Through Financial Advice": Financial Advice is the financial planner's tool. While a financial planner is focused on life goals, the advice that a financial planner provides is Financial Advice.

- "That integrates relevant elements of the Client's personal and financial circumstances": "Integration" is essential to Financial Planning. The process requires integration of relevant elements of the Client's personal and/or financial circumstances. A financial planner examines a Client's circumstances and evaluates how one element of the Client's life may affect other elements. Relevant elements of a Client's personal and financial circumstances vary from Client to Client, and may include the Client's need for or desire to: develop goals, manage assets and liabilities, manage cash flow, identify and manage risks, identify and manage the financial effect of health considerations, provide for educational needs, achieve financial security, preserve or increase wealth, identify tax considerations, prepare for retirement, pursue philanthropic interests, and address estate and legacy matters.

B.3 APPLICATION OF PRACTICE STANDARDS

Question B.3.1: When must a CFP® professional comply with the *Practice Standards* for the Financial Planning Process? (Standard B.3.)

Answer B.3.1: The *Standards of Professional Conduct* that will remain in effect through September 30, 2019 requires a CFP® professional to comply with the Financial Planning process when providing Financial Planning or material elements of Financial Planning. The new *Code and Standards* eliminates the concept of "material elements of Financial Planning." Instead, the new *Code and Standards* specifies – in Standard B.3 – three circumstances in which a CFP® professional must comply with the *Practice Standards*:

1. **When the CFP® professional agrees to provide or provides Financial Planning.** This occurs when a CFP® professional and a Client explicitly agree that the CFP® professional will provide, or the CFP® professional actually provides, Financial Planning. An example of this is when a CFP® professional has provided to the Client, in writing, the terms of the Engagement for Financial Planning as required by Standard A.10.b.ii.
2. **When the CFP® professional agrees to provide or provides Financial Advice that requires integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests.** This occurs when a CFP® professional provides Financial Advice to a Client, but there is no explicit agreement or understanding between the CFP® professional and Client to provide Financial Planning. Rather, the nature of the Financial Advice requires the CFP® professional to provide Financial Planning to meet his or her fiduciary obligations. While this circumstance is similar to the historical concept of "material elements of financial planning" this standard examines the potential effect of the Financial Advice on the Client rather than the types of services the CFP® professional provides to the Client. Another FAQ discusses the factors that CFP Board will examine to determine whether integration is required.
3. **When the Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.** While the current *Practice Standards* examine the Client's subjective understanding and intent in engaging the CFP® professional as one relevant factor in determining whether Financial Planning is required, the new *Code and Standards* provides an objective standard that, if satisfied, is sufficient to require Financial Planning. Whether the CFP® professional has held out to the Client that he or she provides Financial Planning is one of the relevant factors to be considered in assessing whether the Client's belief is reasonable.

Question B.3.2: How does a CFP® professional determine whether the Financial Advice the CFP® professional has agreed to provide or provided to a Client is "Financial Advice that Requires Financial Planning" (i.e., Financial Advice that requires integration of relevant elements of the Client's personal and/ or financial circumstances in order to act in the Client's best interests)?

Answer B.3.2: There are three circumstances when a CFP® professional must provide Financial Planning, and therefore must comply with the *Practice Standards* for the Seven-Step Financial Planning Process (Standard B.3.):

1) The CFP® professional agrees to provide or provides Financial Planning;
2) The CFP® professional agrees to provide or provides Financial Advice that requires integration of relevant elements of the Client's personal and/ or financial circumstances in order to act in the Client's best interests ("Financial Advice that Requires Financial Planning"); or
3) The Client has a reasonable basis to believe the CFP® professional will provide or has provided Financial Planning.

The Integration Factors: This FAQ focuses on the second of these three circumstances: whether the CFP® professional has provided Financial Advice that Requires Financial Planning. CFP Board has established five specific "Integration Factors" that CFP Board will weigh in making that determination:

a. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect;

b. The portion and amount of the Client's Financial Assets that the Financial Advice may affect;

c. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice;

d. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice; and

e. The barriers to modifying the actions taken to implement the Financial Advice.

Additional Duties When Financial Planning is Required: If, based on the Integration Factors, the CFP® professional is providing Financial Advice that requires Financial Planning, then the CFP® professional must comply with the *Practice Standards* for the Seven-Step Financial Planning Process. As set forth in Standard C., the *Practice Standards* for the Financial Planning Process are as follows:

Step 1: Understanding the Client's Personal and Financial Circumstances

Step 2: Identifying and Selecting Goals

Step 3: Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action

Step 4: Developing the Financial Planning Recommendation(s)

Step 5: Presenting the Financial Planning Recommendation(s)

Step 6: Implementing the Financial Planning Recommendation(s)

Step 7: Monitoring Progress and Updating

In complying with the *Practice Standards*, a CFP® professional must act prudently in documenting information, as the facts and circumstances require, taking into account the significance of the information, the need to preserve the information in writing, the obligation to act in the Client's best interests, and the CFP® Professional's Firm's policies and procedures.

If a CFP® professional is required to provide Financial Planning, then under the Duty to Provide Information to a Client (Standard A.10.), most of the information that the CFP® professional may have provided to the Client orally (or in writing) when providing Financial Advice now must be delivered to the Client in writing, in one or more written documents. In addition, the CFP® professional also must provide to the Client, in writing, the terms of the Engagement between the Client and the CFP® professional or the CFP® Professional's Firm, including the Scope of Engagement and any limitations, the period(s) during which the services will be provided, and the Client's responsibilities. The CFP® professional also is responsible for Implementing the Financial Planning Recommendations (Step 6 of the Financial Planning Process) and Monitoring Progress and Updating (Step 7 of the Financial Planning Process) unless specifically excluded from the Scope of the Engagement.

Question B.3.3: Is a CFP® Professional Required to Provide Financial Planning in Every Client Engagement? (Standard B.3.)

Answer B.3.3: No. The *Code of Ethics and Standards of Conduct* (Standard B.1-6 and Glossary) expressly recognizes that a CFP® professional may provide:

a. Information that does not constitute Financial Advice (the provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable CFP® professional would not view as Financial Advice),

b. Financial Advice (a communication that, based on its content, context, and presentation, would reasonably be viewed as a recommendation that the Client take or refrain from taking a particular course of action) that does not require Financial Planning, and

c. Financial Advice that requires Financial Planning (Financial Advice that requires integration of relevant elements of the Client's personal and/ or financial circumstances to act in the Client's best interests).

Thus, CFP Board recognizes that a CFP® professional is not required to provide Financial Planning in every Client Engagement.

B.4 INTEGRATION FACTORS

Question B.4.1: Will a CFP® professional who has collected the information required under the Financial Industry Regulatory Authority's ("FINRA") Know Your Customer Rule be deemed to have engaged in Financial Planning? (Standard B.4.)

Answer B.4.1: No. FINRA's Know Your Customer Rule calls for collecting certain types of information about a Client. Financial Planning is more than the collection of information. CFP Board's new integration factors, which are set forth in Standard B.4 of the new *Standards of Conduct*, set forth the circumstances in which a CFP® professional must provide Financial Planning.

Question B.4.2: What factors will determine whether a CFP® professional is required to provide Financial Planning when providing Financial Advice to a Client, as required under Standard B.3.a.ii? (Standard B.4.)

Answer B.4.2: CFP Board will weigh the following five factors, which are set forth in Standard B.4.:

1. The number of relevant elements of the Client's personal and financial circumstances that the Financial Advice may affect. This factor requires a CFP® professional to review the Financial Advice the CFP® professional will provide to the Client and determine how many of the Client's needs or wants the Financial Advice may affect. Financial Advice concerning one relevant element of the Client's personal and financial circumstances may (or may not) be sufficient to require Financial Planning.
2. The portion and amount of the Client's Financial Assets that the Financial Advice may affect. This factor requires a CFP® professional to review the Financial Advice the CFP® professional will provide to the Client and determine the portion and amount of the Client's Financial Assets the Financial Advice may affect. This factor focuses on both the portion and amount of Financial Assets. The effect on Financial Assets is just one factor that CFP Board would weigh in conjunction with others.
3. The length of time the Client's personal and financial circumstances may be affected by the Financial Advice. This factor requires the CFP® professional to assess the length of time the Financial Advice may affect the Client's personal and financial circumstances.
4. The effect on the Client's overall exposure to risk if the Client implements the Financial Advice. Relevant risks include investment risk, interest rate risk, and inflation risk.
5. The barriers to modifying the actions taken to implement the Financial Advice. This factor requires the CFP® professional to assess how difficult it would be for the Client to unwind or modify the action taken to implement the Financial Advice.

Question B.4.3: Does CFP Board require a CFP® professional to address a certain number of "relevant elements" of a Client's personal and financial circumstances for the Engagement to be considered Financial Planning? (Standard B.4.)

Answer B.4.3: No. CFP Board does not identify a minimum number of "relevant elements" for an Engagement to be considered Financial Planning. While it is more likely that Financial Planning is required when several of the relevant elements of the Client's personal and financial circumstances are involved, in some cases a Financial Planning Engagement may exist even when only one of the "relevant elements" is involved. The "relevant elements" are identified in Standard B.2 of the new *Code and Standards*. CFP Board has developed a five- factor test for determining whether Financial Planning is required, which is set forth in Standard B.4 of the new *Code and Standards* and is addressed in another FAQ.

B.6 NO CLIENT AGREEMENT TO ENGAGE FOR FINANCIAL PLANNING

Question B.6.1: What is required of a CFP® professional when the Client does not agree to engage the CFP® professional to provide Financial Planning even though the Financial Advice that the Client has requested would require the CFP® professional to comply with the *Practice Standards*? (Standard B.6.)

Answer B.6.1: CFP Board recognizes that a Client who does not want to engage a CFP® professional for Financial Planning should be able to engage the CFP® professional to provide more limited services and the Client should not be required to work with a non-CFP® professional. Therefore, when a CFP® professional otherwise would be required to comply with the *Practice Standards*, but the Client does not agree to engage

the CFP® professional for Financial Planning, the CFP® professional has four options. As set forth in Standard B.6 of the new *Code and Standards*, the CFP® professional must either:

1. Not enter into the Engagement;
2. Limit the Scope of Engagement to services that do not require application of the *Practice Standards*, and describe to the Client the services the Client requests that the CFP® professional will not be performing;
3. Provide the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, in which case the CFP® professional is not required to comply with the *Practice Standards*; or
4. Terminate the Engagement.

Not all options will apply under all circumstances. To illustrate these options, assume that a Client seeks Financial Advice on three topics, and that, under the *Code and Standards*, a CFP® professional otherwise would be required to provide Financial Planning to provide that Financial Advice. Assume further that the Client declines to engage the CFP® professional for Financial Planning.

Under the first option, the CFP® professional may decide not to enter into the Engagement. Under the second option, the CFP® professional may limit the Scope of the Engagement to one topic if that would not require Financial Planning, and inform the Client that the CFP® professional will not be providing Financial Advice on the other two topics.

Under the third option, if the CFP® professional informs the Client how Financial Planning would benefit the Client and how the Client's decision not to engage the CFP® professional to provide Financial Planning may limit the CFP® professional's Financial Advice, then the CFP® professional may provide Financial Advice on all three topics without being required to comply with the *Practice Standards*. The CFP® professional continues to be required to act as a fiduciary when providing that Financial Advice.

C. PRACTICE STANDARDS FOR THE FINANICAL PLANNING PROCESS

Question C.1: The new *Code and Standards* contains *Practice Standards* that provide for seven steps in the Financial Planning process. Why and how have the *Practice Standards* changed? (Standard C.)

Answer C.1: The revised *Practice Standards* – which are set forth in Standard C of the new *Code and Standards* – increases the number of steps in the Financial Planning process from six to seven. The new *Code and Standards* provides a comprehensive update to the *Practice Standards* that reflects the delivery of Financial Planning and provides detailed requirements for the Financial Planning process. This FAQ highlights the following three structural changes, which also are set forth in the chart provided below:

1. CFP Board removed from the *Practice Standards* what had been the first step in the process – "Defining the Scope of the Engagement." That standard now is a "Duty to Provide Information to a Client" that is addressed in Standard A.10. CFP Board made that change so that the *Practice Standards* would now solely address the delivery of Financial Planning.
2. The revised *Practice Standards* divide and re-order what had been Step 2 of the Financial Planning process into Steps 1 and 2 of the revised version: "Understanding the Client's Personal and Financial Circumstances" and "Identifying and Selecting Goals." The new *Code and Standards* thus now requires a CFP® professional to work with the Client to obtain information and analyze the Client's personal and financial circumstances before mutually defining the Client's goals, and not after, as the current *Practice Standards* require. This change recognizes that for a CFP® professional to collaborate effectively with the Client to identify and then select goals, a CFP® professional first must understand the Client's circumstances.
3. The new *Code and Standards* divides and reorganizes into three steps what previously had been Steps 3 and 4 under the existing *Practice Standards*. This process now requires a CFP® professional to "Analyze the Client's Current Course of Action and Potential Alternative Course(s) of Action" (Step 3), "Develop the Financial Planning Recommendation(s)" (Step 4), and "Present the Financial Planning Recommendation(s)" (Step 5).

The chart below compares the existing and revised *Practice Standards*:

Existing Practice Standards	Revised Practice Standards
1. Establishing and Defining the Relationship with the Client • Defining the Scope of the Engagement	[Moved to section A.10 of the *Standards of Conduct* (the Duty to "Provide Information to a Client")]
2. Gathering Client Data • Determining a Client's Personal and Financial Goals, Needs and Priorities • Obtaining Quantitative Information and Documents	1. Understanding the Client's Personal and Financial Circumstances • Obtaining Qualitative and Quantitative Information • Analyzing Information • Addressing Incomplete Information
	2. Identifying and Selecting Goals • Identifying Potential Goals • Selecting and Prioritizing Goals
3. Analyzing and Evaluating the Client's Financial Status • Analyzing and Evaluating the Client's Information 4. Developing and Presenting Financial Planning Recommendations • Identifying and Evaluating Financial Planning Alternative(s)	3. Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action • Analyzing Current Course of Action • Analyzing Potential Alternative Courses of Action
4. Developing and Presenting Financial Planning Recommendations • Developing the Financial Planning Recommendation(s)	4. Developing the Financial Planning Recommendation(s)
4. Developing and Presenting Financial Planning Recommendations • Presenting the Financial Planning Recommendation(s)	5. Presenting the Financial Planning Recommendation(s)
Existing Practice Standards	**Revised Practice Standards**
5. Implementing the Financial Planning Recommendation(s) • Agreeing on Implementation Responsibilities • Selecting Products and Services for Implementation	6. Implementing the Financial Planning Recommendation(s) • Addressing Implementation Responsibilities • Identifying, Analyzing, and Selecting Actions, Products and Services • Recommending Actions, Products, and Services for Implementation • Selecting and Implementing Actions, Products, or Services
6. Monitoring • Defining Monitoring Responsibilities	7. Monitoring Progress and Updating • Monitoring and Updating Responsibilities • Monitoring the Client's Progress • Obtaining Current Qualitative and Quantitative Information • Updating Goals, Recommendations, or Implementation Decisions

Question C.2: Does CFP Board require a CFP® professional to complete all seven steps of the Financial Planning process? (Standards A.10 and C.)

Answer C.2: A CFP® professional who is providing Financial Planning must complete the first five steps of the Financial Planning process that are set forth in Standard C. It is not necessary, however, for a CFP® professional to complete the last two steps of the Financial Planning process if those steps are specifically excluded from the Scope of Engagement. For example, some Clients may engage a CFP® professional to complete the first five steps of the Financial Planning process and then work with another financial services provider to implement or monitor those recommendations. However, Standard A.10 provides that a CFP® professional is responsible for implementing, monitoring, and updating the Financial Planning Recommendation(s) unless specifically excluded from the Scope of Engagement.

Question C.3: The new *Code and Standards* requires a CFP® professional to document information when complying with the *Practice Standards*. What is required? (Standard C.)

Answer C.3: The new *Code and Standards* sets forth, in Standard C, which contain the *Practice Standards* for the financial planning process, a principles-based documentation requirement that applies when a CFP® professional provides or is required to provide Financial Advice in accordance with the *Practice Standards*. A CFP® professional may memorialize information in a method of the CFP® professional's choosing. The CFP® professional is not required to provide the information to the Client.

A CFP® professional must act prudently in documenting and retaining information, as the facts and circumstances require, taking into the account the significance of the information, the need to preserve the information in writing, the obligation to act in the Client's best interests, and the CFP® Professional's Firm's policies and procedures. A CFP® professional may consider documenting the following information in writing, where relevant:

1. The qualitative and quantitative information the CFP® professional obtains from the Client;
2. The Client's selected goals;
3. The CFP® professional's analysis of the Client's current course of action;
4. The CFP® professional's analysis of potential alternative courses of action;
5. The assumptions and estimates used in developing the recommendations;
6. The recommendations the CFP® professional selects and the rationale for the recommendations;
7. The basis for the selection of actions, products, and services;
8. Actions the Client takes that deviate from the CFP® professional's recommendations;
9. When engaged for monitoring, the CFP® professional's analysis of the Client's progress towards achieving goals; and
10. When engaged for monitoring and updating, which actions, products, and services are and are not subject to the CFP® professional's monitoring responsibility, how and when the CFP® professional will monitor the actions, products, and services, how the CFP® professional will be informed of any materials changes in the Client's qualitative and quantitative information, and how and when a CFP® professional who is responsible for updating the Financial Planning recommendations will do so.

Documentation may be retained in, among other places, a client file, a Contact Management System file, a paper file, or a digital vault.

E. DUTIES OWED TO CFP BOARD

E.2 REFRAIN FROM ADVERSE CONDUCT

Question E.2.1: How will CFP Board handle bankruptcies under the new *Code and Standards*? (Standards E.2. and E.3.)

Answer E.2.1: The new *Code and Standards* continues to prohibit a CFP® professional from engaging in conduct that reflects adversely on his or her integrity or fitness as a CFP® professional, upon the CFP® marks, or upon the profession. Standard E.2 provides five examples of such conduct. For example, a personal bankruptcy or business bankruptcy filing or adjudication where the CFP® professional was a Control Person of the business may reflect adversely on the CFP® professional's integrity or fitness unless the CFP® professional can rebut the presumption that the bankruptcy demonstrates an inability to manage responsibly the CFP® professional's or the business's financial affairs.

This presents a significant change to CFP Board's procedures. Effective July 2012, CFP Board adopted the Bankruptcy Disclosure Procedures, which provided that CFP Board staff would not investigate, and CFP Board's Disciplinary and Ethics Commission ("DEC") would not adjudicate, a CFP® professional's first bankruptcy. Instead, CFP Board noted the bankruptcy filing on the CFP® professional's public profile on CFP Board's websites and issued a news release identifying the CFP® professional as having filed for bankruptcy. While this did not result in a formal disciplinary action, the effect was similar to a Public Letter of Admonition.

The new *Code and Standards* recognizes that in certain limited circumstances, a bankruptcy does not demonstrate a CFP® professional's inability to manage his or her finances. Therefore, the new *Code and Standards* restores the process that existed prior to July 2012 whereby a CFP® professional had the right to demonstrate to the DEC that the bankruptcy was not the result of an inability to manage responsibly the CFP® professional's financial affairs. In those circumstances where the CFP® professional is able to make that showing, the CFP® professional will not be subject to discipline and CFP Board will not issue a press release announcing the bankruptcy. Regardless of the outcome of the disciplinary proceedings before the DEC, a CFP® professional must provide to the Client the location of all relevant public websites of any authority that sets forth the CFP® professional's personal bankruptcy or business bankruptcy where the CFP® professional was a Control Person of the business. Relevant public websites could include BrokerCheck, CFP Board's website, and the federal court website that contains the bankruptcy information.

As set forth in Standard E.3.I., a CFP® professional is now required to provide written notice to CFP Board within 30 calendar days of filing or being the subject of either a personal bankruptcy or a business bankruptcy where the CFP® professional was a Control Person.

E.3 REPORTING

Question E.3.1: The new *Code and Standards'* "Reporting" standard requires a CFP® professional to notify CFP Board in writing within 30 calendar days of certain events. Does this reporting requirement differ from CFP Board's current reporting requirements? (Standard E.3.)

Answer E.3.1: Yes, the new Reporting standard expands the number and types of events that a CFP® professional is required to disclose to CFP Board within 30 calendar days. The *Standards of Professional Conduct* that will remain in effect through September 30, 2019 requires a CFP® professional to notify CFP Board in writing, within 30 calendar days, only when the CFP® professional has been convicted of a crime (other than a minor traffic offense) or has been the subject of a professional disciplinary suspension, bar, or revocation issued by a governmental agency, an industry self-regulatory organization, or a professional association. A CFP® professional also is required, when renewing the CFP® professional's certification every two years, to report a wider range of potentially problematic conduct on the Ethics Profile Questionnaire.

The new Reporting standard, which is set forth in Standard E.3 of the new *Code and Standards*, requires a CFP® professional to provide written notice to CFP Board within 30 calendar days after the CFP® professional or an entity over which the CFP® professional is a Control Person has engaged in the potentially problematic conduct that is listed in Standard E.3. Potentially problematic conduct includes conduct ranging from being charged with, convicted of, or admitted to a program that defers or withholds the entry of a judgment or conviction for, a Felony or Relevant Misdemeanor to having a professional license, certification, or membership suspended, revoked, or materially restricted because of a violation of laws, rules or standards of conduct.

CFP Board's new reporting requirement generally is based upon the reporting requirements set forth in Form U4 (Uniform Application for Securities Industry Registration or Transfer) without fully adopting or mirroring Form U4's disclosure requirements. In fact, certain potentially problematic conduct may not need to be disclosed on Form U4, but will need to be disclosed to CFP Board. Reporting of potentially problematic conduct on Form U4 will not relieve CFP® professionals of their separate obligation to disclose conduct to CFP Board. The reporting requirement enables CFP Board to receive information in a timely manner and eliminates any confusion about the reporting timeline.

Question E.3.2: The Paycheck Protection Program ("PPP") established by the U.S. Small Business Administration ("SBA") allows eligible individuals and small businesses to obtain loans that can be used during the Covid-19 crisis. A PPP loan is eligible for forgiveness, provided the terms of the loan forgiveness are satisfied. If a CFP® professional or an entity over which the CFP® professional is a Control Person obtains a PPP loan and the loan or part of the loan is forgiven, will the CFP® professional be required to report the loan or loan forgiveness to CFP Board?

Answer E.3.2: CFP Board's Reporting standard, which is set forth in Standard E.3 of the *Code and Standards*, requires a CFP® professional to provide written notice to CFP Board within 30 calendar days after the CFP® professional or an entity over which the CFP® professional is a Control Person has engaged in certain conduct that is listed in Standard E.3.

The *Code and Standards* do not specifically require CFP® professionals to report to CFP Board the receipt of a PPP loan or loan forgiveness under the PPP. However, another reportable event, such as a bankruptcy, public discipline, judgment lien, civil judgment, Regulatory Action, or Civil Action could occur in connection with the

receipt of a PPP loan or loan forgiveness under the PPP. *See* Standard E.3. Similarly, receipt of a PPP loan or loan forgiveness itself does not require an affirmative response to any question in CFP Board's current Ethics Declaration.

CFP Board also reminds CFP® professionals that proceeds of PPP loans should only be used for the limited purposes enumerated by the SBA.

G. MISCELLANEOUS

Question G.1: Why did CFP Board revise its Standards?

Answer G.1: CFP Board periodically updates the *Standards* to keep current with changes in the field of financial planning; to advance the profession; to maintain the value, integrity and relevance of the CFP® certification; and to address new products, services, and technologies that effect the profession. CFP Board last updated its *Standards* in 2007. The updates that become effective on October 1, 2019, include the introduction of the duty to act as a fiduciary at all times when providing Financial Advice to a Client. These revisions are consistent with, and central to, the purpose and mission of CFP Board.

Question G.2: What process did CFP Board follow in revising its Standards?

Answer G.2: In December 2015, CFP Board formed a Commission on Standards to review and recommend to CFP Board's Board of Directors proposed changes to the *Terminology, Code of Ethics and Professional Responsibility, Rules of Conduct, and Practice Standards* sections of the *Standards*. Commission members included CFP® professionals and others in the financial services industry who operated under diverse business models, as well as prominent regulatory experts, a consumer advocate, and a representative of the public. CFP Board gathered input from a wide variety of stakeholders by hosting 17 public forums in cities located across the country, and by hosting meetings with the Financial Planning Association, the National Association of Personal Financial Advisors, the Securities Industry and Financial Markets Association, the Financial Services Institute, and CFP Board's Business Model Council (which is comprised of firm representatives from a wide range of business models). CFP Board also issued two drafts of the *Code and Standards* for public comment, and considered more than 1,500 written comments and hundreds of oral comments from CFP® professionals, firms, regulators, trade associations, consumer groups, and a broad array of additional stakeholders. After following this deliberative, inclusive, and transparent process, CFP Board adopted the *Code and Standards* in March 2018 and announced that it would become effective on October 1, 2019.

Question G.3: How has CFP Board changed the organizational structure of the *Code and Standards*?

Answer G.3: To make the *Standards of Professional Conduct* more user-friendly, the new *Code and Standards* consolidates the *Terminology, Code of Ethics and Professional Responsibility, Rules of Conduct, and Financial Planning Practice Standards*. In the *Standards of Professional Conduct*, each section had its own numbering and organizational system, the *Rules of Conduct* and the *Practice Standards* had overlapping provisions, and the *Code of Ethics* contained language explaining its principles. By consolidating these sections, CFP Board eliminated redundancy, developed a unified structure, and presented content in a more efficient and effective manner. Set forth below is a summary of the organizational structure of the new *Code and Standards*.

The new *Code and Standards* begins with a four-sentence Preamble that succinctly captures its purpose and effect. A concise Code of Ethics then identifies principles that guide the behavior of CFP® professionals. CFP Board elaborates on those principles in its *Standards of Conduct*, which is divided into the following six sections:

A. Duties Owed to Clients

B. Financial Planning and Application of the *Practice Standards* for the Financial Planning Process

C. Practice Standards for the Financial Planning Process

D. Duties Owed to Firms and Subordinates

E. Duties Owed to CFP Board

F. Prohibition on Circumvention

Section A of the *Code and Standards* delineates the following 15 duties that a CFP® professional owes to a Client:

- A.1 Fiduciary Duty
- A.2 Integrity
- A.3 Competence
- A.4 Diligence
- A.5 Disclose and Manage Conflicts of Interest
- A.6 Sound and Objective Professional Judgment
- A.7 Professionalism
- A.8 Comply with the Law
- A.9 Confidentiality and Privacy
- A.10 Provide Information to a Client
- A.11 Duties When Communicating with a Client
- A.12 Duties When Representing Compensation Method
- A.13 Duties When Recommending, Engaging, and Working with Additional Persons
- A.14 Duties When Selecting, Using, and Recommending Technology
- A.15 Refrain from Borrowing or Lending Money and Commingling Financial Assets

Section B of the *Code and Standards* addresses *Financial Planning and Application of the Practice Standards for the Financial Planning Process*. This section sets forth CFP Board's revised definition of Financial Planning, the standard for when the *Practice Standards* apply, and the circumstance in which a CFP® professional must demonstrate that compliance with the *Practice Standards* was not required. This section also includes a standard that applies when a CFP® professional otherwise must comply with the *Practice Standards*, but the Client does not agree to engage the CFP® professional for Financial Planning.

Section C contains CFP Board's *Practice Standards for the Financial Planning Process*, which have been revised to include seven steps:

1. Understanding the Client's Personal and Financial Circumstances
2. Identifying and Selecting Goals
3. Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action
4. Developing the Financial Planning Recommendation(s)
5. Presenting the Financial Planning Recommendation(s)
6. Implementing the Financial Planning Recommendation(s)
7. Monitoring Progress and Updating

Section D of the *Code and Standards* sets forth the three Duties Owed to Firms and Subordinates:

1. Use Reasonable Care When Supervising
2. Comply with Lawful Objectives of CFP® Professional's Firm
3. Provide Notice of Public Discipline

Among other changes in this section, the third standard includes a newly expanded requirement to advise the CFP® Professional's Firm, in writing, of any public discipline imposed by CFP Board.

Section E sets forth the Duties Owed to CFP Board. This section preserves the current prohibition against engaging in conduct that reflects adversely on a CFP® professional's integrity or fitness, upon the CFP® marks, or upon the profession. CFP Board identifies five types of conduct that CFP Board's Disciplinary and Ethics Commission (DEC) has determined violate this standard. This section then delineates 14 reportable events for which a CFP® professional must provide written notice to CFP Board within 30 calendar days. Section E also requires a CFP® professional to provide CFP Board with a narrative statement describing the reportable matter.

CFP Board's list of reportable events is similar to, but not the same as, the events that must be reported to the SEC and FINRA. Finally, a CFP® professional is required to cooperate with CFP Board and to comply with the *Terms and Conditions of Certification and Trademark License*.

Section F contains a Prohibition on Circumvention, which provides that a CFP® professional may not do indirectly, or through or by another person, any act or thing that the *Code and Standards* prohibits the CFP® professional from doing directly.

The *Code and Standards* concludes with a Glossary, which contains definitions of fourteen terms that appear in multiple sections of the document.

CFP Board has developed a Side-by-Side comparison document that compares the *Standards of Professional Conduct*, which applies through September 30, 2019, to the *Code and Standards*, which applies beginning on October 1, 2019.

Question G.4: How does the new *Code and Standards* relate to federal and state statutes, rules, regulations and case law with respect to the obligations of a CFP® professional?

Answer G.4: The new *Code and Standards* requires a CFP® professional to comply with the laws, rules, and regulations governing Professional Services, and prohibits a CFP® professional from intentionally or recklessly participating or assisting in another person's violations of the *Code and Standards* or the laws, rules, or regulations governing Professional Services. (See Standard A.9.) However, CFP® certification represents a commitment to a higher standard. While all practitioners must comply with the law, under certain circumstances, the *Code and Standards* may contain requirements that are in addition to those contained in existing laws or regulations. Therefore, compliance with the law does not always achieve compliance with CFP Board's *Code and Standards*.

Question G.5: Will CFP Board apply the new *Code and Standards* differently for CFP® professionals with different licenses, registrations, or roles (such as registered representatives, bankers, investment adviser representatives, and insurance agents)?

Answer G.5: No. The new *Code and Standards* applies to all CFP® professionals equally.

Question G.6: Does the new *Code and Standards* apply to those who hold CFP® certification but who do not display the CFP® marks or hold themselves out as financial planners?

Answer G.6: Yes. A CFP® professional is obligated to abide by CFP Board's new *Code and Standards*, irrespective of whether the CFP® marks appear on the CFP® professional's business cards or stationery. Removal of the CFP® marks from one's business cards or stationery does not relieve a CFP® professional of the obligation to follow the *Code and Standards*.

Question G.7: Are firms required to ensure that their employees and representatives who hold the CFP® certification adhere to CFP Board's ethical standards?

Answer G.7: No. CFP Board certifies individuals, not firms. As a condition of CFP® certification, CFP® professionals are required to abide by CFP Board's new *Code and Standards*.

Question G.8: What is the relationship between CFP Board, a CFP® Professional, a CFP® Professional's Firm, and a CFP® Professional's Firm's Clients?

Answer G.8: CFP Board is a 501(c)(3) organization whose mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for competent and ethical personal financial planning. CFP Board issues the CFP® certification to individuals ("CFP® professional") who satisfy CFP Board's certification requirements.

The Relationship Between CFP Board and a CFP® Professional: The relationship between CFP Board and each CFP® professional is governed by the *Terms and Conditions of Certification and Trademark License*. In the *Terms and Conditions*, CFP Board certifies a CFP® professional as having satisfied CFP Board's requirements for certification ("Certification"), grants a CFP® professional a Trademark License to use the Certification Marks, and sets forth other provisions that govern the relationship between CFP Board and a CFP® professional, including the requirement that each CFP® professional comply with CFP Board's *Code of Ethics and Standards of Conduct*, which has an effective date of October 1, 2019 and an enforcement date of June 30, 2020. The *Code and Standards* reflects the commitment that a CFP® professional makes to CFP Board. Among other things, the *Code and Standards* includes a Fiduciary Duty that requires a CFP® professional to act as a fiduciary,

and therefore, act in the best interests of the Client, at all times when providing Financial Advice to a Client. Therefore, a CFP® professional makes a commitment to CFP Board that, when providing Financial Advice to a Client, the CFP® professional will provide Professional Services that satisfy the Fiduciary Duty.

The Relationship Between CFP Board and a CFP® Professional's Firm: CFP® professionals often work at financial services firms. CFP Board does not certify firms; therefore, the *Code and Standards* does not establish requirements for firms. However, CFP Board does expect that a CFP® Professional's Firm will support CFP® certification and will allow a CFP® professional to comply with the *Code and Standards*.

The Relationship Between CFP Board and a CFP® Professional's Firm's Clients: A CFP® professional and the CFP® Professional's Firm also have relationships with Clients. As noted above, the *Code and Standards* reflects the commitment that a CFP® professional makes to CFP Board. While a CFP® professional is required to comply with the *Code and Standards*, including the Fiduciary Duty, a CFP® professional and the CFP® Professional's Firm are not required to incorporate the Fiduciary Duty into the Client Engagement or refer to the Fiduciary Duty in Client communications. As was the case with the prior *Standards of Professional Conduct*, the *Code and Standards* is not designed to be a basis for civil liability. Clients of a CFP® professional and other third parties are not intended to be considered third-party beneficiaries of a CFP® professional's agreement with CFP Board to adhere to the *Code and Standards*. CFP Board enforces the *Code and Standards* through a peer-review process set forth in CFP Board's *Procedural Rules* that is credible to the public and fair to those whose conduct CFP Board is evaluating. In the event CFP Board finds a violation of the *Code and Standards* and issues a public sanction, CFP Board will publish the decision in a press release and on CFP Board's website.

Question G.9: May a CFP® professional who is a registered representative of a broker dealer satisfy CFP Board's Fiduciary Duty?

Answer G.9: Yes. A CFP® professional may satisfy CFP Board's Fiduciary Duty when working in any business model, including when working as a registered representative of a broker dealer and earning Sales-Related Compensation. In those business models where CFP Board's Fiduciary Duty exceeds the legal and regulatory requirements of that business model, a CFP® professional is required to satisfy CFP Board's Fiduciary Duty, and therefore, exceed the applicable legal and regulatory requirements.

Question G.10: Does the new *Code and Standards* increase civil liability for CFP® professionals?

Answer G.10: CFP Board developed the new *Code and Standards* to be an enforceable set of requirements that CFP Board can apply to those who hold CFP® certification. It is not designed to be a basis for civil liability.

Clients of a CFP® professional and other third parties are not intended to be third-party beneficiaries of a CFP® professional's agreement with CFP Board to adhere to the *Code and Standards*.

CFP Board welcomes questions about the new *Code and Standards* and its application to specific situations. To submit a question, please contact CFP Board at SRC@CFPBoard.org.

CFP BOARD

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

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TAB G

CFA Institute

CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

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III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:
   - **a.** Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   - **b.** Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   - **c.** Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients. Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Participants in CFA Institute Programs. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

TAB H

STANDARDS OF PRACTICE HANDBOOK

2014
ELEVENTH EDITION



CFA Institute

Standards of Practice Handbook

ELEVENTH EDITION

2014



CFA Institute

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Preface

The *Standards of Practice Handbook* (*Handbook*) provides guidance to the people who grapple with real ethical dilemmas in the investment profession on a daily basis; the *Handbook* addresses the professional intersection where theory meets practice and where the concept of ethical behavior crosses from the abstract to the concrete. The *Handbook* is intended for a diverse and global audience: CFA Institute members navigating ambiguous ethical situations; supervisors and direct/indirect reports determining the nature of their responsibilities to each other, to existing and potential clients, and to the broader financial markets; and candidates preparing for the Chartered Financial Analyst (CFA) examinations.

Recent events in the global financial markets have tested the ethical mettle of financial market participants, including CFA Institute members. The standards taught in the CFA Program and by which CFA Institute members and candidates must abide represent timeless ethical principles and professional conduct for all market conditions. Through adherence to these standards, which continue to serve as the model for ethical behavior in the investment professional globally, each market participant does his or her part to improve the integrity and efficient operations of the financial markets.

The *Handbook* provides guidance in understanding the interconnectedness of the aspirational and practical principles and provisions of the Code of Ethics and Standards of Professional Conduct (Code and Standards). The Code contains high-level aspirational ethical principles that drive members and candidates to create a positive and reputable investment profession. The Standards contain practical ethical principles of conduct that members and candidates must follow to achieve the broader industry expectations. However, applying the principles individually may not capture the complexity of ethical requirements related to the investment industry. The Code and Standards should be viewed and interpreted as an interwoven tapestry of ethical requirements. Through members' and candidates' adherence to these principles as a whole, the integrity of and trust in the capital markets are improved.

Evolution of the CFA Institute Code of Ethics and Standards of Professional Conduct

Generally, changes to the Code and Standards over the years have been minor. CFA Institute has revised the language of the Code and Standards and occasionally added a new standard to address a prominent issue of the day. For instance, in 1992, CFA Institute added the standard addressing performance presentation to the existing list of standards.

Major changes came in 2005 with the ninth edition of the *Handbook*. CFA Institute adopted new standards, revised some existing standards, and reorganized the standards. The revisions were intended to clarify the requirements of

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the Code and Standards and effectively convey to its global membership what constitutes "best practice" in a number of areas relating to the investment profession.

The Code and Standards must be regularly reviewed and updated if they are to remain effective and continue to represent the highest ethical standards in the global investment industry. CFA Institute strongly believes that revisions of the Code and Standards are not undertaken for cosmetic purposes but to add value by addressing legitimate concerns and improving comprehension.

Changes to the Code and Standards have far-reaching implications for the CFA Institute membership, the CFA Program, and the investment industry as a whole. CFA Institute members and candidates are *required* to adhere to the Code and Standards. In addition, the Code and Standards are increasingly being adopted, in whole or in part, by firms and regulatory authorities. Their relevance goes well beyond CFA Institute members and candidates.

Standards of Practice Handbook

The periodic revisions of the Code and Standards have come in conjunction with updates of the *Standards of Practice Handbook*. The *Handbook* is the fundamental element of the ethics education effort of CFA Institute and the primary resource for guidance in interpreting and implementing the Code and Standards. The *Handbook* seeks to educate members and candidates on how to apply the Code and Standards to their professional lives and thereby benefit their clients, employers, and the investing public in general. The *Handbook* explains the purpose of the Code and Standards and how they apply in a variety of situations. The sections discuss and amplify each standard and suggest procedures to prevent violations.

Examples in the "Application of the Standard" sections are meant to illustrate how the standard applies to hypothetical but factual situations. The names contained in the examples are fictional and are not meant to refer to any actual person or entity. Unless otherwise stated (e.g., one or more people specifically identified), individuals in each example are CFA Institute members and holders of the CFA designation. Because factual circumstances vary so widely and often involve gray areas, the explanatory material and examples are not intended to be all inclusive. Many examples set forth in the application sections involve standards that have legal counterparts; ***members are strongly urged to discuss with their supervisors and legal and compliance departments the content of the Code and Standards and the members' general obligations under the Code and Standards.***

CFA Institute recognizes that the presence of any set of ethical standards may create a false sense of security unless the documents are fully understood, enforced, and made a meaningful part of everyday professional activities. The *Handbook* is intended to provide a useful frame of reference that suggests ethical professional behavior in the investment decision-making process. This book cannot cover every contingency or circumstance, however, and it does not attempt to do so. The development and interpretation of the Code and Standards are evolving processes; the Code and Standards will be subject to continuing refinement.

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Summary of Changes in the Eleventh Edition

The comprehensive review of the Code and Standards in 2005 resulted in principle requirements that remain applicable today. The review carried out for the eleventh edition focused on market practices that have evolved since the tenth edition. Along with updates to the guidance and examples within the *Handbook*, the eleventh edition includes an update to the Code of Ethics that embraces the members' role of maintaining the social contract between the industry and investors. Additionally, there are three changes to the Standards of Professional Conduct, which recognize the importance of proper supervision, clear communications with clients, and the expanding educational programs of CFA Institute.

Inclusion of Updated CFA Institute Mission

The CFA Institute Board of Governors approved an updated mission for the organization that is included in the Preamble to the Code and Standards. The new mission conveys the organization's conviction in the investment industry's role in the betterment of society at large.

Mission:

To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

Updated Code of Ethics Principle

One of the bullets in the Code of Ethics was updated to reflect the role that the capital markets have in the greater society. As members work to promote and maintain the integrity of the markets, their actions should also help maintain the social contract with investors.

Old:

Promote the integrity of and uphold the rules governing capital markets.

New:

Promote the integrity and viability of the global capital markets for the ultimate benefit of society.

New Standard Regarding Responsibilities of Supervisors [IV(C)]

The standard for members and candidates with supervision or authority over others within their firms was updated to bring about improvements in preventing illegal and unethical actions from occurring. The prior version of Standard IV(C) focused on the detection and prevention of violations. The updated version stresses broader compliance expectations, which include the detection and prevention aspects of the original version.

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Old:

Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

New:

Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

Additional Requirement under the Standard for Communication with Clients and Prospective Clients [V(B)]

Given the constant development of new and exotic financial instruments and strategies, the standard regarding communicating with clients now includes an implicit requirement to discuss the risks and limitations of recommendations being made to clients. The new principle and related guidance take into account the fact that levels of disclosure will differ between products and services. Members and candidates, along with their firms, must determine the specific disclosures their clients should receive while ensuring appropriate transparency of the individual firms' investment processes.

Addition:

Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

Modification to Standard VII(A)

Since this standard was developed, CFA Institute has launched additional educational programs. The updated standard not only maintains the integrity of the CFA Program but also expands the same ethical considerations when members or candidates participate in such programs as the CIPM Program and the Claritas Investment Certificate. Whether participating as a member assisting with the curriculum or an examination or as a sitting candidate within a program, we expect them to engage in these programs as they would participate in the CFA Program.

Old:

Conduct as Members and Candidates in the CFA Program

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

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New:

Conduct as Participants in CFA Institute Programs

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

General Guidance and Example Revision

The guidance and examples were updated to reflect practices and scenarios applicable to today's investment industry. Two concepts that appear frequently in the updates in this edition relate to the increased use of social media for business communications and the use of and reliance on the output of quantitative models. The use of social media platforms has increased significantly since the publication of the tenth edition. And although financial modeling is not new to the industry, this update reflects upon actions that are viewed as possible contributing factors to the financial crises of the past decade.

CFA Institute Professional Conduct Program

All CFA Institute members and candidates enrolled in the CFA Program are required to comply with the Code and Standards. The CFA Institute Board of Governors maintains oversight and responsibility for the Professional Conduct Program (PCP), which, in conjunction with the Disciplinary Review Committee (DRC), is responsible for enforcement of the Code and Standards. The DRC is a volunteer committee of CFA charterholders who serve on panels to review conduct and partner with Professional Conduct staff to establish and review professional conduct policies. The CFA Institute Bylaws and Rules of Procedure for Professional Conduct (Rules of Procedure) form the basic structure for enforcing the Code and Standards. The Professional Conduct division is also responsible for enforcing testing policies of other CFA Institute education programs as well as the professional conduct of Certificate in Investment Performance Measurement (CIPM) certificants.

Professional Conduct inquiries come from a number of sources. First, members and candidates must self-disclose on the annual Professional Conduct Statement all matters that question their professional conduct, such as involvement in civil litigation or a criminal investigation or being the subject of a written complaint. Second, written complaints received by Professional Conduct staff can bring about an investigation. Third, CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or another public source. Fourth, candidate conduct is monitored by proctors who complete reports on candidates suspected to have violated testing rules on exam day. Lastly, CFA Institute may also conduct analyses of scores and exam materials after the exam, as well as monitor online and social media to detect disclosure of confidential exam information.

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When an inquiry is initiated, the Professional Conduct staff conducts an investigation that may include requesting a written explanation from the member or candidate; interviewing the member or candidate, complaining parties, and third parties; and collecting documents and records relevant to the investigation. Upon reviewing the material obtained during the investigation, the Professional Conduct staff may conclude the inquiry with no disciplinary sanction, issue a cautionary letter, or continue proceedings to discipline the member or candidate. If the Professional Conduct staff believes a violation of the Code and Standards or testing policies has occurred, the member or candidate has the opportunity to reject or accept any charges and the proposed sanctions.

If the member or candidate does not accept the charges and proposed sanction, the matter is referred to a panel composed of DRC members. Panels review materials and presentations from Professional Conduct staff and from the member or candidate. The panel's task is to determine whether a violation of the Code and Standards or testing policies occurred and, if so, what sanction should be imposed.

Sanctions imposed by CFA Institute may have significant consequences; they include public censure, suspension of membership and use of the CFA designation, and revocation of the CFA charter. Candidates enrolled in the CFA Program who have violated the Code and Standards or testing policies may be suspended or prohibited from further participation in the CFA Program.

Adoption of the Code and Standards

The Code and Standards apply to individual members of CFA Institute and candidates in the CFA Program. CFA Institute does encourage firms to adopt the Code and Standards, however, as part of their code of ethics. Those who claim compliance should fully understand the requirements of each of the principles of the Code and Standards.

Once a party—nonmember or firm—ensures its code of ethics meets the principles of the Code and Standards, that party should make the following statement whenever claiming compliance:

> "[Insert name of party] claims compliance with the CFA Institute Code of Ethics and Standards of Professional Conduct. This claim has not been verified by CFA Institute."

CFA Institute welcomes public acknowledgement, when appropriate, that firms are complying with the CFA Institute Code of Ethics and Standards of Professional Conduct and encourages firms to notify us of the adoption plans. For firms that would like to distribute the Code and Standards to clients and potential clients, attractive one-page copies of the Code and Standards, including translations, are available on the CFA Institute website (www.cfainstitute.org).

CFA Institute has also published the Asset Manager Code of Professional Conduct, which is designed, in part, to help asset managers comply with the regulations mandating codes of ethics for investment advisers. Whereas the Code and Standards are aimed at individual investment professionals who are members of CFA Institute or candidates in the CFA Program, the Asset Manager Code was

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drafted specifically for firms. The Asset Manager Code provides specific, practical guidelines for asset managers in six areas: loyalty to clients, the investment process, trading, compliance, performance evaluation, and disclosure. The Asset Manager Code and the appropriate steps to acknowledge adoption or compliance can be found on the CFA Institute website (www.cfainstitute.org).

Acknowledgments

CFA Institute is a not-for-profit organization that is heavily dependent on the expertise and intellectual contributions of member volunteers. Members devote their time because they share a mutual interest in the organization's mission to promote and achieve ethical practice in the investment profession. CFA Institute owes much to the volunteers' abundant generosity and energy in extending ethical integrity.

The CFA Institute Standards of Practice Council (SPC), a group consisting of CFA charterholder volunteers from many different countries, is charged with maintaining and interpreting the Code and Standards and ensuring that they are effective. The SPC draws its membership from a broad spectrum of organizations in the securities field, including brokers, investment advisers, banks, and insurance companies. In most instances, the SPC members have important supervisory responsibilities within their firms.

The SPC continually evaluates the Code and Standards, as well as the guidance in the *Handbook*, to ensure that they are

- representative of high standards of professional conduct,
- relevant to the changing nature of the investment profession,
- globally applicable,
- sufficiently comprehensive, practical, and specific,
- enforceable, and
- testable for the CFA Program.

The SPC has spent countless hours reviewing and discussing revisions to the Code and Standards and updates to the guidance that make up the eleventh edition of the *Handbook*. Following is a list of the current and former members of the SPC who generously donated their time and energy to this effort.

James E. Hollis III, CFA, Chair
Rik Albrecht, CFA
Terence E. Burns, CFA
Laura Dagan, CFA
Samuel B. Jones, Jr., CFA
Ulrike Kaiser-Boeing, CFA
Jinliang (Jack) Li, CFA
Christopher C. Loop, CFA,
James M. Meeth, CFA
Guy G. Rutherfurd, Jr., CFA
Edouard Senechal, CFA
Wenliang (Richard) Wang, CFA
Peng Lian Wee, CFA

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Ethics and the Investment Industry

Society ultimately benefits from efficient markets where capital can freely flow to the most productive or innovative destination. Well-functioning capital markets efficiently match those needing capital with those seeking to invest their assets in revenue-generating ventures. In order for capital markets to be efficient, investors must be able to trust that the markets are fair and transparent and offer them the opportunity to be rewarded for the risk they choose to take. Laws, regulations, and enforcement play a vital role but are insufficient alone to guarantee fair and transparent markets. The markets depend on an ethical foundation to guide participants' judgment and behavior. CFA Institute maintains and promotes the Code of Ethics and Standards of Professional Conduct in order to create a culture of ethics for the ultimate benefit of society.

Why Ethics Matters

Ethics can be defined as a set of moral principles or rules of conduct that provide guidance for our behavior when it affects others. Widely acknowledged fundamental ethical principles include honesty, fairness, diligence, and care and respect for others. Ethical conduct follows those principles and balances self-interest with both the direct and the indirect consequences of that behavior for other people.

Not only does unethical behavior by individuals have serious personal consequences—ranging from job loss and reputational damage to fines and even jail—but unethical conduct from market participants, investment professionals, and those who service investors can damage investor trust and thereby impair the sustainability of the global capital markets as a whole. Unfortunately, there seems to be an unending parade of stories bringing to light accounting frauds and manipulations, Ponzi schemes, insider-trading scandals, and other misdeeds. Not surprisingly, this has led to erosion in public confidence in investment professionals. Empirical evidence from numerous surveys documents the low standing in the eyes of the investing public of banks and financial services firms—the very institutions that are entrusted with the economic well-being and retirement security of society.

Governments and regulators have historically tried to combat misconduct in the industry through regulatory reform, with various levels of success. Global capital markets are highly regulated to protect investors and other market participants. However, compliance with regulation alone is insufficient to fully earn investor trust. Individuals and firms must develop a "culture of integrity" that permeates all levels of operations and promotes the ethical principles of stewardship of investor assets and working in the best interests of clients, above and beyond strict compliance with the law. A strong ethical culture that helps honest, ethical people engage in ethical behavior will foster the trust of investors, lead to robust global capital markets, and ultimately benefit society. That is why ethics matters.

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Ethics, Society, and the Capital Markets

CFA Institute recently added the concept "for the ultimate benefit of society" to its mission. The premise is that we want to live in a socially, politically, and financially stable society that fosters individual well-being and welfare of the public. A key ingredient for this goal is global capital markets that facilitate the efficient allocation of resources so that the available capital finds its way to places where it most benefits that society. These investments are then used to produce goods and services, to fund innovation and jobs, and to promote improvements in standards of living. Indeed, such a function serves the interests of the society. Efficient capital markets, in turn, provide a host of benefits to those providing the investment capital. Investors are provided the opportunity to transfer and transform risk because the capital markets serve as an information exchange, create investment products, provide liquidity, and limit transaction costs.

However, a well-functioning and efficient capital market system is dependent on trust of the participants. If investors believe that capital market participants—investment professionals and firms—cannot be trusted with their financial assets or that the capital markets are unfair such that only insiders can be successful, they will be unlikely to invest or, at the very least, will require a higher risk premium. Decreased investment capital can reduce innovation and job creation and hurt the economy and society as a whole. Reduced trust in capital markets can also result in a less vibrant, if not smaller, investment industry.

Ethics for a global investment industry should be universal and ultimately support trust and integrity above acceptable local or regional customs and culture. Universal ethics for a global industry strongly supports the efficiency, values, and mission of the industry as a whole. Different countries may be at different stages of development in establishing standards of practice, but the end goal must be to achieve rules, regulations, and standards that support and promote fundamental ethical principles on a global basis.

Capital Market Sustainability and the Actions of One

Individuals and firms also have to look at the indirect impacts of their actions on the broader investment community. The increasingly interconnected nature of global finance brings to the fore an added consideration of market sustainability that was, perhaps, less appreciated in years past. In addition to committing to the highest levels of ethical behavior, today's investment professionals and their employers should consider the long-term health of the market as a whole.

As recent events have demonstrated, apparently isolated and unrelated decisions, however innocuous when considered on an individual basis, in aggregate can precipitate a market crisis. In an interconnected global economy and marketplace, each participant should strive to be aware of how his or her actions or the products he or she distributes may have an impact on capital market participants in other regions or countries.

Investment professionals should consider how their investment decision-making processes affect the global financial markets in the broader context of how they apply

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their ethical and professional obligations. Those in positions of authority have a special responsibility to consider the broader context of market sustainability in their development and approval of corporate policies, particularly those involving risk management and product development. In addition, corporate compensation strategies should not encourage otherwise ethically sound individuals to engage in unethical or questionable conduct for financial gain. Ethics, sustainability, and properly functioning capital markets are components of the same concept of protecting the best interests of all. To always place the interests of clients ahead of both investment professionals' own interests and those of their employer remains a key ethos.

The Relationship between Ethics and Regulations

Some equate ethical behavior with legal behavior: If you are following the law, you must be acting appropriately. Ethical principles, like laws and regulations, prescribe appropriate constraints on our natural tendency to pursue self-interest that could harm the interests of others. Laws and regulations often attempt to guide people toward ethical behavior, but they do not cover all unethical behavior. Ethical behavior is often distinguished from legal conduct by describing legal behavior as what is required and ethical behavior as conduct that is morally correct. Ethical principles go beyond that which is legally sufficient and encompass what is the right thing to do.

Given many regulators' lack of sufficient resources to enforce well-conceived rules and regulations, relying on a regulatory framework to lead the charge in establishing ethical behavior has its challenges. Therefore, reliance on compliance with laws and regulation alone is insufficient to ensure ethical behavior of investment professionals or to create a truly ethical culture in the industry.

The recent past has shown us that some individuals will succeed at circumventing the regulatory rules for their personal gain. Only the application of strong ethical principles, at both the individual level and the firm level, will limit abuses. Knowing the rules or regulations to apply in a particular situation, although important, may not be sufficient to ensure ethical conduct. Individuals must be able both to recognize areas that are prone to ethical pitfalls and to identify and process those circumstances and influences that can impair ethical judgment.

Applying an Ethical Framework

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct. When faced with an ethical dilemma, individuals must have a well-developed set of principles; otherwise, their thought processes can lead to, at best, equivocation and indecision and, at worst, fraudulent conduct and destruction of the public trust. Establishing an ethical framework for an internal thought process prior to deciding to act is a crucial step in engaging in ethical conduct.

Most investment professionals are used to making decisions from a business (profit/loss) outlook. But given the importance of ethical behavior in carrying out

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professional responsibilities, it is critical to also analyze decisions and potential conduct from an ethical perspective. Utilizing a framework for ethical decision making will help investment professionals effectively examine their conduct in the context of conflicting interests common to their professional obligations (e.g., researching and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze their conduct in a way that meets high standards of ethical behavior.

An ethical decision-making framework can come in many forms but should provide investment professionals with a tool for following the principles of the firm's code of ethics. Through analyzing the particular circumstances of each decision, investment professionals are able to determine the best course of action to fulfill their responsibilities in an ethical manner.

Commitment to Ethics by Firms

A firm's code of ethics risks becoming a largely ignored, dusty compilation if it is not truly integrated into the fabric of the business. The ability to relate an ethical decision-making framework to a firm's code of ethics allows investment professionals to bring the aspirations and principles of the code of ethics to life—transforming it from a compliance exercise to something that is at the heart of a firm's culture.

An investment professional's natural desire to "do the right thing" must be reinforced by building a culture of integrity in the workplace. Development, maintenance, and demonstration of a strong culture of integrity within the firm by senior management may be the single most important factor in promoting ethical behavior among the firm's employees. Adopting a code that clearly lays out the ethical principles that guide the thought processes and conduct the firm expects from its employees is a critical first step. But a code of ethics, while necessary, is insufficient.

Simply nurturing an inclination to do right is no match for the multitude of daily decisions that investment managers make. We need to exercise ethical decision-making skills to develop the muscle memory necessary for fundamentally ethical people to make good decisions despite the reality of agent conflicts. Just as coaching and practice transform our natural ability to run across a field into the technique and endurance required to run a race, teaching, reinforcing, and practicing ethical decision-making skills prepare us to confront the hard issues effectively. It is good for business, individuals, firms, the industry, and the markets, as well as society as a whole, to engage in the investment management profession in a highly ethical manner.

Ethical Commitment of CFA Institute

An important goal of CFA Institute is to ensure that the organization and its members and candidates develop, promote, and follow the highest ethical standards in the investment industry. The CFA Institute Code of Ethics (Code) and Standards of Professional Conduct (Standards) are the foundation supporting the organization's quest to uphold the industry's highest standards of individual and corporate practice and to help serve the greater good. The Code is a set of principles that define the overarching conduct CFA Institute expects from its members and CFA

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Program candidates. The Code works in tandem with the Standards, which outline professional conduct that constitutes fair and ethical business practices.

For more than 50 years, CFA Institute members and candidates have been required to abide by the organization's Code and Standards. Periodically, CFA Institute has revised and updated its Code and Standards to ensure that they remain relevant to the changing nature of the investment profession and representative of the highest standard of professional conduct. Within this *Handbook*, CFA Institute addresses ethical principles for the profession, including individual professionalism; responsibilities to capital markets, clients, and employers; ethics involved in investment analysis, recommendations, and actions; and possible conflicts of interest. Although the investment world has become a far more complex place since the first publication of the *Standard of Practice Handbook*, distinguishing right from wrong remains the paramount principle of the Code and Standards.

New challenges will continually arise for members and candidates in applying the Code and Standards because many decisions are not unambiguously right or wrong. The dilemma exists because the choice between right and wrong is not always clear. Even well-intentioned investment professionals can find themselves in circumstances that may tempt them to cut corners. Situational influences can overpower the best of intentions.

CFA Institute has made a significant commitment to providing members and candidates with the resources to extend and deepen their understanding of how to appropriately apply the principles of the Code and Standards. The product offerings from CFA Institute offer a wealth of material. Through publications, conferences, webcasts, and podcasts, the ethical challenges of investment professionals are brought to light. Archived issues of these items are available on the CFA Institute website (www.cfainstitute.org).

By reviewing these resources and discussing with their peers, market participants can further enhance their abilities to apply an effective ethical decision-making framework. In time, this should help restore some of the trust recently lost by investors.

Markets function to an important extent on trust. Recent events have shown the fragility of this foundation and the devastating consequences that can ensue when it is fundamentally questioned. Investment professionals should remain mindful of the long-term health of financial markets and incorporate this concern for the market's sustainability in their investment decision making. CFA Institute and the Standards of Practice Council hope this edition of the *Handbook* will assist and guide investment professionals in meeting the ethical demands of the highly interconnected global capital markets for the ultimate benefit of society.

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CFA Institute Code of Ethics and Standards of Professional Conduct

Preamble

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst [CFA] designation) and CFA candidates have the personal responsibility to embrace and uphold the provisions of the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

The Code of Ethics

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

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Standards of Professional Conduct

I. PROFESSIONALISM

A. Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation

Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct

Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information

Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

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III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care

Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing

Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:
   a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation

When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

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E. Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty

In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements

Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors

Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis

Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze

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investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts

Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions

Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees

Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Participants in CFA Institute Programs

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

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B. Reference to CFA Institute, the CFA Designation, and the CFA Program

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

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Standard I: Professionalism

Standard I(A) Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

Guidance

Highlights:

- *Relationship between the Code and Standards and Applicable Law*
- *Participation in or Association with Violations by Others*
- *Investment Products and Applicable Laws*

Members and candidates must understand the applicable laws and regulations of the countries and jurisdictions where they engage in professional activities. These activities may include, but are not limited to, trading of securities or other financial instruments, providing investment advice, conducting research, or performing other investment services. On the basis of their reasonable and good faith understanding, members and candidates must comply with the laws and regulations that directly govern their professional activities and resulting outcomes and that protect the interests of the clients.

When questions arise, members and candidates should know their firm's policies and procedures for accessing compliance guidance. This standard does not require members and candidates to become experts, however, in compliance. Additionally, members and candidates are not required to have detailed knowledge of or be experts on all the laws that could potentially govern their activities.

During times of changing regulations, members and candidates must remain vigilant in maintaining their knowledge of the requirements for their professional activities. New financial products and processes, along with uncovered ethical missteps, create an environment for recurring and potentially wide-ranging regulatory changes. Members and candidates are also continually provided improved and enhanced methods of communicating with both clients and potential clients, such as mobile applications and web-based social networking platforms. As new local, regional, and global requirements are updated to address these and other

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changes, members, candidates, and their firms must adjust their procedures and practices to remain in compliance.

Relationship between the Code and Standards and Applicable Law

Some members or candidates may live, work, or provide investment services to clients living in a country that has no law or regulation governing a particular action or that has laws or regulations that differ from the requirements of the Code and Standards. When applicable law and the Code and Standards require different conduct, members and candidates must follow the more strict of the applicable law or the Code and Standards.

"Applicable law" is the law that governs the member's or candidate's conduct. Which law applies will depend on the particular facts and circumstances of each case. The "more strict" law or regulation is the law or regulation that imposes greater restrictions on the action of the member or candidate or calls for the member or candidate to exert a greater degree of action that protects the interests of investors. For example, applicable law or regulation may not require members and candidates to disclose referral fees received from or paid to others for the recommendation of investment products or services. Because the Code and Standards impose this obligation, however, members and candidates must disclose the existence of such fees.

Members and candidates must adhere to the following principles:

- Members and candidates must comply with applicable laws or regulations related to their professional activities.
- Members and candidates must not engage in conduct that constitutes a violation of the Code and Standards, even though it may otherwise be legal.
- In the absence of any applicable law or regulation or when the Code and Standards impose a higher degree of responsibility than applicable laws and regulations, members and candidates must adhere to the Code and Standards. Applications of these principles are outlined in **Exhibit 1**.

The applicable laws governing the responsibilities of a member or candidate should be viewed as the minimal threshold of acceptable actions. When members and candidates take actions that exceed the minimal requirements, they further support the conduct required of Standard I(A).

CFA Institute members are obligated to abide by the CFA Institute Articles of Incorporation, Bylaws, Code of Ethics, Standards of Professional Conduct, Rules of Procedure, Membership Agreement, and other applicable rules promulgated by CFA Institute, all as amended periodically. CFA candidates who are not members must also abide by these documents (except for the Membership Agreement) as well as rules and regulations related to the administration of the CFA examination, the Candidate Responsibility Statement, and the Candidate Pledge.

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Participation in or Association with Violations by Others

Members and candidates are responsible for violations in which they *knowingly* participate or assist. Although members and candidates are presumed to have knowledge of all applicable laws, rules, and regulations, CFA Institute acknowledges that members may not recognize violations if they are not aware of all the facts giving rise to the violations. Standard I(A) applies when members and candidates know or should know that their conduct may contribute to a violation of applicable laws, rules, or regulations or the Code and Standards.

If a member or candidate has reasonable grounds to believe that imminent or ongoing client or employer activities are illegal or unethical, the member or candidate must dissociate, or separate, from the activity. In extreme cases, dissociation may require a member or candidate to leave his or her employment. Members and candidates may take the following intermediate steps to dissociate from ethical violations of others when direct discussions with the person or persons committing the violation are unsuccessful. The first step should be to attempt to stop the behavior by bringing it to the attention of the employer through a supervisor or the firm's compliance department. If this attempt is unsuccessful, then members and candidates have a responsibility to step away and dissociate from the activity. Dissociation practices will differ on the basis of the member's or candidate's role in the investment industry. It may include removing one's name from written reports or recommendations, asking for a different assignment, or refusing to accept a new client or continue to advise a current client. Inaction combined with continuing association with those involved in illegal or unethical conduct may be construed as participation or assistance in the illegal or unethical conduct.

CFA Institute strongly encourages members and candidates to report potential violations of the Code and Standards committed by fellow members and candidates. Although a failure to report is less likely to be construed as a violation than a failure to dissociate from unethical conduct, the impact of inactivity on the integrity of capital markets can be significant. Although the Code and Standards do not compel members and candidates to report violations to their governmental or regulatory organizations unless such disclosure is mandatory under applicable law (voluntary reporting is often referred to as whistleblowing), such disclosure may be prudent under certain circumstances. Members and candidates should consult their legal and compliance advisers for guidance.

Additionally, CFA Institute encourages members, nonmembers, clients, and the investing public to report violations of the Code and Standards by CFA Institute members or CFA candidates by submitting a complaint in writing to the CFA Institute Professional Conduct Program via e-mail (pcprogram@cfainstitute.org) or the CFA Institute website (www.cfainstitute.org).

Investment Products and Applicable Laws

Members and candidates involved in creating or maintaining investment services or investment products or packages of securities and/or derivatives should be mindful of where these products or packages will be sold as well as their places of

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origination. The applicable laws and regulations of the countries or regions of origination and expected sale should be understood by those responsible for the supervision of the services or creation and maintenance of the products or packages. Members or candidates should make reasonable efforts to review whether associated firms that are distributing products or services developed by their employing firm also abide by the laws and regulations of the countries and regions of distribution. Members and candidates should undertake the necessary due diligence when transacting cross-border business to understand the multiple applicable laws and regulations in order to protect the reputation of their firm and themselves.

Given the complexity that can arise with business transactions in today's market, there may be some uncertainty surrounding which laws or regulations are considered applicable when activities are being conducted in multiple jurisdictions. Members and candidates should seek the appropriate guidance, potentially including the firm's compliance or legal departments and legal counsel outside the organization, to gain a reasonable understanding of their responsibilities and how to implement them appropriately.

Exhibit 1 Global Application of the Code and Standards

Members and candidates who practice in multiple jurisdictions may be subject to varied securities laws and regulations. If applicable law is stricter than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, they must adhere to the Code and Standards. The following chart provides illustrations involving a member who may be subject to the securities laws and regulations of three different types of countries:

NS: country with no securities laws or regulations
LS: country with ***less*** strict securities laws and regulations than the Code and Standards
MS: country with ***more*** strict securities laws and regulations than the Code and Standards

Applicable Law	Duties	Explanation
Member resides in NS country, does business in LS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, the member must adhere to the Code and Standards.

(continued)

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Exhibit 1 Global Application of the Code and Standards (continued)

Applicable Law	Duties	Explanation
Member resides in NS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in LS country, does business in NS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in LS country, does business in NS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and there is no local law, the member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the law of MS country.	Because applicable law of the locality where the business is conducted governs and local law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in MS country, does business in LS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.

(continued)

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Exhibit 1 Global Application of the Code and Standards (continued)

Applicable Law	Duties	Explanation
Member resides in MS country, does business in LS country; MS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and local law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of LS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the client's home country governs (which is less strict than the Code and Standards), member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of MS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the law of MS country.	Because applicable law states that the law of the client's home country governs and the law of the client's home country is stricter than the Code and Standards, the member must adhere to the more strict applicable law.

Recommended Procedures for Compliance

Members and Candidates

Suggested methods by which members and candidates can acquire and maintain understanding of applicable laws, rules, and regulations include the following:

- *Stay informed*: Members and candidates should establish or encourage their employers to establish a procedure by which employees are regularly informed about changes in applicable laws, rules, regulations, and case law. In many instances, the employer's compliance department or legal counsel can provide such information in the form of memorandums distributed to employees in the organization. Also, participation in an internal or external continuing education program is a practical method of staying current.

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- *Review procedures*: Members and candidates should review, or encourage their employers to review, the firm's written compliance procedures on a regular basis to ensure that the procedures reflect current law and provide adequate guidance to employees about what is permissible conduct under the law and/or the Code and Standards. Recommended compliance procedures for specific items of the Code and Standards are discussed in this *Handbook* in the "Guidance" sections associated with each standard.
- *Maintain current files*: Members and candidates should maintain or encourage their employers to maintain readily accessible current reference copies of applicable statutes, rules, regulations, and important cases.

Distribution Area Laws

Members and candidates should make reasonable efforts to understand the applicable laws—both country and regional—for the countries and regions where their investment products are developed and are most likely to be distributed to clients.

Legal Counsel

When in doubt about the appropriate action to undertake, it is recommended that a member or candidate seek the advice of compliance personnel or legal counsel concerning legal requirements. If a potential violation is being committed by a fellow employee, it may also be prudent for the member or candidate to seek the advice of the firm's compliance department or legal counsel.

Dissociation

When dissociating from an activity that violates the Code and Standards, members and candidates should document the violation and urge their firms to attempt to persuade the perpetrator(s) to cease such conduct. To dissociate from the conduct, a member or candidate may have to resign his or her employment.

Firms

The formality and complexity of compliance procedures for firms depend on the nature and size of the organization and the nature of its investment operations. Members and candidates should encourage their firms to consider the following policies and procedures to support the principles of Standard I(A):

- *Develop and/or adopt a code of ethics*: The ethical culture of an organization starts at the top. Members and candidates should encourage their supervisors or managers to adopt a code of ethics. Adhering to a code of ethics facilitates solutions when people face ethical dilemmas and can prevent the need for employees to resort to a "whistleblowing" solution publicly alleging concealed misconduct. CFA Institute has published the *Asset Manager Code of Professional Conduct*, which firms may adopt or use as the basis for their codes (visit www.cfainstitute.org).

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- *Provide information on applicable laws*: Pertinent information that highlights applicable laws and regulations might be distributed to employees or made available in a central location. Information sources might include primary information developed by the relevant government, governmental agencies, regulatory organizations, licensing agencies, and professional associations (e.g., from their websites); law firm memorandums or newsletters; and association memorandums or publications (e.g., *CFA Institute Magazine*).
- *Establish procedures for reporting violations*: Firms might provide written protocols for reporting suspected violations of laws, regulations, or company policies.

Application of the Standard

Example 1 (Notification of Known Violations):

Michael Allen works for a brokerage firm and is responsible for an underwriting of securities. A company official gives Allen information indicating that the financial statements Allen filed with the regulator overstate the issuer's earnings. Allen seeks the advice of the brokerage firm's general counsel, who states that it would be difficult for the regulator to prove that Allen has been involved in any wrongdoing.

> *Comment*: Although it is recommended that members and candidates seek the advice of legal counsel, the reliance on such advice does not absolve a member or candidate from the requirement to comply with the law or regulation. Allen should report this situation to his supervisor, seek an independent legal opinion, and determine whether the regulator should be notified of the error.

Example 2 (Dissociating from a Violation):

Lawrence Brown's employer, an investment banking firm, is the principal underwriter for an issue of convertible debentures by the Courtney Company. Brown discovers that the Courtney Company has concealed severe third-quarter losses in its foreign operations. The preliminary prospectus has already been distributed.

> *Comment*: Knowing that the preliminary prospectus is misleading, Brown should report his findings to the appropriate supervisory persons in his firm. If the matter is not remedied and Brown's employer does not dissociate from the underwriting, Brown should sever all his connections with the underwriting. Brown should also seek legal advice to determine whether additional reporting or other action should be taken.

Example 3 (Dissociating from a Violation):

Kamisha Washington's firm advertises its past performance record by showing the 10-year return of a composite of its client accounts. Washington discovers, however, that the composite omits the performance of accounts that have left the firm

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during the 10-year period, whereas the description of the composite indicates the inclusion of all firm accounts. This omission has led to an inflated performance figure. Washington is asked to use promotional material that includes the erroneous performance number when soliciting business for the firm.

> *Comment*: Misrepresenting performance is a violation of the Code and Standards. Although she did not calculate the performance herself, Washington would be assisting in violating Standard I(A) if she were to use the inflated performance number when soliciting clients. She must dissociate herself from the activity. If discussing the misleading number with the person responsible is not an option for correcting the problem, she can bring the situation to the attention of her supervisor or the compliance department at her firm. If her firm is unwilling to recalculate performance, she must refrain from using the misleading promotional material and should notify the firm of her reasons. If the firm insists that she use the material, she should consider whether her obligation to dissociate from the activity requires her to seek other employment.

Example 4 (Following the Highest Requirements):

James Collins is an investment analyst for a major Wall Street brokerage firm. He works in a developing country with a rapidly modernizing economy and a growing capital market. Local securities laws are minimal—in form and content—and include no punitive prohibitions against insider trading.

> *Comment*: Collins must abide by the requirements of the Code and Standards, which might be more strict than the rules of the developing country. He should be aware of the risks that a small market and the absence of a fairly regulated flow of information to the market represent to his ability to obtain information and make timely judgments. He should include this factor in formulating his advice to clients. In handling material nonpublic information that accidentally comes into his possession, he must follow Standard II(A)–Material Nonpublic Information.

Example 5 (Following the Highest Requirements):

Laura Jameson works for a multinational investment adviser based in the United States. Jameson lives and works as a registered investment adviser in the tiny, but wealthy, island nation of Karramba. Karramba's securities laws state that no investment adviser registered and working in that country can participate in initial public offerings (IPOs) for the adviser's personal account. Jameson, believing that, as a US citizen working for a US-based company, she should comply only with US law, has ignored this Karrambian law. In addition, Jameson believes that as a charterholder, as long as she adheres to the Code and Standards requirement that she disclose her participation in any IPO to her employer and clients when such ownership creates a conflict of interest, she is meeting the highest ethical requirements.

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Comment: Jameson is in violation of Standard I(A). As a registered investment adviser in Karramba, Jameson is prevented by Karrambian securities law from participating in IPOs regardless of the law of her home country. In addition, because the law of the country where she is working is stricter than the Code and Standards, she must follow the stricter requirements of the local law rather than the requirements of the Code and Standards.

Example 6 (Laws and Regulations Based on Religious Tenets):

Amanda Janney is employed as a fixed-income portfolio manager for a large international firm. She is on a team within her firm that is responsible for creating and managing a fixed-income hedge fund to be sold throughout the firm's distribution centers to high-net-worth clients. Her firm receives expressions of interest from potential clients from the Middle East who are seeking investments that comply with Islamic law. The marketing and promotional materials for the fixed-income hedge fund do not specify whether or not the fund is a suitable investment for an investor seeking compliance with Islamic law. Because the fund is being distributed globally, Janney is concerned about the reputation of the fund and the firm and believes disclosure of whether or not the fund complies with Islamic law could help minimize potential mistakes with placing this investment.

Comment: As the financial market continues to become globalized, members and candidates will need to be aware of the differences between cultural and religious laws and requirements as well as the different governmental laws and regulations. Janney and the firm could be proactive in their efforts to acknowledge areas where the new fund may not be suitable for clients.

Example 7 (Reporting Potential Unethical Actions):

Krista Blume is a junior portfolio manager for high-net-worth portfolios at a large global investment manager. She observes a number of new portfolios and relationships coming from a country in Europe where the firm did not have previous business and is told that a broker in that country is responsible for this new business. At a meeting on allocation of research resources to third-party research firms, Blume notes that this broker has been added to the list and is allocated payments for research. However, she knows the portfolios do not invest in securities in the broker's country, and she has not seen any research come from this broker. Blume asks her supervisor about the name being on the list and is told that someone in marketing is receiving the research and that the name being on the list is OK. She believes that what may be going on is that the broker is being paid for new business through the inappropriate research payments, and she wishes to dissociate from the misconduct.

Comment: Blume should follow the firm's policies and procedures for reporting potential unethical activity, which may include discussions with

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her supervisor or someone in a designated compliance department. She should communicate her concerns appropriately while advocating for disclosure between the new broker relationship and the research payments.

Example 8 (Failure to Maintain Knowledge of the Law):

Colleen White is excited to use new technology to communicate with clients and potential clients. She recently began posting investment information, including performance reports and investment opinions and recommendations, to her Facebook page. In addition, she sends out brief announcements, opinions, and thoughts via her Twitter account (for example, "Prospects for future growth of XYZ company look good! #makingmoney4U"). Prior to White's use of these social media platforms, the local regulator had issued new requirements and guidance governing online electronic communication. White's communications appear to conflict with the recent regulatory announcements.

Comment: White is in violation of Standard I(A) because her communications do not comply with the existing guidance and regulation governing use of social media. White must be aware of the evolving legal requirements pertaining to new and dynamic areas of the financial services industry that are applicable to her. She should seek guidance from appropriate, knowledgeable, and reliable sources, such as her firm's compliance department, external service providers, or outside counsel, unless she diligently follows legal and regulatory trends affecting her professional responsibilities.

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Standard I(B) Independence and Objectivity

> Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

Guidance

Highlights:

- *Buy-Side Clients*
- *Fund Manager and Custodial Relationships*
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Standard I(B) states the responsibility of CFA Institute members and candidates in the CFA Program to maintain independence and objectivity so that their clients will have the benefit of their work and opinions unaffected by any potential conflict of interest or other circumstance adversely affecting their judgment. Every member and candidate should endeavor to avoid situations that could cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action.

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of benefits. Corporations may seek expanded research coverage, issuers and underwriters may wish to promote new securities offerings, brokers may want to increase commission business, and independent rating agencies may be influenced by the company requesting the rating. Benefits may include gifts, invitations to lavish functions, tickets, favors, or job referrals. One type of benefit is the allocation of shares in oversubscribed IPOs to investment managers for their personal accounts. This practice affords managers the opportunity to make quick profits that may not be available to their clients. Such a practice is prohibited under Standard I(B). Modest gifts and entertainment are acceptable,

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but special care must be taken by members and candidates to resist subtle and not-so-subtle pressures to act in conflict with the interests of their clients. Best practice dictates that members and candidates reject any offer of gift or entertainment that could be expected to threaten their independence and objectivity.

Receiving a gift, benefit, or consideration from a *client* can be distinguished from gifts given by entities seeking to influence a member or candidate to the detriment of other clients. In a client relationship, the client has already entered some type of compensation arrangement with the member, candidate, or his or her firm. A gift from a client could be considered supplementary compensation. The potential for obtaining influence to the detriment of other clients, although present, is not as great as in situations where no compensation arrangement exists. When possible, prior to accepting "bonuses" or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients. If notification is not possible prior to acceptance, members and candidates must disclose to their employer benefits previously accepted from clients. Disclosure allows the employer of a member or candidate to make an independent determination about the extent to which the gift may affect the member's or candidate's independence and objectivity.

Members and candidates may also come under pressure from their own firms to, for example, issue favorable research reports or recommendations for certain companies with potential or continuing business relationships with the firm. The situation may be aggravated if an executive of the company sits on the bank or investment firm's board and attempts to interfere in investment decision making. Members and candidates acting in a sales or marketing capacity must be especially mindful of their objectivity in promoting appropriate investments for their clients.

Left unmanaged, pressures that threaten independence place research analysts in a difficult position and may jeopardize their ability to act independently and objectively. One of the ways that research analysts have coped with these pressures in the past is to use subtle and ambiguous language in their recommendations or to temper the tone of their research reports. Such subtleties are lost on some investors, however, who reasonably expect research reports and recommendations to be straightforward and transparent and to communicate clearly an analyst's views based on unbiased analysis and independent judgment.

Members and candidates are personally responsible for maintaining independence and objectivity when preparing research reports, making investment recommendations, and taking investment action on behalf of clients. Recommendations must convey the member's or candidate's true opinions, free of bias from internal or external pressures, and be stated in clear and unambiguous language.

Members and candidates also should be aware that some of their professional or social activities within CFA Institute or its member societies may subtly threaten their independence or objectivity. When seeking corporate financial support for conventions, seminars, or even weekly society luncheons, the members or candidates responsible for the activities should evaluate both the actual effect of

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such solicitations on their independence and whether their objectivity might be perceived to be compromised in the eyes of their clients.

Buy-Side Clients

One source of pressure on sell-side analysts is buy-side clients. Institutional clients are traditionally the primary users of sell-side research, either directly or with soft dollar brokerage. Portfolio managers may have significant positions in the security of a company under review. A rating downgrade may adversely affect the portfolio's performance, particularly in the short term, because the sensitivity of stock prices to ratings changes has increased in recent years. A downgrade may also affect the manager's compensation, which is usually tied to portfolio performance. Moreover, portfolio performance is subject to media and public scrutiny, which may affect the manager's professional reputation. Consequently, some portfolio managers implicitly or explicitly support sell-side ratings inflation.

Portfolio managers have a responsibility to respect and foster the intellectual honesty of sell-side research. Therefore, it is improper for portfolio managers to threaten or engage in retaliatory practices, such as reporting sell-side analysts to the covered company in order to instigate negative corporate reactions. Although most portfolio managers do not engage in such practices, the perception by the research analyst that a reprisal is possible may cause concern and make it difficult for the analyst to maintain independence and objectivity.

Fund Manager and Custodial Relationships

Research analysts are not the only people who must be concerned with maintaining their independence. Members and candidates who are responsible for hiring and retaining outside managers and third-party custodians should not accepts gifts, entertainment, or travel funding that may be perceived as impairing their decisions. The use of secondary fund managers has evolved into a common practice to manage specific asset allocations. The use of third-party custodians is common practice for independent investment advisory firms and helps them with trading capabilities and reporting requirements. Primary and secondary fund managers, as well as third-party custodians, often arrange educational and marketing events to inform others about their business strategies, investment process, or custodial services. Members and candidates must review the merits of each offer individually in determining whether they may attend yet maintain their independence.

Investment Banking Relationships

Some sell-side firms may exert pressure on their analysts to issue favorable research reports on current or prospective investment banking clients. For many of these firms, income from investment banking has become increasingly important to overall firm profitability because brokerage income has declined as a result of price competition. Consequently, firms offering investment banking services work hard to develop and maintain relationships with investment banking clients and prospects. These companies are often covered by the firm's research analysts because

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companies often select their investment banks on the basis of the reputation of their research analysts, the quality of their work, and their standing in the industry.

In some countries, research analysts frequently work closely with their investment banking colleagues to help evaluate prospective investment banking clients. In other countries, because of past abuses in managing the obvious conflicts of interest, regulators have established clear rules prohibiting the interaction of these groups. Although collaboration between research analysts and investment banking colleagues may benefit the firm and enhance market efficiency (e.g., by allowing firms to assess risks more accurately and make better pricing assumptions), it requires firms to carefully balance the conflicts of interest inherent in the collaboration. Having analysts work with investment bankers is appropriate only when the conflicts are adequately and effectively managed and disclosed. Firm managers have a responsibility to provide an environment in which analysts are neither coerced nor enticed into issuing research that does not reflect their true opinions. Firms should require public disclosure of actual conflicts of interest to investors.

Members, candidates, and their firms must adopt and follow perceived best practices in maintaining independence and objectivity in the corporate culture and protecting analysts from undue pressure by their investment banking colleagues. The "firewalls" traditionally built between these two functions must be managed to minimize conflicts of interest; indeed, enhanced firewall policies may go as far as prohibiting all communications between these groups. A key element of an enhanced firewall is separate reporting structures for personnel on the research side and personnel on the investment banking side. For example, investment banking personnel should not have any authority to approve, disapprove, or make changes to research reports or recommendations. Another element should be a compensation arrangement that minimizes the pressures on research analysts and rewards objectivity and accuracy. Compensation arrangements should not link analyst remuneration directly to investment banking assignments in which the analyst may participate as a team member. Firms should also regularly review their policies and procedures to determine whether analysts are adequately safeguarded and to improve the transparency of disclosures relating to conflicts of interest. The highest level of transparency is achieved when disclosures are prominent and specific rather than marginalized and generic.

Performance Measurement and Attribution

Members and candidates working within a firm's investment performance measurement department may also be presented with situations that challenge their independence and objectivity. As performance analysts, their analyses may reveal instances where managers may appear to have strayed from their mandate. Additionally, the performance analyst may receive requests to alter the construction of composite indices owing to negative results for a selected account or fund. The member or candidate must not allow internal or external influences to affect their independence and objectivity as they faithfully complete their performance calculation and analysis-related responsibilities.

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Public Companies

Analysts may be pressured to issue favorable reports and recommendations by the companies they follow. Not every stock is a "buy," and not every research report is favorable—for many reasons, including the cyclical nature of many business activities and market fluctuations. For instance, a "good company" does not always translate into a "good stock" rating if the current stock price is fully valued. In making an investment recommendation, the analyst is responsible for anticipating, interpreting, and assessing a company's prospects and stock price performance in a factual manner. Many company managers, however, believe that their company's stock is undervalued, and these managers may find it difficult to accept critical research reports or ratings downgrades. Company managers' compensation may also be dependent on stock performance.

Due diligence in financial research and analysis involves gathering information from a wide variety of sources, including public disclosure documents (such as proxy statements, annual reports, and other regulatory filings) and also company management and investor-relations personnel, suppliers, customers, competitors, and other relevant sources. Research analysts may justifiably fear that companies will limit their ability to conduct thorough research by denying analysts who have "negative" views direct access to company managers and/or barring them from conference calls and other communication venues. Retaliatory practices include companies bringing legal action against analysts personally and/or their firms to seek monetary damages for the economic effects of negative reports and recommendations. Although few companies engage in such behavior, the perception that a reprisal is possible is a reasonable concern for analysts. This concern may make it difficult for them to conduct the comprehensive research needed to make objective recommendations. For further information and guidance, members and candidates should refer to the CFA Institute publication *Best Practice Guidelines Governing Analyst/Corporate Issuer Relations* (www.cfainstitute.org).

Credit Rating Agency Opinions

Credit rating agencies provide a service by grading the fixed-income products offered by companies. Analysts face challenges related to incentives and compensation schemes that may be tied to the final rating and successful placement of the product. Members and candidates employed at rating agencies should ensure that procedures and processes at the agencies prevent undue influences from a sponsoring company during the analysis. Members and candidates should abide by their agencies' and the industry's standards of conduct regarding the analytical process and the distribution of their reports.

The work of credit rating agencies also raises concerns similar to those inherent in investment banking relationships. Analysts may face pressure to issue ratings at a specific level because of other services the agency offers companies—namely, advising on the development of structured products. The rating agencies need to develop the necessary firewalls and protections to allow the independent operations of their different business lines.

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When using information provided by credit rating agencies, members and candidates should be mindful of the potential conflicts of interest. And because of the potential conflicts, members and candidates may need to independently validate the rating granted.

Influence during the Manager Selection/Procurement Process

Members and candidates may find themselves on either side of the manager selection process. An individual may be on the hiring side as a representative of a pension organization or an investment committee member of an endowment or a charitable organization. Additionally, other members may be representing their organizations in attempts to earn new investment allocation mandates. The responsibility of members and candidates to maintain their independence and objectivity extends to the hiring or firing of those who provide business services beyond investment management.

When serving in a hiring capacity, members and candidates should not solicit gifts, contributions, or other compensation that may affect their independence and objectivity. Solicitations do not have to benefit members and candidates personally to conflict with Standard I(B). Requesting contributions to a favorite charity or political organization may also be perceived as an attempt to influence the decision-making process. Additionally, members and candidates serving in a hiring capacity should refuse gifts, donations, and other offered compensation that may be perceived to influence their decision-making process.

When working to earn a new investment allocation, members and candidates should not offer gifts, contributions, or other compensation to influence the decision of the hiring representative. The offering of these items with the intent to impair the independence and objectivity of another person would not comply with Standard I(B). Such prohibited actions may include offering donations to a charitable organization or political candidate referred by the hiring representative.

A clear example of improperly influencing hiring representatives was displayed in the "pay-to-play" scandal involving government-sponsored pension funds in the United States. Managers looking to gain lucrative allocations from the large funds made requested donations to the political campaigns of individuals directly responsible for the hiring decisions. This scandal and other similar events have led to new laws requiring additional reporting concerning political contributions and bans on hiring—or hiring delays for—managers that made campaign contributions to representatives associated with the decision-making process.

Issuer-Paid Research

In light of the recent reduction of sell-side research coverage, many companies, seeking to increase visibility both in the financial markets and with potential investors, have hired analysts to produce research reports analyzing their companies. These reports bridge the gap created by the lack of coverage and can be an effective method of communicating with investors.

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Issuer-paid research conducted by independent analysts, however, is fraught with potential conflicts. Depending on how the research is written and distributed, investors may be misled into believing that the research is from an independent source when, in reality, it has been paid for by the subject company.

Members and candidates must adhere to strict standards of conduct that govern how the research is to be conducted and what disclosures must be made in the report. Analysts must engage in thorough, independent, and unbiased analysis and must fully disclose potential conflicts of interest, including the nature of their compensation. Otherwise, analysts risk misleading investors.

Investors need clear, credible, and thorough information about companies, and they need research based on independent thought. At a minimum, issuer-paid research should include a thorough analysis of the company's financial statements based on publicly disclosed information, benchmarking within a peer group, and industry analysis. Analysts must exercise diligence, independence, and thoroughness in conducting their research in an objective manner. Analysts must distinguish between fact and opinion in their reports. Conclusions must have a reasonable and adequate basis and must be supported by appropriate research.

Independent analysts must also strictly limit the type of compensation that they accept for conducting issuer-paid research. Otherwise, the content and conclusions of the reports could reasonably be expected to be determined or affected by compensation from the sponsoring companies. Compensation that might influence the research report could be direct, such as payment based on the conclusions of the report, or indirect, such as stock warrants or other equity instruments that could increase in value on the basis of positive coverage in the report. In such instances, the independent analyst has an incentive to avoid including negative information or making negative conclusions. Best practice is for independent analysts, prior to writing their reports, to negotiate only a flat fee for their work that is not linked to their conclusions or recommendations.

Travel Funding

The benefits related to accepting paid travel extend beyond the cost savings to the member or candidate and his firm, such as the chance to talk exclusively with the executives of a company or learning more about the investment options provided by an investment organization. Acceptance also comes with potential concerns; for example, members and candidates may be influenced by these discussions when flying on a corporate or chartered jet or attending sponsored conferences where many expenses, including airfare and lodging, are covered. To avoid the appearance of compromising their independence and objectivity, best practice dictates that members and candidates always use commercial transportation at their expense or at the expense of their firm rather than accept paid travel arrangements from an outside company. Should commercial transportation be unavailable, members and candidates may accept modestly arranged travel to participate in appropriate information-gathering events, such as a property tour.

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Recommended Procedures for Compliance

Members and candidates should adhere to the following practices and should encourage their firms to establish procedures to avoid violations of Standard I(B):

- *Protect the integrity of opinions*: Members, candidates, and their firms should establish policies stating that every research report concerning the securities of a corporate client should reflect the unbiased opinion of the analyst. Firms should also design compensation systems that protect the integrity of the investment decision process by maintaining the independence and objectivity of analysts.
- *Create a restricted list*: If the firm is unwilling to permit dissemination of adverse opinions about a corporate client, members and candidates should encourage the firm to remove the controversial company from the research universe and put it on a restricted list so that the firm disseminates only factual information about the company.
- *Restrict special cost arrangements*: When attending meetings at an issuer's headquarters, members and candidates should pay for commercial transportation and hotel charges. No corporate issuer should reimburse members or candidates for air transportation. Members and candidates should encourage issuers to limit the use of corporate aircraft to situations in which commercial transportation is not available or in which efficient movement could not otherwise be arranged. Members and candidates should take particular care that when frequent meetings are held between an individual issuer and an individual member or candidate, the issuer should not always host the member or candidate.
- *Limit gifts*: Members and candidates must limit the acceptance of gratuities and/or gifts to token items. Standard I(B) does not preclude customary, ordinary business-related entertainment as long as its purpose is not to influence or reward members or candidates. Firms should consider a strict value limit for acceptable gifts that is based on the local or regional customs and should address whether the limit is per gift or an aggregate annual value.
- *Restrict investments*: Members and candidates should encourage their investment firms to develop formal polices related to employee purchases of equity or equity-related IPOs. Firms should require prior approval for employee participation in IPOs, with prompt disclosure of investment actions taken following the offering. Strict limits should be imposed on investment personnel acquiring securities in private placements.
- *Review procedures*: Members and candidates should encourage their firms to implement effective supervisory and review procedures to ensure that analysts and portfolio managers comply with policies relating to their personal investment activities.
- *Independence policy*: Members, candidates, and their firms should establish a formal written policy on the independence and objectivity of research

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and implement reporting structures and review procedures to ensure that research analysts do not report to and are not supervised or controlled by any department of the firm that could compromise the independence of the analyst. More detailed recommendations related to a firm's policies regarding research objectivity are set forth in the CFA Institute statement *Research Objectivity Standards* (www.cfainstitute.org).

- *Appointed officer*: Firms should appoint a senior officer with oversight responsibilities for compliance with the firm's code of ethics and all regulations concerning its business. Firms should provide every employee with the procedures and policies for reporting potentially unethical behavior, violations of regulations, or other activities that may harm the firm's reputation.

Application of the Standard

Example 1 (Travel Expenses):

Steven Taylor, a mining analyst with Bronson Brokers, is invited by Precision Metals to join a group of his peers in a tour of mining facilities in several western US states. The company arranges for chartered group flights from site to site and for accommodations in Spartan Motels, the only chain with accommodations near the mines, for three nights. Taylor allows Precision Metals to pick up his tab, as do the other analysts, with one exception—John Adams, an employee of a large trust company who insists on following his company's policy and paying for his hotel room himself.

Comment: The policy of the company where Adams works complies closely with Standard I(B) by avoiding even the appearance of a conflict of interest, but Taylor and the other analysts were not necessarily violating Standard I(B). In general, when allowing companies to pay for travel and/or accommodations in these circumstances, members and candidates must use their judgment. They must be on guard that such arrangements not impinge on a member's or candidate's independence and objectivity. In this example, the trip was strictly for business and Taylor was not accepting irrelevant or lavish hospitality. The itinerary required chartered flights, for which analysts were not expected to pay. The accommodations were modest. These arrangements are not unusual and did not violate Standard I(B) as long as Taylor's independence and objectivity were not compromised. In the final analysis, members and candidates should consider both whether they can remain objective and whether their integrity might be perceived by their clients to have been compromised.

Example 2 (Research Independence):

Susan Dillon, an analyst in the corporate finance department of an investment services firm, is making a presentation to a potential new business client that includes the promise that her firm will provide full research coverage of the potential client.

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Comment: Dillon may agree to provide research coverage, but she must not commit her firm's research department to providing a favorable recommendation. The firm's recommendation (favorable, neutral, or unfavorable) must be based on an independent and objective investigation and analysis of the company and its securities.

Example 3 (Research Independence and Intrafirm Pressure):

Walter Fritz is an equity analyst with Hilton Brokerage who covers the mining industry. He has concluded that the stock of Metals & Mining is overpriced at its current level, but he is concerned that a negative research report will hurt the good relationship between Metals & Mining and the investment banking division of his firm. In fact, a senior manager of Hilton Brokerage has just sent him a copy of a proposal his firm has made to Metals & Mining to underwrite a debt offering. Fritz needs to produce a report right away and is concerned about issuing a less-than-favorable rating.

Comment: Fritz's analysis of Metals & Mining must be objective and based solely on consideration of company fundamentals. Any pressure from other divisions of his firm is inappropriate. This conflict could have been eliminated if, in anticipation of the offering, Hilton Brokerage had placed Metals & Mining on a restricted list for its sales force.

Example 4 (Research Independence and Issuer Relationship Pressure):

As in Example 3, Walter Fritz has concluded that Metals & Mining stock is overvalued at its current level, but he is concerned that a negative research report might jeopardize a close rapport that he has nurtured over the years with Metals & Mining's CEO, chief finance officer, and investment relations officer. Fritz is concerned that a negative report might result also in management retaliation—for instance, cutting him off from participating in conference calls when a quarterly earnings release is made, denying him the ability to ask questions on such calls, and/or denying him access to top management for arranging group meetings between Hilton Brokerage clients and top Metals & Mining managers.

Comment: As in Example 3, Fritz's analysis must be objective and based solely on consideration of company fundamentals. Any pressure from Metals & Mining is inappropriate. Fritz should reinforce the integrity of his conclusions by stressing that his investment recommendation is based on relative valuation, which may include qualitative issues with respect to Metals & Mining's management.

Example 5 (Research Independence and Sales Pressure):

As support for the sales effort of her corporate bond department, Lindsey Warner offers credit guidance to purchasers of fixed-income securities. Her compensation is closely linked to the performance of the corporate bond department. Near the quarter's end, Warner's firm has a large inventory position in the bonds of Milton,

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Ltd., and has been unable to sell the bonds because of Milton's recent announcement of an operating problem. Salespeople have asked her to contact large clients to push the bonds.

Comment: Unethical sales practices create significant potential violations of the Code and Standards. Warner's opinion of the Milton bonds must not be affected by internal pressure or compensation. In this case, Warner must refuse to push the Milton bonds unless she is able to justify that the market price has already adjusted for the operating problem.

Example 6 (Research Independence and Prior Coverage):

Jill Jorund is a securities analyst following airline stocks and a rising star at her firm. Her boss has been carrying a "buy" recommendation on International Airlines and asks Jorund to take over coverage of that airline. He tells Jorund that under no circumstances should the prevailing buy recommendation be changed.

Comment: Jorund must be independent and objective in her analysis of International Airlines. If she believes that her boss's instructions have compromised her, she has two options: She can tell her boss that she cannot cover the company under these constraints, or she can take over coverage of the company, reach her own independent conclusions, and if they conflict with her boss's opinion, share the conclusions with her boss or other supervisors in the firm so that they can make appropriate recommendations. Jorund must issue only recommendations that reflect her independent and objective opinion.

Example 7 (Gifts and Entertainment from Related Party):

Edward Grant directs a large amount of his commission business to a New York–based brokerage house. In appreciation for all the business, the brokerage house gives Grant two tickets to the World Cup in South Africa, two nights at a nearby resort, several meals, and transportation via limousine to the game. Grant fails to disclose receiving this package to his supervisor.

Comment: Grant has violated Standard I(B) because accepting these substantial gifts may impede his independence and objectivity. Every member and candidate should endeavor to avoid situations that might cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action. By accepting the trip, Grant has opened himself up to the accusation that he may give the broker favored treatment in return.

Example 8 (Gifts and Entertainment from Client):

Theresa Green manages the portfolio of Ian Knowlden, a client of Tisbury Investments. Green achieves an annual return for Knowlden that is consistently

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better than that of the benchmark she and the client previously agreed to. As a reward, Knowlden offers Green two tickets to Wimbledon and the use of Knowlden's flat in London for a week. Green discloses this gift to her supervisor at Tisbury.

Comment: Green is in compliance with Standard I(B) because she disclosed the gift from one of her clients in accordance with the firm's policies. Members and candidates may accept bonuses or gifts from clients as long as they disclose them to their employer because gifts in a client relationship are deemed less likely to affect a member's or candidate's objectivity and independence than gifts in other situations. Disclosure is required, however, so that supervisors can monitor such situations to guard against employees favoring a gift-giving client to the detriment of other fee-paying clients (such as by allocating a greater proportion of IPO stock to the gift-giving client's portfolio).

Best practices for monitoring include comparing the transaction costs of the Knowlden account with the costs of other accounts managed by Green and other similar accounts within Tisbury. The supervisor could also compare the performance returns with the returns of other clients with the same mandate. This comparison will assist in determining whether a pattern of favoritism by Green is disadvantaging other Tisbury clients or the possibility that this favoritism could affect her future behavior.

Example 9 (Travel Expenses from External Manager):

Tom Wayne is the investment manager of the Franklin City Employees Pension Plan. He recently completed a successful search for a firm to manage the foreign equity allocation of the plan's diversified portfolio. He followed the plan's standard procedure of seeking presentations from a number of qualified firms and recommended that his board select Penguin Advisors because of its experience, well-defined investment strategy, and performance record. The firm claims compliance with the Global Investment Performance Standards (GIPS) and has been verified. Following the selection of Penguin, a reporter from the *Franklin City Record* calls to ask if there was any connection between this action and the fact that Penguin was one of the sponsors of an "investment fact-finding trip to Asia" that Wayne made earlier in the year. The trip was one of several conducted by the Pension Investment Academy, which had arranged the itinerary of meetings with economic, government, and corporate officials in major cities in several Asian countries. The Pension Investment Academy obtains support for the cost of these trips from a number of investment managers, including Penguin Advisors; the Academy then pays the travel expenses of the various pension plan managers on the trip and provides all meals and accommodations. The president of Penguin Advisors was also one of the travelers on the trip.

Comment: Although Wayne can probably put to good use the knowledge he gained from the trip in selecting portfolio managers and in other

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areas of managing the pension plan, his recommendation of Penguin Advisors may be tainted by the possible conflict incurred when he participated in a trip partly paid for by Penguin Advisors and when he was in the daily company of the president of Penguin Advisors. To avoid violating Standard I(B), Wayne's basic expenses for travel and accommodations should have been paid by his employer or the pension plan; contact with the president of Penguin Advisors should have been limited to informational or educational events only; and the trip, the organizer, and the sponsor should have been made a matter of public record. Even if his actions were not in violation of Standard I(B), Wayne should have been sensitive to the public perception of the trip when reported in the newspaper and the extent to which the subjective elements of his decision might have been affected by the familiarity that the daily contact of such a trip would encourage. This advantage would probably not be shared by firms competing with Penguin Advisors.

Example 10 (Research Independence and Compensation Arrangements):

Javier Herrero recently left his job as a research analyst for a large investment adviser. While looking for a new position, he was hired by an investor-relations firm to write a research report on one of its clients, a small educational software company. The investor-relations firm hopes to generate investor interest in the technology company. The firm will pay Herrero a flat fee plus a bonus if any new investors buy stock in the company as a result of Herrero's report.

Comment: If Herrero accepts this payment arrangement, he will be in violation of Standard I(B) because the compensation arrangement can reasonably be expected to compromise his independence and objectivity. Herrero will receive a bonus for attracting investors, which provides an incentive to draft a positive report regardless of the facts and to ignore or play down any negative information about the company. Herrero should accept only a flat fee that is not tied to the conclusions or recommendations of the report. Issuer-paid research that is objective and unbiased can be done under the right circumstances as long as the analyst takes steps to maintain his or her objectivity and includes in the report proper disclosures regarding potential conflicts of interest.

Example 11 (Recommendation Objectivity and Service Fees):

Two years ago, Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class of funds. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review Western's funds to determine whether they were suitable for clients of Central Midas Bank. The manager completed the normal due diligence review and determined that the

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new funds were fairly valued in the market with fee structures on a par with competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments.

Now, two years later, the funds managed by Western begin to underperform their peers. Wade is counting on the fees to reach his profitability targets and continues to push these funds as acceptable investments for Central's clients.

Comment: Wade is violating Standard I(B) because the fee arrangement has affected the objectivity of his recommendations. Wade is relying on the fee as a component of the department's profitability and is unwilling to offer other products that may affect the fees received.

See also Standard VI(A)–Disclosure of Conflicts.

Example 12 (Recommendation Objectivity):

Bob Thompson has been doing research for the portfolio manager of the fixed-income department. His assignment is to do sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives "prepays" (prepayments of mortgages) and losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. Thompson insists that the analysis should include a scenario run with –10% for Year 1, –5% for Year 2, and then (to project a worst-case scenario) 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative.

Thompson conducts his research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, an unlikely but possible environment. Based on the results of the enhanced scenarios, Thompson does not recommend the purchase of the securitization. Against the general market trends, the manager follows Thompson's recommendation and does not invest. The following year, the housing market collapses. In avoiding the subprime investments, the manager's portfolio outperforms its peer group that year.

Comment: Thompson's actions in running the worst-case scenario against the protests of the portfolio manager are in alignment with the principles of Standard I(B). Thompson did not allow his research to be pressured by the general trends of the market or the manager's desire to limit the research to historical norms.

See also Standard V(A)–Diligence and Reasonable Basis.

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Example 13 (Influencing Manager Selection Decisions):

Adrian Mandel, CFA, is a senior portfolio manager for ZZYY Capital Management who oversees a team of investment professionals who manage labor union pension funds. A few years ago, ZZYY sought to win a competitive asset manager search to manage a significant allocation of the pension fund of the United Doughnut and Pretzel Bakers Union (UDPBU). UDPBU's investment board is chaired by a recognized key decision maker and long-time leader of the union, Ernesto Gomez. To improve ZZYY's chances of winning the competition, Mandel made significant monetary contributions to Gomez's union reelection campaign fund. Even after ZZYY was hired as a primary manager of the pension, Mandel believed that his firm's position was not secure. Mandel continued to contribute to Gomez's reelection campaign chest as well as to entertain lavishly the union leader and his family at top restaurants on a regular basis. All of Mandel's outlays were routinely handled as marketing expenses reimbursed by ZZYY's expense accounts and were disclosed to his senior management as being instrumental in maintaining a strong close relationship with an important client.

> *Comment*: Mandel not only offered but actually gave monetary gifts, benefits, and other considerations that reasonably could be expected to compromise Gomez's objectivity. Therefore, Mandel was in violation of Standard I(B).

Example 14 (Influencing Manager Selection Decisions):

Adrian Mandel, CFA, had heard about the manager search competition for the UDPBU Pension Fund through a broker/dealer contact. The contact told him that a well-known retired professional golfer, Bobby "The Bear" Finlay, who had become a licensed broker/dealer serving as a pension consultant, was orchestrating the UDPBU manager search. Finlay had gained celebrity status with several labor union pension fund boards by entertaining their respective board members and regaling them with colorful stories of fellow pro golfers' antics in clubhouses around the world. Mandel decided to improve ZZYY's chances of being invited to participate in the search competition by befriending Finlay to curry his favor. Knowing Finlay's love of entertainment, Mandel wined and dined Finlay at high-profile bistros where Finlay could glow in the fan recognition lavished on him by all the other patrons. Mandel's endeavors paid off handsomely when Finlay recommended to the UDPBU board that ZZYY be entered as one of three finalist asset management firms in its search.

> *Comment*: Similar to Example 13, Mandel lavished gifts, benefits, and other considerations in the form of expensive entertainment that could reasonably be expected to influence the consultant to recommend the hiring of his firm. Therefore, Mandel was in violation of Standard I(B).

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Example 15 (Fund Manager Relationships):

Amie Scott is a performance analyst within her firm with responsibilities for analyzing the performance of external managers. While completing her quarterly analysis, Scott notices a change in one manager's reported composite construction. The change concealed the bad performance of a particularly large account by placing that account into a new residual composite. This change allowed the manager to remain at the top of the list of manager performance. Scott knows her firm has a large allocation to this manager, and the fund's manager is a close personal friend of the CEO. She needs to deliver her final report but is concerned with pointing out the composite change.

> *Comment*: Scott would be in violation of Standard I(B) if she did not disclose the change in her final report. The analysis of managers' performance should not be influenced by personal relationships or the size of the allocation to the outside managers. By not including the change, Scott would not be providing an independent analysis of the performance metrics for her firm.

Example 16 (Intrafirm Pressure):

Jill Stein is head of performance measurement for her firm. During the last quarter, many members of the organization's research department were removed because of the poor quality of their recommendations. The subpar research caused one larger account holder to experience significant underperformance, which resulted in the client withdrawing his money after the end of the quarter. The head of sales requests that Stein remove this account from the firm's performance composite because the performance decline can be attributed to the departed research team and not the client's adviser.

> *Comment*: Pressure from other internal departments can create situations that cause a member or candidate to violate the Code and Standards. Stein must maintain her independence and objectivity and refuse to exclude specific accounts from the firm's performance composites to which they belong. As long as the client invested under a strategy similar to that of the defined composite, it cannot be excluded because of the poor stock selections that led to the underperformance and asset withdrawal.

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Standard I(C) Misrepresentation

> Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

Guidance

Highlights:

- *Impact on Investment Practice*
- *Performance Reporting*
- *Social Media*
- *Omissions*
- *Plagiarism*
- *Work Completed for Employer*

Trust is the foundation of the investment profession. Investors must be able to rely on the statements and information provided to them by those with whom the investors have trusted their financial well-being. Investment professionals who make false or misleading statements not only harm investors but also reduce the level of investor confidence in the investment profession and threaten the integrity of capital markets as a whole.

A misrepresentation is any untrue statement or omission of a fact or any statement that is otherwise false or misleading. A member or candidate must not knowingly omit or misrepresent information or give a false impression of a firm, organization, or security in the member's or candidate's oral representations, advertising (whether in the press or through brochures), electronic communications, or written materials (whether publicly disseminated or not). In this context, "knowingly" means that the member or candidate either knows or should have known that the misrepresentation was being made or that omitted information could alter the investment decision-making process.

Written materials include, but are not limited to, research reports, underwriting documents, company financial reports, market letters, newspaper columns, and books. Electronic communications include, but are not limited to, internet communications, webpages, mobile applications, and e-mails. Members and candidates who use webpages should regularly monitor materials posted on these sites to ensure that they contain current information. Members and candidates should also ensure that all reasonable precautions have been taken to protect the

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site's integrity and security and that the site does not misrepresent any information and does provide full disclosure.

Standard I(C) prohibits members and candidates from guaranteeing clients any specific return on volatile investments. Most investments contain some element of risk that makes their return inherently unpredictable. For such investments, guaranteeing either a particular rate of return or a guaranteed preservation of investment capital (e.g., "I can guarantee that you will earn 8% on equities this year" or "I can guarantee that you will not lose money on this investment") is misleading to investors. Standard I(C) does not prohibit members and candidates from providing clients with information on investment products that have guarantees built into the structure of the products themselves or for which an institution has agreed to cover any losses.

Impact on Investment Practice

Members and candidates must not misrepresent any aspect of their practice, including (but not limited to) their qualifications or credentials, the qualifications or services provided by their firm, their performance record and the record of their firm, and the characteristics of an investment. Any misrepresentation made by a member or candidate relating to the member's or candidate's professional activities is a breach of this standard.

Members and candidates should exercise care and diligence when incorporating third-party information. Misrepresentations resulting from the use of the credit ratings, research, testimonials, or marketing materials of outside parties become the responsibility of the investment professional when it affects that professional's business practices.

Investing through outside managers continues to expand as an acceptable method of investing in areas outside a firm's core competencies. Members and candidates must disclose their intended use of external managers and must not represent those managers' investment practices as their own. Although the level of involvement of outside managers may change over time, appropriate disclosures by members and candidates are important in avoiding misrepresentations, especially if the primary activity is to invest directly with a single external manager. Standard V(B)–Communication with Clients and Prospective Clients discusses in further detail communicating the firm's investment practices.

Performance Reporting

The performance benchmark selection process is another area where misrepresentations may occur. Members and candidates may misrepresent the success of their performance record through presenting benchmarks that are not comparable to their strategies. Further, clients can be misled if the benchmark's results are not reported on a basis comparable to that of the fund's or client's results. Best practice is selecting the most appropriate available benchmark from a universe of available options. The transparent presentation of appropriate performance

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benchmarks is an important aspect in providing clients with information that is useful in making investment decisions.

However, Standard I(C) does not require that a benchmark always be provided in order to comply. Some investment strategies may not lend themselves to displaying an appropriate benchmark because of the complexity or diversity of the investments included. Furthermore, some investment strategies may use reference indices that do not reflect the opportunity set of the invested assets—for example, a hedge fund comparing its performance with a "cash plus" basis. When such a benchmark is used, members and candidates should make reasonable efforts to ensure that they disclose the reasons behind the use of this reference index to avoid misrepresentations of their performance. Members and candidates should discuss with clients on a continuous basis the appropriate benchmark to be used for performance evaluations and related fee calculations.

Reporting misrepresentations may also occur when valuations for illiquid or non-traded securities are available from more than one source. When different options are available, members and candidates may be tempted to switch providers to obtain higher security valuations. The process of shopping for values may misrepresent a security's worth, lead to misinformed decisions to sell or hold an investment, and result in overcharging clients advisory fees.

Members and candidates should take reasonable steps to provide accurate and reliable security pricing information to clients on a consistent basis. Changing pricing providers should not be based solely on the justification that the new provider reports a higher current value of a security. Consistency in the reported information will improve the perception of the valuation process for illiquid securities. Clients will likely have additional confidence that they were able to make an informed decision about continuing to hold these securities in their portfolios.

Social Media

The advancement of online discussion forums and communication platforms, commonly referred to as "social media," is placing additional responsibilities on members and candidates. When communicating through social media channels, members and candidates should provide only the same information they are allowed to distribute to clients and potential clients through other traditional forms of communication. The online or interactive aspects of social media do not remove the need to be open and honest about the information being distributed.

Along with understanding and following existing and newly developing rules and regulations regarding the allowed use of social media, members and candidates should also ensure that all communications in this format adhere to the requirements of the Code and Standards. The perceived anonymity granted through these platforms may entice individuals to misrepresent their qualifications or abilities or those of their employer. Actions undertaken through social media that knowingly misrepresent investment recommendations or professional activities are considered a violation of Standard I(C).

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Omissions

The omission of a fact or outcome can be misleading, especially given the growing use of models and technical analysis processes. Many members and candidates rely on such models and processes to scan for new investment opportunities, to develop investment vehicles, and to produce investment recommendations and ratings. When inputs are knowingly omitted, the resulting outcomes may provide misleading information to those who rely on it for making investment decisions. Additionally, the outcomes from models shall not be presented as fact because they represent the expected results based on the inputs and analysis process incorporated.

Omissions in the performance measurement and attribution process can also misrepresent a manager's performance and skill. Members and candidates should encourage their firms to develop strict policies for composite development to prevent cherry picking—situations in which selected accounts are presented as representative of the firm's abilities. The omission of any accounts appropriate for the defined composite may misrepresent to clients the success of the manager's implementation of its strategy.

Plagiarism

Standard I(C) also prohibits plagiarism in the preparation of material for distribution to employers, associates, clients, prospects, or the general public. Plagiarism is defined as copying or using in substantially the same form materials prepared by others without acknowledging the source of the material or identifying the author and publisher of such material. Members and candidates must not copy (or represent as their own) original ideas or material without permission and must acknowledge and identify the source of ideas or material that is not their own.

The investment profession uses a myriad of financial, economic, and statistical data in the investment decision-making process. Through various publications and presentations, the investment professional is constantly exposed to the work of others and to the temptation to use that work without proper acknowledgment.

Misrepresentation through plagiarism in investment management can take various forms. The simplest and most flagrant example is to take a research report or study done by another firm or person, change the names, and release the material as one's own original analysis. This action is a clear violation of Standard I(C). Other practices include (1) using excerpts from articles or reports prepared by others either verbatim or with only slight changes in wording without acknowledgment, (2) citing specific quotations as attributable to "leading analysts" and "investment experts" without naming the specific references, (3) presenting statistical estimates of forecasts prepared by others and identifying the sources but without including the qualifying statements or caveats that may have been used, (4) using charts and graphs without stating their sources, and (5) copying proprietary computerized spreadsheets or algorithms without seeking the cooperation or authorization of their creators.

In the case of distributing third-party, outsourced research, members and candidates may use and distribute such reports as long as they do not represent

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themselves as the report's authors. Indeed, the member or candidate may add value for the client by sifting through research and repackaging it for clients. In such cases, clients should be fully informed that they are paying for the ability of the member or candidate to find the best research from a wide variety of sources. Members and candidates must not misrepresent their abilities, the extent of their expertise, or the extent of their work in a way that would mislead their clients or prospective clients. Members and candidates should disclose whether the research being presented to clients comes from another source—from either within or outside the member's or candidate's firm. This allows clients to understand who has the expertise behind the report or whether the work is being done by the analyst, other members of the firm, or an outside party.

Standard I(C) also applies to plagiarism in oral communications, such as through group meetings; visits with associates, clients, and customers; use of audio/video media (which is rapidly increasing); and telecommunications, including electronic data transfer and the outright copying of electronic media.

One of the most egregious practices in violation of this standard is the preparation of research reports based on multiple sources of information without acknowledging the sources. Examples of information from such sources include ideas, statistical compilations, and forecasts combined to give the appearance of original work. Although there is no monopoly on ideas, members and candidates must give credit where it is clearly due. Analysts should not use undocumented forecasts, earnings projections, asset values, and so on. Sources must be revealed to bring the responsibility directly back to the author of the report or the firm involved.

Work Completed for Employer

The preceding paragraphs address actions that would constitute a violation of Standard I(C). In some situations, however, members or candidates may use research conducted or models developed by others within the same firm without committing a violation. The most common example relates to the situation in which one (or more) of the original analysts is no longer with the firm. Research and models developed while employed by a firm are the property of the firm. The firm retains the right to continue using the work completed after a member or candidate has left the organization. The firm may issue future reports without providing attribution to the prior analysts. A member or candidate cannot, however, reissue a previously released report solely under his or her name.

Recommended Procedures for Compliance

Factual Presentations

Members and candidates can prevent unintentional misrepresentations of their qualifications or the services they or their firms provide if each member and candidate understands the limit of the firm's or individual's capabilities and the need to be accurate and complete in presentations. Firms can provide guidance for employees who make written or oral presentations to clients or potential clients by providing

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a written list of the firm's available services and a description of the firm's qualifications. This list should suggest ways of describing the firm's services, qualifications, and compensation that are both accurate and suitable for client or customer presentations. Firms can also help prevent misrepresentation by specifically designating which employees are authorized to speak on behalf of the firm. Regardless of whether the firm provides guidance, members and candidates should make certain that they understand the services the firm can perform and its qualifications.

Qualification Summary

In addition, to ensure accurate presentations to clients, each member and candidate should prepare a summary of his or her own qualifications and experience and a list of the services the member or candidate is capable of performing. Firms can assist member and candidate compliance by periodically reviewing employee correspondence and documents that contain representations of individual or firm qualifications.

Verify Outside Information

When providing information to clients from a third party, members and candidates share a responsibility for the accuracy of the marketing and distribution materials that pertain to the third party's capabilities, services, and products. Misrepresentation by third parties can damage the member's or candidate's reputation, the reputation of the firm, and the integrity of the capital markets. Members and candidates should encourage their employers to develop procedures for verifying information of third-party firms.

Maintain Webpages

Members and candidates who publish a webpage should regularly monitor materials posted on the site to ensure that the site contains current information. Members and candidates should also ensure that all reasonable precautions have been taken to protect the site's integrity, confidentiality, and security and that the site does not misrepresent any information and provides full disclosure.

Plagiarism Policy

To avoid plagiarism in preparing research reports or conclusions of analysis, members and candidates should take the following steps:

- *Maintain copies*: Keep copies of all research reports, articles containing research ideas, material with new statistical methodologies, and other materials that were relied on in preparing the research report.
- *Attribute quotations*: Attribute to their sources any direct quotations, including projections, tables, statistics, model/product ideas, and new methodologies prepared by persons other than recognized financial and statistical reporting services or similar sources.
- *Attribute summaries*: Attribute to their sources any paraphrases or summaries of material prepared by others. For example, to support his analysis of

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Brown Company's competitive position, the author of a research report on Brown might summarize another analyst's report on Brown's chief competitor, but the author of the Brown report must acknowledge in his own report the reliance on the other analyst's report.

Application of the Standard

Example 1 (Disclosure of Issuer-Paid Research):

Anthony McGuire is an issuer-paid analyst hired by publicly traded companies to electronically promote their stocks. McGuire creates a website that promotes his research efforts as a seemingly independent analyst. McGuire posts a profile and a strong buy recommendation for each company on the website indicating that the stock is expected to increase in value. He does not disclose the contractual relationships with the companies he covers on his website, in the research reports he issues, or in the statements he makes about the companies in internet chat rooms.

Comment: McGuire has violated Standard I(C) because the website is misleading to potential investors. Even if the recommendations are valid and supported with thorough research, his omissions regarding the true relationship between himself and the companies he covers constitute a misrepresentation. McGuire has also violated Standard VI(A)–Disclosure of Conflicts by not disclosing the existence of an arrangement with the companies through which he receives compensation in exchange for his services.

Example 2 (Correction of Unintentional Errors):

Hijan Yao is responsible for the creation and distribution of the marketing materials for his firm, which claims compliance with the GIPS standards. Yao creates and distributes a presentation of performance by the firm's Asian equity composite that states the composite has ¥350 billion in assets. In fact, the composite has only ¥35 billion in assets, and the higher figure on the presentation is a result of a typographical error. Nevertheless, the erroneous material is distributed to a number of clients before Yao catches the mistake.

Comment: Once the error is discovered, Yao must take steps to cease distribution of the incorrect material and correct the error by informing those who have received the erroneous information. Because Yao did not knowingly make the misrepresentation, however, he did not violate Standard I(C). Because his firm claims compliance with the GIPS standards, it must also comply with the GIPS Guidance Statement on Error Correction in relation to the error.

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Example 3 (Noncorrection of Known Errors):

Syed Muhammad is the president of an investment management firm. The promotional material for the firm, created by the firm's marketing department, incorrectly claims that Muhammad has an advanced degree in finance from a prestigious business school in addition to the CFA designation. Although Muhammad attended the school for a short period of time, he did not receive a degree. Over the years, Muhammad and others in the firm have distributed this material to numerous prospective clients and consultants.

> *Comment*: Even though Muhammad may not have been directly responsible for the misrepresentation of his credentials in the firm's promotional material, he used this material numerous times over an extended period and should have known of the misrepresentation. Thus, Muhammad has violated Standard I(C).

Example 4 (Plagiarism):

Cindy Grant, a research analyst for a Canadian brokerage firm, has specialized in the Canadian mining industry for the past 10 years. She recently read an extensive research report on Jefferson Mining, Ltd., by Jeremy Barton, another analyst. Barton provided extensive statistics on the mineral reserves, production capacity, selling rates, and marketing factors affecting Jefferson's operations. He also noted that initial drilling results on a new ore body, which had not been made public, might show the existence of mineral zones that could increase the life of Jefferson's main mines, but Barton cited no specific data as to the initial drilling results. Grant called an officer of Jefferson, who gave her the initial drilling results over the telephone. The data indicated that the expected life of the main mines would be tripled. Grant added these statistics to Barton's report and circulated it within her firm as her own report.

> *Comment*: Grant plagiarized Barton's report by reproducing large parts of it in her own report without acknowledgment.

Example 5 (Misrepresentation of Information):

When Ricki Marks sells mortgage-backed derivatives called "interest-only strips" (IOs) to public pension plan clients, she describes them as "guaranteed by the US government." Purchasers of the IOs are entitled only to the interest stream generated by the mortgages, however, not the notional principal itself. One particular municipality's investment policies and local law require that securities purchased by its public pension plans be guaranteed by the US government. Although the underlying mortgages are guaranteed, neither the investor's investment nor the interest stream on the IOs is guaranteed. When interest rates decline, causing an increase in prepayment of mortgages, interest payments to the IOs' investors decline, and these investors lose a portion of their investment.

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Comment: Marks violated Standard I(C) by misrepresenting the terms and character of the investment.

Example 6 (Potential Information Misrepresentation):

Khalouck Abdrabbo manages the investments of several high-net-worth individuals in the United States who are approaching retirement. Abdrabbo advises these individuals that a portion of their investments be moved from equity to bank-sponsored certificates of deposit and money market accounts so that the principal will be "guaranteed" up to a certain amount. The interest is not guaranteed.

Comment: Although there is risk that the institution offering the certificates of deposits and money market accounts could go bankrupt, in the United States, these accounts are insured by the US government through the Federal Deposit Insurance Corporation. Therefore, using the term "guaranteed" in this context is not inappropriate as long as the amount is within the government-insured limit. Abdrabbo should explain these facts to the clients.

Example 7 (Plagiarism):

Steve Swanson is a senior analyst in the investment research department of Ballard and Company. Apex Corporation has asked Ballard to assist in acquiring the majority ownership of stock in the Campbell Company, a financial consulting firm, and to prepare a report recommending that stockholders of Campbell agree to the acquisition. Another investment firm, Davis and Company, had already prepared a report for Apex analyzing both Apex and Campbell and recommending an exchange ratio. Apex has given the Davis report to Ballard officers, who have passed it on to Swanson. Swanson reviews the Davis report and other available material on Apex and Campbell. From his analysis, he concludes that the common stocks of Campbell and Apex represent good value at their current prices; he believes, however, that the Davis report does not consider all the factors a Campbell stockholder would need to know to make a decision. Swanson reports his conclusions to the partner in charge, who tells him to "use the Davis report, change a few words, sign your name, and get it out."

Comment: If Swanson does as requested, he will violate Standard I(C). He could refer to those portions of the Davis report that he agrees with if he identifies Davis as the source; he could then add his own analysis and conclusions to the report before signing and distributing it.

Example 8 (Plagiarism):

Claude Browning, a quantitative analyst for Double Alpha, Inc., returns from a seminar in great excitement. At that seminar, Jack Jorrely, a well-known quantitative analyst at a national brokerage firm, discussed one of his new models in great detail, and Browning is intrigued by the new concepts. He proceeds to test the

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model, making some minor mechanical changes but retaining the concepts, until he produces some very positive results. Browning quickly announces to his supervisors at Double Alpha that he has discovered a new model and that clients and prospective clients should be informed of this positive finding as ongoing proof of Double Alpha's continuing innovation and ability to add value.

> *Comment*: Although Browning tested Jorrely's model on his own and even slightly modified it, he must still acknowledge the original source of the idea. Browning can certainly take credit for the final, practical results; he can also support his conclusions with his own test. The credit for the innovative thinking, however, must be awarded to Jorrely.

Example 9 (Plagiarism):

Fernando Zubia would like to include in his firm's marketing materials some "plain-language" descriptions of various concepts, such as the price-to-earnings (P/E) multiple and why standard deviation is used as a measure of risk. The descriptions come from other sources, but Zubia wishes to use them without reference to the original authors. Would this use of material be a violation of Standard I(C)?

> *Comment*: Copying verbatim any material without acknowledgement, including plain-language descriptions of the P/E multiple and standard deviation, violates Standard I(C). Even though these concepts are general, best practice would be for Zubia to describe them in his own words or cite the sources from which the descriptions are quoted. Members and candidates would be violating Standard I(C) if they either were responsible for creating marketing materials without attribution or knowingly use plagiarized materials.

Example 10 (Plagiarism):

Through a mainstream media outlet, Erika Schneider learns about a study that she would like to cite in her research. Should she cite both the mainstream intermediary source as well as the author of the study itself when using that information?

> *Comment*: In all instances, a member or candidate must cite the actual source of the information. Best practice for Schneider would be to obtain the information directly from the author and review it before citing it in a report. In that case, Schneider would not need to report how she found out about the information. For example, suppose Schneider read in the *Financial Times* about a study issued by CFA Institute; best practice for Schneider would be to obtain a copy of the study from CFA Institute, review it, and then cite it in her report. If she does not use any interpretation of the report from the *Financial Times* and the newspaper does not add value to the report itself, the newspaper is merely a conduit of the original information and does not need to be cited. If she does not obtain the report and review the information, Schneider runs the risk of relying

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on second-hand information that may misstate facts. If, for example, the *Financial Times* erroneously reported some information from the original CFA Institute study and Schneider copied that erroneous information without acknowledging CFA Institute, she could be the object of complaints. Best practice would be either to obtain the complete study from its original author and cite only that author or to use the information provided by the intermediary and cite both sources.

Example 11 (Misrepresentation of Information):

Paul Ostrowski runs a two-person investment management firm. Ostrowski's firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged by smaller firms for those firms' clients. Ostrowski's firm distributes these reports to clients as its own work.

Comment: Ostrowski can rely on third-party research that has a reasonable and adequate basis, but he cannot imply that he is the author of such research. If he does, Ostrowski is misrepresenting the extent of his work in a way that misleads the firm's clients or prospective clients.

Example 12 (Misrepresentation of Information):

Tom Stafford is part of a team within Appleton Investment Management responsible for managing a pool of assets for Open Air Bank, which distributes structured securities to offshore clients. He becomes aware that Open Air is promoting the structured securities as a much less risky investment than the investment management policy followed by him and the team to manage the original pool of assets. Also, Open Air has procured an independent rating for the pool that significantly overstates the quality of the investments. Stafford communicates his concerns to his supervisor, who responds that Open Air owns the product and is responsible for all marketing and distribution. Stafford's supervisor goes on to say that the product is outside of the US regulatory regime that Appleton follows and that all risks of the product are disclosed at the bottom of page 184 of the prospectus.

Comment: As a member of the investment team, Stafford is qualified to recognize the degree of accuracy of the materials that characterize the portfolio, and he is correct to be worried about Appleton's responsibility for a misrepresentation of the risks. Thus, he should continue to pursue the issue of Open Air's inaccurate promotion of the portfolio according to the firm's policies and procedures.

The Code and Standards stress protecting the reputation of the firm and the sustainability and integrity of the capital markets. Misrepresenting the quality and risks associated with the investment pool may lead to negative consequences for others well beyond the direct investors.

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Example 13 (Avoiding a Misrepresentation):

Trina Smith is a fixed-income portfolio manager at a pension fund. She has observed that the market for highly structured mortgages is the focus of salespeople she meets and that these products represent a significant number of trading opportunities. In discussions about this topic with her team, Smith learns that calculating yields on changing cash flows within the deal structure requires very specialized vendor software. After more research, they find out that each deal is unique and that deals can have more than a dozen layers and changing cash flow priorities. Smith comes to the conclusion that, because of the complexity of these securities, the team cannot effectively distinguish between potentially good and bad investment options. To avoid misrepresenting their understanding, the team decides that the highly structured mortgage segment of the securitized market should not become part of the core of the fund's portfolio; they will allow some of the less complex securities to be part of the core.

> *Comment*: Smith is in compliance with Standard I(C) by not investing in securities that she and her team cannot effectively understand. Because she is not able to describe the risk and return profile of the securities to the pension fund beneficiaries and trustees, she appropriately limits the fund's exposure to this sector.

Example 14 (Misrepresenting Composite Construction):

Robert Palmer is head of performance for a fund manager. When asked to provide performance numbers to fund rating agencies, he avoids mentioning that the fund manager is quite liberal in composite construction. The reason accounts are included/excluded is not fully explained. The performance values reported to the rating agencies for the composites, although accurate for the accounts shown each period, may not present a true representation of the fund manager's ability.

> *Comment*: "Cherry picking" accounts to include in either published reports or information provided to rating agencies conflicts with Standard I(C). Moving accounts into or out of a composite to influence the overall performance results materially misrepresents the reported values over time. Palmer should work with his firm to strengthen its reporting practices concerning composite construction to avoid misrepresenting the firm's track record or the quality of the information being provided.

Example 15 (Presenting Out-of-Date Information):

David Finch is a sales director at a commercial bank, where he directs the bank's client advisers in the sale of third-party mutual funds. Each quarter, he holds a division-wide training session where he provides fact sheets on investment funds the bank is allowed to offer to clients. These fact sheets, which can be redistributed to potential clients, are created by the fund firms and contain information about the funds, including investment strategy and target distribution rates.

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Finch knows that some of the fact sheets are out of date; for example, one long-only fund approved the use of significant leverage last quarter as a method to enhance returns. He continues to provide the sheets to the sales team without updates because the bank has no control over the marketing material released by the mutual fund firms.

Comment: Finch is violating Standard I(C) by providing information that misrepresents aspects of the funds. By not providing the sales team and, ultimately, the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets. Finch can instruct the sales team to clarify the deficiencies in the fact sheets with clients and ensure they have the most recent fund prospectus document before accepting orders for investing in any fund.

Example 16 (Overemphasis of Firm Results):

Bob Anderson is chief compliance officer for Optima Asset Management Company, a firm currently offering eight funds to clients. Seven of the eight had 10-year returns below the median for their respective sectors. Anderson approves a recent advertisement, which includes this statement: "Optima Asset Management is achieving excellent returns for its investors. The Optima Emerging Markets Equity fund, for example, has 10-year returns that exceed the sector median by more than 10%."

Comment: From the information provided it is difficult to determine whether a violation has occurred as long as the sector outperformance is correct. Anderson may be attempting to mislead potential clients by citing the performance of the sole fund that achieved such results. Past performance is often used to demonstrate a firm's skill and abilities in comparison to funds in the same sectors.

However, if all the funds outperformed their respective benchmarks, then Anderson's assertion that the company "is achieving excellent returns" may be factual. Funds may exhibit positive returns for investors, exceed benchmarks, and yet have returns below the median in their sectors.

Members and candidates need to ensure that their marketing efforts do not include statements that misrepresent their skills and abilities to remain compliant with Standard I(C). Unless the returns of a single fund reflect the performance of a firm as a whole, the use of a singular fund for performance comparisons should be avoided.

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Standard I(D) Misconduct

> Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

Guidance

Whereas Standard I(A) addresses the obligation of members and candidates to comply with applicable law that governs their professional activities, Standard I(D) addresses *all* conduct that reflects poorly on the professional integrity, good reputation, or competence of members and candidates. Any act that involves lying, cheating, stealing, or other dishonest conduct is a violation of this standard if the offense reflects adversely on a member's or candidate's professional activities. Although CFA Institute discourages any sort of unethical behavior by members and candidates, the Code and Standards are primarily aimed at conduct and actions related to a member's or candidate's professional life.

Conduct that damages trustworthiness or competence may include behavior that, although not illegal, nevertheless negatively affects a member's or candidate's ability to perform his or her responsibilities. For example, abusing alcohol during business hours might constitute a violation of this standard because it could have a detrimental effect on the member's or candidate's ability to fulfill his or her professional responsibilities. Personal bankruptcy may not reflect on the integrity or trustworthiness of the person declaring bankruptcy, but if the circumstances of the bankruptcy involve fraudulent or deceitful business conduct, the bankruptcy may be a violation of this standard.

In some cases, the absence of appropriate conduct or the lack of sufficient effort may be a violation of Standard I(D). The integrity of the investment profession is built on trust. A member or candidate—whether an investment banker, rating or research analyst, or portfolio manager—is expected to conduct the necessary due diligence to properly understand the nature and risks of an investment before making an investment recommendation. By not taking these steps and, instead, relying on someone else in the process to perform them, members or candidates may violate the trust their clients have placed in them. This loss of trust may have a significant impact on the reputation of the member or candidate and the operations of the financial market as a whole.

Individuals may attempt to abuse the CFA Institute Professional Conduct Program by actively seeking CFA Institute enforcement of the Code and Standards, and Standard I(D) in particular, as a method of settling personal, political, or other disputes unrelated to professional ethics. CFA Institute is aware of this issue, and appropriate disciplinary policies, procedures, and enforcement mechanisms are in

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place to address misuse of the Code and Standards and the Professional Conduct Program in this way.

Recommended Procedures for Compliance

In addition to ensuring that their own behavior is consistent with Standard I(D), to prevent general misconduct, members and candidates should encourage their firms to adopt the following policies and procedures to support the principles of Standard I(D):

- *Code of ethics*: Develop and/or adopt a code of ethics to which every employee must subscribe, and make clear that any personal behavior that reflects poorly on the individual involved, the institution as a whole, or the investment industry will not be tolerated.
- *List of violations*: Disseminate to all employees a list of potential violations and associated disciplinary sanctions, up to and including dismissal from the firm.
- *Employee references*: Check references of potential employees to ensure that they are of good character and not ineligible to work in the investment industry because of past infractions of the law.

Application of the Standard

Example 1 (Professionalism and Competence):

Simon Sasserman is a trust investment officer at a bank in a small affluent town. He enjoys lunching every day with friends at the country club, where his clients have observed him having numerous drinks. Back at work after lunch, he clearly is intoxicated while making investment decisions. His colleagues make a point of handling any business with Sasserman in the morning because they distrust his judgment after lunch.

> *Comment*: Sasserman's excessive drinking at lunch and subsequent intoxication at work constitute a violation of Standard I(D) because this conduct has raised questions about his professionalism and competence. His behavior reflects poorly on him, his employer, and the investment industry.

Example 2 (Fraud and Deceit):

Howard Hoffman, a security analyst at ATZ Brothers, Inc., a large brokerage house, submits reimbursement forms over a two-year period to ATZ's self-funded health insurance program for more than two dozen bills, most of which have been altered to increase the amount due. An investigation by the firm's director of employee benefits uncovers the inappropriate conduct. ATZ subsequently terminates Hoffman's employment and notifies CFA Institute.

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Comment: Hoffman violated Standard I(D) because he engaged in intentional conduct involving fraud and deceit in the workplace that adversely reflected on his integrity.

Example 3 (Fraud and Deceit):

Jody Brink, an analyst covering the automotive industry, volunteers much of her spare time to local charities. The board of one of the charitable institutions decides to buy five new vans to deliver hot lunches to low-income elderly people. Brink offers to donate her time to handle purchasing agreements. To pay a long-standing debt to a friend who operates an automobile dealership—and to compensate herself for her trouble—she agrees to a price 20% higher than normal and splits the surcharge with her friend. The director of the charity ultimately discovers the scheme and tells Brink that her services, donated or otherwise, are no longer required.

Comment: Brink engaged in conduct involving dishonesty, fraud, and misrepresentation and has violated Standard I(D).

Example 4 (Personal Actions and Integrity):

Carmen Garcia manages a mutual fund dedicated to socially responsible investing. She is also an environmental activist. As the result of her participation in nonviolent protests, Garcia has been arrested on numerous occasions for trespassing on the property of a large petrochemical plant that is accused of damaging the environment.

Comment: Generally, Standard I(D) is not meant to cover legal transgressions resulting from acts of civil disobedience in support of personal beliefs because such conduct does not reflect poorly on the member's or candidate's professional reputation, integrity, or competence.

Example 5 (Professional Misconduct):

Meredith Rasmussen works on a buy-side trading desk of an investment management firm and concentrates on in-house trades for a hedge fund subsidiary managed by a team at the investment management firm. The hedge fund has been very successful and is marketed globally by the firm. From her experience as the trader for much of the activity of the fund, Rasmussen has become quite knowledgeable about the hedge fund's strategy, tactics, and performance. When a distinct break in the market occurs and many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen observes that the reported performance of the hedge fund does not reflect this decline. In her experience, the lack of effect is a very unlikely occurrence. She approaches the head of trading about her concern and is told that she should not ask any questions and that the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of the hedge fund's reporting.

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Comment: Rasmussen has clearly come across an error in policies, procedures, and compliance practices within the firm's operations. According to the firm's procedures for reporting potentially unethical activity, she should pursue the issue by gathering some proof of her reason for doubt. Should all internal communications within the firm not satisfy her concerns, Rasmussen should consider reporting the potential unethical activity to the appropriate regulator.

See also Standard IV(A) for guidance on whistleblowing and Standard IV(C) for the duties of a supervisor.

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Standard II: Integrity of Capital Markets

Standard II(A) Material Nonpublic Information

Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

Guidance

Highlights:

- *What Is "Material" Information?*
- *What Constitutes "Nonpublic" Information?*
- *Mosaic Theory*
- *Social Media*
- *Using Industry Experts*
- *Investment Research Reports*

Trading or inducing others to trade on material nonpublic information erodes confidence in capital markets, institutions, and investment professionals by supporting the idea that those with inside information and special access can take unfair advantage of the general investing public. Although trading on inside information may lead to short-term profits, in the long run, individuals and the profession as a whole suffer from such trading. These actions have caused and will continue to cause investors to avoid capital markets because the markets are perceived to be "rigged" in favor of the knowledgeable insider. When the investing public avoids capital markets, the markets and capital allocation become less efficient and less supportive of strong and vibrant economies. Standard II(A) promotes and maintains a high level of confidence in market integrity, which is one of the foundations of the investment profession.

The prohibition on using this information goes beyond the direct buying and selling of individual securities or bonds. Members and candidates must not use material nonpublic information to influence their investment actions related to derivatives (e.g., swaps or option contracts), mutual funds, or other alternative investments. *Any* trading based on material nonpublic information constitutes a violation of Standard II(A). The expansion of financial products and the increasing interconnectivity of financial markets globally have resulted in new potential opportunities for trading on material nonpublic information.

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What Is "Material" Information?

Information is "material" if its disclosure would probably have an impact on the price of a security or if reasonable investors would want to know the information before making an investment decision. In other words, information is material if it would significantly alter the total mix of information currently available about a security in such a way that the price of the security would be affected.

The specificity of the information, the extent of its difference from public information, its nature, and its reliability are key factors in determining whether a particular piece of information fits the definition of material. For example, material information may include, but is not limited to, information on the following:

- earnings;
- mergers, acquisitions, tender offers, or joint ventures;
- changes in assets or asset quality;
- innovative products, processes, or discoveries (e.g., new product trials or research efforts);
- new licenses, patents, registered trademarks, or regulatory approval/rejection of a product;
- developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
- changes in management;
- change in auditor notification or the fact that the issuer may no longer rely on an auditor's report or qualified opinion;
- events regarding the issuer's securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits, changes in dividends, changes to the rights of security holders, and public or private sales of additional securities);
- bankruptcies;
- significant legal disputes;
- government reports of economic trends (employment, housing starts, currency information, etc.);
- orders for large trades before they are executed; and
- new or changing equity or debt ratings issued by a third party (e.g., sell-side recommendations and credit ratings).

In addition to the substance and specificity of the information, the source or relative reliability of the information also determines materiality. The less reliable a source, the less likely the information provided would be considered material.

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For example, factual information from a corporate insider regarding a significant new contract for a company is likely to be material, whereas an assumption based on speculation by a competitor about the same contract is likely to be less reliable and, therefore, not material. Additionally, information about trials of a new drug, product, or service under development from qualified personnel involved in the trials is likely to be material, whereas educated conjecture by subject experts not connected to the trials is unlikely to be material.

Also, the more ambiguous the effect of the information on price, the less material that information is considered. If it is unclear whether and to what extent the information will affect the price of a security, the information may not be considered material. The passage of time may also render information that was once important immaterial.

What Constitutes "Nonpublic" Information?

Information is "nonpublic" until it has been disseminated or is available to the marketplace in general (as opposed to a select group of investors). "Disseminated" can be defined as "made known." For example, a company report of profits that is posted on the internet and distributed widely through a press release or accompanied by a filing has been effectively disseminated to the marketplace. Members and candidates must have a reasonable expectation that people have received the information before it can be considered public. It is not necessary, however, to wait for the slowest method of delivery. Once the information is disseminated to the market, it is public information that is no longer covered by this standard.

Members and candidates must be particularly aware of information that is selectively disclosed by corporations to a small group of investors, analysts, or other market participants. Information that is made available to analysts remains nonpublic until it is made available to investors in general. Corporations that disclose information on a limited basis create the potential for insider-trading violations.

Issues of selective disclosure often arise when a corporate insider provides material information to analysts in a briefing or conference call before that information is released to the public. Analysts must be aware that a disclosure made to a room full of analysts does not necessarily make the disclosed information "public." Analysts should also be alert to the possibility that they are selectively receiving material nonpublic information when a company provides them with guidance or interpretation of such publicly available information as financial statements or regulatory filings.

A member or candidate may use insider information provided legitimately by the source company for the specific purpose of conducting due diligence according to the business agreement between the parties for such activities as mergers, loan underwriting, credit ratings, and offering engagements. In such instances, the investment professional would not be considered in violation of Standard II(A) by using the material information. However, the use of insider information provided by the source company for other purposes, especially to trade or entice others to trade the securities of the firm, conflicts with this standard.

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Mosaic Theory

A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the "mosaic theory," financial analysts are free to act on this collection, or mosaic, of information without risking violation.

The practice of financial analysis depends on the free flow of information. For the fair and efficient operation of the capital markets, analysts and investors must have the greatest amount of information possible to facilitate making well-informed investment decisions about how and where to invest capital. Accurate, timely, and intelligible communication is essential if analysts and investors are to obtain the data needed to make informed decisions about how and where to invest capital. These disclosures must go beyond the information mandated by the reporting requirements of the securities laws and should include specific business information about items used to guide a company's future growth, such as new products, capital projects, and the competitive environment. Analysts seek and use such information to compare and contrast investment alternatives.

Much of the information used by analysts comes directly from companies. Analysts often receive such information through contacts with corporate insiders, especially investor-relations staff and financial officers. Information may be disseminated in the form of press releases, through oral presentations by company executives in analysts' meetings or conference calls, or during analysts' visits to company premises. In seeking to develop the most accurate and complete picture of a company, analysts should also reach beyond contacts with companies themselves and collect information from other sources, such as customers, contractors, suppliers, and the companies' competitors.

Analysts are in the business of formulating opinions and insights that are not obvious to the general investing public about the attractiveness of particular securities. In the course of their work, analysts actively seek out corporate information not generally known to the market for the express purpose of analyzing that information, forming an opinion on its significance, and informing their clients, who can be expected to trade on the basis of the recommendation. Analysts' initiatives to discover and analyze information and communicate their findings to their clients significantly enhance market efficiency, thus benefiting all investors (see *Dirks v. Securities and Exchange Commission*). Accordingly, violations of Standard II(A) will *not* result when a perceptive analyst reaches a conclusion about a corporate action or event through an analysis of public information and items of nonmaterial nonpublic information.

Investment professionals should note, however, that although analysts are free to use mosaic information in their research reports, they should save and document all their research [see Standard V(C)–Record Retention]. Evidence of the analyst's knowledge of public and nonmaterial nonpublic information about a corporation

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strengthens the assertion that the analyst reached his or her conclusions solely through appropriate methods rather than through the use of material nonpublic information.

Social Media

The continuing advancement in technology allows members, candidates, and the industry at large to exchange information at rates not previously available. It is important for investment professionals to understand the implications of using information from the internet and social media platforms because all such information may not actually be considered public.

Some social media platforms require membership in specific groups in order to access the published content. Members and candidates participating in groups with membership limitations should verify that material information obtained from these sources can also be accessed from a source that would be considered available to the public (e.g., company filings, webpages, and press releases).

Members and candidates may use social media platforms to communicate with clients or investors without conflicting with this standard. As long as the information reaches all clients or is open to the investing public, the use of these platforms would be comparable with other traditional forms of communications, such as e-mails and press releases. Members and candidates, as required by Standard I(A), should also complete all appropriate regulatory filings related to information distributed through social media platforms.

Using Industry Experts

The increased demand for insights for understanding the complexities of some industries has led to an expansion of engagement with outside experts. As the level of engagement increased, new businesses formed to connect analysts and investors with individuals who have specialized knowledge of their industry (e.g., technology or pharmaceuticals). These networks offer investors the opportunity to reach beyond their usual business circles to speak with experts regarding economic conditions, industry trends, and technical issues relating to specific products and services.

Members and candidates may provide compensation to individuals for their insights without violating this standard. However, members and candidates are ultimately responsible for ensuring that they are not requesting or acting on confidential information received from external experts, which is in violation of security regulations and laws or duties to others. As the recent string of insider-trading cases displayed, some experts are willing to provide confidential and protected information for the right incentive.

Firms connecting experts with members or candidates often require both parties to sign agreements concerning the disclosure of material nonpublic information. Even with the protections from such compliance practices, if an expert provides material nonpublic information, members and candidates would be prohibited from taking investment actions on the associated firm until the information became publicly known to the market.

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Investment Research Reports

When a particularly well-known or respected analyst issues a report or makes changes to his or her recommendation, that information alone may have an effect on the market and thus may be considered material. Theoretically, under Standard II(A), such a report would have to be made public at the time it was distributed to clients. The analyst is not a company insider, however, and does not have access to inside information. Presumably, the analyst created the report from information available to the public (mosaic theory) and by using his or her expertise to interpret the information. The analyst's hard work, paid for by the client, generated the conclusions.

Simply because the public in general would find the conclusions material does not require that the analyst make his or her work public. Investors who are not clients of the analyst can either do the work themselves or become clients of the analyst to gain access to the analyst's expertise.

Recommended Procedures for Compliance

Achieve Public Dissemination

If a member or candidate determines that information is material, the member or candidate should make reasonable efforts to achieve public dissemination of the information. These efforts usually entail encouraging the issuing company to make the information public. If public dissemination is not possible, the member or candidate must communicate the information only to the designated supervisory and compliance personnel within the member's or candidate's firm and must not take investment action or alter current investment recommendations on the basis of the information. Moreover, members and candidates must not knowingly engage in any conduct that may induce company insiders to privately disclose material nonpublic information.

Adopt Compliance Procedures

Members and candidates should encourage their firms to adopt compliance procedures to prevent the misuse of material nonpublic information. Particularly important is improving compliance in such areas as the review of employee and proprietary trading, the review of investment recommendations, documentation of firm procedures, and the supervision of interdepartmental communications in multiservice firms. Compliance procedures should suit the particular characteristics of a firm, including its size and the nature of its business.

Members and candidates are encouraged to inform their supervisor and compliance personnel of suspected inappropriate use of material nonpublic information as the basis for security trading activities or recommendations being made within their firm.

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Adopt Disclosure Procedures

Members and candidates should encourage their firms to develop and follow disclosure policies designed to ensure that information is disseminated to the marketplace in an equitable manner. For example, analysts from small firms should receive the same information and attention from a company as analysts from large firms receive. Similarly, companies should not provide certain information to buy-side analysts but not to sell-side analysts, or vice versa. Furthermore, a company should not discriminate among analysts in the provision of information or "blackball" particular analysts who have given negative reports on the company in the past.

Within investment and research firms, members and candidates should encourage the development of and compliance with procedures for distributing new and updated investment opinions to clients. Recommendations of this nature may represent material market-moving information that needs to be communicated to all clients fairly.

Issue Press Releases

Companies should consider issuing press releases prior to analyst meetings and conference calls and scripting those meetings and calls to decrease the chance that further information will be disclosed. If material nonpublic information is disclosed for the first time in an analyst meeting or call, the company should promptly issue a press release or otherwise make the information publicly available.

Firewall Elements

An information barrier commonly referred to as a "firewall" is the most widely used approach for preventing the communication of material nonpublic information within firms. It restricts the flow of confidential information to those who need to know the information to perform their jobs effectively. The minimum elements of such a system include, but are not limited to, the following:

- substantial control of relevant interdepartmental communications, preferably through a clearance area within the firm in either the compliance or legal department;
- review of employee trading through the maintenance of "watch," "restricted," and "rumor" lists;
- documentation of the procedures designed to limit the flow of information between departments and of the actions taken to enforce those procedures; and
- heightened review or restriction of proprietary trading while a firm is in possession of material nonpublic information.

Appropriate Interdepartmental Communications

Although documentation requirements must, for practical reasons, take into account the differences between the activities of small firms and those of large, multiservice

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firms, firms of all sizes and types benefit by improving the documentation of their internal enforcement of firewall procedures. Therefore, even at small firms, procedures concerning interdepartmental communication, the review of trading activity, and the investigation of possible violations should be compiled and formalized.

Physical Separation of Departments

As a practical matter, to the greatest extent possible, firms should consider the physical separation of departments and files to prevent the communication of sensitive information that should not be shared. For example, the investment banking and corporate finance areas of a brokerage firm should be separated from the sales and research departments, and a bank's commercial lending department should be segregated from its trust and research departments.

Prevention of Personnel Overlap

There should be no overlap of personnel between the investment banking and corporate finance areas of a brokerage firm and the sales and research departments or between a bank's commercial lending department and its trust and research departments. For a firewall to be effective in a multiservice firm, an employee should be on only one side of the firewall at any time. Inside knowledge may not be limited to information about a specific offering or the current financial condition of a company. Analysts may be exposed to much information about the company, including new product developments or future budget projections that clearly constitute inside knowledge and thus preclude the analyst from returning to his or her research function. For example, an analyst who follows a particular company may provide limited assistance to the investment bankers under carefully controlled circumstances when the firm's investment banking department is involved in a deal with the company. That analyst must then be treated as though he or she were an investment banker; the analyst must remain on the investment banking side of the wall until any information he or she learns is publicly disclosed. In short, the analyst cannot use any information learned in the course of the project for research purposes and cannot share that information with colleagues in the research department.

A Reporting System

A primary objective of an effective firewall procedure is to establish a reporting system in which authorized people review and approve communications between departments. If an employee behind a firewall believes that he or she needs to share confidential information with someone on the other side of the wall, the employee should consult a designated compliance officer to determine whether sharing the information is necessary and how much information should be shared. If the sharing is necessary, the compliance officer should coordinate the process of "looking over the wall" so that the necessary information will be shared and the integrity of the procedure will be maintained.

A single supervisor or compliance officer should have the specific authority and responsibility of deciding whether information is material and whether it is

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sufficiently public to be used as the basis for investment decisions. Ideally, the supervisor or compliance officer responsible for communicating information to a firm's research or brokerage area would not be a member of that area.

Personal Trading Limitations

Firms should consider restrictions or prohibitions on personal trading by employees and should carefully monitor both proprietary trading and personal trading by employees. Firms should require employees to make periodic reports (to the extent that such reporting is not already required by securities laws) of their own transactions and transactions made for the benefit of family members. Securities should be placed on a restricted list when a firm has or may have material nonpublic information. The broad distribution of a restricted list often triggers the sort of trading the list was developed to avoid. Therefore, a watch list shown to only the few people responsible for compliance should be used to monitor transactions in specified securities. The use of a watch list in combination with a restricted list is an increasingly common means of ensuring effective control of personal trading.

Record Maintenance

Multiservice firms should maintain written records of the communications between various departments. Firms should place a high priority on training and should consider instituting comprehensive training programs, particularly for employees in sensitive areas.

Proprietary Trading Procedures

Procedures concerning the restriction or review of a firm's proprietary trading while the firm possesses material nonpublic information will necessarily depend on the types of proprietary trading in which the firm may engage. A prohibition on all types of proprietary activity when a firm comes into possession of material nonpublic information is *not* appropriate. For example, when a firm acts as a market maker, a prohibition on proprietary trading may be counterproductive to the goals of maintaining the confidentiality of information and market liquidity. This concern is particularly important in the relationships between small, regional broker/dealers and small issuers. In many situations, a firm will take a small issuer public with the understanding that the firm will continue to be a market maker in the stock. In such instances, a withdrawal by the firm from market-making acts would be a clear tip to outsiders. Firms that continue market-making activity while in the possession of material nonpublic information should, however, instruct their market makers to remain passive with respect to the market—that is, to take only the contra side of unsolicited customer trades.

In risk-arbitrage trading, the case for a trading prohibition is more compelling than it is in the case of market making. The impetus for arbitrage trading is neither passive nor reactive, and the potential for illegal profits is greater than in market making. The most prudent course for firms is to suspend arbitrage activity when a security is placed on the watch list. Those firms that continue arbitrage

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activity face a high hurdle in proving the adequacy of their internal procedures for preventing trading on material nonpublic information and must demonstrate a stringent review and documentation of firm trades.

Communication to All Employees

Members and candidates should encourage their employers to circulate written compliance policies and guidelines to all employees. Policies and guidelines should be used in conjunction with training programs aimed at enabling employees to recognize material nonpublic information. Such information is not always clearly identifiable.

Employees must be given sufficient training to either make an informed decision or to realize they need to consult a supervisor or compliance officer before engaging in questionable transactions. Appropriate policies reinforce that using material nonpublic information is illegal in many countries. Such trading activities based on material nonpublic information undermine the integrity of the individual, the firm, and the capital markets.

Application of the Standard

Example 1 (Acting on Nonpublic Information):

Frank Barnes, the president and controlling shareholder of the SmartTown clothing chain, decides to accept a tender offer and sell the family business at a price almost double the market price of its shares. He describes this decision to his sister (SmartTown's treasurer), who conveys it to her daughter (who owns no stock in the family company at present), who tells her husband, Staple. Staple, however, tells his stockbroker, Alex Halsey, who immediately buys SmartTown stock for himself.

> *Comment*: The information regarding the pending sale is both material and nonpublic. Staple has violated Standard II(A) by communicating the inside information to his broker. Halsey also has violated the standard by buying the shares on the basis of material nonpublic information.

Example 2 (Controlling Nonpublic Information):

Samuel Peter, an analyst with Scotland and Pierce Incorporated, is assisting his firm with a secondary offering for Bright Ideas Lamp Company. Peter participates, via telephone conference call, in a meeting with Scotland and Pierce investment banking employees and Bright Ideas' CEO. Peter is advised that the company's earnings projections for the next year have significantly dropped. Throughout the telephone conference call, several Scotland and Pierce salespeople and portfolio managers walk in and out of Peter's office, where the telephone call is taking place. As a result, they are aware of the drop in projected earnings for Bright Ideas. Before the conference call is concluded, the salespeople trade the stock of the company on behalf of the firm's clients and other firm personnel trade the stock in a firm proprietary account and in employees' personal accounts.

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Comment: Peter has violated Standard II(A) because he failed to prevent the transfer and misuse of material nonpublic information to others in his firm. Peter's firm should have adopted information barriers to prevent the communication of nonpublic information between departments of the firm. The salespeople and portfolio managers who traded on the information have also violated Standard II(A) by trading on inside information.

Example 3 (Selective Disclosure of Material Information):

Elizabeth Levenson is based in Taipei and covers the Taiwanese market for her firm, which is based in Singapore. She is invited, together with the other 10 largest shareholders of a manufacturing company, to meet the finance director of that company. During the meeting, the finance director states that the company expects its workforce to strike next Friday, which will cripple productivity and distribution. Can Levenson use this information as a basis to change her rating on the company from "buy" to "sell"?

Comment: Levenson must first determine whether the material information is public. According to Standard II(A), if the company has not made this information public (a small group forum does not qualify as a method of public dissemination), she cannot use the information.

Example 4 (Determining Materiality):

Leah Fechtman is trying to decide whether to hold or sell shares of an oil-and-gas exploration company that she owns in several of the funds she manages. Although the company has underperformed the index for some time already, the trends in the industry sector signal that companies of this type might become takeover targets. While she is considering her decision, her doctor, who casually follows the markets, mentions that she thinks that the company in question will soon be bought out by a large multinational conglomerate and that it would be a good idea to buy the stock right now. After talking to various investment professionals and checking their opinions on the company as well as checking industry trends, Fechtman decides the next day to accumulate more stock in the oil-and-gas exploration company.

Comment: Although information on an expected takeover bid may be of the type that is generally material and nonpublic, in this case, the source of information is unreliable, so the information cannot be considered material. Therefore, Fechtman is not prohibited from trading the stock on the basis of this information.

Example 5 (Applying the Mosaic Theory):

Jagdish Teja is a buy-side analyst covering the furniture industry. Looking for an attractive company to recommend as a buy, he analyzes several furniture makers by studying their financial reports and visiting their operations. He also talks to some designers and retailers to find out which furniture styles are trendy and popular.

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Although none of the companies that he analyzes are a clear buy, he discovers that one of them, Swan Furniture Company (SFC), may be in financial trouble. SFC's extravagant new designs have been introduced at substantial cost. Even though these designs initially attracted attention, the public is now buying more conservative furniture from other makers. Based on this information and on a profit-and-loss analysis, Teja believes that SFC's next quarter earnings will drop substantially. He issues a sell recommendation for SFC. Immediately after receiving that recommendation, investment managers start reducing the SFC stock in their portfolios.

> *Comment*: Information on quarterly earnings data is material and nonpublic. Teja arrived at his conclusion about the earnings drop on the basis of public information and on pieces of nonmaterial nonpublic information (such as opinions of designers and retailers). Therefore, trading based on Teja's correct conclusion is not prohibited by Standard II(A).

Example 6 (Applying the Mosaic Theory):

Roger Clement is a senior financial analyst who specializes in the European automobile sector at Rivoli Capital. Because he has been repeatedly nominated by many leading industry magazines and newsletters as a "best analyst" for the automobile industry, he is widely regarded as an authority on the sector. After speaking with representatives of Turgot Chariots—a European auto manufacturer with sales primarily in South Korea—and after conducting interviews with salespeople, labor leaders, his firm's Korean currency analysts, and banking officials, Clement analyzed Turgot Chariots and concluded that (1) its newly introduced model will probably not meet sales expectations, (2) its corporate restructuring strategy may well face serious opposition from unions, (3) the depreciation of the Korean won should lead to pressure on margins for the industry in general and Turgot's market segment in particular, and (4) banks could take a tougher-than-expected stance in the upcoming round of credit renegotiations with the company. For these reasons, he changes his conclusion about the company from "market outperform" to "market underperform." Clement retains the support material used to reach his conclusion in case questions later arise.

> *Comment*: To reach a conclusion about the value of the company, Clement has pieced together a number of nonmaterial or public bits of information that affect Turgot Chariots. Therefore, under the mosaic theory, Clement has not violated Standard II(A) in drafting the report.

Example 7 (Analyst Recommendations as Material Nonpublic Information):

The next day, Clement is preparing to be interviewed on a global financial news television program where he will discuss his changed recommendation on Turgot Chariots for the first time in public. While preparing for the program, he mentions to the show's producers and Mary Zito, the journalist who will be interviewing him, the information he will be discussing. Just prior to going on the air, Zito sells her

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holdings in Turgot Chariots. She also phones her father with the information because she knows that he and other family members have investments in Turgot Chariots.

Comment: When Zito receives advance notice of Clement's change of opinion, she knows it will have a material impact on the stock price, even if she is not totally aware of Clement's underlying reasoning. She is not a client of Clement but obtains early access to the material nonpublic information prior to publication. Her trades are thus based on material nonpublic information and violate Standard II(A).

Zito further violates the Standard by relaying the information to her father. It would not matter if he or any other family member traded; the act of providing the information violates Standard II(A). The fact that the information is provided to a family member does not absolve someone of the prohibition of using or communicating material nonpublic information.

Example 8 (Acting on Nonpublic Information):

Ashton Kellogg is a retired investment professional who manages his own portfolio. He owns shares in National Savings, a large local bank. A close friend and golfing buddy, John Mayfield, is a senior executive at National. National has seen its stock price drop considerably, and the news and outlook are not good. In a conversation about the economy and the banking industry on the golf course, Mayfield relays the information that National will surprise the investment community in a few days when it announces excellent earnings for the quarter. Kellogg is pleasantly surprised by this information, and thinking that Mayfield, as a senior executive, knows the law and would not disclose inside information, he doubles his position in the bank. Subsequently, National announces that it had good operating earnings but had to set aside reserves for anticipated significant losses on its loan portfolio. The combined news causes the stock to go down 60%.

Comment: Even though Kellogg believes that Mayfield would not break the law by disclosing inside information and money was lost on the purchase, Kellogg should not have purchased additional shares of National. It is the member's or candidate's responsibility to make sure, before executing investment actions, that comments about earnings are not material nonpublic information. Kellogg has violated Standard II(A).

Example 9 (Mosaic Theory):

John Doll is a research analyst for a hedge fund that also sells its research to a select group of paying client investment firms. Doll's focus is medical technology companies and products, and he has been in the business long enough and has been successful enough to build up a very credible network of friends and experts in the business. Doll has been working on a major research report recommending Boyce Health, a medical device manufacturer. He recently ran into an old acquaintance at a wedding who is a senior executive at Boyce, and Doll asked

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about the business. Doll was drawn to a statement that the executive, who has responsibilities in the new products area, made about a product: "I would not get too excited about the medium-term prospects; we have a lot of work to do first." Doll incorporated this and other information about the new Boyce product in his long-term recommendation of Boyce.

> *Comment*: Doll's conversation with the senior executive is part of the mosaic of information used in recommending Boyce. When holding discussions with a firm executive, Doll would need to guard against soliciting or obtaining material nonpublic information. Before issuing the report, the executive's statement about the continuing development of the product would need to be weighed against the other known public facts to determine whether it would be considered material.

Example 10 (Materiality Determination):

Larry Nadler, a trader for a mutual fund, gets a text message from another firm's trader, whom he has known for years. The message indicates a software company is going to report strong earnings when the firm publicly announces in two days. Nadler has a buy order from a portfolio manager within his firm to purchase several hundred thousand shares of the stock. Nadler is aggressive in placing the portfolio manager's order and completes the purchases by the following morning, a day ahead of the firm's planned earnings announcement.

> *Comment*: There are often rumors and whisper numbers before a release of any kind. The text message from the other trader would most likely be considered market noise. Unless Nadler knew that the trader had an ongoing business relationship with the public firm, he had no reason to suspect he was receiving material nonpublic information that would prevent him from completing the trading request of the portfolio manager.

Example 11 (Using an Expert Network):

Mary McCoy is the senior drug analyst at a mutual fund. Her firm hires a service that connects her to experts in the treatment of cancer. Through various phone conversations, McCoy enhances her understanding of the latest therapies for successful treatment. This information is critical to Mary making informed recommendations of the companies producing these drugs.

> *Comment*: McCoy is appropriately using the expert networks to enhance her evaluation process. She has neither asked for nor received information that may be considered material and nonpublic, such as preliminary trial results. McCoy is allowed to seek advice from professionals within the industry that she follows.

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Example 12 (Using an Expert Network):

Tom Watson is a research analyst working for a hedge fund. To stay informed, Watson relies on outside experts for information on such industries as technology and pharmaceuticals, where new advancements occur frequently. The meetings with the industry experts often are arranged through networks or placement agents that have specific policies and procedures in place to deter the exchange of material nonpublic information.

Watson arranges a call to discuss future prospects for one of the fund's existing technology company holdings, a company that was testing a new semiconductor product. The scientist leading the tests indicates his disappointment with the performance of the new semiconductor. Following the call, Watson relays the insights he received to others at the fund. The fund sells its current position in the company and buys put options because the market is anticipating the success of the new semiconductor and the share price reflects the market's optimism.

Comment: Watson has violated Standard II(A) by passing along material nonpublic information concerning the ongoing product tests, which the fund used to trade in the securities and options of the related company. Watson cannot simply rely on the agreements signed by individuals who participate in expert networks that state that he has not received information that would prohibit his trading activity. He must make his own determination whether information he received through these arrangements reaches a materiality threshold that would affect his trading abilities.

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Standard II(B) Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

Guidance

Highlights:

- *Information-Based Manipulation*
- *Transaction-Based Manipulation*

Standard II(B) requires that members and candidates uphold market integrity by prohibiting market manipulation. Market manipulation includes practices that distort security prices or trading volume with the intent to deceive people or entities that rely on information in the market. Market manipulation damages the interests of all investors by disrupting the smooth functioning of financial markets and lowering investor confidence.

Market manipulation may lead to a lack of trust in the fairness of the capital markets, resulting in higher risk premiums and reduced investor participation. A reduction in the efficiency of a local capital market may negatively affect the growth and economic health of the country and may also influence the operations of the globally interconnected capital markets. Although market manipulation may be less likely to occur in mature financial markets than in emerging markets, cross-border investing increasingly exposes all global investors to the potential for such practices.

Market manipulation includes (1) the dissemination of false or misleading information and (2) transactions that deceive or would be likely to mislead market participants by distorting the price-setting mechanism of financial instruments. The development of new products and technologies increases the incentives, means, and opportunities for market manipulation. Additionally, the increasing complexity and sophistication of the technologies used for communicating with market participants have created new avenues for manipulation.

Information-Based Manipulation

Information-based manipulation includes, but is not limited to, spreading false rumors to induce trading by others. For example, members and candidates must refrain from "pumping up" the price of an investment by issuing misleading positive information or overly optimistic projections of a security's worth only to later "dump" the investment (i.e., sell it) once the price, fueled by the misleading information's effect on other market participants, reaches an artificially high level.

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Transaction-Based Manipulation

Transaction-based manipulation involves instances where a member or candidate knew or should have known that his or her actions could affect the pricing of a security. This type of manipulation includes, but is not limited to, the following:

- transactions that artificially affect prices or volume to give the impression of activity or price movement in a financial instrument, which represent a diversion from the expectations of a fair and efficient market, and
- securing a controlling, dominant position in a financial instrument to exploit and manipulate the price of a related derivative and/or the underlying asset.

Standard II(B) is not intended to preclude transactions undertaken on legitimate trading strategies based on perceived market inefficiencies. The intent of the action is critical to determining whether it is a violation of this standard.

Application of the Standard

Example 1 (Independent Analysis and Company Promotion):

The principal owner of Financial Information Services (FIS) entered into an agreement with two microcap companies to promote the companies' stock in exchange for stock and cash compensation. The principal owner caused FIS to disseminate e-mails, design and maintain several websites, and distribute an online investment newsletter—all of which recommended investment in the two companies. The systematic publication of purportedly independent analyses and recommendations containing inaccurate and highly promotional and speculative statements increased public investment in the companies and led to dramatically higher stock prices.

> *Comment*: The principal owner of FIS violated Standard II(B) by using inaccurate reporting and misleading information under the guise of independent analysis to artificially increase the stock price of the companies. Furthermore, the principal owner violated Standard V(A)–Diligence and Reasonable Basis by not having a reasonable and adequate basis for recommending the two companies and violated Standard VI(A)–Disclosure of Conflicts by not disclosing to investors the compensation agreements (which constituted a conflict of interest).

Example 2 (Personal Trading Practices and Price):

John Gray is a private investor in Belgium who bought a large position several years ago in Fame Pharmaceuticals, a German small-cap security with limited average trading volume. He has now decided to significantly reduce his holdings owing to the poor price performance. Gray is worried that the low trading volume for the stock may cause the price to decline further as he attempts to sell his large position.

Gray devises a plan to divide his holdings into multiple accounts in different brokerage firms and private banks in the names of family members, friends, and

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even a private religious institution. He then creates a rumor campaign on various blogs and social media outlets promoting the company.

Gray begins to buy and sell the stock using the accounts in hopes of raising the trading volume and the price. He conducts the trades through multiple brokers, selling slightly larger positions than he bought on a tactical schedule, and over time, he is able to reduce his holding as desired without negatively affecting the sale price.

> *Comment*: John violated Standard II(B) by fraudulently creating the appearance that there was a greater investor interest in the stock through the online rumors. Additionally, through his trading strategy, he created the appearance that there was greater liquidity in the stock than actually existed. He was able to manipulate the price through both misinformation and trading practices.

Example 3 (Creating Artificial Price Volatility):

Matthew Murphy is an analyst at Divisadero Securities & Co., which has a significant number of hedge funds among its most important brokerage clients. Some of the hedge funds hold short positions on Wirewolf Semiconductor. Two trading days before the publication of a quarter-end report, Murphy alerts his sales force that he is about to issue a research report on Wirewolf that will include the following opinions:

- quarterly revenues are likely to fall short of management's guidance,
- earnings will be as much as 5 cents per share (or more than 10%) below consensus, and
- Wirewolf's highly respected chief financial officer may be about to join another company.

Knowing that Wirewolf has already entered its declared quarter-end "quiet period" before reporting earnings (and thus would be reluctant to respond to rumors), Murphy times the release of his research report specifically to sensationalize the negative aspects of the message in order to create significant downward pressure on Wirewolf's stock—to the distinct advantage of Divisadero's hedge fund clients. The report's conclusions are based on speculation, not on fact. The next day, the research report is broadcast to all of Divisadero's clients and to the usual newswire services.

Before Wirewolf's investor-relations department can assess the damage on the final trading day of the quarter and refute Murphy's report, its stock opens trading sharply lower, allowing Divisadero's clients to cover their short positions at substantial gains.

> *Comment*: Murphy violated Standard II(B) by aiming to create artificial price volatility designed to have a material impact on the price of an issuer's stock. Moreover, by lacking an adequate basis for the recommendation, Murphy also violated Standard V(A)–Diligence and Reasonable Basis.

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Example 4 (Personal Trading and Volume):

Rajesh Sekar manages two funds—an equity fund and a balanced fund—whose equity components are supposed to be managed in accordance with the same model. According to that model, the funds' holdings in stock of Digital Design Inc. (DD) are excessive. Reduction of the DD holdings would not be easy, however, because the stock has low liquidity in the stock market. Sekar decides to start trading larger portions of DD stock back and forth between his two funds to slowly increase the price; he believes market participants will see growing volume and increasing price and become interested in the stock. If other investors are willing to buy the DD stock because of such interest, then Sekar will be able to get rid of at least some of his overweight position without inducing price decreases. In this way, the whole transaction will be for the benefit of fund participants, even if additional brokers' commissions are incurred.

> *Comment*: Sekar's plan would be beneficial for his funds' participants but is based on artificial distortion of both trading volume and the price of the DD stock and thus constitutes a violation of Standard II(B).

Example 5 ("Pump-Priming" Strategy):

ACME Futures Exchange is launching a new bond futures contract. To convince investors, traders, arbitrageurs, hedgers, and so on, to use its contract, the exchange attempts to demonstrate that it has the best liquidity. To do so, it enters into agreements with members in which they commit to a substantial minimum trading volume on the new contract over a specific period in exchange for substantial reductions of their regular commissions.

> *Comment*: The formal liquidity of a market is determined by the obligations set on market makers, but the actual liquidity of a market is better estimated by the actual trading volume and bid–ask spreads. Attempts to mislead participants about the actual liquidity of the market constitute a violation of Standard II(B). In this example, investors have been intentionally misled to believe they chose the most liquid instrument for some specific purpose, but they could eventually see the actual liquidity of the contract significantly reduced after the term of the agreement expires. If the ACME Futures Exchange fully discloses its agreement with members to boost transactions over some initial launch period, it will not violate Standard II(B). ACME's intent is not to harm investors but, on the contrary, to give them a better service. For that purpose, it may engage in a liquidity-pumping strategy, but the strategy must be disclosed.

Example 6 (Creating Artificial Price Volatility):

Emily Gordon, an analyst of household products companies, is employed by a research boutique, Picador & Co. Based on information that she has gathered during a trip through Latin America, she believes that Hygene, Inc., a major marketer

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of personal care products, has generated better-than-expected sales from its new product initiatives in South America. After modestly boosting her projections for revenue and for gross profit margin in her worksheet models for Hygene, Gordon estimates that her earnings projection of US$2.00 per diluted share for the current year may be as much as 5% too low. She contacts the chief financial officer (CFO) of Hygene to try to gain confirmation of her findings from her trip and to get some feedback regarding her revised models. The CFO declines to comment and reiterates management's most recent guidance of US$1.95–US$2.05 for the year.

Gordon decides to try to force a comment from the company by telling Picador & Co. clients who follow a momentum investment style that consensus earnings projections for Hygene are much too low; she explains that she is considering raising her published estimate by an ambitious US$0.15 to US$2.15 per share. She believes that when word of an unrealistically high earnings projection filters back to Hygene's investor-relations department, the company will feel compelled to update its earnings guidance. Meanwhile, Gordon hopes that she is at least correct with respect to the earnings direction and that she will help clients who act on her insights to profit from a quick gain by trading on her advice.

Comment: By exaggerating her earnings projections in order to try to fuel a quick gain in Hygene's stock price, Gordon is in violation of Standard II(B). Furthermore, by virtue of previewing her intentions of revising upward her earnings projections to only a select group of clients, she is in violation of Standard III(B)–Fair Dealing. However, it would have been acceptable for Gordon to write a report that

- framed her earnings projection in a range of possible outcomes,
- outlined clearly the assumptions used in her Hygene models that took into consideration the findings from her trip through Latin America, and
- was distributed to all Picador & Co. clients in an equitable manner.

Example 7 (Pump and Dump Strategy):

In an effort to pump up the price of his holdings in Moosehead & Belfast Railroad Company, Steve Weinberg logs on to several investor chat rooms on the internet to start rumors that the company is about to expand its rail network in anticipation of receiving a large contract for shipping lumber.

Comment: Weinberg has violated Standard II(B) by disseminating false information about Moosehead & Belfast with the intent to mislead market participants.

Example 8 (Manipulating Model Inputs):

Bill Mandeville supervises a structured financing team for Superior Investment Bank. His responsibilities include packaging new structured investment products

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and managing Superior's relationship with relevant rating agencies. To achieve the best rating possible, Mandeville uses mostly positive scenarios as model inputs—scenarios that reflect minimal downside risk in the assets underlying the structured products. The resulting output statistics in the rating request and underwriting prospectus support the idea that the new structured products have minimal potential downside risk. Additionally, Mandeville's compensation from Superior is partially based on both the level of the rating assigned and the successful sale of new structured investment products but does not have a link to the long-term performance of the instruments.

Mandeville is extremely successful and leads Superior as the top originator of structured investment products for the next two years. In the third year, the economy experiences difficulties and the values of the assets underlying structured products significantly decline. The subsequent defaults lead to major turmoil in the capital markets, the demise of Superior Investment Bank, and the loss of Mandeville's employment.

> *Comment*: Mandeville manipulates the inputs of a model to minimize associated risk to achieve higher ratings. His understanding of structured products allows him to skillfully decide which inputs to include in support of the desired rating and price. This information manipulation for short-term gain, which is in violation of Standard II(B), ultimately causes significant damage to many parties and the capital markets as a whole. Mandeville should have realized that promoting a rating and price with inaccurate information could cause not only a loss of price confidence in the particular structured product but also a loss of investor trust in the system. Such loss of confidence affects the ability of the capital markets to operate efficiently.

Example 9 (Information Manipulation):

Allen King is a performance analyst for Torrey Investment Funds. King believes that the portfolio manager for the firm's small- and microcap equity fund dislikes him because the manager never offers him tickets to the local baseball team's games but does offer tickets to other employees. To incite a potential regulatory review of the manager, King creates user profiles on several online forums under the portfolio manager's name and starts rumors about potential mergers for several of the smaller companies in the portfolio. As the prices of these companies' stocks increase, the portfolio manager sells the position, which leads to an investigation by the regulator as King desired.

> *Comment*: King has violated Standard II(B) even though he did not personally profit from the market's reaction to the rumor. In posting the false information, King misleads others into believing the companies were likely to be acquired. Although his intent was to create trouble for the portfolio manager, his actions clearly manipulated the factual information that was available to the market.

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Standard III: Duties to Clients

Standard III(A) Loyalty, Prudence, and Care

> Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

Guidance

Highlights:

- *Understanding the Application of Loyalty, Prudence, and Care*
- *Identifying the Actual Investment Client*
- *Developing the Client's Portfolio*
- *Soft Commission Policies*
- *Proxy Voting Policies*

Standard III(A) clarifies that client interests are paramount. A member's or candidate's responsibility to a client includes a duty of loyalty and a duty to exercise reasonable care. Investment actions must be carried out for the sole benefit of the client and in a manner the member or candidate believes, given the known facts and circumstances, to be in the best interest of the client. Members and candidates must exercise the same level of prudence, judgment, and care that they would apply in the management and disposition of their own interests in similar circumstances.

Prudence requires caution and discretion. The exercise of prudence by investment professionals requires that they act with the care, skill, and diligence that a reasonable person acting in a like capacity and familiar with such matters would use. In the context of managing a client's portfolio, prudence requires following the investment parameters set forth by the client and balancing risk and return. Acting with care requires members and candidates to act in a prudent and judicious manner in avoiding harm to clients.

Standard III(A) sets minimum expectations for members and candidates when fulfilling their responsibilities to their clients. Regulatory and legal requirements for such duties can vary across the investment industry depending on a variety of factors, including job function of the investment professional, the existence of an adviser/client relationship, and the nature of the recommendations being offered. From the perspective of the end user of financial services, these different standards can be arcane and confusing, leaving investors unsure of what level of service to expect from investment professionals they employ. The single

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standard of conduct described in Standard III(A) benefits investors by establishing a benchmark for the duties of loyalty, prudence, and care and clarifies that all CFA Institute members and candidates, regardless of job title, local laws, or cultural differences, are required to comply with these fundamental responsibilities. Investors hiring members or candidates who must adhere to the duty of loyalty, prudence, and care set forth in this standard can be confident that these responsibilities are a requirement regardless of any legally imposed fiduciary duties.

Standard III(A), however, is not a substitute for a member's or candidate's legal or regulatory obligations. As stated in Standard I(A), members and candidates must abide by the most strict requirements imposed on them by regulators or the Code and Standards, including any legally imposed fiduciary duty. Members and candidates must also be aware of whether they have "custody" or effective control of client assets. If so, a heightened level of responsibility arises. Members and candidates are considered to have custody if they have any direct or indirect access to client funds. Members and candidates must manage any pool of assets in their control in accordance with the terms of the governing documents (such as trust documents and investment management agreements), which are the primary determinant of the manager's powers and duties. Whenever their actions are contrary to provisions of those instruments or applicable law, members and candidates are at risk of violating Standard III(A).

Understanding the Application of Loyalty, Prudence, and Care

Standard III(A) establishes a minimum benchmark for the duties of loyalty, prudence, and care that are required of all members and candidates regardless of whether a legal fiduciary duty applies. Although fiduciary duty often encompasses the principles of loyalty, prudence, and care, Standard III(A) does not render all members and candidates fiduciaries. The responsibilities of members and candidates for fulfilling their obligations under this standard depend greatly on the nature of their professional responsibilities and the relationships they have with clients. The conduct of members and candidates may or may not rise to the level of being a fiduciary, depending on the type of client, whether the member or candidate is giving investment advice, and the many facts and circumstances surrounding a particular transaction or client relationship.

Fiduciary duties are often imposed by law or regulation when an individual or institution is charged with the duty of acting for the benefit of another party, such as managing investment assets. The duty required in fiduciary relationships exceeds what is acceptable in many other business relationships because a fiduciary is in an enhanced position of trust. Although members and candidates must comply with any legally imposed fiduciary duty, the Code and Standards neither impose such a legal responsibility nor require all members or candidates to act as fiduciaries. However, Standard III(A) requires members and candidates to work in the client's best interest no matter what the job function.

A member or candidate who does not provide advisory services to a client but who acts only as a trade execution professional must prudently work in the client's

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interest when completing requested trades. Acting in the client's best interest requires these professionals to use their skills and diligence to execute trades in the most favorable terms that can be achieved. Members and candidates operating in such positions must use care to operate within the parameters set by the client's trading instructions.

Members and candidates may also operate in a blended environment where they execute client trades and offer advice on a limited set of investment options. The extent of the advisory arrangement and limitations should be outlined in the agreement with the client at the outset of the relationship. For instance, members and candidates should inform clients that the advice provided will be limited to the propriety products of the firm and not include other products available on the market. Clients who want access to a wider range of investment products would have the information necessary to decide not to engage with members or candidates working under these restrictions.

Members and candidates operating in this blended context would comply with their obligations by recommending the allowable products that are consistent with the client's objectives and risk tolerances. They would exercise care through diligently aligning the client's needs with the attributes of the products being recommended. Members and candidates should place the client's interests first by disregarding any firm or personal interest in motivating a recommended transaction.

There is a large variety of professional relationships that members and candidates have with their clients. Standard III(A) requires them to fulfill the obligations outlined explicitly or implicitly in the client agreements to the best of their abilities and with loyalty, prudence, and care. Whether a member or candidate is structuring a new securitization transaction, completing a credit rating analysis, or leading a public company, he or she must work with prudence and care in delivering the agreed-on services.

Identifying the Actual Investment Client

The first step for members and candidates in fulfilling their duty of loyalty to clients is to determine the identity of the "client" to whom the duty of loyalty is owed. In the context of an investment manager managing the personal assets of an individual, the client is easily identified. When the manager is responsible for the portfolios of pension plans or trusts, however, the client is not the person or entity who hires the manager but, rather, the beneficiaries of the plan or trust. The duty of loyalty is owed to the ultimate beneficiaries.

In some situations, an actual client or group of beneficiaries may not exist. Members and candidates managing a fund to an index or an expected mandate owe the duty of loyalty, prudence, and care to invest in a manner consistent with the stated mandate. The decisions of a fund's manager, although benefiting all fund investors, do not have to be based on an individual investor's requirements and risk profile. Client loyalty and care for those investing in the fund are the responsibility of members and candidates who have an advisory relationship with those individuals.

Situations involving potential conflicts of interest with respect to responsibilities to clients may be extremely complex because they may involve a number

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of competing interests. The duty of loyalty, prudence, and care applies to a large number of persons in varying capacities, but the exact duties may differ in many respects in accord with the relationship with each client or each type of account in which the assets are managed. Members and candidates must not only put their obligations to clients first in all dealings but also endeavor to avoid all real or potential conflicts of interest.

Members and candidates with positions whose responsibilities do not include direct investment management also have "clients" that must be considered. Just as there are various types of advisory relationships, members and candidates must look at their roles and responsibilities when making a determination of who their clients are. Sometimes the client is easily identifiable; such is the case in the relationship between a company executive and the firm's public shareholders. At other times, the client may be the investing public as a whole, in which case the goals of independence and objectivity of research surpass the goal of loyalty to a single organization.

Developing the Client's Portfolio

The duty of loyalty, prudence, and care owed to the individual client is especially important because the professional investment manager typically possesses greater knowledge in the investment arena than the client does. This disparity places the individual client in a vulnerable position; the client must trust the manager. The manager in these situations should ensure that the client's objectives and expectations for the performance of the account are realistic and suitable to the client's circumstances and that the risks involved are appropriate. In most circumstances, recommended investment strategies should relate to the long-term objectives and circumstances of the client.

Particular care must be taken to detect whether the goals of the investment manager or the firm in conducting business, selling products, and executing security transactions potentially conflict with the best interests and objectives of the client. When members and candidates cannot avoid potential conflicts between their firm and clients' interests, they must provide clear and factual disclosures of the circumstances to the clients.

Members and candidates must follow any guidelines set by their clients for the management of their assets. Some clients, such as charitable organizations and pension plans, have strict investment policies that limit investment options to certain types or classes of investment or prohibit investment in certain securities. Other organizations have aggressive policies that do not prohibit investments by type but, instead, set criteria on the basis of the portfolio's total risk and return.

Investment decisions must be judged in the context of the total portfolio rather than by individual investment within the portfolio. The member's or candidate's duty is satisfied with respect to a particular investment if the individual has thoroughly considered the investment's place in the overall portfolio, the risk of loss and opportunity for gains, tax implications, and the diversification, liquidity, cash flow, and overall return requirements of the assets or the portion of the assets for which the manager is responsible.

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Soft Commission Policies

An investment manager often has discretion over the selection of brokers executing transactions. Conflicts may arise when an investment manager uses client brokerage to purchase research services, a practice commonly called "soft dollars" or "soft commissions." A member or candidate who pays a higher brokerage commission than he or she would normally pay to allow for the purchase of goods or services, without corresponding benefit to the client, violates the duty of loyalty to the client.

From time to time, a client will direct a manager to use the client's brokerage to purchase goods or services for the client, a practice that is commonly called "directed brokerage." Because brokerage commission is an asset of the client and is used to benefit that client, not the manager, such a practice does not violate any duty of loyalty. However, a member or candidate is obligated to seek "best price" and "best execution" and be assured by the client that the goods or services purchased from the brokerage will benefit the account beneficiaries. "Best execution" refers to a trading process that seeks to maximize the value of the client's portfolio within the client's stated investment objectives and constraints. In addition, the member or candidate should disclose to the client that the client may not be getting best execution from the directed brokerage.

Proxy Voting Policies

The duty of loyalty, prudence, and care may apply in a number of situations facing the investment professional besides those related directly to investing assets.

Part of a member's or candidate's duty of loyalty includes voting proxies in an informed and responsible manner. Proxies have economic value to a client, and members and candidates must ensure that they properly safeguard and maximize this value. An investment manager who fails to vote, casts a vote without considering the impact of the question, or votes blindly with management on nonroutine governance issues (e.g., a change in company capitalization) may violate this standard. Voting of proxies is an integral part of the management of investments.

A cost–benefit analysis may show that voting all proxies may not benefit the client, so voting proxies may not be necessary in all instances. Members and candidates should disclose to clients their proxy voting policies.

Recommended Procedures for Compliance

Regular Account Information

Members and candidates with control of client assets (1) should submit to each client, at least quarterly, an itemized statement showing the funds and securities in the custody or possession of the member or candidate plus all debits, credits, and transactions that occurred during the period, (2) should disclose to the client where the assets are to be maintained, as well as where or when they are moved, and (3) should separate the client's assets from any other party's assets, including the member's or candidate's own assets.

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Client Approval

If a member or candidate is uncertain about the appropriate course of action with respect to a client, the member or candidate should consider what he or she would expect or demand if the member or candidate were the client. If in doubt, a member or candidate should disclose the questionable matter in writing to the client and obtain client approval.

Firm Policies

Members and candidates should address and encourage their firms to address the following topics when drafting the statements or manuals containing their policies and procedures regarding responsibilities to clients:

- *Follow all applicable rules and laws*: Members and candidates must follow all legal requirements and applicable provisions of the Code and Standards.
- *Establish the investment objectives of the client*: Make a reasonable inquiry into a client's investment experience, risk and return objectives, and financial constraints prior to making investment recommendations or taking investment actions.
- *Consider all the information when taking actions*: When taking investment actions, members and candidates must consider the appropriateness and suitability of the investment relative to (1) the client's needs and circumstances, (2) the investment's basic characteristics, and (3) the basic characteristics of the total portfolio.
- *Diversify*: Members and candidates should diversify investments to reduce the risk of loss, unless diversification is not consistent with plan guidelines or is contrary to the account objectives.
- *Carry out regular reviews*: Members and candidates should establish regular review schedules to ensure that the investments held in the account adhere to the terms of the governing documents.
- *Deal fairly with all clients with respect to investment actions*: Members and candidates must not favor some clients over others and should establish policies for allocating trades and disseminating investment recommendations.
- *Disclose conflicts of interest*: Members and candidates must disclose all actual and potential conflicts of interest so that clients can evaluate those conflicts.
- *Disclose compensation arrangements*: Members and candidates should make their clients aware of all forms of manager compensation.
- *Vote proxies*: In most cases, members and candidates should determine who is authorized to vote shares and vote proxies in the best interests of the clients and ultimate beneficiaries.

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- *Maintain confidentiality*: Members and candidates must preserve the confidentiality of client information.
- *Seek best execution*: Unless directed by the client as ultimate beneficiary, members and candidates must seek best execution for their clients. (Best execution is defined in the preceding text.)
- *Place client interests first*: Members and candidates must serve the best interests of clients.

Application of the Standard

Example 1 (Identifying the Client—Plan Participants):

First Country Bank serves as trustee for the Miller Company's pension plan. Miller is the target of a hostile takeover attempt by Newton, Inc. In attempting to ward off Newton, Miller's managers persuade Julian Wiley, an investment manager at First Country Bank, to purchase Miller common stock in the open market for the employee pension plan. Miller's officials indicate that such action would be favorably received and would probably result in other accounts being placed with the bank. Although Wiley believes the stock is overvalued and would not ordinarily buy it, he purchases the stock to support Miller's managers, to maintain Miller's good favor toward the bank, and to realize additional new business. The heavy stock purchases cause Miller's market price to rise to such a level that Newton retracts its takeover bid.

Comment: Standard III(A) requires that a member or candidate, in evaluating a takeover bid, act prudently and solely in the interests of plan participants and beneficiaries. To meet this requirement, a member or candidate must carefully evaluate the long-term prospects of the company against the short-term prospects presented by the takeover offer and by the ability to invest elsewhere. In this instance, Wiley, acting on behalf of his employer, which was the trustee for a pension plan, clearly violated Standard III(A). He used the pension plan to perpetuate existing management, perhaps to the detriment of plan participants and the company's shareholders, and to benefit himself. Wiley's responsibilities to the plan participants and beneficiaries should have taken precedence over any ties of his bank to corporate managers and over his self-interest. Wiley had a duty to examine the takeover offer on its own merits and to make an independent decision. The guiding principle is the appropriateness of the investment decision to the pension plan, not whether the decision benefited Wiley or the company that hired him.

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Example 2 (Client Commission Practices):

JNI, a successful investment counseling firm, serves as investment manager for the pension plans of several large regionally based companies. Its trading activities generate a significant amount of commission-related business. JNI uses the brokerage and research services of many firms, but most of its trading activity is handled through a large brokerage company, Thompson, Inc., because the executives of the two firms have a close friendship. Thompson's commission structure is high in comparison with charges for similar brokerage services from other firms. JNI considers Thompson's research services and execution capabilities average. In exchange for JNI directing its brokerage to Thompson, Thompson absorbs a number of JNI overhead expenses, including those for rent.

> *Comment*: JNI executives are breaching their responsibilities by using client brokerage for services that do not benefit JNI clients and by not obtaining best price and best execution for their clients. Because JNI executives are not upholding their duty of loyalty, they are violating Standard III(A).

Example 3 (Brokerage Arrangements):

Charlotte Everett, a struggling independent investment adviser, serves as investment manager for the pension plans of several companies. One of her brokers, Scott Company, is close to consummating management agreements with prospective new clients whereby Everett would manage the new client accounts and trade the accounts exclusively through Scott. One of Everett's existing clients, Crayton Corporation, has directed Everett to place securities transactions for Crayton's account exclusively through Scott. But to induce Scott to exert efforts to send more new accounts to her, Everett also directs transactions to Scott from other clients without their knowledge.

> *Comment*: Everett has an obligation at all times to seek best price and best execution on all trades. Everett may direct new client trades exclusively through Scott Company as long as Everett receives best price and execution on the trades or receives a written statement from new clients that she is *not* to seek best price and execution and that they are aware of the consequence for their accounts. Everett may trade other accounts through Scott as a reward for directing clients to Everett only if the accounts receive best price and execution and the practice is disclosed to the accounts. Because Everett does not disclose the directed trading, Everett has violated Standard III(A).

Example 4 (Brokerage Arrangements):

Emilie Rome is a trust officer for Paget Trust Company. Rome's supervisor is responsible for reviewing Rome's trust account transactions and her monthly reports of personal stock transactions. Rome has been using Nathan Gray, a broker, almost exclusively for trust account brokerage transactions. When Gray makes a

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market in stocks, he has been giving Rome a lower price for personal purchases and a higher price for sales than he gives to Rome's trust accounts and other investors.

Comment: Rome is violating her duty of loyalty to the bank's trust accounts by using Gray for brokerage transactions simply because Gray trades Rome's personal account on favorable terms. Rome is placing her own interests before those of her clients.

Example 5 (Client Commission Practices):

Lauren Parker, an analyst with Provo Advisors, covers South American equities for her firm. She likes to travel to the markets for which she is responsible and decides to go on a trip to Chile, Argentina, and Brazil. The trip is sponsored by SouthAM, Inc., a research firm with a small broker/dealer affiliate that uses the clearing facilities of a larger New York brokerage house. SouthAM specializes in arranging South American trips for analysts during which they can meet with central bank officials, government ministers, local economists, and senior executives of corporations. SouthAM accepts commission dollars at a ratio of 2 to 1 against the hard-dollar costs of the research fee for the trip. Parker is not sure that SouthAM's execution is competitive, but without informing her supervisor, she directs the trading desk at Provo to start giving commission business to SouthAM so she can take the trip. SouthAM has conveniently timed the briefing trip to coincide with the beginning of Carnival season, so Parker also decides to spend five days of vacation in Rio de Janeiro at the end of the trip. Parker uses commission dollars to pay for the five days of hotel expenses.

Comment: Parker is violating Standard III(A) by not exercising her duty of loyalty to her clients. She should have determined whether the commissions charged by SouthAM are reasonable in relation to the benefit of the research provided by the trip. She also should have determined whether best execution and prices could be received from SouthAM. In addition, the five extra days are not part of the research effort because they do not assist in the investment decision making. Thus, the hotel expenses for the five days should not be paid for with client assets.

Example 6 (Excessive Trading):

Vida Knauss manages the portfolios of a number of high-net-worth individuals. A major part of her investment management fee is based on trading commissions. Knauss engages in extensive trading for each of her clients to ensure that she attains the minimum commission level set by her firm. Although the securities purchased and sold for the clients are appropriate and fall within the acceptable asset classes for the clients, the amount of trading for each account exceeds what is necessary to accomplish the client's investment objectives.

Comment: Knauss has violated Standard III(A) because she is using the assets of her clients to benefit her firm and herself.

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Example 7 (Managing Family Accounts):

Adam Dill recently joined New Investments Asset Managers. To assist Dill in building a book of clients, both his father and brother opened new fee-paying accounts. Dill followed all the firm's procedures in noting his relationships with these clients and in developing their investment policy statements.

After several years, the number of Dill's clients has grown, but he still manages the original accounts of his family members. An IPO is coming to market that is a suitable investment for many of his clients, including his brother. Dill does not receive the amount of stock he requested, so to avoid any appearance of a conflict of interest, he does not allocate any shares to his brother's account.

Comment: Dill has violated Standard III(A) because he is not acting for the benefit of his brother's account as well as his other accounts. The brother's account is a regular fee-paying account comparable to the accounts of his other clients. By not allocating the shares proportionately across *all* accounts for which he thought the IPO was suitable, Dill is disadvantaging specific clients.

Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm.

Example 8 (Identifying the Client):

Donna Hensley has been hired by a law firm to testify as an expert witness. Although the testimony is intended to represent impartial advice, she is concerned that her work may have negative consequences for the law firm. If the law firm is Hensley's client, how does she ensure that her testimony will not violate the required duty of loyalty, prudence, and care to one's client?

Comment: In this situation, the law firm represents Hensley's employer and the aspect of "who is the client" is not well defined. When acting as an expert witness, Hensley is bound by the standard of independence and objectivity in the same manner as an independent research analyst would be bound. Hensley must not let the law firm influence the testimony she provides in the legal proceedings.

Example 9 (Identifying the Client):

Jon Miller is a mutual fund portfolio manager. The fund is focused on the global financial services sector. Wanda Spears is a private wealth manager in the same city as Miller and is a friend of Miller. At a local CFA Institute society meeting, Spears mentions to Miller that her new client is an investor in Miller's fund. She states that the two of them now share a responsibility to this client.

Comment: Spears' statement is not totally correct. Because she provides the advisory services to her new client, she alone is bound by the duty of

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loyalty to this client. Miller's responsibility is to manage the fund according to the investment policy statement of the fund. His actions should not be influenced by the needs of any particular fund investor.

Example 10 (Client Loyalty):

After providing client account investment performance to the external-facing departments but prior to it being finalized for release to clients, Teresa Nguyen, an investment performance analyst, notices the reporting system missed a trade. Correcting the omission resulted in a large loss for a client that had previously placed the firm on "watch" for potential termination owing to underperformance in prior periods. Nguyen knows this news is unpleasant but informs the appropriate individuals that the report needs to be updated before releasing it to the client.

Comment: Nguyen's actions align with the requirements of Standard III(A). Even though the correction may to lead to the firm's termination by the client, withholding information on errors would not be in the best interest of the client.

Example 11 (Execution-Only Responsibilities):

Baftija Sulejman recently became a candidate in the CFA Program. He is a broker who executes client-directed trades for several high-net-worth individuals. Sulejman does not provide any investment advice and only executes the trading decisions made by clients. He is concerned that the Code and Standards impose a fiduciary duty on him in his dealing with clients and sends an e-mail to the CFA Ethics Helpdesk (ethics@cfainstitute.org) to seek guidance on this issue.

Comment: In this instance, Sulejman serves in an execution-only capacity and his duty of loyalty, prudence, and care is centered on the skill and diligence used when executing trades—namely, by seeking best execution and making trades within the parameters set by the clients (instructions on quantity, price, timing, etc.). Acting in the best interests of the client dictates that trades are executed on the most favorable terms that can be achieved for the client. Given this job function, the requirements of the Code and Standards for loyalty, prudence, and care clearly do not impose a fiduciary duty.

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Standard III(B) Fair Dealing

> Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

Guidance

Highlights:

- *Investment Recommendations*
- *Investment Action*

Standard III(B) requires members and candidates to treat all clients fairly when disseminating investment recommendations or making material changes to prior investment recommendations or when taking investment action with regard to general purchases, new issues, or secondary offerings. Only through the fair treatment of all parties can the investment management profession maintain the confidence of the investing public.

When an investment adviser has multiple clients, the potential exists for the adviser to favor one client over another. This favoritism may take various forms—from the quality and timing of services provided to the allocation of investment opportunities.

The term "fairly" implies that the member or candidate must take care not to discriminate against any clients when disseminating investment recommendations or taking investment action. Standard III(B) does not state "equally" because members and candidates could not possibly reach all clients at exactly the same time—whether by printed mail, telephone (including text messaging), computer (including internet updates and e-mail distribution), facsimile (fax), or wire. Each client has unique needs, investment criteria, and investment objectives, so not all investment opportunities are suitable for all clients. In addition, members and candidates may provide more personal, specialized, or in-depth service to clients who are willing to pay for premium services through higher management fees or higher levels of brokerage. Members and candidates may differentiate their services to clients, but different levels of service must not disadvantage or negatively affect clients. In addition, the different service levels should be disclosed to clients and prospective clients and should be available to everyone (i.e., different service levels should not be offered selectively).

Standard III(B) covers conduct in two broadly defined categories—investment recommendations and investment action.

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Investment Recommendations

The first category of conduct involves members and candidates whose primary function is the preparation of investment recommendations to be disseminated either to the public or within a firm for the use of others in making investment decisions. This group includes members and candidates employed by investment counseling, advisory, or consulting firms as well as banks, brokerage firms, and insurance companies. The criterion is that the member's or candidate's primary responsibility is the preparation of recommendations to be acted on by others, including those in the member's or candidate's organization.

An investment recommendation is any opinion expressed by a member or candidate in regard to purchasing, selling, or holding a given security or other investment. The opinion may be disseminated to customers or clients through an initial detailed research report, through a brief update report, by addition to or deletion from a list of recommended securities, or simply by oral communication. A recommendation that is distributed to anyone outside the organization is considered a communication for general distribution under Standard III(B).

Standard III(B) addresses the manner in which investment recommendations or changes in prior recommendations are disseminated to clients. Each member or candidate is obligated to ensure that information is disseminated in such a manner that all clients have a fair opportunity to act on every recommendation. Communicating with all clients on a uniform basis presents practical problems for members and candidates because of differences in timing and methods of communication with various types of customers and clients. Members and candidates should encourage their firms to design an equitable system to prevent selective or discriminatory disclosure and should inform clients about what kind of communications they will receive.

The duty to clients imposed by Standard III(B) may be more critical when members or candidates change their recommendations than when they make initial recommendations. Material changes in a member's or candidate's prior investment recommendations because of subsequent research should be communicated to all current clients; particular care should be taken that the information reaches those clients who the member or candidate knows have acted on or been affected by the earlier advice. Clients who do not know that the member or candidate has changed a recommendation and who, therefore, place orders contrary to a current recommendation should be advised of the changed recommendation before the order is accepted.

Investment Action

The second category of conduct includes those members and candidates whose primary function is taking investment action (portfolio management) on the basis of recommendations prepared internally or received from external sources. Investment action, like investment recommendations, can affect market value. Consequently, Standard III(B) requires that members or candidates treat all clients fairly in light of their investment objectives and circumstances. For example, when making investments in new offerings or in secondary financings, members and

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candidates should distribute the issues to all customers for whom the investments are appropriate in a manner consistent with the policies of the firm for allocating blocks of stock. If the issue is oversubscribed, then the issue should be prorated to all subscribers. This action should be taken on a round-lot basis to avoid odd-lot distributions. In addition, if the issue is oversubscribed, members and candidates should forgo any sales to themselves or their immediate families in order to free up additional shares for clients. If the investment professional's family-member accounts are managed similarly to the accounts of other clients of the firm, however, the family-member accounts should not be excluded from buying such shares.

Members and candidates must make every effort to treat all individual and institutional clients in a fair and impartial manner. A member or candidate may have multiple relationships with an institution; for example, the member or candidate may be a corporate trustee, pension fund manager, manager of funds for individuals employed by the customer, loan originator, or creditor. A member or candidate must exercise care to treat all clients fairly.

Members and candidates should disclose to clients and prospective clients the documented allocation procedures they or their firms have in place and how the procedures would affect the client or prospect. The disclosure should be clear and complete so that the client can make an informed investment decision. Even when complete disclosure is made, however, members and candidates must put client interests ahead of their own. A member's or candidate's duty of fairness and loyalty to clients can never be overridden by client consent to patently unfair allocation procedures.

Treating clients fairly also means that members and candidates should not take advantage of their position in the industry to the detriment of clients. For instance, in the context of IPOs, members and candidates must make bona fide public distributions of "hot issue" securities (defined as securities of a public offering that are trading at a premium in the secondary market whenever such trading commences because of the great demand for the securities). Members and candidates are prohibited from withholding such securities for their own benefit and must not use such securities as a reward or incentive to gain benefit.

Recommended Procedures for Compliance

Develop Firm Policies

Although Standard III(B) refers to a member's or candidate's responsibility to deal fairly and objectively with clients, members and candidates should also encourage their firms to establish compliance procedures requiring all employees who disseminate investment recommendations or take investment actions to treat customers and clients fairly. At the very least, a member or candidate should recommend appropriate procedures to management if none are in place. And the member or candidate should make management aware of possible violations of fair-dealing practices within the firm when they come to the attention of the member or candidate.

The extent of the formality and complexity of such compliance procedures depends on the nature and size of the organization and the type of securities

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involved. An investment adviser who is a sole proprietor and handles only discretionary accounts might not disseminate recommendations to the public, but that adviser should have formal written procedures to ensure that all clients receive fair investment action.

Good business practice dictates that initial recommendations be made available to all customers who indicate an interest. Although a member or candidate need not communicate a recommendation to all customers, the selection process by which customers receive information should be based on suitability and known interest, not on any preferred or favored status. A common practice to assure fair dealing is to communicate recommendations simultaneously within the firm and to customers.

Members and candidates should consider the following points when establishing fair-dealing compliance procedures:

- *Limit the number of people involved*: Members and candidates should make reasonable efforts to limit the number of people who are privy to the fact that a recommendation is going to be disseminated.
- *Shorten the time frame between decision and dissemination*: Members and candidates should make reasonable efforts to limit the amount of time that elapses between the decision to make an investment recommendation and the time the actual recommendation is disseminated. If a detailed institutional recommendation that might take two or three weeks to publish is in preparation, a short summary report including the conclusion might be published in advance. In an organization where both a research committee and an investment policy committee must approve a recommendation, the meetings should be held on the same day if possible. The process of reviewing reports and printing and mailing them, faxing them, or distributing them by e-mail necessarily involves the passage of time, sometimes long periods of time. In large firms with extensive review processes, the time factor is usually not within the control of the analyst who prepares the report. Thus, many firms and their analysts communicate to customers and firm personnel the new or changed recommendations by an update or "flash" report. The communication technique might be fax, e-mail, wire, or short written report.
- *Publish guidelines for pre-dissemination behavior*: Members and candidates should encourage firms to develop guidelines that prohibit personnel who have prior knowledge of an investment recommendation from discussing or taking any action on the pending recommendation.
- *Simultaneous dissemination*: Members and candidates should establish procedures for the timing of dissemination of investment recommendations so that all clients are treated fairly—that is, are informed at approximately the same time. For example, if a firm is going to announce a new recommendation, supervisory personnel should time the announcement to avoid placing any client or group of clients at an unfair advantage relative to other clients. A communication to all branch offices should be sent at the time of

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the general announcement. (When appropriate, the firm should accompany the announcement of a new recommendation with a statement that trading restrictions for the firm's employees are now in effect. The trading restrictions should stay in effect until the recommendation is widely distributed to all relevant clients.) Once this distribution has occurred, the member or candidate may follow up separately with individual clients, but members and candidates should not give favored clients advance information when such advance notification may disadvantage other clients.

- *Maintain a list of clients and their holdings*: Members and candidates should maintain a list of all clients and the securities or other investments each client holds in order to facilitate notification of customers or clients of a change in an investment recommendation. If a particular security or other investment is to be sold, such a list can be used to ensure that all holders are treated fairly in the liquidation of that particular investment.
- *Develop and document trade allocation procedures*: When formulating procedures for allocating trades, members and candidates should develop a set of guiding principles that ensure
  - fairness to advisory clients, both in priority of execution of orders and in the allocation of the price obtained in execution of block orders or trades,
  - timeliness and efficiency in the execution of orders, and
  - accuracy of the member's or candidate's records as to trade orders and client account positions.

With these principles in mind, members and candidates should develop or encourage their firm to develop written allocation procedures, with particular attention to procedures for block trades and new issues. Procedures to consider are as follows:

- requiring orders and modifications or cancellations of orders to be documented and time stamped;
- processing and executing orders on a first-in, first-out basis with consideration of bundling orders for efficiency as appropriate for the asset class or the security;
- developing a policy to address such issues as calculating execution prices and "partial fills" when trades are grouped, or in a block, for efficiency;
- giving all client accounts participating in a block trade the same execution price and charging the same commission;
- when the full amount of the block order is not executed, allocating partially executed orders among the participating client accounts pro rata on the basis of order size while not going below an established minimum lot size for some securities (e.g., bonds); and

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- when allocating trades for new issues, obtaining advance indications of interest, allocating securities by client (rather than portfolio manager), and providing a method for calculating allocations.

Disclose Trade Allocation Procedures

Members and candidates should disclose to clients and prospective clients how they select accounts to participate in an order and how they determine the amount of securities each account will buy or sell. Trade allocation procedures must be fair and equitable, and disclosure of inequitable allocation methods does not relieve the member or candidate of this obligation.

Establish Systematic Account Review

Member and candidate supervisors should review each account on a regular basis to ensure that no client or customer is being given preferential treatment and that the investment actions taken for each account are suitable for each account's objectives. Because investments should be based on individual needs and circumstances, an investment manager may have good reasons for placing a given security or other investment in one account while selling it from another account and should fully document the reasons behind both sides of the transaction. Members and candidates should encourage firms to establish review procedures, however, to detect whether trading in one account is being used to benefit a favored client.

Disclose Levels of Service

Members and candidates should disclose to all clients whether the organization offers different levels of service to clients for the same fee or different fees. Different levels of service should not be offered to clients selectively.

Application of the Standard

Example 1 (Selective Disclosure):

Bradley Ames, a well-known and respected analyst, follows the computer industry. In the course of his research, he finds that a small, relatively unknown company whose shares are traded over the counter has just signed significant contracts with some of the companies he follows. After a considerable amount of investigation, Ames decides to write a research report on the small company and recommend purchase of its shares. While the report is being reviewed by the company for factual accuracy, Ames schedules a luncheon with several of his best clients to discuss the company. At the luncheon, he mentions the purchase recommendation scheduled to be sent early the following week to all the firm's clients.

> *Comment*: Ames has violated Standard III(B) by disseminating the purchase recommendation to the clients with whom he has lunch a week before the recommendation is sent to all clients.

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Example 2 (Fair Dealing between Funds):

Spencer Rivers, president of XYZ Corporation, moves his company's growth-oriented pension fund to a particular bank primarily because of the excellent investment performance achieved by the bank's commingled fund for the prior five-year period. Later, Rivers compares the results of his pension fund with those of the bank's commingled fund. He is startled to learn that, even though the two accounts have the same investment objectives and similar portfolios, his company's pension fund has significantly underperformed the bank's commingled fund. Questioning this result at his next meeting with the pension fund's manager, Rivers is told that, as a matter of policy, when a new security is placed on the recommended list, Morgan Jackson, the pension fund manager, first purchases the security for the commingled account and then purchases it on a pro rata basis for all other pension fund accounts. Similarly, when a sale is recommended, the security is sold first from the commingled account and then sold on a pro rata basis from all other accounts. Rivers also learns that if the bank cannot get enough shares (especially of hot issues) to be meaningful to all the accounts, its policy is to place the new issues only in the commingled account.

Seeing that Rivers is neither satisfied nor pleased by the explanation, Jackson quickly adds that nondiscretionary pension accounts and personal trust accounts have a lower priority on purchase and sale recommendations than discretionary pension fund accounts. Furthermore, Jackson states, the company's pension fund had the opportunity to invest up to 5% in the commingled fund.

> *Comment*: The bank's policy does not treat all customers fairly, and Jackson has violated her duty to her clients by giving priority to the growth-oriented commingled fund over all other funds and to discretionary accounts over nondiscretionary accounts. Jackson must execute orders on a systematic basis that is fair to all clients. In addition, trade allocation procedures should be disclosed to all clients when they become clients. Of course, in this case, disclosure of the bank's policy would not change the fact that the policy is unfair.

Example 3 (Fair Dealing and IPO Distribution):

Dominic Morris works for a small regional securities firm. His work consists of corporate finance activities and investing for institutional clients. Arena, Ltd., is planning to go public. The partners have secured rights to buy an arena football league franchise and are planning to use the funds from the issue to complete the purchase. Because arena football is the current rage, Morris believes he has a hot issue on his hands. He has quietly negotiated some options for himself for helping convince Arena to do the financing through his securities firm. When he seeks expressions of interest, the institutional buyers oversubscribe the issue. Morris, assuming that the institutions have the financial clout to drive the stock up, then fills all orders (including his own) and decreases the institutional blocks.

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Comment: Morris has violated Standard III(B) by not treating all customers fairly. He should not have taken any shares himself and should have prorated the shares offered among all clients. In addition, he should have disclosed to his firm and to his clients that he received options as part of the deal [see Standard VI(A)–Disclosure of Conflicts].

Example 4 (Fair Dealing and Transaction Allocation):

Eleanor Preston, the chief investment officer of Porter Williams Investments (PWI), a medium-size money management firm, has been trying to retain a client, Colby Company. Management at Colby, which accounts for almost half of PWI's revenues, recently told Preston that if the performance of its account did not improve, it would find a new money manager. Shortly after this threat, Preston purchases mortgage-backed securities (MBSs) for several accounts, including Colby's. Preston is busy with a number of transactions that day, so she fails to allocate the trades immediately or write up the trade tickets. A few days later, when Preston is allocating trades, she notes that some of the MBSs have significantly increased in price and some have dropped. Preston decides to allocate the profitable trades to Colby and spread the losing trades among several other PWI accounts.

Comment: Preston has violated Standard III(B) by failing to deal fairly with her clients in taking these investment actions. Preston should have allocated the trades prior to executing the orders, or she should have had a systematic approach to allocating the trades, such as pro rata, as soon as practical after they were executed. Among other things, Preston must disclose to the client that the adviser may act as broker for, receive commissions from, and have a potential conflict of interest regarding both parties in agency cross-transactions. After the disclosure, she should obtain from the client consent authorizing such transactions in advance.

Example 5 (Selective Disclosure):

Saunders Industrial Waste Management (SIWM) publicly indicates to analysts that it is comfortable with the somewhat disappointing earnings-per-share projection of US$1.16 for the quarter. Bernard Roberts, an analyst at Coffey Investments, is confident that SIWM management has understated the forecasted earnings so that the real announcement will cause an "upside surprise" and boost the price of SIWM stock. The "whisper number" (rumored) estimate based on extensive research and discussed among knowledgeable analysts is higher than US$1.16. Roberts repeats the US$1.16 figure in his research report to all Coffey clients but informally tells his large clients that he expects the earnings per share to be higher, making SIWM a good buy.

Comment: By not sharing his opinion regarding the potential for a significant upside earnings surprise with all clients, Roberts is not treating all clients fairly and has violated Standard III(B).

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Example 6 (Additional Services for Select Clients):

Jenpin Weng uses e-mail to issue a new recommendation to all his clients. He then calls his three largest institutional clients to discuss the recommendation in detail.

> *Comment*: Weng has not violated Standard III(B) because he widely disseminated the recommendation and provided the information to all his clients prior to discussing it with a select few. Weng's largest clients received additional personal service because they presumably pay higher fees or because they have a large amount of assets under Weng's management. If Weng had discussed the report with a select group of clients prior to distributing it to all his clients, he would have violated Standard III(B).

Example 7 (Minimum Lot Allocations):

Lynn Hampton is a well-respected private wealth manager in her community with a diversified client base. She determines that a new 10-year bond being offered by Healthy Pharmaceuticals is appropriate for five of her clients. Three clients request to purchase US$10,000 each, and the other two request US$50,000 each. The minimum lot size is established at US$5,000, and the issue is oversubscribed at the time of placement. Her firm's policy is that odd-lot allocations, especially those below the minimum, should be avoided because they may affect the liquidity of the security at the time of sale.

Hampton is informed she will receive only US$55,000 of the offering for all accounts. Hampton distributes the bond investments as follows: The three accounts that requested US$10,000 are allocated US$5,000 each, and the two accounts that requested US$50,000 are allocated US$20,000 each.

> *Comment*: Hampton has not violated Standard III(B), even though the distribution is not on a completely pro rata basis because of the required minimum lot size. With the total allocation being significantly below the amount requested, Hampton ensured that each client received at least the minimum lot size of the issue. This approach allowed the clients to efficiently sell the bond later if necessary.

Example 8 (Excessive Trading):

Ling Chan manages the accounts for many pension plans, including the plan of his father's employer. Chan developed similar but not identical investment policies for each client, so the investment portfolios are rarely the same. To minimize the cost to his father's pension plan, he intentionally trades more frequently in the accounts of other clients to ensure the required brokerage is incurred to continue receiving free research for use by all the pensions.

> *Comment*: Chan is violating Standard III(B) because his trading actions are disadvantaging his clients to enhance a relationship with a preferred client. All clients are benefiting from the research being provided and should incur their fair portion of the costs. This does not mean that

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additional trading should occur if a client has not paid an equal portion of the commission; trading should occur only as required by the strategy.

Example 9 (Limited Social Media Disclosures):

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto Ltd.'s new solar technology for compact automobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette sends a quick tweet to FIM Twitter followers summarizing her "buy" recommendation for Sun Drive Auto stock.

Comment: Burdette has violated Standard III(B) by sending an investment recommendation to a select group of contacts prior to distributing it to all clients. Burdette must make sure she has received the appropriate training about FIM's policies and procedures, including the appropriate business use of personal social media networks before engaging in such activities.

See Standard IV(C) for guidance related to the duties of the supervisor.

Example 10 (Fair Dealing between Clients):

Paul Rove, performance analyst for Alpha-Beta Investment Management, is describing to the firm's chief investment officer (CIO) two new reports he would like to develop to assist the firm in meeting its obligations to treat clients fairly. Because many of the firm's clients have similar investment objectives and portfolios, Rove suggests a report detailing securities owned across several clients and the percentage of the portfolio the security represents. The second report would compare the monthly performance of portfolios with similar strategies. The outliers within each report would be submitted to the CIO for review.

Comment: As a performance analyst, Rove likely has little direct contact with clients and thus has limited opportunity to treat clients differently. The recommended reports comply with Standard III(B) while helping the firm conduct after-the-fact reviews of how effectively the firm's advisers are dealing with their clients' portfolios. Reports that monitor the fair treatment of clients are an important oversight tool to ensure that clients are treated fairly.

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Standard III(C) Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:
   a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

Guidance

Highlights:

- *Developing an Investment Policy*
- *Understanding the Client's Risk Profile*
- *Updating an Investment Policy*
- *The Need for Diversification*
- *Addressing Unsolicited Trading Requests*
- *Managing to an Index or Mandate*

Standard III(C) requires that members and candidates who are in an investment advisory relationship with clients consider carefully the needs, circumstances, and objectives of the clients when determining the appropriateness and suitability of a given investment or course of investment action. An appropriate suitability determination will not, however, prevent some investments or investment actions from losing value.

In judging the suitability of a potential investment, the member or candidate should review many aspects of the client's knowledge, experience related to

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investing, and financial situation. These aspects include, but are not limited to, the risk profile of the investment as compared with the constraints of the client, the impact of the investment on the diversity of the portfolio, and whether the client has the means or net worth to assume the associated risk. The investment professional's determination of suitability should reflect only the investment recommendations or actions that a prudent person would be willing to undertake. Not every investment opportunity will be suitable for every portfolio, regardless of the potential return being offered.

The responsibilities of members and candidates to gather information and make a suitability analysis prior to making a recommendation or taking investment action fall on those members and candidates who provide investment advice in the course of an advisory relationship with a client. Other members and candidates may be simply executing specific instructions for retail clients when buying or selling securities, such as shares in mutual funds. These members and candidates and some others, such as sell-side analysts, may not have the opportunity to judge the suitability of a particular investment for the ultimate client.

Developing an Investment Policy

When an advisory relationship exists, members and candidates must gather client information at the inception of the relationship. Such information includes the client's financial circumstances, personal data (such as age and occupation) that are relevant to investment decisions, attitudes toward risk, and objectives in investing. This information should be incorporated into a written investment policy statement (IPS) that addresses the client's risk tolerance, return requirements, and all investment constraints (including time horizon, liquidity needs, tax concerns, legal and regulatory factors, and unique circumstances). Without identifying such client factors, members and candidates cannot judge whether a particular investment or strategy is suitable for a particular client. The IPS also should identify and describe the roles and responsibilities of the parties to the advisory relationship and investment process, as well as schedules for review and evaluation of the IPS. After formulating long-term capital market expectations, members and candidates can assist in developing an appropriate strategic asset allocation and investment program for the client, whether these are presented in separate documents or incorporated in the IPS or in appendices to the IPS.

Understanding the Client's Risk Profile

One of the most important factors to be considered in matching appropriateness and suitability of an investment with a client's needs and circumstances is measuring that client's tolerance for risk. The investment professional must consider the possibilities of rapidly changing investment environments and their likely impact on a client's holdings, both individual securities and the collective portfolio. The risk of many investment strategies can and should be analyzed and quantified in advance.

The use of synthetic investment vehicles and derivative investment products has introduced particular issues of risk. Members and candidates should pay

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careful attention to the leverage inherent in many of these vehicles or products when considering them for use in a client's investment program. Such leverage and limited liquidity, depending on the degree to which they are hedged, bear directly on the issue of suitability for the client.

Updating an Investment Policy

Updating the IPS should be repeated at least annually and also prior to material changes to any specific investment recommendations or decisions on behalf of the client. The effort to determine the needs and circumstances of each client is not a one-time occurrence. Investment recommendations or decisions are usually part of an ongoing process that takes into account the diversity and changing nature of portfolio and client characteristics. The passage of time is bound to produce changes that are important with respect to investment objectives.

For an individual client, important changes might include the number of dependents, personal tax status, health, liquidity needs, risk tolerance, amount of wealth beyond that represented in the portfolio, and extent to which compensation and other income provide for current income needs. With respect to an institutional client, such changes might relate to the magnitude of unfunded liabilities in a pension fund, the withdrawal privileges in an employee savings plan, or the distribution requirements of a charitable foundation. Without efforts to update information concerning client factors, one or more factors could change without the investment manager's knowledge.

Suitability review can be done most effectively when the client fully discloses his or her complete financial portfolio, including those portions not managed by the member or candidate. If clients withhold information about their financial portfolios, the suitability analysis conducted by members and candidates cannot be expected to be complete; it must be based on the information provided.

The Need for Diversification

The investment profession has long recognized that combining several different investments is likely to provide a more acceptable level of risk exposure than having all assets in a single investment. The unique characteristics (or risks) of an individual investment may become partially or entirely neutralized when it is combined with other individual investments within a portfolio. Some reasonable amount of diversification is thus the norm for many portfolios, especially those managed by individuals or institutions that have some degree of legal fiduciary responsibility.

An investment with high relative risk on its own may be a suitable investment in the context of the entire portfolio or when the client's stated objectives contemplate speculative or risky investments. The manager may be responsible for only a portion of the client's total portfolio, or the client may not have provided a full financial picture. Members and candidates can be responsible for assessing the suitability of an investment only on the basis of the information and criteria actually provided by the client.

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Addressing Unsolicited Trading Requests

Members and candidates may receive requests from a client for trades that do not properly align with the risk and return objectives outlined in the client's investment policy statement. These transaction requests may be based on the client's individual biases or professional experience. Members and candidates will need to make reasonable efforts to balance their clients' trading requests with their responsibilities to follow the agreed-on investment policy statement.

In cases of unsolicited trade requests that a member or candidate knows are unsuitable for a client, the member or candidate should refrain from making the trade until he or she discusses the concerns with the client. The discussions and resulting actions may encompass a variety of scenarios depending on how the requested unsuitable investment relates to the client's full portfolio.

Many times, an unsolicited request may be expected to have only a minimum impact on the entire portfolio because the size of the requested trade is small or the trade would result in a limited change to the portfolio's risk profile. In discussing the trade, the member or candidate should focus on educating the investor on how the request deviates from the current policy statement. Following the discussion, the member or candidate may follow his or her firm's policies regarding the necessary client approval for executing unsuitable trades. At a minimum, the client should acknowledge the discussion and accept the conditions that make the recommendation unsuitable.

Should the unsolicited request be expected to have a material impact on the portfolio, the member or candidate should use this opportunity to update the investment policy statement. Doing so would allow the client to fully understand the potential effect of the requested trade on his or her current goals or risk levels.

Members and candidates may have some clients who decline to modify their policy statements while insisting an unsolicited trade be made. In such instances, members or candidates will need to evaluate the effectiveness of their services to the client. The options available to the members or candidates will depend on the services provided by their employer. Some firms may allow for the trade to be executed in a new unmanaged account. If alternative options are not available, members and candidates ultimately will need to determine whether they should continue the advisory arrangement with the client.

Managing to an Index or Mandate

Some members and candidates do not manage money for individuals but are responsible for managing a fund to an index or an expected mandate. The responsibility of these members and candidates is to invest in a manner consistent with the stated mandate. For example, a member or candidate who serves as the fund manager for a large-cap income fund would not be following the fund mandate by investing heavily in small-cap or start-up companies whose stock is speculative in nature. Members and candidates who manage pooled assets to a specific mandate are not responsible for determining the suitability of the *fund* as an investment for investors who may be purchasing shares in the fund. The responsibility for

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determining the suitability of an investment for clients can be conferred only on members and candidates who have an advisory relationship with clients.

Recommended Procedures for Compliance

Investment Policy Statement

To fulfill the basic provisions of Standard III(C), a member or candidate should put the needs and circumstances of each client and the client's investment objectives into a written investment policy statement. In formulating an investment policy for the client, the member or candidate should take the following into consideration:

- client identification—(1) type and nature of client, (2) the existence of separate beneficiaries, and (3) approximate portion of total client assets that the member or candidate is managing;
- investor objectives—(1) return objectives (income, growth in principal, maintenance of purchasing power) and (2) risk tolerance (suitability, stability of values);
- investor constraints—(1) liquidity needs, (2) expected cash flows (patterns of additions and/or withdrawals), (3) investable funds (assets and liabilities or other commitments), (4) time horizon, (5) tax considerations, (6) regulatory and legal circumstances, (7) investor preferences, prohibitions, circumstances, and unique needs, and (8) proxy voting responsibilities and guidance; and
- performance measurement benchmarks.

Regular Updates

The investor's objectives and constraints should be maintained and reviewed periodically to reflect any changes in the client's circumstances. Members and candidates should regularly compare client constraints with capital market expectations to arrive at an appropriate asset allocation. Changes in either factor may result in a fundamental change in asset allocation. Annual review is reasonable unless business or other reasons, such as a major change in market conditions, dictate more frequent review. Members and candidates should document attempts to carry out such a review if circumstances prevent it.

Suitability Test Policies

With the increase in regulatory required suitability tests, members and candidates should encourage their firms to develop related policies and procedures. The procedures will differ according to the size of the firm and the scope of the services offered to its clients.

The test procedures should require the investment professional to look beyond the potential return of the investment and include the following:

- an analysis of the impact on the portfolio's diversification,

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- a comparison of the investment risks with the client's assessed risk tolerance, and
- the fit of the investment with the required investment strategy.

Application of the Standard

Example 1 (Investment Suitability—Risk Profile):

Caleb Smith, an investment adviser, has two clients: Larry Robertson, 60 years old, and Gabriel Lanai, 40 years old. Both clients earn roughly the same salary, but Robertson has a much higher risk tolerance because he has a large asset base. Robertson is willing to invest part of his assets very aggressively; Lanai wants only to achieve a steady rate of return with low volatility to pay for his children's education. Smith recommends investing 20% of both portfolios in zero-yield, small-cap, high-technology equity issues.

> *Comment*: In Robertson's case, the investment may be appropriate because of his financial circumstances and aggressive investment position, but this investment is not suitable for Lanai. Smith is violating Standard III(C) by applying Robertson's investment strategy to Lanai because the two clients' financial circumstances and objectives differ.

Example 2 (Investment Suitability—Entire Portfolio):

Jessica McDowell, an investment adviser, suggests to Brian Crosby, a risk-averse client, that covered call options be used in his equity portfolio. The purpose would be to enhance Crosby's income and partially offset any untimely depreciation in the portfolio's value should the stock market or other circumstances affect his holdings unfavorably. McDowell educates Crosby about all possible outcomes, including the risk of incurring an added tax liability if a stock rises in price and is called away and, conversely, the risk of his holdings losing protection on the downside if prices drop sharply.

> *Comment*: When determining suitability of an investment, the primary focus should be the characteristics of the client's entire portfolio, not the characteristics of single securities on an issue-by-issue basis. The basic characteristics of the entire portfolio will largely determine whether investment recommendations are taking client factors into account. Therefore, the most important aspects of a particular investment are those that will affect the characteristics of the total portfolio. In this case, McDowell properly considers the investment in the context of the entire portfolio and thoroughly explains the investment to the client.

Example 3 (IPS Updating):

In a regular meeting with client Seth Jones, the portfolio managers at Blue Chip Investment Advisors are careful to allow some time to review his current needs

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and circumstances. In doing so, they learn that some significant changes have recently taken place in his life. A wealthy uncle left Jones an inheritance that increased his net worth fourfold, to US$1 million.

> *Comment*: The inheritance has significantly increased Jones's ability (and possibly his willingness) to assume risk and has diminished the average yield required to meet his current income needs. Jones's financial circumstances have definitely changed, so Blue Chip managers must update Jones's investment policy statement to reflect how his investment objectives have changed. Accordingly, the Blue Chip portfolio managers should consider a somewhat higher equity ratio for his portfolio than was called for by the previous circumstances, and the managers' specific common stock recommendations might be heavily tilted toward low-yield, growth-oriented issues.

Example 4 (Following an Investment Mandate):

Louis Perkowski manages a high-income mutual fund. He purchases zero-dividend stock in a financial services company because he believes the stock is undervalued and is in a potential growth industry, which makes it an attractive investment.

> *Comment*: A zero-dividend stock does not seem to fit the mandate of the fund that Perkowski is managing. Unless Perkowski's investment fits within the mandate or is within the realm of allowable investments the fund has made clear in its disclosures, Perkowski has violated Standard III(C).

Example 5 (IPS Requirements and Limitations):

Max Gubler, chief investment officer of a property/casualty insurance subsidiary of a large financial conglomerate, wants to improve the diversification of the subsidiary's investment portfolio and increase its returns. The subsidiary's investment policy statement provides for highly liquid investments, such as large-cap equities and government, supranational, and corporate bonds with a minimum credit rating of AA and maturity of no more than five years. In a recent presentation, a venture capital group offered very attractive prospective returns on some of its private equity funds that provide seed capital to ventures. An exit strategy was already contemplated, but investors would have to observe a minimum three-year lockup period and a subsequent laddered exit option for a maximum of one-third of their shares per year. Gubler does not want to miss this opportunity. After extensive analysis, with the intent to optimize the return on the equity assets within the subsidiary's current portfolio, he invests 4% in this seed fund, leaving the portfolio's total equity exposure still well below its upper limit.

> *Comment*: Gubler is violating Standard III(A)–Loyalty, Prudence, and Care as well as Standard III(C). His new investment locks up part of the subsidiary's assets for at least three years and up to as many as five years

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and possibly beyond. The IPS requires investments in highly liquid investments and describes accepted asset classes; private equity investments with a lockup period certainly do not qualify. Even without a lockup period, an asset class with only an occasional, and thus implicitly illiquid, market may not be suitable for the portfolio. Although an IPS typically describes objectives and constraints in great detail, the manager must also make every effort to understand the client's business and circumstances. Doing so should enable the manager to recognize, understand, and discuss with the client other factors that may be or may become material in the investment management process.

Example 6 (Submanager and IPS Reviews):

Paul Ostrowski's investment management business has grown significantly over the past couple of years, and some clients want to diversify internationally. Ostrowski decides to find a submanager to handle the expected international investments. Because this will be his first subadviser, Ostrowski uses the CFA Institute model "request for proposal" to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm's bottom line.

Comment: When selecting an external manager or subadviser, Ostrowski needs to ensure that the new manager's services are appropriate for his clients. This due diligence includes comparing the risk profile of the clients with the investment strategy of the manager. In basing the decision on the fee structure alone, Ostrowski may be violating Standard III(C).

When clients ask to diversify into international products, it is an appropriate time to review and update the clients' IPSs. Ostrowski's review may determine that the risk of international investments modifies the risk profiles of the clients or does not represent an appropriate investment.

See also Standard V(A)–Diligence and Reasonable Basis for further discussion of the review process needed in selecting appropriate submanagers.

Example 7 (Investment Suitability—Risk Profile):

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indices. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases

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are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

Comment: Snead violated Standard III(C) by investing the clients' assets in high-beta stocks. These high-risk investments are contrary to the long-term risk profile established in the clients' IPSs. Snead has changed the investment strategy of the clients in an attempt to reap short-term rewards offered by her firm's new compensation arrangement, not in response to changes in clients' investment policy statements.

See also Standard VI(A)–Disclosure of Conflicts.

Example 8 (Investment Suitability):

Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

Comment: Shrub has violated Standard III(C) because the risk profile of the new fund may not be suitable for every client. As an investment adviser, Shrub needs to establish an investment policy statement for each client and recommend only investments that match each client's risk and return profile in the IPS. Shrub is required to act as more than a simple sales agent for Elite.

Although Shrub cannot disobey the direct request of a client to purchase a specific security, he should fully discuss the risks of a planned purchase and provide reasons why it might not be suitable for a client. This requirement may lead members and candidates to decline new customers if those customers' requested investment decisions are significantly out of line with their stated requirements.

See also Standard V(A)–Diligence and Reasonable Basis.

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Standard III(D) Performance Presentation

When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

Guidance

Standard III(D) requires members and candidates to provide credible performance information to clients and prospective clients and to avoid misstating performance or misleading clients and prospective clients about the investment performance of members or candidates or their firms. This standard encourages full disclosure of investment performance data to clients and prospective clients.

Standard III(D) covers any practice that would lead to misrepresentation of a member's or candidate's performance record, whether the practice involves performance presentation or performance measurement. This standard prohibits misrepresentations of past performance or reasonably expected performance. A member or candidate must give a fair and complete presentation of performance information whenever communicating data with respect to the performance history of individual accounts, composites or groups of accounts, or composites of an analyst's or firm's performance results. Furthermore, members and candidates should not state or imply that clients will obtain or benefit from a rate of return that was generated in the past.

The requirements of this standard are not limited to members and candidates managing separate accounts. Whenever a member or candidate provides performance information for which the manager is claiming responsibility, such as for pooled funds, the history must be accurate. Research analysts promoting the success or accuracy of their recommendations must ensure that their claims are fair, accurate, and complete.

If the presentation is brief, the member or candidate must make available to clients and prospects, on request, the detailed information supporting that communication. Best practice dictates that brief presentations include a reference to the limited nature of the information provided.

Recommended Procedures for Compliance

Apply the GIPS Standards

For members and candidates who are showing the performance history of the assets they manage, compliance with the GIPS standards is the best method to meet their obligations under Standard III(D). Members and candidates should encourage their firms to comply with the GIPS standards.

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Compliance without Applying GIPS Standards

Members and candidates can also meet their obligations under Standard III(D) by

- considering the knowledge and sophistication of the audience to whom a performance presentation is addressed,
- presenting the performance of the weighted composite of similar portfolios rather than using a single representative account,
- including terminated accounts as part of performance history with a clear indication of when the accounts were terminated,
- including disclosures that fully explain the performance results being reported (for example, stating, when appropriate, that results are simulated when model results are used, clearly indicating when the performance record is that of a prior entity, or disclosing whether the performance is gross of fees, net of fees, or after tax), and
- maintaining the data and records used to calculate the performance being presented.

Application of the Standard

Example 1 (Performance Calculation and Length of Time):

Kyle Taylor of Taylor Trust Company, noting the performance of Taylor's common trust fund for the past two years, states in a brochure sent to his potential clients, "You can expect steady 25% annual compound growth of the value of your investments over the year." Taylor Trust's common trust fund did increase at the rate of 25% per year for the past year, which mirrored the increase of the entire market. The fund has never averaged that growth for more than one year, however, and the average rate of growth of all of its trust accounts for five years is 5% per year.

> *Comment*: Taylor's brochure is in violation of Standard III(D). Taylor should have disclosed that the 25% growth occurred only in one year. Additionally, Taylor did not include client accounts other than those in the firm's common trust fund. A general claim of firm performance should take into account the performance of all categories of accounts. Finally, by stating that clients can expect a steady 25% annual compound growth rate, Taylor is also violating Standard I(C)–Misrepresentation, which prohibits assurances or guarantees regarding an investment.

Example 2 (Performance Calculation and Asset Weighting):

Anna Judd, a senior partner of Alexander Capital Management, circulates a performance report for the capital appreciation accounts for the years 1988 through 2004. The firm claims compliance with the GIPS standards. Returns are not

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calculated in accordance with the requirements of the GIPS standards, however, because the composites are not asset weighted.

Comment: Judd is in violation of Standard III(D). When claiming compliance with the GIPS standards, firms must meet *all* of the requirements, make mandatory disclosures, and meet any other requirements that apply to that firm's specific situation. Judd's violation is not from any misuse of the data but from a false claim of GIPS compliance.

Example 3 (Performance Presentation and Prior Fund/Employer):

Aaron McCoy is vice president and managing partner of the equity investment group of Mastermind Financial Advisors, a new business. Mastermind recruited McCoy because he had a proven six-year track record with G&P Financial. In developing Mastermind's advertising and marketing campaign, McCoy prepares an advertisement that includes the equity investment performance he achieved at G&P Financial. The advertisement for Mastermind does not identify the equity performance as being earned while at G&P. The advertisement is distributed to existing clients and prospective clients of Mastermind.

Comment: McCoy has violated Standard III(D) by distributing an advertisement that contains material misrepresentations about the historical performance of Mastermind. Standard III(D) requires that members and candidates make every reasonable effort to ensure that performance information is a fair, accurate, and complete representation of an individual's or firm's performance. As a general matter, this standard does not prohibit showing past performance of funds managed at a prior firm as part of a performance track record as long as showing that record is accompanied by appropriate disclosures about where the performance took place and the person's specific role in achieving that performance. If McCoy chooses to use his past performance from G&P in Mastermind's advertising, he should make full disclosure of the source of the historical performance.

Example 4 (Performance Presentation and Simulated Results):

Jed Davis has developed a mutual fund selection product based on historical information from the 1990–95 period. Davis tested his methodology by applying it retroactively to data from the 1996–2003 period, thus producing simulated performance results for those years. In January 2004, Davis's employer decided to offer the product and Davis began promoting it through trade journal advertisements and direct dissemination to clients. The advertisements included the performance results for the 1996–2003 period but did not indicate that the results were simulated.

Comment: Davis violated Standard III(D) by failing to clearly identify simulated performance results. Standard III(D) prohibits members and candidates from making any statements that misrepresent the

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performance achieved by them or their firms and requires members and candidates to make every reasonable effort to ensure that performance information presented to clients is fair, accurate, and complete. Use of simulated results should be accompanied by full disclosure as to the source of the performance data, including the fact that the results from 1995 through 2003 were the result of applying the model retroactively to that time period.

Example 5 (Performance Calculation and Selected Accounts Only):

In a presentation prepared for prospective clients, William Kilmer shows the rates of return realized over a five-year period by a "composite" of his firm's discretionary accounts that have a "balanced" objective. This composite, however, consisted of only a few of the accounts that met the balanced criterion set by the firm, excluded accounts under a certain asset level without disclosing the fact of their exclusion, and included accounts that did not have the balanced mandate because those accounts would boost the investment results. In addition, to achieve better results, Kilmer manipulated the narrow range of accounts included in the composite by changing the accounts that made up the composite over time.

Comment: Kilmer violated Standard III(D) by misrepresenting the facts in the promotional material sent to prospective clients, distorting his firm's performance record, and failing to include disclosures that would have clarified the presentation.

Example 6 (Performance Attribution Changes):

Art Purell is reviewing the quarterly performance attribution reports for distribution to clients. Purell works for an investment management firm with a bottom-up, fundamentals-driven investment process that seeks to add value through stock selection. The attribution methodology currently compares each stock with its sector. The attribution report indicates that the value added this quarter came from asset allocation and that stock selection contributed negatively to the calculated return.

Through running several different scenarios, Purell discovers that calculating attribution by comparing each stock with its industry and then rolling the effect to the sector level improves the appearance of the manager's stock selection activities. Because the firm defines the attribution terms and the results better reflect the stated strategy, Purell recommends that the client reports should use the revised methodology.

Comment: Modifying the attribution methodology without proper notifications to clients would fail to meet the requirements of Standard III(D). Purrell's recommendation is being done solely for the interest of the firm to improve its perceived ability to meet the stated investment strategy. Such changes are unfair to clients and obscure the facts regarding the firm's abilities.

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Had Purell believed the new methodology offered improvements to the original model, then he would have needed to report the results of both calculations to the client. The report should also include the reasons why the new methodology is preferred, which would allow the client to make a meaningful comparison to prior results and provide a basis for comparing future attributions.

Example 7 (Performance Calculation Methodology Disclosure):

While developing a new reporting package for existing clients, Alisha Singh, a performance analyst, discovers that her company's new system automatically calculates both time-weighted and money-weighted returns. She asks the head of client services and retention which value would be preferred given that the firm has various investment strategies that include bonds, equities, securities without leverage, and alternatives. Singh is told not to label the return value so that the firm may show whichever value is greatest for the period.

Comment: Following these instructions would lead to Singh violating Standard III(D). In reporting inconsistent return values, Singh would not be providing complete information to the firm's clients. Full information is provided when clients have sufficient information to judge the performance generated by the firm.

Example 8 (Performance Calculation Methodology Disclosure):

Richmond Equity Investors manages a long–short equity fund in which clients can trade once a week (on Fridays). For transparency reasons, a daily net asset value of the fund is calculated by Richmond. The monthly fact sheets of the fund report month-to-date and year-to-date performance. Richmond publishes the performance based on the higher of the last trading day of the month (typically, not the last business day) or the last business day of the month as determined by Richmond. The fact sheet mentions only that the data are as of the end of the month, without giving the exact date. Maggie Clark, the investment performance analyst in charge of the calculations, is concerned about the frequent changes and asks her supervisor whether they are appropriate.

Comment: Clark's actions in questioning the changing performance metric comply with Standard III(D). She has shown concern that these changes are not presenting an accurate and complete picture of the performance generated.

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Standard III(E) Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client;
2. Disclosure is required by law; or
3. The client or prospective client permits disclosure of the information.

Guidance

Highlights:

- *Status of Client*
- *Compliance with Laws*
- *Electronic Information and Security*
- *Professional Conduct Investigations by CFA Institute*

Standard III(E) requires that members and candidates preserve the confidentiality of information communicated to them by their clients, prospective clients, and former clients. This standard is applicable when (1) the member or candidate receives information because of his or her special ability to conduct a portion of the client's business or personal affairs and (2) the member or candidate receives information that arises from or is relevant to that portion of the client's business that is the subject of the special or confidential relationship. If disclosure of the information is required by law or the information concerns illegal activities by the client, however, the member or candidate may have an obligation to report the activities to the appropriate authorities.

Status of Client

This standard protects the confidentiality of client information even if the person or entity is no longer a client of the member or candidate. Therefore, members and candidates must continue to maintain the confidentiality of client records even after the client relationship has ended. If a client or former client expressly authorizes the member or candidate to disclose information, however, the member or candidate may follow the terms of the authorization and provide the information.

Compliance with Laws

As a general matter, members and candidates must comply with applicable law. If applicable law requires disclosure of client information in certain circumstances, members and candidates must comply with the law. Similarly, if applicable law

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requires members and candidates to maintain confidentiality, even if the information concerns illegal activities on the part of the client, members and candidates should not disclose such information. Additionally, applicable laws, such as inter-departmental communication restrictions within financial institutions, can impose limitations on information flow about a client within an entity that may lead to a violation of confidentiality. When in doubt, members and candidates should consult with their employer's compliance personnel or legal counsel before disclosing confidential information about clients.

Electronic Information and Security

Because of the ever-increasing volume of electronically stored information, members and candidates need to be particularly aware of possible accidental disclosures. Many employers have strict policies about how to electronically communicate sensitive client information and store client information on personal laptops, mobile devices, or portable disk/flash drives. In recent years, regulatory authorities have imposed stricter data security laws applying to the use of mobile remote digital communication, including the use of social media, that must be considered. Standard III(E) does not require members or candidates to become experts in information security technology, but they should have a thorough understanding of the policies of their employer. The size and operations of the firm will lead to differing policies for ensuring the security of confidential information maintained within the firm. Members and candidates should encourage their firm to conduct regular periodic training on confidentiality procedures for all firm personnel, including portfolio associates, receptionists, and other non-investment staff who have routine direct contact with clients and their records.

Professional Conduct Investigations by CFA Institute

The requirements of Standard III(E) are not intended to prevent members and candidates from cooperating with an investigation by the CFA Institute Professional Conduct Program (PCP). When permissible under applicable law, members and candidates shall consider the PCP an extension of themselves when requested to provide information about a client in support of a PCP investigation into their own conduct. Members and candidates are encouraged to cooperate with investigations into the conduct of others. Any information turned over to the PCP is kept in the strictest confidence. Members and candidates will not be considered in violation of this standard by forwarding confidential information to the PCP.

Recommended Procedures for Compliance

The simplest, most conservative, and most effective way to comply with Standard III(E) is to avoid disclosing any information received from a client except to authorized fellow employees who are also working for the client. In some instances, however, a member or candidate may want to disclose information received from clients that is

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outside the scope of the confidential relationship and does not involve illegal activities. Before making such a disclosure, a member or candidate should ask the following:

- In what context was the information disclosed? If disclosed in a discussion of work being performed for the client, is the information relevant to the work?
- Is the information background material that, if disclosed, will enable the member or candidate to improve service to the client?

Members and candidates need to understand and follow their firm's electronic information communication and storage procedures. If the firm does not have procedures in place, members and candidates should encourage the development of procedures that appropriately reflect the firm's size and business operations.

Communicating with Clients

Technological changes are constantly enhancing the methods that are used to communicate with clients and prospective clients. Members and candidates should make reasonable efforts to ensure that firm-supported communication methods and compliance procedures follow practices designed for preventing accidental distribution of confidential information. Given the rate at which technology changes, a regular review of privacy protection measures is encouraged.

Members and candidates should be diligent in discussing with clients the appropriate methods for providing confidential information. It is important to convey to clients that not all firm-sponsored resources may be appropriate for such communications.

Application of the Standard

Example 1 (Possessing Confidential Information):

Sarah Connor, a financial analyst employed by Johnson Investment Counselors, Inc., provides investment advice to the trustees of City Medical Center. The trustees have given her a number of internal reports concerning City Medical's needs for physical plant renovation and expansion. They have asked Connor to recommend investments that would generate capital appreciation in endowment funds to meet projected capital expenditures. Connor is approached by a local businessman, Thomas Kasey, who is considering a substantial contribution either to City Medical Center or to another local hospital. Kasey wants to find out the building plans of both institutions before making a decision, but he does not want to speak to the trustees.

> *Comment*: The trustees gave Connor the internal reports so she could advise them on how to manage their endowment funds. Because the information in the reports is clearly both confidential and within the scope of the confidential relationship, Standard III(E) requires that Connor refuse to divulge information to Kasey.

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Example 2 (Disclosing Confidential Information):

Lynn Moody is an investment officer at the Lester Trust Company. She has an advisory customer who has talked to her about giving approximately US$50,000 to charity to reduce her income taxes. Moody is also treasurer of the Home for Indigent Widows (HIW), which is planning its annual giving campaign. HIW hopes to expand its list of prospects, particularly those capable of substantial gifts. Moody recommends that HIW's vice president for corporate gifts call on her customer and ask for a donation in the US$50,000 range.

> *Comment*: Even though the attempt to help the Home for Indigent Widows was well intended, Moody violated Standard III(E) by revealing confidential information about her client.

Example 3 (Disclosing Possible Illegal Activity):

Government officials approach Casey Samuel, the portfolio manager for Garcia Company's pension plan, to examine pension fund records. They tell her that Garcia's corporate tax returns are being audited and the pension fund is being reviewed. Two days earlier, Samuel had learned in a regular investment review with Garcia officers that potentially excessive and improper charges were being made to the pension plan by Garcia. Samuel consults her employer's general counsel and is advised that Garcia has probably violated tax and fiduciary regulations and laws.

> *Comment*: Samuel should inform her supervisor of these activities, and her employer should take steps, with Garcia, to remedy the violations. If that approach is not successful, Samuel and her employer should seek advice of legal counsel to determine the appropriate steps to be taken. Samuel may well have a duty to disclose the evidence she has of the continuing legal violations and to resign as asset manager for Garcia.

Example 4 (Disclosing Possible Illegal Activity):

David Bradford manages money for a family-owned real estate development corporation. He also manages the individual portfolios of several of the family members and officers of the corporation, including the chief financial officer (CFO). Based on the financial records of the corporation and some questionable practices of the CFO that Bradford has observed, Bradford believes that the CFO is embezzling money from the corporation and putting it into his personal investment account.

> *Comment*: Bradford should check with his firm's compliance department or appropriate legal counsel to determine whether applicable securities regulations require reporting the CFO's financial records.

Example 5 (Accidental Disclosure of Confidential Information):

Lynn Moody is an investment officer at the Lester Trust Company (LTC). She has stewardship of a significant number of individually managed taxable accounts.

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In addition to receiving quarterly written reports, about a dozen high-net-worth individuals have indicated to Moody a willingness to receive communications about overall economic and financial market outlooks directly from her by way of a social media platform. Under the direction of her firm's technology and compliance departments, she established a new group page on an existing social media platform specifically for her clients. In the instructions provided to clients, Moody asked them to "join" the group so they may be granted access to the posted content. The instructions also advised clients that all comments posted would be available to the public and thus the platform was not an appropriate method for communicating personal or confidential information.

Six months later, in early January, Moody posted LTC's year-end "Market Outlook." The report outlined a new asset allocation strategy that the firm is adding to its recommendations in the new year. Moody introduced the publication with a note informing her clients that she would be discussing the changes with them individually in their upcoming meetings.

One of Moody's clients responded directly on the group page that his family recently experienced a major change in their financial profile. The client described highly personal and confidential details of the event. Unfortunately, all clients that were part of the group were also able to read the detailed posting until Moody was able to have the comment removed.

Comment: Moody has taken reasonable steps for protecting the confidentiality of client information while using the social media platform. She provided instructions clarifying that all information posted to the site would be publically viewable to all group members and warned against using this method for communicating confidential information. The accidental disclosure of confidential information by a client is not under Moody's control. Her actions to remove the information promptly once she became aware further align with Standard III(E).

In understanding the potential sensitivity clients express surrounding the confidentiality of personal information, this event highlights a need for further training. Moody might advocate for additional warnings or controls for clients when they consider using social media platforms for two-way communications.

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Standard IV: Duties to Employers

Standard IV(A) Loyalty

> In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

Guidance

Highlights:

- *Employer Responsibilities*
- *Independent Practice*
- *Leaving an Employer*
- *Use of Social Media*
- *Whistleblowing*
- *Nature of Employment*

Standard IV(A) requires members and candidates to protect the interests of their firm by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the member's or candidate's skills and ability. Members and candidates must always place the interests of clients above the interests of their employer but should also consider the effects of their conduct on the sustainability and integrity of the employer firm. In matters related to their employment, members and candidates must not engage in conduct that harms the interests of their employer. Implicit in this standard is the obligation of members and candidates to comply with the policies and procedures established by their employers that govern the employer–employee relationship—to the extent that such policies and procedures do not conflict with applicable laws, rules, or regulations or the Code and Standards.

This standard is not meant to be a blanket requirement to place employer interests ahead of personal interests in all matters. The standard does not require members and candidates to subordinate important personal and family obligations to their work. Members and candidates should enter into a dialogue with their employer about balancing personal and employment obligations when personal matters may interfere with their work on a regular or significant basis.

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Employer Responsibilities

The employer–employee relationship imposes duties and responsibilities on both parties. Employers must recognize the duties and responsibilities that they owe to their employees if they expect to have content and productive employees.

Members and candidates are encouraged to provide their employer with a copy of the Code and Standards. These materials will inform the employer of the responsibilities of a CFA Institute member or a candidate in the CFA Program. The Code and Standards also serve as a basis for questioning employer policies and practices that conflict with these responsibilities.

Employers are not obligated to adhere to the Code and Standards. In expecting to retain competent employees who are members and candidates, however, they should not develop conflicting policies and procedures. The employer is responsible for a positive working environment, which includes an ethical workplace. Senior management has the additional responsibility to devise compensation structures and incentive arrangements that do not encourage unethical behavior.

Independent Practice

Included in Standard IV(A) is the requirement that members and candidates abstain from independent competitive activity that could conflict with the interests of their employer. Although Standard IV(A) does not preclude members or candidates from entering into an independent business while still employed, members and candidates who plan to engage in independent practice for compensation must notify their employer and describe the types of services they will render to prospective independent clients, the expected duration of the services, and the compensation for the services. Members and candidates should not render services until they receive consent from their employer to all of the terms of the arrangement. "Practice" means any service that the employer currently makes available for remuneration. "Undertaking independent practice" means engaging in competitive business, as opposed to making preparations to begin such practice.

Leaving an Employer

When members and candidates are planning to leave their current employer, they must continue to act in the employer's best interest. They must not engage in any activities that would conflict with this duty until their resignation becomes effective. It is difficult to define specific guidelines for those members and candidates who are planning to compete with their employer as part of a new venture. The circumstances of each situation must be reviewed to distinguish permissible preparations from violations of duty. Activities that might constitute a violation, especially in combination, include the following:

- misappropriation of trade secrets,
- misuse of confidential information,
- solicitation of the employer's clients prior to cessation of employment,

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- self-dealing (appropriating for one's own property a business opportunity or information belonging to one's employer), and
- misappropriation of clients or client lists.

A departing employee is generally free to make arrangements or preparations to go into a competitive business before terminating the relationship with his or her employer as long as such preparations do not breach the employee's duty of loyalty. A member or candidate who is contemplating seeking other employment must not contact existing clients or potential clients prior to leaving his or her employer for purposes of soliciting their business for the new employer. Once notice is provided to the employer of the intent to resign, the member or candidate must follow the employer's policies and procedures related to notifying clients of his or her planned departure. In addition, the member or candidate must not take records or files to a new employer without the written permission of the previous employer.

Once an employee has left the firm, the skills and experience that an employee obtained while employed are not "confidential" or "privileged" information. Similarly, simple knowledge of the names and existence of former clients is generally not confidential information unless deemed such by an agreement or by law. Standard IV(A) does not prohibit experience or knowledge gained at one employer from being used at another employer. Firm records or work performed on behalf of the firm that is stored in paper copy or electronically for the member's or candidate's convenience while employed, however, should be erased or returned to the employer unless the firm gives permission to keep those records after employment ends.

The standard does not prohibit former employees from contacting clients of their previous firm as long as the contact information does not come from the records of the former employer or violate an applicable "noncompete agreement." Members and candidates are free to use public information after departing to contact former clients without violating Standard IV(A) as long as there is no specific agreement not to do so.

Employers often require employees to sign noncompete agreements that preclude a departing employee from engaging in certain conduct. Members and candidates should take care to review the terms of any such agreement when leaving their employer to determine what, if any, conduct those agreements may prohibit.

In some markets, there are agreements between employers within an industry that outline information that departing employees are permitted to take upon resignation, such as the "Protocol for Broker Recruiting" in the United States. These agreements ease individuals' transition between firms that have agreed to follow the outlined procedures. Members and candidates who move between firms that sign such agreements may rely on the protections provided as long as they faithfully adhere to all the procedures outlined.

For example, under the agreement between many US brokers, individuals are allowed to take some general client contact information when departing. To be protected, a copy of the information the individual is taking must be provided to the

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local management team for review. Additionally, the specific client information may only be used by the departing employee and not others employed by the new firm.

Use of Social Media

The growth in various online networking platforms, such as LinkedIn, Twitter, and Facebook (commonly referred to as social media platforms), is providing new opportunities and challenges for businesses. Members and candidates should understand and abide by all applicable firm policies and regulations as to the acceptable use of social media platforms to interact with clients and prospective clients. This is especially important when a member or candidate is planning to leave an employer.

Social media use makes determining how and when departure notification is delivered to clients more complex. Members and candidates may have developed profiles on these platforms that include connections with individuals who are clients of the firm, as well as individuals unrelated to their employer. Communications through social media platforms that potentially reach current clients should adhere to the employer's policies and procedures regarding notification of departing employees.

Social media connections with clients are also raising questions concerning the differences between public information and firm property. Specific accounts and user profiles of members and candidates may be created for solely professional reasons, including firm-approved accounts for client engagements. Such firm-approved business-related accounts would be considered part of the firm's assets, thus requiring members and candidates to transfer or delete the accounts as directed by their firm's policies and procedures. Best practice for members and candidates is to maintain separate accounts for their personal and professional social media activities. Members and candidates should discuss with their employers how profiles should be treated when a single account includes personal connections and also is used to conduct aspects of their professional activities.

Whistleblowing

A member's or candidate's personal interests, as well as the interests of his or her employer, are secondary to protecting the integrity of capital markets and the interests of clients. Therefore, circumstances may arise (e.g., when an employer is engaged in illegal or unethical activity) in which members and candidates must act contrary to their employer's interests in order to comply with their duties to the market and clients. In such instances, activities that would normally violate a member's or candidate's duty to his or her employer (such as contradicting employer instructions, violating certain policies and procedures, or preserving a record by copying employer records) may be justified. Such action would be permitted only if the intent is clearly aimed at protecting clients or the integrity of the market, not for personal gain.

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Nature of Employment

A wide variety of business relationships exists within the investment industry. For instance, a member or candidate may be an employee or an independent contractor. Members and candidates must determine whether they are employees or independent contractors in order to determine the applicability of Standard IV(A). This issue will be decided largely by the degree of control exercised by the employing entity over the member or candidate. Factors determining control include whether the member's or candidate's hours, work location, and other parameters of the job are set; whether facilities are provided to the member or candidate; whether the member's or candidate's expenses are reimbursed; whether the member or candidate seeks work from other employers; and the number of clients or employers the member or candidate works for.

A member's or candidate's duties within an independent contractor relationship are governed by the oral or written agreement between the member and the client. Members and candidates should take care to define clearly the scope of their responsibilities and the expectations of each client within the context of each relationship. Once a member or candidate establishes a relationship with a client, the member or candidate has a duty to abide by the terms of the agreement.

Recommended Procedures for Compliance

Employers may establish codes of conduct and operating procedures for their employees to follow. Members and candidates should fully understand the policies to ensure that they are not in conflict with the Code and Standards. The following topics identify policies that members and candidates should encourage their firms to adopt if the policies are not currently in place.

Competition Policy

A member or candidate must understand any restrictions placed by the employer on offering similar services outside the firm while employed by the firm. The policy may outline the procedures for requesting approval to undertake the outside service or may be a strict prohibition of such service. If a member's or candidate's employer elects to have its employees sign a noncompete agreement as part of the employment agreement, the member or candidate should ensure that the details are clear and fully explained prior to signing the agreement.

Termination Policy

Members and candidates should clearly understand the termination policies of their employer. Termination policies should establish clear procedures regarding the resignation process, including addressing how the termination will be disclosed to clients and staff and whether updates posted through social media platforms will be allowed. The firm's policy may also outline the procedures for transferring ongoing research and account management responsibilities. Finally,

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the procedures should address agreements that allow departing employees to remove specific client-related information upon resignation.

Incident-Reporting Procedures

Members and candidates should be aware of their firm's policies related to whistleblowing and encourage their firm to adopt industry best practices in this area. Many firms are required by regulatory mandates to establish confidential and anonymous reporting procedures that allow employees to report potentially unethical and illegal activities in the firm.

Employee Classification

Members and candidates should understand their status within their employer firm. Firms are encouraged to adopt a standardized classification structure (e.g., part time, full time, outside contractor) for their employees and indicate how each of the firm's policies applies to each employee class.

Application of the Standard

Example 1 (Soliciting Former Clients):

Samuel Magee manages pension accounts for Trust Assets, Inc., but has become frustrated with the working environment and has been offered a position with Fiduciary Management. Before resigning from Trust Assets, Magee asks four big accounts to leave that firm and open accounts with Fiduciary. Magee also persuades several prospective clients to sign agreements with Fiduciary Management. Magee had previously made presentations to these prospects on behalf of Trust Assets.

> *Comment*: Magee violated the employee–employer principle requiring him to act solely for his employer's benefit. Magee's duty is to Trust Assets as long as he is employed there. The solicitation of Trust Assets' current clients and prospective clients is unethical and violates Standard IV(A).

Example 2 (Former Employer's Documents and Files):

James Hightower has been employed by Jason Investment Management Corporation for 15 years. He began as an analyst but assumed increasing responsibilities and is now a senior portfolio manager and a member of the firm's investment policy committee. Hightower has decided to leave Jason Investment and start his own investment management business. He has been careful not to tell any of Jason's clients that he is leaving; he does not want to be accused of breaching his duty to Jason by soliciting Jason's clients before his departure. Hightower is planning to copy and take with him the following documents and information he developed or worked on while at Jason: (1) the client list, with addresses, telephone numbers, and other pertinent client information; (2) client account statements; (3) sample marketing presentations to prospective clients containing Jason's performance record; (4) Jason's recommended list of securities; (5) computer models

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to determine asset allocations for accounts with various objectives; (6) computer models for stock selection; and (7) personal computer spreadsheets for Hightower's major corporate recommendations, which he developed when he was an analyst.

> *Comment*: Except with the consent of their employer, departing members and candidates may not take employer property, which includes books, records, reports, and other materials, because taking such materials may interfere with their employer's business opportunities. Taking any employer records, even those the member or candidate prepared, violates Standard IV(A). Employer records include items stored in hard copy or any other medium (e.g., home computers, portable storage devices, cell phones).

Example 3 (Addressing Rumors):

Reuben Winston manages all-equity portfolios at Target Asset Management (TAM), a large, established investment counselor. Ten years previously, Philpott & Company, which manages a family of global bond mutual funds, acquired TAM in a diversification move. After the merger, the combined operations prospered in the fixed-income business but the equity management business at TAM languished. Lately, a few of the equity pension accounts that had been with TAM before the merger have terminated their relationships with TAM. One day, Winston finds on his voice mail the following message from a concerned client: "Hey! I just heard that Philpott is close to announcing the sale of your firm's equity management business to Rugged Life. What is going on?" Not being aware of any such deal, Winston and his associates are stunned. Their internal inquiries are met with denials from Philpott management, but the rumors persist. Feeling left in the dark, Winston contemplates leading an employee buyout of TAM's equity management business.

> *Comment*: An employee-led buyout of TAM's equity asset management business would be consistent with Standard IV(A) because it would rest on the permission of the employer and, ultimately, the clients. In this case, however, in which employees suspect the senior managers or principals are not truthful or forthcoming, Winston should consult legal counsel to determine appropriate action.

Example 4 (Ownership of Completed Prior Work):

Laura Clay, who is unemployed, wants part-time consulting work while seeking a full-time analyst position. During an interview at Bradley Associates, a large institutional asset manager, Clay is told that the firm has no immediate research openings but would be willing to pay her a flat fee to complete a study of the wireless communications industry within a given period of time. Clay would be allowed unlimited access to Bradley's research files and would be welcome to come to the offices and use whatever support facilities are available during normal working hours. Bradley's research director does not seek any exclusivity for Clay's output, and the two agree to the arrangement on a handshake. As Clay nears completion

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of the study, she is offered an analyst job in the research department of Winston & Company, a brokerage firm, and she is pondering submitting the draft of her wireless study for publication by Winston.

> *Comment*: Although she is under no written contractual obligation to Bradley, Clay has an obligation to let Bradley act on the output of her study before Winston & Company or Clay uses the information to their advantage. That is, unless Bradley gives permission to Clay and waives its rights to her wireless report, Clay would be in violation of Standard IV(A) if she were to immediately recommend to Winston the same transactions recommended in the report to Bradley. Furthermore, Clay must not take from Bradley any research file material or other property that she may have used.

Example 5 (Ownership of Completed Prior Work):

Emma Madeline, a recent college graduate and a candidate in the CFA Program, spends her summer as an unpaid intern at Murdoch and Lowell. The senior managers at Murdoch are attempting to bring the firm into compliance with the GIPS standards, and Madeline is assigned to assist in its efforts. Two months into her internship, Madeline applies for a job at McMillan & Company, which has plans to become GIPS compliant. Madeline accepts the job with McMillan. Before leaving Murdoch, she copies the firm's software that she helped develop because she believes this software will assist her in her new position.

> *Comment*: Even though Madeline does not receive monetary compensation for her services at Murdoch, she has used firm resources in creating the software and is considered an employee because she receives compensation and benefits in the form of work experience and knowledge. By copying the software, Madeline violated Standard IV(A) because she misappropriated Murdoch's property without permission.

Example 6 (Soliciting Former Clients):

Dennis Elliot has hired Sam Chisolm, who previously worked for a competing firm. Chisolm left his former firm after 18 years of employment. When Chisolm begins working for Elliot, he wants to contact his former clients because he knows them well and is certain that many will follow him to his new employer. Is Chisolm in violation of Standard IV(A) if he contacts his former clients?

> *Comment*: Because client records are the property of the firm, contacting former clients for any reason through the use of client lists or other information taken from a former employer without permission would be a violation of Standard IV(A). In addition, the nature and extent of the contact with former clients may be governed by the terms of any noncompete agreement signed by the employee and the former employer that covers contact with former clients after employment.

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Simple knowledge of the names and existence of former clients is not confidential information, just as skills or experience that an employee obtains while employed are not "confidential" or "privileged" information. The Code and Standards do not impose a prohibition on the use of experience or knowledge gained at one employer from being used at another employer. The Code and Standards also do not prohibit former employees from contacting clients of their previous firm, in the absence of a noncompete agreement. Members and candidates are free to use public information about their former firm after departing to contact former clients without violating Standard IV(A).

In the absence of a noncompete agreement, as long as Chisolm maintains his duty of loyalty to his employer before joining Elliot's firm, does not take steps to solicit clients until he has left his former firm, and does not use material from his former employer without its permission after he has left, he is not in violation of the Code and Standards.

Example 7 (Starting a New Firm):

Geraldine Allen currently works at a registered investment company as an equity analyst. Without notice to her employer, she registers with government authorities to start an investment company that will compete with her employer, but she does not actively seek clients. Does registration of this competing company with the appropriate regulatory authorities constitute a violation of Standard IV(A)?

Comment: Allen's preparation for the new business by registering with the regulatory authorities does not conflict with the work for her employer if the preparations have been done on Allen's own time outside the office and if Allen will not be soliciting clients for the business or otherwise operating the new company until she has left her current employer.

Example 8 (Competing with Current Employer):

Several employees are planning to depart their current employer within a few weeks and have been careful to not engage in any activities that would conflict with their duty to their current employer. They have just learned that one of their employer's clients has undertaken a request for proposal (RFP) to review and possibly hire a new investment consultant. The RFP has been sent to the employer and all of its competitors. The group believes that the new entity to be formed would be qualified to respond to the RFP and be eligible for the business. The RFP submission period is likely to conclude before the employees' resignations are effective. Is it permissible for the group of departing employees to respond to the RFP for their anticipated new firm?

Comment: A group of employees responding to an RFP that their employer is also responding to would lead to direct competition between the employees and the employer. Such conduct violates Standard IV(A)

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unless the group of employees receives permission from their employer as well as the entity sending out the RFP.

Example 9 (Externally Compensated Assignments):

Alfonso Mota is a research analyst with Tyson Investments. He works part time as a mayor for his hometown, a position for which he receives compensation. Must Mota seek permission from Tyson to serve as mayor?

Comment: If Mota's mayoral duties are so extensive and time-consuming that they might detract from his ability to fulfill his responsibilities at Tyson, he should discuss his outside activities with his employer and come to a mutual agreement regarding how to manage his personal commitments with his responsibilities to his employer.

Example 10 (Soliciting Former Clients):

After leaving her employer, Shawna McQuillen establishes her own money management business. While with her former employer, she did not sign a noncompete agreement that would have prevented her from soliciting former clients. Upon her departure, she does not take any of her client lists or contact information and she clears her personal computer of any employer records, including client contact information. She obtains the phone numbers of her former clients through public records and contacts them to solicit their business.

Comment: McQuillen is not in violation of Standard IV(A) because she has not used information or records from her former employer and is not prevented by an agreement with her former employer from soliciting her former clients.

Example 11 (Whistleblowing Actions):

Meredith Rasmussen works on a buy-side trading desk and concentrates on in-house trades for a hedge fund subsidiary managed by a team at the investment management firm. The hedge fund has been very successful and is marketed globally by the firm. From her experience as the trader for much of the activity of the fund, Rasmussen has become quite knowledgeable about the hedge fund's strategy, tactics, and performance. When a distinct break in the market occurs, however, and many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen observes that the reported performance of the hedge fund does not reflect this decline. In her experience, the lack of any effect is a very unlikely occurrence. She approaches the head of trading about her concern and is told that she should not ask any questions and that the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of this hedge fund's reporting.

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Comment: Rasmussen has clearly come upon an error in policies, procedures, and compliance practices in the firm's operations. Having been unsuccessful in finding a resolution with her supervisor and the compliance officer, Rasmussen should consult the firm's whistleblowing policy to determine the appropriate next step toward informing management of her concerns. The potentially unethical actions of the investment management division are appropriate grounds for further disclosure, so Rasmussen's whistleblowing would not represent a violation of Standard IV(A).

See also Standard I(D)–Misconduct and Standard IV(C)–Responsibilities of Supervisors.

Example 12 (Soliciting Former Clients):

Angel Crome has been a private banker for YBSafe Bank for the past eight years. She has been very successful and built a considerable client portfolio during that time but is extremely frustrated by the recent loss of reputation by her current employer and subsequent client insecurity. A locally renowned headhunter contacted Crome a few days ago and offered her an interesting job with a competing private bank. This bank offers a substantial signing bonus for advisers with their own client portfolios. Crome figures that she can solicit at least 70% of her clients to follow her and gladly enters into the new employment contract.

Comment: Crome may contact former clients upon termination of her employment with YBSafe Bank, but she is prohibited from using client records built by and kept with her in her capacity as an employee of YBSafe Bank. Client lists are proprietary information of her former employer and must not be used for her or her new employer's benefit. The use of written, electronic, or any other form of records other than publicly available information to contact her former clients at YBSafe Bank will be a violation of Standard IV(A).

Example 13 (Notification of Code and Standards):

Krista Smith is a relatively new assistant trader for the fixed-income desk of a major investment bank. She is on a team responsible for structuring collateralized debt obligations (CDOs) made up of securities in the inventory of the trading desk. At a meeting of the team, senior executives explain the opportunity to eventually separate the CDO into various risk-rated tranches to be sold to the clients of the firm. After the senior executives leave the meeting, the head trader announces various responsibilities of each member of the team and then says, "This is a good time to unload some of the junk we have been stuck with for a while and disguise it with ratings and a thick, unreadable prospectus, so don't be shy in putting this CDO together. Just kidding." Smith is worried by this remark and asks some of her colleagues what the head trader meant. They all respond that he was just kidding but

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that there is some truth in the remark because the CDO is seen by management as an opportunity to improve the quality of the securities in the firm's inventory.

Concerned about the ethical environment of the workplace, Smith decides to talk to her supervisor about her concerns and provides the head trader with a copy of the Code and Standards. Smith discusses the principle of placing the client above the interest of the firm and the possibility that the development of the new CDO will not adhere to this responsibility. The head trader assures Smith that the appropriate analysis will be conducted when determining the appropriate securities for collateral. Furthermore, the ratings are assigned by an independent firm and the prospectus will include full and factual disclosures. Smith is reassured by the meeting, but she also reviews the company's procedures and requirements for reporting potential violations of company policy and securities laws.

> *Comment*: Smith's review of the company policies and procedures for reporting violations allows her to be prepared to report through the appropriate whistleblower process if she decides that the CDO development process involves unethical actions by others. Smith's actions comply with the Code and Standards principles of placing the client's interests first and being loyal to her employer. In providing her supervisor with a copy of the Code and Standards, Smith is highlighting the high level of ethical conduct she is required to adhere to in her professional activities.

Example 14 (Leaving an Employer):

Laura Webb just left her position as portfolio analyst at Research Systems, Inc. (RSI). Her employment contract included a non-solicitation agreement that requires her to wait two years before soliciting RSI clients for any investment-related services. Upon leaving, Webb was informed that RSI would contact clients immediately about her departure and introduce her replacement.

While working at RSI, Webb connected with clients, other industry associates, and friends through her LinkedIn network. Her business and personal relationships were intermingled because she considered many of her clients to be personal friends. Realizing that her LinkedIn network would be a valuable resource for new employment opportunities, she updated her profile several days following her departure from RSI. LinkedIn automatically sent a notification to Webb's entire network that her employment status had been changed in her profile.

> *Comment*: Prior to her departure, Webb should have discussed any client information contained in her social media networks. By updating her LinkedIn profile after RSI notified clients and after her employment ended, she has appropriately placed her employer's interests ahead of her own personal interests. In addition, she has not violated the non-solicitation agreement with RSI, unless it prohibited any contact with clients during the two-year period.

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Example 15 (Confidential Firm Information):

Sanjay Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process to develop recommendations on investment opportunities covered by the team members. Gupta, like others, provides commentary for NIM's clients through the company blog, which is posted weekly on the NIM password-protected website. According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting. Any opinions expressed on the website are disclosed as representing the perspective of NIM.

Gupta also writes a personal blog to share his experiences with friends and family. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.

Comment: Gupta is in violation of Standard IV(A) for disclosing confidential firm information through his personal blog. The recommendations on the firm's blog to clients are not freely available across the internet, but his personal blog post indirectly provides the firm's recommendations.

Additionally, by posting research commentary on his personal blog, Gupta is using firm resources for his personal advantage. To comply with Standard IV(A), members and candidates must receive consent from their employer prior to using company resources.

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Standard IV(B) Additional Compensation Arrangements

> Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

Guidance

Standard IV(B) requires members and candidates to obtain permission from their employer before accepting compensation or other benefits from third parties for the services rendered to the employer or for any services that might create a conflict with their employer's interest. Compensation and benefits include direct compensation by the client and any indirect compensation or other benefits received from third parties. "Written consent" includes any form of communication that can be documented (for example, communication via e-mail that can be retrieved and documented).

Members and candidates must obtain permission for additional compensation/benefits because such arrangements may affect loyalties and objectivity and create potential conflicts of interest. Disclosure allows an employer to consider the outside arrangements when evaluating the actions and motivations of members and candidates. Moreover, the employer is entitled to have full knowledge of all compensation/benefit arrangements so as to be able to assess the true cost of the services members or candidates are providing.

There may be instances in which a member or candidate is hired by an employer on a "part-time" basis. "Part-time" status applies to employees who do not commit the full number of hours required for a normal work week. Members and candidates should discuss possible limitations to their abilities to provide services that may be competitive with their employer during the negotiation and hiring process. The requirements of Standard IV(B) would be applicable to limitations identified at that time.

Recommended Procedures for Compliance

Members and candidates should make an immediate written report to their supervisor and compliance officer specifying any compensation they propose to receive for services in addition to the compensation or benefits received from their employer. The details of the report should be confirmed by the party offering the additional compensation, including performance incentives offered by clients. This written report should state the terms of any agreement under which a member or candidate will receive additional compensation; "terms" include the nature of the compensation, the approximate amount of compensation, and the duration of the agreement.

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Application of the Standard

Example 1 (Notification of Client Bonus Compensation):

Geoff Whitman, a portfolio analyst for Adams Trust Company, manages the account of Carol Cochran, a client. Whitman is paid a salary by his employer, and Cochran pays the trust company a standard fee based on the market value of assets in her portfolio. Cochran proposes to Whitman that "any year that my portfolio achieves at least a 15% return before taxes, you and your wife can fly to Monaco at my expense and use my condominium during the third week of January." Whitman does not inform his employer of the arrangement and vacations in Monaco the following January as Cochran's guest.

> *Comment*: Whitman violated Standard IV(B) by failing to inform his employer in writing of this supplemental, contingent compensation arrangement. The nature of the arrangement could have resulted in partiality to Cochran's account, which could have detracted from Whitman's performance with respect to other accounts he handles for Adams Trust. Whitman must obtain the consent of his employer to accept such a supplemental benefit.

Example 2 (Notification of Outside Compensation):

Terry Jones sits on the board of directors of Exercise Unlimited, Inc. In return for his services on the board, Jones receives unlimited membership privileges for his family at all Exercise Unlimited facilities. Jones purchases Exercise Unlimited stock for the client accounts for which it is appropriate. Jones does not disclose this arrangement to his employer because he does not receive monetary compensation for his services to the board.

> *Comment*: Jones has violated Standard IV(B) by failing to disclose to his employer benefits received in exchange for his services on the board of directors. The nonmonetary compensation may create a conflict of interest in the same manner as being paid to serve as a director.

Example 3 (Prior Approval for Outside Compensation):

Jonathan Hollis is an analyst of oil-and-gas companies for Specialty Investment Management. He is currently recommending the purchase of ABC Oil Company shares and has published a long, well-thought-out research report to substantiate his recommendation. Several weeks after publishing the report, Hollis receives a call from the investor-relations office of ABC Oil saying that Thomas Andrews, CEO of the company, saw the report and really liked the analyst's grasp of the business and his company. The investor-relations officer invites Hollis to visit ABC Oil to discuss the industry further. ABC Oil offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after

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gaining the appropriate approvals, accepts the meeting with the CEO but declines the offered travel arrangements.

Several weeks later, Andrews and Hollis meet to discuss the oil business and Hollis's report. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC Oil's headquarters.

Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.

Comment: Hollis's actions did not violate Standard IV(B). Through gaining approval before accepting the meeting and declining the offered travel arrangements, Hollis sought to avoid any potential conflicts of interest between his company and ABC Oil. Because the location of the dinner was not available prior to arrival and Hollis notified his company of the dinner upon his return, accepting the dinner should not impair his objectivity. By disclosing the dinner, Hollis has enabled Specialty Investment Management to assess whether it has any impact on future reports and recommendations by Hollis related to ABC Oil.

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Standard IV(C) Responsibilities of Supervisors

> Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

Guidance

Highlights:

- *System for Supervision*
- *Supervision Includes Detection*

Standard IV(C) states that members and candidates must promote actions by all employees under their supervision and authority to comply with applicable laws, rules, regulations, and firm policies and the Code and Standards.

Any investment professional who has employees subject to her or his control or influence—whether or not the employees are CFA Institute members, CFA charterholders, or candidates in the CFA Program—exercises supervisory responsibility. Members and candidates acting as supervisors must also have in-depth knowledge of the Code and Standards so that they can apply this knowledge in discharging their supervisory responsibilities.

The conduct that constitutes reasonable supervision in a particular case depends on the number of employees supervised and the work performed by those employees. Members and candidates with oversight responsibilities for large numbers of employees may not be able to personally evaluate the conduct of these employees on a continuing basis. These members and candidates may delegate supervisory duties to subordinates who directly oversee the other employees. A member's or candidate's responsibilities under Standard IV(C) include instructing those subordinates to whom supervision is delegated about methods to promote compliance, including preventing and detecting violations of laws, rules, regulations, firm policies, and the Code and Standards.

At a minimum, Standard IV(C) requires that members and candidates with supervisory responsibility make reasonable efforts to prevent and detect violations by ensuring the establishment of effective compliance systems. However, an effective compliance system goes beyond enacting a code of ethics, establishing policies and procedures to achieve compliance with the code and applicable law, and reviewing employee actions to determine whether they are following the rules.

To be effective supervisors, members and candidates should implement education and training programs on a recurring or regular basis for employees under their supervision. Such programs will assist the employees with meeting their professional obligations to practice in an ethical manner within the applicable legal system.

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Further, establishing incentives—monetary or otherwise—for employees not only to meet business goals but also to reward ethical behavior offers supervisors another way to assist employees in complying with their legal and ethical obligations.

Often, especially in large organizations, members and candidates may have supervisory responsibility but not the authority to establish or modify firm-wide compliance policies and procedures or incentive structures. Such limitations should not prevent a member or candidate from working with his or her own superiors and within the firm structure to develop and implement effective compliance tools, including but not limited to:

- a code of ethics,
- compliance policies and procedures,
- education and training programs,
- an incentive structure that rewards ethical conduct, and
- adoption of firm-wide best practice standards (e.g., the GIPS standards, the CFA Institute Asset Manager Code of Professional Conduct).

A member or candidate with supervisory responsibility should bring an inadequate compliance system to the attention of the firm's senior managers and recommend corrective action. If the member or candidate clearly cannot discharge supervisory responsibilities because of the absence of a compliance system or because of an inadequate compliance system, the member or candidate should decline in writing to accept supervisory responsibility until the firm adopts reasonable procedures to allow adequate exercise of supervisory responsibility.

System for Supervision

Members and candidates with supervisory responsibility must understand what constitutes an adequate compliance system for their firms and make reasonable efforts to see that appropriate compliance procedures are established, documented, communicated to covered personnel, and followed. "Adequate" procedures are those designed to meet industry standards, regulatory requirements, the requirements of the Code and Standards, and the circumstances of the firm. Once compliance procedures are established, the supervisor must also make reasonable efforts to ensure that the procedures are monitored and enforced.

To be effective, compliance procedures must be in place prior to the occurrence of a violation of the law or the Code and Standards. Although compliance procedures cannot be designed to anticipate every potential violation, they should be designed to anticipate the activities most likely to result in misconduct. Compliance programs must be appropriate for the size and nature of the organization. The member or candidate should review model compliance procedures or other industry programs to ensure that the firm's procedures meet the minimum industry standards.

Once a supervisor learns that an employee has violated or may have violated the law or the Code and Standards, the supervisor must promptly initiate an

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assessment to determine the extent of the wrongdoing. Relying on an employee's statements about the extent of the violation or assurances that the wrongdoing will not reoccur is not enough. Reporting the misconduct up the chain of command and warning the employee to cease the activity are also not enough. Pending the outcome of the investigation, a supervisor should take steps to ensure that the violation will not be repeated, such as placing limits on the employee's activities or increasing the monitoring of the employee's activities.

Supervision Includes Detection

Members and candidates with supervisory responsibility must also make reasonable efforts to detect violations of laws, rules, regulations, firm policies, and the Code and Standards. The supervisors exercise reasonable supervision by establishing and implementing written compliance procedures and ensuring that those procedures are followed through periodic review. If a member or candidate has adopted reasonable procedures and taken steps to institute an effective compliance program, then the member or candidate may not be in violation of Standard IV(C) if he or she does not detect violations that occur despite these efforts. The fact that violations do occur may indicate, however, that the compliance procedures are inadequate. In addition, in some cases, merely enacting such procedures may not be sufficient to fulfill the duty required by Standard IV(C). A member or candidate may be in violation of Standard IV(C) if he or she knows or should know that the procedures designed to promote compliance, including detecting and preventing violations, are not being followed.

Recommended Procedures for Compliance

Codes of Ethics or Compliance Procedures

Members and candidates are encouraged to recommend that their employers adopt a code of ethics. Adoption of a code of ethics is critical to establishing a strong ethical foundation for investment advisory firms and their employees. Codes of ethics formally emphasize and reinforce the client loyalty responsibilities of investment firm personnel, protect investing clients by deterring misconduct, and protect the firm's reputation for integrity.

There is a distinction, however, between codes of ethics and the specific policies and procedures needed to ensure compliance with the codes and with securities laws and regulations. Although both are important, codes of ethics should consist of fundamental, principle-based ethical and fiduciary concepts that are applicable to all of the firm's employees. In this way, firms can best convey to employees and clients the ethical ideals that investment advisers strive to achieve. These concepts need to be implemented, however, by detailed, firm-wide compliance policies and procedures. Compliance procedures assist the firm's personnel in fulfilling the responsibilities enumerated in the code of ethics and make probable that the ideals expressed in the code of ethics will be adhered to in the day-to-day operation of the firm.

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Stand-alone codes of ethics should be written in plain language and should address general fiduciary concepts. They should be unencumbered by numerous detailed procedures. Codes presented in this way are the most effective in stressing to employees that they are in positions of trust and must act with integrity at all times. Mingling compliance procedures in the firm's code of ethics goes against the goal of reinforcing the ethical obligations of employees.

Separating the code of ethics from compliance procedures will also reduce, if not eliminate, the legal terminology and "boilerplate" language that can make the underlying ethical principles incomprehensible to the average person. Above all, to ensure the creation of a culture of ethics and integrity rather than one that merely focuses on following the rules, the principles in the code of ethics must be stated in a way that is accessible and understandable to everyone in the firm.

Members and candidates should encourage their employers to provide their codes of ethics to clients. In this case also, a simple, straightforward code of ethics will be best understood by clients. Unencumbered by the compliance procedures, the code of ethics will be effective in conveying that the firm is committed to conducting business in an ethical manner and in the best interests of the clients.

Adequate Compliance Procedures

A supervisor complies with Standard IV(C) by identifying situations in which legal violations or violations of the Code and Standards are likely to occur and by establishing and enforcing compliance procedures to prevent such violations. Adequate compliance procedures should

- be contained in a clearly written and accessible manual that is tailored to the firm's operations,
- be drafted so that the procedures are easy to understand,
- designate a compliance officer whose authority and responsibility are clearly defined and who has the necessary resources and authority to implement the firm's compliance procedures,
- describe the hierarchy of supervision and assign duties among supervisors,
- implement a system of checks and balances,
- outline the scope of the procedures,
- outline procedures to document the monitoring and testing of compliance procedures,
- outline permissible conduct, and
- delineate procedures for reporting violations and sanctions.

Once a compliance program is in place, a supervisor should

- disseminate the contents of the program to appropriate personnel,

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- periodically update procedures to ensure that the measures are adequate under the law,
- continually educate personnel regarding the compliance procedures,
- issue periodic reminders of the procedures to appropriate personnel,
- incorporate a professional conduct evaluation as part of an employee's performance review,
- review the actions of employees to ensure compliance and identify violators, and
- take the necessary steps to enforce the procedures once a violation has occurred.

Once a violation is discovered, a supervisor should

- respond promptly,
- conduct a thorough investigation of the activities to determine the scope of the wrongdoing,
- increase supervision or place appropriate limitations on the wrongdoer pending the outcome of the investigation, and
- review procedures for potential changes necessary to prevent future violations from occurring.

Implementation of Compliance Education and Training

No amount of ethics education and awareness will deter someone determined to commit fraud for personal enrichment. But the vast majority of investment professionals strive to achieve personal success with dedicated service to their clients and employers.

Regular ethics and compliance training, in conjunction with adoption of a code of ethics, is critical to investment firms seeking to establish a strong culture of integrity and to provide an environment in which employees routinely engage in ethical conduct in compliance with the law. Training and education assist individuals in both recognizing areas that are prone to ethical and legal pitfalls and identifying those circumstances and influences that can impair ethical judgment.

By implementing educational programs, supervisors can train their subordinates to put into practice what the firm's code of ethics requires. Education helps employees make the link between legal and ethical conduct and the long-term success of the business; a strong culture of compliance signals to clients and potential clients that the firm has truly embraced ethical conduct as fundamental to the firm's mission to serve its clients.

Establish an Appropriate Incentive Structure

Even if individuals want to make the right choices and follow an ethical course of conduct and are aware of the obstacles that may trip them up, they can still be influenced to act improperly by a corporate culture that embraces a "succeed at all costs"

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mentality, stresses results regardless of the methods used to achieve those results, and does not reward ethical behavior. Supervisors can reinforce an individual's natural desire to "do the right thing" by building a culture of integrity in the workplace.

Supervisors and firms must look closely at their incentive structure to determine whether the structure encourages profits and returns at the expense of ethically appropriate conduct. Reward structures may turn a blind eye to how desired outcomes are achieved and encourage dysfunctional or counterproductive behavior. Only when compensation and incentives are firmly tied to client interests and *how* outcomes are achieved, rather than *how much* is generated for the firm, will employees work to achieve a culture of integrity.

Application of the Standard

Example 1 (Supervising Research Activities):

Jane Mattock, senior vice president and head of the research department of H&V, Inc., a regional brokerage firm, has decided to change her recommendation for Timber Products from buy to sell. In line with H&V's procedures, she orally advises certain other H&V executives of her proposed actions before the report is prepared for publication. As a result of Mattock's conversation with Dieter Frampton, one of the H&V executives accountable to Mattock, Frampton immediately sells Timber's stock from his own account and from certain discretionary client accounts. In addition, other personnel inform certain institutional customers of the changed recommendation before it is printed and disseminated to all H&V customers who have received previous Timber reports.

> *Comment*: Mattock has violated Standard IV(C) by failing to reasonably and adequately supervise the actions of those accountable to her. She did not prevent or establish reasonable procedures designed to prevent dissemination of or trading on the information by those who knew of her changed recommendation. She must ensure that her firm has procedures for reviewing or recording any trading in the stock of a corporation that has been the subject of an unpublished change in recommendation. Adequate procedures would have informed the subordinates of their duties and detected sales by Frampton and selected customers.

Example 2 (Supervising Research Activities):

Deion Miller is the research director for Jamestown Investment Programs. The portfolio managers have become critical of Miller and his staff because the Jamestown portfolios do not include any stock that has been the subject of a merger or tender offer. Georgia Ginn, a member of Miller's staff, tells Miller that she has been studying a local company, Excelsior, Inc., and recommends its purchase. Ginn adds that the company has been widely rumored to be the subject of a merger study by a well-known conglomerate and discussions between them are under way. At Miller's request, Ginn prepares a memo recommending the

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stock. Miller passes along Ginn's memo to the portfolio managers prior to leaving for vacation, and he notes that he has not reviewed the memo. As a result of the memo, the portfolio managers buy Excelsior stock immediately. The day Miller returns to the office, he learns that Ginn's only sources for the report were her brother, who is an acquisitions analyst with Acme Industries, the "well-known conglomerate," and that the merger discussions were planned but not held.

> *Comment*: Miller violated Standard IV(C) by not exercising reasonable supervision when he disseminated the memo without checking to ensure that Ginn had a reasonable and adequate basis for her recommendations and that Ginn was not relying on material nonpublic information.

Example 3 (Supervising Trading Activities):

David Edwards, a trainee trader at Wheeler & Company, a major national brokerage firm, assists a customer in paying for the securities of Highland, Inc., by using anticipated profits from the immediate sale of the same securities. Despite the fact that Highland is not on Wheeler's recommended list, a large volume of its stock is traded through Wheeler in this manner. Roberta Ann Mason is a Wheeler vice president responsible for supervising compliance with the securities laws in the trading department. Part of her compensation from Wheeler is based on commission revenues from the trading department. Although she notices the increased trading activity, she does nothing to investigate or halt it.

> *Comment*: Mason's failure to adequately review and investigate purchase orders in Highland stock executed by Edwards and her failure to supervise the trainee's activities violate Standard IV(C). Supervisors should be especially sensitive to actual or potential conflicts between their own self-interests and their supervisory responsibilities.

Example 4 (Supervising Trading Activities and Record Keeping):

Samantha Tabbing is senior vice president and portfolio manager for Crozet, Inc., a registered investment advisory and registered broker/dealer firm. She reports to Charles Henry, the president of Crozet. Crozet serves as the investment adviser and principal underwriter for ABC and XYZ public mutual funds. The two funds' prospectuses allow Crozet to trade financial futures for the funds for the limited purpose of hedging against market risks. Henry, extremely impressed by Tabbing's performance in the past two years, directs Tabbing to act as portfolio manager for the funds. For the benefit of its employees, Crozet has also organized the Crozet Employee Profit-Sharing Plan (CEPSP), a defined contribution retirement plan. Henry assigns Tabbing to manage 20% of the assets of CEPSP. Tabbing's investment objective for her portion of CEPSP's assets is aggressive growth. Unbeknownst to Henry, Tabbing frequently places S&P 500 Index purchase and sale orders for the funds and the CEPSP without providing the futures commission merchants (FCMs) who take the orders with any prior or simultaneous

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designation of the account for which the trade has been placed. Frequently, neither Tabbing nor anyone else at Crozet completes an internal trade ticket to record the time an order was placed or the specific account for which the order was intended. FCMs often designate a specific account only after the trade, when Tabbing provides such designation. Crozet has no written operating procedures or compliance manual concerning its futures trading, and its compliance department does not review such trading. After observing the market's movement, Tabbing assigns to CEPSP the S&P 500 positions with more favorable execution prices and assigns positions with less favorable execution prices to the funds.

> *Comment*: Henry violated Standard IV(C) by failing to adequately supervise Tabbing with respect to her S&P 500 trading. Henry further violated Standard IV(C) by failing to establish record-keeping and reporting procedures to prevent or detect Tabbing's violations. Henry must make a reasonable effort to determine that adequate compliance procedures covering all employee trading activity are established, documented, communicated, and followed.

Example 5 (Accepting Responsibility):

Meredith Rasmussen works on a buy-side trading desk and concentrates on in-house trades for a hedge fund subsidiary managed by a team at the investment management firm. The hedge fund has been very successful and is marketed globally by the firm. From her experience as the trader for much of the activity of the fund, Rasmussen has become quite knowledgeable about the hedge fund's strategy, tactics, and performance. When a distinct break in the market occurs and many of the securities involved in the hedge fund's strategy decline markedly in value, however, Rasmussen observes that the reported performance of the hedge fund does not at all reflect this decline. From her experience, this lack of an effect is a very unlikely occurrence. She approaches the head of trading about her concern and is told that she should not ask any questions and that the fund is too big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer and is again told to stay away from the hedge fund reporting issue.

> *Comment*: Rasmussen has clearly come upon an error in policies, procedures, and compliance practices within the firm's operations. According to Standard IV(C), the supervisor and the compliance officer have the responsibility to review the concerns brought forth by Rasmussen. Supervisors have the responsibility of establishing and encouraging an ethical culture in the firm. The dismissal of Rasmussen's question violates Standard IV(C) and undermines the firm's ethical operations.
>
> See also Standard I(D)–Misconduct and, for guidance on whistleblowing, Standard IV(A)–Loyalty.

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Example 6 (Inadequate Procedures):

Brendan Witt, a former junior sell-side technology analyst, decided to return to school to earn an MBA. To keep his research skills and industry knowledge sharp, Witt accepted a position with On-line and Informed, an independent internet-based research company. The position requires the publication of a recommendation and report on a different company every month. Initially, Witt is a regular contributor of new research and a participant in the associated discussion boards that generally have positive comments on the technology sector. Over time, his ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.

Comment: Allowing the report submitted by Witt to be posted highlights a lack of compliance procedures by the research firm. Witt's supervisor needs to work with the management of On-line to develop an appropriate review process to ensure that all contracted analysts comply with the requirements.

See also Standard V(A)–Diligence and Reasonable Basis because it relates to Witt's responsibility for substantiating a recommendation.

Example 7 (Inadequate Supervision):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

Comment: Papis's actions highlight the need for supervision and review at all levels in an organization. His responsibilities may include the selection of external advisers, but the decision to change advisers appears arbitrary. Members and candidates should ensure that their firm has appropriate policies and procedures in place to detect inappropriate actions, such as the action taken by Papis.

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See also Standard V(A)–Diligence and Reasonable Basis, Standard V(B)–Communication with Clients and Prospective Clients, and Standard VI(A)–Disclosure of Conflicts.

Example 8 (Supervising Research Activities):

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto Ltd.'s new solar technology for compact automobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette sends a quick tweet to FIM Twitter followers summarizing her "buy" recommendation for Sun Drive Auto stock.

Comment: Graf has violated Standard IV(C) by failing to reasonably supervise Burdette with respect to the contents of her tweet. He did not establish reasonable procedures to prevent the unauthorized dissemination of company research through social media networks. Graf must make sure all employees receive regular training about FIM's policies and procedures, including the appropriate business use of personal social media networks.

See Standard III(B) for additional guidance.

Example 9 (Supervising Research Activities):

Chen Wang leads the research department at YYRA Retirement Planning Specialists. Chen supervises a team of 10 analysts in a fast-paced and understaffed organization. He is responsible for coordinating the firm's approved process to review all reports before they are provided to the portfolio management team for use in rebalancing client portfolios.

One of Chen's direct reports, Huang Mei, covers the banking industry. Chen must submit the latest updates to the portfolio management team tomorrow morning. Huang has yet to submit her research report on ZYX Bank because she is uncomfortable providing a "buy" or "sell" opinion of ZYX on the basis of the completed analysis. Pressed for time and concerned that Chen will reject a "hold" recommendation, she researches various websites and blogs on the banking sector for whatever she can find on ZYX. One independent blogger provides a new

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interpretation of the recently reported data Huang has analyzed and concludes with a strong "sell" recommendation for ZYX. She is impressed by the originality and resourcefulness of this blogger's report.

Very late in the evening, Huang submits her report and "sell" recommendation to Chen without any reference to the independent blogger's report. Given the late time of the submission and the competence of Huang's prior work, Chen compiles this report with the recommendations from each of the other analysts and meets with the portfolio managers to discuss implementation.

Comment: Chen has violated Standard IV(C) by neglecting to reasonably and adequately follow the firm's approved review process for Huang's research report. The delayed submission and the quality of prior work do not remove Chen's requirement to uphold the designated review process. A member or candidate with supervisory responsibility must make reasonable efforts to see that appropriate procedures are established, documented, communicated to covered personnel, and followed.

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Standard V: Investment Analysis, Recommendations, and Actions

Standard V(A) Diligence and Reasonable Basis

Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

Guidance

Highlights:

- *Defining Diligence and Reasonable Basis*
- *Using Secondary or Third-Party Research*
- *Using Quantitatively Oriented Research*
- *Developing Quantitatively Oriented Techniques*
- *Selecting External Advisers and Subadvisers*
- *Group Research and Decision Making*

The application of Standard V(A) depends on the investment philosophy the member, candidate, or firm is following, the role of the member or candidate in the investment decision-making process, and the support and resources provided by the member's or candidate's employer. These factors will dictate the nature of the diligence and thoroughness of the research and the level of investigation required by Standard V(A).

The requirements for issuing conclusions based on research will vary in relation to the member's or candidate's role in the investment decision-making process, but the member or candidate must make reasonable efforts to cover all pertinent issues when arriving at a recommendation. Members and candidates enhance transparency by providing or offering to provide supporting information to clients when recommending a purchase or sale or when changing a recommendation.

Defining Diligence and Reasonable Basis

Every investment decision is based on a set of facts known and understood at the time. Clients turn to members and candidates for advice and expect these advisers

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to have more information and knowledge than they do. This information and knowledge is the basis from which members and candidates apply their professional judgment in taking investment actions and making recommendations.

At a basic level, clients want assurance that members and candidates are putting forth the necessary effort to support the recommendations they are making. Communicating the level and thoroughness of the information reviewed before the member or candidate makes a judgment allows clients to understand the reasonableness of the recommended investment actions.

As with determining the suitability of an investment for the client, the necessary level of research and analysis will differ with the product, security, or service being offered. In providing an investment service, members and candidates typically use a variety of resources, including company reports, third-party research, and results from quantitative models. A reasonable basis is formed through a balance of these resources appropriate for the security or decision being analyzed.

The following list provides some, but definitely not all, examples of attributes to consider while forming the basis for a recommendation:

- global, regional, and country macroeconomic conditions,
- a company's operating and financial history,
- the industry's and sector's current conditions and the stage of the business cycle,
- a mutual fund's fee structure and management history,
- the output and potential limitations of quantitative models,
- the quality of the assets included in a securitization, and
- the appropriateness of selected peer-group comparisons.

Even though an investment recommendation may be well informed, downside risk remains for any investment. Members and candidates can base their decisions only on the information available at the time decisions are made. The steps taken in developing a diligent and reasonable recommendation should minimize unexpected downside events.

Using Secondary or Third-Party Research

If members and candidates rely on secondary or third-party research, they must make reasonable and diligent efforts to determine whether such research is sound. Secondary research is defined as research conducted by someone else in the member's or candidate's firm. Third-party research is research conducted by entities outside the member's or candidate's firm, such as a brokerage firm, bank, or research firm. If a member or candidate has reason to suspect that either secondary or third-party research or information comes from a source that lacks a sound basis, the member or candidate must not rely on that information.

Members and candidates should make reasonable enquiries into the source and accuracy of all data used in completing their investment analysis and

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recommendations. The sources of the information and data will influence the level of the review a member or candidate must undertake. Information and data taken from internet sources, such as personal blogs, independent research aggregation websites, or social media websites, likely require a greater level of review than information from more established research organizations.

Criteria that a member or candidate can use in forming an opinion on whether research is sound include the following:

- assumptions used,
- rigor of the analysis performed,
- date/timeliness of the research, and
- evaluation of the objectivity and independence of the recommendations.

A member or candidate may rely on others in his or her firm to determine whether secondary or third-party research is sound and use the information in good faith unless the member or candidate has reason to question its validity or the processes and procedures used by those responsible for the research. For example, a portfolio manager may not have a choice of a data source because the firm's senior managers conducted due diligence to determine which vendor would provide services; the member or candidate can use the information in good faith assuming the due diligence process was deemed adequate.

A member or candidate should verify that the firm has a policy about the timely and consistent review of approved research providers to ensure that the quality of the research continues to meet the necessary standards. If such a policy is not in place at the firm, the member or candidate should encourage the development and adoption of a formal review practice.

Using Quantitatively Oriented Research

Standard V(A) applies to the rapidly expanding use of quantitatively oriented research models and processes, such as computer-generated modeling, screening, and ranking of investment securities; the creation or valuation of derivative instruments; and quantitative portfolio construction techniques. These models and processes are being used for much more than the back testing of investment strategies, especially with continually advancing technology and techniques. The continued broad development of quantitative methods and models is an important part of capital market developments.

Members and candidates need to have an understanding of the parameters used in models and quantitative research that are incorporated into their investment recommendations. Although they are not required to become experts in every technical aspect of the models, they must understand the assumptions and limitations inherent in any model and how the results were used in the decision-making process.

The reliance on and potential limitations of financial models became clear through the investment crisis that unfolded in 2007 and 2008. In some cases, the financial models used to value specific securities and related derivative products

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did not adequately demonstrate the level of associated risks. Members and candidates should make reasonable efforts to test the output of investment models and other pre-programed analytical tools they use. Such validation should occur before incorporating the process into their methods, models, or analyses.

Although not every model can test for every factor or outcome, members and candidates should ensure that their analyses incorporate a broad range of assumptions sufficient to capture the underlying characteristics of investments. The omission from the analysis of potentially negative outcomes or of levels of risk outside the norm may misrepresent the true economic value of an investment. The possible scenarios for analysis should include factors that are likely to have a substantial influence on the investment value and may include extremely positive and negative scenarios.

Developing Quantitatively Oriented Techniques

Individuals who create new quantitative models and services must exhibit a higher level of diligence in reviewing new products than the individuals who ultimately use the analytical output. Members and candidates involved in the development and oversight of quantitatively oriented models, methods, and algorithms must understand the technical aspects of the products they provide to clients. A thorough testing of the model and resulting analysis should be completed prior to product distribution.

Members and candidates need to consider the source and time horizon of the data used as inputs in financial models. The information from many commercially available databases may not effectively incorporate both positive and negative market cycles. In the development of a recommendation, the member or candidate may need to test the models by using volatility and performance expectations that represent scenarios outside the observable databases. In reviewing the computer models or the resulting output, members and candidates need to pay particular attention to the assumptions used in the analysis and the rigor of the analysis to ensure that the model incorporates a wide range of possible input expectations, including negative market events.

Selecting External Advisers and Subadvisers

Financial instruments and asset allocation techniques continue to develop and evolve. This progression has led to the use of specialized managers to invest in specific asset classes or diversification strategies that complement a firm's in-house expertise. Standard V(A) applies to the level of review necessary in selecting an external adviser or subadviser to manage a specifically mandated allocation. Members and candidates must review managers as diligently as they review individual funds and securities.

Members and candidates who are directly involved with the use of external advisers need to ensure that their firms have standardized criteria for reviewing these selected external advisers and managers. Such criteria would include, but would not be limited to, the following:

- reviewing the adviser's established code of ethics,

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- understanding the adviser's compliance and internal control procedures,
- assessing the quality of the published return information, and
- reviewing the adviser's investment process and adherence to its stated strategy.

Codes, standards, and guides to best practice published by CFA Institute provide members and candidates with examples of acceptable practices for external advisers and advice in selecting a new adviser. The following guides are available at the CFA Institute website (www.cfainstitute.org): Asset Manager Code of Professional Conduct, Global Investment Performance Standards, and Model Request for Proposal (for equity, credit, or real estate managers).

Group Research and Decision Making

Commonly, members and candidates are part of a group or team that is collectively responsible for producing investment analysis or research. The conclusions or recommendations of the group report represent the consensus of the group and are not necessarily the views of the member or candidate, even though the name of the member or candidate is included on the report. In some instances, a member or candidate will not agree with the view of the group. If, however, the member or candidate believes that the consensus opinion has a reasonable and adequate basis and is independent and objective, the member or candidate need not decline to be identified with the report. If the member or candidate is confident in the process, the member or candidate does not need to dissociate from the report even if it does not reflect his or her opinion.

Recommended Procedures for Compliance

Members and candidates should encourage their firms to consider the following policies and procedures to support the principles of Standard V(A):

- Establish a policy requiring that research reports, credit ratings, and investment recommendations have a basis that can be substantiated as reasonable and adequate. An individual employee (a supervisory analyst) or a group of employees (a review committee) should be appointed to review and approve such items prior to external circulation to determine whether the criteria established in the policy have been met.
- Develop detailed, written guidance for analysts (research, investment, or credit), supervisory analysts, and review committees that establishes the due diligence procedures for judging whether a particular recommendation has a reasonable and adequate basis.
- Develop measurable criteria for assessing the quality of research, the reasonableness and adequacy of the basis for any recommendation or rating, and the accuracy of recommendations over time. In some cases, firms may consider

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implementing compensation arrangements that depend on these measurable criteria and that are applied consistently to all related analysts.

- Develop detailed, written guidance that establishes minimum levels of scenario testing of all computer-based models used in developing, rating, and evaluating financial instruments. The policy should contain criteria related to the breadth of the scenarios tested, the accuracy of the output over time, and the analysis of cash flow sensitivity to inputs.
- Develop measurable criteria for assessing outside providers, including the quality of information being provided, the reasonableness and adequacy of the provider's collection practices, and the accuracy of the information over time. The established policy should outline how often the provider's products are reviewed.
- Adopt a standardized set of criteria for evaluating the adequacy of external advisers. The policy should include how often and on what basis the allocation of funds to the adviser will be reviewed.

Application of the Standard

Example 1 (Sufficient Due Diligence):

Helen Hawke manages the corporate finance department of Sarkozi Securities, Ltd. The firm is anticipating that the government will soon close a tax loophole that currently allows oil-and-gas exploration companies to pass on drilling expenses to holders of a certain class of shares. Because market demand for this tax-advantaged class of stock is currently high, Sarkozi convinces several companies to undertake new equity financings at once, before the loophole closes. Time is of the essence, but Sarkozi lacks sufficient resources to conduct adequate research on all the prospective issuing companies. Hawke decides to estimate the IPO prices on the basis of the relative size of each company and to justify the pricing later when her staff has time.

> *Comment*: Sarkozi should have taken on only the work that it could adequately handle. By categorizing the issuers by general size, Hawke has bypassed researching all the other relevant aspects that should be considered when pricing new issues and thus has not performed sufficient due diligence. Such an omission can result in investors purchasing shares at prices that have no actual basis. Hawke has violated Standard V(A).

Example 2 (Sufficient Scenario Testing):

Babu Dhaliwal works for Heinrich Brokerage in the corporate finance group. He has just persuaded Feggans Resources, Ltd., to allow his firm to do a secondary equity financing at Feggans Resources' current stock price. Because the stock has been trading at higher multiples than similar companies with equivalent production, Dhaliwal presses the Feggans Resources managers to project what would be

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the maximum production they could achieve in an optimal scenario. Based on these numbers, he is able to justify the price his firm will be asking for the secondary issue. During a sales pitch to the brokers, Dhaliwal then uses these numbers as the base-case production levels that Feggans Resources will achieve.

> *Comment*: When presenting information to the brokers, Dhaliwal should have given a range of production scenarios and the probability of Feggans Resources achieving each level. By giving the maximum production level as the likely level of production, he has misrepresented the chances of achieving that production level and seriously misled the brokers. Dhaliwal has violated Standard V(A).

Example 3 (Developing a Reasonable Basis):

Brendan Witt, a former junior sell-side technology analyst, decided to return to school to earn an MBA. To keep his research skills and industry knowledge sharp, Witt accepted a position with On-line and Informed, an independent internet-based research company. The position requires the publication of a recommendation and report on a different company every month. Initially, Witt is a regular contributor of new research and a participant in the associated discussion boards that generally have positive comments on the technology sector. Over time, his ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.

> *Comment*: Witt's knowledge of and exuberance for technology stocks, a few news articles, and the conventional wisdom of the markets do not constitute, without more information, a reasonable and adequate basis for a stock recommendation that is supported by appropriate research and investigation. Therefore, Witt has violated Standard V(A).
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> See also Standard IV(C)–Responsibilities of Supervisors because it relates to the firm's inadequate procedures.

Example 4 (Timely Client Updates):

Kristen Chandler is an investment consultant in the London office of Dalton Securities, a major global investment consultant firm. One of her UK pension funds has decided to appoint a specialist US equity manager. Dalton's global manager of research relies on local consultants to cover managers within their regions and, after conducting thorough due diligence, puts their views and ratings in Dalton's manager database. Chandler accesses Dalton's global manager research database and conducts a screen of all US equity managers on the basis of a match with the client's desired philosophy/style, performance, and tracking-error targets. She selects the five managers that meet these criteria and puts them in a briefing report that is delivered to the client 10 days later. Between the time of

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Chandler's database search and the delivery of the report to the client, Chandler is told that Dalton has updated the database with the information that one of the firms that Chandler has recommended for consideration lost its chief investment officer, the head of its US equity research, and the majority of its portfolio managers on the US equity product—all of whom have left to establish their own firm. Chandler does not revise her report with this updated information.

> *Comment*: Chandler has failed to satisfy the requirement of Standard V(A). Although Dalton updated the manager ratings to reflect the personnel turnover at one of the firms, Chandler did not update her report to reflect the new information.

Example 5 (Group Research Opinions):

Evelyn Mastakis is a junior analyst who has been asked by her firm to write a research report predicting the expected interest rate for residential mortgages over the next six months. Mastakis submits her report to the fixed-income investment committee of her firm for review, as required by firm procedures. Although some committee members support Mastakis's conclusion, the majority of the committee disagrees with her conclusion, and the report is significantly changed to indicate that interest rates are likely to increase more than originally predicted by Mastakis. Should Mastakis ask that her name be taken off the report when it is disseminated?

> *Comment*: The results of research are not always clear, and different people may have different opinions based on the same factual evidence. In this case, the committee may have valid reasons for issuing a report that differs from the analyst's original research. The firm can issue a report that is different from the original report of an analyst as long as there is a reasonable and adequate basis for its conclusions.
>
> Generally, analysts must write research reports that reflect their own opinion and can ask the firm not to put their name on reports that ultimately differ from that opinion. When the work is a group effort, however, not all members of the team may agree with all aspects of the report. Ultimately, members and candidates can ask to have their names removed from the report, but if they are satisfied that the process has produced results or conclusions that have a reasonable and adequate basis, members and candidates do not have to dissociate from the report even when they do not agree with its contents. If Mastakis is confident in the process, she does not need to dissociate from the report even if it does not reflect her opinion.

Example 6 (Reliance on Third-Party Research):

Gary McDermott runs a two-person investment management firm. McDermott's firm subscribes to a service from a large investment research firm that provides research reports. McDermott's firm makes investment recommendations on the basis of these reports.

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Comment: Members and candidates can rely on third-party research but must make reasonable and diligent efforts to determine that such research is sound. If McDermott undertakes due diligence efforts on a regular basis to ensure that the research produced by the large firm is objective and reasonably based, McDermott can rely on that research when making investment recommendations to clients.

Example 7 (Due Diligence in Submanager Selection):

Paul Ostrowski's business has grown significantly over the past couple of years, and some clients want to diversify internationally. Ostrowski decides to find a submanager to handle the expected international investments. Because this will be his first subadviser, Ostrowski uses the CFA Institute model "request for proposal" to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm's bottom line.

Comment: The selection of an external adviser or subadviser should be based on a full and complete review of the adviser's services, performance history, and cost structure. In basing the decision on the fee structure alone, Ostrowski may be violating Standard V(A).

See also Standard III(C)–Suitability because it relates to the ability of the selected adviser to meet the needs of the clients.

Example 8 (Sufficient Due Diligence):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

Comment: Papis violated Standard V(A). His responsibilities may include the selection of the external advisers, but the decision to change advisers appears to have been arbitrary. If Papis was dissatisfied with the current real estate adviser, he should have conducted a proper solicitation to select the most appropriate adviser.

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See also Standard IV(C)–Responsibilities of Supervisors, Standard V(B)–Communication with Clients and Prospective Clients, and Standard VI(A)–Disclosure of Conflicts.

Example 9 (Sufficient Due Diligence):

Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

Comment: Shrub violated Standard V(A) by not conducting a thorough analysis of the funds managed by Reed before developing the new Conduit fund. Shrub's reliance on his personal relationship with Reed and his prior knowledge of Elite are insufficient justification for the investments. The funds may be appropriately considered, but a full review of their operating procedures, reporting practices, and transparency are some elements of the necessary due diligence.

See also Standard III(C)–Suitability.

Example 10 (Sufficient Due Diligence):

Bob Thompson has been doing research for the portfolio manager of the fixed-income department. His assignment is to do sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives "prepays" (prepayments of mortgages) and losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. Thompson insists that the analysis should include a scenario run with –10% for Year 1, –5% for Year 2, and then (to project a worst-case scenario) 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative.

Thompson conducts his research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, a less likely but possible environment. Based on the results of the enhanced scenarios, Thompson does not recommend the purchase of the securitization. Against the general market trends, the manager follows Thompson's recommendation and does not invest. The following year, the housing market collapses. In avoiding the subprime investments, the manager's portfolio outperforms its peer group that year.

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Comment: Thompson's actions in running the scenario test with inputs beyond the historical trends available in the firm's databases adhere to the principles of Standard V(A). His concerns over recent trends provide a sound basis for further analysis. Thompson understands the limitations of his model, when combined with the limited available historical information, to accurately predict the performance of the funds if market conditions change negatively.

See also Standard I(B)–Independence and Objectivity.

Example 11 (Use of Quantitatively Oriented Models):

Espacia Liakos works in sales for Hellenica Securities, a firm specializing in developing intricate derivative strategies to profit from particular views on market expectations. One of her clients is Eugenie Carapalis, who has become convinced that commodity prices will become more volatile over the coming months. Carapalis asks Liakos to quickly engineer a strategy that will benefit from this expectation. Liakos turns to Hellenica's modeling group to fulfill this request. Because of the tight deadline, the modeling group outsources parts of the work to several trusted third parties. Liakos implements the disparate components of the strategy as the firms complete them.

Within a month, Carapalis is proven correct: Volatility across a range of commodities increases sharply. But her derivatives position with Hellenica returns huge losses, and the losses increase daily. Liakos investigates and realizes that although each of the various components of the strategy had been validated, they had never been evaluated as an integrated whole. In extreme conditions, portions of the model worked at cross-purposes with other portions, causing the overall strategy to fail dramatically.

Comment: Liakos violated Standard V(A). Members and candidates must understand the statistical significance of the results of the models they recommend and must be able to explain them to clients. Liakos did not take adequate care to ensure a thorough review of the whole model; its components were evaluated only individually. Because Carapalis clearly intended to implement the strategy as a whole rather than as separate parts, Liakos should have tested how the components of the strategy interacted as well as how they performed individually.

Example 12 (Successful Due Diligence/Failed Investment):

Alton Newbury is an investment adviser to high-net-worth clients. A client with an aggressive risk profile in his investment policy statement asks about investing in the Top Shelf hedge fund. This fund, based in Calgary, Alberta, Canada, has reported 20% returns for the first three years. The fund prospectus states that its strategy involves long and short positions in the energy sector and extensive leverage. Based on his analysis of the fund's track record, the principals involved in

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managing the fund, the fees charged, and the fund's risk profile, Newbury recommends the fund to the client and secures a position in it. The next week, the fund announces that it has suffered a loss of 60% of its value and is suspending operations and redemptions until after a regulatory review. Newbury's client calls him in a panic and asks for an explanation.

> *Comment*: Newbury's actions were consistent with Standard V(A). Analysis of an investment that results in a reasonable basis for recommendation does not guarantee that the investment has no downside risk. Newbury should discuss the analysis process with the client while reminding him or her that past performance does not lead to guaranteed future gains and that losses in an aggressive investment portfolio should be expected.

Example 13 (Quantitative Model Diligence):

Barry Cannon is the lead quantitative analyst at CityCenter Hedge Fund. He is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Cannon reads several high-level mathematical publications and blogs to stay informed of current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Cannon is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

> *Comment*: Cannon has violated Standard V(A) by failing to have a reasonable basis for the new recommendations made to the portfolio managers. He needed to diligently research the effect of incorporating the new factors before offering the output recommendations. Cannon may use the blog for ideas, but it is his responsibility to determine the effect on the firm's proprietary models.
>
> See Standard VII(B) regarding the violation by "Expert CFA" in the use of the CFA designation.

Example 14 (Selecting a Service Provider):

Ellen Smith is a performance analyst at Artic Global Advisors, a firm that manages global equity mandates for institutional clients. She was asked by her supervisor to review five new performance attribution systems and recommend one that would more appropriately explain the firm's investment strategy to clients. On the list was a system she recalled learning about when visiting an exhibitor booth at a recent conference. The system is highly quantitative and something of a "black box" in how it calculates the attribution values. Smith recommended this option without researching the others because the sheer complexity of the process was sure to impress the clients.

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Comment: Smith's actions do not demonstrate a sufficient level of diligence in reviewing this product to make a recommendation for selecting the service. Besides not reviewing or considering the other four potential systems, she did not determine whether the "black box" attribution process aligns with the investment practices of the firm, including its investments in different countries and currencies. Smith must review and understand the process of any software or system before recommending its use as the firm's attribution system.

Example 15 (Subadviser Selection):

Craig Jackson is working for Adams Partners, Inc., and has been assigned to select a hedge fund subadviser to improve the diversification of the firm's large fund-of-funds product. The allocation must be in place before the start of the next quarter. Jackson uses a consultant database to find a list of suitable firms that claim compliance with the GIPS standards. He calls more than 20 firms on the list to confirm their potential interest and to determine their most recent quarterly and annual total return values. Because of the short turnaround, Jackson recommends the firm with the greatest total return values for selection.

Comment: By considering only performance and GIPS compliance, Jackson has not conducted sufficient review of potential firms to satisfy the requirements of Standard V(A). A thorough investigation of the firms and their operations should be conducted to ensure that their addition would increase the diversity of clients' portfolios and that they are suitable for the fund-of-funds product.

Example 16 (Manager Selection):

Timothy Green works for Peach Asset Management, where he creates proprietary models that analyze data from the firm request for proposal questionnaires to identify managers for possible inclusion in the firm's fund-of-funds investment platform. Various criteria must be met to be accepted to the platform. Because of the number of respondents to the questionnaires, Green uses only the data submitted to make a recommendation for adding a new manager.

Comment: By failing to conduct any additional outside review of the information to verify what was submitted through the request for proposal, Green has likely not satisfied the requirements of Standard V(A). The amount of information requested from outside managers varies among firms. Although the requested information may be comprehensive, Green should ensure sufficient effort is undertaken to verify the submitted information before recommending a firm for inclusion. This requires that he go beyond the information provided by the manager on the request for proposal questionnaire and may include interviews with interested managers, reviews of regulatory filings, and discussions with the managers' custodian or auditor.

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Example 17 (Technical Model Requirements):

Jérôme Dupont works for the credit research group of XYZ Asset Management, where he is in charge of developing and updating credit risk models. In order to perform accurately, his models need to be regularly updated with the latest market data.

Dupont does not interact with or manage money for any of the firm's clients. He is in contact with the firm's US corporate bond fund manager, John Smith, who has only very superficial knowledge of the model and who from time to time asks very basic questions regarding the output recommendations. Smith does not consult Dupont with respect to finalizing his clients' investment strategies.

Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. The firm is planning to expand into emerging credit, and the development of such a model is a critical step in this process. Because Smith seems to follow the model's recommendations without much concern for its quality as he develops his clients' investment strategies, Dupont decides to focus his time on the development of the new emerging market model and neglects to update the US model.

After several months without regular updates, Dupont's diagnostic statistics start to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix." He thinks this change will address the issue without needing to complete the full data update, so he continues working on the new emerging market model.

Several months following the quick "fix," another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith rebalances the portfolio to remove the securities purchased on the basis of the questionable results without reporting the issue to anyone else.

Comment: Smith violated standard V(A) because exercising "diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions" means that members and candidates must understand the technical aspects of the products they provide to clients. Smith does not understand the model he is relying on to manage money. Members and candidates should also make reasonable enquiries into the source and accuracy of all data used in completing their investment analysis and recommendations.

Dupont violated V(A) even if he does not trade securities or make investment decisions. Dupont's models give investment recommendations, and Dupont is accountable for the quality of those recommendations. Members and candidates should make reasonable efforts to test the output of pre-programed analytical tools they use. Such validation should occur before incorporating the tools into their decision-making process.

See also Standard V(B)–Communication with Clients and Prospective Clients.

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Standard V(B) Communication with Clients and Prospective Clients

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analyses and recommendations.

Guidance

Highlights:

- *Informing Clients of the Investment Process*
- *Different Forms of Communication*
- *Identifying Risk and Limitations*
- *Report Presentation*
- *Distinction between Facts and Opinions in Reports*

Standard V(B) addresses member and candidate conduct with respect to communicating with clients. Developing and maintaining clear, frequent, and thorough communication practices is critical to providing high-quality financial services to clients. When clients understand the information communicated to them, they also can understand exactly how members and candidates are acting on their behalf, which gives clients the opportunity to make well-informed decisions about their investments. Such understanding can be accomplished only through clear communication.

Standard V(B) states that members and candidates should communicate in a recommendation the factors that were instrumental in making the investment recommendation. A critical part of this requirement is to distinguish clearly between opinions and facts. In preparing a research report, the member or candidate must present the basic characteristics of the security(ies) being analyzed,

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which will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision-making process.

Similarly, in preparing a recommendation about, for example, an asset allocation strategy, alternative investment vehicle, or structured investment product, the member or candidate should include factors that are relevant to the asset classes that are being discussed. Follow-up communication of significant changes in the risk characteristics of a security or asset strategy is required. Providing regular updates to any changes in the risk characteristics is recommended.

Informing Clients of the Investment Process

Members and candidates must adequately describe to clients and prospective clients the manner in which they conduct the investment decision-making process. Such disclosure should address factors that have positive and negative influences on the recommendations, including significant risks and limitations of the investment process used. The member or candidate must keep clients and other interested parties informed on an ongoing basis about changes to the investment process, especially newly identified significant risks and limitations. Only by thoroughly understanding the nature of the investment product or service can a client determine whether changes to that product or service could materially affect his or her investment objectives.

Understanding the basic characteristics of an investment is of great importance in judging the suitability of that investment on a standalone basis, but it is especially important in determining the impact each investment will have on the characteristics of a portfolio. Although the risk and return characteristics of a common stock might seem to be essentially the same for any investor when the stock is viewed in isolation, the effects of those characteristics greatly depend on the other investments held. For instance, if the particular stock will represent 90% of an individual's investments, the stock's importance in the portfolio is vastly different from what it would be to an investor with a highly diversified portfolio for whom the stock will represent only 2% of the holdings.

A firm's investment policy may include the use of outside advisers to manage various portions of clients' assets under management. Members and candidates should inform the clients about the specialization or diversification expertise provided by the external adviser(s). This information allows clients to understand the full mix of products and strategies being applied that may affect their investment objectives.

Different Forms of Communication

For purposes of Standard V(B), communication is not confined to a written report of the type traditionally generated by an analyst researching a security, company, or industry. A presentation of information can be made via any means of communication, including in-person recommendation or description, telephone conversation, media broadcast, or transmission by computer (e.g., on the internet).

Computer and mobile device communications have rapidly evolved over the past few years. Members and candidates using any social media service to

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communicate business information must be diligent in their efforts to avoid unintended problems because these services may not be available to all clients. When providing information to clients through new technologies, members and candidates should take reasonable steps to ensure that such delivery would treat all clients fairly and, if necessary, be considered publicly disseminated.

The nature of client communications is highly diverse—from one word ("buy" or "sell") to in-depth reports of more than 100 pages. A communication may contain a general recommendation about the market, asset allocations, or classes of investments (e.g., stocks, bonds, real estate) or may relate to a specific security. If recommendations are contained in capsule form (such as a recommended stock list), members and candidates should notify clients that additional information and analyses are available from the producer of the report.

Identifying Risks and Limitations

Members and candidates must outline to clients and prospective clients significant risks and limitations of the analysis contained in their investment products or recommendations. The type and nature of significant risks will depend on the investment process that members and candidates are following and on the personal circumstances of the client. In general, the use of leverage constitutes a significant risk and should be disclosed.

Members and candidates must adequately disclose the general market-related risks and the risks associated with the use of complex financial instruments that are deemed significant. Other types of risks that members and candidates may consider disclosing include, but are not limited to, counterparty risk, country risk, sector or industry risk, security-specific risk, and credit risk.

Investment securities and vehicles may have limiting factors that influence a client's or potential client's investment decision. Members and candidates must report to clients and prospective clients the existence of limitations significant to the decision-making process. Examples of such factors and attributes include, but are not limited to, investment liquidity and capacity. Liquidity is the ability to liquidate an investment on a timely basis at a reasonable cost. Capacity is the investment amount beyond which returns will be negatively affected by new investments.

The appropriateness of risk disclosure should be assessed on the basis of what was known at the time the investment action was taken (often called an *ex ante* basis). Members and candidates must disclose significant risks known to them at the time of the disclosure. Members and candidates cannot be expected to disclose risks they are unaware of at the time recommendations or investment actions are made. In assessing compliance with Standard V(B), it is important to establish knowledge of a purported significant risk or limitation. A one-time investment loss that occurs after the disclosure does not constitute a pertinent factor in assessing whether significant risks and limitations were properly disclosed. Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis of the research of the member or candidate but may not reveal a breach of Standard V(B).

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Report Presentation

Once the analytical process has been completed, the member or candidate who prepares the report must include those elements that are important to the analysis and conclusions of the report so that the reader can follow and challenge the report's reasoning. A report writer who has done adequate investigation may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant. For instance, a report may dwell on a quarterly earnings release or new-product introduction and omit other matters as long as the analyst clearly stipulates the limits to the scope of the report.

Investment advice based on quantitative research and analysis must be supported by readily available reference material and should be applied in a manner consistent with previously applied methodology. If changes in methodology are made, they should be highlighted.

Distinction between Facts and Opinions in Reports

Standard V(B) requires that opinion be separated from fact. Violations often occur when reports fail to separate the past from the future by not indicating that earnings estimates, changes in the outlook for dividends, or future market price information are *opinions* subject to future circumstances.

In the case of complex quantitative analyses, members and candidates must clearly separate fact from statistical conjecture and should identify the known limitations of an analysis. Members and candidates may violate Standard V(B) by failing to identify the limits of statistically developed projections because such omission leaves readers unaware of the limits of the published projections.

Members and candidates should explicitly discuss with clients and prospective clients the assumptions used in the investment models and processes to generate the analysis. Caution should be used in promoting the perceived accuracy of any model or process to clients because the ultimate output is merely an estimate of future results and not a certainty.

Recommended Procedures for Compliance

Because the selection of relevant factors is an analytical skill, determination of whether a member or candidate has used reasonable judgment in excluding and including information in research reports depends heavily on case-by-case review rather than a specific checklist.

Members and candidates should encourage their firms to have a rigorous methodology for reviewing research that is created for publication and dissemination to clients.

To assist in the after-the-fact review of a report, the member or candidate must maintain records indicating the nature of the research and should, if asked, be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

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Application of the Standard

Example 1 (Sufficient Disclosure of Investment System):

Sarah Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technicians' income and diversifying its product base. Williamson plans to build on Country Technicians' reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technicians' investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio construction rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top five "buy" and "sell" recommendations and to leave out details of the valuation models and the portfolio structuring scheme.

> *Comment*: Williamson's plans for the newsletter violate Standard V(B). Williamson need not describe the investment system in detail in order to implement the advice effectively, but she must inform clients of Country Technicians' basic process and logic. Without understanding the basis for a recommendation, clients cannot possibly understand its limitations or its inherent risks.

Example 2 (Providing Opinions as Facts):

Richard Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation on the basis of the core samples from the company's latest drilling. According to Dox's calculations, the company has more than 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong BUY."

> *Comment*: If Dox issues the report as written, he will violate Standard V(B). His calculation of the total gold reserves for the property based on the company's recent sample drilling is a quantitative opinion, not a fact. Opinion must be distinguished from fact in research reports.

Example 3 (Proper Description of a Security):

Olivia Thomas, an analyst at Government Brokers, Inc., which is a brokerage firm specializing in government bond trading, has produced a report that describes an investment strategy designed to benefit from an expected decline in US interest rates. The firm's derivative products group has designed a structured product that will allow the firm's clients to benefit from this strategy. Thomas's report describing the strategy indicates that high returns are possible if various scenarios for declining interest rates are assumed. Citing the proprietary nature of the structured product

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underlying the strategy, the report does not describe in detail how the firm is able to offer such returns or the related risks in the scenarios, nor does the report address the likely returns of the strategy if, contrary to expectations, interest rates rise.

> *Comment*: Thomas has violated Standard V(B) because her report fails to describe properly the basic characteristics of the actual and implied risks of the investment strategy, including how the structure was created and the degree to which leverage was embedded in the structure. The report should include a balanced discussion of how the strategy would perform in the case of rising as well as falling interest rates, preferably illustrating how the strategies might be expected to perform in the event of a reasonable variety of interest rate and credit risk–spread scenarios. If liquidity issues are relevant with regard to the valuation of either the derivatives or the underlying securities, provisions the firm has made to address those risks should also be disclosed.

Example 4 (Notification of Fund Mandate Change):

May & Associates is an aggressive growth manager that has represented itself since its inception as a specialist at investing in small-cap US stocks. One of May's selection criteria is a maximum capitalization of US$250 million for any given company. After a string of successful years of superior performance relative to its peers, May has expanded its client base significantly, to the point at which assets under management now exceed US$3 billion. For liquidity purposes, May's chief investment officer (CIO) decides to lift the maximum permissible market-cap ceiling to US$500 million and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

> *Comment*: Although May's CIO is correct about informing potentially interested parties as to the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap and large-cap specialists in a multiple-manager approach. Such clients could regard May's change of criteria as a style change that distorts their overall asset allocations.

Example 5 (Notification of Fund Mandate Change):

Rather than lifting the ceiling for its universe from US$250 million to US$500 million, May & Associates extends its small-cap universe to include a number of non-US companies.

> *Comment*: Standard V(B) requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in US small-cap stocks. Other changes that require client notification are introducing derivatives to emulate a certain market sector or relaxing various other constraints,

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such as portfolio beta. In all such cases, members and candidates must disclose changes to all interested parties.

Example 6 (Notification of Changes to the Investment Process):

RJZ Capital Management is an active value-style equity manager that selects stocks by using a combination of four multifactor models. The firm has found favorable results when back testing the most recent 10 years of available market data in a new dividend discount model (DDM) designed by the firm. This model is based on projected inflation rates, earnings growth rates, and interest rates. The president of RJZ decides to replace its simple model that uses price to trailing 12-month earnings with the new DDM.

Comment: Because the introduction of a new and different valuation model represents a material change in the investment process, RJZ's president must communicate the change to the firm's clients. RJZ is moving away from a model based on hard data toward a new model that is at least partly dependent on the firm's forecasting skills. Clients would likely view such a model as a significant change rather than a mere refinement of RJZ's process.

Example 7 (Notification of Changes to the Investment Process):

RJZ Capital Management loses the chief architect of its multifactor valuation system. Without informing its clients, the president of RJZ decides to redirect the firm's talents and resources toward developing a product for passive equity management—a product that will emulate the performance of a major market index.

Comment: By failing to disclose to clients a substantial change to its investment process, the president of RJZ has violated Standard V(B).

Example 8 (Notification of Changes to the Investment Process):

At Fundamental Asset Management, Inc., the responsibility for selecting stocks for addition to the firm's "approved" list has just shifted from individual security analysts to a committee consisting of the research director and three senior portfolio managers. Eleanor Morales, a portfolio manager with Fundamental Asset Management, thinks this change is not important enough to communicate to her clients.

Comment: Morales must disclose the process change to all her clients. Some of Fundamental's clients might be concerned about the morale and motivation among the firm's best research analysts after such a change. Moreover, clients might challenge the stock-picking track record of the portfolio managers and might even want to monitor the situation closely.

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Example 9 (Sufficient Disclosure of Investment System):

Amanda Chinn is the investment director for Diversified Asset Management, which manages the endowment of a charitable organization. Because of recent staff departures, Diversified has decided to limit its direct investment focus to large-cap securities and supplement the needs for small-cap and mid-cap management by hiring outside fund managers. In describing the planned strategy change to the charity, Chinn's update letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have to be considered.

> *Comment*: Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is one example of information that needs to be communicated to clients. Chinn and her firm have embraced the principles of Standard V(B) by providing their client with relevant information. The charity can now make a reasonable decision about whether Diversified Asset Management remains the appropriate manager for its fund.

Example 10 (Notification of Changes to the Investment Process):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

> *Comment*: Papis has violated Standard V(B). He attempted to hide the nature of his decision to change external managers by making only a limited disclosure. The plan recipients and the fund's trustees need to be aware when changes are made to ensure that operational procedures are being followed.
>
> See also Standard IV(C)–Responsibilities of Supervisors, Standard V(A)–Diligence and Reasonable Basis, and Standard VI(A)–Disclosure of Conflicts.

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Example 11 (Notification of Errors):

Jérôme Dupont works for the credit research group of XYZ Asset Management, where he is in charge of developing and updating credit risk models. In order to perform accurately, his models need to be regularly updated with the latest market data.

Dupont does not interact with or manage money for any of the firm's clients. He is in contact with the firm's US corporate bond fund manager, John Smith, who has only very superficial knowledge of the model and who from time to time asks very basic questions regarding the output recommendations. Smith does not consult Dupont with respect to finalizing his clients' investment strategies.

Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. The firm is planning to expand into emerging credit, and the development of such a model is a critical step in this process. Because Smith seems to follow the model's recommendations without much concern for its quality as he develops his clients' investment strategies, Dupont decides to focus his time on the development of the new emerging market model and neglects to update the US model.

After several months without regular updates, Dupont's diagnostic statistics start to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix." He thinks this change will address the issue without needing to complete the full data update, so he continues working on the new emerging market model.

Several months following the quick "fix," another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith rebalances the portfolio to remove the securities purchased on the basis of the questionable results without reporting the issue to anyone else.

Comment: Smith violated V(B) by not disclosing a material error in the investment process. Clients should have been informed about the error and the corrective actions the firm was undertaking on their behalf.

See also Standard V(A)–Diligence and Reasonable Basis.

Example 12 (Notification of Risks and Limitations):

Quantitative analyst Yuri Yakovlev has developed an investment strategy that selects small-cap stocks on the basis of quantitative signals. Yakovlev's strategy typically identifies only a small number of stocks (10–20) that tend to be illiquid, but according to his backtests, the strategy generates significant risk-adjusted returns. The partners at Yakovlev's firm, QSC Capital, are impressed by these results. After a thorough examination of the strategy's risks, stress testing, historical back testing, and scenario analysis, QSC decides to seed the strategy with US$10 million of internal capital in order for Yakovlev to create a track record for the strategy.

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After two years, the strategy has generated performance returns greater than the appropriate benchmark and the Sharpe ratio of the fund is close to 1.0. On the basis of these results, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. The extent of the limitation is difficult to ascertain with precision; it depends on market liquidity and other factors in his model that can evolve over time. Yakovlev indicates that given the current market conditions, investments in the fund beyond US$100 million of capital could become more difficult and negatively affect expected fund returns.

Alan Wellard, the manager of the marketing team, is a partner with 30 years of marketing experience and explains to Yakovlev that these are complex technical issues that will muddy the marketing message. According to Wellard, the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund has only US$12 million of capital, very far from the US$100 million threshold.

> *Comment*: Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund. Although the fund is currently far from the US$100 million mark, current and prospective investors must be made aware of this capacity issue. If significant limitations are complicated to grasp and clients do not have the technical background required to understand them, Yakovlev and Wellard should either educate the clients or ascertain whether the fund is suitable for each client.

Example 13 (Notification of Risks and Limitations):

Brickell Advisers offers investment advisory services mainly to South American clients. Julietta Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an *ex ante* Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.

> *Comment*: Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B). The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts. Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.

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Example 14 (Notification of Risks and Limitations):

Lily Smith attended an industry conference and noticed that John Baker, an investment manager with Baker Associates, attracted a great deal of attention from the conference participants. On the basis of her knowledge of Baker's reputation and the interest he received at the conference, Smith recommends adding Baker Associates to the approved manager platform. Her recommendation to the approval committee included the statement "John Baker is well respected in the industry, and his insights are consistently sought after by investors. Our clients are sure to benefit from investing with Baker Associates."

Comment: Smith is not appropriately separating facts from opinions in her recommendation to include the manager within the platform. Her actions conflict with the requirements of Standard V(B). Smith is relying on her opinions about Baker's reputation and the fact that many attendees were talking with him at the conference. Smith should also review the requirements of Standard V(A) regarding reasonable basis to determine the level of review necessary to recommend Baker Associates.

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Standard V(C) Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

Guidance

Highlights:

- *New Media Records*
- *Records Are Property of the Firm*
- *Local Requirements*

Members and candidates must retain records that substantiate the scope of their research and reasons for their actions or conclusions. The retention requirement applies to decisions to buy or sell a security as well as reviews undertaken that do not lead to a change in position. Which records are required to support recommendations or investment actions depends on the role of the member or candidate in the investment decision-making process. Records may be maintained either in hard copy or electronic form.

Some examples of supporting documentation that assists the member or candidate in meeting the requirements for retention are as follows:

- personal notes from meetings with the covered company,
- press releases or presentations issued by the covered company,
- computer-based model outputs and analyses,
- computer-based model input parameters,
- risk analyses of securities' impacts on a portfolio,
- selection criteria for external advisers,
- notes from clients from meetings to review investment policy statements, and
- outside research reports.

New Media Records

The increased use of new and evolving technological formats (e.g., social media) for gathering and sharing information creates new challenges in maintaining the appropriate records and files. The nature or format of the information does not

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remove a member's or candidate's responsibility to maintain a record of information used in his or her analysis or communicated to clients.

Members and candidates should understand that although employers and local regulators are developing digital media retention policies, these policies may lag behind the advent of new communication channels. Such lag places greater responsibility on the individual for ensuring that all relevant information is retained. Examples of non-print media formats that should be retained include, but are not limited to,

- e-mails,
- text messages,
- blog posts, and
- Twitter posts.

Records Are Property of the Firm

As a general matter, records created as part of a member's or candidate's professional activity on behalf of his or her employer are the property of the firm. When a member or candidate leaves a firm to seek other employment, the member or candidate cannot take the property of the firm, including original forms or copies of supporting records of the member's or candidate's work, to the new employer without the express consent of the previous employer. The member or candidate cannot use historical recommendations or research reports created at the previous firm because the supporting documentation is unavailable. For future use, the member or candidate must re-create the supporting records at the new firm with information gathered through public sources or directly from the covered company and not from memory or sources obtained at the previous employer.

Local Requirements

Local regulators often impose requirements on members, candidates, and their firms related to record retention that must be followed. Firms may also implement policies detailing the applicable time frame for retaining research and client communication records. Fulfilling such regulatory and firm requirements satisfies the requirements of Standard V(C). In the absence of regulatory guidance or firm policies, CFA Institute recommends maintaining records for at least seven years.

Recommended Procedures for Compliance

The responsibility to maintain records that support investment action generally falls with the firm rather than individuals. Members and candidates must, however, archive research notes and other documents, either electronically or in hard copy, that support their current investment-related communications. Doing so will assist their firms in complying with requirements for preservation of internal or external records.

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Application of the Standard

Example 1 (Record Retention and IPS Objectives and Recommendations):

One of Nikolas Lindstrom's clients is upset by the negative investment returns of his equity portfolio. The investment policy statement for the client requires that the portfolio manager follow a benchmark-oriented approach. The benchmark for the client includes a 35% investment allocation in the technology sector. The client acknowledges that this allocation was appropriate, but over the past three years, technology stocks have suffered severe losses. The client complains to the investment manager for allocating so much money to this sector.

> *Comment*: For Lindstrom, having appropriate records is important to show that over the past three years, the portion of technology stocks in the benchmark index was 35%, as called for in the IPS. Lindstrom should also have the client's IPS stating that the benchmark was appropriate for the client's investment objectives. He should also have records indicating that the investment has been explained appropriately to the client and that the IPS was updated on a regular basis. Taking these actions, Lindstrom would be in compliance with Standard V(C).

Example 2 (Record Retention and Research Process):

Malcolm Young is a research analyst who writes numerous reports rating companies in the luxury retail industry. His reports are based on a variety of sources, including interviews with company managers, manufacturers, and economists; on-site company visits; customer surveys; and secondary research from analysts covering related industries.

> *Comment*: Young must carefully document and keep copies of all the information that goes into his reports, including the secondary or third-party research of other analysts. Failure to maintain such files would violate Standard V(C).

Example 3 (Records as Firm, Not Employee, Property):

Martin Blank develops an analytical model while he is employed by Green Partners Investment Management, LLP (GPIM). While at the firm, he systematically documents the assumptions that make up the model as well as his reasoning behind the assumptions. As a result of the success of his model, Blank is hired to be the head of the research department of one of GPIM's competitors. Blank takes copies of the records supporting his model to his new firm.

> *Comment*: The records created by Blank supporting the research model he developed at GPIM are the records of GPIM. Taking the documents with him to his new employer without GPIM's permission violates Standard V(C). To use the model in the future, Blank must re-create the records supporting his model at the new firm.

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Standard VI: Conflicts of Interest

Standard VI(A) Disclosure of Conflicts

Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Guidance

Highlights:

- *Disclosure of Conflicts to Employers*
- *Disclosure to Clients*
- *Cross-Departmental Conflicts*
- *Conflicts with Stock Ownership*
- *Conflicts as a Director*

Best practice is to avoid actual conflicts or the appearance of conflicts of interest when possible. Conflicts of interest often arise in the investment profession. Conflicts can occur between the interests of clients, the interests of employers, and the member's or candidate's own personal interests. Common sources for conflict are compensation structures, especially incentive and bonus structures that provide immediate returns for members and candidates with little or no consideration of long-term value creation.

Identifying and managing these conflicts is a critical part of working in the investment industry and can take many forms. When conflicts cannot be reasonably avoided, clear and complete disclosure of their existence is necessary.

Standard VI(A) protects investors and employers by requiring members and candidates to fully disclose to clients, potential clients, and employers all actual and potential conflicts of interest. Once a member or candidate has made full disclosure, the member's or candidate's employer, clients, and prospective clients will have the information needed to evaluate the objectivity of the investment advice or action taken on their behalf.

To be effective, disclosures must be prominent and must be made in plain language and in a manner designed to effectively communicate the information. Members and candidates have the responsibility of determining how often, in what manner, and in what particular circumstances the disclosure of conflicts

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must be made. Best practices dictate updating disclosures when the nature of a conflict of interest changes materially—for example, if the nature of a conflict of interest worsens through the introduction of bonuses based on each quarter's profits as to opposed annual profits. In making and updating disclosures of conflicts of interest, members and candidates should err on the side of caution to ensure that conflicts are effectively communicated.

Disclosure of Conflicts to Employers

Disclosure of conflicts to employers may be appropriate in many instances. When reporting conflicts of interest to employers, members and candidates must give their employers enough information to assess the impact of the conflict. By complying with employer guidelines, members and candidates allow their employers to avoid potentially embarrassing and costly ethical or regulatory violations.

Reportable situations include conflicts that would interfere with rendering unbiased investment advice and conflicts that would cause a member or candidate to act not in the employer's best interest. The same circumstances that generate conflicts to be reported to clients and prospective clients also would dictate reporting to employers. Ownership of stocks analyzed or recommended, participation on outside boards, and financial or other pressures that could influence a decision are to be promptly reported to the employer so that their impact can be assessed and a decision on how to resolve the conflict can be made.

The mere appearance of a conflict of interest may create problems for members, candidates, and their employers. Therefore, many of the conflicts previously mentioned could be explicitly prohibited by an employer. For example, many employers restrict personal trading, outside board membership, and related activities to prevent situations that might not normally be considered problematic from a conflict-of-interest point of view but that could give the appearance of a conflict of interest. Members and candidates must comply with these restrictions. Members and candidates must take reasonable steps to avoid conflicts and, if they occur inadvertently, must report them promptly so that the employer and the member or candidate can resolve them as quickly and effectively as possible.

Standard VI(A) also deals with a member's or candidate's conflicts of interest that might be detrimental to the employer's business. Any potential conflict situation that could prevent clear judgment about or full commitment to the execution of a member's or candidate's duties to the employer should be reported to the member's or candidate's employer and promptly resolved.

Disclosure to Clients

Members and candidates must maintain their objectivity when rendering investment advice or taking investment action. Investment advice or actions may be perceived to be tainted in numerous situations. Can a member or candidate remain objective if, on behalf of the firm, the member or candidate obtains or assists in obtaining fees for services? Can a member or candidate give objective advice if he or she owns stock in the company that is the subject of an investment recommendation

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or if the member or candidate has a close personal relationship with the company managers? Requiring members and candidates to disclose all matters that reasonably could be expected to impair the member's or candidate's objectivity allows clients and prospective clients to judge motives and possible biases for themselves.

Often in the investment industry, a conflict, or the perception of a conflict, cannot be avoided. The most obvious conflicts of interest, which should always be disclosed, are relationships between an issuer and the member, the candidate, or his or her firm (such as a directorship or consultancy by a member; investment banking, underwriting, and financial relationships; broker/dealer market-making activities; and material beneficial ownership of stock). For the purposes of Standard VI(A), members and candidates beneficially own securities or other investments if they have a direct or indirect pecuniary interest in the securities, have the power to vote or direct the voting of the shares of the securities or investments, or have the power to dispose or direct the disposition of the security or investment.

A member or candidate must take reasonable steps to determine whether a conflict of interest exists and disclose to clients any known conflicts of the member's or candidate's firm. Disclosure of broker/dealer market-making activities alerts clients that a purchase or sale might be made from or to the firm's principal account and that the firm has a special interest in the price of the stock.

Additionally, disclosures should be made to clients regarding fee arrangements, subadvisory agreements, or other situations involving nonstandard fee structures. Equally important is the disclosure of arrangements in which the firm benefits directly from investment recommendations. An obvious conflict of interest is the rebate of a portion of the service fee some classes of mutual funds charge to investors. Members and candidates should ensure that their firms disclose such relationships so clients can fully understand the costs of their investments and the benefits received by their investment manager's employer.

Cross-Departmental Conflicts

Other circumstances can give rise to actual or potential conflicts of interest. For instance, a sell-side analyst working for a broker/dealer may be encouraged, not only by members of her or his own firm but by corporate issuers themselves, to write research reports about particular companies. The buy-side analyst is likely to be faced with similar conflicts as banks exercise their underwriting and security-dealing powers. The marketing division may ask an analyst to recommend the stock of a certain company in order to obtain business from that company.

The potential for conflicts of interest also exists with broker-sponsored limited partnerships formed to invest venture capital. Increasingly, members and candidates are expected not only to follow issues from these partnerships once they are offered to the public but also to promote the issues in the secondary market after public offerings. Members, candidates, and their firms should attempt to resolve situations presenting potential conflicts of interest or disclose them in accordance with the principles set forth in Standard VI(A).

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Conflicts with Stock Ownership

The most prevalent conflict requiring disclosure under Standard VI(A) is a member's or candidate's ownership of stock in companies that he or she recommends to clients or that clients hold. Clearly, the easiest method for preventing a conflict is to prohibit members and candidates from owning any such securities, but this approach is overly burdensome and discriminates against members and candidates.

Therefore, sell-side members and candidates should disclose any materially beneficial ownership interest in a security or other investment that the member or candidate is recommending. Buy-side members and candidates should disclose their procedures for reporting requirements for personal transactions. Conflicts arising from personal investing are discussed more fully in the guidance for Standard VI(B).

Conflicts as a Director

Service as a director poses three basic conflicts of interest. First, a conflict may exist between the duties owed to clients and the duties owed to shareholders of the company. Second, investment personnel who serve as directors may receive the securities or options to purchase securities of the company as compensation for serving on the board, which could raise questions about trading actions that might increase the value of those securities. Third, board service creates the opportunity to receive material nonpublic information involving the company. Even though the information is confidential, the perception could be that information not available to the public is being communicated to a director's firm—whether a broker, investment adviser, or other type of organization. When members or candidates providing investment services also serve as directors, they should be isolated from those making investment decisions by the use of firewalls or similar restrictions.

Recommended Procedures for Compliance

Members or candidates should disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees. If the member's or candidate's firm does not permit such disclosure, the member or candidate should document the request and may consider dissociating from the activity.

Members' and candidates' firms are encouraged to include information on compensation packages in firms' promotional literature. If a member or candidate manages a portfolio for which the fee is based on capital gains or capital appreciation (a performance fee), this information should be disclosed to clients. If a member, a candidate, or a member's or candidate's firm has outstanding agent options to buy stock as part of the compensation package for corporate financing activities, the amount and expiration date of these options should be disclosed as a footnote to any research report published by the member's or candidate's firm.

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Application of the Standard

Example 1 (Conflict of Interest and Business Relationships):

Hunter Weiss is a research analyst with Farmington Company, a broker and investment banking firm. Farmington's merger and acquisition department has represented Vimco, a conglomerate, in all of Vimco's acquisitions for 20 years. From time to time, Farmington officers sit on the boards of directors of various Vimco subsidiaries. Weiss is writing a research report on Vimco.

Comment: Weiss must disclose in his research report Farmington's special relationship with Vimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company entails a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report writer and must be disclosed.

Example 2 (Conflict of Interest and Business Stock Ownership):

The investment management firm of Dover & Roe sells a 25% interest in its partnership to a multinational bank holding company, First of New York. Immediately after the sale, Margaret Hobbs, president of Dover & Roe, changes her recommendation for First of New York's common stock from "sell" to "buy" and adds First of New York's commercial paper to Dover & Roe's approved list for purchase.

Comment: Hobbs must disclose the new relationship with First of New York to all Dover & Roe clients. This relationship must also be disclosed to clients by the firm's portfolio managers when they make specific investment recommendations or take investment actions with respect to First of New York's securities.

Example 3 (Conflict of Interest and Personal Stock Ownership):

Carl Fargmon, a research analyst who follows firms producing office equipment, has been recommending purchase of Kincaid Printing because of its innovative new line of copiers. After his initial report on the company, Fargmon's wife inherits from a distant relative US$3 million of Kincaid stock. He has been asked to write a follow-up report on Kincaid.

Comment: Fargmon must disclose his wife's ownership of the Kincaid stock to his employer and in his follow-up report. Best practice would be to avoid the conflict by asking his employer to assign another analyst to draft the follow-up report.

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Example 4 (Conflict of Interest and Personal Stock Ownership):

Betty Roberts is speculating in penny stocks for her own account and purchases 100,000 shares of Drew Mining, Inc., for US$0.30 a share. She intends to sell these shares at the sign of any substantial upward price movement of the stock. A week later, her employer asks her to write a report on penny stocks in the mining industry to be published in two weeks. Even without owning the Drew stock, Roberts would recommend it in her report as a "buy." A surge in the price of the stock to the US$2 range is likely to result once the report is issued.

> *Comment*: Although this holding may not be material, Roberts must disclose it in the report and to her employer before writing the report because the gain for her will be substantial if the market responds strongly to her recommendation. The fact that she has only recently purchased the stock adds to the appearance that she is not entirely objective.

Example 5 (Conflict of Interest and Compensation Arrangements):

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indices. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

> *Comment*: Snead has violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her employer, which created a conflict of interest between her compensation and her clients' IPSs. Firms may pay employees on the basis of performance, but pressure by Thomas Investment Counsel to achieve short-term performance goals is in basic conflict with the objectives of Snead's accounts.
>
> See also Standard III(C)–Suitability.

Example 6 (Conflict of Interest, Options, and Compensation Arrangements):

Wayland Securities works with small companies doing IPOs or secondary offerings. Typically, these deals are in the US$10 million to US$50 million range, and as a result, the corporate finance fees are quite small. To compensate for the small fees, Wayland Securities usually takes "agent options"—that is, rights (exercisable within

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a two-year time frame) to acquire up to an additional 10% of the current offering. Following an IPO performed by Wayland for Falk Resources, Ltd., Darcy Hunter, the head of corporate finance at Wayland, is concerned about receiving value for her Falk Resources options. The options are due to expire in one month, and the stock is not doing well. She contacts John Fitzpatrick in the research department of Wayland Securities, reminds him that he is eligible for 30% of these options, and indicates that now would be a good time to give some additional coverage to Falk Resources. Fitzpatrick agrees and immediately issues a favorable report.

Comment: For Fitzpatrick to avoid being in violation of Standard VI(A), he must indicate in the report the volume and expiration date of agent options outstanding. Furthermore, because he is personally eligible for some of the options, Fitzpatrick must disclose the extent of this compensation. He also must be careful to not violate his duty of independence and objectivity under Standard I(B).

Example 7 (Conflict of Interest and Compensation Arrangements):

Gary Carter is a representative with Bengal International, a registered broker/dealer. Carter is approached by a stock promoter for Badger Company, who offers to pay Carter additional compensation for sales of Badger Company's stock to Carter's clients. Carter accepts the stock promoter's offer but does not disclose the arrangements to his clients or to his employer. Carter sells shares of the stock to his clients.

Comment: Carter has violated Standard VI(A) by failing to disclose to clients that he is receiving additional compensation for recommending and selling Badger stock. Because he did not disclose the arrangement with Badger to his clients, the clients were unable to evaluate whether Carter's recommendations to buy Badger were affected by this arrangement. Carter's conduct also violated Standard VI(A) by failing to disclose to his employer monetary compensation received in addition to the compensation and benefits conferred by his employer. Carter was required by Standard VI(A) to disclose the arrangement with Badger to his employer so that his employer could evaluate whether the arrangement affected Carter's objectivity and loyalty.

Example 8 (Conflict of Interest and Directorship):

Carol Corky, a senior portfolio manager for Universal Management, recently became involved as a trustee with the Chelsea Foundation, a large not-for-profit foundation in her hometown. Universal is a small money manager (with assets under management of approximately US$100 million) that caters to individual investors. Chelsea has assets in excess of US$2 billion. Corky does not believe informing Universal of her involvement with Chelsea is necessary.

Comment: By failing to inform Universal of her involvement with Chelsea, Corky violated Standard VI(A). Given the large size of the endowment at

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Chelsea, Corky's new role as a trustee can reasonably be expected to be time consuming, to the possible detriment of Corky's portfolio responsibilities with Universal. Also, as a trustee, Corky may become involved in the investment decisions at Chelsea. Therefore, Standard VI(A) obligates Corky to discuss becoming a trustee at Chelsea with her compliance officer or supervisor at Universal before accepting the position, and she should have disclosed the degree to which she would be involved in investment decisions at Chelsea.

Example 9 (Conflict of Interest and Personal Trading):

Bruce Smith covers eastern European equities for Marlborough Investments, an investment management firm with a strong presence in emerging markets. While on a business trip to Russia, Smith learns that investing in Russian equities directly is difficult but that equity-linked notes that replicate the performance of underlying Russian equities can be purchased from a New York–based investment bank. Believing that his firm would not be interested in such a security, Smith purchases a note linked to a Russian telecommunications company for his own account without informing Marlborough. A month later, Smith decides that the firm should consider investing in Russian equities by way of the equity-linked notes. He prepares a write-up on the market that concludes with a recommendation to purchase several of the notes. One note he recommends is linked to the same Russian telecom company that Smith holds in his personal account.

Comment: Smith has violated Standard VI(A) by failing to disclose his purchase and ownership of the note linked to the Russian telecom company. Smith is required by the standard to disclose the investment opportunity to his employer and look to his company's policies on personal trading to determine whether it was proper for him to purchase the note for his own account. By purchasing the note, Smith may or may not have impaired his ability to make an unbiased and objective assessment of the appropriateness of the derivative instrument for his firm, but Smith's failure to disclose the purchase to his employer impaired his employer's ability to decide whether his ownership of the security is a conflict of interest that might affect Smith's future recommendations. Then, when he recommended the particular telecom notes to his firm, Smith compounded his problems by not disclosing that he owned the notes in his personal account—a clear conflict of interest.

Example 10 (Conflict of Interest and Requested Favors):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm,

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Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

Comment: Papis has violated Standard VI(A) by not disclosing to his employer his personal relationship with Nagle. Disclosure of his past history with Nagle would allow his firm to determine whether the conflict may have impaired Papis's independence in deciding to change managers.

See also Standard IV(C)–Responsibilities of Supervisors, Standard V(A)–Diligence and Reasonable Basis, and Standard V(B)–Communication with Clients and Prospective Clients.

Example 11 (Conflict of Interest and Business Relationships):

Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review the Western Funds family of funds to determine whether they were suitable for clients of Central. The manager completed the normal due diligence review and determined that the funds were fairly valued in the market with fee structures on a par with their competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments. So as to not influence the investment managers, Wade did not disclose the fee offer and allowed that income to flow directly to the bank.

Comment: Wade is violating Standard VI(A) by not disclosing the portion of the service fee being paid to Central. Although the investment managers may not be influenced by the fee, neither they nor the client have the proper information about Wade's decision to exclusively market this fund family and class of investments. Central may come to rely on the new fee as a component of the firm's profitability and may be unwilling to offer other products in the future that could affect the fees received.

See also Standard I(B)–Independence and Objectivity.

Example 12 (Disclosure of Conflicts to Employers):

Yehudit Dagan is a portfolio manager for Risk Management Bank (RMB), whose clients include retirement plans and corporations. RMB provides a defined

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contribution retirement plan for its employees that offers 20 large diversified mutual fund investment options, including a mutual fund managed by Dagan's RMB colleagues. After being employed for six months, Dagan became eligible to participate in the retirement plan, and she intends to allocate her retirement plan assets in six of the investment options, including the fund managed by her RMB colleagues. Dagan is concerned that joining the plan will lead to a potentially significant amount of paperwork for her (e.g., disclosure of her retirement account holdings and needing preclearance for her transactions), especially with her investing in the in-house fund.

Comment: Standard VI(A) would not require Dagan to disclosure her personal or retirement investments in large diversified mutual funds, unless specifically required by her employer. For practical reasons, the standard does not require Dagan to gain preclearance for ongoing payroll deduction contributions to retirement plan account investment options.

Dagan should ensure that her firm does not have a specific policy regarding investment—whether personal or in the retirement account—for funds managed by the company's employees. These mutual funds may be subject to the company's disclosure, preclearance, and trading restriction procedures to identify possible conflicts prior to the execution of trades.

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Standard VI(B) Priority of Transactions

> Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

Guidance

Highlights:

- *Avoiding Potential Conflicts*
- *Personal Trading Secondary to Trading for Clients*
- *Standards for Nonpublic Information*
- *Impact on All Accounts with Beneficial Ownership*

Standard VI(B) reinforces the responsibility of members and candidates to give the interests of their clients and employers priority over their personal financial interests. This standard is designed to prevent any potential conflict of interest or the appearance of a conflict of interest with respect to personal transactions. Client interests have priority. Client transactions must take precedence over transactions made on behalf of the member's or candidate's firm or personal transactions.

Avoiding Potential Conflicts

Conflicts between the client's interest and an investment professional's personal interest may occur. Although conflicts of interest exist, nothing is inherently unethical about individual managers, advisers, or mutual fund employees making money from personal investments as long as (1) the client is not disadvantaged by the trade, (2) the investment professional does not benefit personally from trades undertaken for clients, and (3) the investment professional complies with applicable regulatory requirements.

Some situations occur where a member or candidate may need to enter a personal transaction that runs counter to current recommendations or what the portfolio manager is doing for client portfolios. For example, a member or candidate may be required at some point to sell an asset to make a college tuition payment or a down payment on a home, to meet a margin call, or so on. The sale may be contrary to the long-term advice the member or candidate is currently providing to clients. In these situations, the same three criteria given in the preceding paragraph should be applied in the transaction so as to not violate Standard VI(B).

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Personal Trading Secondary to Trading for Clients

Standard VI(B) states that transactions for clients and employers must have priority over transactions in securities or other investments for which a member or candidate is the beneficial owner. The objective of the standard is to prevent personal transactions from adversely affecting the interests of clients or employers. A member or candidate having the same investment positions or being coinvested with clients does not always create a conflict. Some clients in certain investment situations require members or candidates to have aligned interests. Personal investment positions or transactions of members or candidates or their firm should never, however, adversely affect client investments.

Standards for Nonpublic Information

Standard VI(B) covers the activities of members and candidates who have knowledge of pending transactions that may be made on behalf of their clients or employers, who have access to nonpublic information during the normal preparation of research recommendations, or who take investment actions. Members and candidates are prohibited from conveying nonpublic information to any person whose relationship to the member or candidate makes the member or candidate a beneficial owner of the person's securities. Members and candidates must not convey this information to any other person if the nonpublic information can be deemed material.

Impact on All Accounts with Beneficial Ownership

Members or candidates may undertake transactions in accounts for which they are a beneficial owner only after their clients and employers have had adequate opportunity to act on a recommendation. Personal transactions include those made for the member's or candidate's own account, for family (including spouse, children, and other immediate family members) accounts, and for accounts in which the member or candidate has a direct or indirect pecuniary interest, such as a trust or retirement account. Family accounts that are client accounts should be treated like any other firm account and should neither be given special treatment nor be disadvantaged because of the family relationship. If a member or candidate has a beneficial ownership in the account, however, the member or candidate may be subject to preclearance or reporting requirements of the employer or applicable law.

Recommended Procedures for Compliance

Policies and procedures designed to prevent potential conflicts of interest, and even the appearance of a conflict of interest, with respect to personal transactions are critical to establishing investor confidence in the securities industry. Therefore, members and candidates should urge their firms to establish such policies and procedures. Because investment firms vary greatly in assets under management, types of clients, number of employees, and so on, each firm should have policies regarding

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personal investing that are best suited to the firm. Members and candidates should then prominently disclose these policies to clients and prospective clients.

The specific provisions of each firm's standards will vary, but all firms should adopt certain basic procedures to address the conflict areas created by personal investing. These procedures include the following:

- *Limited participation in equity IPOs*: Some eagerly awaited IPOs rise significantly in value shortly after the issue is brought to market. Because the new issue may be highly attractive and sought after, the opportunity to participate in the IPO may be limited. Therefore, purchases of IPOs by investment personnel create conflicts of interest in two principal ways. First, participation in an IPO may have the appearance of taking away an attractive investment opportunity from clients for personal gain—a clear breach of the duty of loyalty to clients. Second, personal purchases in IPOs may have the appearance that the investment opportunity is being bestowed as an incentive to make future investment decisions for the benefit of the party providing the opportunity. Members and candidates can avoid these conflicts or appearances of conflicts of interest by not participating in IPOs.

  Reliable and systematic review procedures should be established to ensure that conflicts relating to IPOs are identified and appropriately dealt with by supervisors. Members and candidates should preclear their participation in IPOs, even in situations without any conflict of interest between a member's or candidate's participation in an IPO and the client's interests. Members and candidates should not benefit from the position that their clients occupy in the marketplace—through preferred trading, the allocation of limited offerings, or oversubscription.

- *Restrictions on private placements*: Strict limits should be placed on investment personnel acquiring securities in private placements, and appropriate supervisory and review procedures should be established to prevent noncompliance.

  Firms do not routinely use private placements for clients (e.g., venture capital deals) because of the high risk associated with them. Conflicts related to private placements are more significant to members and candidates who manage large pools of assets or act as plan sponsors because these managers may be offered special opportunities, such as private placements, as a reward or an enticement for continuing to do business with a particular broker.

  Participation in private placements raises conflict-of-interest issues that are similar to issues surrounding IPOs. Investment personnel should not be involved in transactions, including (but not limited to) private placements, that could be perceived as favors or gifts that seem designed to influence future judgment or to reward past business deals.

  Whether the venture eventually proves to be good or bad, managers have an immediate conflict concerning private placement opportunities. If and when the investments go public, participants in private placements have an

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incentive to recommend the investments to clients regardless of the suitability of the investments for their clients. Doing so increases the value of the participants' personal portfolios.

- *Establish blackout/restricted periods*: Investment personnel involved in the investment decision-making process should establish blackout periods prior to trades for clients so that managers cannot take advantage of their knowledge of client activity by "front-running" client trades (trading for one's personal account before trading for client accounts).

  Individual firms must decide who within the firm should be required to comply with the trading restrictions. At a minimum, all individuals who are involved in the investment decision-making process should be subject to the same restricted period. Each firm must determine specific requirements related to blackout and restricted periods that are most relevant to the firm while ensuring that the procedures are governed by the guiding principles set forth in the Code and Standards. Size of firm and type of securities purchased are relevant factors. For example, in a large firm, a blackout requirement is, in effect, a total trading ban because the firm is continually trading in most securities. In a small firm, the blackout period is more likely to prevent the investment manager from front-running.

- *Reporting requirements*: Supervisors should establish reporting procedures for investment personnel, including disclosure of personal holdings/beneficial ownerships, confirmations of trades to the firm and the employee, and preclearance procedures. Once trading restrictions are in place, they must be enforced. The best method for monitoring and enforcing procedures to eliminate conflicts of interest in personal trading is through reporting requirements, including the following:

  - **Disclosure of holdings in which the employee has a beneficial interest**. Disclosure by investment personnel to the firm should be made upon commencement of the employment relationship and at least annually thereafter. To address privacy considerations, disclosure of personal holdings should be handled in a confidential manner by the firm.

  - **Providing duplicate confirmations of transactions.** Investment personnel should be required to direct their brokers to supply to firms duplicate copies or confirmations of all their personal securities transactions and copies of periodic statements for all securities accounts. The duplicate confirmation requirement has two purposes: (1) The requirement sends a message that there is independent verification, which reduces the likelihood of unethical behavior, and (2) it enables verification of the accounting of the flow of personal investments that cannot be determined from merely looking at holdings.

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- **Preclearance procedures**. Investment personnel should examine all planned personal trades to identify possible conflicts prior to the execution of the trades. Preclearance procedures are designed to identify possible conflicts before a problem arises.

- *Disclosure of policies*: Upon request, members and candidates should fully disclose to investors their firm's policies regarding personal investing. The information about employees' personal investment activities and policies will foster an atmosphere of full and complete disclosure and calm the public's legitimate concerns about the conflicts of interest posed by investment personnel's personal trading. The disclosure must provide helpful information to investors; it should not be simply boilerplate language, such as "investment personnel are subject to policies and procedures regarding their personal trading."

Application of the Standard

Example 1 (Personal Trading):

Research analyst Marlon Long does not recommend purchase of a common stock for his employer's account because he wants to purchase the stock personally and does not want to wait until the recommendation is approved and the stock is purchased by his employer.

> *Comment*: Long has violated Standard VI(B) by taking advantage of his knowledge of the stock's value before allowing his employer to benefit from that information.

Example 2 (Trading for Family Member Account):

Carol Baker, the portfolio manager of an aggressive growth mutual fund, maintains an account in her husband's name at several brokerage firms with which the fund and a number of Baker's other individual clients do a substantial amount of business. Whenever a hot issue becomes available, she instructs the brokers to buy it for her husband's account. Because such issues normally are scarce, Baker often acquires shares in hot issues but her clients are not able to participate in them.

> *Comment*: To avoid violating Standard VI(B), Baker must acquire shares for her mutual fund first and acquire them for her husband's account only after doing so, even though she might miss out on participating in new issues via her husband's account. She also must disclose the trading for her husband's account to her employer because this activity creates a conflict between her personal interests and her employer's interests.

Example 3 (Family Accounts as Equals):

Erin Toffler, a portfolio manager at Esposito Investments, manages the retirement account established with the firm by her parents. Whenever IPOs become

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available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place any remaining portion in her parents' account, if the issue is appropriate for them. She has adopted this procedure so that no one can accuse her of favoring her parents.

> *Comment*: Toffler has violated Standard VI(B) by breaching her duty to her parents by treating them differently from her other accounts simply because of the family relationship. As fee-paying clients of Esposito Investments, Toffler's parents are entitled to the same treatment as any other client of the firm. If Toffler has beneficial ownership in the account, however, and Esposito Investments has preclearance and reporting requirements for personal transactions, she may have to preclear the trades and report the transactions to Esposito.

Example 4 (Personal Trading and Disclosure):

Gary Michaels is an entry-level employee who holds a low-paying job serving both the research department and the investment management department of an active investment management firm. He purchases a sports car and begins to wear expensive clothes after only a year of employment with the firm. The director of the investment management department, who has responsibility for monitoring the personal stock transactions of all employees, investigates and discovers that Michaels has made substantial investment gains by purchasing stocks just before they were put on the firm's recommended "buy" list. Michaels was regularly given the firm's quarterly personal transaction form but declined to complete it.

> *Comment*: Michaels violated Standard VI(B) by placing personal transactions ahead of client transactions. In addition, his supervisor violated Standard IV(C)–Responsibilities of Supervisors by permitting Michaels to continue to perform his assigned tasks without having signed the quarterly personal transaction form. Note also that if Michaels had communicated information about the firm's recommendations to a person who traded the security, that action would be a misappropriation of the information and a violation of Standard II(A)–Material Nonpublic Information.

Example 5 (Trading Prior to Report Dissemination):

A brokerage's insurance analyst, Denise Wilson, makes a closed-circuit TV report to her firm's branches around the country. During the broadcast, she includes negative comments about a major company in the insurance industry. The following day, Wilson's report is printed and distributed to the sales force and public customers. The report recommends that both short-term traders and intermediate investors take profits by selling that insurance company's stock. Seven minutes after the broadcast, however, Ellen Riley, head of the firm's trading department, had closed out a long "call" position in the stock. Shortly thereafter, Riley established a

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sizable "put" position in the stock. When asked about her activities, Riley claimed she took the actions to facilitate anticipated sales by institutional clients.

Comment: Riley did not give customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Riley's firm may have depressed the price of the calls and increased the price of the puts. The firm could have avoided a conflict of interest if it had waited to trade for its own account until its clients had an opportunity to receive and assimilate Wilson's recommendations. As it is, Riley's actions violated Standard VI(B).

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Standard VI(C) Referral Fees

> Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

Guidance

Standard VI(C) states the responsibility of members and candidates to inform their employer, clients, and prospective clients of any benefit received for referrals of customers and clients. Such disclosures allow clients or employers to evaluate (1) any partiality shown in any recommendation of services and (2) the full cost of the services. Members and candidates must disclose when they pay a fee or provide compensation to others who have referred prospective clients to the member or candidate.

Appropriate disclosure means that members and candidates must advise the client or prospective client, before entry into any formal agreement for services, of any benefit given or received for the recommendation of any services provided by the member or candidate. In addition, the member or candidate must disclose the nature of the consideration or benefit—for example, flat fee or percentage basis, one-time or continuing benefit, based on performance, benefit in the form of provision of research or other noncash benefit—together with the estimated dollar value. Consideration includes all fees, whether paid in cash, in soft dollars, or in kind.

Recommended Procedures for Compliance

Members and candidates should encourage their employers to develop procedures related to referral fees. The firm may completely restrict such fees. If the firm does not adopt a strict prohibition of such fees, the procedures should indicate the appropriate steps for requesting approval.

Employers should have investment professionals provide to the clients notification of approved referral fee programs and provide the employer regular (at least quarterly) updates on the amount and nature of compensation received.

Application of the Standard

Example 1 (Disclosure of Referral Arrangements and Outside Parties):

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment counseling firm. In this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations

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and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral accounts to Brady Securities.

Willard White, a partner in Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities are US$20,000 annually.

Referrals from Brady Securities last year resulted in fee income of US$200,000 for Lewis Brothers, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of US$10,000.

Diane Branch, the chief financial officer of Maxwell Inc., contacts White and says that she is seeking an investment manager for Maxwell's profit-sharing plan. She adds, "My friend Harold Hill at Brady Securities recommended your firm without qualification, and that's good enough for me. Do we have a deal?" White accepts the new account but does not disclose his firm's referral arrangement with Brady Securities.

> *Comment*: White has violated Standard VI(C) by failing to inform the prospective customer of the referral fee payable in services and commissions for an indefinite period to Brady Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

Example 2 (Disclosure of Interdepartmental Referral Arrangements):

James Handley works for the trust department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage department and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement within Central Trust to his clients.

> *Comment*: Handley has violated Standard VI(C) by not disclosing the referral arrangement at Central Trust Bank to his clients. Standard VI(C) does not distinguish between referral payments paid by a third party for referring clients to the third party and internal payments paid within the firm to attract new business to a subsidiary. Members and candidates must disclose all such referral fees. Therefore, Handley is required to disclose, at the time of referral, any referral fee agreement in place among Central Trust Bank's departments. The disclosure should include the nature and the value of the benefit and should be made in writing.

Example 3 (Disclosure of Referral Arrangements and Informing Firm):

Katherine Roberts is a portfolio manager at Katama Investments, an advisory firm specializing in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients. Roberts asks the trading desk to direct a large portion of its commissions

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to Naushon, Inc., a small broker/dealer run by one of Roberts' business school classmates. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research to be not especially useful. Nevertheless, the traders do as Roberts asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment services of Roberts and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

Comment: Roberts is violating Standard VI(C) by failing to inform her employer of the referral arrangement.

Example 4 (Disclosure of Referral Arrangements and Outside Organizations):

Alex Burl is a portfolio manager at Helpful Investments, a local investment advisory firm. Burl is on the advisory board of his child's school, which is looking for ways to raise money to purchase new playground equipment for the school. Burl discusses a plan with his supervisor in which he will donate to the school a portion of his service fee from new clients referred by the parents of students at the school. Upon getting the approval from Helpful, Burl presents the idea to the school's advisory board and directors. The school agrees to announce the program at the next parent event and asks Burl to provide the appropriate written materials to be distributed. A week following the distribution of the flyers, Burl receives the first school-related referral. In establishing the client's investment policy statement, Burl clearly discusses the school's referral and outlines the plans for distributing the donation back to the school.

Comment: Burl has not violated Standard VI(C) because he secured the permission of his employer, Helpful Investments, and the school prior to beginning the program and because he discussed the arrangement with the client at the time the investment policy statement was designed.

Example 5 (Disclosure of Referral Arrangements and Outside Parties):

The sponsor of a state employee pension is seeking to hire a firm to manage the pension plan's emerging market allocation. To assist in the review process, the sponsor has hired Thomas Arrow as a consultant to solicit proposals from various advisers. Arrow is contracted by the sponsor to represent its best interest in selecting the most appropriate new manager. The process runs smoothly, and Overseas Investments is selected as the new manager.

The following year, news breaks that Arrow is under investigation by the local regulator for accepting kickbacks from investment managers after they are awarded new pension allocations. Overseas Investments is included in the list of firms allegedly making these payments. Although the sponsor is happy with the performance of Overseas since it has been managing the pension plan's emerging market funds, the sponsor still decides to have an independent review of the proposals and the

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selection process to ensure that Overseas was the appropriate firm for its needs. This review confirms that, even though Arrow was being paid by both parties, the recommendation of Overseas appeared to be objective and appropriate.

Comment: Arrow has violated Standard VI(C) because he did not disclose the fee being paid by Overseas. Withholding this information raises the question of a potential lack of objectivity in the recommendation of Overseas by Arrow; this aspect is in addition to questions about the legality of having firms pay to be considered for an allocation.

Regulators and governmental agencies may adopt requirements concerning allowable consultant activities. Local regulations sometimes include having a consultant register with the regulatory agency's ethics board. Regulator policies may include a prohibition on acceptance of payments from investment managers receiving allocations and require regular reporting of contributions made to political organizations and candidates. Arrow would have to adhere to these requirements as well as the Code and Standards.

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Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate

Standard VII(A) Conduct as Participants in CFA Institute Programs

> Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

Guidance

Highlights:

- *Confidential Program Information*
- *Additional CFA Program Restrictions*
- *Expressing an Opinion*

Standard VII(A) covers the conduct of CFA Institute members and candidates involved with the CFA Program and prohibits any conduct that undermines the public's confidence that the CFA charter represents a level of achievement based on merit and ethical conduct. There is an array of CFA Institute programs beyond the CFA Program that provide additional educational and credentialing opportunities, including the Certificate in Investment Performance Measurement (CIPM) Program and the Claritas Investment Certificate. The standard's function is to hold members and candidates to a high ethical criterion while they are participating in or involved with any CFA Institute program. Conduct covered includes but is not limited to

- giving or receiving assistance (cheating) on any CFA Institute examinations;
- violating the rules, regulations, and testing policies of CFA Institute programs;
- providing confidential program or exam information to candidates or the public;
- disregarding or attempting to circumvent security measures established for any CFA Institute examinations;
- improperly using an association with CFA Institute to further personal or professional goals; and
- misrepresenting information on the Professional Conduct Statement or in the CFA Institute Continuing Education Program.

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Confidential Program Information

CFA Institute is vigilant about protecting the integrity of CFA Institute programs' content and examination processes. CFA Institute program rules, regulations, and policies prohibit candidates from disclosing confidential material gained during the exam process.

Examples of information that cannot be disclosed by candidates sitting for an exam include but are not limited to

- specific details of questions appearing on the exam and
- broad topical areas and formulas tested or not tested on the exam.

All aspects of the exam, including questions, broad topical areas, and formulas, tested or not tested, are considered confidential until such time as CFA Institute elects to release them publicly. This confidentiality requirement allows CFA Institute to maintain the integrity and rigor of exams for future candidates. Standard VII(A) does not prohibit candidates from discussing nonconfidential information or curriculum material with others or in study groups in preparation for the exam.

Candidates increasingly use online forums and new technology as part of their exam preparations. CFA Institute actively polices blogs, forums, and related social networking groups for information considered confidential. The organization works with both individual candidates and the sponsors of online or offline services to promptly remove any and all violations. As noted in the discussion of Standard I(A)–Knowledge of the Law, candidates, members, and the public are encouraged to report suspected violations to CFA Institute.

Additional CFA Program Restrictions

The CFA Program rules, regulations, and policies define additional allowed and disallowed actions concerning the exams. Violating any of the testing policies, such as the calculator policy, personal belongings policy, or the Candidate Pledge, constitutes a violation of Standard VII(A). Candidates will find all of these policies on the CFA Program portion of the CFA Institute website (www.cfainstitute.org). **Exhibit 2** provides the Candidate Pledge, which highlights the respect candidates must have for the integrity, validity, and security of the CFA exam.

Members may participate as volunteers in various aspects of the CFA Program. Standard VII(A) prohibits members from disclosing and/or soliciting confidential material gained prior to or during the exam and grading processes with those outside the CFA exam development process.

Examples of information that cannot be shared by members involved in developing, administering, or grading the exams include but are not limited to

- questions appearing on the exam or under consideration,
- deliberation related to the exam process, and
- information related to the scoring of questions.

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Members may also be asked to offer assistance with other CFA Institute programs, including but not limited to the CIPM and Claritas programs. Members participating in any CFA Institute program should do so with the same level of integrity and confidentiality as is required of participation in the CFA Program.

Expressing an Opinion

Standard VII(A) does *not* cover expressing opinions regarding CFA Institute, the CFA Program, or other CFA Institute programs. Members and candidates are free to disagree and express their disagreement with CFA Institute on its policies, its procedures, or any advocacy positions taken by the organization. When expressing a personal opinion, a candidate is prohibited from disclosing content-specific information, including any actual exam question and the information as to subject matter covered or not covered in the exam.

Exhibit 2 Sample of CFA Program Testing Policies

Candidate Pledge

As a candidate in the CFA Program, I am obligated to follow Standard VII(A) of the CFA Institute Standards of Professional Conduct, which states that members and candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA exam.

- Prior to this exam, I have not given or received information regarding the content of this exam. During this exam, I will not give or receive any information regarding the content of this exam.
- After this exam, I will not disclose **ANY** portion of this exam and I will not remove **ANY** exam materials from the testing room in original or copied form. I understand that all exam materials, including my answers, are the property of CFA Institute and will not be returned to me in any form.
- I will follow **ALL** rules of the CFA Program as stated on the CFA Institute website and the back cover of the exam book. My violation of any rules of the CFA Program will result in CFA Institute voiding my exam results and may lead to suspension or termination of my candidacy in the CFA Program.

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Application of the Standard

Example 1 (Sharing Exam Questions):

Travis Nero serves as a proctor for the administration of the CFA examination in his city. In the course of his service, he reviews a copy of the Level II exam on the evening prior to the exam's administration and provides information concerning the exam questions to two candidates who use it to prepare for the exam.

> *Comment*: Nero and the two candidates have violated Standard VII(A). By giving information about the exam questions to two candidates, Nero provided an unfair advantage to the two candidates and undermined the integrity and validity of the Level II exam as an accurate measure of the knowledge, skills, and abilities necessary to earn the right to use the CFA designation. By accepting the information, the candidates also compromised the integrity and validity of the Level II exam and undermined the ethical framework that is a key part of the designation.

Example 2 (Bringing Written Material into Exam Room):

Loren Sullivan is enrolled to take the Level II CFA examination. He has been having difficulty remembering a particular formula, so prior to entering the exam room, he writes the formula on the palm of his hand. During the afternoon section of the exam, a proctor notices Sullivan looking at the palm of his hand. She asks to see his hand and finds the formula.

> *Comment*: Because Sullivan wrote down information from the Candidate Body of Knowledge (CBOK) and took that written information into the exam room, his conduct compromised the validity of his exam performance and violated Standard VII(A). Sullivan's conduct was also in direct contradiction with the rules and regulations of the CFA Program, the Candidate Pledge, and the CFA Institute Code and Standards.

Example 3 (Writing after Exam Period End):

At the conclusion of the morning section of the Level I CFA examination, the proctors announce, "Stop writing now." John Davis has not completed the exam, so he continues to randomly fill in ovals on his answer sheet. A proctor approaches Davis's desk and reminds him that he should stop writing immediately. Davis, however, continues to complete the answer sheet. After the proctor asks him to stop writing two additional times, Davis finally puts down his pencil.

> *Comment*: By continuing to complete his exam after time was called, Davis has violated Standard VII(A). By continuing to write, Davis took an unfair advantage over other candidates, and his conduct compromised the validity of his exam performance. Additionally, by not heeding the proctor's repeated instructions, Davis violated the rules and regulations of the CFA Program.

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Example 4 (Sharing Exam Content):

After completing Level II of the CFA exam, Annabelle Rossi posts on her blog about her experience. She posts the following: "Level II is complete! I think I did fairly well on the exam. It was really difficult, but fair. I think I did especially well on the derivatives questions. And there were tons of them! I think I counted 18! The ethics questions were really hard. I'm glad I spent so much time on the Code and Standards. I was surprised to see there were no questions at all about IPO allocations. I expected there to be a couple. Well, off to celebrate getting through it. See you tonight?"

Comment: Rossi did not violate Standard VII(A) when she wrote about how difficult she found the exam or how well she thinks she may have done. By revealing portions of the CBOK covered on the exam and areas not covered, however, she did violate Standard VII(A) and the Candidate Pledge. Depending on the time frame in which the comments were posted, Rossi not only may have assisted future candidates but also may have provided an unfair advantage to candidates yet to sit for the same exam, thereby undermining the integrity and validity of the Level II exam.

Example 5 (Sharing Exam Content):

Level I candidate Etienne Gagne has been a frequent visitor to an internet forum designed specifically for CFA Program candidates. The week after completing the Level I examination, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.

Comment: Gagne has violated Standard VII(A) by providing and soliciting confidential exam information, which compromises the integrity of the exam process and violates the Candidate Pledge. In trying to determine correct answers to specific questions, the group's discussion included question-specific details considered to be confidential to the CFA Program.

Example 6 (Sharing Exam Content):

CFA4Sure is a company that produces test-preparation materials for CFA Program candidates. Many candidates register for and use the company's products. The day after the CFA examination, CFA4Sure sends an e-mail to all its customers asking them to share with the company the hardest questions from the exam so that CFA4Sure can better prepare its customers for the next exam administration. Marisol Pena e-mails a summary of the questions she found most difficult on the exam.

Comment: Pena has violated Standard VII(A) by disclosing a portion of the exam questions. The information provided is considered confidential until publicly released by CFA Institute. CFA4Sure is likely to use such feedback to refine its review materials for future candidates. Pena's sharing of the specific questions undermines the integrity of the exam while potentially making the exam easier for future candidates.

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If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also have violated Standard VII(A).

Example 7 (Discussion of Exam Grading Guidelines and Results):

Prior to participating in grading CFA examinations, Wesley Whitcomb is required to sign a CFA Institute Grader Agreement. As part of the Grader Agreement, Whitcomb agrees not to reveal or discuss the exam materials with anyone except CFA Institute staff or other graders. Several weeks after the conclusion of the CFA exam grading, Whitcomb tells several colleagues who are candidates in the CFA Program which question he graded. He also discusses the guideline answer and adds that few candidates scored well on the question.

Comment: Whitcomb violated Standard VII(A) by breaking the Grader Agreement and disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

Example 8 (Compromising CFA Institute Integrity as a Volunteer):

Jose Ramirez is an investor-relations consultant for several small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute society in the city where he works. Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies.

Comment: Ramirez, by using his volunteer position at CFA Institute to benefit himself and his clients, compromises the reputation and integrity of CFA Institute and thus violates Standard VII(A).

Example 9 (Compromising CFA Institute Integrity as a Volunteer):

Marguerite Warrenski is a member of the CFA Institute GIPS Executive Committee, which oversees the creation, implementation, and revision of the GIPS standards. As a member of the Executive Committee, she has advance knowledge of confidential information regarding the GIPS standards, including any new or revised standards the committee is considering. She tells her clients that her Executive Committee membership will allow her to better assist her clients in keeping up with changes to the Standards and facilitating their compliance with the changes.

Comment: Warrenski is using her association with the GIPS Executive Committee to promote her firm's services to clients and potential clients. In defining her volunteer position at CFA Institute as a strategic business advantage over competing firms and implying to clients that she would use confidential information to further their interests, Warrenski is compromising the reputation and integrity of CFA Institute and thus violating Standard VII(A). She may factually state her involvement with the Executive Committee but cannot infer any special advantage to her clients from such participation.

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Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

Guidance

Highlights:

- *CFA Institute Membership*
- *Using the CFA Designation*
- *Referring to Candidacy in the CFA Program*
- *Proper Usage of the CFA Marks*

Standard VII(B) is intended to prevent promotional efforts that make promises or guarantees that are tied to the CFA designation. Individuals may refer to their CFA designation, CFA Institute membership, or candidacy in the CFA Program but must not exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

Standard VII(B) is not intended to prohibit factual statements related to the positive benefit of earning the CFA designation. However, statements referring to CFA Institute, the CFA designation, or the CFA Program that overstate the competency of an individual or imply, either directly or indirectly, that superior performance can be expected from someone with the CFA designation are not allowed under the standard.

Statements that highlight or emphasize the commitment of CFA Institute members, CFA charterholders, and CFA candidates to ethical and professional conduct or mention the thoroughness and rigor of the CFA Program are appropriate. Members and candidates may make claims about the relative merits of CFA Institute, the CFA Program, or the Code and Standards as long as those statements are implicitly or explicitly stated as the opinion of the speaker. Statements that do not express opinions have to be supported by facts.

Standard VII(B) applies to any form of communication, including but not limited to communications made in electronic or written form (such as on firm letterhead, business cards, professional biographies, directory listings, printed advertising, firm brochures, or personal resumes) and oral statements made to the public, clients, or prospects.

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CFA Institute Membership

The term "CFA Institute member" refers to "regular" and "affiliate" members of CFA Institute who have met the membership requirements as defined in the CFA Institute Bylaws. Once accepted as a CFA Institute member, the member must satisfy the following requirements to maintain his or her status:

- remit annually to CFA Institute a completed Professional Conduct Statement, which renews the commitment to abide by the requirements of the Code and Standards and the CFA Institute Professional Conduct Program, and
- pay applicable CFA Institute membership dues on an annual basis.

If a CFA Institute member fails to meet any of these requirements, the individual is no longer considered an active member. Until membership is reactivated, individuals must not present themselves to others as active members. They may state, however, that they were CFA Institute members in the past or refer to the years when their membership was active.

Using the CFA Designation

Those who have earned the right to use the Chartered Financial Analyst designation may use the trademarks or registered marks "Chartered Financial Analyst" or "CFA" and are encouraged to do so but only in a manner that does not misrepresent or exaggerate the meaning or implications of the designation. The use of the designation may be accompanied by an accurate explanation of the requirements that have been met to earn the right to use the designation.

"CFA charterholders" are those individuals who have earned the right to use the CFA designation granted by CFA Institute. These people have satisfied certain requirements, including completion of the CFA Program and required years of acceptable work experience. Once granted the right to use the designation, individuals must also satisfy the CFA Institute membership requirements (see above) to maintain their right to use the designation.

If a CFA charterholder fails to meet any of the membership requirements, he or she forfeits the right to use the CFA designation. Until membership is reactivated, individuals must not present themselves to others as CFA charterholders. They may state, however, that they were charterholders in the past.

Given the growing popularity of social media, where individuals may anonymously express their opinions, pseudonyms or online profile names created to hide a member's identity should not be tagged with the CFA designation.

Referring to Candidacy in the CFA Program

Candidates in the CFA Program may refer to their participation in the CFA Program, but such references must clearly state that an individual is a *candidate* in the CFA Program and must not imply that the candidate has achieved any type of partial designation. A person is a candidate in the CFA Program if

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- the person's application for registration in the CFA Program has been accepted by CFA Institute, as evidenced by issuance of a notice of acceptance, and the person is enrolled to sit for a specified examination or
- the registered person has sat for a specified examination but exam results have not yet been received.

If an individual is registered for the CFA Program but declines to sit for an exam or otherwise does not meet the definition of a candidate as described in the CFA Institute Bylaws, then that individual is no longer considered an active candidate. Once the person is enrolled to sit for a future examination, his or her CFA candidacy resumes.

CFA candidates must never state or imply that they have a partial designation as a result of passing one or more levels or cite an expected completion date of any level of the CFA Program. Final award of the charter is subject to meeting the CFA Program requirements and approval by the CFA Institute Board of Governors.

If a candidate passes each level of the exam in consecutive years and wants to state that he or she did so, that is not a violation of Standard VII(B) because it is a statement of fact. If the candidate then goes on to claim or imply superior ability by obtaining the designation in only three years, however, he or she is in violation of Standard VII(B).

Exhibit 3 provides examples of proper and improper references to the CFA designation.

Exhibit 3 Proper and Improper References to the CFA Designation

Proper References	Improper References
"Completion of the CFA Program has enhanced my portfolio management skills."	"CFA charterholders achieve better performance results."
"John Smith passed all three CFA examinations in three consecutive years."	"John Smith is among the elite, having passed all three CFA examinations in three consecutive attempts."
"The CFA designation is globally recognized and attests to a charterholder's success in a rigorous and comprehensive study program in the field of investment management and research analysis."	"As a CFA charterholder, I am the most qualified to manage client investments."
"The credibility that the CFA designation affords and the skills the CFA Program cultivates are key assets for my future career development."	"As a CFA charterholder, Jane White provides the best value in trade execution."

(continued)

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Exhibit 3 Proper and Improper References to the CFA Designation (continued)

Proper References	Improper References
"I enrolled in the CFA Program to obtain the highest set of credentials in the global investment management industry."	"Enrolling as a candidate in the CFA Program ensures one of becoming better at valuing debt securities."
"I passed Level I of the CFA exam."	"CFA, Level II"
"I am a 2010 Level III candidate in the CFA Program."	"CFA, Expected 2011" "Level III CFA Candidate"
"I passed all three levels of the CFA Program and will be eligible for the CFA charter upon completion of the required work experience."	"CFA, Expected 2011" "John Smith, Charter Pending"
"As a CFA charterholder, I am committed to the highest ethical standards."	

Proper Usage of the CFA Marks

Upon obtaining the CFA charter from CFA Institute, charterholders are given the right to use the CFA marks, including Chartered Financial Analyst®, CFA®, and the CFA logo (a certification mark):

These marks are registered by CFA Institute in countries around the world.

The Chartered Financial Analyst and CFA marks must always be used either after a charterholder's name or as adjectives (never as nouns) in written documents or oral conversations. For example, to refer to oneself as "a CFA" or "a Chartered Financial Analyst" is improper.

Members and candidates must not use a pseudonym or fictitious phrase meant to hide their identity in conjunction with the CFA designation. CFA Institute can verify only that a specific individual has earned the designation according to the name that is maintained in the membership database.

The CFA logo certification mark is used by charterholders as a distinctive visual symbol of the CFA designation that can be easily recognized by employers, colleagues, and clients. As a certification mark, it must be used only to directly refer to an individual charterholder or group of charterholders.

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Exhibit 4 provides examples of correct and incorrect use of the marks. CFA charterholders should refer to the complete guidelines published by CFA Institute for additional and up-to-date information and examples illustrating proper and improper use of the CFA logo, Chartered Financial Analyst mark, and CFA mark. These guidelines and the CFA logo are available on the CFA Institute website (www.cfainstitute.org).

Exhibit 4 Correct and Incorrect Use of the Chartered Financial Analyst and CFA Marks

Correct	Incorrect	Principle
He is one of two CFA charterholders in the company.	He is one of two CFAs in the company.	The CFA and Chartered Financial Analyst designations must always be used as adjectives, never as nouns or common names.
He earned the right to use the Chartered Financial Analyst designation.	He is a Chartered Financial Analyst.	
Jane Smith, CFA	Jane Smith, C.F.A. John Doe, cfa	No periods. Always capitalize the letters "CFA".
John Jones, CFA	John, a CFA-type portfolio manager. The focus is on Chartered Financial Analysis. CFA-equivalent program. Swiss-CFA.	Do not alter the designation to create new words or phrases.
John Jones, Chartered Financial Analyst	Jones Chartered Financial Analysts, Inc.	The designation must not be used as part of the name of a firm.
Jane Smith, CFA John Doe, Chartered Financial Analyst	Jane Smith, **CFA** John Doe, **Chartered Financial Analyst**	The CFA designation should not be given more prominence (e.g., larger or bold font) than the charterholder's name.
Level I candidate in the CFA Program.	Chartered Financial Analyst (CFA), September 2011.	Candidates in the CFA Program must not cite the expected date of exam completion and award of charter.

(continued)

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Exhibit 4 Correct and Incorrect Use of the Chartered Financial Analyst and CFA Marks (continued)

Correct	Incorrect	Principle
Passed Level I of the CFA examination in 2010.	CFA Level I. CFA degree expected in 2011.	No designation exists for someone who has passed Level I, Level II, or Level III of the exam. The CFA designation should not be referred to as a degree.
I have passed all three levels of the CFA Program and may be eligible for the CFA charter upon completion of the required work experience.	CFA (Passed Finalist) CFA Charter Pending Pending CFA Charterholder	A candidate who has passed Level III but has not yet received his or her charter cannot use the CFA or Chartered Financial Analyst designation.
CFA Charter, 2009, CFA Institute (optional: Charlottesville, Virginia, USA)	CFA Charter, 2009, CFA Society of the UK	In citing the designation in a resume, a charterholder should use the date that he or she received the designation and should cite CFA Institute as the conferring body.
John Smith, CFA	Crazy Bear CFA (Online social media user name)	Charterholders should not attach the CFA designation to anonymous or fictitious names meant to conceal their identity.

Recommended Procedures for Compliance

Misuse of a member's CFA designation or CFA candidacy or improper reference to it is common by those in a member's or candidate's firm who do not possess knowledge of the requirements of Standard VII(B). As an appropriate step to reduce this risk, members and candidates should disseminate written information about Standard VII(B) and the accompanying guidance to their firm's legal, compliance, public relations, and marketing departments (see www.cfainstitute.org).

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For materials that refer to employees' affiliation with CFA Institute, members and candidates should encourage their firms to create templates that are approved by a central authority (such as the compliance department) as being consistent with Standard VII(B). This practice promotes consistency and accuracy in the firm of references to CFA Institute membership, the CFA designation, and CFA candidacy.

Application of the Standard

Example 1 (Passing Exams in Consecutive Years):

An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.

> *Comment*: AZ may state that all principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try may be more successful than those who do not violates Standard VII(B).

Example 2 (Right to Use CFA Designation):

Five years after receiving his CFA charter, Louis Vasseur resigns his position as an investment analyst and spends the next two years traveling abroad. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. At the conclusion of his travels, Vasseur becomes a self-employed analyst accepting assignments as an independent contractor. Without reinstating his CFA Institute membership by filing his Professional Conduct Statement and paying his dues, he prints business cards that display "CFA" after his name.

> *Comment*: Vasseur has violated Standard VII(B) because his right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues. Therefore, he no longer is able to state or imply that he is an active CFA charterholder. When Vasseur files his Professional Conduct Statement, resumes paying CFA Institute dues to activate his membership, and completes the CFA Institute reinstatement procedures, he will be eligible to use the CFA designation.

Example 3 ("Retired" CFA Institute Membership Status):

After a 25-year career, James Simpson retires from his firm. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA

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Institute membership dues. Simpson designs a plain business card (without a corporate logo) to hand out to friends with his new contact details, and he continues to put "CFA" after his name.

Comment: Simpson has violated Standard VII(B). Because he failed to file his Professional Conduct Statement and ceased paying dues, his membership has been suspended and he has given up the right to use the CFA designation. CFA Institute has procedures, however, for reclassifying a member and charterholder as "retired" and reducing the annual dues. If he wants to obtain retired status, he needs to file the appropriate paperwork with CFA Institute. When Simpson receives his notification from CFA Institute that his membership has been reclassified as retired and he resumes paying reduced dues, his membership will be reactivated and his right to use the CFA designation will be reinstated.

Example 4 (CFA Logo—Individual Use Only):

Asia Futures Ltd. is a small quantitative investment advisory firm. The firm takes great pride in the fact that all its employees are CFA charterholders. To underscore this fact, the firm's senior partner is proposing to change the firm's letterhead to include the following:

Asia Futures Ltd. 

Comment: The CFA logo is a certification mark intended to identify *individual* charterholders and must not be incorporated in a company name, confused with a company logo, or placed in such close proximity to a company name or logo as to give the reader the idea that the certification mark certifies the company. The only appropriate use of the CFA logo is on the business card or letterhead of each individual CFA charterholder.

Example 5 (Stating Facts about CFA Designation and Program):

Rhonda Reese has been a CFA charterholder since 2000. In a conversation with a friend who is considering enrolling in the CFA Program, she states that she has learned a great deal from the CFA Program and that many firms require their employees to be CFA charterholders. She would recommend the CFA Program to anyone pursuing a career in investment management.

Comment: Reese's comments comply with Standard VII(B). Her statements refer to facts: The CFA Program enhanced her knowledge, and many firms require the CFA designation for their investment professionals.

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Example 6 (Order of Professional and Academic Designations):

Tatiana Prittima has earned both her CFA designation and a PhD in finance. She would like to cite both her accomplishments on her business card but is unsure of the proper method for doing so.

Comment: The order of designations cited on such items as resumes and business cards is a matter of personal preference. Prittima is free to cite the CFA designation either before or after citing her PhD.

Example 7 (Use of Fictitious Name):

Barry Glass is the lead quantitative analyst at CityCenter Hedge Fund. Glass is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Glass reads several high-level mathematical publications and blogs to stay informed on current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Glass is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

Comment: "Expert CFA" has violated Standard VII(B) by using the CFA designation inappropriately. As with any research report, authorship of online comments must include the charterholder's full name along with any reference to the CFA designation.

See also Standard V(A), which Glass has violated for guidance on diligence and reasonable basis.

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Sample CFA Institute Standards of Practice Exam

Unless otherwise stated in the question, all individuals in the following questions are CFA Institute members or candidates in the CFA Program and, therefore, are subject to the CFA Institute Code of Ethics and Standards of Professional Conduct.

1. Smith, a research analyst with a brokerage firm, decides to change his recommendation for the common stock of Green Company, Inc., from a "buy" to a "sell." He mails this change in investment advice to all the firm's clients on Wednesday. The day after the mailing, a client calls with a buy order for 500 shares of Green Company. In this circumstance, Smith should:

   A. Accept the order.

   B. Advise the customer of the change in recommendation before accepting the order.

   C. Not accept the order because it is contrary to the firm's recommendation.

2. Which statement about a manager's use of client brokerage commissions violates the Code and Standards?

   A. A client may direct a manager to use that client's brokerage commissions to purchase goods and services for that client.

   B. Client brokerage commissions should be used to benefit the client and should be commensurate with the value of the brokerage and research services received.

   C. Client brokerage commissions may be directed to pay for the investment manager's operating expenses.

3. Jamison is a junior research analyst with Howard & Howard, a brokerage and investment banking firm. Howard & Howard's mergers and acquisitions department has represented the Britland Company in all of its acquisitions for the past 20 years. Two of Howard & Howard's senior officers are directors of various Britland subsidiaries. Jamison has been asked to write a research report on Britland. What is the best course of action for her to follow?

   A. Jamison may write the report but must refrain from expressing any opinions because of the special relationships between the two companies.

   B. Jamison should not write the report because the two Howard & Howard officers serve as directors for subsidiaries of Britland.

   C. Jamison may write the report if she discloses the special relationships with the company in the report.

4. Which of the following statements clearly *conflicts* with the recommended procedures for compliance presented in the CFA Institute *Standards of Practice Handbook*?

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A. Firms should disclose to clients the personal investing policies and procedures established for their employees.

B. Prior approval must be obtained for the personal investment transactions of all employees.

C. For confidentiality reasons, personal transactions and holdings should not be reported to employers unless mandated by regulatory organizations.

5. Bronson provides investment advice to the board of trustees of a private university endowment fund. The trustees have provided Bronson with the fund's financial information, including planned expenditures. Bronson receives a phone call on Friday afternoon from Murdock, a prominent alumnus, requesting that Bronson fax him comprehensive financial information about the fund. According to Murdock, he has a potential contributor but needs the information that day to close the deal and cannot contact any of the trustees. Based on the CFA Institute Standards, Bronson should:

A. Send Murdock the information because disclosure would benefit the client.

B. Not send Murdock the information to preserve confidentiality.

C. Send Murdock the information, provided Bronson promptly notifies the trustees.

6. Miller heads the research department of a large brokerage firm. The firm has many analysts, some of whom are subject to the Code and Standards. If Miller delegates some supervisory duties, which statement best describes her responsibilities under the Code and Standards?

A. Miller's supervisory responsibilities do not apply to those subordinates who are not subject to the Code and Standards.

B. Miller no longer has supervisory responsibility for those duties delegated to her subordinates.

C. Miller retains supervisory responsibility for all subordinates despite her delegation of some duties.

7. Willier is the research analyst responsible for following Company X. All the information he has accumulated and documented suggests that the outlook for the company's new products is poor, so the stock should be rated a weak "hold." During lunch, however, Willier overhears a financial analyst from another firm whom he respects offer opinions that conflict with Willier's forecasts and expectations. Upon returning to his office, Willier releases a strong "buy" recommendation to the public. Willier:

A. Violated the Standards by failing to distinguish between facts and opinions in his recommendation.

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B. Violated the Standards because he did not have a reasonable and adequate basis for his recommendation.

C. Was in full compliance with the Standards.

8. An investment management firm has been hired by ETV Corporation to work on an additional public offering for the company. The firm's brokerage unit now has a "sell" recommendation on ETV, but the head of the investment banking department has asked the head of the brokerage unit to change the recommendation from "sell" to "buy." According to the Standards, the head of the brokerage unit would be permitted to:

A. Increase the recommendation by no more than one increment (in this case, to a "hold" recommendation).

B. Place the company on a restricted list and give only factual information about the company.

C. Assign a new analyst to decide if the stock deserves a higher rating.

9. Albert and Tye, who recently started their own investment advisory business, have registered to take the Level III CFA examination. Albert's business card reads, "Judy Albert, CFA Level II." Tye has not put anything about the CFA designation on his business card, but promotional material that he designed for the business describes the CFA requirements and indicates that Tye participates in the CFA Program and has completed Levels I and II. According to the Standards:

A. Albert has violated the Standards, but Tye has not.

B. Tye has violated the Standards, but Albert has not.

C. Both Albert and Tye have violated the Standards.

10. Scott works for a regional brokerage firm. He estimates that Walkton Industries will increase its dividend by US$1.50 a share during the next year. He realizes that this increase is contingent on pending legislation that would, if enacted, give Walkton a substantial tax break. The US representative for Walkton's home district has told Scott that, although she is lobbying hard for the bill and prospects for its passage are favorable, concern of the US Congress over the federal deficit could cause the tax bill to be voted down. Walkton Industries has not made any statements about a change in dividend policy. Scott writes in his research report, "We expect Walkton's stock price to rise by at least US$8.00 a share by the end of the year because the dividend will increase by US$1.50 a share. Investors buying the stock at the current time should expect to realize a total return of at least 15% on the stock." According to the Standards:

A. Scott violated the Standards because he used material inside information.

B. Scott violated the Standards because he failed to separate opinion from fact.

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C. Scott violated the Standards by basing his research on uncertain predictions of future government action.

11. Which one of the following actions will help to ensure the fair treatment of brokerage firm clients when a new investment recommendation is made?

A. Informing all people in the firm in advance that a recommendation is to be disseminated.

B. Distributing recommendations to institutional clients prior to individual accounts.

C. Minimizing the time between the decision and the dissemination of a recommendation.

12. The mosaic theory holds that an analyst:

A. Violates the Code and Standards if the analyst fails to have knowledge of and comply with applicable laws.

B. Can use material public information and nonmaterial nonpublic information in the analyst's analysis.

C. Should use all available and relevant information in support of an investment recommendation.

13. Jurgen is a portfolio manager. One of her firm's clients has told Jurgen that he will compensate her beyond the compensation provided by her firm on the basis of the capital appreciation of his portfolio each year. Jurgen should:

A. Turn down the additional compensation because it will result in conflicts with the interests of other clients' accounts.

B. Turn down the additional compensation because it will create undue pressure on her to achieve strong short-term performance.

C. Obtain permission from her employer prior to accepting the compensation arrangement.

14. One of the discretionary accounts managed by Farnsworth is the Jones Corporation employee profit-sharing plan. Jones, the company president, recently asked Farnsworth to vote the shares in the profit-sharing plan in favor of the slate of directors nominated by Jones Corporation and against the directors sponsored by a dissident stockholder group. Farnsworth does not want to lose this account because he directs all the account's trades to a brokerage firm that provides Farnsworth with useful information about tax-free investments. Although this information is not of value in managing the Jones Corporation account, it does help in managing several other accounts. The brokerage firm providing this information also offers the lowest commissions for trades and provides best execution. Farnsworth investigates the director issue, concludes

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that the management-nominated slate is better for the long-run performance of the company than the dissident group's slate, and votes accordingly. Farnsworth:

A. Violated the Standards in voting the shares in the manner requested by Jones but not in directing trades to the brokerage firm.

B. Did not violate the Standards in voting the shares in the manner requested by Jones or in directing trades to the brokerage firm.

C. Violated the Standards in directing trades to the brokerage firm but not in voting the shares as requested by Jones.

15. Brown works for an investment counseling firm. Green, a new client of the firm, is meeting with Brown for the first time. Green used another counseling firm for financial advice for years, but she has switched her account to Brown's firm. After spending a few minutes getting acquainted, Brown explains to Green that she has discovered a highly undervalued stock that offers large potential gains. She recommends that Green purchase the stock. Brown has committed a violation of the Standards. What should she have done differently?

A. Brown should have determined Green's needs, objectives, and tolerance for risk before making a recommendation of any type of security.

B. Brown should have thoroughly explained the characteristics of the company to Green, including the characteristics of the industry in which the company operates.

C. Brown should have explained her qualifications, including her education, training, and experience and the meaning of the CFA designation.

16. Grey recommends the purchase of a mutual fund that invests solely in long-term US Treasury bonds. He makes the following statements to his clients:

I. "The payment of the bonds is guaranteed by the US government; therefore, the default risk of the bonds is virtually zero."

II. "If you invest in the mutual fund, you will earn a 10% rate of return each year for the next several years based on historical performance of the market."

Did Grey's statements violate the CFA Institute Code and Standards?

A. Neither statement violated the Code and Standards.

B. Only statement I violated the Code and Standards.

C. Only statement II violated the Code and Standards.

17. Anderb, a portfolio manager for XYZ Investment Management Company—a registered investment organization that advises investment firms and private accounts—was promoted to that position three years ago. Bates, her supervisor, is responsible for reviewing Anderb's portfolio account transactions and her

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required monthly reports of personal stock transactions. Anderb has been using Jonelli, a broker, almost exclusively for brokerage transactions for the portfolio account. For securities in which Jonelli's firm makes a market, Jonelli has been giving Anderb lower prices for personal purchases and higher prices for personal sales than Jonelli gives to Anderb's portfolio accounts and other investors. Anderb has been filing monthly reports with Bates only for those months in which she has no personal transactions, which is about every fourth month. Which of the following is *most likely* to be a violation of the Code and Standards?

A. Anderb failed to disclose to her employer her personal transactions.

B. Anderb owned the same securities as those of her clients.

C. Bates allowed Anderb to use Jonelli as her broker for personal trades.

18. Which of the following is a correct statement of a member's or candidate's duty under the Code and Standards?

A. In the absence of specific applicable law or other regulatory requirements, the Code and Standards govern the member's or candidate's actions.

B. A member or candidate is required to comply only with applicable local laws, rules, regulations, or customs, even though the Code and Standards may impose a higher degree of responsibility or a higher duty on the member or candidate.

C. A member or candidate who trades securities in a securities market where no applicable local laws or stock exchange rules regulate the use of material nonpublic information may take investment action based on material nonpublic information.

19. Ward is scheduled to visit the corporate headquarters of Evans Industries. Ward expects to use the information he obtains there to complete his research report on Evans stock. Ward learns that Evans plans to pay all of Ward's expenses for the trip, including costs of meals, hotel room, and air transportation. Which of the following actions would be the *best* course for Ward to take under the Code and Standards?

A. Accept the expense-paid trip and write an objective report.

B. Pay for all travel expenses, including costs of meals and incidental items.

C. Accept the expense-paid trip but disclose the value of the services accepted in the report.

20. Which of the following statements is *correct* under the Code and Standards?

A. CFA Institute members and candidates are prohibited from undertaking independent practice in competition with their employer.

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B. Written consent from the employer is necessary to permit independent practice that could result in compensation or other benefits in competition with a member's or candidate's employer.

C. Members and candidates are prohibited from making arrangements or preparations to go into a competitive business before terminating their relationship with their employer.

21. Smith is a financial analyst with XYZ Brokerage Firm. She is preparing a purchase recommendation on JNI Corporation. Which of the following situations is *most likely* to represent a conflict of interest for Smith that would have to be disclosed?

A. Smith frequently purchases items produced by JNI.

B. XYZ holds for its own account a substantial common stock position in JNI.

C. Smith's brother-in-law is a supplier to JNI.

22. Michelieu tells a prospective client, "I may not have a long-term track record yet, but I'm sure that you'll be very pleased with my recommendations and service. In the three years that I've been in the business, my equity-oriented clients have averaged a total return of more than 26% a year." The statement is true, but Michelieu only has a few clients, and one of his clients took a large position in a penny stock (against Michelieu's advice) and realized a huge gain. This large return caused the average of all of Michelieu's clients to exceed 26% a year. Without this one investment, the average gain would have been 8% a year. Has Michelieu violated the Standards?

A. No, because Michelieu is not promising that he can earn a 26% return in the future.

B. No, because the statement is a true and accurate description of Michelieu's track record.

C. Yes, because the statement misrepresents Michelieu's track record.

23. An investment banking department of a brokerage firm often receives material nonpublic information that could have considerable value if used in advising the firm's brokerage clients. In order to conform to the Code and Standards, which one of the following is the best policy for the brokerage firm?

A. Permanently prohibit both "buy" and "sell" recommendations of the stocks of clients of the investment banking department.

B. Establish physical and informational barriers within the firm to prevent the exchange of information between the investment banking and brokerage operations.

C. Monitor the exchange of information between the investment banking department and the brokerage operation.

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24. Stewart has been hired by Goodner Industries, Inc., to manage its pension fund. Stewart's duty of loyalty, prudence, and care is owed to:

    A. The management of Goodner.

    B. The participants and beneficiaries of Goodner's pension plan.

    C. The shareholders of Goodner.

25. Which of the following statements is a stated purpose of disclosure in Standard VI(C)–Referral Fees?

    A. Disclosure will allow the client to request discounted service fees.

    B. Disclosure will help the client evaluate any possible partiality shown in the recommendation of services.

    C. Disclosure means advising a prospective client about the referral arrangement once a formal client relationship has been established.

26. Rose, a portfolio manager for a local investment advisory firm, is planning to sell a portion of his personal investment portfolio to cover the costs of his child's academic tuition. Rose wants to sell a portion of his holdings in Household Products, but his firm recently upgraded the stock to "strong buy." Which of the following describes Rose's options under the Code and Standards?

    A. Based on his firm's "buy" recommendation, Rose cannot sell the shares because he would be improperly prospering from the inflated recommendation.

    B. Rose is free to sell his personal holdings once his firm is properly informed of his intentions.

    C. Rose can sell his personal holdings but only when a client of the firm places an order to buy shares of Household.

27. A former hedge fund manager, Jackman, has decided to launch a new private wealth management firm. From his prior experiences, he believes the new firm needs to achieve US$1 million in assets under management in the first year. Jackman offers a $10,000 incentive to any adviser who joins his firm with the minimum of $200,000 in committed investments. Jackman places notice of the opening on several industry web portals and career search sites. Which of the following is *correct* according to the Code and Standards?

    A. A member or candidate is eligible for the new position and incentive if he or she can arrange for enough current clients to switch to the new firm and if the member or candidate discloses the incentive fee.

    B. A member or candidate may not accept employment with the new firm because Jackman's incentive offer violates the Code and Standards.

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C. A member or candidate is not eligible for the new position unless he or she is currently unemployed because soliciting the clients of the member's or candidate's current employer is prohibited.

28. Carter works for Invest Today, a local asset management firm. A broker that provides Carter with proprietary research through client brokerage arrangements is offering a new trading service. The broker is offering low-fee, execution-only trades to complement its traditional full-service, execution-and-research trades. To entice Carter and other asset managers to send additional business its way, the broker will apply the commissions paid on the new service toward satisfying the brokerage commitment of the prior full-service arrangements. Carter has always been satisfied with the execution provided on the full-service trades, and the new low-fee trades are comparable to the fees of other brokers currently used for the accounts that prohibit soft dollar arrangements.

A. Carter can trade for his accounts that prohibit soft dollar arrangements under the new low-fee trading scheme.

B. Carter cannot use the new trading scheme because the commissions are prohibited by the soft dollar restrictions of the accounts.

C. Carter should trade only through the new low-fee scheme and should increase his trading volume to meet his required commission commitment.

29. Rule has worked as a portfolio manager for a large investment management firm for the past 10 years. Rule earned his CFA charter last year and has decided to open his own investment management firm. After leaving his current employer, Rule creates some marketing material for his new firm. He states in the material, "In earning the CFA charter, a highly regarded credential in the investment management industry, I further enhanced the portfolio management skills learned during my professional career. While completing the examination process in three consecutive years, I consistently received the highest possible scores on the topics of Ethics, Alternative Investments, and Portfolio Management." Has Rule violated Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program in his marketing material?

A. Rule violated Standard VII(B) in stating that he completed the exams in three consecutive years.

B. Rule violated Standard VII(B) in stating that he received the highest scores in the topics of Ethics, Alternative Investments, and Portfolio Management.

C. Rule did not violate Standard VII(B).

30. Stafford is a portfolio manager for a specialized real estate mutual fund. Her firm clearly describes in the fund's prospectus its soft dollar policies. Stafford decides that entering the CFA Program will enhance her investment decision-making skill and decides to use the fund's soft dollar account to pay

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the registration and exam fees for the CFA Program. Which of the following statements is *most likely* correct?

A. Stafford did not violate the Code and Standards because the prospectus informed investors of the fund's soft dollar policies.

B. Stafford violated the Code and Standards because improving her investment skills is not a reasonable use of the soft dollar account.

C. Stafford violated the Code and Standards because the CFA Program does not meet the definition of research allowed to be purchased with brokerage commissions.

31. Long has been asked to be the keynote speaker at an upcoming investment conference. The event is being hosted by one of the third-party investment managers currently used by his pension fund. The manager offers to cover all conference and travel costs for Long and make the conference registrations free for three additional members of his investment management team. To ensure that the conference obtains the best speakers, the host firm has arranged for an exclusive golf outing for the day following the conference on a local championship-caliber course. Which of the following is *least likely* to violate Standard I(B)?

A. Long may accept only the offer to have his conference-related expenses paid by the host firm.

B. Long may accept the offer to have his conference-related expenses paid and may attend the exclusive golf outing at the expense of the hosting firm.

C. Long may accept the entire package of incentives offered to speak at this conference.

32. Andrews, a private wealth manager, is conducting interviews for a new research analyst for his firm. One of the candidates is Wright, an analyst with a local investment bank. During the interview, while Wright is describing his analytical skills, he mentions a current merger in which his firm is acting as the adviser. Andrews has heard rumors of a possible merger between the two companies, but no releases have been made by the companies concerned. Which of the following actions by Andrews is *least likely* a violation of the Code and Standards?

A. Waiting until the next day before trading on the information to allow time for it to become public.

B. Notifying all investment managers in his firm of the new information so none of their clients are disadvantaged.

C. Placing the securities mentioned as part of the merger on the firm's restricted trading list.

33. Pietro, president of Local Bank, has hired the bank's market maker, Vogt, to seek a merger partner. Local is currently listed on a stock exchange and has

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not reported that it is seeking strategic alternatives. Vogt has discussed the possibility of a merger with several firms, but they have all decided to wait until after the next period's financial data are available. The potential buyers believe the results will be worse than the results of prior periods and will allow them to pay less for Local Bank.

Pietro wants to increase the likelihood of structuring a merger deal quickly. Which of the following actions would *most likely* be a violation of the Code and Standards?

A. Pietro could instruct Local Bank to issue a press release announcing that it has retained Vogt to find a merger partner.

B. Pietro could place a buy order for 2,000 shares (or four times the average weekly volume) through Vogt for his personal account.

C. After confirming with Local's chief financial officer, Pietro could instruct Local to issue a press release reaffirming the firm's prior announced earnings guidance for the full fiscal year.

34. ABC Investment Management acquires a new, very large account with two concentrated positions. The firm's current policy is to add new accounts for the purpose of performance calculation after the first full month of management. Cupp is responsible for calculating the firm's performance returns. Before the end of the initial month, Cupp notices that one of the significant holdings of the new accounts is acquired by another company, causing the value of the investment to double. Because of this holding, Cupp decides to account for the new portfolio as of the date of transfer, thereby allowing ABC Investment to reap the positive impact of that month's portfolio return.

A. Cupp did not violate the Code and Standards because the GIPS standards allow composites to be updated on the date of large external cash flows.

B. Cupp did not violate the Code and Standards because companies are allowed to determine when to incorporate new accounts into their composite calculation.

C. Cupp violated the Code and Standards because the inclusion of the new account produces an inaccurate calculation of the monthly results according to the firm's stated policies.

35. Cannan has been working from home on weekends and occasionally saves correspondence with clients and completed work on her home computer. Because of worsening market conditions, Cannan is one of several employees released by her firm. While Cannan is looking for a new job, she uses the files she saved at home to request letters of recommendation from former clients. She also provides to prospective clients some of the reports as examples of her abilities.

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A. Cannan violated the Code and Standards because she did not receive permission from her former employer to keep or use the files after her employment ended.

B. Cannan did not violate the Code and Standards because the files were created and saved on her own time and computer.

C. Cannan violated the Code and Standards because she is prohibited from saving files on her home computer.

36. Quinn sat for the Level III CFA exam this past weekend. He updates his resume with the following statement: "In finishing the CFA Program, I improved my skills related to researching investments and managing portfolios. I will be eligible for the CFA charter upon completion of the required work experience."

A. Quinn violated the Code and Standards by claiming he improved his skills through the CFA Program.

B. Quinn violated the Code and Standards by incorrectly stating that he is eligible for the CFA charter.

C. Quinn did not violate the Code and Standards with his resume update.

37. During a round of golf, Rodriguez, chief financial officer of Mega Retail, mentions to Hart, a local investment adviser and long-time personal friend, that Mega is having an exceptional sales quarter. Rodriguez expects the results to be almost 10% above the current estimates. The next day, Hart initiates the purchase of a large stake in the local exchange-traded retail fund for her personal account.

A. Hart violated the Code and Standards by investing in the exchange-traded fund that included Mega Retail.

B. Hart did not violate the Code and Standards because she did not invest directly in securities of Mega Retail.

C. Rodriguez did not violate the Code and Standards because the comments made to Hart were not intended to solicit an investment in Mega Retail.

38. Park is very frustrated after taking her Level II exam. While she was studying for the exam, to supplement the curriculum provided, she ordered and used study material from a third-party provider. Park believes the additional material focused her attention on specific topic areas that were not tested while ignoring other areas. She posts the following statement on the provider's discussion board: "I am very dissatisfied with your firm's CFA Program Level II material. I found the exam extremely difficult and myself unprepared for specific questions after using your product. How could your service provide such limited instructional resources on the analysis of inventories and taxes when the exam had multiple questions about them? I will not recommend your products to other candidates."

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A. Park violated the Code and Standards by purchasing third-party review material.

B. Park violated the Code and Standards by providing her opinion on the difficulty of the exam.

C. Park violated the Code and Standards by providing specific information on topics tested on the exam.

39. Paper was recently terminated as one of a team of five managers of an equity fund. The fund had two value-focused managers and terminated one of them to reduce costs. In a letter sent to prospective employers, Paper presents, with written permission of the firm, the performance history of the fund to demonstrate his past success.

A. Paper did not violate the Code and Standards.

B. Paper violated the Code and Standards by claiming the performance of the entire fund as his own.

C. Paper violated the Code and Standards by including the historical results of his prior employer.

40. Townsend was recently appointed to the board of directors of a youth golf program that is the local chapter of a national not-for-profit organization. The program is beginning a new fund-raising campaign to expand the number of annual scholarships it provides. Townsend believes many of her clients make annual donations to charity. The next week in her regular newsletter to all clients, she includes a small section discussing the fund-raising campaign and her position on the organization's board.

A. Townsend did not violate the Code and Standards.

B. Townsend violated the Code and Standards by soliciting donations from her clients through the newsletter.

C. Townsend violated the Code and Standards by not getting approval of the organization before soliciting her clients.

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Exam Answers and Analysis

1. The correct answer is B. This question involves Standard III(B)–Fair Dealing. Smith disseminated a change in the stock recommendation to his clients but then received a request contrary to that recommendation from a client who probably had not yet received the recommendation. Prior to executing the order, Smith should take additional steps to ensure that the customer has received the change of recommendation. Answer A is incorrect because the client placed the order prior to receiving the recommendation and, therefore, does not have the benefit of Smith's most recent recommendation. Answer C is also incorrect; simply because the client request is contrary to the firm's recommendation does not mean a member can override a direct request by a client. After Smith contacts the client to ensure that the client has received the changed recommendation, if the client still wants to place a buy order for the shares, Smith is obligated to comply with the client's directive.

2. The correct answer is C. This question involves Standard III(A)–Loyalty, Prudence, and Care and the specific topic of soft dollars or soft commissions. Answer C is the correct choice because client brokerage commissions may not be directed to pay for the investment manager's operating expenses. Answer B describes how members and candidates should determine how to use brokerage commissions—that is, if the use is in the best interests of clients and is commensurate with the value of the services provided. Answer A describes a practice that is commonly referred to as "directed brokerage." Because brokerage is an asset of the client and is used to benefit the client, not the manager, such practice does not violate a duty of loyalty to the client. Members and candidates are obligated in all situations to disclose to clients their practices in the use of client brokerage commissions.

3. The correct answer is C. This question involves Standard VI(A)–Disclosure of Conflicts. The question establishes a conflict of interest in which an analyst, Jamison, is asked to write a research report on a company that is a client of the analyst's employer. In addition, two directors of the company are senior officers of Jamison's employer. Both facts establish that there are conflicts of interest that must be disclosed by Jamison in her research report. Answer B is incorrect because an analyst is not prevented from writing a report simply because of the special relationship the analyst's employer has with the company as long as that relationship is disclosed. Answer A is incorrect because whether or not Jamison expresses any opinions in the report is irrelevant to her duty to disclose a conflict of interest. Not expressing opinions does not relieve the analyst of the responsibility to disclose the special relationships between the two companies.

4. The correct answer is C. This question asks about compliance procedures relating to personal investments of members and candidates. The statement in answer C clearly conflicts with the recommended procedures in the *Standards*

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of Practice Handbook. Employers should compare personal transactions of employees with those of clients on a regular basis regardless of the existence of a requirement by any regulatory organization. Such comparisons ensure that employees' personal trades do not conflict with their duty to their clients, and the comparisons can be conducted in a confidential manner. The statement in answer A does not conflict with the procedures in the *Handbook*. Disclosure of such policies will give full information to clients regarding potential conflicts of interest on the part of those entrusted to manage their money. Answer B is incorrect because firms are encouraged to establish policies whereby employees clear their personal holdings and transactions with their employers.

5. The correct answer is B. This question relates to Standard III(A)–Loyalty, Prudence, and Care and Standard III(E)–Preservation of Confidentiality. In this case, the member manages funds of a private endowment. Clients, who are, in this case, the trustees of the fund, must place some trust in members and candidates. Bronson cannot disclose confidential financial information to anyone without the permission of the fund, regardless of whether the disclosure may benefit the fund. Therefore, answer A is incorrect. Answer C is incorrect because Bronson must notify the fund and obtain the fund's permission before publicizing the information.

6. The correct answer is C. Under Standard IV(C)–Responsibilities of Supervisors, members and candidates may delegate supervisory duties to subordinates but such delegation does not relieve members or candidates of their supervisory responsibilities. As a result, answer B is incorrect. Moreover, whether or not Miller's subordinates are subject to the Code and Standards is irrelevant to her supervisory responsibilities. Therefore, answer A is incorrect.

7. The correct answer is B. This question relates to Standard V(A)–Diligence and Reasonable Basis. The opinion of another financial analyst is not an adequate basis for Willier's action in changing the recommendation. Answer C is thus incorrect. So is answer A because, although it is true that members and candidates must distinguish between facts and opinions in recommendations, the question does not illustrate a violation of that nature. If the opinion overheard by Willier had sparked him to conduct additional research and investigation that justified a change of opinion, then a changed recommendation would be appropriate.

8. The correct answer is B. This question relates to Standard I(B)–Independence and Objectivity. When asked to change a recommendation on a company stock to gain business for the firm, the head of the brokerage unit must refuse in order to maintain his independence and objectivity in making recommendations. He must not yield to pressure by the firm's investment banking department. To avoid the appearance of a conflict of interest, the firm should discontinue issuing recommendations about the company. Answer A is incorrect; changing the recommendation in any manner that is contrary to the analyst's opinion violates the duty to maintain independence and objectivity. Answer C is incorrect

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because merely assigning a new analyst to decide whether the stock deserves a higher rating will not address the conflict of interest.

9. The correct answer is A. Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program is the subject of this question. The reference on Albert's business card implies that there is a "CFA Level II" designation; Tye merely indicates in promotional material that he is participating in the CFA Program and has completed Levels I and II. Candidates may not imply that there is some sort of partial designation earned after passing a level of the CFA exam. Therefore, Albert has violated Standard VII(B). Candidates may communicate that they are participating in the CFA Program, however, and may state the levels that they have completed. Therefore, Tye has not violated Standard VII(B).

10. The correct answer is B. This question relates to Standard V(B)–Communication with Clients and Prospective Clients. Scott has issued a research report stating that he expects the price of Walkton Industries stock to rise by US$8 a share "because the dividend will increase" by US$1.50 per share. He has made this statement knowing that the dividend will increase only if Congress enacts certain legislation, an uncertain prospect. By stating that the dividend will increase, Scott failed to separate fact from opinion.

    The information regarding passage of legislation is not material nonpublic information because it is conjecture, and the question does not state whether the US representative gave Scott her opinion on the passage of the legislation in confidence. She could have been offering this opinion to anyone who asked. Therefore, statement A is incorrect. It may be acceptable to base a recommendation, in part, on an expectation of future events, even though they may be uncertain. Therefore, answer C is incorrect.

11. The correct answer is C. This question, which relates to Standard III(B)–Fair Dealing, tests the knowledge of the procedures that will assist members and candidates in treating clients fairly when making investment recommendations. The step listed in C will help ensure the fair treatment of clients. Answer A may have negative effects on the fair treatment of clients. The more people who know about a pending change, the greater the chance that someone will inform some clients before the information's release. The firm should establish policies that limit the number of people who are aware in advance that a recommendation is to be disseminated. Answer B, distributing recommendations to institutional clients before distributing them to individual accounts, discriminates among clients on the basis of size and class of assets and is a violation of Standard III(B).

12. The correct answer is B. This question deals with Standard II(A)–Material Nonpublic Information. The mosaic theory states that an analyst may use material public information and nonmaterial nonpublic information in creating a larger picture than shown by any individual piece of information and the conclusions the analyst reaches become material only after the pieces are

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assembled. Answers A and C are accurate statements relating to the Code and Standards but do not describe the mosaic theory.

13. The correct answer is C. This question involves Standard IV(B)–Additional Compensation Arrangements. The arrangement described in the question—whereby Jurgen would be compensated beyond the compensation provided by her firm, on the basis of an account's performance—is not a violation of the Standards as long as Jurgen discloses the arrangement in writing to her employer and obtains permission from her employer prior to entering into the arrangement. Answers A and B are incorrect; although the private compensation arrangement could conflict with the interests of other clients and lead to short-term performance pressures, members and candidates may enter into such agreements as long as they have disclosed the arrangements to their employer and obtained permission for the arrangement from their employer.

14. The correct answer is B. This question relates to Standard III(A)–Loyalty, Prudence, and Care—specifically, a member's or candidate's responsibility for voting proxies and the use of client brokerage. According to the facts stated in the question, Farnsworth did not violate Standard III(A). Although the company president asked Farnsworth to vote the shares of the Jones Corporation profit-sharing plan a certain way, Farnsworth investigated the issue and concluded, independently, the best way to vote. Therefore, even though his decision coincided with the wishes of the company president, Farnsworth is not in violation of his responsibility to be loyal and to provide care to his clients. In this case, the participants and the beneficiaries of the profit-sharing plan are the clients, not the company's management. Had Farnsworth not investigated the issue or had he yielded to the president's wishes and voted for a slate of directors that he had determined was not in the best interest of the company, Farnsworth would have violated his responsibilities to the beneficiaries of the plan. In addition, because the brokerage firm provides the lowest commissions and best execution for securities transactions, Farnsworth has met his obligations to the client in using this brokerage firm. It does not matter that the brokerage firm also provides research information that is not useful for the account generating the commission because Farnsworth is not paying extra money of the client's for that information.

15. The correct answer is A. In this question, Brown is providing investment recommendations before making inquiries about the client's financial situation, investment experience, or investment objectives. Brown is thus violating Standard III(C)–Suitability. Answers B and C provide examples of information members and candidates should discuss with their clients at the outset of the relationship, but these answers do not constitute a complete list of those factors. Answer A is the best answer.

16. The correct answer *is* C. This question involves Standard I(C)–Misrepresentation. Statement I is a factual statement that discloses to clients

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and prospects accurate information about the terms of the investment instrument. Statement II, which guarantees a specific rate of return for a mutual fund, is an opinion stated as a fact and, therefore, violates Standard I(C). If statement II were rephrased to include a qualifying statement, such as "in my opinion, investors may earn . . . ," it would not be in violation of the Standards.

17. The correct answer is A. This question involves three of the Standards. Anderb, the portfolio manager, has been obtaining more favorable prices for her personal securities transactions than she gets for her clients, which is a breach of Standard III(A)–Loyalty, Prudence, and Care. In addition, she violated Standard I(D)–Misconduct by failing to adhere to company policy and by hiding her personal transactions from her firm. Anderb's supervisor, Bates, violated Standard IV(C)–Responsibilities of Supervisors; although the company had requirements for reporting personal trading, Bates failed to adequately enforce those requirements. Answer B does not represent a violation because Standard VI(B)–Priority of Transactions requires that personal trading in a security be conducted after the trading in that security of clients and the employer. The Code and Standards do not prohibit owning such investments, although firms may establish policies that limit the investment opportunities of members and candidates. Answer C does not represent a violation because the Code and Standards do not contain a prohibition against employees using the same broker for their personal accounts that they use for their client accounts. This arrangement should be disclosed to the employer so that the employer may determine whether a conflict of interest exists.

18. The correct answer is A because this question relates to Standard I(A)–Knowledge of the Law—specifically, global application of the Code and Standards. Members and candidates who practice in multiple jurisdictions may be subject to various securities laws and regulations. If applicable law is more strict than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, members and candidates must adhere to the Code and Standards. Therefore, answer A is correct. Answer B is incorrect because members and candidates must adhere to the higher standard set by the Code and Standards if local applicable law is less strict. Answer C is incorrect because when no applicable law exists, members and candidates are required to adhere to the Code and Standards, and the Code and Standards prohibit the use of material nonpublic information.

19. The correct answer is B. The best course of action under Standard I(B)–Independence and Objectivity is to avoid a conflict of interest whenever possible. Therefore, for Ward to pay for all his expenses is the correct answer. Answer C details a course of action in which the conflict would be disclosed, but the solution is not as appropriate as avoiding the conflict of interest. Answer A would not be the best course because it would not remove the appearance of a conflict of interest; even though the report would not be affected by the reimbursement of expenses, it could appear to be.

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20. The correct answer is B. Under Standard IV(A)–Loyalty, members and candidates may undertake independent practice that may result in compensation or other benefit in competition with their employer as long as they obtain consent from their employer. Answer C is not consistent with the Standards because the Standards allow members and candidates to make arrangements or preparations to go into competitive business as long as those arrangements do not interfere with their duty to their current employer. Answer A is not consistent with the Standards because the Standards do not include a complete prohibition against undertaking independent practice.

21. The correct answer is B. This question involves Standard VI(A)–Disclosure of Conflicts—specifically, the holdings of an analyst's employer in company stock. Answers A and C do not describe conflicts of interest that Smith would have to disclose. Answer A describes the use of a firm's products, which would not be a required disclosure. In answer C, the relationship between the analyst and the company through a relative is so tangential that it does not create a conflict of interest necessitating disclosure.

22. The correct answer is C. This question relates to Standard I(C)–Misrepresentation. Although Michelieu's statement about the total return of his clients' accounts on average may be technically true, it is misleading because the majority of the gain resulted from one client's large position taken against Michelieu's advice. Therefore, this statement misrepresents the investment performance the member is responsible for. He has not taken steps to present a fair, accurate, and complete presentation of performance. Answer B is thus incorrect. Answer A is incorrect because although Michelieu is not guaranteeing future results, his words are still a misrepresentation of his performance history.

23. The correct answer is B. The best policy to prevent violation of Standard II(A)–Material Nonpublic Information is the establishment of firewalls in a firm to prevent exchange of insider information. The physical and informational barrier of a firewall between the investment banking department and the brokerage operation prevents the investment banking department from providing information to analysts on the brokerage side who may be writing recommendations on a company stock. Prohibiting recommendations of the stock of companies that are clients of the investment banking department is an alternative, but answer A states that this prohibition would be permanent, which is not the best answer. Once an offering is complete and the material nonpublic information obtained by the investment banking department becomes public, resuming publishing recommendations on the stock is not a violation of the Code and Standards because the information of the investment banking department no longer gives the brokerage operation an advantage in writing the report. Answer C is incorrect because no exchange of information should be occurring between the investment banking department and the brokerage operation, so monitoring of such exchanges is not an effective compliance procedure for preventing the use of material nonpublic information.

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24. The correct answer is B. Under Standard III(A)–Loyalty, Prudence, and Care, members and candidates who manage a company's pension fund owe these duties to the participants and beneficiaries of the pension plan, not the management of the company or the company's shareholders.

25. The correct answer is B. Answer B gives one of the two primary reasons listed in the *Handbook* for disclosing referral fees to clients under Standard VI(C)–Referral Fees. (The other is to allow clients and employers to evaluate the full cost of the services.) Answer A is incorrect because Standard VI(C) does not require members or candidates to discount their fees when they receive referral fees. Answer C is inconsistent with Standard VI(C) because disclosure of referral fees, to be effective, should be made to prospective clients before entering into a formal client relationship with them.

26. The correct answer is B. Standard VI(B)–Priority of Transactions does not limit transactions of company employees that differ from current recommendations as long as the sale does not disadvantage current clients. Thus, answer A is incorrect. Answer C is incorrect because the Standard does not require the matching of personal and client trades.

27. Answer C is correct. Standard IV(A)–Loyalty discusses activities permissible to members and candidates when they are leaving their current employer; soliciting clients is strictly prohibited. Thus, answer A is inconsistent with the Code and Standards even with the required disclosure. Answer B is incorrect because the offer does not directly violate the Code and Standards. There may be out-of-work members and candidates who can arrange the necessary commitments without violating the Code and Standards.

28. Answer A is correct. The question relates to Standard III(A)–Loyalty, Prudence, and Care. Carter believes the broker offers effective execution at a fee that is comparable with those of other brokers, so he is free to use the broker for all accounts. Answer B is incorrect because the accounts that prohibit soft dollar arrangements do not want to fund the purchase of research by Carter. The new trading scheme does not incur additional commissions from clients, so it would not go against the prohibitions. Answer C is incorrect because Carter should not incur unnecessary or excessive "churning" of the portfolios (excessive trading) for the purpose of meeting the brokerage commitments of soft dollar arrangements.

29. Answer B is correct according to Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program. CFA Program candidates do not receive their actual scores on the exam. Topic and subtopic results are grouped into three broad categories, and the exam is graded only as "pass" or "fail." Although a candidate may have achieved a topical score of "above 70%," she or he cannot factually state that she or he received the highest possible score because that information is not reported. Thus, answer C is incorrect. Answer A is incorrect as long as the member or candidate actually completed the exams

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consecutively. Standard VII(B) does not prohibit the communication of factual information about completing the CFA Program in three consecutive years.

30. Answer C is correct. According to Standard III(A)–Loyalty, Prudence, and Care, the CFA Program would be considered a personal or firm expense and should not be paid for with the fund's brokerage commissions. Soft dollar accounts should be used only to purchase research services that directly assist the investment manager in the investment decision-making process, not to assist the management of the firm or to further education. Thus, answer A is incorrect. Answer B is incorrect because the reasonableness of how the money is used is not an issue; the issue is that educational expense is not research.

31. Answer A is correct. Standard I(B)–Independence and Objectivity emphasizes the need for members and candidates to maintain their independence and objectivity. Best practices dictate that firms adopt a strict policy not to accept compensation for travel arrangements. At times, however, accepting paid travel would not compromise one's independence and objectivity. Answers B and C are incorrect because the added benefits—free conference admission for additional staff members and an exclusive golf retreat for the speaker—could be viewed as inducements related to the firm's working arrangements and not solely related to the speaking engagement. Should Long wish to bring other team members or participate in the golf outing, he or his firm should be responsible for the associated fees.

32. Answer C is correct. The guidance to Standard II(A)–Material Nonpublic Information recommends adding securities to the firm's restricted list when the firm has or may have material nonpublic information. By adding these securities to this list, Andrews would uphold this standard. Because waiting until the next day will not ensure that news of the merger is made public, answer A is incorrect. Negotiations may take much longer between the two companies, and the merger may never happen. Andrews must wait until the information is disseminated to the market before he trades on that information. Answer B is incorrect because Andrews should not disclose the information to other managers; no trading is allowed on material nonpublic information.

33. Answer B is correct. Through placing a personal purchase order that is significantly greater than the average volume, Pietro is violating Standard IIB–Market Manipulation. He is attempting to manipulate an increase in the share price and thus bring a buyer to the negotiating table. The news of a possible merger and confirmation of the firm's earnings guidance may also have positive effects on the price of Local Bank, but Pietro's actions in instructing the release of the information does not represent a violation through market manipulation. Announcements of this nature are common and practical to keep investors informed. Thus, answers A and C are incorrect.

34. Answer C is correct. Cupp violated Standard III(D)–Performance Presentations when he deviated from the firm's stated policies solely to

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capture the gain from the holding being acquired. Answer A is incorrect because the firm does not claim GIPS compliance and the GIPS standards require external cash flows to be treated in a consistent manner with the firm's documented policies. Answer B is incorrect because the firm does not state that it is updating its composite policies. If such a change were to occur, all cash flows for the month would have to be reviewed to ensure their consistent treatment under the new policy.

35. Answer A is correct. According to Standard V(C)–Record Retention, Cannan needed the permission of her employer to maintain the files at home after her employment ended. Without that permission, she should have deleted the files. All files created as part of a member's or candidate's professional activity are the property of the firm, even those created outside normal work hours. Thus, answer B is incorrect. Answer C is incorrect because the Code and Standards do not prohibit using one's personal computer to complete work for one's employer.

36. Answer B is correct. According to Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program, Quinn cannot claim to have finished the CFA Program or be eligible for the CFA charter until he officially learns that he has passed the Level III exam. Until the results for the most recent exam are released, those who sat for the exam should continue to refer to themselves as "candidates." Thus, answer C is incorrect. Answer A is incorrect because members and candidates may discuss areas of practice in which they believe the CFA Program improved their personal skills.

37. Answer A is correct. Hart's decision to invest in the retail fund appears directly correlated with Rodriguez's statement about the successful quarter of Mega Retail and thus violates Standard II(A)–Material Nonpublic Information. Rodriguez's information would be considered material because it would influence the share price of Mega Retail and probably influence the price of the entire exchange-traded retail fund. Thus, answer B is incorrect. Answer C is also incorrect because Rodriguez shared information that was both material and nonpublic. Company officers regularly have such knowledge about their firms, which is not a violation. The sharing of such information, however, even in a conversation between friends, does violate Standard II(A).

38. Answer C is correct. Standard VII(A)–Conduct as Members and Candidates in the CFA Program prohibits providing information to candidates or the public that is considered confidential to the CFA Program. In revealing that questions related to the analysis of inventories and analysis of taxes were on the exam, Park has violated this standard. Answer B is incorrect because the guidance for the standard explicitly acknowledges that members and candidates are allowed to offer their opinions about the CFA Program. Answer A is incorrect because candidates are not prohibited from using outside resources.

39. Answer B is correct. Paper has violated Standard III(D)–Performance Presentation by not disclosing that he was part of a team of managers that

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achieved the results shown. If he had also included the return of the portion he directly managed, he would not have violated the standard. Thus, answer A is incorrect. Answer C is incorrect because Paper received written permission from his prior employer to include the results.

40. Answer A is correct. Townsend has not provided any information about her clients to the leaders or managers of the golf program; thus, she has not violated Standard III(E)–Preservation of Confidentiality. Providing contact information about her clients for a direct-mail solicitation would have been a violation. Answer B is incorrect because the notice in the newsletter does not violate Standard III(E). Answer C is incorrect because the golf program's fund-raising campaign had already begun, so discussing the opportunity to donate was appropriate.

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GWG – What Brokerage Firms Should Have Known, and When Should They Have Known It.

Joseph R. Wojciechowski[1]

I. Introduction

The more the securities industry changes, the more it stays the same. History seems to repeat itself and investors are usually the ones left holding the bag. Securities issued by GWG Holdings to retail investors is history repeating itself. A poorly run, border-line defaulted company issued billions of dollars in securities through a network of broker-dealers who sell the securities to their clients. It should bring back memories to more experienced PIABA members and arbitration practitioners of Medical Capital, DBSI, or Provident Royalties. More recent examples of "product cases" include GPB Capital and various non-traded REITs, like UDF.

When these securities products "break", it can result in a feeding frenzy for attorneys in our practice. It is a welcome opportunity to represent investors in meritorious cases against hopefully collectable broker-dealers.

II. Background on GWG Holdings

GWG Holdings Inc. was originally a Minneapolis-based finance company whose business focused on buying life insurance policies from insureds seeking liquidity in exchange for their policies. GWG purportedly earned revenue on the spread between what they paid for the policies, the cost of maintaining those policies, and the death benefit received when the original insured died. It is a morbidity-based business model.

[1] This article is incorporated into the 2023 PIABA Annual Meeting materials to accompany the breakout session to be held on Thursday, October 26, 2023, at 11:10-12:10. which will be moderated by Mr. Wojciechowski, at which time Craig McCann, Joshua Kons, Esq., and Aaron Israels, Esq., will be presenting a detailed presentation explaining their experience in GWG cases. Included with the written materials, is a sample Statement of Claim and sample motion to compel which includes dozens of specific RFPs.

GWG Holdings first came to the market in June 2011 when it issued a Form S-1, registering $250 million in debentures. These were the first "L-Bonds" of sort. Those debentures came to market in January 2012 through a public offering. In November 2011, GWG issued its first private placement, seeking to raise $25 million through a Regulation D offering. GWG common stock began trading on September 8, 2014, under the symbol GWGH at an opening price of $11.75. At all times, GWGH common stock was very thinly traded, and did not revisit the original offering price until almost four years later. After briefly surpassing the original offering price, it crashed back to under $6 per share only a few months later. In 2019, the price shot up rapidly, peaking at $16.70 on May 13, 2019, only for the price to crater to near $6 per share six weeks later. The price chart for the GWG common stock is good demonstrative evidence of the type of company GWG was. GWGH was a borderline penny-stock company with very little real operating history and no established success.

The "L-Bonds" began with the January 2012 offering, originally being issued in 1-year terms. The "liquidity bonds" were issued for one purpose; to raise money from investors for GWG to use to buy life insurance policies. Though "public" offerings, GWG always represented the L-Bonds to brokers and investors alike as an "alternative" investment. There are several reasons for this. First, although the L-Bonds were debt of a publicly traded company, these debt-securities were not publicly traded themselves. They were completely illiquid, and no secondary market was ever established where they could trade. The bonds were unrated, thus never going through the crucible of fixed income market analysts.

GWG would stop offering the 1-year bonds and proceed to sell 2-year, 3-year, 5-year, and 7-year bonds. The interest rates on these bonds increased with maturity from 5.5%, 6.25%, 7.5%, to 8.5% annualized. GWG incentivized broker-dealers to sell longer-term maturity L-Bonds by

offering higher commissions. The bonds had an auto-renewal feature so that in the event an investor did not so state, their bond would renew upon maturity into a new bond of the same maturity. In every instance we have seen, anecdotally, the financial adviser was apprised of the coming maturity by GWG and in almost every instance, an affirmative recommendation was made to "roll" the bonds into new terms.

GWG issued its second L-Bond in January 2015, offering $1 billion to the market. Virtually all L-Bond purchases would be executed through the L-Bond selling group of broker/dealers. In February 2017, GWG issued $250 million in preferred stock, again sold mostly through its broker/dealer network headed-up by Emerson Equity. Shortly thereafter, GWG issued another public offering of $1 billion in L-Bonds on December 1, 2017. A month later, GWG began its "strategic relationship" with Benificient. Amidst extreme turmoil, on June 3, 2020, GWG issued another public offering for $2 billion in L-Bonds.

For less than 10 years, GWG managed not to default on its debt. Brokers and financial advisers recommended L-Bonds based at least in part on the "perfect payment history" narrative, but it is not like GWG had been around since 1850. In January 2022, GWG defaulted on the L-Bonds and filed for Chapter 11 bankruptcy in April 2022.

GWG began to fundamentally change as a company when it began its "strategic relationship" with Benificient in January 2018. By this point in GWG's short lifecycle, the writing was already on the wall that it could not continue to sell L-Bonds to fund buying life insurance policies and do so profitably. Beneficient offered an opportunity for GWG to unwind from the life insurance portfolio business and diversify into providing liquidity solutions for alternative investment investors. Thus, instead of being exclusively a company that provided liquidity to life

insurance insureds, GWG was going to diversify, through Beneficient, into providing liquidity to alternative investment owners.

As detailed in three Wall Street Journal articles, the Beneficient transaction was troubling. First, much like GWG, Beneficient had no proven long-term business model. It hadn't provided "liquidity solutions" to alternative investment investors. Furthermore, from a valuation perspective, Beneficient reported "goodwill" as comprising roughly 70% of its assets ($1.5 billion). There was certainly a lot of smoke with the Beneficient transaction, including that more than $17 million went to pay for Brad Heppner's private jets and ranch.

The L-Bonds were not secured by GWG's life insurance portfolio. Various GWG entities owned that portfolio, and whatever security there was, was limited to the equity of those other GWG entities. By 2019, the original owners and founders of GWG, the Sabes brothers, who had their own litigation history of some note, received their golden parachute because of the Beneficient transaction, cashing out for $25 million. A new board and new executive team were now in place to lead GWG and Beneficient. Unfortunately for the thousands of retail investors who entrusted over a billion dollars into GWG debt, the house of cards was already crumbling.

III. What Can Investors Expect from The Bankruptcy

When GWG went into Chapter 11 in April 2022, it was widely represented by broker-dealers responsible for soliciting L-Bonds to investors, not to worry because GWG listed assets in excess of its debt on the bankruptcy filings. Essentially, financial advisors committed an ongoing tort by representing to their clients that they would get their money back through the bankruptcy because GWG owned so many life insurance policies. None of that was true.

Over one year later, there is some clarity on what L-bond investors can expect to receive when the liquidation is completed. First, the L-Bonds have officially been cancelled in exchange

for shares in the "Wind-Down Trust." Second, the value of those shares is dependent almost exclusively on the Wind-Down Trust's ability to sell its massive stake in Beneficient. In June 2023, Ben, LP went public through a SPAC offering and listed on the NASDAQ. The company listed at $15 per share and since the moment it listed, has dropped precipitously on very low volume. The Wind-Down Trust owns roughly 142.8 million shares of Beneficient stock. So, doing some rudimentary math, given the amount owed, if the WDT can sell off its Beneficient shares for $10 a share, then L-Bond holders could be made whole. That is a pipe dream and here is why.

First, as of August 8, 2023, Beneficient's stock is down to $1.77 and drops almost daily on very low volume, roughly 300,000 shares a day. At that rate, it would take years of selling daily by the WDT just to get rid of the shares. Obviously, that level of selling would prove catastrophic to a share price that is already below $2 per share. Thus, it is highly unlikely that L-Bond investors can expect to receive any substantial recovery from the WDT selling Beneficient shares. Even if the WDT can sell out in a block transaction, even at $150 million for the shares, that will yield less than 10% to L-Bond investors. Through other means, the WDT may be able to recover another 5-10 cents on the dollar, through litigation, the liquidation of a small stake in FOXO (another penny stock spun out from GWG), and through the sale of the few remaining life insurance policies. In short, even with an optimistic forecast to sell Beneficient stock, L-Bond investors will likely receive 10-20 cents on the dollar over the next three to five years. In the event you represent a preferred shareholder, the preferred stock was essentially wiped out and preferred stock owners will not recover from the WFT.

With this backdrop in mind, many practitioners with GWG cases are facing familiar roadblocks and some new ones. Whether your case is filed in FINRA, or your client invested

through an RIA and you are in JAMS, AAA, or court, there are a few different ways to skin the GWG cat.

IV. Timing is everything with GWG

PIABA members understand how to bring a case. With GWG, so much comes down to two primary temporal questions: 1) When were the L-Bonds or preferred stock sold to your clients? 2) what duration of L-Bonds were sold?

The timing of events with GWG superficially reflects that, as time went on, matters became progressively worse. From a bulletin-board perspective, that is undeniable. The company that issued L-Bonds in 2016 did not look anything like the company that issued L-Bonds in 2020. But this is an easy trap to stumble into. Do not discount earlier L-Bond or preferred stock cases. In fact, one factor sides in favor of earlier cases being stronger than later solicitation cases, namely the fact that in 2016 and 2017, GWG was a fledgling company with very little track record, and yet was raising billions from investors in unrated debt. In the later L-Bond cases in 2020, brokers can argue with a straight fact that GWG had never missed a payment in eight years. Although that is a specious position to take, defense lawyers will make that argument.

Furthermore, as cited in the "GWG Statement of Claim" included with the written materials, there was an analyst report for GWG from just after its stock debuted on the NASDAQ. This analyst report from January 31, 2015, which was posted on Seeking Alpha, identifies a number of very disconcerting issues with this new company, including the title of the article itself "GWG Holdings: A Bizarre Borrowing From Peter to Pay Paul Business Model."[2] A simple Google search for GWG revealed the existence of this report, which GWG tried to explain away a few years later in a letter to brokerage firms due diligence departments. The title itself should cause

[2] *See,* Salazar, Dallas, GWG Holdings: A Bizarre Borrowing from Peter to Pay Paul Business Model Jan. 31, 2015 https://seekingalpha.com/article/2869256-gwg-holdings-a-bizarre-borrowing-from-peter-to-pay-paul-businessmodel

a brokerage firm at least some hesitation. This analyst referred to GWG's entire business model as "prayer" and that investing in it was a "riverboat gamble."[3]

This Seeking Alpha article is important for obvious reasons. Even if the article is conjecture or opinion, it raises some very important questions that a brokerage firm or RIA should pay attention to and vet prior to recommending their client invest in the company's unrated debt. The article's questions about the business model proved true too. Once GWG's relationship with Beneficient became official, it was a clear sign that GWG was abandoning its previous business model and moving into something else.

V. Two Paths at Once – Before Regulation Best Interest

For solicitations to invest in, or roll-over, L-Bonds prior to June 2020, there are two different ways to prosecute the suitability of L-Bond solicitations in a FINRA case. After the effective date of Regulation Best-Interest, this changes substantially. First, there are two relevant prongs under the "old" FINRA Rule 2111 Suitability Rule[4]:

> **Reasonable-basis suitability** requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards of the recommended security or strategy.
>
> **Customer-specific suitability** requires that a broker, based on a particular customer's investment profile, has a reasonable basis to believe that the recommendation is suitable for that customer. The broker must attempt to obtain and analyze a broad array of customer-specific factors to support this determination.

See FINRA Rule 2111.05(a) and (b). Most practitioners will approach a product case, like an L-Bond case, both ways. First, the broker-dealer did not have a reasonable basis to recommend the security in the first place because it either failed to perform adequate due diligence, or the broker-

[3] *Id.* at 4-5, and 8.
[4] This presentation will not discuss Quantitative Suitability of L-Bond solicitations.

dealer performed the due diligence but ignored the red flags and results of the analysis, and was negligent in approving the investment for sale to firm customers. Second, the investment was not suitable for the investor based on the investor's investment and financial profile.

The "due diligence" case under the reasonable basis prong is your first step. Before the L-Bonds are even introduced to the broker, before there is a selling agreement in place with the issuer, the broker-dealer must perform "reasonable due diligence." This concept is open to interpretation. There are numerous NASD and FINRA notices that describe when this investigation has to take place and how best it should be executed. These notices serve as an excellent guide for a practitioner to challenge a firm's due diligence process.

The first Notice to Members that comes to mind, attached hereto as Exhibit 1, is NASD Notice to Members 03-71. This notice speaks to "non-conventional investments" and broker/dealer "obligations when selling" them. The Notice defines the issue as discovered by the NASD as "retail investors being offered an array of different investments as alternatives to conventional equity and fixed-income investments. These alternative investments do not fall under a common category;". *Id*. at 1. This notice "reminds members of their obligations" to:

> (1) conduct adequate due diligence to understand the features of the product; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis in connection with any recommended transactions; (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors; (5) implement appropriate internal controls; and (6) train registered persons regarding the features, risks, and suitability of these products.

Id. NTM-03-71, importantly, describes the "type of due diligence investigation that is appropriate" and that there are "some common features that members must understand about products before registered representatives can perform the appropriate suitability analysis." *Id.* at 3. This statement makes it crystal clear that the due diligence obligation falls to the member firm *before*

the registered representative undertakes the customer-specific suitability assessment. The "common features" identified in NASD NTM 03-71 are:

- The liquidity of the product
- The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions
- The creditworthiness of the issuer*
- The creditworthiness and value of any underlying collateral*
- Where applicable, the creditworthiness of the counterparties*
- Principal, return, and/or interest rate risks and the factors that determine those risks
- The tax consequences of the product
- The costs and fees associated with purchasing and selling the product

Id. This statement is critical: "A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes." *Id* at 4. NASD instructs its members that it must seek additional information or conclude that the product should not be sold. Of course, it is important that the people performing due diligence are trained and skilled to evaluate the terms of the investment.

The asterisks on three of the bullet-points above are particularly relevant to GWG due diligence. GWG's creditworthiness, the creditworthiness of the collateral (first the life insurance portfolio and then the equity interests in the subsidiaries), and the creditworthiness of Beneficient are fertile hunting grounds in GWG cases. As made clear in the Seeking Alpha review from 2015,

there were some very optimistic assumptions made in the financials and projections. The basis for these projections, including demanding from GWG the hard proof – the math – on these assumptions is fundamental to GWG's creditworthiness and its ability to continue as a going concern. NTM 03-71 makes clear that the responsibility to perform this review falls on the member firm.

NASD Notice to Member 04-30 is an excellent notice specific to bonds and bond funds. (*See* Exhibit 2). Again, NASD reiterates the firm's duty to "ensure that the product being offered is reasonably suitable for investment in general. To make this determination, firms must carefully review and understand the terms and conditions of the product being offered. With individual bonds, for example, the firm must understand…the creditworthiness of the issuer; the collateral securing the bond, if any…and any other important features as described in the prospectus." *Id.* at 3. For a GWG L-Bond case, this notice is an outstanding place to start your dive into the firm's due diligence. This notice also reinforces the edict that a prospectus does not cure unbalanced or unreasonable representations made by the financial advisor at the point of sale.

The next relevant Notice in connection with due diligence is NASD Notice to Members 05-26 – New Products. (See Exhibit 3). This notice sets forth NASD guidance deemed "minimal" when firms review new products. These vetting procedures should include, at a minimum:

- Clear, specific and practical guidelines for determining what constitutes a new product;
- Ensure that the right questions are asked before a new product is offered for sale;
- Provide post-approval follow-up and review, particularly of products that are complex or are approved only for limited distribution.

NASD NTM 05-26 at 1. Of particular relevance to L-Bond cases, this Notice provides specific guidance on when a modification of an existing product is material enough to warrant the same level of review as a new product. NASD instructed firms to "err on the side of caution, and subject any material modification to an existing product to the same level of review as a new product." *Id.* at 3. As noted, GWG changed in material and critical ways over the few years that it offered L-Bonds. Each time it presented a new offering of L-Bonds, firms should have engaged in a complete soup-to-nuts review of the offering as if it were new.

The gold standard for FINRA guidance on due diligence is found in Regulatory Notice 10-22. The notice is specifically related to Regulation D Offerings. (*See* Exhibit 4). This notice reiterates a member firm's due diligence obligations which must be met before the any financial advisor can sell it to a client. RN 10-22 is specific to Regulation D private placements, so it is possible any attempt to introduce it in a GWG L-Bond case is met with an objection or at a minimum, argument that it simply does not apply. The trick here could be to avoid its introduction and simply use the Notice as a guide in discovery and for cross examination of the Respondent's expert and the Respondent's due diligence officer. The Notice provides specific areas which should be examined in any due diligence investigation. Without introducing the notice, simply ask the due diligence offer:

- You would agree with me, would you not, that a reasonable due diligence investigation would include investigating GWG and its management, right?
- You would agree with me that a reasonable investigation includes reviewing the business prospects of the issuer, right?
- You would agree with me, would you not, that a reasonable investigation into GWG would include a review of its assets, specifically, its life insurance portfolio?

- You would agree with me, would you not, that a reasonable investigation includes investigating claims being made by the issuer about its financials and future business prospects, correct?
- You would agree with me, would you not, that if "red flags" come up in the course of your due diligence investigation, like Brad Heppner using investor money to pay for his private jets and ranch, that there is an obligation to follow-up on that red flag with the issuer?

Due diligence should be adversarial in nature. The analyst investigating the issuer should not be chummy with them. The role of broker-dealer due diligence is to challenge the assumptions made by the issuer and to confront the issuer if red flags show up. Broker-Dealer due diligence is a "gate keeper function." Many of these issues are specifically referenced in RN 10-22, and any due diligence officer that answers "no" to any of these questions may be helping your case more than if he or she agrees with you. RN 10-22 is riddled with information and guidance that can form the basis of your cross examinations, and the notice cites myriad enforcement actions which can be used too.

If you convince the arbitrators that the brokerage firm lacked a reasonable basis – i.e., failed to perform adequate due diligence in reviewing and approving GWG for sale to its clients, you win your case. Customer specific suitability should not matter at that point. Typically, however, the customer specific suitability analysis is inevitable. Focusing on the reasonable basis side will result in a detailed analysis into the serious issues, risks, some disclosed, some under the carpet, about GWG that will poison the arbitrators' minds about the product, which should lead to an easier customer specific suitability case.

As much as respondents rely on the prospectus defense, it is important to remember furnishing a prospectus to a client does not cure oral misrepresentations made by the broker. *See* Notice to Member 04-30. There is substantial case law on the availability of the "prospectus defense", which is prominent in GWG cases. To be clear, the prospectus defense or "bespeaks caution" defense is not as strong as the broker-dealer wishes it were.

The "Bespeaks Caution" doctrine applies when "optimistic projections are coupled with cautionary language-in particular, relevant specific facts or assumptions-affecting the reasonableness of the reliance on and the materiality of those projections." *Allyn v. Wortman*, 725 So.2d 94, 103 (Miss. 1998). Offered documents, prospectuses, and other materials disclosing the risk of a particular investment must be read as a whole, and their statements must be read **in context**. See *id.* at 103; citing *Rubinstein v. Collins*, 20 F.3d 160, 167 (5th Cir. 1994). A vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation. *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig*., 7 F.3d 357, 371 (3d Dist. 1993); see also *In re NationsMart Corp. Sec. Litig*., 130 F.3d 309, 317 (8th Cir. 1997) (stating that "**Cautionary statements, however, cannot be general risk warnings or mere boilerplate; they must be detailed and specific**") (emphasis added).

Oral representations or omissions may effectively nullify the warnings in a written statement by discounting its general significance and its relevance to the customer's particular situation. See *Clayton Brokerage Co. of St. Louis, Inc. v. Commodity Futures Trading Comm'n*, 794 F.2d 573, 580 (11th Cir. 1986); citing *Myron v. Hauser*, 673 F.2d 994, 1007 (8th Cir. 1982) and *Kelley v. Carr*, 442 F. Supp. 346, 353-54 (W.D. Mich. 1977); see also *McCoy v. Goldberg*, 748 F. Supp. 146, 152 (S.D.N.Y. 1990) (stating that "After luring plaintiff into ignorant reliance, defendants cannot now avail themselves of the doctrine of constructive knowledge" of the offering

memorandum); *In re Phar-Mor, Inc. Litig.*, 848 F. Supp. 46, 49 (W.D. Pa. 1993); and *Medine v. Washington Mut., FA*, 185 F.R.D. 366, 370-71 (S.D. Fla. 1989). In *Halperin v. eBanker USA.com*, the Second Circuit discussed disclosures made in investments offering materials and the "total mix of information" upon which investors can rely upon:

> …when cautionary language is present, we analyze the allegedly fraudulent materials in their entirety to determine whether a reasonable investor would have been misled. The touchstone of the inquiry is **not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor** regarding the nature of the securities offered.

Halperin v. eBanker USA.com, Inc., 295 F.3d 352, 357 (2d Cir. 2002) (emphasis added).

The SEC and the NASD also believe that providing the investor with a prospectus does not preclude him or her from relying on other information:

> [T]he [Securities and Exchange] Commission set forth its view that investors in private actions also should be able to rely on the oral representations of their brokers…whether an investor's reliance on a registered representative's oral representations is reasonable depends upon the circumstances of each case. It cannot be said that in all cases such reliance is, as a matter of law, unjustified **even where the investor had access to a prospectus providing full disclosure**.

In re Robert A. Foster, 51 S.E.C. 1211, Admin. Proceeding File No. 3-8423 (July 20, 1994) (emphasis added). In NASD Notice to Members 94-16, the NASD stated:

> Members are also advised that, although the prospectus and sales material of a fund include disclosures on many matters, **oral representations by sales personnel that contradict the disclosures in the prospectus or sale literature may nullify the effect of the written disclosures and <u>may make the member liable for rule violations and civil damages</u>** to the customers that result from such oral representations.

See NASD Notice to Members 94-16 (emphasis added). *See also* NASD Notice to Members 03-71, which states that:

> [M]embers should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. NASD reminds members, however, that **simply providing a prospectus or offering memoranda does not cure unfair or unbalanced sales or promotional materials**, whether prepared by the member, sponsor, or issuer.

(Exhibit 1).

VI. Reg BI – Game Changer or Variation on the Same Theme?

Effective June 30, 2020, Regulation Best Interest – or Reg BI – changed the landscape of broker-dealer regulation in a material way. Reg BI essentially eliminates the "suitability" rule for retail client recommendations after June 30, 2020, and replaced it with a "best interest" standard. If "best interest standard" sounds a lot like "fiduciary duty" to you, the SEC tends to agree with you. In a Staff Bulletin released March 30, 2020, titled "Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors" the SEC attempted to provide some clarity on what, if any, differences remained between the broker/dealer standard of care and the investment adviser fiduciary standard of care. (See Exhibit 5). The SEC stated, "Both Regulation Best Interest for broker-dealers and the fiduciary standard for investment advisers under the Investment Advisers Act are drawn from key fiduciary principles that include an obligation to act in the retail investor's best interest and not to place their own interests ahead of the investor's interest." *Id.* at 1.

The SEC issued a Reg BI adopting release on June 5, 2019, that is 770 pages long and on that same day, issued Commission Interpretation Regarding Standard of Conduct for Investment Advisers which is only forty-two pages long.[5] The Reg BI adopting release reiterates that a

[5] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No.86031, 84 FR 33318 (June 5, 2019) available at https://www.sec.gov/files/rules/final/2019/34-86031.pdf (last viewed August 8, 2023).
See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669 (June 5, 2019) available at https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf (Last viewed August 8, 2023).

broker/dealer can not comply with the "reasonable basis component of the Care Obligation" and duty to act in a client's best interest without "establishing a threshold understanding of the particular recommended security…" *Adopting Release* at 261. The release makes clear that Regulation Best Interest is intended to incorporate and build upon a broker-dealer's existing "reasonable basis suitability" obligations and would relate to the broker-dealer's understanding of the particular security or investment strategy recommended, rather than to any particular retail customer." *Id.* To meet the requirement of this section, a broker-dealer must "undertake reasonable diligence, care, and skill to understand the nature of the recommended security…as well as the potential risks, rewards, and costs…" *Id.*

On May 9, 2023, FINRA issued Regulatory Notice 23-08, reminding member firms of their obligations when selling private placements. (*See* Exhibit 6). This notice incorporates RN 10-22 and reminds members of their now "best interest" obligations when recommending private placements to retail clients. In addition to the areas in which FINRA stated in 10-22 a broker-dealer should investigate "at a minimum", RN 23-08 also includes:

- Regulatory and litigation history of the issuer and its management, including the criminal, disciplinary, regulatory, and litigation history associated with the issuer, its management, and any affiliate that may be materially involved in the issuer's business, as well as the issuer's compliance with the bad actor provisions under Rule 506(d)–(e).
- New material developments, including events that are or should be reasonably known to the member during an offering, for example, when there are ongoing legal proceedings or regulatory inquiries involving the issuer.
- Transactions or payments between an issuer and the issuer's affiliates involving offering proceeds, including the terms of the transaction between the related parties and whether an arrangement presents a material conflict of interest for the issuer and, if so, the sufficiency of disclosure.
- Representations of past performance of the issuer, its sponsor, or its manager to identify any such representations that may be misleading or exclusively selected based on positive results (or "cherry-picking"). This is particularly important when the representations pertain to specific prior issuances.

Id. at 6. Much like RN 10-22, this notice is specific to private placements. However, crafting an examination based on these areas identified in the notice could yield great results. Any broker-dealer investigating GWG should have requested details of the Beneficient transaction which would have established that Brad Heppner was using GWG money to pay for his private planes and ranch. Under the care obligation, if a broker-dealer asks for the information and is stonewalled, then the broker-dealer should decline to offer the L-Bonds.

VII. Use the FINRA Rules and Regulatory Notices for What They Are: Evidence of the Standard of Care

It seems preposterous that broker/dealers make arguments in FINRA arbitrations that FINRA Rules and notices cannot form the basis for a cause of action. No matter what claim it is, establishing a violation of various FINRA rules will be outcome determinative to maintain liability against the brokerage firm. Of course, there is no "cause of action" for violating FINRA Rules – which is how respondents always frame the issue for an important reason: the case law is overwhelming that there is no "private right of action" for violation of FINRA rules. *See e.g., Fox v. Lifemark Sec. Corp.,* 84 F. Supp.3d 239 (W.D.N.Y. 2015).

Do not fall for the trap – be precise. The FINRA rules and the notices interpreting them are *evidence of the standard of care* owed by brokerage firms to clients. *See McGraw v. Wachovia Sec., LLC,*756 F.Supp.2d 1053, 1075 (N.D. Iowa 2010); *Garrison v. Sagepoint Financial, Inc.*, 185 Wash. App. 461 (Wash. Ct. App. 2015); *Mihara v. Dean Witter 7 Co.*, 619 F.2d 814, 824 (9th Cir. 1980); *Rolf v. Blyth, Eastman, Dillon*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977); *Scott v. Dime Savings Bank of N.Y., FSB*, 886 F. Supp. 1073 (S.D.N.Y. 1995); and *Ginzkey v. National Securities Corp.*, 2022 U.S. Dist. LEXIS 42985*11 (W.D. Wash. March 10, 2022). The case law is stacked in favor of using FINRA rules and these notices as evidence of the standard of care owed by brokerage firms and registered representatives. Make it clear in the Statement of Claim, or complaint if you're

filing in court, that by introducing the FINRA rules in your pleading, it is to provide evidence of the standard of care.

VIII. Discovery In a Due Diligence Case Should be Voluminous

Discovery in product and "due diligence" cases can be voluminous. It can be disheartening when a broker-dealer produces tens of thousands of pages of purported "due diligence" materials, when you thought they didn't perform any due diligence. Be careful to adjust your mindset. Just because a brokerage firm collected thousands of pages of prospectuses and third-party due diligence reports, does not mean anyone at the firm reviewed the materials or deliberated over them. In fact, the more documents, the harder it will be for them to convince a trier of fact that they actually reviewed them all.

Focus your discovery efforts on identifying who performed due diligence on a particular offering and any emails to or from that individual(s) relating to the product at issue. Then seek all notes or memoranda prepared by the person(s) responsible for due diligence for presentation to either the investment committee or due diligence committee. Then seek any notes of any meetings where those securities were discussed. When you keep drilling into due diligence, what will invariably be determined is that there are a lot of documents – usually with a lot of red flags in them. There is a lack of communication between the issuer and the broker-dealer due diligence people, other than niceties and being informed when their next "presentation" is. Especially for smaller firms, like those that sold GWG, there tends to be a lack of institutional sophistication, so that the same person charged with due diligence is also the president of the firm, or the CCO. Last, there is typically a lack of any records indicating any detailed review of the materials presented.

The job of reviewing third party due diligence reports and prospectuses can be arduous and time consuming. These documents almost always contain the red flags that should have resulted

in follow-up verification by broker-dealer due diligence. Occasionally, the third-party reports identify red flags or material facts that are not disclosed in the offering materials, thereby creating a road map for your misrepresentation or omission claims.

It is also important to establish how much "product" the broker-dealer pushed. This relates directly to the conflict-of-interest issues in Regulation BI or any fiduciary duty claim. Remember for GWG, the longer-term the bonds, the higher the commissions. GWG had a material interest in holding investor's money longer because redemptions would sink the ship. The more GWG a broker-dealer sold, the worse the conflict, the higher quality their due diligence better be. Further, if the broker-dealer had a long relationship with the issuer, it is likely subsequent L-Bond offerings were "rubber stamped" without a true fresh look. With GWG, this would be a serious problem for any broker-dealer due diligence department given the evolving nature of GWG, its business model, and its descent into financial catastrophe.

IX. Trying the Case - Conclusion

You've got your discovery, your expert, and you are ready to try your case. In a reasonable basis case, Respondent's defense will be in the pile of documents it contends is evidence of due diligence. It is critical to grasp that the due diligence officer for the broker-dealer will know more about the investment at issue at your hearing than he or she did when the investigation was supposed to take place. Use that sudden intelligence to your advantage. Painstakingly take the due diligence analyst through the notices and the red flags you have identified.

At the close of your reasonable basis presentation, consider moving for a directed verdict or for summary judgment on that specific issue. After all, if you convinced the arbitrators that the broker-dealer had no reasonable basis to recommend GWG to their clients, customer specific suitability becomes irrelevant. You may continue with your state securities act and common law

fraud claims, but there should be no further findings of unsuitability required.

In GWG case, remember the worse you can make the issuer look the better it is for your case. With GWG, that is not too difficult to accomplish. PIABA has literally dozens of schooled practitioners who have tried many product/due diligence cases. Do not hesitate to ask questions on the List Serve, or simply pick up the phone and call.

EXHIBIT 1

Notice to Members

NOVEMBER 2003

SUGGESTED ROUTING

Legal/Compliance
Retail
Senior Management
Internal Audit

KEY TOPICS

Advertising and Sales Literature
Due Diligence
Non-Conventional Investments
Suitability

INFORMATIONAL

Non-Conventional Investments

NASD Reminds Members of Obligations When Selling Non-Conventional Investments

Executive Summary

In the aftermath of the recent downturn in the equity markets, NASD reviewed the services and products offered by members and observed that retail investors were being offered an array of different investments as alternatives to conventional equity and fixed-income investments. These alternative investments do not fall under a common category; the staff review indicates that brokers and retail investors have shown increased interest in products such as asset-backed securities, distressed debt, and derivative products (for ease of reference these products are collectively refered to as non-conventional investments or "NCIs"). NCIs often have complex terms and features that are not easily understood. NASD staff reminds members that the fact that an investment is an NCI does not in any way diminish a member's responsibility to ensure that such a product is offered and sold in a manner consistent with the member's general sales conduct obligations. This *Notice to Members* reminds members offering NCIs of their obligations to: (1) conduct adequate due diligence to understand the features of the product; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis in connection with any recommended transactions; (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors; (5) implement appropriate internal controls; and (6) train registered persons regarding the features, risks, and suitability of these products.

Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8104; or Janene Marasciullo, Senior Attorney, Regulatory Policy and Oversight, NASD, at (202) 974-2978.

Background and Discussion

As a result of the recent downturn in the equity markets and historically low interest rates, brokers and retail investors have been turning to alternative investment vehicles in search of a better return or yield on investments. A review of members indicated that there is an increased interest in a variety of NCIs that have a wide array of terms, conditions, risks, and rewards.[1] Some of these NCIs are marketed as offering greater security or a "guaranteed" return on investments. Other products seek to maximize the potential return on investments. Some of these products have unique features relating to risk and reward that may not be readily understood, especially by retail investors.

For example, certain asset-backed securities and corporate bonds are secured by a range of collateral such as mobile homes, future royalty payments on popular music, payments from consumer credit cards or other consumer goods. The credit risks associated with these myriad forms of collateral are varied and for many non-institutional parties may be difficult to understand and assess. Other NCIs, such as distressed corporate bonds and certain derivative contracts, may be offered to retail investors in an attempt to maximize the return on investment, but they correspondingly may involve greater degrees of risk. These products also tend to have less market liquidity, less transparency as to their pricing and value and may entail significant credit risks that are difficult to understand and assess.

In sum, recent trends indicate that brokers and investors may be turning to NCIs in search of increased yield or return. Although these products may have attractive qualities, it is crucial that members understand the distinct features, and risks and rewards, of any product they sell. Thus, whenever members recommend NCIs to investors, they must take special care to ensure that all registered persons understand the features of the product in order to be in a position to perform the required suitability analysis before executing a transaction. Likewise, members have an obligation to ensure that all marketing materials used by the member provide an accurate and balanced description of the risks and rewards.

NASD is issuing this *Notice to Members* to remind members of their sales conduct obligations.[2] Given the complex nature of NCIs and the potential for customer harm or confusion, members are cautioned to ensure that their sales conduct procedures fully and accurately address any of the special circumstances presented by the sale of NCIs. Additionally, NASD is concerned that investors, particularly retail investors, may not fully understand the risks associated with these products. Accordingly, NASD reminds members that the sale of NCIs, like more traditional investments, requires them to:

(1) conduct appropriate due diligence with respect to these products; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis for recommended transactions; (4) ensure that promotional materials used by the member are fair, accurate, and balanced; (5) implement appropriate internal controls; and (6) provide appropriate training to registered representatives that sell these products. Given the complex and, at times, difficult-to-understand nature of NCIs, members should take particular care to assure that they are fulfilling these obligations.

Due Diligence/Reasonable-Basis Suitability

As NASD noted most recently in *Notice to Members 03-07* (pertaining to hedge fund sales to customers), performing appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis.[3] A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination, discussed below, which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI only to institutional investors does not relieve the member of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

The type of due diligence investigation that is appropriate will vary from product to product. However, there are some common features that members must understand about products before registered representatives can perform the appropriate suitability analysis. These features include, but are not limited to:

- The liquidity of the product
- The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions
- The creditworthiness of the issuer
- The creditworthiness and value of any underlying collateral
- Where applicable, the creditworthiness of the counterparties
- Principal, return, and/or interest rate risks and the factors that determine those risks
- The tax consequences of the product
- The costs and fees associated with purchasing and selling the product

Members should examine these and other appropriate factors when conducting due diligence. A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes. In such case, the member must seek additional information about the NCI or conclude that the product is not appropriate for sale to the public. In addition, members should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits.

Customer-Specific Suitability

Members and their associated persons must reasonably believe that the product is a suitable investment prior to making a recommendation to a particular customer. To ensure that a particular investment is suitable for a specific customer, members and their registered persons must examine: (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. [4]

NASD cautions members against relying too heavily upon a customer's financial status as the basis for recommending NCIs. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor. Given the unique nature of NCIs, these products may present challenges when it comes to a member's duty to dispense its suitability obligation; however, the difficulty in meeting such challenges cannot be considered as a mitigating factor in determining whether members have met their suitability obligations. NCIs with particular risks may be suitable for recommendation to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

Promotional Materials

Sales materials and oral presentations regarding NCIs must present a fair and balanced picture regarding both the risks and benefits of investing in these products. For example, members may not claim that certain NCI products, such as asset-backed securities, distressed debt, derivative contracts, or other products, offer protection against declining markets or protection of invested capital unless these statements are fair and accurate. Moreover, when promoting the advantages of NCIs, it is critical that members balance their promotional materials with disclosures of the corresponding risks and limitations of the product discussed above in the "Due Diligence/Reasonable Basis Suitability" section of this *Notice*.

Additionally, if applicable, members should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. NASD reminds members, however, that simply providing a prospectus or offering memoranda does not cure unfair or unbalanced sales or promotional materials, whether prepared by the member, sponsor, or issuer.[5]

Internal Controls

Members must establish sufficient internal controls, including supervision and training requirements, that are reasonably designed to ensure that sales of NCIs comply with all applicable NASD and SEC rules. Members must ensure that their written procedures for supervisory and compliance personnel require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; (3) all promotional materials are accurate and balanced; and (4) all NASD and SEC rules are followed. In addition to establishing written procedures, members also must document the steps they have taken to ensure adherence to these procedures.

Training

Members must train registered persons about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors. Likewise, members should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. Members' focus on training should not be limited to representatives selling such products; members also should provide appropriate training to supervisors of registered persons selling NCIs.

For a variety of reasons, the need for adequate training is heightened when registered persons sell NCIs. First, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to provide a full and balanced disclosure regarding both the risks and the rewards of these products.

Educational brochures, videos, lectures, explanatory memoranda, and Web-based seminars are all appropriate ways of delivering training. The particular training methods will vary based upon the products themselves, as well as the size and customer base of the firm. NASD encourages firms that offer NCIs to offer training about these products as part of the Firm Element of their Continuing Education Program.

Conclusion

NCIs can be unusual and complex investment vehicles that may appear increasingly attractive to investors during periods in which traditional equity and fixed income investments come into disfavor. However, the unique and complex features of some NCIs may be difficult to understand and may obscure the risks. Accordingly, members must conduct appropriate due diligence/reasonable-basis suitability before offering any product to the public. Likewise, members must conduct a customer-specific suitability analysis prior to making any recommendations to a customer. Members also must ensure that all promotional materials are fair, accurate, and balanced. Finally, in connection with the recommendation and sale of NCIs, members must ensure that they implement appropriate supervisory internal control and appropriate training to all registered persons who sell such products to customers.

Endnotes

1 Approximately 35% of the firms reviewed sold NCIs in denominations that raise the possibility of sales to retail investors. The list of NCIs being offered is broad and includes asset-backed securities, index-linked notes, non-traded REITS, equity-linked notes, multi-callable step up notes, redeemable secured notes, auction rate preferred securities, principal protected index-linked CDs, distressed debt, derivative products, and emerging market debt securities.

2 Members also are reminded of the application of IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products), which emphasizes members' obligations for fair dealing with customers when making recommendations or accepting orders for new financial products.

3 NASD's use of the term "due diligence" is not intended to equate the responsibilities of a member for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176.

4 NASD Conduct Rule 2310(b).

5 *See* NASD Letter of Acceptance, Waiver and Consent, Altegris Invs., Inc., and Robert Amedeo, No. CAF030015 (April 15, 2003).

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EXHIBIT 2

APRIL 2004

GUIDANCE

Sales Practice Obligations

NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds

SUGGESTED ROUTING

Advertising/Investment Companies
Debt Securities
Executive Representatives
Legal & Compliance
Mutual Funds
Registered Representatives
Senior Management
Training

KEY TOPICS

Debt Securities
Municipal Securities
Mutual Funds
Sales Practice Obligations

Executive Summary

As the number of retail customers investing in bonds and bond funds grows, NASD is concerned that many investors may not fully appreciate the risks and costs associated with such products.[1] It is the responsibility of firms to take appropriate steps to ensure that their registered representatives understand and inform their customers about the risks as well as the rewards of the products they offer and recommend. The purpose of this *Notice* is to remind firms that sell bonds and bond funds of their sales practice obligations in connection with such products.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Sharon Zackula, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight (RPO), at (202) 728-8985; or Laura Gansler, Assistant General Counsel, Office of General Counsel, RPO, at (202) 728-8275.

Discussion

The number of individual investors purchasing bonds or bond funds has increased dramatically in recent years. Bonds and bond funds may be viewed—and in some cases, marketed—as low-risk, or sometimes even as risk-free alternatives to equity securities. Purchasers of bonds and bond funds often believe that their principal is safe, they are guaranteed a particular yield on their investment, and bonds are inexpensive to purchase because they do not pay a commission or other acquisition cost on the transaction.

While bonds and bond funds can play an important role in stabilizing diversified portfolios, neither product is entirely risk-free. Moreover, their terms, conditions, risks, and rewards vary widely, and in some cases, such as high-yield bonds, the risks may be substantial. NASD is concerned that some investors may not understand the risks and costs associated with bonds and bond funds. For example, a recent study by NASD indicates that 60 percent of investors do not understand that, as interest rates rise, existing bond prices fall, and that long-term bonds are more exposed to interest rate risk than short-term bonds (*see* "NASD Investor Literacy Research" at *www.nasd.com/Investor/pdf-text/surveyexecsum.pdf*). Therefore, when interest rates rise, investors who decide to sell their bond fund may not receive their full investment. In the same environment, investors who decide to sell bonds prior to a call or the maturity date also may not receive the full amount of their principal invested. Because interest rate risk is universal, it is in some ways more problematic for investors than the risk of default, at least with respect to investment grade bonds.

It is the responsibility of firms to take appropriate steps to ensure that their associated persons understand and inform their customers about the risks as well as the rewards of the products they recommend and offer. Given that interest rates are likely to rise from their current and historically low rate, NASD believes that it is imperative that investors understand the various risks, as well as the rewards, associated with debt securities. The purpose of this *Notice*, therefore, is to remind firms of their sales practice obligations in connection with bonds and bond funds. The obligations include:

- Understanding the terms, conditions, risks, and rewards of bonds and bond funds they sell (performing a reasonable-basis suitability analysis);
- Making certain that a particular bond or bond fund is appropriate for a particular customer before recommending it to that customer (performing a customer-specific suitability analysis);[2]
- Providing a balanced disclosure of the risks, costs, and rewards associated with a particular bond or bond fund, especially when selling to retail investors;

- Adequately training and supervising employees who sell bonds and bond funds; and
- Implementing adequate supervisory controls to reasonably ensure compliance with NASD and SEC sales practice rules in connection with bonds and bond funds.

The first step in meeting a firm's sales practice obligations with respect to a bond or bond fund is to ensure that the product being offered is reasonably suitable for investment in general. To make this determination, firms must carefully review and understand the terms and conditions of the product being offered. With individual bonds, for example, the firm must understand the type, term, and yield of the bond; when and if periodic interest payments will be made; if applicable, the conditions under which the issuer may call the bond or the holder may redeem the bond; the credit-worthiness of the issuer; the collateral securing the bond, if any; the costs of the transaction; and any other important features as described in the prospectus. For bond funds, it means, among other things, understanding what type of bonds the fund will purchase; the general terms, conditions, and risks of such bonds; and the costs and fees associated with purchasing and selling shares in the fund. And, in both cases, firms should also understand the tax consequences of the product.

Secondly, firms must ensure that the bonds and bond funds they recommend are suitable for the customer to whom they recommend them. To ensure that a particular investment is suitable for a specific customer, firms and their registered persons must examine a variety of factors, including the customer's financial status, the customer's tax status, the customer's investment objectives, and any other information that the firm uses or considers reasonable to use in making recommendations to that customer.[3] NASD cautions firms against relying too heavily upon a customer's financial status as the basis for recommending particularly risky bonds or bond funds. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor. Certain high-yield, high-risk products may be suitable for recommending to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

Thirdly, firms offering bonds and bond funds should take care to present a fair and balanced picture of the risks, costs, and benefits of investing in these products. For example, in the case of individual bonds, customers should be advised as to the credit risk, or risk of default, associated with a particular issuer, and how that risk might affect the safety of the invested principal. Customers should also be advised as to the interest rate risk, or the risk that changes in interest rates during the term of the bond might affect the market value of the bond prior to the call or maturity date. And customers should understand that these investments engender inflation risk; this is the risk that the rate of the yield to call or maturity of the investment will not provide a positive

return over the rate of inflation for the period of the investment. For example, if the rate of inflation for the period of an investment is 6 percent and the yield to maturity of a fixed income investment is 4 percent, then, although more dollars are returned to the investor in interest and principal than were invested, the value of those aggregate dollars returned is actually less than the amount originally invested. While this can be true of any investment, investors may believe that the interest rate paid on a bond or bond fund may guard against this effect in a manner superior to an investment in equity securities, which is not necessarily the case. Finally, customers should understand that when a firm buys or sells a bond, the customer is charged for the service, in the form of either a commission, or a mark-up or mark-down.[4]

In the case of bond funds, customers should be aware that return of principal is not guaranteed because of the fluctuation in the net asset value of the fund that is occasioned by changes in the price of specific bonds held in the fund and the buying and selling of bonds within the fund by its investment adviser. In addition, investors should understand that, as with direct bond ownership, bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds owned by the fund. Bond fund purchasers should also understand that, in contrast to owning individual bonds, there are ongoing fees and expenses associated with owning shares of bonds funds.

Firms offering bonds and bond funds should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. However, NASD reminds firms that simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer.[5]

Firms should also take steps to provide appropriate training to, and supervision of, employees who sell bonds and bond funds about the characteristics, risks, and rewards of each product before they allow employees to sell that product to investors. Firms should also train employees who sell such products about the factors that would make such products either suitable or unsuitable for certain investors. In so doing, the firm's focus should not be limited only to registered representatives selling such bonds and bond funds, but should also include supervisors of registered persons selling such products.

And finally, firms should make sure that they implement adequate supervisory controls to ensure that sales of bonds and bond funds comply with all applicable NASD, MSRB, and SEC rules. Among other things, firms must ensure that their written procedures for supervisory and compliance personnel require that the appropriate reasonable-basis suitability is completed before products are offered for sale; associated persons perform appropriate customer-specific suitability analysis and such information is updated periodically; all promotional materials are accurate and balanced; and all applicable NASD, MSRB, and SEC rules are followed. In addition to establishing written procedures, firms also must document the steps they have taken to ensure adherence to these procedures.

Conclusion

There may be a widespread perception among many individual investors that bonds and bond funds are low risk, if not entirely risk-free, investments. In fact, all such products entail some risk, and in some cases, the risk may be substantial. As part of their sales practice obligations, it is the responsibility of firms to take appropriate steps to ensure that they understand and inform their customers about the risks as well as the rewards of all products that they recommend and offer, including bonds and bond funds.

Endnotes

1 Throughout this *Notice*, the term "bond" is used to mean all types of debt securities.

2 For a fuller discussion of the distinctions between "reasonable basis" and "customer specific" suitability analyses, see *NASD Notice to Members 01-23*, Online Suitability (April 2001), Endnote 4.

3 *See* NASD Conduct Rule 2310(b). For municipal securities, see Municipal Securities Rulemaking Board (MSRB) Rule G-19 ("Suitability of Recommendations and Transactions; Discretionary Accounts").

4 Nothing in this *Notice* is meant to broaden a member firm's obligation, under current law and rules, to disclose the amount of remuneration through mark-ups, mark-downs, or commissions. However, members do have an obligation to their customers to disclose that they do in fact receive compensation for such transactions.

5 *See* NASD Letter of Acceptance, Waiver and Consent, *Altegris Invs., Inc., and Robert Amedeo,* No. CAF030015 (April 15, 2003).

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EXHIBIT 3

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Internal Audit
Legal and Compliance
Retail
Senior Management

KEY TOPICS

Best Practices
New Products
Non-Conventional Instruments
Rule 3010
Suitability

GUIDANCE

New Products

NASD Recommends Best Practices for Reviewing New Products

Executive Summary

NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

The purpose of this *Notice* is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

Questions/Further Information

Questions concerning these new reporting provisions can be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, at (202) 728-8275.

Background and Discussion

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including asset-backed securities, distressed debt, structured notes, and derivative products, are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

In 2003, NASD published *Notices to Members (NTMs)* addressing the sale of hedge funds and non-conventional instruments to retail customers.[1] More recently, we have proposed new rules tailored specifically to sales of deferred variable annuities, including new sales practice standards, supervisory approval and sales force training requirements,[2] and a new rule establishing pre-use advertising filing requirements for certain products not previously offered by the selling firm.[3] And, as discussed more fully below, we met with numerous firms during the past year to learn more about their practices for developing and vetting new products.

NASD continues to monitor new products carefully and will respond to specific products and problem areas as appropriate. However, we also urge firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

Written Procedures for Vetting New Products

As part of the supervisory responsibilities imposed by NASD Rule 3010, all firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory as well as a business perspective. At a minimum, those procedures should identify what constitutes a new product, and ensure that the right questions are asked and answered before a new product is offered for sale.

What Is a New Product?

As a threshold matter, a firm's written procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, including when a modification of an existing product is material enough to warrant the same level of review as a new product. Among the things to consider are:

- Is the product new to the marketplace or the firm?
- Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors? Will the product be offered by representatives who have not previously sold the product?
- Does the product involve material modifications to an existing product, whether risk to the customer, product structure, or fees and costs?
- Does the product require material operational or system changes?
- Is the product an existing product that is being offered in a new geographic region, in a new currency, or to a new type of customer?
- Would the product involve a new or significant change in sales practices?
- Does the product raise conflicts that have not previously been identified and addressed?

This list is not necessarily exhaustive of all factors that determine whether a product is new. Firms should not simply assume that if something is "like" a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary. NASD believes that when firms are unsure as to whether something warrants new product review, the best practice is to err on the side of caution, and subject any material modification to an existing product (whether the existing product is sold by the firm or not) to the same level of review as a new product. It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

Ask the Right Questions

The fundamental goal of every vetting process should be to ensure that the right questions are asked during the review period. Consequently, a firm's policies and procedures addressing new products should be designed to answer these questions. While the right questions will depend in part on the nature of the product, NASD believes that, at a minimum, every firm should ask and answer the following questions before a new product is offered for sale:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should this product NOT be offered?
- What is the product's investment objective? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.
- Does the product present any novel legal, tax, market investment, or credit risks?
- What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.

- What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications comport with the expertise necessary to reach sound conclusions?
- Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
- Will this product be sold only by the firm, or by third parties? How liquid is the product? Is there a secondary market for the product?
- Do the firm's current systems support the product, or will new systems be required? If promises will be made to customers (such as volume-based discounts), can current systems deliver on those promises?
- Does the structure or a feature of the new product, including the proposed sales plan, implicate any additional regulations (*i.e.*, NASD Rule 2860 or NASD Rule 2720)?

Asking the right questions is critical not only to determine if the product should be offered at all (is it suitable for targeted investors, does it present insurmountable conflicts between the firm and its customers), but also to identify important features of the product that should be highlighted for the sales and marketing staff, and to plan for appropriate training and supervision.

Survey of Best Practices

To help firms determine whether their current procedures for vetting new products are appropriate, NASD has surveyed a number of firms that manufacture proprietary products and/or distribute third-party products and has conferred with certain of its committees, including the NASD Consultative Committees. The remainder of this *Notice* highlights practices employed by some firms that NASD believes others should consider. These practices can make it easier for firms to comply with their various suitability obligations, avoid conflicts, and plan for appropriate training and supervision. This *Notice* is not intended to be a comprehensive roadmap for compliance and supervision with respect to vetting new products, but rather highlights measures that some firms are using to ensure better compliance. Firms should consider the information in this section of the *Notice* in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While firms must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have policies and procedures concerning new products reasonably designed to achieve compliance with NASD rules and the federal securities laws because of the limitation of its size, structure, or operations. Using the information in this *Notice* may be helpful, but it is not designed as a safe harbor as circumstances may dictate different practices, processes, and procedures.

While the procedures used by the firms we surveyed vary slightly depending on their own business model and culture, they tended to share the following components:

- A mandatory, standardized process that requires a written "new product" proposal and thorough accompanying documentation, that:
  - assigns clear "ownership" of the product or concept to a particular business unit, product group, or department;
  - is clearly communicated to, and has a high profile within, the firm; and
  - is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity;
- A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management; and
- If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

Initial Product Review

Whatever the specifics of a firm's review process, the most successful processes require review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval.

A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage. Some firms do this by having compliance and legal personnel attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise. Others include compliance and legal personnel in the initial product assessment, as well as in the detailed review. However it is done, firms that include these perspectives early in the development process report that their business units are likely to view compliance personnel as a positive "part of the team," rather than as a stumbling block. The opposite can also be true. When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.[4]

The firms we surveyed also reported that it is extremely helpful to have operations, sales, and supervisory personnel participate in the product review process, rather than waiting until after a product has been approved to determine what training, controls, or operational enhancements are necessary. Many important questions are best answered by those personnel. For example, they may be in the best position to determine whether current systems support the product, including delivering on promises such as volume-based discounts. If additional training is required, firms should plan in advance how that training will be administered, and how the firm will ensure that only brokers who have had the required training are allowed to offer the product to customers. Firms also should plan to ensure that the necessary training is available as long as the product is offered. Consideration also should be given to whether offering the product will require any additional licensing for sales personnel.

Firms manage the initial review process differently, with many utilizing Web-based applications to streamline and document the process. While some firms rely on the proposing business unit to shepherd a product through the process, at least one firm has established an independent new products group that is responsible for managing the process and ensuring that all relevant departments have reviewed and signed off on the proposed product before it is submitted for formal approval. The new products group also formally notifies all relevant departments about product modifications that it deems do not warrant full review in a process of negative consent; if any department disagrees with the new product group's initial assessment, the product is submitted for full review.

Formal Approval

After the appropriate initial review has been completed, most of the firms we surveyed require formal approval by a committee consisting of representatives from senior management before a product can be offered, which enhances a firm's ability to apply consistent standards and ensures accountability. The committee may base its decision on a written proposal supported by detailed documentation, an oral presentation, or, as in most cases, both. A number of firms reported that approval of complex or unusual products will often be made contingent of specific limitations or conditions, including to whom the product can be sold, what kind of training must be required, or what kind of market conditions must exist for the approval to remain effective. For example, the product may be approved on the condition that it is offered only to customers whose investment objectives are coded "speculative," who have a certain minimum risk tolerance level, or who have a minimum net wealth. (While these limitations may be helpful, NASD cautions that there is no substitute for a suitability analysis, and "accredited" status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth.) Other conditions of approval might include that no more than a set percentage of a customer's net worth be invested in the same or a similar product. In such cases, it is important to determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

Post-Approval Review

Some firms require that complex products, those approved on a contingent or limited basis, or those based on critical market assumptions, be formally reviewed for a specific period of time, often six months or a year. This allows the firm to assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product. Firms also should ensure that they:

- track and monitor customer complaints and grievances relating to new products;
- reassess the firm's training needs regarding a product on a continuing basis;
- establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- periodically reassess the suitability of the product; and
- review any product before lifting any restrictions or conditions on the sale of the product.

Conclusion

NASD urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. At a minimum, firms should have in place written procedures for determining what is a new product, and for making sure that the right questions are asked and answered before a new product is offered for sale. In addition, while NASD recognizes that what specific procedures are appropriate will vary depending on firm size and structure, we believe that the best practices identified above can help firms avoid conflicts, unsuitable recommendations, and other problems before violations occur. Finally, NASD notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

Endnotes

1 NASD Reminds Members of Obligations When Selling Hedge Funds, *NTM 03-07* (February 2003), and Non-Conventional Investments, *NTM 03-71* (November 2003).

2 Proposed New Rule 2821 Regarding Transactions in Deferred Variable Annuities, SR-NASD-2004-183 (December 2004).

3 *See NTM 05-25* (April 2005) (NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; Comment Period Expires May 20, 2005).

4 Nothing in this *Notice* is intended to imply that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.

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EXHIBIT 4

Regulatory Notice 10-22

Regulation D Offerings

Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

April 2010

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Communications With the Public
- Private Placements
- Suitability
- Supervision

Referenced Rules & Notices

- Regulation D
- Securities Act Section 17
- SEA Section 10(b)
- Rule 10b-5
- FINRA Rule 2010
- FINRA Rule 2020
- NASD Rule 2210
- NASD Rule 2310
- NASD Rule 3010
- NTM 03-71
- NTM 05-18
- NTM 05-48
- Regulatory Notice 09-05

Executive Summary

FINRA reminds broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the Securities and Exchange Commission's Regulation D under the Securities Act of 1933—also known as private placements.

Regulation D provides exemptions from the registration requirements of Section 5 under the Act. Regulation D transactions, however, are not exempt from the antifraud provisions of the federal securities laws. A broker-dealer has a duty—enforceable under federal securities laws and FINRA rules—to conduct a reasonable investigation of securities that it recommends, including those sold in a Regulation D offering.

Moreover, any broker-dealer that recommends securities offered under Regulation D must meet its suitability requirements under NASD Rule 2310 (Suitability), and must comply with the advertising and supervisory rules of FINRA and the SEC.

Questions regarding this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President Corporate Financing/Advertising, at (240) 386-4623;
- Paul Mathews, Director, Corporate Financing Department, at (240) 386-4639; or
- Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104.

Background and Discussion

Part I of this *Notice* describes Regulation D. Part II describes broker-dealers' regulatory responsibilities to engage in a reasonable investigation of a Regulation D offering, enforceable under the antifraud provisions of the federal securities laws and FINRA rules. Part II also describes specific issues that pertain to a broker-dealer's (BD's) responsibilities and how the scope of a BD's responsibility to conduct a reasonable investigation will necessarily depend upon its affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail investors or more sophisticated institutional investors.[1]

Part III describes practices that some broker-dealers have adopted to help them discharge their reasonable investigation obligations. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act of 1934. BDs, however, may find that many of the practices are appropriate for other types of offerings.

I. Regulation D

The private placement market is an essential source of capital for American business, particularly small firms. According to one estimate, in 2008 companies intended to issue approximately $609 billion of securities in Regulation D offerings.[2] While the private placement market is an important source of capital for many U.S. companies, especially smaller issuers, FINRA has found significant problems in several recent examinations and investigations. These problems include fraud and sales practice abuses in Regulation D offerings. Recently, for example, broker-dealers were sanctioned for providing private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.[3]

Rule 504 under Regulation D provides an exemption from the registration provisions under Section 3(b) of the Securities Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed $1,000,000. Rule 505 provides an exemption under Section 3(b) of the Act for limited offerings for which the aggregate offering price of securities within a 12-month period does not exceed $5,000,000. Rule 505 permits an offering to an unlimited number of "accredited investors" and up to 35 non-accredited investors. Rule 501 defines "accredited investor" as any person who meets, or who the issuer reasonably believes meets, certain requirements, including natural persons with a net worth in excess of $1,000,000, or annual income in excess of $200,000 (or $300,000 jointly with a spouse).

Rule 506 provides a legal safe harbor for an exemption from registration under Section 4(2) of the Act for the sale of securities to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 506 (unlike Rule 505) does not limit the permissible size of the offering, but requires that non-accredited investors possess a degree of financial sophistication. Specifically, Rule 506 requires that each non-accredited investor, "either alone or with his purchaser representative(s)," have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," or the issuer must reasonably believe immediately prior to making any sale that the purchaser comes within this description.

Rule 505 and Rule 506 do not require that an issuer provide any specific written information concerning the offering to accredited investors, although issuers must provide specified information to a non-accredited investor who purchases in an offering. In practice, issuers often provide a private placement memorandum that describes the offering to all prospective purchasers, including accredited investors.[4]

II. BD Regulatory Requirements in Regulation D Offerings

A. Antifraud Provisions and FINRA Rules

The Securities and Exchange Commission (SEC) and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it.[5] This duty emanates from the BD's "special relationship" to the customer, and from the fact that in recommending the security, the BD represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[6] Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.[7] It also can constitute a violation of FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.[8]

Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer.[9] For example, the SEC and courts recognize that a more thorough investigation is required for "securities issued by smaller companies of recent origin,"[10] which could include many Regulation D issuers. While there are no "iron clad rules as to what a broker must do to meet his responsibility,"[11] the presence of any "red flags" also would alert the broker to the need for further inquiry.[12] Each BD must make a determination of the scope of its investigation based upon the facts and circumstances.

A BD that lacks essential information about an issuer or its securities when it makes a recommendation, including recommendations of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from its lack of information.[13] The degree to which a broker-dealer that relies on information supplied by the issuer may be found to have conducted a reasonable investigation as a basis for its recommendation will depend on the facts and circumstances. With respect to reporting companies under the Securities Exchange Act, in the absence of red flags, a BD that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company.

In general, however, a BD "may not rely blindly upon the issuer for information concerning a company,"[14] nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.[15] While BDs are not expected to have the same knowledge as an issuer or its management, firms are required to exercise a "high degree of care" in investigating and independently verifying an issuer's representations and claims.[16] Indeed, when an issuer seeks to finance a new speculative venture, BDs "must be particularly careful in verifying the issuer's obviously self-serving statements."[17]

The fact that a BD's customers may be sophisticated and knowledgeable does not obviate the duty to investigate.[18] Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions.[19]

B. FINRA Suitability Obligations

NASD Rule 2310 states that a BD must have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.[20] This analysis has two principal components. First, the "reasonable basis" suitability analysis requires the BD to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, the "customer specific suitability" analysis requires that the BD determine whether the security is suitable for the customer to whom it would be recommended.[21]

In the context of a Regulation D offering, Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors' knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis. The BD must make reasonable efforts to gather and analyze information about the customer's other holdings, financial situation and needs, tax status, investment objectives and such other information that would enable the firm to make its suitability determination. A BD also must be satisfied that the customer "fully understands the risks involved and is...able...to take those risks."[22]

In order to ensure that it has fulfilled its suitability responsibilities, a BD in a Regulation D offering should, at a minimum, conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made; and
- the intended use of proceeds of the offering.[23]

A BD must conduct a reasonable investigation in connection with each offering, notwithstanding that a subsequent offering may be for the same issuer.[24]

C. Specific Issues Related to a BD's Responsibilities

The scope of a BD's investigation will necessarily depend upon a number of factors, including the BD's affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors.

1. BD That Is Affiliated With the Issuer

A BD that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation.[25] The BD must resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation. Indeed, its affiliation with the issuer typically would raise expectations by its customers, particularly some retail customers, that the BD has special expertise concerning the issuer.[26]

2. BD That Prepares the Private Placement Memorandum

A BD that prepares the private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document.[27] In a recent enforcement action, FINRA found that a BD that prepared a private placement memorandum containing material misstatements and omissions about such matters as the amount and timing of distributions and the targeted return of principal to investors violated FINRA Rule 2010, which requires BDs to comply with just and equitable principles of trade.[28]

A BD that assists in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by that BD for purposes of NASD Rule 2210, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the BD that assisted in its preparation may be deemed to have violated NASD Rule 2210. Moreover, sales literature concerning a private placement that a BD distributes will generally be deemed to constitute a communication by that BD with the public, whether or not the BD assisted in its preparation.

3. The Presence of Red Flags

In the course of a reasonable investigation, a BD must note any information that it encounters that could be considered a "red flag" that would alert a prudent person to conduct further inquiry. Red flags might arise from information that is publicly available or information that is discovered during the course of the investigation. A BD's reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.[29]

When presented with red flags, the BD must do more than simply rely upon representations by issuer's management, the disclosure in an offering document or even a due diligence report of issuer's counsel. In *Kunz and Cline*, the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous "red flags" indicated that the financial statements were inaccurate.[30] The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances. The SEC also found that the broker acted contrary to just and equitable principles of trade when the private placement memorandum failed to disclose both the broker's consulting relationship with the issuer and the litigation history of the issuer's president and CEO.

An issuer's refusal to provide a broker-dealer with information that is necessary for the broker-dealer to meet its duty to investigate could itself constitute a red flag. If an issuer is not forthcoming with information requested by a broker-dealer (or provides information that is non-responsive or out-of-date), the broker-dealer must determine whether sufficient information is otherwise obtainable. While issuers are not required to provide accredited investors with a private placement memorandum in order to qualify for the exemptions in Rule 505 or Rule 506, these memoranda typically are used in Regulation D offerings and firms may need to consider whether the absence of a private placement memorandum itself might constitute a red flag.

4. Reliance on Counsel and Syndicate Managers

A BD may retain counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation. A BD must carefully review the qualifications and competency of counsel or experts retained to perform an investigation on its behalf [31] and must ensure that all gaps or omissions in the investigation by such counsel or experts are separately addressed by the BD. Moreover, the use of counsel or experts does not necessarily complete the BD's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues or concerns that require further investigation by the BD.

It may be appropriate in a Regulation D offering in which a BD is merely a member of a syndicate or selling group to rely upon a reasonable investigation by the syndicate manager, provided the BD has reason to believe that the syndicate manager has the expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has in fact performed such an inquiry with respect to the particular Regulation D offering. Any BD who intends to rely upon the efforts of a syndicate manager should meet with the manager, obtain a description of the manager's reasonable investigation efforts, and ask questions of the manager concerning the independence and thoroughness of the manager's exercise of its responsibilities. A BD that relies upon the efforts of the syndicate manager retains its own responsibilities, to the extent that they are not addressed by the syndicate manager's efforts. For example, if there is reason to believe that the syndicate manager has not addressed a particular issue, then each BD participating in the offering will be responsible to the extent that it implicates the BD's own suitability analysis.

D. Supervision

A firm that engages in Regulation D offerings must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel, including its registered representatives:

- engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
- perform the analysis required by NASD Rule 2310;
- qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and
- do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.

These procedures must be reasonably designed to ensure that each Regulation D offering is properly supervised before it is marketed to other firms or sold directly to customers.[32]

E. Documentation of Reasonable Investigation

To demonstrate that it has performed a reasonable investigation, a BD should retain records documenting both the process and results of its investigation. Such records may include descriptions of the meetings that were conducted in the course of the investigation, including meetings with the issuer or other parties, the tasks performed, the documents and other information reviewed, the results of such reviews, the date such events occurred, and the individuals who attended the meetings or conducted the reviews.

III. Reasonable Investigation Practices

A BD's reasonable investigation must be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. Accordingly, a single checklist of possible practices for a BD engaged in a Regulation D offering will not suffice for every offering, and mechanical reliance upon a single checklist may result in an inadequate investigation. Nevertheless, we are providing a list of practices that some firms have adopted to help them adequately discharge their responsibilities. Many of the practices described below are designed to satisfy BDs' regulatory requirements. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Securities Exchange Act.

Industry participants that we surveyed described the following as practices that help ensure they meet their reasonable investigation obligations.

A. Issuer and Management

Reasonable investigations of the issuer and its management concerning the issuer's history and management's background and qualifications to conduct the business might include:

- Examining the issuer's governing documents, including any charter, bylaws and partnership agreement, noting particularly the amount of its authorized stock and any restriction on its activities. If the issuer is a corporation, a BD might determine whether it has perpetual existence.
- Examining historical financial statements of the issuer and its affiliates, with particular focus, if available, on financial statements that have been audited by an independent certified public accountant and auditor letters to management.
- Looking for any trends indicated by the financial statements.
- Inquiring about the business of affiliates of the issuer and the extent to which any cash needs or other expectations for the affiliate might affect the business prospects of the issuer.
- Inquiring about internal audit controls of the issuer.
- Contacting customers and suppliers regarding their dealing with the issuer.
- Reviewing the issuer's contracts, leases, mortgages, financing arrangements, contractual arrangements between the issuer and its management, employment agreements and stock option plans.

- Inquiring about past securities offerings by the issuer and the degree of their success while keeping in mind that simply because a certain product or sponsor historically met obligations to investors, there are no guarantees that it will continue to do so, particularly if the issuer has been dependent on continuously raising new capital. This inquiry could be especially important for any blind pool or blank-check offering.
- Inquiring about pending litigation of the issuer or its affiliates.
- Inquiring about previous or potential regulatory or disciplinary problems of the issuer. A BD might make a credit check of the issuer.
- Making reasonable inquiries concerning the issuer's management. A BD might inquire about such issues as the expertise of management for the issuer's business and the extent to which management has changed or is expected to change. For example, a BD might inquire about any regulatory or disciplinary history on the part of management and any loans or other transactions between the issuer or its affiliates and members of management that might be inappropriate or might otherwise affect the issuer's business.
- Inquiring about the forms and amount of management compensation, who determines the compensation and the extent to which the forms of compensation could present serious conflicts of interest. A BD might make similar inquiries concerning the qualifications and integrity of any board of directors or similar body of the issuer.
- Inquiring about the length of time that the issuer has been in business and whether the focus of its business is expected to change.

B. Issuer's Business Prospects

Reasonable investigations of the issuer's business prospects, and the relationship of those prospects to the proposed price of the securities being offered, might include:

- Inquiring about the viability of any patent or other intellectual property rights held by the issuer.
- Inquiring about the industry in which the issuer conducts its business, the prospects for that industry, any existing or potential regulatory restrictions on that business and the competitive position of the issuer.
- Requesting any business plan, business model or other description of the business intentions of the issuer and its management and their expectations for the business, and analyzing management's assumptions upon which any business forecast is based. A BD might test models with information from representative assets to validate projected returns, break-even points and similar information provided to investors.

- Requesting financial models used to generate projections or targeted returns.
- Maintaining in the BD's files a summary of the analysis that was performed on financial models provided by the issuer that detail the results of any stress tests performed on the issuer's assumptions and projections.

C. Issuer's Assets

Reasonable investigations of the quality of the assets and facilities of the issuer might include:

- Visiting and inspecting a sample of the issuer's assets and facilities to determine whether the value of assets reflected in the financial statements is reasonable and that management's assertions concerning the condition of the issuer's physical plants and the adequacy of its equipment are accurate.
- Carefully examining any geological, land use, engineering or other reports by third-party experts that may raise red flags.
- Obtaining, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others are necessary as a basis for determining the suitability of the investment prior to recommending the security to investors.

Endnotes

1 As a general matter, any reference in this *Notice* to the obligations of a BD firm is also intended to cover the concomitant responsibilities of any registered representative who recommends a Regulation D offering to his/her customers and any registered principal who is charged by his/her firm with supervising this registered representative.

2 Office of the Inspector General, Securities and Exchange Commission, *Regulation D Exemption Process 2* (March 31, 2009).

3 *See, e.g.*, Provident Asset Management, LLC, FINRA Case No. 2009017497201 (2010); *Pacific Cornerstone Capital, Inc.* FINRA AWC No. 2007010591701 (2009).

4 A note to Rule 502(b)(1) states that when an issuer provides required information to any non-accredited investor, it should consider providing the information to accredited investors, too, "in view of the anti-fraud provisions of the federal securities laws."

5 *See Hanly v. SEC*, 415 F.2d 589, 595-96 (2d. Cir. 1969); *SEC v. Great Lake Equities Co.*, 1990 U.S. Dist. LEXIS 19819 at *16-17 (E.D. Mich. 1990); *SEC v. North American Research and Development Corp.*, 424 F.2d 63,84 (2d Cir. 1970). *See also SEC v. Current Financial Services, Inc.*, 100 F. Supp. 2d 1, 14-15 (D.D.C. 2000); *District Business Conduct Committee for District No. 4 v. Everest Securities, Inc., 1994 NASD Discip. Lexis 188* (Sept. 2, 1994), *aff'd*, 52 S.E.C.

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Endnotes continued

958, 962-63 (Aug. 26, 1996), *aff'd*, 116 F. 3d 1235 (8th Cir. 1997); Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).

6 *Hanly, supra* note 5 at 597.

7 *See generally Hanly, supra* note 5.

8 *See Everest Securities, Inc*, supra note 5.

9 *See Hanly, supra* note 5. *See also University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976).

10 *Hanly, supra* note 5 at 597.

11 *University Hill Foundation, supra* note 9 at 898.

12 *See, e.g., SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS 16204 (S.D.N.Y. 2000), where the court held that the duty to independently investigate is greater "where promotional materials are in some ways questionable, for example by promising unusually high returns."

13 *See Hanly, supra* note 5 at 597 ("Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information"). *See also* Securities Act Release No. 4445, *supra* note 5; *Regulatory Notice 09-05* (Guidance to Member Firms Participating in Unregistered Resales of Restricted Securities) (January 2009).

14 *Hanly, supra* note 5 at 597. The duty of inquiry under the antifraud provisions is distinguished from the "reasonable investigation" that, under Section 11(b) of the Securities Act, permits an underwriter to escape liability for misrepresentations in a registration statement. Courts have compared the Section 11 reasonable investigation and the BD's general duty to investigate and concluded that "somewhat more is required of an underwriter than a broker to discharge its obligation to the investing public." *University Hill Foundation, supra* note 9 at 898-99. This is because "an underwriter's relationship to the issuer is more substantial" than a BD that is only recommending a security, and the underwriter "plays a more central role in the marketing process." *Id.*

15 *See Everest Securities, Inc.* v. US, supra note 5 at 1239 ("reliance on others does not excuse [the respondents] own lack of investigation").

16 *Everest Securities, Inc., supra* note 5 at 963.

17 *Everest Securities, Inc., supra* note 5 at 963.

18 *Hanly* at 596, *supra* note 5.

19 Note to Rule 502(b)(1).

20 FINRA has previously discussed the responsibilities of a BD to conduct a reasonable investigation of securities it is recommending. *See, e.g., Notice to Members 03-71* (concerning non-conventional investments)(November 2003); *Notice to Members 05-18* (concerning private placements of tenants-in-common interests) (March 2005).

21 *F.J. Kaufman & Co.*, 50 S.E.C. 164, 168-69 (Dec. 13, 1989). *See also In the Matter of Michael Frederick Siegel,* Securities Exchange Act Release No. 58737 (October 6, 2008), 2008 SEC Lexis 2459, at *28.

22 *See James B. Chase*, 56 S.E.C. 149, 159 (2003).

23 BDs should analyze whether the investor's money is likely to be applied according to the stated use of proceeds, and whether the stated use of proceeds is reasonable in light of the issuer's business purpose and prospects. *See In Re Brian Prendergast*, 2001 SEC LEXIS 1533 (August 1, 2001); *Legend Merchant Group, Inc.*, NASD No. C10030058, summarized in NASD Disciplinary Actions (July 2004); *Shelman Securities, Inc.*, NASD No. C06030013, summarized in NASD Disciplinary Actions (February 2004).

Endnotes continued

24 *See, e.g., Shelman Securities, supra* note 23 (private placement memoranda contained material misrepresentations and omissions about use of proceeds in a previous offering).

25 *See In the Matter of C. Gilman Johnston*, 42 S.E.C. 217 (Aug. 14, 1964) (broker-dealer's control person prepared memorandum describing broker-dealer's own "highly speculative" securities without any reasonable basis for believing that the securities were suitable for some purchasers). *See generally Pacific Cornerstone Capital, supra* note 3 at 10 (person providing information for and reviewing and approving private placement memorandum and sales literature was BD's control person and issuer's founder). Regulation D generally prohibits a broker or other person that is affiliated with the issuer from serving as a purchaser representative to an investor. *See* Rule 501(h)(1)(definition of "purchaser representative").

26 *Cf.* FINRA Rule 5122 (requiring members to comply with certain requirements when engaging in private placement of securities issued by the member or a control entity).

27 *SEC v. Kunz and Cline Investment Management, Inc.* Admin. Proc. File No. 3-9960, *aff'd* 2003 U.S. App. LEXIS 6011 (10th Cir. 2003) (unpublished opinion).

28 *Pacific Cornerstone Capital, Inc., supra* note 3.

29 *Everest Securities, Inc. v. SEC, supra* note 5 at 1239 (finding "the investigation that was performed was itself insufficient," and even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading).

30 *Kunz and Cline*, supra note 27.

31 *See Notice to Members 05-48* (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers) (July 2005) (discussing a member's accountability and supervisory responsibility for outsourced functions).

32 *Pacific Cornerstone Capital, Inc., supra* note 3 at 9.

EXHIBIT 5

Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors [1]

Introduction: The following is a staff bulletin styled as questions and answers reiterating the standards of conduct for broker-dealers and investment advisers when they are making account recommendations to retail investors.[2] Both Regulation Best Interest ("Reg BI") for broker-dealers and the fiduciary standard for investment advisers under the Investment Advisers Act (the "IA fiduciary standard") are drawn from key fiduciary principles that include an obligation to act in the retail investor's best interest and not to place their own interests ahead of the investor's interest. Although the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors.

This staff bulletin should be read in conjunction with, among other sources, the specific Commission releases discussing Reg BI and the IA fiduciary standard.[3] In addition, the staff has made available other resources, including a variety of staff FAQs addressing compliance with Form CRS, Reg BI and the IA fiduciary standard, risk alerts, and other statements highlighting relevant compliance practices and staff observations.[4]

This staff bulletin provides staff views on how broker-dealers, investment advisers, and their associated persons can satisfy their obligations to retail investors when making account recommendations. Selection of an account type is a consequential decision for retail investors and is associated with potentially significant conflicts of interest and raises particular issues for financial professionals operating within dually registered or affiliated firms, as well as dually licensed financial professionals.[5] This staff bulletin is designed to assist firms and their financial professionals with considering reasonably available alternatives and cost, addressing conflicts of interest, and adopting and implementing reasonably designed policies and procedures when making account recommendations.

Questions:

1. **Dually licensed financial professionals' obligations when recommending accounts to prospective retail investors.**
    a. **How do I know which standard to follow when making account recommendations?[6]**

Both Reg BI and the IA fiduciary standard require your account recommendations to be in the retail investor's best interest and require you not to place your or your firm's interests ahead of the retail investor's interest. The staff believes that, unless you obtain and evaluate sufficient information about a retail investor, you will not have the ability to form a reasonable basis to believe your account recommendations are in the retail investor's best interest.[7]

The standard you must follow depends on the capacity in which you are acting (*i.e.*, broker-dealer, investment

adviser, or both). In addition, the antifraud provisions of the Advisers Act apply to investment advisers in connection with current and prospective clients. Accordingly, in many cases, both Reg BI and the Advisers Act apply as you assess an account type recommendation for current and prospective retail investors.[8]

b. **Do I need to disclose my capacity under both Reg BI and the IA fiduciary standard when making a recommendation?**

Yes. Under Reg BI, when making an account recommendation, you must disclose all material facts relating to the scope and terms of your relationship with the retail investor, including the capacity in which you are acting. Investment advisers have a similar obligation under the duty of loyalty to disclose all material facts relating to the advisory relationship, including the capacity in which they are acting. Where you have not yet established the capacity in which you will be acting, you should assume that both standards apply[9] and disclose to the investor, prior to or at the time of the recommendation, that you are acting in both capacities. Firms should provide clear guidance, through policies and procedures and other instructions to their financial professionals, on how to disclose capacity to retail investors.

c. **Do I need to consider reasonably available alternatives when making account recommendations?**

Yes. Under both Reg BI and the IA fiduciary standard you may recommend an account to a retail investor only when you have a reasonable basis to believe that the account is in the retail investor's best interest. For example, if you are a dually licensed financial professional, you need to make a best interest evaluation taking into consideration the spectrum of accounts you offer (*i.e.*, both brokerage and advisory accounts, subject to any eligibility requirements such as account minimums).[10]

Moreover, you cannot recommend an account that is not in a retail investor's best interest solely based on your firm's limited product menu or arising from limitations on your licensing. Any limitations on account types considered, in the staff's view, are material facts that should be disclosed (along with other relevant material facts, including services, fees, and conflicts of interest) to retail investors.

2. **Factors to consider before making an account recommendation**[11]

Both Reg BI and the IA fiduciary standard require you to have a reasonable basis for an account recommendation, based on a reasonable understanding of the retail investor's investment profile and the account characteristics.

a. **What are examples of investor characteristics I should consider to have a reasonable basis to believe the recommendation is in the retail investor's best interest?**

As part of establishing a reasonable understanding of the retail investor's investment profile, the staff believes that you should consider, without limitation, the retail investor's: financial situation (including current income) and needs; investments; assets and debts; marital status; tax status; age; investment time horizon; liquidity needs; risk tolerance; investment experience; investment objectives and financial goals; and any other information the retail investor may disclose to you in connection with an account recommendation.[12] The staff also believes that you should consider, without limitation, the retail investor's: anticipated investment strategy (*e.g.*, buy and hold versus more frequent trading); level of financial sophistication; preference for making their own investment decisions or relying on advice from a financial professional; and the need or desire for account monitoring or ongoing account management.

You must, in any case, obtain and evaluate enough information about the retail investor to have a reasonable basis to believe the account recommendation is in the best interest of that retail investor and that your recommendation is not based on materially inaccurate or incomplete information.

b. **What if investor information is unavailable?**

Where investor information is unavailable despite your reasonable diligence, the staff believes you should

carefully consider whether you have a sufficient understanding of the investor to evaluate if any account recommendation is in that investor's best interest. The staff believes you will not be able to have a reasonable belief that an account recommendation is in an investor's best interest under Reg BI or the IA fiduciary standard without sufficient information about the retail investor and therefore should generally decline such account recommendations until you obtain the necessary investor information.[13]

c. **What are examples of account characteristics I should consider to have a reasonable basis to believe the account recommendation is in the retail investor's best interest?**

In order to establish a reasonable understanding of the characteristics of a particular type of account, the staff believes that you should consider, without limitation, factors such as the services and products provided in the account (including ancillary services provided in conjunction with an account type, account monitoring services, etc.); the projected costs to the retail investor; alternative account types available; and whether the account offers the services requested by the retail investor.[14] The staff believes that in assessing whether a particular account recommendation is in a retail investor's best interest, a financial professional also should consider whether these factors are consistent with the retail investor's investment profile and stated investment goals.

3. **Consideration of Costs in Account Recommendations**

a. **Are costs always a relevant factor to consider when making account recommendations?**

Yes, you must always consider cost as a factor when making an account recommendation.[15] While Reg BI and the IA fiduciary standard do not always obligate you to recommend the least expensive type of account, both require you to have a reasonable basis to believe that the account recommendation is in the retail investor's best interest and does not place your or your firm's interests ahead of the retail investor's interest. As discussed further below, if you recommend a higher cost account, you must have a reasonable basis to believe the account recommendation is nonetheless in the retail investor's best interest based on other factors and in light of the particular situation and needs of the retail investor. The Commission has pursued enforcement actions against investment advisers for recommending higher-cost products to clients when similar, lower-cost products were available.[16]

b. **What are examples of costs that I should consider when recommending an account?**

In the staff's view, you should consider the total potential costs when evaluating whether an account is in a retail investor's best interest, including indirect costs that could be borne by the retail investor.[17] Examples of costs can include account fees (*e.g.*, asset-based, engagement, hourly), commissions and transaction costs (*e.g.*, markups and markdowns), tax considerations, as well as indirect costs, such as those associated with payment for order flow and cash sweep programs. When applicable, cost of an account also includes fees associated with the investment products that are available through the account, such as the internal expenses of funds, including management fees, distribution and servicing fees, and the costs of investing in funds, including front-end and back-end fees. The effect of certain costs, such as distribution and servicing fees and transaction costs related to purchasing fund shares, may depend on the investor's anticipated investment horizon. In these cases, you should consider the potential impact of those costs on the investor's account based on an understanding of that horizon.

c. **What are examples of other factors that may be considered alongside cost?**

As discussed above, you must have a reasonable basis for believing the account recommendation is in the retail investor's best interest. Some examples of factors, alongside cost, that you may consider can include the investor's need for certain services or certain types of investment products or strategies that are only available in certain account types; the account's characteristics, including any special or unusual features requested by the retail investor, such as tax advantages; potential benefits and risks;[18] time horizon; and anticipated

composition of investments in the investment account. The existence of special features or other potential benefits would not alone support a reasonable belief that an account recommendation is in an investor's best interest. Rather, such factors should be considered in light of the investor's needs, investment objectives, and preferences, and your account recommendation must not place your interests or the interests of your firm ahead of the retail investor's interest. It is the staff's view that it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for such conclusions.

4. **Retirement Account Rollover Recommendations[19]**

    a. **Are there additional factors that I should consider when making a rollover recommendation in order to have a reasonable basis to believe the recommendation is in the retail investor's best interest?**

Yes. When making a rollover recommendation to a retail investor, you must have a reasonable basis to believe both that the rollover itself and that the account being recommended are in the retail investor's best interest. In addition to the factors discussed above, the staff believes that there are specific factors potentially relevant to rollovers that you should generally consider when making a rollover recommendation to a retail investor. These factors include, without limitation, costs; level of services available; features of the existing account, including costs; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; and holdings of employer stock.[20]

As with account recommendations more generally, relevant factors should be considered in light of, among other things, the retail investor's investment profile to develop a reasonable belief that the retirement account or rollover recommendation is in the retail investor's best interest.[21] In the staff's view, when making a rollover recommendation, it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for the recommendation.

In addition to Reg BI and the IA fiduciary standard, some rollovers also are subject to regulation by the Department of Labor. If you are relying on Prohibited Transaction Exemption 2020-02 ("PTE 2020-02"), you may want to review guidance from the Department of Labor on factors to consider in making a rollover recommendation, as well as relevant documentation requirements.[22]

    b. **When considering a rollover recommendation, do I have to consider the option of leaving the retail investor's investments in the employer's plan?**

As discussed above, you must have a reasonable basis to believe that an account recommendation is in the retail investor's best interest and does not place your or your firm's interests ahead of the retail investor's interest. In the staff's view, it would be difficult to form a reasonable basis to believe that a rollover recommendation is in the retail investor's best interest and does not place your or your firm's interests ahead of the retail investor's interest, if you do not consider the alternative of leaving the retail investor's investments in their employer's plan, where that is an option. To evaluate any recommendation to transfer assets out of an employer's plan, or between individual retirement accounts, you would need to obtain information about the existing plan, including the costs associated with the options available in the investor's current plan.[23]

5. **If a retail investor expresses a preference for a particular type of account, would making an account recommendation on the basis of that preference satisfy the standards?**

No. Although the retail investor's preference should be considered, you would not satisfy the standards based on the retail investor's preference alone. For example, a retail investor may express a preference for a brokerage account during an initial conversation, but may not fully understand what the differences between brokerage and advisory accounts actually are in terms of costs and available products and services. As stated above, when making an account recommendation to a retail investor, you must have a reasonable basis to

believe that the recommendation is in the retail investor's best interest based on, among other things, a reasonable understanding of the retail investor's investment profile and the account characteristics. Where a retail investor expresses a preference for a particular type of account, the staff believes that factor should be considered. You would not, however, be relieved of the obligation to consider reasonably available alternatives and recommend an account you reasonably believe is in the retail investor's best interest.

In the staff's view, however, if the retail investor ultimately directs you to open an account that is contrary to your recommendation, you would not be required to refuse to accept the investor's direction.[24] In such instances, the staff believes that it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for opening the account.

6. **Should firms document the basis for the account that was recommended to a retail investor?**

Broker-dealers and investment advisers are subject to recordkeeping rules that may affect their decisions or obligations to document the basis for account recommendations.[25] Additionally, in the staff's view, it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for certain recommendations.[26] Reg BI's Compliance Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. Similarly, the Advisers Act compliance rule requires investment advisers registered or required to be registered under the Advisers Act to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, which include preventing breaches of the IA fiduciary standard in violation of section 206 of the Advisers Act.[27]

7. **What are some examples of practices that can assist firms in meeting their obligations to address conflicts of interest associated with account recommendations?**

Both Reg BI and the IA fiduciary standard require firms to act in the retail investor's best interest and not place the firm's interests ahead of the retail investor's interest. The following is a non-exhaustive list of practices that can help firms meet their obligations with respect to conflicts of interest associated with account recommendations:

- Avoid compensation thresholds that disproportionately increase compensation through openings of certain account types;
- Adopt and implement policies and procedures reasonably designed to minimize or eliminate incentives, including both compensation and non-compensation incentives, for employees to favor one type of account over another;
- Implement supervisory procedures to monitor recommendations that involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA); and
- Adjust compensation for financial professionals who fail to adequately manage conflicts of interest associated with account recommendations.[28]

In the staff's view, firms should exercise particular care when creating incentives that could have the effect of encouraging account recommendations that would place the interests of the firm or financial professional ahead of the interest of the retail investor. The staff strongly encourages firms to eliminate or mitigate any incentive that poses a risk of causing the firm or its financial professionals to place their interests ahead of the retail investor's interest. The Commission has previously brought a settled enforcement action in connection with compensation incentives for financial professionals making account recommendations.[29]

[1] This staff bulletin represents the views of the staff of the Securities and Exchange Commission ("Commission") and is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved this staff bulletin. The staff bulletin, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

[2] For the purposes of this staff bulletin, we use the term "retail investor" to mean any person who qualifies as a "retail customer" as defined in Exchange Act rule 15*l*-1(b)(1), or a natural person client of an investment adviser.

[3] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 FR 33318 (June 5, 2019) ("Reg BI Adopting Release"); Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669 (June 5, 2019) ("Fiduciary Interpretation").

[4] *See* SEC Spotlight, Regulation Best Interest, Form CRS and Related Interpretations, *available at* https://www.sec.gov/regulation-best-interest.

[5] For the purposes of this staff bulletin, we use the term "dually licensed financial professional" to mean any natural person who is both an associated person of a broker-dealer registered under Exchange Act § 15, as defined in Exchange Act § 3(a)(18), and a supervised person of an investment adviser registered under Advisers Act § 203, as defined in Advisers Act § 202(a)(25).

[6] *See also* Frequently Asked Questions on Regulation Best Interest ("Reg BI FAQs") (discussing how to determine capacity in which a dual-registrant is making a recommendation), *available at* https://www.sec.gov/tm/faq-regulation-best-interest#care.

[7] In the staff's view, because each standard is drawn from key fiduciary principles, you should generally collect similar information, perform a similar analysis, and arrive at a similar conclusion about which account type(s) would be in the retail investor's best interest, regardless of the capacity that you end up serving in. *See supra* note 3. Under Reg BI, broker-dealers must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. *See* Reg BI Adopting Release, *supra* note 3, at 33379. For investment advisers, the duty to provide advice that is in the best interest of the client based on a reasonable understanding of the client's objectives and a reasonable investigation into the investment is a critical component of the duty of care, which includes obtaining a range of personal and financial information about the client. *See* Fiduciary Interpretation, *supra* note 2, at nn. 35-36 and accompanying text.

[8] Fiduciary Interpretation, *supra* note 3, at n. 44 (citing Reg BI Adopting Release).

[9] *See supra* note 6.

[10] *See also supra* note 6 (discussing account recommendation considerations for dually registered financial professionals and a financial professional only registered as an associated person of a broker-dealer, where the firm is a dual registrant), *available at* https://www.sec.gov/tm/faq-regulation-best-interest#recommendation. In addition to the financial professional's obligations, the staff also reminds firms that they too have related obligations under Reg BI and the Advisers Act, including, for example, the obligation to adopt and implement reasonably designed policies and procedures to comply with Reg BI, in the case of brokers-dealers, and to prevent violations of the Advisers Act and the rules issued thereunder, in the case of investment advisers registered or required to be registered.

[11] These factors are not meant to be exhaustive, and their relative importance will vary depending on the particular facts and circumstances of each recommendation. The relevant factors should be considered with respect to the particular retail investor to whom the account recommendation is being made before either a financial professional or the financial professional's firm can form a reasonable belief that the account (or, if the

financial professional is recommending both a brokerage and advisory account, the accounts) they recommend would be in the retail investor's best interest and does not place the interests of the firm or financial professional ahead of the interest of the retail investor.

[12] *See* Reg BI Adopting Release, *supra* note 3, at 33492; Fiduciary Interpretation, *supra* note 3, at 33673.

[13] If you determine not to obtain or evaluate information that would normally be contained in an investor profile, the staff believes you should consider documenting the basis for your belief that such information is not relevant in light of the facts and circumstances of the particular account recommendation.

[14] *See* Reg BI Adopting Release, *supra* note 3, at 33382-83.

[15] *See* Exchange Act rule 15*l*-1(a)(2)(ii) (explicitly requiring consideration of cost under Reg BI's Care Obligation); *see also* Fiduciary Interpretation, *supra* note 3, at 33674 (noting that cost would generally be one of many important factors to consider when determining if a security or investment strategy is in the client's best interest).

[16] *See* In the Matter of Centaurus Financial, Inc., Investment Advisers Act Release No. 5744 (June 2, 2021), *available at* https://www.sec.gov/litigation/admin/2021/34-92095.pdf (settled action); In the Matter of Cowen Prime Advisors, LLC, Investment Advisers Act Release No. 5874 (Sept. 27, 2021), *available at* https://www.sec.gov/litigation/admin/2021/ia-5874.pdf (settled action); In the Matter of O.N. Investment Management Company, Investment Advisers Act Release No. 5944 (Jan. 11, 2022), *available at* https://www.sec.gov/litigation/admin/2022/ia-5944.pdf (settled action); In the Matter of Rothschild Investment Corp., Investment Advisers Act Release No. 5860 (Sept. 13, 2021), *available at* https://www.sec.gov/litigation/admin/2021/34-92951.pdf (settled action).

[17] *See supra* note 15.

[18] Under Reg BI, broker-dealers must consider potential risks, rewards, and costs associated with a recommendation in light of a retail customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. *See* Reg BI Adopting Release, *supra* note 3, at 33321.

[19] The staff of the Division of Trading and Markets also has published an FAQ regarding the roll over or transfer of assets more generally under Reg BI, such as from a brokerage account to an advisory account. *See* Reg BI FAQs, *supra* note 6, *available at* https://www.sec.gov/tm/faq-regulation-best-interest#care.

[20] *See* Reg BI Adopting Release, *supra* note 3, at 33383.

[21] For example, the Commission has cautioned broker-dealers not to rely on an IRA having "more investment options" as the basis for recommending a rollover. *See id*.

[22] *See* Prohibited Transaction Exemption 2020–02, Improving Investment Advice for Workers & Retirees, 89 Fed. Reg. 82798, (Dec. 18, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-18/pdf/2020-27825.pdf.; *see also* New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers & Retirees Frequently Asked Questions (Department of Labor), *available at* https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/new-fiduciary-advice-exemption.pdf.

[23] The staff believes that a financial professional should take all reasonable efforts to obtain such information, which may include requesting the information from the retail investor or the investor's agent.

[24] Reg BI does not apply to a retail investor's selection of an account without a recommendation by a broker-dealer, regardless of whether the retail investor also receives recommendations of transactions from the broker-dealer that are subject to Reg BI.

[25] *See* Exchange Act rule 17a-4 (requiring broker-dealers to preserve, among other records, all

communications sent or received relating to the firm's business, including written communications with retail customers); Exchange Act rule 17a-3(a)(35)(i) (requiring broker-dealers to keep a record of all information collected from and provided to the retail customer pursuant to Reg BI, as well as the identity of each person who is an associated person responsible for the account); and Advisers Act rule 204-2(a)(7) (requiring investment advisers registered or required to be registered to retain all written communications related to any recommendation made or proposed to be made and any advice given or proposed to be given).

[26] In adopting Reg BI, the Commission determined not to require broker-dealers to document the basis for any recommendations, but encouraged them to take a risk-based approach when deciding whether to document certain recommendations. *See* Reg BI Adopting Release, *supra* note 3, at 33360. The Commission has not specifically addressed such documentation for investment advisers.

[27] In addition, in complying with Advisers Act compliance rule, investment advisers registered or required to be registered should adopt policies and procedures addressing the maintenance of required records, which include records related to the adviser's recommendations and investment advice. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003); *see also* Advisers Act rule 204-2(a)(7).

[28] The staff notes that certain of these practices are required under Reg BI and the Advisers Act. *See, e.g.,* Exchange Act rule 15*l*-1(a)(2)(iii) (requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to disclose and mitigate (i.e., reasonably reduce), or eliminate, certain conflicts); Reg BI Adopting Release, *supra* note 3, at 33391 (providing guidance on mitigation methods); Advisers Act rule 206(4)-7 (requiring any investment adviser registered or required to be registered under the Advisers Act to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons). *Cf. also* Fiduciary Interpretation, *supra* note 3, at 33676-78 ("In all of these cases where an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.").

[29] *See* In the Matter of TIAA-CREF Individual & Institutional Services, LLC, Investment Advisers Act Release No. 5772 (July 13, 2021), *available at* https://www.sec.gov/litigation/admin/2021/33-10954.pdf (settled action).

Modified: March 30, 2022

EXHIBIT 6

Regulatory Notice 23-08

Private Placements

FINRA Reminds Members of Their Obligations When Selling Private Placements

May 9, 2023

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Compliance Programs
- Corporate Financing
- Private Placements
- Regulation Best Interest
- Supervision

Referenced Rules & Notices
- FINRA Rules 2010, 2020, 2111, 2210, 3110, 3120, 3280, 5122 and 5123
- JOBS Act
- Notice to Members 01-23
- Regulatory Notices 10-22, 11-02, 12-25, 16-08, 20-18, 20-21, 21-26 and 23-09
- Regulation Best Interest
- Regulation D
- Securities Act Sections 3, 4 and 17(a)
- Securities Exchange Act Section 10(b)
- Securities Exchange Act Rule 10b-5
- Securities Exchange Act Rule 10b-9
- Securities Exchange Act Rule 15c2-4

Summary

In this *Notice*, FINRA reminds members of their obligations when selling private placements (*i.e.,* unregistered offerings sold pursuant to the Regulation D safe harbors under Sections 3 and 4 of the Securities Act of 1933 (Securities Act)). In *Regulatory Notice 10-22* (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings), FINRA reminded members of their obligations to conduct reasonable investigations of the issuers and the securities they recommend in private offerings made under Regulation D. In the years since FINRA published *Regulatory Notice 10-22*, the unregistered offering market and the related regulatory landscape have evolved, and FINRA has observed both areas of concern and effective practices in the sales of private placements by members. This *Notice* updates and supplements the prior guidance in light of those developments and observations. It is not intended to alter the principles or the guidance FINRA provided in prior *Regulatory Notices*.

This *Notice* highlights a member's obligation, when recommending a security, to conduct a reasonable investigation of the security. This duty has long been rooted in the antifraud provisions of the federal securities laws and is a core component of a broker-dealer's obligations under Securities and Exchange Commission (SEC) Regulation Best Interest (Reg BI) and FINRA Rule 2111 (Suitability), the fundamental standards that members must meet when recommending securities.[1] This *Notice* also addresses certain additional obligations for members when selling private placements, including FINRA's filing requirements and its communications with the public and supervision rules.

This *Notice* does not create new legal or regulatory requirements or new interpretations of existing requirements, nor does it relieve firms of any existing obligations under federal securities laws and regulations. Members may consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member's size and business model.

FINRA notes that it is issuing a companion notice, *Regulatory Notice 23-09*, requesting comment on whether changes to FINRA rules, operations or administrative processes would enhance the capital-raising process without compromising protections for investors and issuers.[2] FINRA encourages members to provide feedback pursuant to that *Notice*.

Questions regarding this *Notice* should be directed to:

- Minh Le, Senior Director, Corporate Financing, at minh.le@finra.org or (240) 386-4638;
- Janet Boysen, Associate Director & Counsel, Corporate Financing, at janet.boysen@finra.org or (240) 386-5101;
- James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at jim.wrona@finra.org or (202) 728-8270;
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- Alicia Goldin, Associate General Counsel, OGC, at alicia.goldin@finra.org or (202) 728-8155;
- Scott Maestri, Examination Director, Member Supervision, at scott.maestri@finra.org or (972) 716-7634; or
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Background and Discussion

Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available.[3] Private placements are unregistered, non-public securities offerings that rely on an available exemption from registration with the SEC under either Section 3 or 4 of the Securities Act.[4] This *Notice* principally focuses on private placements sold pursuant to the Regulation D safe harbors under Sections 3 and 4 of the Securities Act (*i.e.,* Rules 504, 506(b) and 506(c)).[5]

Part I of this *Notice* provides an overview of developments in the unregistered offering market generally. Part II discusses members' regulatory requirements when participating in private placements. It focuses primarily on members' critical role, when recommending private placements, in performing reasonable investigations under the reasonable basis obligations of Reg BI, the suitability rule and caselaw interpreting the antifraud provisions of the federal securities laws. Part II also examines key member obligations applicable to private placement activity irrespective of whether recommendations are involved. For instance, Part II discusses FINRA's filing requirements for private placement memoranda (PPMs)

and related documents, as well as FINRA's communications with the public and supervision rules, including the duty to investigate and act upon "red flags" revealing irregularities or potential misconduct.

Part III discusses practices FINRA has observed since *Regulatory Notice 10-22* was published that members have adopted to address their reasonable investigation obligations and related supervisory obligations when recommending private placements. These practices are examples of potentially effective measures for compliance with regulatory requirements that FINRA has observed in private placement examinations and through feedback provided by members in a recent private placement survey.[6] They add to those practices highlighted in *Regulatory Notice 10-22*.

I. Developments in Unregistered Offerings

The unregistered offering market is an important source of capital for American businesses, including small and midsize companies. In recent years, the unregistered offering market outpaced the public market. According to SEC analysis, in 2019, 69 percent of new capital ($2.7 trillion) was raised through unregistered offerings, compared to 31 percent ($1.2 trillion) through registered public offerings.[7] The amount of capital raised in Regulation D offerings alone more than doubled from 2009 to 2019.[8]

The majority of Regulation D offerings are sold directly by issuers without any broker-dealer involvement. Approximately 20 percent of Regulation D offerings involve "intermediaries," such as broker-dealers.[9] Thus, only a small percentage of investors in private placements are afforded the protections of FINRA rules and other relevant broker-dealer regulations that apply when a Regulation D offering involves a member.

However, member involvement in private placements has kept pace with the growth of the Regulation D market in general. In 2021, for example, members submitted over 3,800 unique filings for private placements pursuant to FINRA Rules 5122 and 5123, which require filings for private placements generally sold to individuals, in comparison to roughly 2,000 submissions in 2013.[10]

The growth of the unregistered market is due in part to legislative and regulatory developments that reduced barriers to capital formation. The Jumpstart Our Business Startups (JOBS) Act of 2012 required the SEC to eliminate the prohibition on general solicitation in Rule 506 offerings under Regulation D, lifting a significant restriction on the manner in which a private offering may be sold, among other initiatives to promote capital formation.[11] In recent years, the SEC also revised its rules to facilitate intrastate offerings, increased the offering limits for certain exempt offerings and established consistent guidelines across the exempt offering

framework.[12] These measures were part of a larger effort by the SEC and Congress to reduce restrictions and provide issuers with capital-raising alternatives to public offerings.[13]

While these changes and the growth of the unregistered offering market have increased funding opportunities for issuers (in particular, small and midsize businesses) and investment options for investors, private offerings may present certain risks to investors. These risks include, for many private placements, their illiquid nature, the lack of access to comprehensive information with which to value the securities or a transparent market to set the market price, the absence of substantial operating histories, and the lack of independently audited financial statements.

In contemplation of such risks, the SEC and Congress also imposed measures to reduce risk to investors in recent years. These include, among other things, adopting "bad actor" disqualification provisions[14] and requiring verification of accredited investor status for offerings that involve general solicitation.[15] In addition, as discussed below, with the adoption of Reg BI, the SEC enhanced the broker-dealer standard of conduct beyond existing suitability obligations and imposed new investor protection obligations on members and their associated persons when they recommend securities, including private placements, to retail customers.

II. Member Regulatory Requirements for Private Placements

Members that participate in private placements are subject to important regulatory obligations that help ensure the protection of investors and maintain confidence in the marketplace, thereby ultimately benefiting capital formation. While key obligations are highlighted below, depending on the facts and circumstances, additional requirements could apply.[16]

A. Requirements Applicable When Recommending Private Placements—Best Interest and Suitability

Among the regulatory developments since the publication of *Regulatory Notice 10-22* was the SEC's adoption of Reg BI, which requires a member or associated person, when making a recommendation[17] of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer,[18] to act in the best interest of the retail customer without placing the financial or other interest of the member or associated person ahead of the interest of the retail customer.[19] This general obligation is satisfied only by complying with four specified component obligations: the Care Obligation, the Disclosure Obligation, the Conflict of Interest Obligation and the Compliance Obligation.

Reg BI's Care Obligation incorporates and builds on broker-dealers' longstanding suitability obligations, and like FINRA Rule 2111 (Suitability), it includes reasonable basis, customer specific and quantitative components.[20] Members and their associated persons must comply with Reg BI when recommending private placements to retail customers, and with FINRA Rule 2111 when recommending private placements to non-retail customers.

Reasonable Basis Obligations and the Duty to Conduct a Reasonable Investigation

FINRA Rule 2111 and Reg BI each require a member or associated person that recommends a private placement to have a reasonable basis for that recommendation.

FINRA's reasonable basis obligation requires a member or associated person, when recommending a security, to perform reasonable diligence to understand the nature of the security, as well as the potential risks and rewards, and to determine whether the recommendation is suitable for at least some customers based on that understanding.[21]

Similarly, the SEC's Reg BI Care Obligation requires that the member or associated person undertake reasonable diligence, care and skill to understand the nature of the recommended security or investment strategy involving a security—as well as the potential risks, rewards and costs[22] of the recommended security or investment strategy—and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding.[23]

To fulfill these reasonable basis obligations, a member or associated person must conduct a reasonable investigation of any security or investment strategy involving a security it recommends.[24] This duty, which also has long been recognized by the SEC and federal courts under the antifraud provisions of the federal securities laws,[25] originally emanated from the broker's "special relationship" to the customer and from the fact that, in recommending the security, the broker represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[26]

What constitutes a reasonable investigation depends on the facts and circumstances.[27] As the duty has been applied under the antifraud provisions, certain guiding principles have emerged.[28] Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer.[29] For example, a more thorough investigation is required for "securities issued by smaller companies of recent origin,"[30] which could include many private placement issuers. There is no hard and fast rule as to what a broker must do to meet this responsibility, but the presence of "red flags" should alert the broker to the need for further inquiry.[31]

Regulatory Notice 10-22 explained that a member or associated person recommending a private placement should, at a minimum, conduct a reasonable investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made; and
- the intended use of proceeds of the offering.[32]

While these areas of review continue to be essential to a reasonable investigation, since FINRA published *Regulatory Notice 10-22*, FINRA has observed, through its examinations[33] and disciplinary actions,[34] other areas in which some members' investigations into private placements could be strengthened. Based on these observations, as part of a reasonable investigation of a private placement, members should also consider addressing, where relevant, the following:

- Regulatory and litigation history of the issuer and its management, including the criminal, disciplinary, regulatory, and litigation history associated with the issuer, its management, and any affiliate that may be materially involved in the issuer's business, as well as the issuer's compliance with the bad actor provisions under Rule 506(d)–(e).[35]
- New material developments, including events that are or should be reasonably known to the member during an offering, for example, when there are ongoing legal proceedings or regulatory inquiries involving the issuer.
- Transactions or payments between an issuer and the issuer's affiliates involving offering proceeds, including the terms of the transaction between the related parties and whether an arrangement presents a material conflict of interest for the issuer and, if so, the sufficiency of disclosure.
- Representations of past performance of the issuer, its sponsor, or its manager to identify any such representations that may be misleading or exclusively selected based on positive results (or "cherry-picking"). This is particularly important when the representations pertain to specific prior issuances.

While members are not expected to have the same knowledge as an issuer or its management, FINRA reminds members of the importance of conducting a reasonable investigation that independently verifies an issuer's material representations and claims, particularly when the member or its associated persons are affiliated with the issuer or when red flags are present.[36] A member's independent analysis of the offering should not rely solely upon representations made by the issuer or its affiliates.

Often, members rely on information provided by a third party hired by the member or the issuer. Appraisers, attorneys and due diligence experts may provide valuable assistance to a member in fulfilling its reasonable investigation obligations. However, the member should review the information from these sources with reasonable care, considering the independence, incentives and qualifications of the third party.[37] This is particularly important with regard to third parties hired by the issuer.[38]

A member may demonstrate that it has conducted a reasonable, independent investigation by:

- Documenting the inquiries, research, and analysis that the member conducted.
- Obtaining additional information from an issuer, such as primary documents, to perform an independent analysis of issuer representations.[39] For example, if the PPM contains a representation concerning the contracts or permits the issuer has in place, a reasonable independent review may involve obtaining and reviewing copies of the contracts or permits.[40]
- Critically analyzing third-party due diligence reports. When a member encounters red flags through its own review, the member must address those issues prior to recommending the offering.[41] For instance, where a due diligence report contains inconsistencies or inadequately addresses potential concerns, a member should obtain a more thorough explanation of the issue from the source of the report or by independently researching the matter.[42]

FINRA also cautions members to consider the impact an issuer's timeline for the offering may have on the quality or thoroughness of the member's reasonable investigation. For example, it may raise a concern if an issuer or managing members condition a selling member's participation in the offering on a selling schedule that does not accommodate sufficient time for the member to complete a reasonable investigation.

Finally, while in practice members often take on the operational responsibility for gathering and analyzing reasonable investigation materials to approve an offering, associated persons should be mindful that they, themselves, have an independent obligation to satisfy Reg BI or Rule 2111 when making recommendations.[43]

Customer-Specific Obligations

When members or associated persons recommend a private placement, they also have customer-specific obligations under FINRA's suitability rule and Reg BI's Care Obligation.[44]

Under FINRA Rule 2111, 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.[45]

Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors only if certain conditions are satisfied relating to the investors' capability to evaluate the risks, and the investors affirmatively indicating that they are exercising independent judgment.[46]

The customer specific component of Reg BI's Care Obligation requires the member or associated person to exercise reasonable diligence, care and skill to have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation and does not place the financial or other interest of the member or associated person ahead of the interest of the retail customer.[47]

As part of this requirement under Reg BI, members must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. Where retail customer information is unavailable despite a member's reasonable diligence, the member should carefully consider whether it has a sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the best interest of that retail customer.[48]

SEC staff guidance under Reg BI concerning risky or complex products (including private placements) provides that members and their financial professionals generally should apply heightened scrutiny to whether a risky or complex product is in the retail customer's best interest.[49] Among the relevant considerations when recommending such a product is whether the retail customer "has an identified, investor-specific trading objective that is consistent with the product's description in its prospectus or offering documents, and/or has the ability to withstand heightened risk of financial loss."[50]

In addition, a member or associated person should consider "reasonably available alternatives" offered by the member as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the retail customer.[51] For complex or risky products (including private placements), this involves considering whether lower risk or less complex options can achieve the same investment objectives.[52]

Other Reg BI Component Obligations

As noted above, Reg BI's general obligation is satisfied only by complying with four specified component obligations. In addition to the Care Obligation, Reg BI also has the following component obligations: Disclosure, Conflict of Interest and Compliance.

The Disclosure Obligation requires the member or associated person, prior to or at the time of the recommendation, to provide the retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer and all material facts relating to conflicts of interest that are associated with the recommendation.[53] Material facts relating to the scope and terms of the relationship with the retail customer that must be disclosed include, but are not limited to: (1) the capacity in which the broker-dealer is acting; (2) the material fees and costs that apply to the retail customer's transactions, holdings and accounts; and (3) the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer. Importantly, disclosure of conflicts of interests alone does not satisfy the obligation to act in the retail customer's best interest.[54]

The Conflict of Interest Obligation requires a member to identify and address conflicts of interest that may incline the member or its associated persons—consciously or unconsciously—to make a recommendation that is not disinterested.[55] Specifically, members must establish, maintain and enforce written policies and procedures reasonably designed to:

- identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate, all conflicts of interest associated with recommendations;
- identify and mitigate any conflicts of interest associated with recommendations that create an incentive for the member's associated persons to place their interest or the interest of the member ahead of the retail customer's interest;
- identify and disclose any material limitations (*e.g.,* a limited product menu) placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations and prevent such limitations and associated conflicts of interest from causing the member or the associated person to make recommendations that place the interest of the member or the associated person ahead of the retail customer's interest;[56] and
- identify and eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

This process "should not be merely a 'check-the-box' exercise, but a robust, ongoing process that is tailored to each conflict[,]" including those regarding relationships with affiliates or third parties.[57]

Conflicts may be of particular concern when members recommend to retail customers private placements of securities issued by an affiliated company. However, even where the securities are not issued by an affiliated company, conflicts can arise from a close relationship with the issuer, including when a member engages in other activities for or with the issuer or when an associated person separately may be connected to the issuer. Moreover, there are conflicts inherent in any recommendation of securities, including private placements, based on the potential or actual receipt of compensation, revenue or other benefits (financial or otherwise) that must be addressed in accordance with the rule.[58]

Finally, under the Compliance Obligation, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.[59] SEC staff guidance concerning complex and risky products (including private placements) suggests, among other things, that firms should consider developing procedures outlining the due diligence process for complex or risky financial products to help ensure that these products are assessed by qualified and experienced firm personnel, and should consider establishing procedures requiring appropriate training and supervision to help ensure financial professionals understand the features, risks and costs of a complex financial product.[60] The guidance suggests, moreover, that members should consider documenting the process and reasoning behind particular recommendations of complex or risky products, including consideration of less complex alternatives, and how it fits within the retail customer's broader goals or strategy.[61]

Of course, even if a member complies with its Disclosure, Conflict of Interest, and Compliance Obligations, "it has not fully complied with Reg BI unless it has also satisfied the Care Obligation," discussed above, including the requirement "to have a reasonable basis to believe that each recommendation or series of recommendations made is in the best interest of the particular retail customer and does not place their financial or other interests ahead of the interest of the retail customer."[62] For example, some members that offer private placements may materially limit their product offerings. FINRA reminds such members that even if they have disclosed and taken steps to prevent the limitation from placing the interests of the member ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligations, they cannot use their limited menu to justify recommending a private placement that does not satisfy the obligation to act in a retail customer's best interest.[63]

B. Other Requirements Applicable to Private Placements

Members are subject to important obligations even in the absence of a recommendation. Some key requirements for members and associated persons engaged in private placement activities are highlighted below. Members and associated persons should keep in mind, however, that this list is not exhaustive.

Communications with the Public

Under FINRA rules, offering materials will be considered a communication with the public for purposes of FINRA Rule 2210 (Communications with the Public) if the member was involved in preparing the materials. If a PPM or other offering document presents information that is not fair and balanced or that is misleading, then the member that assisted in its preparation may be found to have violated FINRA Rule 2210.[64] Moreover, sales literature concerning a private placement that a member distributes generally constitutes a communication by that member with the public, whether or not the member assisted in its preparation.[65] In 2020, FINRA published *Regulatory Notice 20-21* to help member firms comply with FINRA Rule 2210 when creating, reviewing, approving, distributing or using retail communications concerning private placement offerings.

FINRA has brought enforcement actions under the federal securities laws and FINRA rules against members and associated persons in matters involving private offerings containing materially misleading information.[66] In one case, for example, a FINRA hearing panel found that a member affiliated with the issuer helped prepare the PPM and, because of its inside knowledge, had the ability to approximately calculate the issuer's costs related to drilling operations.[67] The panel found the member violated Securities Exchange Act of 1934 (Exchange Act) Rule 10b-5 and FINRA Rule 2020 for recommending a private placement using a PPM that inaccurately stated that the costs related to the drilling operations could not be reasonably predicted.[68]

Private Placement Filings with FINRA

FINRA Rule 5122 imposes disclosure and filing requirements for members that sell a private placement of securities issued by a member or a control entity.[69] Its companion rule, FINRA Rule 5123, requires members that sell any other type of private placement to file a copy of any offering documents with FINRA within 15 calendar days of the first sale, subject to various exemptions.[70] Both Rules 5122 and 5123 require filings to include retail communications used by the member that promote or recommend the private placement.[71]

Pursuant to Rules 5122 and 5123, FINRA requires members to submit a form that contains information about the member selling the private placement securities, the issuer and the offering terms as well as any offering documents, if applicable, electronically through the FINRA Gateway (the Filer Form). FINRA uses the information in the Filer Form to conduct oversight on particular areas of risk in the private placement market and enhance investor protection.

Supervision

Under FINRA Rule 3110, a member must establish and maintain a system to supervise the activities of each associated person, and must establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with FINRA rules.[72] In the context of private placements, these procedures must be reasonably designed to ensure that each private placement offering is properly supervised before it is marketed to other members or sold directly to customers.[73] Moreover, as has long been the case under Rule 3110 (and its predecessor), if a member were faced with "red flags" revealing irregularities or potential misconduct, including with regard to private placements, the member must investigate and act upon them.[74]

To meet their supervisory obligations, members may need to periodically update their written supervisory procedures, supervisory systems and training programs to keep pace with regulatory and business developments.[75] For example, members may need to update their procedures to incorporate SEC staff guidance on Reg BI,[76] changes to the member's business activities and customer base or to strengthen practices in areas of known concern.

Private Securities Transactions

At times, private placements are sold by an associated person outside of his or her relationship with the member. These are considered to be private securities transactions (PSTs). FINRA Rule 3280 requires that the associated person provide written notice to and receive written approval from the member when the transaction involves selling compensation. If the member approves a person's participation in the PST for compensation, the transaction must be recorded on the books and records of the member and the member must supervise the person's participation in the transaction as if the transaction were executed on behalf of the member. When recommending a private placement security in a PST to a retail customer, the associated person also must comply with the rules applicable to recommendations of securities, including Reg BI.

III. Effective Practices Relating to Reasonable Investigation and Related Supervisory Practices

A member's reasonable investigation of a recommended private placement will yield an understanding of the issuer and its prospects and reflect the member's reasonable analysis of the offering documents and the representations made to customers. *Regulatory Notice 10-22* provides examples of practices that some members adopted to help them adequately discharge their responsibilities in these areas. FINRA has observed the following additional practices from its private placement examination findings and through feedback received from its survey of members.[77]

A. Offering-Specific Investigations

A member's process for conducting a reasonable investigation of a private placement should include attention to the unique facts and circumstances of the offering. A reasonable investigation process might include:

- Reviewing the offering terms to determine if they are reasonably structured for compliance with applicable rules. For example, analyzing the escrow arrangements and termination provisions in contingency offerings as required under Rules 10b-9 and 15c2-4 of the Exchange Act.[78]
- Maintaining contact with the issuer. The vast majority of members surveyed stated that as a matter of practice they always or frequently maintain regular contact with the issuer to obtain updates on developments.
- Applying a heightened analysis when recommending an investment that involves complex features or unique benefits to investors. For example, where potential tax benefits are a critical component of an investment, many members take additional steps to understand the relevant tax requirements, the risks associated with the complex tax strategies, legal implications, valuation methodologies, or other unique factors.[79]
- Maintaining an updated due diligence file, for example, when recommending securities in follow-on offerings by the same issuer or sponsor in order to have a reasonable basis to recommend the current offering. Consistent with previous guidance in *Regulatory Notice 10-22*, members often retain records documenting both the process and results of the updated investigation.

B. Supervision of the Reasonable Investigation Process

To maintain adequate supervision of its private placement reasonable investigations under FINRA Rule 3110, or to meet the requirements of Reg BI's Compliance Obligation, members' procedures might include:

- When using a checklist, ensuring it is reasonably designed to address the private placement, requirements for filing and related documentation, assignment of staff responsible for performing functions and tasks, and evidence of supervisory approval for the reasonable investigation process.
- Assigning responsibility for the member's private placement reasonable investigation and compliance with filing requirements to specific individual(s) or team(s) and conducting targeted, in-depth training about the firms' policies, process and filing requirements.
- Creating a system that alerts responsible individual(s) and supervisor(s) about upcoming and missed filing deadlines.

- Requiring documentation of the process, completeness, and results of its investigations and retention of documents collected through due diligence. Some firms, for example, include descriptions of the meetings that were conducted in the course of the investigation, such as meetings with the issuer or other parties, the tasks performed, the documents and other information reviewed, the results of such reviews, the date such events occurred, and the individuals who attended the meetings or conducted the reviews. Firms also document efforts to evaluate potential red flags and risk factors that they identified in the course of the investigation.
- Implementing standards for the reasonable investigation process that specifically address certain types of offerings sold by the member. For example, members that routinely engage in offerings that are particularly complex or risky may create guidelines to help ensure that the security is not recommended to customers whose investment profiles may not align with the security's characteristics.
- Taking steps to ensure that the member's sale of an offering does not precede the completion of its reasonable investigation.

IV. Conclusion

As the private placement market has evolved and grown in recent years, members have continued to play an important role in providing an essential source of capital for American businesses, while promoting the integrity of the offering process and protecting investors. This *Notice* discusses key requirements for members that engage in private placement activity, including obligations adopted after FINRA issued *Regulatory Notice 10-22*. Based on private placement examinations and feedback provided by members, this *Notice* also highlights potentially effective practices by members to comply with regulatory and legal requirements. Members may wish to consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member firm's size and business model.

Endnotes

1. A duty to conduct a reasonable investigation when recommending a security or an investment strategy involving a security arises under the reasonable basis component of Reg BI's Care Obligation and FINRA Rule 2111.05(a). *See Regulation Best Interest*, Exchange Act Release No. 83062 (April 18, 2018), 83 FR 21574, 21609 (May 9, 2018) (Reg BI Proposing Release) ("To meet this proposed requirement under paragraph (a)(2)(ii)(A), a broker-dealer would need to: (1) undertake reasonable diligence (*i.e.,* reasonable investigation and inquiry) to understand the potential risks and rewards of the recommended security or strategy (*i.e.,* to understand the security or strategy)[…]"); Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318, 33375 (July 12, 2019) (Reg BI Adopting Release) ("Paragraph (a)(2)(ii)(A) of Regulation Best Interest is intended to incorporate and build upon broker-dealer's existing "reasonable-basis suitability" obligations and would relate to the broker-dealer's understanding of the particular security or investment strategy recommended, rather than to any particular retail customer); FINRA Rule 2111.05(a); *Regulatory Notice 12-25* (May 2012); *see also Regulatory Notice 10-22* (April 2010). The duty also arises from caselaw interpretations of the antifraud provisions of the federal securities laws. *See Everest Sec., Inc.,* 52 S.E.C. 958, 962 (1996) ("Broker-dealers are under a duty to investigate the securities that they recommend, and their failure to do so subjects them to liability for violations of the antifraud provisions of the securities laws."), *aff'd,* 116 F.3d 1235 (8th Cir. 1997).
2. *See Regulatory Notice 23-09* (May 2023).
3. *See* SEC Investor Bulletin: Private Placements under Regulation D (August 17, 2022).
4. *See* 15 U.S.C. 77c and 77d. Section 3(b) is the exemptive authority for Rule 504 under Regulation D and Section 4(a)(2) is the exemptive authority for Rules 506(b) and 506(c) under Regulation D.
5. *See* 17 CFR 230.504, 230.506(b) and 230.506(c). Other types of unregistered offerings include those made pursuant to Regulation A, Regulation Crowdfunding, Regulation S, and Rule 144A.
6. FINRA Private Placement Survey (November 2021), distributed to approximately 500 FINRA members who had engaged in private offerings filed with FINRA under FINRA Rules 5122 or 5123. Ninety-one members responded to the survey.
7. *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,* Securities Act Release No. 10884 (November 2, 2020), 86 FR 3496 (January 14, 2021) (Facilitating Capital Formation), at 202-203.
8. In 2009, approximately $0.7 trillion was raised under Regulation D, in comparison to approximately $1.5 trillion in 2019. *See Facilitating Capital Formation, supra* note 7; and *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis (DERA), U.S. Securities and Exchange Commission (Aug. 2018) (Capital Raising in the U.S.).
9. *See Capital Raising in the U.S., supra* note 8. The SEC's analysis of private offerings that involve "intermediaries" did not distinguish between those that involved broker-dealers versus those that involved other types of intermediaries, such as unregistered "finders." *Id*.

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10. FINRA Rule 5122 requires members to make a filing when they offer or sell any security in a private placement of unregistered securities by a member or control entity. FINRA Rule 5123 requires members to make a filing when they sell a security in any other private placement. Both rules provide exemptions from filing for certain types of offerings, and for offerings sold solely to certain types of investors such as qualified purchasers, institutional purchasers, and other sophisticated investors.

11. In 2013, pursuant to the JOBS Act, the SEC established Rule 506(c), an exemption from registration that permits general solicitation in a private placement where all investors are accredited and the issuer or its agent takes reasonable steps to verify their accredited status. The SEC also adopted Regulation Crowdfunding and expanded Regulation A to facilitate smaller companies' access to capital.

12. In 2016, the SEC amended Rule 147 and adopted new Rule 147A to modernize the rules surrounding intrastate offerings. In 2017 and 2021, the SEC amended Rule 504 to increase the aggregate amount that may be offered and sold in any 12-month period from $1 million to $5 million and then to $10 million. In 2020 – 2021, the SEC amended several rules to update the exempt offering framework and further promote access to capital, including expanding the definition of accredited investor, simplifying the integration rules, increasing offering limits for Regulation A and Regulation Crowdfunding offerings as well as Rule 504, and revising the disclosure, eligibility, and bad actor requirements across the exempt offering framework. *See Facilitating Capital Formation, supra* note 7. The SEC's amendments in 2020 to the definition of "accredited investor" increased the number of categories through which an individual investor may be identified as accredited. *Accredited Investor Definition*, Exchange Act Release No. 89669 (August 26, 2020), 85 FR 64234 (October 9, 2020).

13. Other legislative actions designed to encourage business development through capital formation led to the creation and promotion of specialized investment products. For example, the Tax Cuts and Jobs Act (TCJA) of 2017 created a new tax-advantaged product, Qualified Opportunity Funds, that promote investment in economically distressed areas of the United States. The EB-5 Regional Center Program, providing opportunities for foreign capital investment in the United States, was reauthorized by Congress in 2022.

14. In 2013, the SEC adopted bad actor disqualification provisions for Rule 506 of Regulation D. Under Rule 506(d), an offering is disqualified from relying on the Rule 506 safe harbor if the issuer or related person covered by 506(d) is subject to a disqualifying event that occurred on or after September 23, 2013. Under 506(e), if there is a disqualifying event that occurred prior to September 23, 2013, the issuer may rely on Rule 506 but must comply with the disclosure requirements of 506(e). Similar disqualification provisions apply for offerings under Rule 504, Reg A, and Reg CF. In 2020, the SEC harmonized the bad actor disqualification provisions across Reg D, Reg A, and Reg CF. *See Facilitating Capital Formation, supra* note 7.

15. Rule 506(c).

16. For example, Anti-Money Laundering (AML) requirements, among others, may apply.

17. For purposes of Reg BI, whether a "recommendation" is made is interpreted consistent with precedent under the federal securities laws and with how the term has been applied under FINRA rules. Reg BI Adopting Release, *supra* note 1, at 33337. As the SEC explained, "the determination of whether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest should turn 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 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor to trade a particular security or group of securities.' 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 the likelihood that the communication may be viewed as a recommendation." *Id.* at 33335 (citation omitted). *See also* NASD *Notice to Members 01-23* (March 2001); *Regulatory Notice 11-02* (January 2011); *Regulatory Notice 12-25* (May 2012).

18. "Retail customer" is defined in Exchange Act Rule 15*l*-1(b)(1) as "a natural person, or the legal representative of such natural person, who: (i) [r]eceives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) [u]ses the recommendation primarily for personal, family, or household purposes."

19. Exchange Act Rule 15*l*-1(a). It is important to note, as well, that SEC staff has emphasized that Reg BI applies "to limited purpose broker-dealers, for example, broker-dealers that make recommendations of private offerings to accredited investors[.]" Frequently Asked Questions on Regulation Best Interest. SEC staff explained that the "definition of 'retail customer' does not exclude high-net worth natural persons and natural persons that are accredited investors" and that "[w]hether a broker-dealer engages in limited activity does not dictate whether or not [Reg BI] applies." *Id*.

20. In connection with the adoption of Reg BI, to provide clarity over which standard applies, FINRA amended its suitability rule to state that Rule 2111 does not apply to recommendations that are subject to Reg BI. *See* FINRA Rule 2111.08; *Regulatory Notice 20-18* (June 2020) ("FINRA's suitability rule is still needed for entities and institutions (*e.g.*, pension funds), and natural persons who will not use recommendations primarily for personal, family, or household purposes (*e.g.*, small business owners and charitable trusts).").

21. *See* Rule 2111.05(a).

22. The express requirement to consider cost in evaluating a recommendation is one of Reg BI's key enhancements to existing suitability obligations. *See* Reg BI Adopting Release, *supra* note 1, at 33327.

23. *See* Regulation Best Interest, Exchange Act Rule 15*l*-1(a)(2)(ii)(A); Reg BI Adopting Release, *supra* note 1, at 33376. A member or associated person could violate the reasonable basis obligation "by not understanding the potential risks, rewards, or costs of the recommended security or investment strategy, even if the security or investment strategy could have been in the best interest of at least some retail customers."

24. *See supra* note 1.

25. *See Hanly v. SEC,* 415 F.2d 589, 595-97 (2d. Cir. 1969) ("[Brokers] must disclose facts which he knows and those which are reasonably ascertainable."); *see also SEC v. CKB168 Holdings, Ltd.,* 210 F. Supp. 3d 421, 449 n. 31 (E.D.N.Y. 2016) ("[B]y acting as brokers, each of the promoters acquired heightened duties to investigate and disclose."); *SEC v. Milan Cap. Grp, Inc.,* 2000 U.S. Dist. LEXIS 16204, at *14 (S.D.N.Y. 2000) ("A broker is under a duty to investigate the truth of his representations to clients. . . ."); *SEC v. Great Lakes Equities Co.,* 1990 U.S. Dist. LEXIS 19819, at *18 (E.D. Mich. 1990) ("A registered representative cannot rely blindly on information provided by the issuer but must investigate further to authenticate the information."); *Everest Sec., Inc.,* 52 S.E.C. at 962; *Dep't of Enf't v. Titan Sec.,* Complaint No. 2013035345701, 2021 FINRA DISCIP. LEXIS 5 at *44 (FINRA NAC June 2, 2021) ("In the context of private placement offerings, a registered representative has an obligation to conduct a reasonable investigation. . ."); *Dep't. of Enf't v. Gomez,* Complaint No. 2011030293503, 2018 FINRA Discip. LEXIS 10, at *47 (FINRA NAC March 28, 2018) ("[I]n the context of a private placement of securities, a registered representative has an obligation to conduct a reasonable investigation of the issuer and the securities offering.").

26. *Hanly,* 415 F.2d at 597; *see also Dep't. of Enf't v. Luo,* Complaint No. 2011026346206, 2017 FINRA Discip. LEXIS 4 at *18 (FINRA NAC Jan. 13, 2017) ("This duty [to investigate] is based upon the broker's 'special relationship' to the investor."). Failures by members to comply with the duty to conduct a reasonable investigation have been found in violation of the antifraud provisions of the federal securities laws, including Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5. Failure to conduct a reasonable investigation can amount to recklessness for purposes of scienter under the anti-fraud provisions of the federal securities laws and FINRA rules. *See SEC v. CKB168,* 210 F. Supp.3d at 448 (explaining that a failure to perform a reasonable investigation "in the face of doubtful facts . . . amounts to recklessness as a matter of law."); *Alvin W. Gebhart,* Exchange Act Release No. 58951, 2008 SEC LEXIS 3142, at *27 28 (Nov. 14, 2008) (finding respondents recklessly made representations related to the safety of notes without performing a reasonable investigation into the actual securitization of the notes), aff'd, 595 F.3d 1034 (9th Cir. 2010); *Milan,* 2000 U.S. Dist. LEXIS 16204 at *15 ("A variety of circumstances may raise enough questions about the legitimacy of an investment to make a person's failure to investigate . . . reckless."); *Gomez,* 2018 FINRA Discip. LEXIS 10 at *47 (finding that Gomez acted recklessly by failing to perform an investigation of the securities and their promoters).

27. Reg BI Adopting Release, *supra* note 1, at 33376. ("What would constitute reasonable diligence, care, and skill under Paragraph (a)(2)(ii)(A) will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy. . . . [B]roker-dealers generally should consider important factors such as the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of

the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy. Together, this inquiry should allow the broker-dealer to develop a sufficient understanding of the security or investment strategy and to be able to reasonably believe that it could be in the best interest of at least some retail customers."). *See also Regulatory Notice 10-22* ("Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer.").

28. *See generally Regulatory Notice 10-22*.

29. *See Hanly,* 415 F.2d. at 595–96. *See also University Hill Foundation v. Goldman, Sachs & Co.,* 422 F. Supp. 879, 898 (S.D.N.Y. 1976).

30. *Hanly,* 415 F.2d. at 597 ("Securities issued by smaller companies of recent origin obviously require more thorough investigation.").

31. *See generally Regulatory Notice 10-22; see also Milan,* 2000 U.S. Dist. LEXIS 16204, at *15 (explaining that broker's duty to conduct a reasonable investigation is greater "where promotional materials are in some ways questionable, for example by promising unusually high returns").

32. *See Regulatory Notice 10-22.*

33. *See, e.g.,* 2023 Report on FINRA's Examination and Risk Monitoring Program (noting failures to conduct a reasonable investigation of private placement offerings prior to recommending them to retail investors).

34. *See, e.g. Dep't of Enf't v. Carolina Fin. Securities, LLC,* Complaint No. 2014040295201, 2017 FINRA Discip. LEXIS 24, at *159-70 (FINRA Hearing Panel May 26, 2017) (finding that respondents violated FINRA Rule 2111(a) by recommending securities without conducting a reasonable investigation, including with respect to a significant contract and a pending lawsuit); *Gomez,* 2018 FINRA Discip. LEXIS 10, at *38 (finding, in connection with recommendations of securities that claim to involve pre-IPO securities, respondent violated NASD Rule 2310 and 2010 as a result of conducting insufficient diligence that, among other things, failed to uncover "significant, adverse public information about the past criminal or fraudulent activity" of relevant individuals); and *Nobles & Richards, Inc.,* Case No. 2017055743101 (Feb. 9, 2022) (FINRA AWC) (finding member violated FINRA Rules 3110(a) and 2010 as a result of failing to conduct reasonable due diligence prior to serving as the managing broker-dealer for two offerings involving a manager who was subject to a consent order and undertaking with a securities regulator.); CFD Investments, Inc., Case No. 2018057457101 (Aug. 24, 2020) (FINRA AWC) (finding member violated FINRA Rules 2111, 3010, 3110 and 2010 as a result of failing to conduct reasonable due diligence, despite the presence of multiple red flags, including with respect to the issuer's financial position, the circumstances of a lawsuit and resulting jury verdict, the issuer's prior offerings, and payment arrangements between the issuer and an affiliate associated with the project); *Mark D. Martino,* Case 2019064535602 (Aug. 15, 2022) (FINRA AWC) (finding respondent violated FINRA Rules 2111(a) and 2010 by failing to conduct reasonable due diligence of an acknowledged red flag concerning a lawsuit, and violated FINRA Rules 3110 and 2010 by failing to reasonably

supervise the firm's due diligence of the offering); *Axiom Capital Management, Inc.,* Case No. 2019064535601 (Aug. 15, 2022) (FINRA AWC) (finding the member violated FINRA Rule 2111 when it conducted due diligence and identified a "red flag," a fraud-related lawsuit by the Federal Trade Commission (FTC) against the company's founder, but failed to conduct reasonable ongoing due diligence in connection with the lawsuit during the three-month offering period, including by unreasonably relying on the lead placement agent (and the defendant in the lawsuit) to keep it apprised of material developments).

35. *See supra* note 14.

36. *See* Everest Sec., Inc., 52 S.E.C. at 963 ("When an issuer seeks funds to finance a new and speculative venture, brokers and underwriters 'must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects.'"); *Newbridge Sec. Corp.,* Case No. 2016047569601 (Sept. 26, 2019) (FINRA AWC) (The member violated FINRA Rule 2111 when it failed to conduct an independent review of an affiliated investment fund, relying entirely on the issuer to conduct its own diligence); *Regulatory Notice 10-22*.

37. *See, e.g. Everest Sec., Inc.,* 52 S.E.C. at 1239 (stating that "reliance on others does not excuse [the respondents] own lack of investigation"). As stated in *Regulatory Notice 10-22*, a member may retain its own counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation. A member must carefully review the qualifications and competency of counsel or experts retained to perform an investigation on its behalf and must ensure that all gaps or omissions in the investigation by such counsel or experts are separately addressed by the member. Moreover, the use of counsel or experts does not necessarily complete the member's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues or concerns that require further investigation by the member. For a discussion of a member's reliance on a syndicate manager's investigation, see *Regulatory Notice 10-22*.

38. *See, e.g., DBCC v. Kevin D. Kunz,* Complaint No. C3A960029, 1999 NASD Discip. LEXIS 20, at *33-36 (NASD NAC July 7, 1999) (holding respondents liable for failing to reasonably investigate "red flags" of material misstatements in a financial statement in offering material even though the financials had been audited by a certified public accountant), *aff'd,* Exchange Act Release No. 45290, 55 S.E.C. 551 (2002); *Regulatory Notice 10-22* ("[A] BD 'may not rely blindly upon the issuer for information concerning a company,' nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.") (citation omitted).

39. An issuer's failure to furnish information necessary to corroborate a claim or resolve an issue is a significant risk factor that should be considered in a member's determination of whether to recommend those securities to its customers. *See Regulatory Notice 10-22*. Nearly one-third of members surveyed indicated that the issuer's inability to supply necessary information was the most common reason not to proceed with the sale of the offering.

40. *See, e.g., Carolina Fin. Securities, LLC,* 2017 FINRA Discip. LEXIS at *161 (emphasizing that the diligence failures relating to a contract were significant factors in the hearing panel's finding that Carolina did not conduct a reasonable investigation).

41. *See, e.g., Everest Sec., Inc.,* 52 S.E.C. at 1239 (finding "the investigation that was performed was itself insufficient," and even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading); *Kunz,* 1999 NASD Discip. LEXIS 20, at *33-36.

42. *See, e.g. First Am. Sec., Inc.,* Case No. 2015046056405 (Nov. 7, 2016) (FINRA AWC) (The member violated FINRA Rule 2111 when it failed to conduct sufficient additional due diligence after obtaining a third-party diligence report that contained no independent assessment or any substantive analysis of the issuer).

43. *See* SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (April 20, 2022) (SEC Staff Bulletin on Care) ("Although firms have duties under their care obligations, including a general responsibility to understand the investments or investment strategies that they are recommending . . . , financial professionals also have this responsibility. [F]irms should generally help ensure those financial professionals have sufficient information and training to understand the investment and investment strategies they recommend . . . ; however, financial professionals cannot satisfy their own care obligations by solely relying on the efforts of others at their firm. Rather, financial professionals remain responsible for personally understanding an investment or investment strategy before they recommend [it]."); Exchange Act Rule 15*l*-1(a)(2)(ii) (a natural person who is an associated person of a broker or dealer, in making a recommendation, is required to exercise reasonable diligence, care and skill); Rule 2111.05(a) (an associated person making a recommendation has a reasonable basis obligation). Particularly where the associated person has identified red flags, a reasonable investigation would require additional follow-up. In a FINRA disciplinary matter, a member's due diligence gathering efforts were insufficient and its associated persons who recommended the offering without resolving those deficiencies consented to sanctions for making unsuitable recommendations. *See Richard Seefried,* Case No. 2014041862703 (Dec. 4, 2017) (FINRA AWC) and *Brenton Bataille,* Case No. 2014041862704 (Dec. 4, 2017) (FINRA AWC) (finding that two associated persons conducted insufficient due diligence on the offering; each agreed to sanctions for violating FINRA Rule 2111 by lacking a reasonable basis to recommend the security). *See also Luo,* 2017 FINRA Discip. LEXIS 4; *Harry Seth Datys,* Case No. 2017054381601 (Sept. 7, 2020) (FINRA AWC). Associated persons also should not detract from or minimize the risk factors known to them or disclosed in the offering documents when recommending an offering to a customer. FINRA has found that associated persons violated suitability rules and antifraud provisions when they orally misrepresented terms of an investment that did not conform to the disclosures in the PPM. *See Dep't of Enf't v. David Joseph Escarcega,* Complaint No. 2012034936005, 2017 FINRA Discip. LEXIS 32 (FINRA NAC July 20, 2017) (finding that despite the risk disclosures in the PPM, the registered representative's recommendations were unsuitable when he misrepresented to customers that the security offered "guaranteed returns"). *See also Dep't of Enf't v. Jorge A. Reyes,* Complaint No. 2016051493704, 2019 FINRA DISCIP. LEXIS 59, at *41 (FINRA Hearing Panel Dec. 17, 2019) (finding that "written disclosures found in a PPM do not excuse Reyes's responsibility to ensure that his oral representations are not misleading").

44. Both rules also impose quantitative obligations. *See* FINRA Rule 2111.05(c); Exchange Act Rule 15/-1(a)(2)(ii)(C).

45. FINRA Rule 2111.05(b).

46. FINRA Rule 2111(b) and .07.

47. Exchange Act Rule 15/-1(a)(2)(ii)(B).

48. Reg BI Adopting Release, *supra* note 1, at 33379.

49. *See* SEC Staff Bulletin on Care, *supra* note 43 ("Examples of products where heightened scrutiny may be necessary include, but are not limited to, inverse or leveraged exchange-traded products, investments traded on margin, derivatives, crypto asset securities, penny stocks, private placements, asset-backed securities, volatility-linked exchange-traded products, and reverse-convertible notes.").

50. *Id*.

51. Reg BI Adopting Release, *supra* note 1, at 33374. As the SEC explained, under the Compliance Obligation, "a broker-dealer should have a reasonable process for establishing and understanding the scope of such 'reasonably available alternatives' that would be considered by particular associated persons or groups of associated persons (*e.g.,* groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements under the Care Obligation." *Id* at 33381. The SEC also noted, "With respect to broker-dealers that materially limit the range of products or services that they recommend to retail customers (*e.g.,* limits its product offerings to only proprietary or other limited menus of products), the Conflict of Interest Obligation provision requires broker-dealers to have reasonably designed policies and procedures to identify and disclose the material limitations and any conflicts of interest associated with such limitations, and to prevent such limitations and associated conflicts of interest from causing the broker-dealer or associated person to make recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer." *Id* at 33381-2. *See also infra* notes 56 and 63 and accompanying text. Moreover, the SEC Staff Bulletin on Care stated that, when a firm has a limited menu of investments, depending on the facts and circumstances, a financial professional considering reasonably available alternatives "generally should be familiar with each of those investments that are available to investors." SEC Staff Bulletin on Care, *supra* note 43.

52. SEC Staff Bulletin on Care, *supra* note 43. *See also* Reg BI Adopting Release, *supra* note 1, at 33381 and n.638 (citing FINRA *Regulatory Notice 12-03*).

53. Exchange Act Rule 15/-1(a)(2)(i). Concurrent with the adoption of Reg BI, the SEC also adopted Form CRS and related rules, which require SEC-registered broker-dealers and investment advisers to deliver to retail investors a brief customer or client relationship summary that provides information about the firm. *See* Form CRS Relationship Summary; Amendments to Form ADV, SEC File No. S7-08-18 (Sept. 10, 2019). The Form CRS obligation is triggered when a broker-dealer "offers services" to a retail investor, which can include opening a brokerage account for a retail investor, placing an order for a retail investor or recommending a security or investment strategy involving a security (including a recommendation of account type) to a retail investor. The obligation thus applies to a broader range of broker-dealers than Reg BI, which only applies to broker-dealers who make recommendations.

54. *See* SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (Aug. 3, 2022) (SEC Staff Bulletin on Conflicts).

55. Exchange Act Rule 15*l*-1(a)(2)(iii); 15*l*-1(b)(3).

56. *See supra* note 51 and *infra* note 63.

57. SEC Staff Bulletin on Conflicts, *supra* note 54.

58. *See generally* Reg BI Adopting Release, *supra* note 1; and SEC Staff Bulletin on Conflicts, *supra* note 54.

59. Exchange Act Rule 15*l*-1(a)(2)(iv). *Id.*

60. *See* SEC Staff Bulletin on Care, *supra* note 43.

61. *Id.*

62. SEC Staff Bulletin on Conflicts, *supra* note 54.

63. Reg BI Adopting Release, *supra* note 1, at 33326 ("Furthermore, we clarify that, when a broker-dealer materially limits its product offerings to certain proprietary or other limited menus of products, it must still comply with the Care Obligation—even if it has disclosed and taken steps to prevent the limitation from placing the interests of the broker-dealer ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligation—and thus could not use its limited menu to justify recommending a product that does not satisfy the obligation to act in a retail customer's best interest."). *See also supra* note 51.

64. FINRA Rule 2210(d)(1). *See also Bridge Cap. Assocs., Inc.,* Case No. 2014039283801 (Dec. 12, 2016) (FINRA AWC); *Regulatory Notice 10-22*.

65. *See Regulatory Notice 10-22; Regulatory Notice 20-21* (July 2020).

66. *See, e.g., Titan Securities,* 2021 FINRA DISCIP. LEXIS 5; *Gomez,* 2018 FINRA Discip. LEXIS 10.

67. *Dep't of Enf't v. Red River Sec, LLC,* Complaint No. 2013035344201 (FINRA Hearing Panel Feb. 9, 2017). The panel in *Red River* found Hardwick, the CEO, was the "maker" of material misrepresentations and omissions in the PPMs because he had "ultimate authority" over the content of the PPMs. *Id.* at 18 (citing *Janus Cap. Grp, Inc.* v. *First Derivative Traders,* 564 U. S. 135, 142 (2011)).

68. *Id.* The panel in *Red River* found the firm violated Exchange Act Rule 10b-5 and FINRA Rules 2020, 3110, 2111 and 2010. The panel also found the CEO violated Exchange Act Rule 10b-5 and FINRA Rules 2020, 3110 and 2010.

69. Rule 5122 requires a member to file the PPM, term sheet or other offering document with FINRA at or prior to the first time the document is provided to any prospective investor, subject to certain exemptions.

70. The date of first sale is defined as the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check. This is the same definition applied by the SEC in the context of the Form D filing requirement. *See* Securities Act Release No. 8891 (February 6, 2008) and the Form D filing instruction.

71. *Regulatory Notice 21-26* (July 2021) (FINRA Amends Rules 5122 and 5123 Filing Requirements to Include Retail Communications That Promote or Recommend Private Placements).

72. In addition to FINRA's supervision rule, under the Exchange Act the SEC is authorized 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. *See* Exchange Act Sections 15(b)(4)(E) and (b)(6)(A). *See also* Reg BI Adopting Release, *supra* note 1, at 33397 n.809 ("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.").

73. *See Dep't of Enf't v. Spencer Edwards, Inc.,* Complaint No. 2014041862701, 2018 FINRA Discip. LEXIS 34, at *36-40 (FINRA Hearing Panel Nov. 14, 2018) (applying FINRA Rule 3110's predecessor, NASD Rule 3010); *Dep't of Enf't v. Pacific Cornerstone Cap., Inc.* Case No. 2007010591702 (Dec. 11, 2009) (FINRA AWC).

74. *See, e.g., Spencer Edwards, Inc.,* 2018 FINRA Discip. LEXIS 34, at *88-93 (stating that the duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation and finding that "Spencer Edwards' supervisory procedures and responses to red flags signaling irregularities woefully deficient with respect to due diligence"); *Dep't of Enf't v. Fox Fin. Mgmt. Corp.,* Complaint No. 2012030724101, 2017 FINRA Discip. LEXIS 3, at *17-18 (FINRA NAC Jan. 6, 2017) (stating that the "supervisory duties imposed under NASD Rule 3010 include a responsibility to investigate and act upon 'red flags' that reveal irregularities or the potential for misconduct"); *Dep't of Enf't v. Merrimac Corp. Sec.,* Complaint No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at *9 (FINRA NAC Apr. 29, 2015). *See also Kevin D. Kunz,* 1999 NASD Discip. LEXIS 20, at *33-36.

75. *See* Rule 3110(b)(7) ("Each member shall promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA rules, and as changes occur in its supervisory system."). *See also* Rule 3120 (Supervisory Control System) (requiring each member to have a system of supervisory control policies and procedures that tests and verifies a firm's supervisory procedures to ensure that they are reviewed and amended regularly in light of changing business and regulatory requirements).

76. *See, e.g.,* SEC Staff Bulletin on Care, *supra* note 43; SEC Staff Bulletin on Conflicts, *supra* note 54; SEC Staff Bulletin on Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (March 30, 2022); Frequently Asked Questions on Regulation Best Interest.

77. FINRA's survey was sent to members active in the private placement market and focused on understanding industry due diligence practices and the challenges members face in meeting their reasonable investigation obligations.

78. *See Regulatory Notice 16-08* (February 2016) (Private Placements and Public Offerings Subject to a Contingency) (providing guidance regarding the requirements of Exchange Act Rules 10b-9 and 15c2-4 in the sale of contingency offerings, and reminding members of their responsibility to have procedures reasonably designed to achieve compliance with these rules); *see also McDonald Partners LLC,* Case No. 2019060692401 (June 22, 2022) (FINRA AWC). Until the appropriate contingency has occurred, investor funds must

be promptly deposited in a separate bank account, as agent or trustee for the person who has the beneficial interest therein, in accordance with Rule 15c2-4(b)(1), or transmitted to a bank that has agreed in writing to hold all such funds in escrow in accordance with Rule 15c2-4(b)(2). Escrow arrangements must therefore reflect the applicable paragraph under Rule 15c2-4 with respect to the subject offering. Depending on the payment method used, certain additional fees such as a processing fee withdrawn, prior to the deposit in an escrow account, cannot be applied toward meeting the contingency. To meet the requirements of Rule 15c2-4(b)(2), the full amount of investor funds must promptly be deposited into the escrow account.

79. Risk disclosures to customers that the investment may not successfully deliver the intended tax benefits do not discharge the member's obligation to understand those aspects of the offering. *See, e.g.,* FINRA Rule 2111.02 ("A member or associated person cannot disclaim any responsibilities under the suitability rule"); Reg BI Adopting Release, supra note 1, at 33318 ("The standard of conduct established by Regulation Best Interest cannot be satisfied through disclosure alone") and 33327 ("a broker-dealer will not be able to waive compliance with Regulation Best Interest, nor can a retail customer agree to waive her protections under Regulation Best Interest"). *See also* SEC Staff Bulletin on Care, *supra* note 43 (addressing what it means to consider the investor's tax status when providing recommendations or advice and cautioning that the existence of a tax advantage alone would not provide a reasonable belief that a recommendation would be in the retail customer's best interest, and that a factor such as a tax advantage should be considered in light of the other features of the investment or investment strategies, reasonably available alternatives, and the retail investor's entire investment profile, including time horizon.).

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Why Arbitration Is A Beneficial Way For Financial Services Companies To Resolve Disputes - Private Wealth - The Magazine for Wealth Managers, Family Offices, Estate Planning and Asset Management

Russ Alan Prince

6–8 minutes

Jeffrey T. Zaino, Esq., is vice president of the Commercial Division of the American Arbitration Association (AAA), the leading provider of alternative dispute resolution (ADR) services for parties in commercial disputes. He oversees the administration of the large, complex commercial caseload, as well as user outreach and the panel of commercial neutrals in New York.

Russ Alan Prince: What does the American Arbitration Association do, and how is it unique in comparison to other alternative dispute resolution (ADR) institutions?

Jeffrey T. Zaino: We are a neutral resource providing an alternative to the overburdened court system. In addition to serving companies in financial services and other sectors, we also handle high-volume caseloads for state and federal government agencies.

We are unique because we are a nonprofit organization founded nearly 100 years ago dedicated to improving the dispute resolution

process, expanding access to arbitration and mediation services, and educating the public about the benefits of ADR. To that end, we speak frequently at bar associations, law firms, companies and law schools around the country, and the world, about the advantages the process offers. We also organize and sponsor educational opportunities for young ADR professionals, including those from underrepresented communities.

As a nonprofit, we are primarily concerned with resolving disputes as quickly and efficiently as possible. It is not in our interest to drag cases out longer than necessary.

Because we work for the parties involved in cases, not for arbitrators, we have no hidden fees, and we don't take any percentage of an arbitrator's compensation. Our arbitrators are independent, and they can be removed from our panels at any point. We also disclose our administrative fee schedule upfront instead of advertising a minimal fee to file a case and then allowing the cost to increase as the case runs.

Prince: How does the organization work within the financial services space to ensure effective and fair dispute resolution?

Zaino: Our financial services caseload is one of the largest in our organization, and it continues to grow. Many of the cases we facilitate ADR services for in this sector are business-to-business disputes related to lender/debtor services, client services and banking partnerships. Several years ago, we formed a financial advisory committee with internal staff members as well as external experts from the finance space to ensure the arbitrators on our roster have the necessary backgrounds and skills to preside over cases and to make sure we, as an organization provides financial services companies the ADR services they need, given the complexities of the industry and the cases that emerge from it.

The AAA is a thought leader in the financial services space. We work with business law associations across the country, including the Loan Syndications and Trading Association, the American Bar Association's Business Law Section, and the American Bankruptcy Association, to keep abreast of how ADR can help financial services companies and what needs we can meet for them.

We also meet with judges and officials in states around the country about how we can assist the court system with respect to financial services cases. The U.S. court system became severely backed up during the pandemic, and we were able to assist the court system during that time by offering an alternative forum to the court system for financial services and other types of cases.

Some in the court system were grateful for our help because, with the backup from the pandemic, cases could take up to two to three years to come to trial. We can help cases get resolved in months as opposed to years, and in addition to the time and money financial services companies can save by choosing arbitration, they can also benefit from ADR because they can select their own decision-makers—experts who actually understand financial services. This is a very complex and specialized area, like healthcare. Judges may not always understand all of the nuances of a financial services case, so being able to tap into the expertise and experience of neutrals who are actually in the field is a big advantage.

And, of course, confidentiality is very important in the financial services industry, and that principle applies to ADR. Arbitrators generally have the authority to declare the entire ADR process to be confidential. Parties can also declare the process confidential by agreement. We have handled corporate bankruptcy cases involving multiple parties and more than $1 billion in assets, so we are adept at ensuring the confidentiality of proceedings and the security of

data and other information.

Prince: In what ways is ADR, including arbitration and mediation services, more beneficial to parties than going through a traditional court system?

Zaino: ADR saves parties time and money. We've conducted studies showing that arbitration can resolve cases on average in six to nine months, compared to multiple years if you go to court. Some people complain about the hourly payments to an arbitrator. Still, if you take into consideration the length of the case, including discovery, in court, you lose out because you have to pay your lawyers during that entire time as well. The speed of arbitration—up to nine months versus two to three years in court—makes a huge difference.

Also, ADR offers more flexibility than a court case. If the lawyers for the parties agree, they can deviate from certain rules, for ethical reasons obviously, to make the process faster and more informal.

In addition, many people and companies want to keep their trade secrets private, and generally, arbitration enables them to keep them confidential. In contrast, they could be exposed in a public forum.

Furthermore, contrary to a common misconception, the vast majority of arbitration cases are decided on behalf of one side or the other—and most AAA-administered cases are settled early.

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COMMERCIAL

Commercial

Arbitration Rules and Mediation Procedures

Including Procedures for Large, Complex Commercial Disputes



AMERICAN ARBITRATION ASSOCIATION®

Available online at **adr.org/commercial**

Rules Amended and Effective September 1, 2022

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Commercial Arbitration Rules and Mediation Procedures

(Including Procedures for Large, Complex Commercial Disputes)



Important Notice

These rules and any amendment of them shall apply in the form in effect at the time the administrative filing requirements are met for a demand for arbitration or submission agreement received by the AAA®. To ensure that you have the most current information, see our web site at **www.adr.org.**

Introduction

Each year, many millions of business transactions take place. Occasionally, disagreements develop over these business transactions. Many of these disputes are resolved by arbitration, the voluntary submission of a dispute to an impartial person or persons for final and binding determination. Arbitration has proven to be an effective way to resolve these disputes privately, promptly, and economically.

The American Arbitration Association® (AAA), a not-for-profit, public service organization, offers a broad range of dispute resolution services to business executives, attorneys, individuals, trade associations, unions, management, consumers, families, communities, and all levels of government. Services are available through AAA headquarters in New York and through offices located in major cities throughout the United States. Hearings may be held at locations convenient for the parties and are not limited to cities with AAA offices. In addition, the AAA serves as a center for education and training, issues specialized publications, and conducts research on various forms of alternative dispute resolution.

Standard Arbitration Clause

The parties can provide for arbitration of future disputes by inserting the following clause into their contracts:

> *Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.*

Arbitration of existing disputes may be accomplished by use of the following:

> *We, the undersigned parties, hereby agree to submit to arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules the following Controversy: (describe briefly). We further agree that the above controversy be submitted to (one) (three) arbitrator(s). We further agree that we will faithfully observe this agreement and the rules, that we will abide by and perform any award rendered by the arbitrator(s), and that a judgment of any court having jurisdiction may be entered on the award.*

The services of the AAA are generally concluded with the transmittal of the award. Although there is voluntary compliance with the majority of awards, judgment on the award can be entered in a court having appropriate jurisdiction if necessary.

Administrative Fees

The AAA charges a filing fee based on the amount of the claim or counterclaim. This fee information, which is included with these rules, allows the parties to exercise control over their administrative fees. The fees cover AAA administrative services; they do not cover arbitrator compensation or expenses, if any, reporting services, or any post-award charges incurred by the parties in enforcing the award.

Mediation

Subject to the right of any party to opt out, in cases where a claim or counterclaim exceeds $100,000, the Rules provide that the parties shall mediate their dispute upon the administration of the arbitration or at any time when the arbitration is pending. In mediation, the neutral mediator assists the parties in reaching a

settlement but does not have the authority to make a binding decision or award. Mediation is administered by the AAA in accordance with its Commercial Mediation Procedures. There is no additional filing fee where parties to a pending arbitration attempt to mediate their dispute under the AAA's auspices.

Although these rules include a mediation procedure that will apply to many cases, parties may still want to incorporate mediation into their contractual dispute settlement process. Parties can do so by inserting the following mediation clause into their contract in conjunction with a standard arbitration provision:

> *If a dispute arises out of or relates to this contract, or the breach thereof, and if the dispute cannot be settled through negotiation, the parties agree first to try in good faith to settle the dispute by mediation administered by the American Arbitration Association under its Commercial Mediation Procedures before resorting to arbitration, litigation, or some other dispute resolution procedure.*

If the parties want to use a mediator to resolve an existing dispute, they can enter into the following submission agreement:

> *The parties hereby submit the following dispute to mediation administered by the American Arbitration Association under its Commercial Mediation Procedures. (The clause may also provide for the qualifications of the mediator(s), method of payment, locale of meetings, and any other item of concern to the parties.)*

Large, Complex Cases

Unless the parties agree otherwise, the Procedures for Large, Complex Commercial Disputes, which appear in this pamphlet, will be applied to all cases administered by the AAA under the Commercial Arbitration Rules in which the disclosed claim or counterclaim of any party is at least $1,000,000 exclusive of claimed interest, arbitration fees and costs. The key features of these Procedures include:

- A highly qualified, trained Roster of Neutrals;
- A mandatory preliminary hearing with the arbitrators, which may be conducted by teleconference or other electronic means;
- Broad arbitrator authority to order and control the exchange of information, including depositions;
- A presumption that hearings will proceed on a consecutive or block basis.

Commercial Arbitration Rules

R-1. Agreement of Parties*

(a) The parties shall be deemed to have made these Rules a part of their arbitration agreement whenever they have provided for arbitration by the American Arbitration Association ("AAA") under its Commercial Arbitration Rules or for arbitration by the AAA of a domestic commercial dispute without specifying particular rules. These Rules and any amendment to them shall apply in the form in effect at the time the administrative requirements are met for a Demand for Arbitration or Submission Agreement received by the AAA. Any disputes regarding which AAA rules shall apply shall be decided by the AAA. The parties, by written agreement, may vary the procedures set forth in these Rules. After appointment of the arbitrator, such modifications may be made only with the consent of the arbitrator.

(b) Unless the parties agree or the AAA determines otherwise, the Expedited Procedures shall apply in any case in which no disclosed claim or counterclaim exceeds $100,000, exclusive of interest, attorneys' fees, and arbitration fees and costs. Parties may also agree to use these Procedures in larger cases. Unless the parties agree otherwise, these Procedures will not apply in cases involving more than two parties. The Expedited Procedures shall be applied as described in Procedures E-1 through E-10, in addition to any other portion of these Rules that is not in conflict with the Expedited Procedures.

(c) Unless the parties agree otherwise, the Procedures for Large, Complex Commercial Disputes shall apply to all cases in which the disclosed claim or counterclaim of any party is at least $1,000,000, exclusive of claimed interest, attorneys' fees, arbitration fees and costs. Parties may also agree to use the Procedures in cases involving claims or counterclaims under $1,000,000 or in nonmonetary cases. The Procedures for Large, Complex Commercial Disputes shall be applied as described in Procedures L-1 through L-3 in addition to any other portion of these Rules that is not in conflict with the Procedures for Large, Complex Commercial Disputes.

(d) Parties may, by agreement, apply the Expedited Procedures; the Procedures for Large, Complex Commercial Disputes; or the Procedures for the Resolution of Disputes Through Document Submission (Procedure E-6) to any dispute.

(e) All other cases shall be administered in accordance with Rules R-1 through R-60 of these Rules.

* *The AAA will apply the Employment Fee Schedule to any dispute between an individual employee or an independent contractor (working or performing as an individual and not incorporated) and a business or organization and the dispute involves work or work-related claims, including any statutory claims and including work-related claims under independent contractor agreements. A dispute arising out of an employment plan will be administered under the AAA's Employment Arbitration Rules and Mediation Procedures. A dispute arising out of a consumer arbitration agreement will be administered under the AAA's Consumer Arbitration Rules.*

* *Beginning June 1, 2021, the AAA will apply the Consumer Arbitration Fee Schedule to any dispute between an online marketplace or platform and an individual user or subscriber (using or subscribed to the service as an individual and not incorporated) and the dispute does not involve work or work-related claims.*

R-2. AAA, Delegation of Duties, Conduct of Parties, Administrative Review Council

(a) When parties agree to arbitrate under these Rules, or when they provide for arbitration by the AAA and an arbitration is initiated under these Rules, they thereby authorize the AAA to administer the arbitration.

(b) The authority and duties of the AAA are prescribed in the agreement of the parties and in these Rules, and may be carried out through such of the AAA's representatives as it may direct. The AAA may, in its discretion, assign the administration of an arbitration to any of its offices. Arbitrations administered under these Rules shall only be administered by the AAA or by an individual or organization authorized by the AAA to do so.

(c) The AAA requires that parties and their representatives conduct themselves in accordance with the AAA's *Standards of Conduct for Parties and Representatives* when utilizing the AAA's services. Failure to do so may result in the AAA's declining to further administer a particular case or caseload.

(d) For cases proceeding under the Procedures for Large, Complex Commercial Disputes, and for other cases where the AAA, in its sole discretion, deems it appropriate, the AAA may act through its Administrative Review Council to take the following administrative actions:

i) determine challenges to the appointment or continuing service of an arbitrator;

ii) make an initial determination as to the locale of the arbitration, subject to the power of the arbitrator to make a final determination; or

iii) decide whether a party has met the administrative requirements to file an arbitration under these Rules.

R-3. National Roster of Arbitrators

The AAA shall establish and maintain a National Roster of Arbitrators ("National Roster") and shall appoint arbitrators as provided in these Rules. The term "arbitrator" in these Rules refers to the arbitration panel, constituted for a particular case, whether composed of one or more arbitrators, or to an individual arbitrator, as the context requires.

R-4. Filing Requirements and Procedures

(a) Filing Requirements

i) Arbitration under an arbitration provision in a contract shall be initiated by the initiating party ("claimant") filing with the AAA a Demand for Arbitration, the administrative filing fee, and a copy of the applicable arbitration agreement from the parties' contract which provides for arbitration. The filing fee must be paid before a matter is considered properly filed.

ii) Arbitration pursuant to a court order shall be initiated by the initiating party filing with the AAA a Demand for Arbitration, the administrative filing fee, and a copy of any applicable arbitration agreement from the parties' contract which provides for arbitration.

a) The filing party shall include a copy of the court order.

b) The filing fee must be paid before a matter is considered properly filed. If the court order directs that a specific party is responsible for the filing fee, it is the responsibility of the filing party to either make such payment to the AAA and seek reimbursement as directed in the court order or to make other such arrangements so that the filing fee is submitted to the AAA with the Demand.

c) The party filing the Demand with the AAA is the claimant and the opposing party is the respondent regardless of which party initiated the court action. Parties may request that the arbitrator alter the order of proceedings if necessary pursuant to Rule R-33.

iii) Parties to any existing dispute who have not previously agreed to use these Rules may commence an arbitration under these Rules by filing a written Submission Agreement and the administrative filing fee. To the extent that the parties' Submission Agreement contains any variances from these Rules, such variances should be clearly stated in the Submission Agreement.

iv) Information to be included with any arbitration filing includes:

a) the name of each party;

b) the address of each party and, if known, the telephone number and email address;

c) if applicable, the name, address, telephone number, and email address of any known representative for each party;

d) a statement setting forth the nature of the claim including the relief sought and the amount involved; and

e) the locale requested if the arbitration agreement does not specify one.

(b) Filing Procedures

i) The initiating party may file or submit a dispute to the AAA in the following manner:

a) through AAA WebFile®, located at **www.adr.org;**

b) by filing the complete Demand or Submission with any AAA office, regardless of the intended locale of hearing; or

c) by emailing the complete Demand or Submission to **casefiling@adr.org,** with payment to follow as directed by the AAA.

ii) The filing party shall simultaneously provide a copy of the Demand and any supporting documents to the opposing party.

iii) Any papers, notices, or process necessary or proper for the initiation of an arbitration under this Rule may be served on a party:

a) by mail addressed to the party or its authorized representative at their last known address;

b) by electronic service/email, with the prior agreement of the party being served;

c) by personal service; or

d) by any other service methods provided for under the applicable procedures of the courts of the state where the party to be served is located.

iv) The AAA shall provide notice to the parties (or their representatives if so named) of the receipt of a Demand or Submission when the administrative filing requirements have been satisfied. The date on which the filing requirements are satisfied shall establish the date of filing the dispute for administration. However, all disputes in connection with the AAA's determination of the date of filing may be decided by the arbitrator.

v) It is the responsibility of the filing party to ensure that any conditions precedent to the filing of a case are met prior to filing an arbitration, as well as any time requirements associated with the filing. Any dispute regarding whether a condition precedent has been met may be raised with the arbitrator for determination.

vi) The AAA has the authority to make an administrative determination whether the filing requirements set forth in this Rule have been met.

vii) If the filing does not satisfy the filing requirements set forth in Section (a) above, the AAA shall acknowledge to all named parties receipt of the incomplete filing, and the filing may be returned to the initiating party.

(c) *Authority of arbitrator.* Any decision made by the AAA regarding filing requirements and procedures shall not interfere with the arbitrator's authority to determine jurisdiction pursuant to Rule R-7.

R-5. Answers and Counterclaims

(a) A respondent may file an answering statement with the AAA within 14 calendar days after notice of the filing of the Demand is sent by the AAA. The respondent shall, at the time of any such filing, send a copy of any answering statement to the claimant and to all other parties to the arbitration. If no answering statement is filed within the stated time, the respondent will be deemed to deny the claim. Failure to file an answering statement shall not operate to delay the arbitration.

(b) A respondent may file a counterclaim at any time after notice of the filing of the Demand is sent by the AAA, subject to the limitations set forth in Rule R-6. The respondent shall send a copy of the counterclaim to the claimant and all other parties to the arbitration. If a counterclaim is asserted, it shall include a statement setting forth the nature of the counterclaim including the relief sought and the

amount involved. The filing fee as specified in the applicable AAA Fee Schedule must be paid at the time of filing. The claimant may file an answering statement or reply in response to the counterclaim with the AAA within 14 calendar days after notice of the filing of the counterclaim is sent by the AAA.

(c) If the respondent alleges that a different arbitration provision is controlling, the matter will be administered in accordance with the arbitration provision submitted by the initiating party subject to a final determination by the arbitrator.

(d) If the counterclaim does not meet the requirements for filing a claim and the deficiency is not cured by the date specified by the AAA, it may be returned to the filing party.

R-6. Changes of Claim

(a) A party may at any time prior to the close of the hearing or by any earlier date established by the arbitrator increase or decrease the amount of its claim or counterclaim. Written notice of the change of claim amount must be provided to the AAA and all parties. If the change of claim amount results in an increase in the administrative fee, the balance of the fee is due before the change of claim or counterclaim amount may be accepted by the arbitrator. After the arbitrator is appointed, however, a party may increase the amount of its claim or counterclaim, or alter its request for non-monetary relief, only with the arbitrator's consent.

(b) Any new or different claim or counterclaim, as opposed to an increase or decrease in the amount of a pending claim or counterclaim, shall be made in writing and filed with the AAA, and a copy shall be provided to the other party, who shall have 14 calendar days from the date of such transmittal within which to file an answer to the proposed change of claim or counterclaim with the AAA. After the arbitrator is appointed, however, no new or different claim or counterclaim may be submitted except with the arbitrator's consent.

(c) A party that filed a claim or counterclaim of an undisclosed or undetermined amount must specify the amount of the claim or counterclaim to the AAA, all parties, and the arbitrator at least seven calendar days prior to the commencement of the hearing or by any other date established by the arbitrator. If the disclosed amount of the claim or counterclaim results in an increased filing fee, that fee must be paid at the time the claim or counterclaim amount is disclosed. For good cause shown and with the consent of the arbitrator, a party may proceed to the hearing with an undisclosed or undetermined claim or counterclaim, provided that the final amount of the claim or counterclaim is set forth in a post-hearing brief or submission and any appropriate filing fee is paid.

R-7. Jurisdiction

(a) The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim, without any need to refer such matters first to a court.

(b) The arbitrator shall have the power to determine the existence or validity of a contract of which an arbitration clause forms a part. Such an arbitration clause shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitrator that the contract is null and void shall not for that reason alone render invalid the arbitration clause.

(c) A party must object to the jurisdiction of the arbitrator or to the arbitrability of a claim or counterclaim no later than the filing of the answering statement to the claim or counterclaim that gives rise to the objection. The arbitrator may rule on such objections as a preliminary matter or as part of the final award.

R-8. Consolidation and Joinder

(a) Consolidation

i) Two or more arbitrations may be consolidated if all parties to all of the arbitrations to be consolidated so agree.

ii) Unless all parties agree to consolidation, the party requesting consolidation of two or more arbitrations must file with the AAA and serve on all other parties a written request for consolidation with the supporting reasons for such request within 90 days of the date the AAA determines that all administrative filing requirements were satisfied for the last-filed case that is part of the consolidation request. Such time limit may be extended by the arbitrator appointed in the first-filed case upon a showing of good cause for the late request. The other parties to the arbitrations shall provide their written responses to the consolidation request within 10 calendar days after the AAA sends notice of receipt of the request.

iii) At its discretion, the AAA either may direct that the consolidation request be decided by the arbitrator appointed in the first-filed case or may appoint a consolidation arbitrator for the sole purpose of deciding the consolidation request.

iv) The arbitrator deciding consolidation may order consolidation of two or more cases for all purposes or for such limited purposes and under such conditions as the arbitrator may direct.

v) Absent agreement of all parties, an arbitrator appointed for the sole purpose of deciding the consolidation request shall have no further power to act, and shall be removed from the case, after the consolidation request is decided.

vi) In deciding whether to consolidate, the arbitrator or consolidation arbitrator shall take into account all relevant circumstances, including:

a) the terms and compatibility of the agreements to arbitrate,

b) applicable law,

c) the timeliness of the request to consolidate and the progress already made in the arbitrations,

d) whether the arbitrations raise common issues of law and/or fact, and

e) whether consolidation of the arbitrations would serve the interests of justice and efficiency.

(b) Joinder

i) Additional parties may be joined to an arbitration if all parties to the arbitration and the parties proposed to be joined so agree.

ii) Absent such consent, all requests for joinder must be submitted to the AAA prior to the appointment of an arbitrator pursuant to these Rules or within 90 days of the date the AAA determines that all administrative filing requirements have been satisfied. The arbitrator may extend this deadline on a showing of good cause for the late request.

iii) If the existing parties and the parties proposed to be joined are unable to agree to the joinder of those additional parties to an ongoing arbitration, the arbitrator shall decide whether parties should be joined. If an arbitrator has not yet been appointed in the case, the AAA may appoint an arbitrator for the sole purpose of deciding the joinder request. Absent agreement of all parties, the arbitrator appointed for the sole purpose of deciding the joinder request shall have no further power to act, and shall be removed from the case, after the joinder request is decided.

iv) The party requesting the joinder of one or more parties to a pending arbitration must file with the AAA a written request that provides the names and contact information for such parties; the names and contact information for the parties' representatives, if known; and the supporting reasons for such request, including applicable law. The requesting party must provide a copy of the joinder request to all parties in the arbitration and all parties it seeks to join at the same time it files the request with the AAA. The other parties to the arbitration and the parties sought to be joined shall provide their written responses to the joinder request within 14 days after the AAA sends notice of receipt of the request for joinder.

v) The requesting party shall comply with the provisions of Rule R-4(a) as to all parties sought to be joined.

(c) If an arbitrator determines that separate arbitrations shall be consolidated or that the joinder of additional parties is permissible, that arbitrator may also determine:

i) whether any arbitrator previously appointed to an existing case that was consolidated shall remain on the newly constituted case;

ii) whether any arbitrator previously appointed to a case where additional parties have been joined shall remain;

iii) if appropriate, a process for selecting the arbitrator(s) to fill any vacancies; and

iv) unless agreed otherwise by the parties, the allocation among the parties of arbitrator compensation and expenses, subject to reapportionment by the arbitrator appointed to the ongoing or newly constituted case in the final award.

(d) The AAA may take reasonable administrative actions to accomplish any consolidation or joinder ordered by the arbitrator or as agreed to by the parties. Pending the determination on a consolidation or joinder request, the AAA shall have the authority to stay the arbitration or arbitrations impacted by the consolidation or joinder request, at its sole discretion.

R-9. Interpretation and Application of Rules

The arbitrator shall interpret and apply these Rules insofar as they relate to the arbitrator's powers and duties. When there is more than one arbitrator and a difference arises among them concerning the meaning or application of these Rules, it shall be decided by a majority vote. If that is not possible, either an arbitrator or a party may refer the question to the AAA for final decision. All other rules shall be interpreted and applied by the AAA.

R-10. Mediation

In all cases where a claim or counterclaim exceeds $100,000, upon the AAA's administration of the arbitration or at any time while the arbitration is pending, the parties shall mediate their dispute pursuant to the applicable provisions of the AAA's Commercial Mediation Procedures, or as otherwise agreed by the parties. Absent an agreement of the parties to the contrary, the mediation shall take place concurrently with the arbitration and shall not serve to delay the arbitration proceedings. However, any party to an arbitration may unilaterally }opt out of this Rule upon notification to the AAA and the other parties to the arbitration. The parties shall confirm the completion of any mediation or any decision to opt out of this Rule to the AAA. Unless agreed to by all parties and the mediator, the mediator shall not be appointed as an arbitrator to the case.

R-11. Administrative Conference

At the request of any party or upon the AAA's own initiative, the AAA may conduct an administrative conference, in person, by videoconference or by telephone, with the parties and/or their representatives. The conference may address such issues as arbitrator selection, mediation of the dispute, potential exchange of information, a timetable for hearings, and any other administrative matters.

R-12. Fixing of Locale

The parties may mutually agree on the locale where the arbitration is to be held. When the parties' arbitration agreement requires a specific locale, absent the parties' agreement to change it, or a determination by the arbitrator that

applicable law requires a different locale, the locale shall be that specified in the arbitration agreement.

Any disputes regarding the locale that are to be decided by the AAA must be submitted to the AAA and all other parties within 14 calendar days after the AAA sends notice of the filing of the Demand or by the date established by the AAA. Disputes regarding locale shall be determined in the following manner:

(a) When the parties' arbitration agreement is silent with respect to locale, and if the parties disagree as to the locale, the AAA shall initially determine the locale of arbitration, subject to the power of the arbitrator after appointment to make a final determination on the locale.

(b) If the reference to a locale in the arbitration agreement is ambiguous, and the parties are unable to agree to a specific locale, the AAA shall determine the locale, subject to the power of the arbitrator to finally determine the locale.

(c) If the parties' arbitration agreement specifies more than one possible locale, the filing party may select any of the specified locales at the time of filing, subject to the power of the arbitrator to finally determine the locale.

The arbitrator, at the arbitrator's sole discretion, shall have the authority to conduct special hearings for document production purposes or otherwise at other locations if reasonably necessary and beneficial to the process.

R-13. Appointment from National Roster

If the parties have not appointed an arbitrator and have not provided any other method of appointment, the arbitrator shall be appointed in the following manner:

(a) The AAA shall send simultaneously to each party to the dispute an identical list of 10 (unless the AAA decides that a different number is appropriate) names of persons chosen from the National Roster. The parties are encouraged to agree to an arbitrator from the submitted list and to advise the AAA of their agreement.

(b) If the parties are unable to agree upon an arbitrator, each party to the dispute shall have 14 calendar days from the transmittal date in which to strike names objected to, number the remaining names in order of preference, and return the list to the AAA. At its discretion, the AAA may limit the number of strikes permitted. The parties are not required to exchange selection lists. If a party does not return the list within the time specified, all persons named therein shall be deemed acceptable to that party. From among the persons who have been approved on both lists, and in accordance with the designated order of mutual preference, the AAA shall invite the acceptance of an arbitrator to serve. If the parties fail to agree on any of the persons named, or if acceptable arbitrators are unable to act, or if

for any other reason the appointment cannot be made from the submitted lists, the AAA shall have the power to make the appointment from among other members of the National Roster without the submission of additional lists.

(c) Unless the parties agree otherwise, when there are two or more claimants or two or more respondents, the AAA may appoint all the arbitrators.

R-14. Direct Appointment by Party

(a) If the agreement of the parties names an arbitrator or specifies a method of appointing an arbitrator, that designation or method shall be followed. If a party selects an arbitrator for appointment, it shall file the name, address, telephone number, and email address of the arbitrator with the AAA. Upon the request of any appointing party, the AAA shall submit a list of members of the National Roster from which the party may, if it so desires, make the appointment.

(b) Where the parties have agreed that each party is to name one arbitrator, the arbitrators so named must meet the standards of Rule R-19 with respect to impartiality and independence unless the parties have specifically agreed pursuant to Rule R-19(b) that the party-appointed arbitrators are to be non-neutral and need not meet those standards.

(c) If the agreement specifies a period of time within which an arbitrator shall be appointed and any party fails to make the appointment within that period, the AAA shall make the appointment.

(d) If no period of time is specified in the agreement, the AAA shall notify the party to make the appointment. If within 14 calendar days after such notice has been sent, an arbitrator has not been appointed by a party, the AAA shall make the appointment.

R-15. Appointment of Chairperson by Party-Appointed Arbitrators, Parties, or the AAA

(a) Where there is a panel of three or more arbitrators, one arbitrator will be designated as the panel chairperson. Such designation will be according to the terms of the parties' arbitration agreement. However, if the parties' arbitration agreement does not specify how the chairperson is to be selected, the chairperson can be designated, at the AAA's discretion, by the party-appointed arbitrators, the parties, the panel, or the AAA.

(b) If the arbitration agreement specifies a period of time for appointment of the chairperson and no appointment is made within that period or any agreed extension, the AAA may appoint the chairperson. If no period of time is specified for appointment of the chairperson, and the party-appointed arbitrators or the parties do not make the appointment within 14 calendar days from the date of the appointment of the last party-appointed arbitrator, the AAA may appoint the chairperson.

(c) Absent the agreement of the parties, the chairperson shall be appointed from the National Roster, and the AAA shall furnish to the party-appointed arbitrators, in the manner provided in Rule R-13, a list selected from the National Roster, and the appointment of the chairperson shall be made as provided in that Rule.

R-16. Nationality of Arbitrator

Where the parties are nationals of different countries, the AAA, at the request of any party or on its own initiative, may appoint as arbitrator a national of a country other than that of any of the parties. The request must be made before the time set for the appointment of the arbitrator as agreed by the parties or set by these Rules.

R-17. Number of Arbitrators

(a) The parties may agree on the number of arbitrators to hear and determine the case. If the arbitration agreement does not specify the number of arbitrators or is ambiguous, and the parties do not otherwise agree, the dispute shall be heard and determined by one arbitrator, unless the AAA, in its discretion, directs that three arbitrators be appointed. A party may request three arbitrators in the Demand or Answer, which request the AAA will consider in exercising its discretion regarding the number of arbitrators appointed to the dispute.

(b) Use of terms such as "the arbitrator", "an arbitrator", or "the arbitrators" in the arbitration agreement, without further specifying the number of arbitrators, shall not be deemed by the AAA to reflect an agreement as to the number of arbitrators.

(c) Any request for a change in the number of arbitrators as a result of an increase or decrease in the amount of a claim or a new or different claim must be made to the AAA and other parties to the arbitration no later than seven calendar days after receipt of the Rule R-6-required notice of change of claim amount. If the parties are unable to agree with respect to the request for a change in the number of arbitrators, the AAA shall make that determination.

R-18. Disclosure

(a) Any person appointed or to be appointed as an arbitrator, as well as the parties and their representatives, shall disclose to the AAA any circumstance likely to give rise to justifiable doubt as to the arbitrator's impartiality or independence, including any bias or any financial or personal interest in the result of the arbitration or any past or present relationship with the parties or their representatives. Such obligation shall remain in effect throughout the arbitration. Failure on the part of a party or a representative to comply with the requirements of this Rule may result in the waiver of the right to object to an arbitrator in accordance with Rule R-42.

(b) Upon receipt of such information from the arbitrator or another source, the AAA shall communicate the information to the parties and, if it deems it appropriate to do so, to the arbitrator and others.

(c) Disclosure of information pursuant to this Rule R-18 is not an indication that the arbitrator considers the disclosed circumstance likely to affect impartiality or independence.

R-19. Disqualification of Arbitrator

(a) Any arbitrator shall be impartial and independent and shall perform his or her duties with diligence and in good faith, and shall be subject to disqualification for:

- **i)** partiality or lack of independence,
- **ii)** inability or refusal to perform his or her duties with diligence and in good faith, and
- **iii)** any grounds for disqualification provided by applicable law.

(b) The parties may agree in writing, however, that arbitrators directly appointed by a party pursuant to Rule R-14 shall be non-neutral, in which case such arbitrators need not be impartial or independent and shall not be subject to disqualification for partiality or lack of independence.

(c) Upon objection of a party to the continued service of an arbitrator, or on its own initiative, the AAA shall determine whether the arbitrator should be disqualified on the grounds set out above, and shall inform the parties of its decision, which decision shall be conclusive.

R-20. Communication with Arbitrator

(a) No party and no one acting on behalf of any party shall communicate *ex parte* with an arbitrator or a candidate for arbitrator concerning the arbitration, except that a party, or someone acting on behalf of a party, may communicate *ex parte* with a candidate for direct appointment pursuant to Rule R-14 in order to advise the candidate of the general nature of the controversy and of the anticipated proceedings and to discuss the candidate's qualifications, availability, or independence in relation to the parties or to discuss the suitability of candidates for selection as a third arbitrator where the parties or party-designated arbitrators are to participate in that selection.

(b) Rule R-20(a) does not apply to arbitrators directly appointed by the parties who, pursuant to Rule R-19(b), the parties have agreed in writing are non-neutral. Where the parties have so agreed under Rule R-19(b), the AAA shall as an administrative practice suggest to the parties that they agree further that Rule R-20(a) should nonetheless apply prospectively.

(c) As set forth in Rule R-44, unless otherwise instructed by the AAA, in the Rules, or by the arbitrator, any documents submitted by any party to the AAA or to the arbitrator shall simultaneously be provided to the other party or parties to the arbitration.

R-21. Vacancies

(a) If for any reason an arbitrator is unable or unwilling to perform the duties of the office, the AAA may, on proof satisfactory to it, declare the office vacant. Vacancies shall be filled in accordance with the applicable provisions of these Rules.

(b) In the event of a vacancy in a panel of neutral arbitrators after the hearings have commenced, the remaining arbitrator or arbitrators may continue with the hearing and determination of the controversy, unless the parties agree otherwise.

(c) In the event of the appointment of a substitute arbitrator, the panel of arbitrators shall determine in its sole discretion whether it is necessary to repeat all or part of any prior hearings.

R-22. Preliminary Hearing

(a) At the discretion of the arbitrator, and depending on the size and complexity of the arbitration, a preliminary hearing should be scheduled as soon as practicable after the arbitrator has been appointed. The parties should be invited to attend the preliminary hearing along with their representatives. The preliminary hearing may be conducted in person, by video conference or by telephone.

(b) At the preliminary hearing, the parties and the arbitrator should be prepared to discuss and establish a procedure for the conduct of the arbitration that is appropriate to achieve a fair, efficient, and economical resolution of the dispute. Procedures P-1 and P-2 of these Rules address the issues to be considered at the preliminary hearing.

R-23. Pre-Hearing Exchange and Production of Information

(a) *Authority of arbitrator.* The arbitrator shall manage any necessary exchange of information among the parties with a view to achieving an efficient and economical resolution of the dispute, while at the same time promoting equality of treatment and safeguarding each party's opportunity to fairly present its claims and defenses.

(b) *Documents.* The arbitrator may, on application of a party or on the arbitrator's own initiative:

i) require the parties to exchange documents in their possession or custody on which they intend to rely;

ii) require the parties to update their exchanges of the documents on which they intend to rely as such documents become known to them;

iii) require the parties, in response to reasonable document requests, to make available to the other party documents in the responding party's possession or custody, not otherwise readily available to the party seeking the documents, and reasonably believed by the party seeking the documents to exist and to be relevant and material to the outcome of disputed issues; and

iv) require the parties, when documents to be exchanged or produced are maintained in electronic form, to make such documents available in the form most convenient and economical for the party in possession of such documents, unless the arbitrator determines that there is good cause for requiring the documents to be produced in a different form. The parties should attempt to agree in advance upon, and the arbitrator may determine, reasonable search parameters to balance the need for production of electronically stored documents relevant and material to the outcome of disputed issues against the cost of locating and producing them.

R-24. Enforcement Powers of Arbitrator

The arbitrator shall have the authority to issue any orders necessary to enforce the provisions of Rules R-22 and R-23 and any other rule or procedure and to otherwise achieve a fair, efficient and economical resolution of the case, including, without limitation:

(a) conditioning any exchange or production of confidential documents and information, and the admission of confidential evidence at the hearing, on appropriate orders to preserve such confidentiality;

(b) imposing reasonable search parameters for electronic and other documents if the parties are unable to agree;

(c) allocating costs of producing documentation, including electronically stored documentation;

(d) in the case of willful non-compliance with any order issued by the arbitrator, drawing adverse inferences, excluding evidence and other submissions, and/or making special allocations of costs or an interim award of costs arising from such non-compliance; and

(e) issuing any other enforcement orders which the arbitrator is empowered to issue under applicable law.

R-25. Date, Time, Place, and Method of Hearing

The arbitrator shall set the date, time, place, and method (including video, audio or other electronic means when appropriate) for each hearing. The parties shall respond to requests for hearing dates in a timely manner, be cooperative in scheduling the earliest practicable date, and adhere to the established hearing schedule. The AAA shall send a notice of hearing to the parties at least 10 calendar days in advance of the hearing date, unless otherwise agreed by the parties.

R-26. Attendance at Hearing

The arbitrator and the AAA shall maintain the privacy of the hearings unless the law provides to the contrary. Any person having a direct interest in the arbitration is entitled to attend hearings. The arbitrator shall otherwise have the power to require the exclusion of any witness, other than a party or other essential person, during the testimony of any other witness. It shall be discretionary with the arbitrator to determine the propriety of the attendance of any other person.

R-27. Representation

Any party may participate without representation (*pro se*), or by counsel or any other representative of the party's choosing, unless such choice is prohibited by applicable law. A party intending to be so represented shall notify the other party and the AAA of the name, telephone number and address, and email address if available, of the representative at least seven calendar days prior to the date set for the hearing at which that person is first to appear. When such a representative initiates an arbitration or responds for a party, notice is deemed to have been given.

R-28. Oaths

Before proceeding with the first hearing, each arbitrator may take an oath of office and, if required by law, shall do so. The arbitrator may require witnesses to testify under oath administered by any duly qualified person and, if it is required by law or requested by any party, shall do so.

R-29. Official Record of Proceedings

(a) Any party desiring a transcribed record of a hearing shall make arrangements directly with a transcriber or transcription service and shall notify the arbitrator and the other parties of these arrangements at least seven calendar days in advance of the hearing. The requesting party or parties shall pay the cost of the record.

(b) No other means of recording any proceeding will be permitted absent the agreement of the parties or per the direction of the arbitrator.

(c) If the transcript or any other recording is agreed by the parties or determined by the arbitrator to be the official record of the proceeding, it must be provided to the arbitrator and made available to the other parties at the direction of the arbitrator.

(d) The arbitrator may resolve any disputes with regard to apportionment of the costs of the transcription or other recording.

R-30. Interpreters

Any party wishing an interpreter shall make all arrangements directly with the interpreter and shall assume the costs of the service.

R-31. Postponements

The arbitrator may postpone any hearing upon agreement of the parties, upon request of a party for good cause shown, or upon the arbitrator's own initiative.

R-32. Arbitration in the Absence of a Party or Representative

Unless the law provides to the contrary, the arbitration may proceed in the absence of any party or representative who, after due notice, fails to be present or fails to obtain a postponement. An award shall not be made solely on the default of a party. The arbitrator shall require the party who is present to submit such evidence as the arbitrator may require for the making of an award.

R-33. Conduct of Proceedings

(a) The claimant shall present evidence to support its claim. The respondent shall then present evidence to support its defense. Witnesses for each party shall also submit to questions from the arbitrator and the adverse party. The arbitrator has the discretion to vary this procedure, provided that the parties are treated with equality and that each party has the right to be heard and is given a fair opportunity to present its case.

(b) The arbitrator, exercising his or her discretion, shall conduct the proceedings with a view to expediting the resolution of the dispute and may direct the order of proof, bifurcate proceedings and direct the parties to focus their presentations on issues the decision of which could dispose of all or part of the case.

(c) The arbitrator may also allow for some or all of the presentation of evidence by alternative means including video, audio or other electronic means other than an in-person presentation. Such alternative means must afford a full opportunity for all parties to present any evidence that the arbitrator deems material and relevant to the resolution of the dispute and, when involving witnesses, provide an opportunity for cross-examination.

(d) The parties may agree to waive oral hearings in any case and may also agree to utilize the *Procedures for Resolution of Disputes Through Document Submission*, found in Procedure E-6.

R-34. Dispositive Motions

(a) The arbitrator may allow the filing of and make rulings upon a dispositive motion only if the arbitrator determines the moving party has shown that the motion is likely to succeed and to dispose of or narrow the issues in the case.

(b) Consistent with the goal of achieving an efficient and economical resolution of the dispute, the arbitrator shall consider the time and cost associated with the briefing of a dispositive motion in deciding whether to allow any such motion.

(c) Fees, expenses, and compensation associated with a motion or an application to make a motion may be assessed as provided for in Rule R-49(c).

R-35. Evidence

(a) The parties may offer such evidence as is relevant and material to the dispute and shall produce such evidence as the arbitrator may deem necessary to an understanding and determination of the dispute. Conformity to legal rules of evidence shall not be necessary. All evidence shall be taken in the presence of all of the arbitrators and all of the parties, except where any of the parties is absent, in default, or has waived the right to be present.

(b) The arbitrator shall determine the admissibility, relevance, and materiality of the evidence offered and may exclude evidence deemed by the arbitrator to be cumulative or irrelevant.

(c) The arbitrator shall take into account applicable principles of legal privilege, such as those involving the confidentiality of communications between a lawyer and client.

(d) An arbitrator or other person authorized by law to subpoena witnesses or documents may do so upon the request of any party or independently.

R-36. Evidence by Written Statements and Post-Hearing Filing of Documents or Other Evidence

(a) At a date agreed upon by the parties or ordered by the arbitrator, the parties shall give written notice for any witness or expert witness who has provided a written witness statement to appear in person at the arbitration hearing for examination. If such notice is given, and the witness fails to appear, the arbitrator may disregard the written witness statement and/or expert report of the witness or make such other order as the arbitrator may consider to be just and reasonable.

(b) If a witness whose testimony is represented by a party to be essential is unable or unwilling to testify at the hearing, either in person or through electronic or other means, either party may request that the arbitrator order the witness to appear in person for examination before the arbitrator at a time and location where the witness is willing and able to appear voluntarily or can legally be compelled to do so. Any such order may be conditioned upon payment by the requesting party of all reasonable costs associated with such examination.

(c) If the parties agree or the arbitrator directs that documents or other evidence be submitted to the arbitrator after the hearing, the documents or other evidence shall be filed with the AAA for transmission to the arbitrator. All parties shall be afforded an opportunity to examine and respond to such documents or other evidence.

R-37. Inspection or Investigation

An arbitrator finding it necessary to make an inspection or investigation in connection with the arbitration shall direct the AAA to so advise the parties. The arbitrator shall set the date and time and the AAA shall notify the parties. Any party who so desires may be present at such an inspection or investigation. In the event that one or all parties are not present at the inspection or investigation, the arbitrator shall make an oral or written report to the parties and afford them an opportunity to comment.

R-38. Interim Measures

(a) The arbitrator may take whatever interim measures he or she deems necessary, including injunctive relief and measures for the protection or conservation of property and disposition of perishable goods.

(b) Such interim measures may take the form of an interim award, and the arbitrator may require security for the costs of such measures.

(c) A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.

R-39. Emergency Measures of Protection

(a) Unless the parties agree otherwise, the provisions of this Rule shall apply to arbitrations conducted under arbitration clauses or agreements entered on or after October 1, 2013. This Rule shall not apply to cases administered pursuant to the Expedited Procedures.

(b) A party in need of emergency relief prior to the constitution of the panel shall notify the AAA and all other parties in writing of the nature of the relief sought and the reasons why such relief is required on an emergency basis. The application shall also set forth the reasons why the party is entitled to such relief. Such notice may be given by facsimile or email or other reliable means, but must include a statement certifying that all other parties have been notified or an explanation of the steps taken in good faith to notify other parties.

(c) Within one business day of receipt of notice from the AAA initiating the request referenced in section (b), the AAA shall appoint a single emergency arbitrator designated to rule on emergency applications. The emergency arbitrator shall expeditiously disclose any circumstance likely, on the basis of the facts disclosed on the application, to affect such arbitrator's impartiality or independence. Any challenge to the appointment of the emergency arbitrator must be made within one business day of the communication by the AAA to the parties of the appointment of the emergency arbitrator and the circumstances disclosed.

(d) The emergency arbitrator shall as soon as possible, but in any event within two business days of appointment, establish a schedule for consideration of the application for emergency relief. Such a schedule shall provide a reasonable opportunity to all parties to be heard, but may provide for proceeding by telephone or video conference or on written submissions as alternatives to a formal hearing. The emergency arbitrator shall have the authority vested in the tribunal under Rule R-7, including the authority to rule on her or his own jurisdiction, and shall resolve any disputes over the applicability of this Rule R-39.

(e) If, after consideration, the emergency arbitrator is satisfied that the party seeking the emergency relief has shown that immediate and irreparable loss or damage shall result in the absence of emergency relief, and that such party is entitled to such relief under applicable law, the emergency arbitrator may enter an interim order or award granting the relief and stating the reason therefore.

(f) Any application to modify an interim award of emergency relief must be based on changed circumstances and may be made to the emergency arbitrator until the non-emergency ("merits") arbitrator is appointed; thereafter such a request shall be addressed to the merits arbitrator. The emergency arbitrator shall have no further power to act after the merits arbitrator is appointed unless the emergency arbitrator is named as the merits arbitrator or as a member of the panel.

(g) Any interim award of emergency relief may be conditioned on provision by the party seeking such relief for appropriate security.

(h) A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with this Rule, the agreement to arbitrate or a waiver of the right to arbitrate. If the AAA is directed by a judicial authority to nominate a special master to consider and report on an application for emergency relief, the AAA shall proceed as provided in this Rule, and the references to the emergency arbitrator shall be read to mean the special master, except that the special master shall issue a report rather than an interim award.

(i) The costs associated with applications for emergency relief shall initially be apportioned by the emergency arbitrator or special master, subject to the power of the merits arbitrator to determine finally the apportionment of such costs. The emergency arbitrator may take into consideration whether the request for emergency relief was made in good faith.

R-40. Closing of Hearing

(a) The arbitrator shall specifically inquire of all parties whether they have any further proofs to offer or witnesses to be heard. Upon receiving negative replies or if satisfied that the record is complete, the arbitrator shall declare the hearing closed.

(b) If documents or responses are to be filed as provided in Rule R-36, or if briefs are to be filed, the hearing shall be declared closed as of the date the arbitrator is satisfied that the record is complete, and such date shall occur no later than seven calendar days from the date of receipt of the last such submissions or hearing transcript.

(c) The time limit within which the arbitrator is required to make the award shall commence, in the absence of other agreements by the parties, upon the closing of the hearing. The AAA may extend the time limit for rendering of the award only in unusual and extreme circumstances.

R-41. Reopening of Hearing

The hearing may be reopened on the arbitrator's initiative, or by the direction of the arbitrator upon application of a party, at any time before the award is made. If reopening the hearing would prevent the making of the award within the specific time agreed to by the parties in the arbitration agreement, the matter may not be reopened unless the parties agree to an extension of time. When no specific date is fixed by agreement of the parties, the arbitrator shall have 30 calendar days from the closing of the reopened hearing within which to make an award (or 14 calendar days if the case is governed by the Expedited Procedures).

R-42. Waiver of Rules

Any party who proceeds with the arbitration after knowledge that any provision or requirement of these Rules has not been complied with and who fails to state an objection in writing shall be deemed to have waived the right to object.

R-43. Extensions of Time

The parties may modify by mutual agreement any period of time established by these Rules or the parties' arbitration agreement. The AAA or the arbitrator may for good cause extend any period of time established by these Rules, except the time for making the award. The AAA shall notify the parties of any extension.

R-44. Serving of Notice and Communications

(a) The service methods set forth in Rule R-4(b)(iii) may also be used for the delivery of any filing, notice or communication throughout the course of the arbitration proceeding.

(b) The AAA, the arbitrator, and the parties may also use alternative methods of communication or other platforms as directed by the AAA or as agreed by the parties or directed by the arbitrator to exchange any communication or other notice required by these Rules during the course of the arbitration.

(c) Unless otherwise instructed by the AAA or by the arbitrator, any party submitting any document or written communication to another party, the AAA or the arbitrator, shall simultaneously provide that material to all other participants, including the AAA.

(d) Failure to provide the other party with copies of communications provided to the AAA or the arbitrator may prevent the AAA or the arbitrator from acting on any requests or objections contained therein.

(e) The AAA may direct that any oral or written communications sent by a party or their representative shall be sent in a particular manner. The failure of a party or their representative to comply with any such direction may result in the AAA's refusal to consider the issue raised in the communication

(f) The AAA may initiate administrative communications with the parties or their representatives either jointly or individually.

(g) Any method of service on or notice to a party must be made in such a manner to provide that party with reasonable opportunity to be heard with regard to the dispute.

R-45. Confidentiality

(a) Unless otherwise required by applicable law, court order, or the parties' agreement, the AAA and the arbitrator shall keep confidential all matters relating to the arbitration or the award.

(b) Upon the agreement of the parties or the request of any party, the arbitrator may make orders concerning the confidentiality of the arbitration proceedings or of any other matters in connection with the arbitration and may take measures for protecting trade secrets and confidential information.

R-46. Majority Decision

(a) When the panel consists of more than one arbitrator, unless required by law or by the arbitration agreement or section (b) of this Rule, a majority of the arbitrators must make all decisions.

(b) Where there is a panel of three arbitrators, absent an objection of a party or another member of the panel, the chairperson of the panel is authorized to

resolve any disputes related to the exchange of information or procedural matters without the need to consult the full panel.

(c) Absent an objection of a party or another member of the panel, the chairperson may sign any order on behalf of the panel.

R-47. Time of Award

The award shall be made promptly by the arbitrator and, unless otherwise agreed by the parties or specified by law, no later than 30 calendar days from the date of closing the hearing, or, if oral hearings have been waived, from the due date set for receipt of the parties' final statements and proofs.

R-48. Form of Award

(a) Any award shall be in writing and signed by a majority of the arbitrators. Signatures may be executed in electronic or digital form. The award shall be executed in the form and manner required by law.

(b) The arbitrator need not render a reasoned award unless the parties request such an award in writing prior to appointment of the arbitrator or unless the arbitrator determines that a reasoned award is appropriate.

R-49. Scope of Award

(a) The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract.

(b) In addition to a final award, the arbitrator may make other decisions, including interim, interlocutory, or partial rulings, orders, and awards. In any interim, interlocutory, or partial award, the arbitrator may assess and apportion the fees, expenses, and compensation related to such award as the arbitrator determines is appropriate.

(c) In the final award or any order disposing of all of the case, the arbitrator shall assess the fees, expenses, and compensation provided in Rules R-55, R-56, and R-57. The arbitrator may also assess such fees, expenses, and compensation in any order or award disposing of part of the case. The arbitrator may apportion such fees, expenses, and compensation among the parties in such amounts as the arbitrator determines is appropriate.

(d) The award of the arbitrator may include:

- **i)** interest at such rate and from such date as the arbitrator may deem appropriate; and
- **ii)** an award of attorneys' fees if all parties have requested such an award or it is authorized by law or the parties' arbitration agreement.

R-50. Award Upon Settlement – Consent Award

(a) If the parties settle their dispute during the course of the arbitration and if the parties so request, the arbitrator may set forth the terms of the settlement in a "consent award." A consent award must include an allocation of arbitration costs, including administrative fees and expenses as well as arbitrator fees and expenses as set forth in Rule R-49(c).

(b) The consent award shall not be released to the parties until all administrative fees and all arbitrator compensation have been paid in full.

R-51. Delivery of Award to Parties

Parties shall accept as notice and delivery of the award the placing of the award or a true copy thereof in the mail addressed to the parties or their representatives at their last known addresses, personal or electronic service of the award, or the filing of the award in any other manner that is permitted by law.

R-52. Modification of Award

(a) Within 20 calendar days after the transmittal of any award, any party, upon notice to the other parties, may request the arbitrator, through the AAA, interpret the award or correct any clerical, typographical, or computational errors in the award. The arbitrator is not empowered to re-determine the merits of any claim already decided. The other parties shall be given 10 calendar days to respond to the request. The arbitrator shall dispose of the request within 20 calendar days after transmittal by the AAA to the arbitrator of the request and any response thereto.

(b) If the arbitrator has established a different schedule for such requests, responses, and disposition, the arbitrator's schedule will supersede the deadlines set forth in this Rule.

R-53. Release of Documents for Judicial Proceedings

The AAA shall, upon the written request of a party to the arbitration, furnish to the party, at its expense, copies or certified copies of any papers in the AAA's possession that are not determined by the AAA to be privileged or confidential.

R-54. Applications to Court and Exclusion of Liability

(a) No judicial proceeding by a party relating to the subject matter of the arbitration shall be deemed a waiver of the party's right to arbitrate.

(b) Neither the AAA nor any arbitrator in a proceeding under these Rules is a necessary or proper party in any judicial proceedings relating to the arbitration or any other services provided by the AAA.

(c) Parties to an arbitration under these Rules shall be deemed to have consented that judgment upon the arbitration award may be entered in any federal or state court having jurisdiction thereof.

(d) Parties to an arbitration under these Rules shall be deemed to have consented that the AAA shall not be liable to any party in any action for damages, or injunctive or other relief, for any act or omission in connection with any arbitration administered in whole or in part by the AAA or conducted under these Rules. Parties shall also be deemed to have consented that the arbitrator shall not be liable to any party in any action for damages, or injunctive or other relief, for an act or omission in connection with any arbitration administered in whole or in part by the AAA.

(e) Parties to an arbitration under these Rules may not call the arbitrator, the AAA, or AAA employees as a witness in litigation or any other proceeding relating to the arbitration. The arbitrator, the AAA and AAA employees are not competent to testify as witnesses in any such proceeding.

R-55. Administrative Fees

As a not-for-profit organization, the AAA shall prescribe administrative fees to compensate it for the cost of providing administrative services. The fee schedule in effect when the Demand is filed will apply throughout the pendency of the case. The administrative fees shall be paid initially by the party or parties making a claim or counterclaim, subject to final apportionment by the arbitrator in the award. The AAA may, in the event of extreme hardship on the part of any party, defer or reduce the administrative fees.

R-56. Expenses

The expenses of witnesses for either side shall be paid by the party producing such witnesses. All other expenses of the arbitration, including required travel and other expenses of the arbitrator, AAA representatives, and any witness and the cost of any proof produced at the direct request of the arbitrator, shall be borne equally by the parties, unless they agree otherwise or unless the arbitrator in the award assesses such expenses or any part thereof against any specified party or parties.

R-57. Neutral Arbitrator's Compensation

(a) Arbitrators shall be compensated at a rate consistent with the arbitrator's stated rate of compensation at the time their AAA resume is presented to the parties for consideration pursuant to Rule R-13, unless otherwise determined by the AAA. Such compensation will be consistent with the provisions of the arbitrator's executed *Notice of Compensation Arrangements*.

(b) If there is disagreement concerning the terms of compensation, an appropriate rate shall be established with the arbitrator by the AAA and confirmed to the parties.

(c) Any arrangement for the compensation of a neutral arbitrator shall be made through the AAA and not directly between the parties and the arbitrator.

R-58. Deposits

(a) The AAA will require the parties to deposit in advance of any hearings such sums of money as it deems necessary to cover the expense of the arbitration, including the arbitrator's compensation and expenses, if any, and shall render an accounting to the parties and return any unexpended balance at the conclusion of the case. A party's failure to make the requested deposits by the date established by the AAA may result in the AAA's or the arbitrator's taking any appropriate steps as set forth in Rule R-59.

(b) Other than in cases where the arbitrator serves for a flat fee, deposit amounts requested will be based on estimates provided by the arbitrator. The arbitrator will determine the estimated amount of deposits using the information provided by the parties with respect to the complexity of each case.

(c) The AAA shall request from the arbitrator an itemization or explanation for the arbitrator's request for deposits.

(d) The AAA will allocate the deposits requested among the parties and will establish due dates for the collection of those deposits.

R-59. Remedies for Nonpayment

If arbitrator compensation or expenses or the AAA's administrative fees have not been paid in full, the AAA may so inform the parties so that one of them may advance the required payment.

(a) Upon receipt of information from the AAA that payment for administrative fees or deposits for arbitrator compensation or expense have not been paid in full, to the extent the law allows, a party may request that the arbitrator take specific measures relating to a party's non-payment. Such measures may include, but are not limited to:

- **i)** limiting a party's ability to assert or pursue its claim, and
- **ii)** prohibiting a non-paying party from filing any motion.

(b) In no event, however, shall a party be precluded from defending a claim or counterclaim.

(c) The arbitrator must provide the party opposing a request for such measures with the opportunity to respond prior to making any ruling regarding the same.

(d) In the event that the arbitrator grants any request for relief which limits any party's participation in the arbitration, the arbitrator shall require the party who is making a claim and who has made appropriate payments to submit such evidence as the arbitrator may require for the making of an award.

(e) Upon receipt of information from the AAA that full payments have not been received, the arbitrator, on the arbitrator's own initiative or at the request of the AAA or a party, may order the suspension of the arbitration. If no arbitrator has yet been appointed, the AAA may suspend the proceedings.

(f) If the arbitration has been suspended by either the AAA or the arbitrator and the parties have failed to make the full payments requested within the time provided after the suspension, the arbitrator, or the AAA if an arbitrator has not been appointed, may terminate the proceedings.

R-60. Sanctions

(a) The arbitrator may, upon a party's request, order appropriate sanctions where a party fails to comply with its obligations under these Rules or with an order of the arbitrator. In the event that the arbitrator enters a sanction that limits any party's participation in the arbitration or results in an adverse determination of an issue or issues, the arbitrator shall explain that order in writing and shall require the submission of evidence and legal argument prior to making of an award. The arbitrator may not enter a default award as a sanction.

(b) The arbitrator must provide a party that is subject to a sanction request with the opportunity to respond prior to making any determination regarding the sanctions application.

Preliminary Hearing Procedures

P-1. General

(a) In all but the simplest cases, holding a preliminary hearing as early in the process as possible will help the parties and the arbitrator organize the proceeding in a manner that will maximize efficiency and economy, and will provide each party a fair opportunity to present its case.

(b) Care must be taken to avoid importing procedures from court systems, as such procedures may not be appropriate to the conduct of arbitrations as an alternative form of dispute resolution that is designed to be simpler, less expensive and more expeditious.

P-2. Checklist

(a) The following checklist suggests subjects that the parties and the arbitrator should address at the preliminary hearing, in addition to any others that the parties or the arbitrator believe to be appropriate to the particular case. The items to be addressed in a particular case will depend on the size, subject matter, and complexity of the dispute, and are subject to the discretion of the arbitrator:

- **i)** the possibility of other non-adjudicative methods of dispute resolution, including mediation pursuant to Rule R-10;
- **ii)** whether all necessary or appropriate parties are included in the arbitration;
- **iii)** whether a party will seek a more detailed statement of claims, counterclaims or defenses;
- **iv)** whether there are any anticipated amendments to the parties' claims, counterclaims, or defenses;
- **v)** which
  - **a)** arbitration rules;
  - **b)** procedural law; and
  - **c)** substantive law govern the arbitration;
- **vi)** issues related to cybersecurity, privacy and data protection to provide for an appropriate level of security and compliance in connection with the proceeding;
- **vii)** whether there are any threshold or dispositive issues that can efficiently be decided without considering the entire case, including without limitation,
  - **a)** any preconditions that must be satisfied before proceeding with the arbitration;
  - **b)** whether any claim or counterclaim falls outside the arbitrator's jurisdiction or is otherwise not arbitrable;

c) consolidation of the claims or counterclaims with another arbitration; or

d) bifurcation of the proceeding.

viii) whether the parties will exchange documents, including electronically stored documents, on which they intend to rely in the arbitration, and/or make written requests for production of documents within defined parameters;

ix) whether to establish any additional procedures to obtain information that is relevant and material to the outcome of disputed issues;

x) how costs of any searches for requested information or documents that would result in substantial costs should be borne;

xi) whether any measures are required to protect confidential information;

xii) Whether the parties shall disclose:

a) whether any non-party (such as a third-party funder or an insurer) has undertaken to pay or to contribute to the cost of a party's participation in the arbitration, and if so, to identify the person or entity concerned and to describe the nature of the undertaking; and

b) whether any non-party (such as a funder, insurer, parent company, or ultimate beneficial owner) has an economic interest in the outcome of the arbitration, and if so, to identify the person or entity concerned and to describe the nature of the interest;

xiii) whether the parties intend to present evidence from expert witnesses, and if so, whether to establish a schedule for the parties to identify their experts and exchange expert reports;

xiv) whether, according to a schedule set by the arbitrator, the parties will:

a) identify all witnesses, the subject matter of their anticipated testimonies, exchange written witness statements, and determine whether written witness statements will replace direct testimony at the hearing;

b) exchange and pre-mark documents that each party intends to submit; and

c) exchange pre-hearing submissions, including exhibits;

xv) the date, time and place of the arbitration hearing;

a) whether, at the arbitration hearing,

b) testimony may be presented in person, in writing, by videoconference, via the internet, telephonically, or by other reasonable means;

xvi) there will be a stenographic transcript or other record of the proceeding and, if so, who will make arrangements to provide it;

xvii) whether any procedure needs to be established for the issuance of subpoenas;

xviii) the identification of any ongoing, related litigation or arbitration;

xix) whether post-hearing submissions will be filed;

xx) the form of the arbitration award; and

xxi) any other matter the arbitrator considers appropriate or a party wishes to raise.

(b) The arbitrator shall issue a written order memorializing decisions made and agreements reached during or following the preliminary hearing.

Expedited Procedures

E-1. Limitation on Extensions

(a) Except in extraordinary circumstances, the AAA or the arbitrator may grant a party no more than one seven-day extension of time to respond to the Demand for Arbitration or counterclaim as provided in Rule R-5.

(b) Any other extension requests may be granted only after consideration of Procedure E-7.

E-2. Changes of Claim or Counterclaim

A claim or counterclaim may be increased in amount, or a new or different claim or counterclaim added, any time prior to the appointment of the arbitrator. However, after the arbitrator is appointed, no new or different claim or counterclaim may be submitted except with the arbitrator's consent. If an increased claim or counterclaim exceeds $100,000, the case will be administered under the regular Commercial Arbitration Rules unless all parties and the arbitrator agree that the case may continue to be administered under the Expedited Procedures.

E-3. Serving of Notice

In addition to notice provided by Rule R-44, the parties shall also accept notice by telephone. Telephonic notices by the AAA shall subsequently be confirmed in writing to the parties. Should there be a failure to confirm in writing any such oral notice, the proceeding shall nevertheless be valid if notice has, in fact, been given by telephone.

E-4. Appointment and Qualifications of Arbitrator

(a) The AAA shall simultaneously submit to each party an identical list of five proposed arbitrators drawn from its National Roster from which one arbitrator shall be appointed.

(b) The parties are encouraged to agree to an arbitrator from this list and to advise the AAA of their agreement. If the parties are unable to agree upon an arbitrator, each party may strike two names from the list and return it to the AAA within seven days from the date of the AAA's mailing to the parties. If for any reason the appointment of an arbitrator cannot be made from the list, the AAA may make the appointment from other members of the panel without the submission of additional lists.

(c) The parties will be given notice by the AAA of the appointment of the arbitrator, who shall be subject to disqualification for the reasons specified in Rule R-19.

The parties shall notify the AAA within seven calendar days of any objection to the arbitrator appointed. Any such objection shall be for cause and shall be confirmed in writing to the AAA with a copy to the other party or parties.

E-5. Discovery, Motions, and Conduct of Proceedings

(a) At least two business days prior to the hearing, the parties shall exchange copies of all exhibits they intend to submit at the hearing. The arbitrator shall resolve disputes concerning the exchange of exhibits.

(b) No other discovery shall be permitted except as allowed by the arbitrator for good cause shown. If the arbitrator allows additional discovery, the AAA, in consultation with the arbitrator, may remove the case from the Expedited Procedures.

(c) There shall be no motions except as allowed by the arbitrator for good cause shown.

E-6. Proceedings on Documents and Procedures for the Resolution of Disputes Through Document Submission

Where no party's claim exceeds $25,000, exclusive of interest, attorneys' fees and arbitration costs, and other cases in which the parties agree, the dispute shall be resolved by submission of documents, unless any party requests an oral hearing, or the arbitrator determines that an oral hearing is necessary. Where cases are resolved by submission of documents, the following procedures may be utilized at the agreement of the parties or the discretion of the arbitrator:

(a) Within 14 calendar days of confirmation of the arbitrator's appointment, the arbitrator may convene a preliminary management hearing, via conference call, video conference, or internet, to establish a fair and equitable procedure for the submission of documents, and, if the arbitrator deems appropriate, a schedule for one or more telephonic or electronic conferences.

(b) The arbitrator has the discretion to remove the case from the documents-only process if the arbitrator determines that an in-person hearing is necessary.

(c) If the parties agree to in-person hearings after a previous agreement to proceed under this Procedure, the arbitrator shall conduct such hearings. If a party seeks to have in-person hearings after agreeing to this Procedure, but there is not agreement among the parties to proceed with in-person hearings, the arbitrator shall resolve the issue after the parties have been given the opportunity to provide their respective positions on the issue.

(d) The arbitrator shall establish the date for either written submissions or a final telephonic or electronic conference. Such date shall operate to close the hearing and the time for the rendering of the award shall commence.

(e) Unless the parties have agreed to a form of award other than that set forth in Rule R-48, when the parties have agreed to resolve their dispute by this Procedure, the

arbitrator shall render the award within 14 calendar days from the date the hearing is closed.

(f) If the parties agree to a form of award other than that described in Rule R-48, the arbitrator shall have 30 calendar days from the date the hearing is declared closed in which to render the award.

(g) The award is subject to all other provisions of the regular Commercial Arbitration Rules which pertain to awards.

E-7. Date, Time, Place, and Method of Hearing

In cases in which a hearing is to be held, the arbitrator shall set the date, time, place, and method of the hearing, to be scheduled to take place no more than 60 days after the preliminary hearing or as otherwise mutually agreed to between the parties and the arbitrator. The AAA will notify the parties in advance of the hearing date.

E-8. The Hearing

(a) Absent good cause shown, the hearing shall not exceed one day. Each party shall have equal opportunity to submit its proofs and complete its case. The arbitrator shall determine the order of the hearing, and may require further submission of documents within two business days after the hearing.

(b) For good cause shown, the arbitrator may schedule one additional day of hearings to be completed within seven business days after the initial day of hearing or as soon as practicable as determined by the arbitrator. In cases where the hearing is scheduled to exceed one day, the AAA, in consultation with the arbitrator, may remove the case from the Expedited Procedures.

(c) Generally, there will be no stenographic record. Any party desiring a transcribed record of the hearing may arrange for one pursuant to the provisions of Rule R-29.

E-9. Time of Award

Unless otherwise agreed by the parties and arbitrator, the award shall be rendered not later than 14 calendar days from the date of the closing of the hearing or, if oral hearings have been waived, from the due date established for the receipt of the parties' final statements and proofs.

E-10. Arbitrator's Compensation

(a) Arbitrators will receive compensation at a rate to be suggested by the AAA regional office.

(b) For cases that are removed from the Expedited Procedures after the preliminary hearing is held, the arbitrator shall be compensated pursuant to Rule R-57.

Procedures for Large, Complex Commercial Disputes

L-1. Administrative Conference

Prior to the dissemination of a list of potential arbitrators, the AAA may, unless the parties agree otherwise, conduct an administrative conference with the parties and/or their attorneys or other representatives by conference call or video conference. The conference will take place as soon as practicable after the commencement of the arbitration. In the event the parties are unable to agree on a mutually acceptable time for the conference, the AAA may contact the parties individually to discuss the issues contemplated herein. Such administrative conference shall be conducted for the following purposes and for such additional purposes as the parties or the AAA may deem appropriate:

(a) to obtain additional information about the nature and magnitude of the dispute and the anticipated length of hearing and scheduling;

(b) to discuss the views of the parties about the technical and other qualifications of the arbitrators;

(c) to obtain conflicts statements from the parties; and

(d) to consider, with the parties, whether mediation or other non-adjudicative methods of dispute resolution might be appropriate.

L-2. Arbitrators

(a) Large, complex commercial cases shall be heard and determined by either one or three arbitrators, as may be agreed upon by the parties. With the exception in paragraph (b) below, if the parties do not agree upon the number of arbitrators and a claim or counterclaim involves at least $3,000,000 then three arbitrators shall hear and determine the case; otherwise one arbitrator shall hear and determine the case.

(b) In cases involving the financial hardship of a party or other circumstance, the AAA at its discretion may require that only one arbitrator hear and determine the case, regardless of the amount of the claim and counterclaim.

(c) The AAA shall appoint the arbitrator as agreed by the parties. If they are unable to agree on a method of appointment, the AAA shall appoint arbitrators from the Large, Complex Commercial Case Panel, in the manner provided in the regular Commercial Arbitration Rules. Absent agreement of the parties, the arbitrator shall not have served as the mediator in the mediation phase of the instant proceeding.

L-3. Management of Proceedings

(a) The arbitrator shall take such steps as deemed necessary or desirable to avoid delay and to achieve a fair, speedy and cost-effective resolution of a Large, Complex Commercial Dispute.

(b) As promptly as practicable after the selection of the arbitrator(s), a preliminary hearing shall be scheduled in accordance with Procedures P-1 and P-2 of these rules.

(c) The parties shall exchange copies of all exhibits they intend to submit at the hearing at least 10 calendar days prior to the hearing unless the arbitrator determines otherwise.

(d) The parties and the arbitrator shall address issues pertaining to the pre-hearing exchange and production of information in accordance with Rule R-23 of the AAA Commercial Rules, and the arbitrator's determinations on such issues shall be included within a scheduling order.

(e) The arbitrator, or any single member of the panel, shall be authorized to resolve any disputes concerning the pre-hearing exchange and production of documents and information by any reasonable means within their discretion, including, without limitation, the issuance of orders set forth in Rules R-23 and R-24 of the AAA Commercial Rules.

(f) In exceptional cases, at the discretion of the arbitrator, upon good cause shown and consistent with the expedited nature of arbitration, the arbitrator may order depositions to obtain the testimony of a person who may possess information determined by the arbitrator to be relevant and material to the outcome of the case. The arbitrator may allocate the cost of taking such a deposition.

(g) Generally, hearings will be scheduled on consecutive days or in blocks of consecutive days in order to maximize efficiency and minimize costs.

Administrative Fee Schedules (Standard and Flexible Fees)

FOR THE CURRENT ADMINISTRATIVE FEE SCHEDULE, PLEASE VISIT ***www.adr.org/feeschedule***.

Commercial Mediation Procedures

M-1. Agreement of Parties

Whenever, by stipulation or in their contract, the parties have provided for mediation or conciliation of existing or future disputes under the auspices of the American Arbitration Association or under these procedures, the parties and their representatives, unless agreed otherwise in writing, shall be deemed to have made these procedural guidelines, as amended and in effect as of the date of filing of a request for mediation, a part of their agreement and designate the AAA as the administrator of their mediation.

The parties by mutual agreement may vary any part of these procedures including, but not limited to, agreeing to conduct the mediation via telephone or other electronic or technical means.

M-2. Initiation of Mediation

Any party or parties to a dispute may initiate mediation under the AAA's auspices by making a request for mediation to any of the AAA's regional offices or case management centers via telephone, email, regular mail or fax. Requests for mediation may also be filed online via AAA WebFile at **www.adr.org.**

The party initiating the mediation shall simultaneously notify the other party or parties of the request. The initiating party shall provide the following information to the AAA and the other party or parties as applicable:

(i) A copy of the mediation provision of the parties' contract or the parties' stipulation to mediate.

(ii) The names, regular mail addresses, email addresses, and telephone numbers of all parties to the dispute and representatives, if any, in the mediation.

(iii) A brief statement of the nature of the dispute and the relief requested.

(iv) Any specific qualifications the mediator should possess.

M-3. Representation

Subject to any applicable law, any party may be represented by persons of the party's choice. The names and addresses of such persons shall be communicated in writing to all parties and to the AAA.

M-4. Appointment of the Mediator

If the parties have not agreed to the appointment of a mediator and have not provided any other method of appointment, the mediator shall be appointed in the following manner:

(i) Upon receipt of a request for mediation, the AAA will send to each party a list of mediators from the AAA's Panel of Mediators. The parties are encouraged to agree to a mediator from the submitted list and to advise the AAA of their agreement.

(ii) If the parties are unable to agree upon a mediator, each party shall strike unacceptable names from the list, number the remaining names in order of preference, and return the list to the AAA. If a party does not return the list within the time specified, all mediators on the list shall be deemed acceptable. From among the mediators who have been mutually approved by the parties, and in accordance with the designated order of mutual preference, the AAA shall invite a mediator to serve.

(iii) If the parties fail to agree on any of the mediators listed, or if acceptable mediators are unable to serve, or if for any other reason the appointment cannot be made from the submitted list, the AAA shall have the authority to make the appointment from among other members of the Panel of Mediators without the submission of additional lists.

M-5. Mediator's Impartiality and Duty to Disclose

AAA mediators are required to abide by the *Model Standards of Conduct for Mediators* in effect at the time a mediator is appointed to a case. Where there is a conflict between the *Model Standards* and any provision of these Mediation Procedures, these Mediation Procedures shall govern. The Standards require mediators to (i) decline a mediation if the mediator cannot conduct it in an impartial manner, and (ii) disclose, as soon as practicable, all actual and potential conflicts of interest that are reasonably known to the mediator and could reasonably be seen as raising a question about the mediator's impartiality.

Prior to accepting an appointment, AAA mediators are required to make a reasonable inquiry to determine whether there are any facts that a reasonable individual would consider likely to create a potential or actual conflict of interest for the mediator. AAA mediators are required to disclose any circumstance likely to create a presumption of bias or prevent a resolution of the parties' dispute within the time-frame desired by the parties. Upon receipt of such disclosures, the AAA shall immediately communicate the disclosures to the parties for their comments.

The parties may, upon receiving disclosure of actual or potential conflicts of interest of the mediator, waive such conflicts and proceed with the mediation. In the event that a party disagrees as to whether the mediator shall serve, or in the event that the mediator's conflict of interest might reasonably be viewed as undermining the integrity of the mediation, the mediator shall be replaced.

M-6. Vacancies

If any mediator shall become unwilling or unable to serve, the AAA will appoint another mediator, unless the parties agree otherwise, in accordance with section M-4.

M-7. Duties and Responsibilities of the Mediator

(i) The mediator shall conduct the mediation based on the principle of party self-determination. Self-determination is the act of coming to a voluntary, uncoerced decision in which each party makes free and informed choices as to process and outcome.

(ii) The mediator is authorized to conduct separate or *ex parte* meetings and other communications with the parties and/or their representatives, before, during, and after any scheduled mediation conference. Such communications may be conducted via telephone, in writing, via email, online, in person or otherwise.

(iii) The parties are encouraged to exchange all documents pertinent to the relief requested. The mediator may request the exchange of memoranda on issues, including the underlying interests and the history of the parties' negotiations. Information that a party wishes to keep confidential may be sent to the mediator, as necessary, in a separate communication with the mediator.

(iv) The mediator does not have the authority to impose a settlement on the parties but will attempt to help them reach a satisfactory resolution of their dispute. Subject to the discretion of the mediator, the mediator may make oral or written recommendations for settlement to a party privately or, if the parties agree, to all parties jointly.

(v) In the event a complete settlement of all or some issues in dispute is not achieved within the scheduled mediation session(s), the mediator may continue to communicate with the parties, for a period of time, in an ongoing effort to facilitate a complete settlement.

(vi) The mediator is not a legal representative of any party and has no fiduciary duty to any party.

M-8. Responsibilities of the Parties

The parties shall ensure that appropriate representatives of each party, having authority to consummate a settlement, attend the mediation conference.

Prior to and during the scheduled mediation conference session(s) the parties and their representatives shall, as appropriate to each party's circumstances, exercise their best efforts to prepare for and engage in a meaningful and productive mediation.

M-9. Privacy

Mediation sessions and related mediation communications are private proceedings. The parties and their representatives may attend mediation sessions. Other persons may attend only with the permission of the parties and with the consent of the mediator.

M-10. Confidentiality

Subject to applicable law or the parties' agreement, confidential information disclosed to a mediator by the parties or by other participants (witnesses) in the course of the mediation shall not be divulged by the mediator. The mediator shall maintain the confidentiality of all information obtained in the mediation, and all records, reports, or other documents received by a mediator while serving in that capacity shall be confidential.

The mediator shall not be compelled to divulge such records or to testify in regard to the mediation in any adversary proceeding or judicial forum.

The parties shall maintain the confidentiality of the mediation and shall not rely on, or introduce as evidence in any arbitral, judicial, or other proceeding the following, unless agreed to by the parties or required by applicable law:

(i) Views expressed or suggestions made by a party or other participant with respect to a possible settlement of the dispute;

(ii) Admissions made by a party or other participant in the course of the mediation proceedings;

(iii) Proposals made or views expressed by the mediator; or

(iv) The fact that a party had or had not indicated willingness to accept a proposal for settlement made by the mediator.

M-11. No Stenographic Record

There shall be no stenographic record of the mediation process.

M-12. Termination of Mediation

The mediation shall be terminated:

(i) By the execution of a settlement agreement by the parties; or

(ii) By a written or verbal declaration of the mediator to the effect that further efforts at mediation would not contribute to a resolution of the parties' dispute; or

(iii) By a written or verbal declaration of all parties to the effect that the mediation proceedings are terminated; or

(iv) When there has been no communication between the mediator and any party or party's representative for 21 days following the conclusion of the mediation conference.

M-13. Exclusion of Liability

Neither the AAA nor any mediator is a necessary party in judicial proceedings relating to the mediation. Neither the AAA nor any mediator shall be liable to any party for any error, act or omission in connection with any mediation conducted under these procedures.

M-14. Interpretation and Application of Procedures

The mediator shall interpret and apply these procedures insofar as they relate to the mediator's duties and responsibilities. All other procedures shall be interpreted and applied by the AAA.

M-15. Deposits

Unless otherwise directed by the mediator, the AAA will require the parties to deposit in advance of the mediation conference such sums of money as it, in consultation with the mediator, deems necessary to cover the costs and expenses of the mediation and shall render an accounting to the parties and return any unexpended balance at the conclusion of the mediation.

M-16. Expenses

All expenses of the mediation, including required traveling and other expenses or charges of the mediator, shall be borne equally by the parties unless they agree otherwise. The expenses of participants for either side shall be paid by the party requesting the attendance of such participants.

M-17. Cost of the Mediation

FOR THE CURRENT ADMINISTRATIVE FEE SCHEDULE, PLEASE VISIT ***www.adr.org/feeschedule***.

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CONSUMER

Consumer Arbitration Rules



AMERICAN ARBITRATION ASSOCIATION®

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Consumer Arbitration Rules



Introduction

Millions of consumer purchases take place each year. Occasionally, these transactions lead to disagreements between consumers and businesses. These disputes can be resolved by arbitration. Arbitration is usually faster and cheaper than going to court.

The American Arbitration Association® ("AAA®," "the Association") applies the *Consumer Arbitration Rules* ("Rules") to arbitration clauses in agreements between individual consumers and businesses where the business has a standardized, systematic application of arbitration clauses with customers and where the terms and conditions of the purchase of standardized, consumable goods or services are non-negotiable or primarily non-negotiable in most or all of its terms, conditions, features, or choices. The product or service must be for personal or household use. The AAA has the discretion to apply or not to apply the *Consumer Arbitration Rule,* and the parties are able to bring any disputes concerning the application or non-application of the Rules to the attention of the arbitrator. Consumers and businesses are permitted to seek relief in a small claims court for disputes or claims within the scope of the small claims court's jurisdiction. These Rules were drafted and designed to be consistent with the minimum due process principles of the *Consumer Due Process Protocol.*

About the AAA

The administrator's role is to manage the administrative aspects of the arbitration, such as the appointment of the arbitrator, preliminary decisions about where hearings might take place, and handling the fees associated with the arbitration. As administrator, however, the AAA does not decide the merits of a case or make any rulings on issues such as what documents must be shared with each side. Because the AAA's role is only administrative, the AAA cannot overrule or change an arbitrator's decisions or rulings. The administrator will comply with any court orders issued from litigation involving the parties to the dispute.

The American Arbitration Association, founded in 1926, is a neutral, independent, and private not-for-profit organization. We offer a broad range of conflict management services to businesses, organizations, and individuals. We also provide education, training, and publications focused on methods for settling disputes out of court.

The Arbitrator

Except where the parties to a case reach their own settlement, the arbitrator will make the final, binding decision called the Award on the dispute and render it in writing. The Arbitrator makes all the procedural decisions on a case not made by the Administrator or not decided jointly by the parties. The arbitrator may grant any remedy, relief, or outcome that the parties could have received in court, including awards of attorney's fees and costs, in accordance with the law or laws that apply to the case.

Arbitrators are neutral and independent decision makers who are not employees of the AAA. Once appointed to a case, an arbitrator may not be removed by one party without the other party's consent or unless the Administrator determines an arbitrator should be removed and replaced by another arbitrator chosen by the Administrator in a manner described in these Rules.

The AAA's Consumer Arbitration Rules

The AAA has developed the *Consumer Arbitration Rules* for consumers and businesses that want to have their disagreements resolved through arbitration.

Availability of Mediation through AAA Mediation.org

Mediation in consumer disputes is also available to help parties resolve their disputes. Parties interested in participating in mediation may find a mediator through **www.aaamediation.org.**

Administrative Fees

The Association charges a fee for its services under these Rules. A fee schedule is included at the end of these Rules in the Costs of Arbitration section.

Arbitrator's Fees

Arbitrators are paid for the time they spend resolving disputes. The business makes deposits as outlined in the fee schedule in the Costs of Arbitration section of these Rules. Unused deposits are refunded at the end of the case.

Notification

A business intending to incorporate these Rules or to refer to the dispute resolution services of the AAA in a consumer alternative dispute resolution ("ADR") plan should, at least 30 days prior to the planned effective date of the program,

- notify the Association of its intention to do so, and
- provide the Association with a copy of the consumer dispute resolution plan.

If a business does not comply with this requirement, the Association reserves the right to withhold its administrative services. For more information, please see R-12 below.

Filing a Case and Initial AAA Administrative Steps

R-1. Applicability (When the AAA Applies These Rules)

(a) The parties shall have made these *Consumer Arbitration Rules* ("Rules") a part of their arbitration agreement whenever they have provided for arbitration by the American Arbitration Association ("AAA"), and

1) have specified that these *Consumer Arbitration Rules* shall apply;

2) have specified that the *Supplementary Procedures for Consumer-Related Disputes* shall apply, which have been amended and renamed the Consumer Arbitration Rules;

3) the arbitration agreement is contained within a consumer agreement, as defined below, that does not specify a particular set of rules; or

4) the arbitration agreement is contained within a consumer agreement, as defined below, that specifies a particular set of rules other than the *Consumer Arbitration Rules*.

When parties have provided for the AAA's rules or AAA administration as part of their consumer agreement, they shall be deemed to have agreed that the application of the AAA's rules and AAA administration of the consumer arbitration shall be an essential term of their consumer agreement.

The AAA defines a consumer agreement as an agreement between an individual consumer and a business where the business has a standardized, systematic application of arbitration clauses with customers and where the terms and conditions of the purchase of standardized, consumable goods or services are non-negotiable or primarily non-negotiable in most or all of its terms, conditions, features, or choices. The product or service must be for personal or household use.

Examples of contracts that typically meet the criteria for application of these Rules, if the contract is for personal or household goods or services and has an arbitration provision, include, but are not limited to the following:

- Credit card agreements
- Telecommunications (cell phone, ISP, cable TV) agreements
- Leases (residential, automobile)
- Automobile and manufactured home purchase contracts
- Finance agreements (car loans, mortgages, bank accounts)
- Home inspection contracts
- Pest control services

- Moving and storage contracts
- Warranties (home, automobile, product)
- Legal funding
- Health and fitness club membership agreements
- Travel services
- Insurance policies
- Private school enrollment agreements

Examples of contracts that typically do not meet the criteria for application of these Rules, should the contract contain an arbitration provision, include, but are not limited to the following:

- Home construction and remodeling contracts
- Real estate purchase and sale agreements
- Condominium or homeowner association by-laws
- Business insurance policies (including crop insurance)
- Commercial loan and lease agreements
- Commercial guaranty agreements

(b) When parties agree to arbitrate under these Rules, or when they provide for arbitration by the AAA and an arbitration is initiated under these Rules, they thereby authorize the AAA to administer the arbitration. The authority and duties of the AAA are prescribed in the agreement of the parties and in these Rules and may be carried out through such of the AAA's representatives as it may direct. The AAA may, in its discretion, assign the administration of an arbitration to any of its offices. Arbitrations administered under these Rules shall only be administered by the AAA or by an individual or organization authorized by the AAA to do so.

(c) The consumer and the business may agree to change these Rules. If they agree to change the Rules, they must agree in writing. If the consumer and the business want to change these Rules after the appointment of the arbitrator, any changes may be made only with the approval of the arbitrator.

(d) The AAA administers consumer disputes that meet the due process standards contained in the *Consumer Due Process Protocol* and the *Consumer Arbitration Rules*. The AAA will accept cases after the AAA reviews the parties' arbitration agreement and if the AAA determines the agreement substantially and materially complies with the due process standards of these Rules and the *Consumer Due Process Protocol*. Should the AAA decline to administer an arbitration, either party may choose to submit its dispute to the appropriate court for resolution.

(e) The AAA has the initial authority to apply or not to apply the *Consumer*

Arbitration Rules. If either the consumer or the business disagrees with the AAA's decision, the objecting party must submit the objection by the due date for filing an answer to the demand for arbitration. If an objection is filed, the arbitrator shall have the authority to make the final decision on which AAA rules will apply.

(f) If, within 30 days after the AAA's commencement of administration, a party seeks judicial intervention with respect to a pending arbitration and provides the AAA with documentation that judicial intervention has been sought, the AAA will suspend administration for 30 days to permit the party to obtain a stay of arbitration from the court.

(g) Where no disclosed claims or counterclaims exceed $25,000, the dispute shall be resolved by the submission of documents only/desk arbitration (see R-29 and the *Procedures for the Resolution of Disputes through Document Submission* below). Any party, however, may ask for a hearing. The arbitrator also may decide that a hearing is necessary.

R-2. Starting Arbitration under an Arbitration Agreement in a Contract

(a) Arbitration filed under an arbitration agreement naming the AAA shall be started in the following manner:

(1) The party who starts the arbitration (referred to as the "claimant" throughout the arbitration) must contact, in writing, the party that the case is filed against (referred to as the "respondent" throughout the arbitration) that it wishes to arbitrate a dispute. This written contact is referred to as the Demand for Arbitration ("Demand"). The Demand must do the following:

- Briefly explain the dispute
- List the names and addresses of the consumer and the business, and, if known, the names of any representatives of the consumer and the business
- Specify the amount of money in dispute, if applicable
- Identify the requested location for the hearing if an in-person hearing is requested
- State what the claimant wants

(2) The claimant must also send one copy of the Demand to the AAA at the same time the demand is sent to the respondent. When sending a Demand to the AAA, the claimant must also send the following:

- A copy of the arbitration agreement contained in the contract and/or agreement and/or purchase document
- The proper filing fee; the amount of the filing fee can be found in the Costs of Arbitration section at the end of these Rules.

(3) If the arbitration is pursuant to a court order, the claimant must send one copy of the Demand to the AAA at the same time the Demand is sent to the respondent. When sending a demand to the AAA, the claimant must also send the following:

- A copy of the court order
- A copy of the arbitration agreement contained in the contract and/or agreement and/or purchase document
- The proper filing fee

The filing fee must be paid before a matter is considered properly filed. If the court order directs that a specific party is responsible for the filing fee, it is the responsibility of the filing party either to make such payment to the AAA and seek reimbursement as directed in the court order or to make other such arrangements so that the filing fee is submitted to the AAA with the Demand.

The claimant may file by mail. The mailing address of the AAA's Case Filing Services is:

American Arbitration Association
Case Filing Services
1101 Laurel Oak Road, Suite 100
Voorhees, NJ 08043

Or, the claimant may file online using AAA WebFile: **https://www.adr.org**

Or, the claimant may file at any of the AAA's offices.

(b) The AAA will send a written notice letting the consumer and the business know the Demand for Arbitration has been received.

(c) The respondent may submit a written response to the Demand, known as an "answer," which describes how the respondent responds to the claimant's claim. The answer must be sent to the AAA within 14 calendar days after the date the AAA notifies the parties that the Demand for Arbitration was received and all filing requirements were met. The answer must be

- in writing,
- sent to the AAA, and
- sent to the claimant at the same time.

(d) The respondent may also file a counterclaim, which is the respondent filing a Demand against the claimant. If the respondent has a counterclaim, the counterclaim must briefly explain the dispute, specify the amount of money involved, and state what the respondent wants.

(e) If no answer is filed within 14 calendar days, the AAA will assume that the respondent does not agree with the claim filed by the claimant. The case will move forward after 14 days regardless of whether an answer is filed.

(f) When sending a Demand or an answer, the consumer and the business are encouraged to provide enough details to make the dispute clear to the arbitrator.

R-3. Agreement to Arbitrate When There is No AAA Arbitration Clause

If the consumer and business do not have an arbitration agreement or their arbitration agreement does not name the AAA, the parties may agree to have the AAA arbitrate their dispute. To start the arbitration, the parties must send the AAA a submission agreement, which is an agreement to arbitrate their case with the AAA, signed by the consumer and the business (email communications between all parties to a dispute reflecting an agreement to arbitrate also is acceptable). The submission agreement must

- be in writing (electronic communication is acceptable);
- be signed by both parties;
- briefly explain the dispute;
- list the names and addresses of the consumer and the business;
- specify the amount of money involved;
- specify the requested location for the hearing if an in-person hearing is requested; and
- state the solution sought.

The parties should send one copy of the submission agreement to the AAA. They must also send the proper filing fees. A fee schedule can be found in the Costs of Arbitration section at the end of these Rules.

R-4. AAA Administrative Fees

As a not-for-profit organization, the AAA charges fees to compensate it for the cost of providing administrative services. The fee schedule in effect when the case is filed shall apply for all fees charged during the administration of the case. The AAA may, in the event of the consumer's extreme hardship, defer or reduce the consumer's administrative fees.

AAA fees shall be paid in accordance with the Costs of Arbitration section found at the end of these Rules.

R-5. Neutral Arbitrator's Compensation

(a) Arbitrators serving under these Rules shall be compensated at a rate established by the AAA.

(b) Any arrangement for the compensation of an arbitrator shall be made through the AAA and not directly between the parties and the arbitrator.

(c) Arbitrator compensation shall be paid in accordance with the Costs of Arbitration section found at the end of these Rules.

R-6. Depositing Neutral Arbitrator's Compensation with the AAA

The AAA may require the parties to deposit in advance of any hearings such sums of money as it decides are necessary to cover the expense of the arbitration, including the arbitrator's fee, and shall render an accounting to the parties and return any unused money at the conclusion of the case.

R-7. Expenses

Unless otherwise agreed by the parties or as provided under applicable law, the expenses of witnesses for either side shall be borne by the party producing such witnesses.

All expenses of the arbitrator, including required travel and other expenses, and any AAA expenses, as well as the costs relating to proof and witnesses produced at the direction of the arbitrator, shall be borne in accordance with the Costs of Arbitration section found at the end of these Rules.

R-8. Changes of Claim

Once a Demand has been filed, any new claims or counterclaims, or changes to the claim or counterclaim, must be made in writing and sent to the AAA. The party making the new or different claim or counterclaim shall send a copy to the opposing party. As with the original Demand or counterclaim, a party shall have 14 calendar days from the date the AAA notifies the parties it received the new or different claim or counterclaim to file an answering statement with the AAA.

If an arbitrator has already been appointed, a new or different claim or counterclaim may only be considered if the arbitrator allows it.

R-9. Small Claims Option for the Parties

If a party's claim is within the jurisdiction of a small claims court, either party may choose to take the claim to that court instead of arbitration as follows:

(a) The parties may take their claims to small claims court without first filing with the AAA.

(b) After a case is filed with the AAA, but before the arbitrator is formally appointed to the case by the AAA, a party can send a written notice to the opposing party and the AAA that it wants the case decided by a small claims court. After receiving this notice, the AAA will administratively close the case.

(c) After the arbitrator is appointed, if a party wants to take the case to small claims court and notifies the opposing party and the AAA, it is up to the arbitrator to determine if the case should be decided in arbitration or if the arbitration case should be closed and the dispute decided in small claims court.

R-10. Administrative Conference with the AAA

At the request of any party or if the AAA should so decide, the AAA may have a telephone conference with the parties and/or their representatives. The conference may address issues such as arbitrator selection, the possibility of a mediated settlement, exchange of information before the hearing, timing of the hearing, the type of hearing that will be held, and other administrative matters.

R-11. Fixing of Locale (the city, county, state, territory and or country where the arbitration will take place)

If an in-person hearing is to be held and if the parties do not agree to the locale where the hearing is to be held, the AAA initially will determine the locale of the arbitration. If a party does not agree with the AAA's decision, that party can ask the arbitrator, once appointed, to make a final determination. The locale determination will be made after considering the positions of the parties, the circumstances of the parties and the dispute, and the *Consumer Due Process Protocol*.

R-12. Business Notification and Publicly-Accessible Consumer Clause Registry

Beginning September 1, 2014, a business that provides for or intends to provide for these Rules or another set of AAA Rules in a consumer contract (as defined in R-1) should

1. notify the AAA of the existence of such a consumer contract or of its intention to do so at least 30 days before the planned effective date of the contract.
2. provide the AAA a copy of the arbitration agreement.

Upon receiving the arbitration agreement, the AAA will review the agreement for material compliance with due process standards contained in the *Consumer Due Process Protocol* and the *Consumer Arbitration Rules* (see Rule 1(d)). There is a nonrefundable fee to conduct this initial review and maintain a publicly-available clause registry, which is detailed in the Costs of Arbitration section found at the end of these Rules. Any subsequent changes, additions, deletions, or amendments to a currently-registered arbitration agreement must be resubmitted for review and a review fee will be assessed at that time. The AAA will decline to administer consumer arbitrations arising out of that arbitration agreement where the business fails to pay the review fee.

If a business does not submit its arbitration agreement for review and a consumer arbitration then is filed with the AAA, the AAA will conduct an expedited review at that time. Along with any other filing fees that are owed for that case, the business also will be responsible for paying the nonrefundable review and Registry fee (including any fee for expedited review at the time of filing) for this initial review, which is detailed in the Costs of Arbitration section found at the end of these Rules. The AAA will decline to administer consumer arbitrations arising out of that arbitration agreement if the business declines to pay the review and Registry fee.

After the AAA reviews the submitted consumer clause, receives the annual consumer registry fee, and determines it will administer consumer-related disputes filed pursuant to the consumer clause, the business will be included on the publicly-accessible Consumer Clause Registry. This Consumer Clause Registry maintained by the AAA will contain the name of the business, the address, and the consumer arbitration clause, along with any related documents as deemed necessary by the AAA. The AAA's review of a consumer arbitration clause and determination whether or not to administer arbitrations pursuant to that clause is only an administrative determination by the AAA and cannot be

relied upon or construed as a legal opinion or advice regarding the enforceability of the arbitration clause. Consumer arbitration agreements may be registered at: **www.adr.org/ClauseRegistry** or via email at **consumerreview@adr.org.**

For more information concerning the Consumer Clause Registry, please visit the AAA's website at **www.adr.org/ClauseRegistry.**

The Registry fee to initially review a business's agreement and maintain the clause registry list is a yearly, non-refundable fee for the business's arbitration agreement. Any different arbitration agreements submitted by the same business or its subsidiaries must be submitted for review and are subject to the current review fee.

If the AAA declines to administer a case due to the business's non-compliance with this notification requirement, the parties may choose to submit their dispute to the appropriate court.

R-13. AAA and Delegation of Duties

When the consumer and the business agree to arbitrate under these Rules or other AAA rules, or when they provide for arbitration by the AAA and an arbitration is filed under these Rules, the parties also agree that the AAA will administer the arbitration. The AAA's administrative duties are set forth in the parties' arbitration agreement and in these Rules. The AAA will have the final decision on which office and which AAA staff members will administer the case. Arbitrations administered under these Rules shall only be administered by the AAA or by an individual or organization authorized by the AAA to do so.

R-14. Jurisdiction

(a) The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim.

(b) The arbitrator shall have the power to determine the existence or validity of a contract of which an arbitration clause forms a part. Such an arbitration clause shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitrator that the contract is null and void shall not for that reason alone render invalid the arbitration clause.

(c) A party must object to the jurisdiction of the arbitrator or to the arbitrability of a claim or counterclaim no later than the filing of the answering statement to the claim or counterclaim that gives rise to the objection. The arbitrator may rule on such objections as a preliminary matter or as part of the final award.

Appointing the Arbitrator

R-15. National Roster of Arbitrators

The AAA maintains a National Roster of Arbitrators ("National Roster") and shall appoint arbitrators from this National Roster to resolve the parties' dispute(s).

R-16. Appointment from National Roster

(a) If the parties have not appointed an arbitrator and have not agreed to a process for appointing the arbitrator, immediately after the filing of the submission agreement or the answer, or after the deadline for filing the answer, the AAA will administratively appoint an arbitrator from the National Roster.

(b) If the parties' arbitration agreement provides for three or more arbitrators and they have not appointed the arbitrators and have not agreed to a process for appointing the arbitrators, immediately after the filing of the submission agreement or the answer, or after the deadline for filing the answer, the AAA will administratively appoint the arbitrators from the National Roster. The AAA will appoint the chairperson.

(c) Arbitrator(s) serving under these Rules will be neutral and must meet the standards of R-19 with respect to being impartial and independent.

R-17. Number of Arbitrators

If the arbitration agreement does not specify the number of arbitrators and the parties do not agree on the number, the dispute shall be heard and decided by one arbitrator.

R-18. Disclosure

(a) Any person appointed or to be appointed as an arbitrator, as well as the parties and their representatives, must provide information to the AAA of any circumstances likely to raise justifiable doubt as to whether the arbitrator can remain impartial or independent. This disclosure of information would include

(1) any bias;

(2) any financial interest in the result of the arbitration;

(3) any personal interest in the result of the arbitration; or

(4) any past or present relationship with the parties or their representatives.

Such obligation to provide disclosure information remains in effect throughout the arbitration. A failure on the part of a party or a representative to comply with the requirements of this rule may result in the waiver of the right to object to an arbitrator in accordance with Rule R-50.

(b) If the AAA receives such information from the arbitrator or another source, the AAA will communicate the information to the parties. If the AAA decides it is appropriate, it will also communicate the information to the arbitrator and others.

(c) In order to encourage disclosure by arbitrators, disclosing such information does not mean that the arbitrator considers the disclosed information will likely affect his or her ability to be impartial or independent.

R-19. Disqualification of Arbitrator

(a) Any arbitrator shall be impartial and independent and shall perform his or her duties carefully and in good faith. The AAA may disqualify an arbitrator who shows

(1) partiality or lack of independence;

(2) inability or refusal to perform his or her duties with diligence and in good faith; or

(3) any grounds for disqualification provided by applicable law.

(b) If a party objects to the continued service of an arbitrator, or if the AAA should so decide to raise the issue of whether the arbitrator should continue on the case, the AAA will decide if the arbitrator should be disqualified. After gathering the opinions of the parties, the AAA will decide and that decision shall be final and conclusive.

R-20. Vacancies

If for any reason an arbitrator cannot or is unwilling to perform the duties of the office, the AAA may declare the office vacant. Any vacancies shall be filled based on the original procedures used to appoint the arbitrator. If a substitute arbitrator is appointed, the substitute arbitrator will decide if it is necessary to repeat all or part of any prior ruling or hearing.

Pre-Hearing Preparation

R-21. Preliminary Management Hearing with the Arbitrator

(a) If any party asks for, or if the AAA or the arbitrator decides to hold one, the arbitrator will schedule a preliminary management hearing with the parties and/or their representatives as soon as possible. The preliminary management hearing will be conducted by telephone unless the arbitrator decides an in-person preliminary management hearing is necessary.

(b) During the preliminary management hearing, the parties and the arbitrator should discuss the future conduct of the case, including clarification of issues and claims, scheduling of the hearings, and any other preliminary matters.

(c) The arbitrator shall promptly issue written orders that state the arbitrator's decisions made during or as a result of the preliminary management hearing. The arbitrator may also conduct additional preliminary management hearings if the need arises.

R-22. Exchange of Information between the Parties

(a) If any party asks or if the arbitrator decides on his or her own, keeping in mind that arbitration must remain a fast and economical process, the arbitrator may direct

1) specific documents and other information to be shared between the consumer and business, and

2) that the consumer and business identify the witnesses, if any, they plan to have testify at the hearing.

(b) Any exhibits the parties plan to submit at the hearing need to be shared between the parties at least five business days before the hearing, unless the arbitrator sets a different exchange date.

(c) No other exchange of information beyond what is provided for in section (a) above is contemplated under these Rules, unless an arbitrator determines further information exchange is needed to provide for a fundamentally fair process.

(d) The arbitrator has authority to resolve any disputes between the parties about exchanging information.

R-23. Enforcement Powers of the Arbitrator

The arbitrator may issue any orders necessary to enforce the provisions of rules R-21 and R-22 and to otherwise achieve a fair, efficient, and economical resolution of the case, including, but not limited to:

(a) an order setting the conditions for any exchange or production of confidential documents and information, and the admission of confidential evidence at the hearing in order to preserve such confidentiality;

(b) to the extent the exchange of information takes place pursuant to R-22, imposing reasonable search limitations for electronic and other documents if the parties are unable to agree;

(c) allocating costs of producing documentation, including electronically-stored documentation;

(d) in the case of willful non-compliance with any order issued by the arbitrator, drawing adverse inferences, excluding evidence and other submissions, and/or making special allocations of costs or an interim award of costs arising from such non-compliance; and

(e) issuing any other enforcement orders that the arbitrator is empowered to issue under applicable law.

R-24. Written Motions (except for Dispositive Motions—see R-33)

The arbitrator may consider a party's request to file a written motion (except for Dispositive Motions— see R-33) only after the parties and the arbitrator conduct a conference call to attempt to resolve the issue that gives rise to the proposed motion. Only after the parties and the arbitrator hold the call may the arbitrator consider a party's request to file a written motion. The arbitrator has the sole discretion to allow or deny the filing of a written motion and his or her decision is final.

R-25. Representation of a Party

Any party may participate in the arbitration without representation, or may be represented by counsel or other authorized representative, unless such choice is prohibited by applicable law. A party intending to be represented shall give the opposing party and the AAA the name, address, and contact information of the representative at least three business days before the hearing where that representative will first appear in the case. It will be considered proper notice if a representative files the arbitration demand or answer or responds for a party during the course of the arbitration.

While parties do not need an attorney to participate in arbitration, arbitration is a final, legally-binding process that may impact a party's rights. As such, parties may want to consider consulting an attorney.

R-26. Setting the Date, Time, and Place (the physical site of the hearing within the designated locale) of Hearing

The arbitrator will set the date, time, and place for each hearing within the locale as determined in R-11. A hearing may be by telephone or in person. For their part, the parties commit to

(1) respond promptly to the arbitrator when he or she asks what dates the parties are available to have the hearings;

(2) cooperate in the scheduling of the hearing on the earliest possible date; and

(3) follow the hearing schedule set up by the arbitrator.

The AAA will send a notice of the hearing to the parties at least 10 days before the hearing date, unless the parties agree to a different time frame.

R-27. Written Record of Hearing

(a) If a party wants a written record of the hearing, that party must make such arrangement directly with a stenographer (court reporter) and notify the opposing parties, the AAA, and the arbitrator of these arrangements at least three business days before the hearing. The party or parties who request the written record shall pay the cost of the service.

(b) No other type of recording will be allowed unless the parties agree or the arbitrator directs a different form of recording.

(c) The arbitrator may resolve disputes between the parties over who will pay the costs of the written record or other type of recording.

(d) The parties can agree or the arbitrator may decide that the transcript (written record) is the official record of the hearing. If it is the official record of the hearing, the transcript must be given to the arbitrator and made available to all the parties so that it can be reviewed. The date, time, and place of the inspection will be decided by the arbitrator.

R-28. Interpreters

If a party wants an interpreter present for any part of the process, that party must make arrangements directly with the interpreter and shall pay for the costs of the service.

R-29. Documents-Only Procedure

Disputes may be resolved by submission of documents and without in-person or telephonic hearings. For cases being decided by the submission of documents only, the *Procedures for the Resolution of Disputes through Document Submission* (found at the end of these Rules) shall supplement these Rules. These Procedures will apply where no disclosed claims or counterclaims exceed $25,000 (see R-1(g)), unless any party requests an in-person or telephonic hearing or the arbitrator decides that a hearing is necessary.

Hearing Procedures

R-30. Attendance at Hearings

The arbitrator and the AAA will keep information about the arbitration private except to the extent that a law provides that such information shall be shared or made public. The parties and their representatives in the arbitration are entitled to attend the hearings. The arbitrator will determine any disputes over whether a non-party may attend the hearing.

R-31. Oaths

Before starting the hearing, each arbitrator may take an oath of office and, if required by law, shall do so. If the arbitrator determines that witnesses shall testify under oath, then the arbitrator will direct the oath be given by a duly-qualified person.

R-32. Conduct of Proceedings

(a) The claimant must present evidence to support its claim. The respondent must then present evidence to support its defense. Witnesses for each party also must answer questions from the arbitrator and the opposing party. The arbitrator may change this procedure, as long as each party has the right to be heard and is given a fair opportunity to present its case.

(b) When the arbitrator decides it is appropriate, the arbitrator may also allow the parties to present evidence in alternative ways, including web conferencing, Internet communication, and telephonic conferences. All procedures must provide the parties with a full and equal opportunity to present any evidence that the arbitrator decides is material and relevant to deciding the dispute. If the alternative ways to present evidence involve witnesses, those ways may include that the witness submit to direct and cross-examination questioning.

(c) The arbitrator will use his or her discretion to resolve the dispute as quickly as possible and may direct the parties to present the evidence in a certain order, or may split the proceedings into multiple parts and direct the parties in the presentation of evidence.

(d) The hearing generally will not exceed one day. However, if a party shows good cause, the arbitrator may schedule additional hearings within seven calendar days after the initial day of hearing.

(e) The parties may agree in writing to waive oral hearings.

R-33. Dispositive Motions

The arbitrator may allow the filing of a dispositive motion if the arbitrator determines that the moving party has shown substantial cause that the motion is likely to succeed and dispose of or narrow the issues in the case.

R-34. Evidence

(a) The parties may offer relevant and material evidence and must produce any evidence the arbitrator decides is necessary to understand and decide the dispute. Following the legal rules of evidence shall not be necessary. All evidence should be taken in the presence of the arbitrator and all of the parties, unless any of the parties is absent, in default, or has waived the right to be present.

(b) The arbitrator shall determine what evidence will be admitted, what evidence is relevant, and what evidence is material to the case. The arbitrator may also exclude evidence that the arbitrator decides is cumulative or not relevant.

(c) The arbitrator shall consider applicable principles of legal privilege, such as those that involve the confidentiality of communications between a lawyer and a client.

(d) An arbitrator or other person authorized by law to subpoena witnesses or documents may do so on the request of any party or on the arbitrator's own determination. If a party requests the arbitrator sign a subpoena, that party shall copy the request to the other parties in the arbitration at the same time it is provided to the arbitrator.

R-35. Evidence by Affidavit and Post-Hearing Filing of Documents or Other Evidence

(a) The arbitrator may receive and consider the evidence of witnesses by declaration or affidavit rather than in-person testimony but will give this evidence only such credence as the arbitrator decides is appropriate. The arbitrator will consider any objection to such evidence made by the opposing party.

(b) If the parties agree or the arbitrator decides that documents or other evidence need to be submitted to the arbitrator after the hearing, those documents or other evidence will be filed with the AAA so that they can be sent to the arbitrator. All parties will be given the opportunity to review and respond to these documents or other evidence.

R-36. Inspection or Investigation

An arbitrator finding it necessary to inspect property or conduct an investigation in connection with the arbitration will request that the AAA inform the parties. The arbitrator will set the date and time of the inspection and investigation, and the AAA will notify the parties. Any party who would like to be present at the

inspection or investigation may attend. If one or all parties are not present at the inspection or investigation, the arbitrator will make an oral or written report to the parties and allow them an opportunity to comment.

R-37. Interim Measures (a preliminary decision made by the arbitrator involving part or all of the issue(s) in dispute in the arbitration)

(a) The arbitrator may grant whatever interim measures he or she decides are necessary, including granting an injunction and ordering that property be protected.

(b) Such interim measures may take the form of an interim award, and the arbitrator may require a security payment for the costs of such measures.

(c) When making a decision on an interim measure, the arbitrator may grant any remedy, relief, or outcome that the parties could have received in court.

(d) A party to an arbitration agreement under these Rules may instead file in state or federal court for interim relief. Applying to the court for this type of relief, including temporary restraining orders, is consistent with the agreement to arbitrate and will not be considered a waiver of the right to arbitrate.

R-38. Postponements

The arbitrator may postpone any hearing

(a) if requested by a party, and the party shows good cause for the postponement;

(b) if all parties agree to a postponement;

(c) on his or her own decision.

R-39. Arbitration in the Absence of a Party or Representative

The arbitration may proceed even if any party or representative is absent, so long as proper notice was given and that party or representative fails to appear or obtain a postponement from the arbitrator. An award cannot be made only because of the default of a party. The arbitrator shall require the party who participates in the hearing to submit the evidence needed by the arbitrator to make an award.

Conclusion of the Hearing

R-40. Closing of Hearing

The arbitrator must specifically ask all parties whether they have any further proofs to offer or witnesses to be heard. When the arbitrator receives negative replies or he or she is satisfied that the record is complete, the arbitrator will declare the hearing closed.

If briefs or other written documentation are to be filed by the parties, the hearing shall be declared closed as of the final date set by the arbitrator. Absent agreement of the parties, the time that the arbitrator has to make the award begins upon the closing of the hearing. The AAA may extend the time limit for the rendering of the award only in unusual and extreme circumstances.

R-41. Reopening of Hearing

If a party requests, or if the arbitrator decides to do so, the hearing may be reopened at any time before the award is made. If reopening the hearing would prevent the making of the award within the specific time agreed on by the parties in the contract(s) out of which the controversy has arisen, the matter may not be reopened unless the parties agree on an extension of time. If the arbitrator reopens the hearing, he or she shall have 30 days from the closing of the reopened hearing within which to make an award.

R-42. Time of Award

The award shall be issued promptly by the arbitrator and, unless the parties agree differently or the law indicates a different time frame, no later than 30 calendar days from the date the hearing is closed, or, if the case is a documents-only procedure, 14 calendar days from the date the arbitrator set for his or her receipt of the final statements and proofs. The AAA may extend the time limit for the rendering of the award only in unusual and extreme circumstances.

R-43. Form of Award

(a) Any award shall be in writing and executed in the form and manner required by law.

(b) The award shall provide the concise written reasons for the decision unless the parties all agree otherwise. Any disagreements over the form of the award shall be decided by the arbitrator.

(c) The AAA may choose to publish an award rendered under these Rules; however, the names of the parties and witnesses will be removed from awards that are published, unless a party agrees in writing to have its name included in the award.

R-44. Scope of Award

(a) The arbitrator may grant any remedy, relief, or outcome that the parties could have received in court, including awards of attorney's fees and costs, in accordance with the law(s) that applies to the case.

(b) In addition to a final award, the arbitrator may make other decisions, including interim, interlocutory, or partial rulings, orders, and awards. In any interim, interlocutory, or partial award, the arbitrator may assess and divide up the fees, expenses, and compensation related to such award as the arbitrator decides is appropriate, subject to the provisions and limitations contained in the Costs of Arbitration section.

(c) The arbitrator may also allocate compensation, expenses as defined in sections (v) and (vii) of the Costs of Arbitration section, and administrative fees (which include Filing and Hearing Fees) to any party upon the arbitrator's determination that the party's claim or counterclaim was filed for purposes of harassment or is patently frivolous.

(d) In the final award, the arbitrator shall assess the fees, expenses, and compensation provided in Sections R-4, R-5, and R-7 in favor of any party, subject to the provisions and limitations contained in the Costs of Arbitration section.

R-45. Award upon Settlement

If the parties settle their dispute at any point during the arbitration and at the parties' request, the arbitrator may lay out the terms of the settlement in a "consent award" (an award drafted and signed by the arbitrator that reflects the settlement terms of the parties). A consent award must include a division of the arbitration costs, including administrative fees and expenses as well as arbitrator fees and expenses. Consent awards will not be made available to the public per Rule 43(c) unless the parties agree otherwise.

R-46. Delivery of Award to Parties

Parties shall accept as notice and delivery of the award the placing of the award or a true copy thereof in the mail addressed to the parties or their representatives at the last known addresses, personal or electronic service of the award, or the filing of the award in any other manner that is permitted by law.

R-47. Modification of Award for Clerical, Typographical, or Mathematical Errors

(a) Within 20 days after the award is transmitted, any party, upon notice to the opposing parties, may contact the AAA and request that the arbitrator correct any clerical, typographical, or mathematical errors in the award. The arbitrator has no power to re-determine the merits of any claim already decided.

(b) The opposing parties shall be given 10 days to respond to the request. The arbitrator shall make a decision on the request within 20 days after the AAA transmits the request and any responses to the arbitrator.

(c) If applicable law provides a different procedural time frame, that procedure shall be followed.

Post Hearing

R-48. Release of Documents for Judicial Proceedings

The AAA shall give a party certified copies of any records in the AAA's possession that may be required in judicial proceedings relating to the arbitration, except for records determined by the AAA to be privileged or confidential. The party will have to pay a fee for this service.

R-49. Applications to Court and Exclusion of Liability

(a) No court or judicial proceeding by a party relating to the subject matter of the arbitration shall be deemed a waiver of the party's right to arbitrate.

(b) Neither the AAA nor any arbitrator in a proceeding under these Rules is a necessary or proper party in judicial proceedings relating to the arbitration.

(c) Parties to an arbitration under these Rules shall be deemed to have consented that judgment upon the arbitration award may be entered in any federal or state court having jurisdiction thereof.

(d) Parties to an arbitration under these Rules shall be deemed to have consented that neither the AAA, AAA employees, nor any arbitrator shall be liable to any party in any action for damages or injunctive relief for any act or omission in connection with any arbitration under these rules.

(e) Parties to an arbitration under these Rules may not call the arbitrator, the AAA, or any AAA employee as a witness in litigation or any other proceeding relating to the arbitration. The arbitrator, the AAA, and AAA employees are not competent to and may not testify as witnesses in any such proceeding.

General Procedural Rules

R-50. Waiver of Rules

If a party knows that any of these Rules have not been followed, it must object in writing before proceeding with arbitration or it will lose its right to object that the rule has not been followed.

R-51. Extensions of Time

The parties may agree to change any period of time provided for in the Rules, except that any such modification that negatively affects the efficient resolution of the dispute is subject to review and approval by the arbitrator. The AAA or the arbitrator may for good cause extend any period of time in these Rules, except as set forth in R-42. The AAA will notify the parties of any extension.

R-52. Serving of Notice and AAA and Arbitrator Communications

(a) Any papers or notices necessary for the initiation or continuation of an arbitration under these Rules, or for the entry of judgment on any award made under these Rules, may be served on a party by mail or email addressed to the party or its representative at the last-known address or by personal service, in or outside the state where the arbitration is to be held, provided that reasonable opportunity to be heard with regard to the dispute is or has been granted to the party.

(b) The AAA, the arbitrator, and the parties also may use overnight delivery, electronic facsimile transmission (fax), or electronic mail (email) to give the notices required by these rules. Where all parties and the arbitrator agree, notices may be sent by other methods of communication.

(c) Unless directed differently by the AAA or by the arbitrator, any documents and all written communications submitted by any party to the AAA or to the arbitrator also shall be sent at the same time to all parties to the arbitration.

(d) A failure to provide the other parties with copies of communications made to the AAA or to the arbitrator may prevent the AAA or the arbitrator from acting on any requests or objections contained within those communications.

(e) A party and/or someone acting on behalf of a party cannot have any communications with an arbitrator or a potential arbitrator about the arbitration outside of the presence of the opposing party. All such communications shall be conducted through the AAA.

(f) The AAA may direct that any oral or written communications that are sent by a party or their representative shall be sent in a particular manner. The failure of a party or its representative to do so may result in the AAA's refusal to consider the issue raised in the communication.

R-53. Interpretation and Application of Rules

The arbitrator shall interpret and apply these Rules as they relate to the arbitrator's powers and duties. When there is more than one arbitrator and a difference arises among them concerning the meaning or application of these Rules, it shall be decided by a majority vote. If that is not possible, either an arbitrator or a party may refer the question to the AAA for final decision. All other Rules shall be interpreted and applied by the AAA.

R-54. Remedies for Nonpayment

(a) If arbitrator compensation or administrative charges have not been paid in full, the AAA may inform the parties so that one of them may forward the required payment.

(b) Once the AAA informs the parties that payments have not been received, a party may request an order from the arbitrator directing what measures might be taken in light of a party's nonpayment.

Such measures may include limiting a party's ability to assert or pursue its claim. However, a party shall never be precluded from defending a claim or counterclaim. The arbitrator must provide the party opposing a request for relief with the opportunity to respond prior to making any determination. In the event that the arbitrator grants any request for relief that limits any party's participation in the arbitration, the arbitrator will require the party who is making a claim and who has made appropriate payments to submit the evidence required to make an award.

(c) Upon receipt of information from the AAA that full payments have not been received, the arbitrator, on the arbitrator's own initiative, may order the suspension of the arbitration. If no arbitrator has yet been appointed, the AAA may suspend the proceedings.

(d) If arbitrator compensation or AAA administrative fees remain unpaid after a determination to suspend an arbitration due to nonpayment, the arbitrator has the authority to terminate the proceedings. Such an order shall be in writing and signed by the arbitrator. The impact of the termination for nonpayment of the Consumer Clause Registry fee is the removal from the "Registered" section of the Registry.

R-55. Declining or Ceasing Arbitration

The AAA in its sole discretion may decline to accept a Demand for Arbitration or stop the administration of an ongoing arbitration due to a party's improper conduct, including threatening or harassing behavior towards any AAA staff, an arbitrator, or a party or party's representative.

Costs of Arbitration

FOR THE CURRENT ADMINISTRATIVE FEE SCHEDULE, PLEASE VISIT ***www.adr.org/consumerfeeschedule***.

Procedures for the Resolution of Disputes through Document Submission

D-1. Applicability

(a) In any case, regardless of claim size, the parties may agree to waive in-person/telephonic hearings and resolve the dispute through submission of documents to one arbitrator. Such agreement should be confirmed in writing no later than the deadline for the filing of an answer.

(b) Where no disclosed claims or counterclaims exceed $25,000, the dispute shall be resolved by these Procedures, unless a party asks for a hearing or the arbitrator decides that a hearing is necessary.

(c) If one party makes a request to use the Procedures for the Resolution of Disputes through Document Submission (Procedures) and the opposing party is unresponsive, the arbitrator shall have the power to determine whether to proceed under the Procedures. If both parties seek to use the Procedures after the appointment of an arbitrator, the arbitrator must also consent to the process.

(d) When parties agree to these Procedures, the procedures in Sections D-1 through D-4 of these Rules shall supplement other portions of these rules which are not in conflict with the Procedures.

D-2. Preliminary Management Hearing

Within 14 calendar days of confirmation of the arbitrator's appointment, the arbitrator shall convene a preliminary management hearing, via conference call, video conference, or internet, to establish a fair and equitable procedure for the submission of documents, and, if the arbitrator deems appropriate, a schedule for one or more telephonic or electronic conferences.

D-3. Removal from the Procedures

(a) The arbitrator has the discretion to remove the case from the Procedures if the arbitrator determines that an in-person or telephonic hearing is necessary.

(b) If the parties agree to in-person or telephonic hearings after a previous agreement to proceed under the Procedures, the arbitrator shall conduct such hearings. If a party seeks to have in-person or telephonic hearings after agreeing to the

Procedures, but there is not agreement among the parties to proceed with in-person or telephonic hearings, the arbitrator shall resolve the issue after the parties have been given the opportunity to provide their respective positions on the issue.

D-4. Time of Award

(a) The arbitrator shall establish the date for either final written submissions or a final telephonic or electronic conference. Such date shall operate to close the hearing, and the time for the rendering of the award shall commence on that day as well.

(b) The arbitrator shall render the award within 14 calendar days from the date the hearing is closed.

(c) The award is subject to all other provisions of these Rules that pertain to awards.

Glossary of Terms

Administrator

The Administrator's role is to manage the administrative aspects of the arbitration, such as the appointment of the arbitrator, to make preliminary decisions about where hearings might take place, and to handle the fees associated with the arbitration. As Administrator, however, the Administrator does not decide the merits of a case or make any rulings on issues such as what documents must be shared with each side. Because the Administrator's role is only administrative, the Administrator cannot overrule or change an arbitrator's decisions or rulings. The Administrator will comply with any court orders issued from litigation involving the parties to the dispute.

ADR Agreement

An ADR Agreement is an agreement between a business and a consumer to submit disputes to mediation, arbitration, or other ADR processes.

ADR Process

An ADR (Alternative Dispute Resolution) Process is a method of resolving a dispute other than by court litigation. Mediation and Arbitration are the most widely used ADR processes.

ADR Program

An ADR Program is any program or service set up or used by a business to resolve disputes out of court.

Arbitration

In arbitration, the parties submit disputes to an impartial person (the arbitrator) for a decision. Each party can present evidence to the arbitrator. Arbitrators do not have to follow the Rules of Evidence used in court.

Arbitrators decide cases with written decisions or "awards." An award is usually binding on the parties. A court may enforce an arbitration award and the court's review of arbitration awards is limited.

Arbitration Agreement

An arbitration agreement is a contract between parties to settle their disputes by binding arbitration. It is typically found in the parties' contract in a section entitled "Arbitration" or "Dispute Resolution." It gives the parties information about how they are choosing to settle any disputes that they might have.

Arbitrator

Arbitrators are neutral and independent decision makers who are not employees of the administrator. Except where the parties to a case reach their own settlement, the Arbitrator will make the final, binding decision on the dispute and render it in writing, called the Award. The Arbitrator makes all the procedural decisions on a case not made by the administrator or not decided jointly by the parties. The Arbitrator may grant any remedy, relief, or outcome that the parties could have received in court, including awards of attorney's fees and costs, in accordance with the law(s) that applies to the case.

Once appointed to a case, an Arbitrator may not be removed by one party without the other party's consent or unless the administrator determines an Arbitrator should be removed and replaced by another Arbitrator chosen by the administrator in a manner described in these Rules.

Case Administrator

The Case Administrator is the AAA's employee assigned to handle the administrative aspects of the case. He or she does not decide the case. He or she manages the case's administrative steps, such as exchanging documents, matching schedules, and setting up hearings. The Case Administrator is the parties' contact point for almost all aspects of the case outside of any hearings.

Claimant

A Claimant is the party who files the claim or starts the arbitration. Either the consumer or the business may be the Claimant.

Demand for Arbitration (also referred to as "Demand")

The written document created by the claimant that informs the respondent that it wishes to arbitrate a dispute. This document provides basic information about

the dispute, the parties involved and what the claimant wants as a result of the arbitration.

Documents-Only Arbitration

In a Documents-Only Arbitration, the parties submit their arguments and evidence to the arbitrator in writing. The arbitrator then makes an award based only on the documents. No in-person or telephone hearing is held.

Independent ADR Institution

An Independent ADR Institution is an organization that provides independent and impartial administration of ADR programs for consumers and businesses. The American Arbitration Association is an Independent ADR Institution.

In-Person Hearing

During an In-Person Hearing, the parties and the arbitrator meet in a conference room or office and the parties present their evidence in a process that is similar to going to court. However, an In-Person Hearing is not as formal as going to court.

Mediation

In Mediation, an impartial person (the mediator) helps the parties try to settle their dispute by reaching an agreement together. A mediator's role is to help the parties come to an agreement. A mediator does not arbitrate or decide the outcome.

Neutral

A "Neutral" is a mediator, arbitrator, or other independent, impartial person selected to serve as the independent third party in an ADR process.

Party

The party is the person(s) or business that is involved in the dispute in the arbitration process. Usually, these are the people or businesses that have an arbitration agreement between them that specifies that a dispute should be resolved by arbitration.

Parties

Parties are all the separate individuals, businesses, or organizations involved in the arbitration.

Opposing Party

The opposing party is the other party that is on the opposite side of the arbitration from you. If you are the claimant, the Opposing Party is the respondent. If you are the respondent, the Opposing Party is the claimant. If you are the consumer, the Opposing Party is the business. If you are the business, the Opposing Party is the consumer.

Respondent

The respondent is the party against whom the claim is filed. If a Respondent states a claim in arbitration, it is called a counterclaim. Either the consumer or the business may be the Respondent.

Telephone Hearing

In a Telephone Hearing, the parties have the opportunity to tell the arbitrator about their case during a conference call. They also present their evidence to the arbitrator during the call. Often this is done after the parties have sent in documents for the arbitrator to review.

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OPTIONAL APPELLATE **ARBITRATION RULES**

Rules Effective November 1, 2013

Available online at **adr.org**

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Optional Appellate Arbitration Rules

Introduction

The objective of arbitration is a fair, fast and expert result that is achieved economically. Consistent with this goal, an arbitration award traditionally will be set aside by a court only where narrowly defined statutory grounds exist. Sometimes, however, the parties may desire a more comprehensive appeal of an arbitration award within the arbitral process. The American Arbitration Association® has included clauses for appellate arbitration in its *Drafting Dispute Resolution Clauses - A Practical Guide* for a number of years. In addition, parties have developed their own processes and standards for conducting these proceedings. In order to provide for an easier, more standardized process, the AAA has developed these Optional Appellate Rules.

The following rules provide for an appeal to an appellate arbitral panel that would apply a standard of review greater than that allowed by existing federal and state statutes. The appellate rules anticipate an appellate process that can be completed in about three months, while giving both sides adequate time to submit appellate briefs. The rules permit review of errors of law that are material and prejudicial, and determinations of fact that are clearly erroneous.

Utilization of these rules is predicated upon agreement of the parties. The right to appeal an arbitration proceeding is a matter of contract. A party may not unilaterally appeal an arbitration award under these rules absent agreement with the other party(s). The following sample language provides for such appellate review assuming a standard arbitration clause is already in place:

> *"Notwithstanding any language to the contrary in the contract documents, the parties hereby agree: that the Underlying Award may be appealed pursuant to the AAA's Optional Appellate Arbitration Rules ("Appellate Rules"); that the Underlying Award rendered by the arbitrator(s) shall, at a minimum, be a reasoned award; and that the Underlying Award shall not be considered final*

until after the time for filing the notice of appeal pursuant to the Appellate Rules has expired. Appeals must be initiated within thirty (30) days of receipt of an Underlying Award, as defined by Rule A-3 of the Appellate Rules, by filing a Notice of Appeal with any AAA office. Following the appeal process the decision rendered by the appeal tribunal may be entered in any court having jurisdiction thereof."

Optional Appellate Arbitration Rules

A-1. Agreement of Parties

Whenever, by stipulation or in their contract, the parties have provided for the appeal of an arbitration award* ("Underlying Award") rendered under the auspices of the American Arbitration Association (AAA), or the International Centre for Dispute Resolution® (ICDR®), or have otherwise provided for these Appellate Arbitration Rules, they shall be deemed to have made these Rules, as amended and in effect as of the date of submission of the appeal, a part of their agreement.

**These Appellate Rules do not apply to disputes where the arbitration clause is contained in an agreement between individual consumers and businesses where the business has a standardized, systematic application of arbitration clauses with customers and where the terms and conditions of the purchase of standardized, consumable goods or services are non-negotiable or primarily non-negotiable in most or all of its terms, conditions, features, or choices.*

A-2. Effect of Appeal on Underlying Award

(a) Upon the filing of a Notice of Appeal pursuant to Rule A-3 of these Rules, the parties agree that the Underlying Award shall not be considered final for purposes of any court actions to modify, enforce, correct, or vacate the Underlying Award ("judicial enforcement proceedings"), and the time period for commencement of judicial enforcement proceedings shall be tolled during the pendency of the appeal. The parties agree to stay any already initiated judicial enforcement proceedings until the conclusion of the appeal process. If the appeal is withdrawn, the Underlying Award shall be deemed final as of the date of withdrawal.

(b) The appellate process is not intended to replace the modification of award remedies available under the AAA's Commercial Arbitration Rules and Mediation Procedures ("AAA Commercial Rules"), or similar rule if applicable to the Underlying Award. Accordingly, if the sole subject of the appeal is a request for modification then a party must pursue those remedies under the applicable rules governing the Underlying Award. A party may appeal an adverse decision arising from a request for modification.

A-3. Filing Requirements

(a) Filing an Appeal: Provided the parties have an agreement for the appeal of an arbitration award pursuant to these Rules, an appeal may be initiated in the following manner:

(i) Any party to an Underlying Award may initiate an appeal by filing with the AAA, within thirty (30) days from the date the Underlying Award is submitted to the parties, a Notice of Appeal, the administrative filing fee as set forth in the Fee Schedule, a copy of the applicable arbitration agreement providing for appeal of the Underlying Award, and a copy of the Underlying Award. Filing may be accomplished through use of AAA WebFile®, located at **www.adr.org,** or by filing with any AAA office.

(ii) The party filing the Notice of Appeal (the "Appellant") shall simultaneously provide a copy of the Notice of Appeal and the applicable arbitration agreement to every other party to the Underlying Award (the "Appellees").

(iii) The Notice of Appeal shall include:

a. The name of each party;

b. The address for each party, including, if known, telephone and fax numbers and email address;

c. If applicable, the names, addresses, telephone and fax numbers and, if known, email address of the known representative for each party;

d. A statement setting forth the portion or portions of the Underlying Award being appealed and the errors alleged;

e. The qualifications, expertise and number of appellate arbitrators requested; and

f. The filing fee.

(b) The AAA shall provide notice to the parties (or their representatives if so named) of the receipt of the Notice of Appeal when the filing requirements have been satisfied. The date on which the filing requirements are satisfied shall establish the date of filing for the appeal for administrative purposes, however, any disputes under this rule shall be reviewed and decided by the appeal tribunal.

If the filing does not satisfy the filing requirements set forth above, the AAA shall acknowledge to all named parties receipt of the incomplete filing and inform the parties of the filing deficiencies. If the deficiencies are not cured by the due date specified by the AAA, the filing may be returned to the filing party.

(c) Cross-Appeal. Each Appellee may file a cross-appeal with the AAA within seven (7) days after notice of filing of a Notice of Appeal. The Appellee shall, at the time of any such filing, send a copy of the cross-appeal to the Appellant and all other parties to the Underlying Award. The cross-appeal shall include a statement setting forth the portion or portions of the Underlying Award being appealed and the errors alleged, and the qualifications, expertise and number of appellate arbitrators requested. The administrative filing fee as set forth in the Fee Schedule must be paid at the time of the filing of any cross-appeal.

If the cross-appeal filing is deficient, and not cured by the date specified by the AAA, it may be returned to the filing party.

A-4. Qualifications of Appeal Tribunal

(a) The appeal tribunal shall be selected from the AAA's Appellate Panel, or, if an international dispute, from its International Appellate Panel.

(b) No person shall serve as an appellate arbitrator in any dispute in which that person is precluded from serving under the applicable code of ethics governing the appointment of arbitrators. Prior to accepting an appointment, the prospective appellate arbitrator(s) shall disclose to the AAA any circumstances likely to create

a presumption of bias or prevent a prompt resolution of the appeal. Upon receipt of such information, the AAA shall either replace the appellate arbitrator(s) or immediately communicate the information to the parties for their comments. In the event that the parties disagree as to whether the appellate arbitrator shall serve, the AAA has the authority to make the decision as to whether the appellate arbitrator(s) shall serve or whether another appellate arbitrator(s) shall be appointed by the AAA. The AAA is authorized to appoint another appellate arbitrator(s) if the appointed appellate arbitrator(s) is unable to serve promptly.

A-5. Appointment of Appeal Tribunal

If the parties have not appointed an appeal tribunal and have not provided for any other method of appointment, the appeal tribunal will be appointed by the AAA in the following manner:

(a) Upon receipt of a Notice of Appeal, the AAA shall send simultaneously to each party to the dispute an identical list of ten (10) (unless the AAA decides that a different number is appropriate) names of persons chosen from the AAA's Appellate Panel. The parties are encouraged to agree to the appeal tribunal from the submitted list and to advise the AAA of their agreement.

(b) If the parties are unable to agree upon the appeal tribunal, each party shall have fourteen (14) days from the transmittal date in which to strike names objected to, number the remaining names in order of preference, and return the list to the AAA. If a party does not return the list within the time specified, all persons named therein shall be deemed acceptable. From among the persons who have been approved on both lists, and in accordance with the designated order of mutual preference, the AAA shall invite the acceptance of the appeal tribunal to serve. If the parties fail to agree on the appeal tribunal from the persons named, or if acceptable arbitrators are unable to act, or if for any other reason the appointment cannot be made from the submitted lists, the AAA shall have the power to make the appointment from among other members of the AAA's Appellate Panel without the submission of additional lists.

(c) A panel of three appellate arbitrators will be appointed unless the parties agree to utilize a single arbitrator. The AAA shall appoint the Chairperson of the panel.

(d) If the parties have requested an appellate arbitrator with specific qualifications, the AAA will consider such requests when creating the list of the appellate arbitrators. Such requests shall be made by the Appellant in its Notice of Appeal, and by the Appellee within three (3) days of receipt of the Notice of Appeal.

A-6. Vacancies

If an appellate arbitrator shall become unwilling or unable to serve, the AAA shall administratively appoint a substitute appellate arbitrator.

A-7. Preliminary Conference Call

(a) Within one week of the appointment of the appeal tribunal a preliminary conference call will be scheduled with the parties, the appeal tribunal and the Case Manager to review and formalize the briefing schedule, set a deadline for the submission of the record on appeal and address any other procedural issues consistent with these rules and the objectives for an expedited, cost effective and just appellate process.

(b) The appeal tribunal shall enter an order reflecting any briefing schedules, and any other timeframes and administrative matters determined during the preliminary conference call.

(c) The appeal tribunal may require a detailed specification of issues on appeal in advance of the first Appellant brief, and may direct or limit the Appellant/Appellee to certain areas or issues in their briefing or request additional briefing.

A-8. Absent Parties

The appeal tribunal may proceed with the appeal process in the absence of a party if it is determined by the appeal tribunal that the absent party consented to the jurisdiction of the appeal process by agreement, due notice was provided, and the absent party is provided a copy of the order from the preliminary conference call.

A-9. Jurisdiction

The appeal tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement.

If the appeal tribunal determines that it does not have jurisdiction to hear the appeal, the appeal shall be dismissed and the Underlying Award shall be deemed to be final.

A-10. Issues Subject to Appeal

A party may appeal on the grounds that the Underlying Award is based upon:

(1) an error of law that is material and prejudicial; or

(2) determinations of fact that are clearly erroneous.

A-11. Assessment of Costs

The Appellant/Cross-Appellant may be assessed the appeal costs, and other reasonable costs of the Appellee/Cross-Appellee, including attorneys' fees (if a statute or the parties' contract provides for an award of attorneys' fees), incurred after the commencement of the appeal if the Appellant/Cross-Appellant is not determined to be the prevailing party by the appeal tribunal.

A-12. AAA Fees and Costs of Underlying Arbitration and Appeal

(a) As a preliminary matter, all outstanding and unpaid AAA fees and costs from the arbitration proceeding giving rise to the Underlying Award owed by the party filing the appeal must be paid in full before an appeal will be initiated. For cross-appeals, all outstanding and unpaid AAA fees and costs owed by the Cross-Appellant must be paid in full before Cross-Appellant's cross-appeal will be initiated.

(b) The Appellant shall be responsible for the AAA's administrative fees and appeal tribunal fees and costs arising from the appeal where there is no cross-appeal. If there is a cross-appeal the fees and costs of the appeal shall be shared equally by the Appellant and Appellee, or shared pro rata if there is more than one Appellant or Appellee.

(c) Within seven (7) days after the appointment of the appeal tribunal the Appellant will be required to pay a deposit to cover the anticipated fees and expenses of the appeal tribunal. If there is a cross-appeal this deposit shall be shared equally or pro rata as set forth in (b) above.

(d) The appeal tribunal's decision may include a reallocation of a party's share of the fees and costs of the appeal.

(e) When the appeal has terminated, the AAA shall provide an accounting and return any unexpended balance and excess deposits paid by a party.

(f) A party's failure to timely pay the deposits required in Rule A-12(c) shall automatically place the nonpaying party's appeal in abeyance for a period of seven (7) days, following which if the deposits are not paid in full within this seven (7)-day grace period, the nonpaying party's appeal may be dismissed. If the appeal has been suspended by either the AAA or the appeal tribunal and the parties have failed to make the full deposits requested within the time provided after the suspension, the appeal tribunal, or the AAA if an appeal tribunal has not been appointed, may terminate the proceedings. The arbitration will terminate on its own accord after fourteen (14) days from the date of suspension.

A-13. Interpretation of Rules

The appeal tribunal shall interpret and apply these rules insofar as they relate to the appeal tribunal's powers and duties. All other rules shall be interpreted and applied by the AAA.

A-14. Place of Appeal

Unless all parties and the appeal tribunal agree otherwise, the appeal shall be conducted at the same place of arbitration as the underlying arbitration.

A-15. Oral Argument

(a) Unless otherwise directed by the appeal tribunal, all appeals will be determined upon the written documents submitted by the parties. If the appeal tribunal deems oral argument necessary, or a party requests oral argument, the appeal tribunal at its discretion may schedule same.

(b) Requests for oral argument must be made within thirty (30) days of service of the Notice of Appeal or it is waived. If oral argument is granted it shall be scheduled to take place within thirty (30) days of filing of the last brief.

A-16. Record on Appeal

The parties shall cooperate in compiling the record on appeal, and may submit as part of the record on appeal relevant excerpts of the transcript of the arbitration hearing giving rise to the Underlying Award, if any, expert reports, deposition transcripts or affidavits that were admitted as part of the arbitration hearing, documentary evidence admitted into evidence during the arbitration hearing, Appellant and Appellee pre- and post-hearing briefs, or other evidence relevant to the appeal that was presented at the arbitration hearing. A party may not present for the first time on appeal an issue or evidence that was not raised during the arbitration hearing. Any disputes concerning whether a document is part of the record on appeal shall be determined by the appeal tribunal. The record on appeal shall be submitted by the parties by the deadline determined by the appeal tribunal at the preliminary conference.

A-17. Appeal Briefs

Unless otherwise agreed by the parties and approved by the appeal tribunal, or determined by the appeal tribunal as a necessary deviation, the following briefing schedule shall be followed:

(a) Appellant's Initial Brief shall be served no later than twenty-one (21) days after service of its Notice of Appeal and limited to 30 double-spaced, typewritten pages.

(b) Appellee's Answer Brief shall be served no later than twenty-one (21) days after service of Appellant's Initial Brief and limited to 30 double-spaced, typewritten pages.

(c) If Appellee cross-appeals, then its Cross-Appeal Brief shall be served at the same time as Appellee's Answer Brief and limited to 30 double-spaced, typewritten pages.

(d) Appellant's Reply Brief to Appellee's Answer Brief, if any, shall be served within ten (10) days of service of Appellee's Answer Brief and limited to 10 double-spaced, typewritten pages.

(e) Appellant's Answer Brief to Appellee's Cross-Appeal shall be served no later than twenty-one (21) days after service of Appellee's Cross-Appeal Brief and limited to 30 double-spaced, typewritten pages.

(f) Appellee's Reply Brief to Appellant's Answer Brief, if any, shall be served within ten (10) days of service of Appellant's Answer Brief and limited to 10 double-spaced, typewritten pages.

(g) For good cause shown, each party is entitled to request a single seven (7)- day extension for filing a brief that is to be served under these rules, such extension to be granted by the Case Manager. In extraordinary circumstances, subject to the discretion of the appeal tribunal, an additional extension may be granted.

A-18. Service of Documents

(a) Service of notices, briefs, answers, and replies can be accomplished by electronic submission, facsimile, or mail provided all parties who are to receive copies are served contemporaneously in the same manner. Copies of cases, exhibits and the like attached to or referenced in briefs shall be delivered to the appeal tribunal directly via mail or overnight courier at the address provided by the Case Manager (in lieu or in addition to electronic or facsimile submission of these items, as determined by the appeal tribunal at the preliminary conference).

(b) Unless the rule provides a different method of calculating time periods, all deadlines under these Rules shall be determined by calendar days. If the last day of the time period is a legal holiday or weekend day, the period shall be extended until the first business day which follows.

A-19. Appeal Tribunal's Decision

(a) Within thirty (30) days of service of the last brief, the appeal tribunal shall take one of the following actions:

1. adopt the Underlying Award as its own, or,

2. substitute its own award for the Underlying Award (incorporating those aspects of the Underlying Award that are not vacated or modified), or,

3. request additional information and notify the parties of the tribunal's exercise of an option to extend the time to render a decision, not to exceed thirty (30) days.

The appeal tribunal may not order a new arbitration hearing or send the case back to the original arbitrator(s) for corrections or further review.

(b) The initial thirty (30)-day time frame may be modified for good cause or if oral argument is to take place and it has not yet occurred. In the event the extension is because of oral argument, the initial thirty (30) days for rendering a decision will commence the day following the conclusion of the oral argument.

(c) The appeal tribunal's decision shall be in writing and shall include a concise summary of the decision and an explanation for the decision, unless the parties agree otherwise.

(d) When the appeal tribunal consists of more than one arbitrator, unless required by law or by the arbitration agreement, a majority of the appeal tribunal must make all decisions.

A-20. Finality of Appeal

Upon the conclusion of the appeal process and after service of the appeal tribunal's decision upon the parties, the appeal tribunal's decision shall become the final award for purposes of judicial enforcement proceedings.

A-21. Confidentiality

The parties and the appeal tribunal shall maintain the confidentiality of these proceedings except in the case of a judicial challenge or court order concerning the proceeding, or as otherwise required by law.

A-22. Applications to Court and Exclusion of Liability

(a) No judicial proceeding by a party relating to the subject matter of the arbitration shall be deemed a waiver of the party's right to arbitrate.

(b) Neither the AAA nor any arbitrator in a proceeding under these rules is a necessary or proper party in judicial proceedings relating to the arbitration.

(c) Parties to an arbitration under these rules shall be deemed to have consented that judgment upon the arbitration award may be entered in any federal or state court having jurisdiction thereof.

(d) Parties to an arbitration under these rules shall be deemed to have consented that neither the AAA nor any arbitrator shall be liable to any party in any action for damages, injunctive or declaratory relief for any act or omission in connection with any arbitration under these rules.

(e) Parties to an arbitration under these rules may not call an arbitrator, the AAA or AAA employees as a witness in litigation or any other proceeding relating to the arbitration. The arbitrator, the AAA and its employees are not competent to testify as witnesses in any such proceeding.

Administrative Fee Schedule

There is a non-refundable $6,000 administrative fee to be paid by the party seeking an appellate arbitration under these Appellate Rules. An additional $6,000 administrative fee is to be paid by any party filing a cross-appeal under these Appellate Rules. These fees do not include the fees and costs of the Appeal Tribunal. Hearing rooms are also available for an additional cost. Please contact the AAA for additional information.

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AAA® ARBITRATION ROAD MAP

REACHING RESOLUTION

American Arbitration Association®

Arbitration is the out-of-court submission of a dispute to an impartial third party or parties for a binding decision. The AAA arbitration administration process comprises a well-defined set of steps by which most commercial cases proceed.



FILING AND INITIATION

DAY 1 - 15

The AAA typically commences administration of an arbitration case when one party submits a **Demand for Arbitration**, a **copy of the arbitration provision** from the contract between the parties, and the **appropriate filing fee** to the AAA. The AAA acknowledges receipt to all parties and sets a deadline for the respondent to answer and/or to file a counterclaim. If no arbitration clause exists or the AAA is not named as the resolution provider in the parties' contract, cases may commence with the **consent of all parties, a filed Submission to Dispute Resolution**, and the **appropriate filing fee** to the AAA.

EXPECTED COSTS AT THIS STAGE

Filing fees are based on claim amounts and are paid by the party that asserts the claim or counterclaim.



ARBITRATOR SELECTION

DAY 15 – 44

Based upon the parties' expressed criteria of qualifications, the AAA identifies arbitrators from the **AAA National Roster of Arbitrators** and provides their curriculum vitae to the parties. If parties are unable to agree upon the arbitrator(s), the AAA establishes a deadline for each party to independently state its preferences from the list. The AAA invites the most mutually agreeable arbitrator(s) to serve on the case.

EXPECTED COSTS

Partial refunds of filing and counterclaim fees are available under some AAA fee schedules. No refunds are available after an arbitrator has been appointed.



PRELIMINARY HEARING

DAY 44 – 85

Conducted by the arbitrator often via conference call, this management meeting is the first time the parties and arbitrator discuss the substantive issues of the case and procedural matters, such as exchange of information, witness lists, and dates. The Scheduling Order, which serves as the framework for hearing prepara-tions, is established.

EXPECTED COSTS

Parties will incur compensation charges by each arbitrator for time spent before and during the Preliminary Hearing and in preparation of the Scheduling Order.



INFORMATION EXCHANGE AND PREPARATION

DAY 85 – 222

The parties work within the time frames set forth at the Preliminary Hearing to exchange information and prepare their presentations. The arbitrator addresses any impasses or challenges related to information sharing.

EXPECTED COSTS

The time spent by the arbitrator in this phase is proportional to the number of procedural matters needing resolution. Additionally, the arbitrator will spend time reviewing the parties' pre-hearing submissions, if any.



MEDIATION STEP

Subject to the right of any party to opt out, in cases where a claim or counterclaim exceeds $75,000, the rules provide that the parties shall mediate their dispute with the AAA concurrently with arbitration, at no additional fee. The mediator assists parties in reaching a settlement but has no authority to make a binding decision or award.

EXPECTED COSTS

The parties are responsible for the mediator's compensation plus an AAA fee of $75 for each hour charged by the mediator.



HEARING

DAY 222-223

Parties present testimony and evidence to the arbitrator.

EXPECTED COSTS

The arbitrator is compensated for time spent in hearings, reviewing evidence, and reasonable expenses, such as mileage and tolls.



POST-HEARING SUBMISSIONS

DAY 223 – 258

If the arbitrator allows, parties may submit additional documentation, usually shortly after the hearing.

EXPECTED COSTS

The arbitrator is compensated for reviewing evidence and any post-hearing submissions, as well as drafting the award. Any unused deposits are returned to the parties.



THE AWARD

DAY 258 – 288

The arbitrator closes the record and, no more than 30 days later, issues a decision addressing all claims raised in the arbitration. The award may direct one or more parties to pay another party a monetary amount, or it may direct parties to take specific actions. Aside from any administrative matters unrelated to the merits of the case, the services of the arbitrator and the AAA are completed when the award is issued.

EXPECTED COSTS

The arbitrator apportions arbitrator compensation and expenses and AAA fees among the parties.

AAA197

ECONOMIC DAMAGES IN SECURITIES CASES

Brian J. Henderson
Associate Professor of Finance
George Washington University

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Peiffer Wolf Carr Kane Conway & Wise, LLP

Michael S. Hill
Managing Partner
Menzer & Hill, P.A.

PIABA Annual Meeting
October 26, 2023

Overview

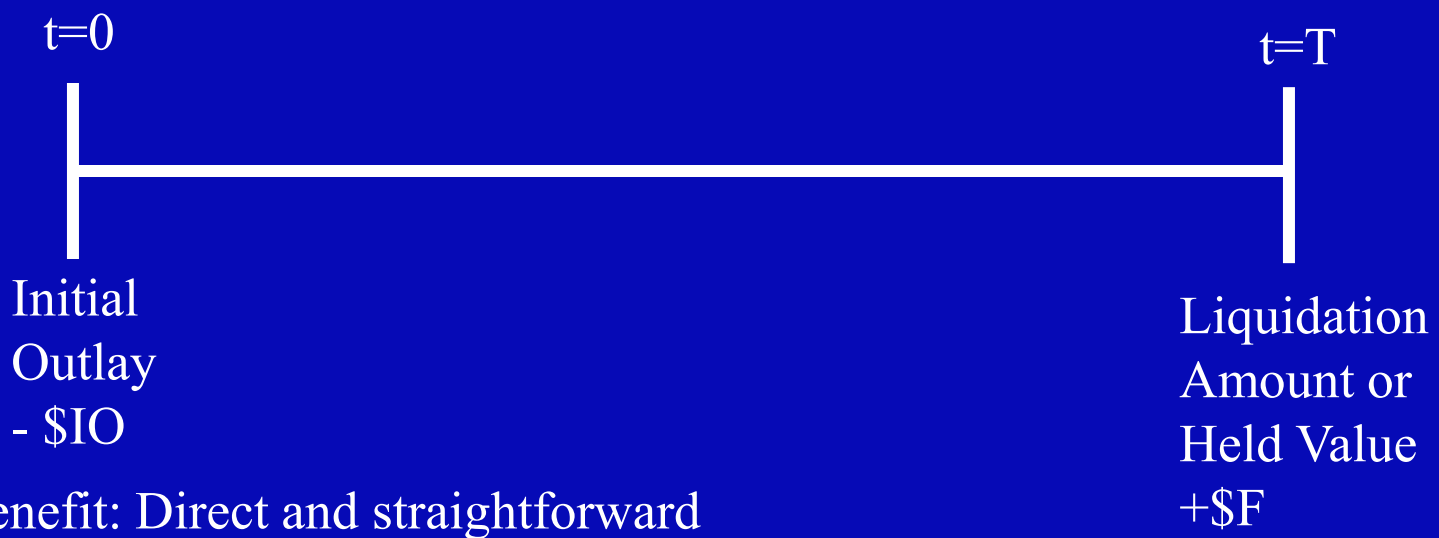
- Monetary damages outlined in the FINRA Arbitrator's Guide
- An expert's explanation of common ways to calculate damages
- Calculating damages in-house and requesting damage models at final hearing

FINRA Arbitrator's Guide, April 2023 Edition

- Actual Damages and/or Statutory Damages p. 66-67
  - Net Out-of-Pocket Losses (what was put in versus what was received)
  - Benefit of the Bargain (profits Claimant would have received if a misrepresentation by Respondent had been true)
  - Well-Managed Portfolio Account/Market Adjusted Damages (what the Claimant would have earned had their money been appropriately invested)
  - Statutory Damages (a statute explains how damages are calculated)

Capital Gain(Loss)

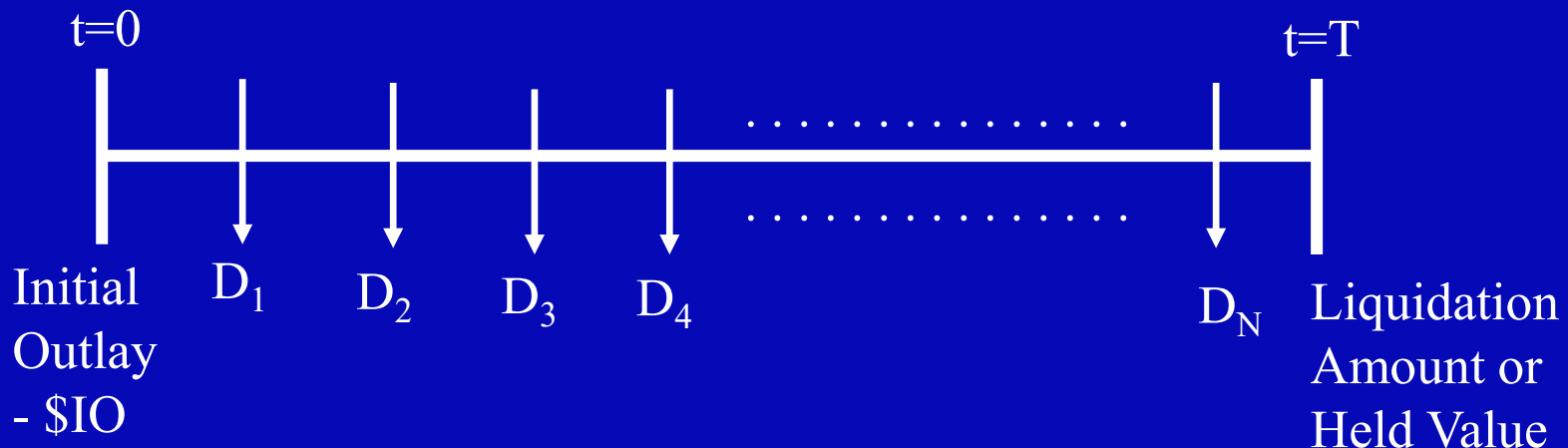
- How to quantify the harm caused to an investor?
- General framework: investment timeline describing the investor's contribution(s) and sales/held amounts.
- Capital gain (loss) = $F - $IO



- Benefit: Direct and straightforward
- Drawbacks:
  - ignores opportunity cost over T-year holding period
  - simplistic: what about interim cash flows?

Net Out of Pocket Amount

- Expand the framework to include all (N) distributions over the investment period:



- Capital gain (loss) = $F - $IO
- Net Out of Pocket = $F - $IO + D_1+…+D_N
- Benefit: Direct and straightforward (total out minus total in)
- Drawback: ignores opportunity cost over T-year holding period. Credits interim cash flows without considering opportunity cost.

Example: Capital Gain, NOP

- Consider an example: Noble Royalty Access Fund VIII
- Investment of $50,000 on July 28, 2010
- Made distributions approximately monthly.
- Held value: assumed to be zero.
  - For non-traded DPPs, held values are notoriously hard to estimate.

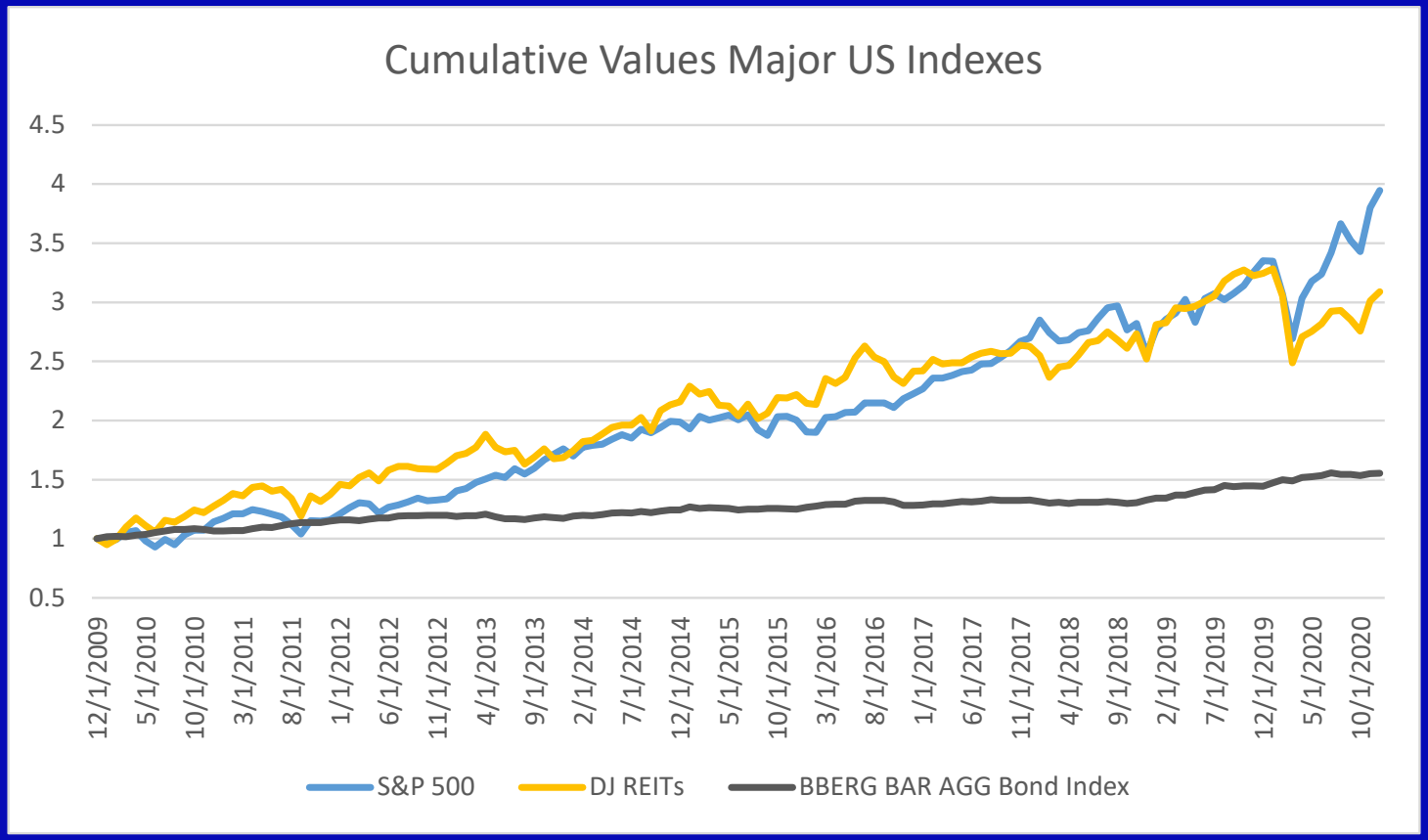
Date	Distribution
12/31/2011	1,458.90
12/31/2012	2,158.41
12/31/2013	2,315.64
12/31/2014	2,280.49
12/31/2015	1,226.20
4/29/2016	227.32
Total	9,666.96

Example: Capital Gain, NOP (continued)

- Capital Gain = Liquidation/Held Value – Capital Invested
  - Capital Gain(Loss) = 0 - $50,000 = -$50,000
- Net Out of Pocket Amount = Capital Gain(Loss) + Distributions
  - NOP = -$50,000 + 9,666.96 = -$40,333.04
- Negative NOP amount tells us: over the investment period, the investor walks away with $40,333.04 less than they invested.
- A shortcoming of the NOP amount is that it does not adjust for the amount of time over which the loss was realized.
- Also ignores market conditions during that time (effectively benchmarks investment performance against a "zero benchmark.")

Market Adjusted Damages

How did the capital market reward investment risks during a period of harm?



Market Adjusted Damages

- Market Adjusted Damages build in the opportunity cost incurred by the investor, which is incremental to the direct loss of nominal monetary amount from NOP amounts.
- Quantify the investor harm caused by the deficient investment, as opposed to investing in a well managed portfolio.
- Must carefully evaluate the choice of an appropriate "benchmark" for comparison.
- The benchmark should:
  - Appropriately match the risk exposure of the investment being evaluated.
  - Be objective.
  - Be diversified (not idiosyncratic).
- Should the benchmark reflect the risk of the selected investments or the risk of an appropriate investment?
  - Delineate between inappropriate investments and selecting deficient products.

Example: Market Adjusted Damages

- As an example, return to the Noble Royalty example.
- Considerations when selecting an appropriate benchmark:
  - What is an appropriate match for the risk and investment exposure specific to this 'investment?' Allows us to measure damages based on the risk taken by the investor.
    - Non-traded (highly illiquid), risky investment in oil exploration and production.
    - A good candidate: an investment in a diversified portfolio of companies involved in oil exploration and production. Possibly the Vanguard Energy Fund (VGENX), with the caveat that its not as risky and doesn't match the illiquidity risk of the Noble program.
  - Was the investment appropriate for the investor? If not, what type of investment would have been appropriate? Allows us to measure damages against what would have been appropriate investment selections for the investor.

Example: Market Adjusted Damages (continued)

- Let us select the VGENX for comparison.
- To compute market-adjusted damages, we want to construct a measure that captures the total loss to an investor from the deficient investment relative to what they would have had with a plausible alternative.
- How do we account for periodic distributions?
- IRR is a bad choice of measure!
- The key insight: by assuming the same contributions and withdrawals from the benchmark investment, we can directly compare the ending values for the damages number.

Example: Market Adjusted Damages (continued)

- To compute the market-adjusted damages number, we need to create a hypothetical investment, here VGENX, in the chosen alternative matching the timing and amount.
  - Also match all distributions.

Date	Amount	Action
7/28/2010	(50,000.00)	Purchase
12/31/2011	1,458.90	Distribution
12/31/2012	2,158.41	Distribution
12/31/2013	2,315.64	Distribution
12/31/2014	2,280.49	Distribution
12/31/2015	1,226.20	Distribution
4/29/2016	227.32	Distribution
12/31/2016	-	Liquidation / Held

Example: Market Adjusted Damages

Date	Amount	Action	Well Managed Account	VGENX Total Return Index	VGENX Return	VGENX Cumulative Return
7/28/2010	(50,000.00)	Purchase	50,000.00	86.9		0.0%
12/31/2011	1,458.90	Distribution	58,264.92	103.8	19.4%	19.4%
12/31/2012	2,158.41	Distribution	57,661.36	106.57	2.7%	22.6%
12/31/2013	2,315.64	Distribution	65,804.52	125.9	18.1%	44.9%
12/31/2014	2,280.49	Distribution	54,136.83	107.94	-14.3%	24.2%
12/31/2015	1,226.20	Distribution	41,279.79	84.75	-21.5%	-2.5%
4/29/2016	227.32	Distribution	48,753.15	100.56	18.7%	15.7%
12/31/2016	-	Liquidation / Held	54,677.61	112.78	12.2%	29.8%
	Well Managed Damage =		(54,677.61)			

Example: Damages, Imprudent Retirement Plan Offering

- We can extend these same concepts to ERISA cases.
- Plan sponsor allegedly violated fiduciary duty by selecting or retaining inferior investment choices.
- Fidelity Low Priced Stock Fund (FLPSX)
- Measure Damages against an alternative
- Use an appropriate index fun as neutral reference point.
- Vanguard mid-cap value index fund (VMVAX)

Year	FLPSX	VMVAX	Difference	Investment Balance	Contributions	Replacement Fund Balance	Damages
2013				50,000,000.00		50,000,000.00	
2014	8.8%	13.9%	-5.1%	55,632,996.46	1,250,000	58,180,250.02	(2,547,253.56)
2015	-0.3%	0.8%	-1.1%	56,741,411.17	1,250,000	59,923,875.20	(3,182,464.03)
2016	7.7%	14.6%	-7.0%	62,347,672.14	1,250,000	69,952,085.63	(7,604,413.49)
2017	21.2%	17.1%	4.1%	76,788,835.91	1,250,000	83,134,037.44	(6,345,201.53)
2018	-13.4%	-12.6%	-0.8%	67,713,226.63	1,250,000	73,875,394.35	(6,162,167.72)
2019*	12.7%	16.3%	-3.6%	77,572,629.94	1,250,000	87,155,837.22	(9,583,207.28)

Example: Damages, Excess Fees

- We can extend these same concepts to cases involving excess mutual fund fees where a higher share cost fund is offered although lower cost share class is available.
- For example, the offering of Vanguard Mid-Cap Value Index Fund (VMVAZ) may be prudent, but offering the investor share class (VMVIX) instead of lower cost admiral shares (or even institutional class shares) results in excess fee.

Year	VMVIX	VMVAX	Difference	Investment Balance	Contributions	Replacement Fund Balance	Damages
2013				50,000,000.00		50,000,000.00	
2014	13.7%	13.9%	-0.1%	58,117,190.89	1,250,000	58,180,250.02	(63,059.13)
2015	0.5%	0.8%	-0.4%	59,642,067.26	1,250,000	59,923,875.20	(281,807.94)
2016	15.1%	14.6%	0.5%	69,907,742.10	1,250,000	69,952,085.63	(44,343.52)
2017	16.9%	17.1%	-0.1%	82,993,628.32	1,250,000	83,134,037.44	(140,409.12)
2018	-12.8%	-12.6%	-0.1%	73,647,706.47	1,250,000	73,875,394.35	(227,687.88)
2019*	16.2%	16.3%	-0.1%	86,812,905.70	1,250,000	87,155,837.22	(342,931.52)

REIT/BDC
Damages In-House

- Use issuer / DST statements
- Reinvested distributions adjust cost bases
- BDs ignore reinv dist for cost bases
- Well managed damages
- When to retain damages expert

CONFIDENTIAL DAMAGES REVIEW

	Date	Initial	Prc	Shs	CashDivs	ReinvDivs	TotPrinc	TotShs	Splt Shs
Northstar Healthcare	11/28/2014	$ 61,000	$ 10.00	6,100	$ 3,995	$ 17,031	$ 78,031	7,989	
FS Investment Corp II	2/1/2013	$ 43,000	$ 10.35	4,154	$ 11,939	$ 20,763	$ 63,763	4,300	1,076
								(877)	
								(1,266)	
FS Energy and Power Fd	2/1/2013	$ 50,000	$ 10.50	4,761	$ 5,534	$ 21,352	$ 71,352	5,040	
								(1,463)	
								(949)	
		$ 154,000			$ 21,468	$ 59,146	$ 213,146		

	FSKR->FSK	Curr Prc	Curr Val	P&L	NOP		
Northstar Healthcare		$ 1.33	$ 10,625	$ (67,406)	$ (46,380)	NAV pricing	* CTT Auction price 10/2022
FS Investment Corp II	1,022	$ 17.97	$ 18,369	$ (27,253)	$ 5,449	stk price	* 10/19 STOCK PRICE
			$ 7,373				* redeemed 10/4/2018
			$ 10,768				* redeemed 7/10/2018
FS Energy and Power Fd		$ 2.71	$ 13,658	$ (41,722)	$ (14,836)	NAV pricing	* CTT Auction price 10/2022
			$ 9,657				* redeemed 7/10/13
			$ 6,315				* redeemed 10/1/18
			$ 76,766	**$ (136,380)**	**$ (55,767)**		

P&L = **Curr Val - TotPrinc**

TotPrinc = **Initial + ReinvDivs**

NOP = **P&L + CashDivs + ReinvDivs**

Transaction History

10 20 AM CST, Tue, Nov 30, 2021

Account #: REDACTED
BIN: 15297366
Registration: PR VATE TRUST CO
REDACTED
REDACTED
REDACTED -4970
Phone #:
- Day REDACTED

Mgmt CO: FS NVESTMENTS
Fund Name: FS ENERGY AND POWER FUND
Fund Code: 3804
Ticker:
CUSIP: 30264D109
Account Type: 17 - RA
Total Shares: 0 0000
Account Value: $0 00

Transaction History: 02/01/2013 - 11/30/2021

Transaction Type	Confirm Date	Trade Date	Share Balance	# of Shares	Price	Amount +/
TRANSFER TO 8380409833	08/22/2014	08/22/2014	0 0000	5274 8740	$0 0000	$0 00 -
NCOME RE NVEST	07/30/2014	07/29/2014	5,274 8740	36 0510	$9 9000	$356 90 +
NCOME RE NVEST	06/25/2014	06/24/2014	5,238 8230	27 9370	$9 8550	$275 32 +
NCOME RE NVEST	05/28/2014	05/27/2014	5,210 8860	27 0420	$9 8100	$265 28 +
NCOME RE NVEST	04/30/2014	04/29/2014	5,183 8440	33 5820	$9 8100	$329 44 +
NCOME RE NVEST	03/26/2014	03/25/2014	5,150 2620	26 6010	$9 8100	$260 96 +
NCOME RE NVEST	02/26/2014	02/25/2014	5,123 6610	26 4970	$9 7650	$258 74 +
NCOME RE NVEST	01/29/2014	01/28/2014	5,097 1640	26 4490	$9 7200	$257 08 +
NCOME RE NVEST	01/02/2014	12/31/2013	5,070 7150	32 7260	$9 7200	$318 10 +
NCOME RE NVEST	11/27/2013	11/26/2013	5,037 9890	26 1420	$9 6750	$252 92 +
NCOME RE NVEST	10/30/2013	10/29/2013	5,011 8470	32 4650	$9 6750	$314 10 +
NCOME RE NVEST	09/25/2013	09/24/2013	4,979 3820	25 8360	$9 6750	$249 96 +
NCOME RE NVEST	08/30/2013	08/30/2013	4,953 5460	27 8330	$9 6750	$269 28 +
NCOME RE NVEST	07/31/2013	07/31/2013	4,925 7130	27 6750	$9 6750	$267 76 +
NCOME RE NVEST	06/28/2013	06/28/2013	4,898 0380	27 5200	$9 6750	$266 26 +
NCOME RE NVEST	05/31/2013	05/31/2013	4,870 5180	27 3020	$9 6750	$264 15 +

REDACTED

NCOME RE NVEST	04/30/2013	04/30/2013	4,843 2160	27 0860	$9 6300	$260 84 +
NCOME RE NVEST	03/28/2013	03/28/2013	4,816 1300	27 0610	$9 5400	$258 16 +
NCOME RE NVEST	02/28/2013	02/28/2013	4,789 0690	27 1640	$9 4500	$256 70 +
SHARES PURCHASED BY W RE	02/01/2013	02/01/2013	4,761 9050	4761 9050	$10 5000	$50,000 00 +

NOTE: Alternative Investment Product account values displayed are those provided by the issuer of the securities. The account value is not necessarily the amount an investor can expect to receive upon liquidation, share repurchase or tender. Please also note certain products may prorate based upon specific share repurchase or tender requirements.

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Covered by US Patent No. 7,275,046

REDACTED

Transaction History

10 21 AM CST, Tue, Nov 30, 2021

Account #: REDACTED
BIN: 15297366
Registration: REDACTED

Phone #: Not On F e

Mgmt CO: FS NVESTMENTS
Fund Name: FS ENERGY AND POWER FUND
Fund Code: 3804
Ticker:
CUSIP: 30264D109
Account Type: 17 - RA

Total Shares: 5,040 6390
Account Value: $17,995 08

Transaction History: 08/22/2014 - 11/30/2021

Transaction Type	Confirm Date	Trade Date	Share Balance	# of Shares	Price	Amount +/
NCOME D STR BUT ON CASH	10/14/2021	10/13/2021	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	07/19/2021	07/16/2021	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	04/15/2021	04/14/2021	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	01/13/2021	01/12/2021	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	10/13/2020	10/12/2020	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	07/13/2020	07/10/2020	5,040 6390	0 0000	$0 0000	$151 22
NCOME D STR BUT ON CASH	04/01/2020	03/31/2020	5,040 6390	0 0000	$0 0000	$105 01
NCOME D STR BUT ON CASH	03/02/2020	02/28/2020	5,040 6390	0 0000	$0 0000	$105 01
NCOME D STR BUT ON CASH	02/03/2020	01/31/2020	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	01/02/2020	12/31/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	12/02/2019	11/29/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	11/01/2019	10/31/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	10/01/2019	09/30/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	09/04/2019	08/30/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	08/01/2019	07/31/2019	5,040 6390	0 0000	$0 0000	$210 03
NCOME D STR BUT ON CASH	07/01/2019	06/28/2019	5,040 6390	0 0000	$0 0000	$210 03

REDACTED

NCOME D STR BUT ON CASH	06/03/2019	05/31/2019	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	05/01/2019	04/30/2019	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	04/01/2019	03/29/2019	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	03/01/2019	02/28/2019	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	02/01/2019	01/31/2019	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	01/02/2019	12/31/2018	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	12/03/2018	11/30/2018	5,040 6390	0 0000	$0 0000	$210 03	
NCOME D STR BUT ON CASH	11/01/2018	10/31/2018	5,040 6390	0 0000	$0 0000	$210 03	
SHARES REDEEMED	10/04/2018	10/01/2018	5,040 6390	949 7100	$6 6500	$6,315 57	-
NCOME D STR BUT ON CASH	10/01/2018	09/28/2018	5,990 3490	0 0000	$0 0000	$249 60	
NCOME D STR BUT ON CASH	09/04/2018	08/31/2018	5,990 3490	0 0000	$0 0000	$249 60	
NCOME D STR BUT ON CASH	08/01/2018	07/31/2018	5,990 3490	0 0000	$0 0000	$249 60	
SHARES REDEEMED	07/10/2018	07/02/2018	5,990 3490	1463 3010	$6 6000	$9,657 78	-
NCOME D STR BUT ON CASH	07/02/2018	06/29/2018	7,453 6500	0 0000	$0 0000	$310 57	
NCOME RE NVEST	06/01/2018	05/31/2018	7,453 6500	47 1160	$6 5500	$308 61	+
NCOME RE NVEST	05/01/2018	04/30/2018	7,406 5340	46 8180	$6 5500	$306 66	+
NCOME RE NVEST	04/03/2018	03/29/2018	7,359 7160	46 5220	$6 5500	$304 72	+
NCOME RE NVEST	03/01/2018	02/28/2018	7,313 1940	45 2000	$6 7000	$302 84	+
NCOME RE NVEST	02/01/2018	01/31/2018	7,267 9940	44 9190	$6 7000	$300 96	+
NCOME RE NVEST	01/02/2018	12/29/2017	7,223 0750	63 0960	$6 7000	$422 74	+
NCOME RE NVEST	12/01/2017	11/30/2017	7,159 9790	58 6410	$7 1500	$419 28	+

REDACTED

NCOME RE NVEST	11/01/2017	10/31/2017	7,101 3380	58 1590	$7 1500	$415 84 +
NCOME RE NVEST	10/02/2017	09/29/2017	7,043 1790	57 6840	$7 1500	$412 44 +
NCOME RE NVEST	09/01/2017	08/31/2017	6,985 4950	57 2110	$7 1500	$409 06 +
NCOME RE NVEST	08/03/2017	07/31/2017	6,928 2840	56 3510	$7 2000	$405 73 +
NCOME RE NVEST	07/03/2017	06/30/2017	6,871 9330	55 8930	$7 2000	$402 43 +
NCOME RE NVEST	06/01/2017	05/31/2017	6,816 0400	52 2030	$7 6500	$399 35 +
NCOME RE NVEST	05/01/2017	04/28/2017	6,763 8370	51 4690	$7 7000	$396 31 +
NCOME RE NVEST	04/03/2017	03/31/2017	6,712 3680	50 7510	$7 7500	$393 32 +
NCOME RE NVEST	03/01/2017	02/28/2017	6,661 6170	50 3660	$7 7500	$390 34 +
NCOME RE NVEST	02/01/2017	01/31/2017	6,611 2510	49 9860	$7 7500	$387 39 +
NCOME RE NVEST	01/03/2017	12/30/2016	6,561 2650	46 1140	$7 7000	$355 08 +
NCOME RE NVEST	11/30/2016	11/30/2016	6,515 1510	58 5300	$7 5150	$439 85 +
NCOME RE NVEST	10/26/2016	10/26/2016	6,456 6210	46 4880	$7 5150	$349 36 +
NCOME RE NVEST	09/28/2016	09/28/2016	6,410 1330	46 7070	$7 4250	$346 80 +
NCOME RE NVEST	08/31/2016	08/31/2016	6,363 4260	58 9160	$7 2900	$429 50 +
NCOME RE NVEST	07/27/2016	07/27/2016	6,304 5100	46 7820	$7 2900	$341 04 +
NCOME RE NVEST	06/29/2016	06/29/2016	6,257 7280	47 6010	$7 1100	$338 44 +
NCOME RE NVEST	06/01/2016	05/31/2016	6,210 1270	62 4610	$6 7050	$418 80 +
NCOME RE NVEST	04/27/2016	04/27/2016	6,147 6660	50 5750	$6 5700	$332 28 +
NCOME RE NVEST	03/30/2016	03/30/2016	6,097 0910	64 7680	$6 3450	$410 95 +
NCOME RE NVEST	02/24/2016	02/24/2016	6,032 3230	52 1060	$6 2550	$325 92 +

REDACTED

NCOME RE NVEST	01/27/2016	01/27/2016	5,980 2170	49 8770	$6 4800	$323 20 +
NCOME RE NVEST	12/30/2015	12/30/2015	5,930 3400	59 2520	$6 7500	$399 95 +
NCOME RE NVEST	11/25/2015	11/25/2015	5,871 0880	42 5220	$7 4700	$317 64 +
NCOME RE NVEST	10/28/2015	10/28/2015	5,828 5660	40 2910	$7 8300	$315 48 +
NCOME RE NVEST	09/30/2015	09/30/2015	5,788 2750	49 6440	$7 8750	$390 95 +
NCOME RE NVEST	08/26/2015	08/26/2015	5,738 6310	37 3240	$8 3250	$310 72 +
NCOME RE NVEST	07/29/2015	07/29/2015	5,701 3070	35 5560	$8 6850	$308 80 +
NCOME RE NVEST	07/01/2015	06/30/2015	5,665 7510	43 4240	$8 8200	$383 00 +
NCOME RE NVEST	05/27/2015	05/27/2015	5,622 3270	34 5260	$8 8200	$304 52 +
NCOME RE NVEST	04/29/2015	04/29/2015	5,587 8010	34 6670	$8 7300	$302 64 +
NCOME RE NVEST	04/01/2015	03/31/2015	5,553 1340	43 0010	$8 7300	$375 40 +
NCOME RE NVEST	02/26/2015	02/25/2015	5,510 1330	34 1860	$8 7300	$298 44 +
NCOME RE NVEST	01/29/2015	01/28/2015	5,475 9470	34 3240	$8 6400	$296 56 +
NCOME RE NVEST	01/02/2015	12/31/2014	5,441 6230	41 7060	$8 8200	$367 85 +
NCOME RE NVEST	11/28/2014	11/26/2014	5,399 9170	30 1070	$9 7200	$292 64 +
NCOME RE NVEST	10/30/2014	10/29/2014	5,369 8100	29 3980	$9 9000	$291 04 +
NCOME RE NVEST	10/01/2014	09/30/2014	5,340 4120	36 5000	$9 9000	$361 35 +
NCOME RE NVEST	08/27/2014	08/26/2014	5,303 9120	29 0380	$9 9000	$287 48 +
TRANSFER FROM 150087190	08/22/2014	08/22/2014	5,274 8740	5274 8740	$0 0000	$0 00 +

NOTE: Alternative Investment Product account values displayed are those provided by the issuer of the securities. The account value is not necessarily the amount an investor can expect to receive upon liquidation, share repurchase or tender. Please also note certain products may prorate based upon specific share repurchase or tender requirements.

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Covered by US Patent No. 7,275,046

REDACTED

Categories

FS Energy & Power Fund (category/BDCs/FS+Energy+%26amp%3B+Power+Fund/)

View all categories (category/All+Listings)

FS Energy & Power Fund (/category/BDCs/FS+Energy+%26amp%3B+Power+Fund?v=rss&lang=en_US)

NOTICE: This page will NOT refresh automatically

QMS

I Have Not Bid On This Item | My Bid Is Low | My Bid Is Winning

Watch	Item	Id	Time Left	End Date	Quantity	Price	Max	
(/user/favourites/OFFER/12547)	FS Energy & Power Fund (/offer/details/FS_Energy_%26amp%3B_Power_Fund-12547)	12547	5 Hours 9 Minutes 35 Seconds	11/22/2022 01:55:00 PM	8,707.725	$2.65		Bid

Offering Details | Auction History | Sec Information | Tender Offer | Documents

Auction #	Quantity	Start Price	Ending Price	End Date	Ex-dividend Date	Views	Status
12522 (/offer/details/12522)	3535.227	$2.7	$2.71	11/17/2022 12:10:00 PM	11/14/2022	13	Sold
12518 (/offer/details/12518)	3924.164	$2.7	$2.72	11/16/2022 11:35:00 AM	11/11/2022	8	Sold
12515 (/offer/details/12515)	2487.27	$2.7	$2.72	11/15/2022 01:45:00 PM	11/10/2022	13	Sold
12486 (/offer/details/12486)	949.19	$2.75	$2.8	11/08/2022 11:10:00 AM	11/03/2022	18	Sold
12473 (/offer/details/12473)	3227.757	$2.7	$2.8	11/04/2022 12:15:00 PM	11/01/2022	24	Sold
12464 (/offer/details/12464)	1563.183	$2.75	$2.79	11/02/2022 01:15:00 PM	10/30/2022	18	Sold
12447 (/offer/details/12447)	23744.574	$2.7	$2.78	10/24/2022 11:40:00 AM	10/19/2022	31	Sold
12446 (/offer/details/12446)	7981.358	$2.65	$2.77	10/24/2022 11:25:00 AM	10/19/2022	38	Sold
12441 (/offer/details/12441)	2171.712	$2.7	$2.76	10/20/2022 01:15:00 PM	10/17/2022	16	Sold
12419 (/offer/details/12419)	4093.327	$2.75	$2.75	10/13/2022 12:35:00 PM	10/10/2022	14	Sold
12386 (/offer/details/12386)	1000	$2.8	$2.8	10/06/2022 12:00:00 PM	10/03/2022	17	Sold
12367 (/offer/details/12367)	2688.486	$2.85	$2.85	09/30/2022 11:20:00 AM	09/27/2022	11	Sold
12330 (/offer/details/12330)	1073.267	$2.75	$2.84	09/23/2022 01:00:00 PM	09/20/2022	19	Sold
12317 (/offer/details/12317)	20004.001	$2.65	$2.87	09/16/2022 12:30:00 PM	09/13/2022	39	Sold
12270 (/offer/details/12270)	1118.293	$2.75	$2.76	08/31/2022 11:45:00 AM	08/26/2022	13	Sold
12258 (/offer/details/12258)	2899.07	$2.75	$2.77	08/26/2022 02:20:00 PM	08/23/2022	12	Sold
12247 (/offer/details/12247)	1463.277	$2.75	$2.77	08/25/2022 01:20:00 PM	08/22/2022	13	Sold

Auction #	Quantity	Start Price	Ending Price	End Date	Ex-dividend Date	Views	Status
12241 (/offer/details/12241)	1341.997	$2.7	$2.76	08/24/2022 12:30:00 PM	08/19/2022	14	Sold
12228 (/offer/details/12228)	1185.303	$2.7	$2.76	08/19/2022 01:00:00 PM	08/16/2022	23	Sold
12214 (/offer/details/12214)	1170.896	$2.8	$2.8	08/15/2022 11:25:00 AM	08/11/2022	8	Sold
12206 (/offer/details/12206)	5050	$2.8	$2.81	08/11/2022 01:15:00 PM	08/08/2022	10	Sold
12202 (/offer/details/12202)	1771.542	$2.75	$2.81	08/11/2022 11:15:00 AM	08/08/2022	24	Sold
12186 (/offer/details/12186)	1577.947	$2.75	$2.77	08/05/2022 11:45:00 AM	08/02/2022	16	Sold
12178 (/offer/details/12178)	17257.236	$3	$3.03	08/03/2022 01:25:00 PM	07/29/2022	14	Sold
12163 (/offer/details/12163)	11535.093	$2.8	$3.06	07/28/2022 02:15:00 PM	07/25/2022	41	Sold
12125 (/offer/details/12125)	8376.19	$2.8	$3.02	07/15/2022 01:15:00 PM	07/12/2022	25	Sold
12122 (/offer/details/12122)	2796.25	$2.8	$3.02	07/14/2022 02:35:00 PM	07/11/2022	33	Sold
12098 (/offer/details/12098)	2294.311	$2.75	$2.76	07/06/2022 02:10:00 PM	07/03/2022	13	Sold
12094 (/offer/details/12094)	2368.902	$2.75	$2.76	07/06/2022 01:15:00 PM	07/03/2022	10	Sold
12091 (/offer/details/12091)	1179.739	$2.75	$2.8	07/06/2022 12:40:00 PM	07/03/2022	28	Sold

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CONFIDENTIAL DAMAGES REVIEW

	Date	Initial	Prc	Shs	CashDivs	ReinvDivs	TotPrinc	TotShs	Splt Shs
Northstar Healthcare	11/28/2014	$ 61,000	$ 10.00	6,100	$ 3,995	$ 17,031	$ 78,031	7,989	
FS Investment Corp II	2/1/2013	$ 43,000	$ 10.35	4,154	$ 11,939	$ 20,763	$ 63,763	4,300	1,076
								(877)	
								(1,266)	
FS Energy and Power Fund	2/1/2013	$ 50,000	$ 10.50	4,761	$ 5,534	$ 21,352	$ 71,352	5,040	
								(1,463)	
								(949)	
		$ 154,000			$ 21,468	$ 59,146	$ 213,146		

	FSKR->FSK	Curr Prc	Curr Val	P&L	NOP	Respondent Math P&L	Respondent Math NOP
Northstar Healthcare		$ 1.33	$ 10,625	$ (67,406)	$ (46,380)	$ (50,375)	$ (29,349)
FS Investment Corp II	1,022	$ 17.97	$ 18,369	$ (27,253)	$ 5,449	$ (24,631)	$ 8,071
			$ 7,373				
			$ 10,768				
FS Energy and Power Fund		$ 2.71	$ 13,658	$ (41,722)	$ (14,836)	$ (36,342)	$ (9,456)
			$ 9,657				
			$ 6,315				
			$ 76,766	**$ (136,380)**	**$ (55,767)**	**$ (111,347)**	**$ (30,734)**

P&L = **Curr Val - TotPrinc**

TotPrinc = **Initial + ReinvDivs**

NOP = **P&L + CashDivs + ReinvDivs**

P&L ignores reinvested divs but uses total shares

NOP = P&L + CashDivs + ReinvDivs

CONFIDENTIAL DAMAGES REVIEW

	Date	Initial	Prc	Shs	CashDivs	ReinvDivs	TotPrinc	TotShs	Splt Shs
Northstar Healthcare	11/28/2014	$ 61,000	$ 10.00	6,100	$ 3,995	$ 17,031	$ 78,031	7,989	
FS Investment Corp II	2/1/2013	$ 43,000	$ 10.35	4,154	$ 11,939	$ 20,763	$ 63,763	4,300	1,076
								(877)	
								(1,266)	
FS Energy and Power Fund	2/1/2013	$ 50,000	$ 10.50	4,761	$ 5,534	$ 21,352	$ 71,352	5,040	
								(1,463)	
								(949)	
		$ 154,000			$ 21,468	$ 59,146	$ 213,146		

	FSKR->FSK	Curr Prc	Curr Val	P&L	NOP	SPY	SPY Shs	SPY End	P&L
Northstar Healthcare		$ 1.33	$ 10,625	$ (67,406)	$ (46,380)	$ 178.83	341	$ 374.13	$ 66,618
FS Investment Corp II	1,022	$ 17.97	$ 18,369	$ (27,253)	$ 5,449	$ 126.19	341	$ 374.13	$ 84,487
			$ 7,373						
			$ 10,768						
FS Energy and Power Fund		$ 2.76	$ 13,910	$ (41,470)	$ (14,584)	$ 126.19	396	$ 374.13	$ 98,241
			$ 9,657						
			$ 6,315						
			$ 77,018	**$ (136,128)**	**$ (55,515)**				$ 249,346

Well managed damages	**304,860**

CASES AGAINST DISCOUNT BROKERAGE FIRMS AND SUPERVISION OF THIRD-PARTY ACCOUNTS

Jason Kane, August Iorio, Douglas Schulz

FINRA Rule 2111 (Reg BI)

- Standard defense #1

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.

FINRA Rule 2111 (Reg BI)

- Standard defense #1

We didn’t make a recommendation therefore suitability rule does not apply to us

Since suitability rule does not apply to us the other FINRA rules do not apply to us either

We don’t make recommendations, we don’t have any duties

FINRA Rule 2111 (Reg BI)

- Standard defense #1

[BD] did not have any duty of care beyond the execution of the transactions upon Claimant's instruction…

[BD] had no duty to monitor Claimant's account.

"…[BD] does not have an independent duty to oversee" the investments made for clients by an independent investment advisor."

Education

- Potentially blows up the FINRA Rule 2111 no recommendation defense
- When does education turn into a recommendation?
  - Options Idea Hub – specific trades based on bullish, bearish, or neutral
  - Education “built around you”

No Duty, But We Do It Anyway

- Standard defense #2

The cake and eat it too defense

The "continued execution of [an] adviser's orders where a **broker-dealer has knowledge of improprieties in an investment adviser's handling of accounts may subject the broker-dealer to liability for aiding and abetting a violation of the federal securities laws if the adviser is in fact a primary violator of some provision of those laws"**

- In re Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 19070 (Sept. 21, 1982)

If not suitability, what duties?

- FINRA Rule 2360 (Options)
- FINRA Rule 2220 (Options Communications)
- FINRA Rule 2260 (Disclosures)
- FINRA Rule 2264 (Margin Disclosure Statement)
- FINRA Rule 3110 (Supervision)
- FINRA Rule 4210 (Margin Requirements)
- FINRA Rule 4512 (Customer Account Information)
- FINRA Rule 2090 (Know Your Customer)
- FINRA Rule 2210 (Communications with the Public)
- CBOE Rule 9.1 (Opening of Accounts)
- CBOE Rule 9.2 (Supervision of Accounts)

Helpful FINRA Notices

- November 2022 – FINRA Provided Update on Sweep: Option Account Opening, Supervision and Related Areas
- April 9, 2021 – FINRA Reg. Not. 21-15 Options Account Approval, Supervision and margin
- March 8, 2022 – FINRA Reg. Not. 22-08, Complex Products and Options

If not suitability, what duties?

- Anti-Money Laundering – AML
  - FINRA Rule 3310 (Anti-Money Laundering Compliance Program)
  - Money Laundering Red-Flags
    - FINRA Notice to Members 02-21
    - FINRA AWC Case No. 2015047770302, Department of Enforcement re: Arnold Feist

If not suitability, what duties?

- FINRA Rule 2130 (Approval Procedures for Day Trading)
- FINRA Rule 2270 (Day-Trading Risk Disclosure Statement)
- FINRA Notice to Members 00-62

If not suitability, what duties?

- Senior and Elderly Investors
  - FINRA Rule 2165
  - FINRA Regulatory Notice 07-43
  - FINRA Regulatory Notice 17-11
  - FINRA Regulatory Notice 20-38
  - FINRA Report, “Protecting Senior Investors 2015 – 2020”

If not suitability, what duties?

- FINRA Rule 3110 (Supervision)
  - Requires supervision of all activities
  - Requires supervision of all employees
  - Requires supervision of all opening of customer accounts
  - Requires supervision of all trading activity in customer accounts
- Red-Flags
  - NASD Notice to Members 98-38: NASD Reminds Members of Supervisory and Inspection Obligations
  - “must act decisively to detect and prevent violations of the federal securities laws”

If not suitability, what duties?

- FINRA Rule 2090 (Know Your Customer)
  - FINRA Notice to Members 11-02
- FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices)
- FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)
- FINRA Regulatory Notice 21-16 (Brokerage firms can't limit a client's rights)

Regulators

- June 2021 – FINRA fined Robinhood $57 million and order restitution of $12.6 million
  - Failed to exercise due diligence before approving options accounts

- June 2014 – TD Ameritrade fined for failing to maintain updated account records

- October 2021 – Massachusetts Securities Division filed a complaint against Robinhood
  - Targeting young, in experienced investors
  - List of investments to customers is a recommendation

ROUNDING UP THE WILD WEST OF CRYPTO: TODAY'S REAL WORLD CRYPTO LITIGATION[1]

Michael C. Bixby, Joe Wojciechowski, Birgitta Siegel, and Howard A. Fisher

The breadth of damages caused by Cryptocurency related fraud, scams, and misconduct is astronomical. "Scammers around the world took home a record $14 billion in cryptocurrency in 2021."[2] Crypto-related crime losses rose 79% in 2021 (compared to 2020).[3] Crypto theft grew an astounding 516% in 2021.[4] Bitcoin plummeted over 81% in 2022, but consistent with its wild volatility Bitcoin's price has climbed nearly 80% already this year. The impact of the market collapse has shaken up the market and brought many of the biggest and most well-known crypto players to their knees. Just a sampling of the many examples since July 2022:

- FTX – Filed for bankruptcy in November 2022. FTX was one of the largest cryptocurrency exchange firms, which had been previously valued as much as $40 billion. Its founder, Sam Bankman-Fried, currently faces various criminal charges.
- BlockFi filed for Chapter 11 in November 2022
- Celsius filed for bankruptcy in July 2022 and has been subject to various fraud investigations
- Genesis – Filed for bankruptcy in January 2023. Has an estimated 100,000 creditors
- Bittrex – Filed for bankruptcy in May 2023 and facing an SEC Action
- Voyager Digital – Filed for bankruptcy July 2022
- Three Arrows Capital – Filed for bankruptcy July 2022

In addition, the SEC is actively pursuing a variety of charges and actions against crypto-entities including:

- SEC v. Terraform Labs PTE Ltd
- SEC v. Genesis Global Capital LLC
- SEC v. Binance Holdings Ltd.
- SEC v. Coinbase Inc.

How extensive is the SEC's enforcement actions? The SEC even charged Kanye West's ex-wife (Kim Kardashian) for unlawfully touting crypto security on social media![5]

Change just might be the only constant hallmark in crypto. The regulatory and legal landscape surrounding crypto constantly changes and evolves, now more than ever. Some information included in these materials, prepared in early August, will likely be obsolete within a couple of months (or less). An hour is like a day, a day like a month, and a week So goes crypto.

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[1] This article does not necessarily represent the views or opinions of all of the listed authors. Any errors, inaccuracies, or complaints should be credited to or directed to Michael Bixby.
[2] MacKenzie Sigalos, *Crypto Scammers took a record $14 billion in 2021* CNBC (Jan. 6, 2022), available at t https://www.cnbc.com/2022/01/06/crypto-scammers-took-a-record-14-billion-in-2021-chainalysis.html.
[3] Id.
[4] Id.
[5] SEC Press Release, available at https://www.sec.gov/news/press-release/2022-183

This article and corresponding session will focus primarily on examples of active litigation that could be viable against solvent Defendants or entities. Ongoing litigation will likely be shaped, destroyed, or enhanced by legislative and regulatory actions, including the SEC's active enforcement dockets in the crypto space. Copies of some of the current important decisions are included with this material and may be discussed further as relevant in the corresponding presentation.

However, this article will focus on several representative examples, case studies, and deep dives to demonstrate some areas that may be ripe for active litigation.

Coinbase's Vulnerable Platform: A Brief Case Study

Coinbase is a publicly traded company out of San Francisco, California that operates the largest Crypto platform in the United States. However, Coinbase has been prone to a variety of hacks and security breaches (for instance sim swap hacks) and abuse of its platform by fraudsters. Coinbase is subject to a varied scheme of state and federal oversight including the Department of Treasury's Financial Crimes Enforcement Network Bureau ("FinCEN"), the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Coinbase is federally registered as a money services business with FinCEN. Coinbase is also licensed as a money transmitter in 42 states. Coinbase also holds a "BitLicense" from the New York Department of Financial Services. Coinbase is also subject to oversight by entities such as the Federal Trade Commission and the Consumer Financial Protection Bureau, among others.

Coinbase's Promises to Consumers

In any cryptocurrency related case, some of the best evidence and admissions, at least initially, may come straight from the mouth (or website/advertisements) of the defendant. Coinbase is a good example.

Coinbase routinely represents to its customers that Coinbase "[takes] extensive security measures to ensure [customers'] account[s] and cryptocurrency investment[s] [remain] **as safe as possible**..."[6] Coinbase splits no hairs, even directly stating to customers "TLDR[7]: **Your funds are safe, secure**, and yours."[8] In fact, Coinbase's second Institutional Core Principal is customer security as posted on their website:

> Our Commitment: **Coinbase will provide the highest levels of protection to our customers**. That includes **institutional-grade cybersecurity, compliance, onboarding processes and operating standards**.[9]

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[6] *See* Coinbase, Introducing our Institutional Core Principals. (Aug. 20, 2018) available at https://blog.coinbase.com/introducing-our-institutional-core-principles-58c6f244258f).

[7] For all you old fogies out there: TLDR is internet slang for "too long; didn't read" – confirming Coinbase's recognition that its customers were relying on Coinbase to understand and handle the complex and intricate dealings such as financial compliance and supervision.

[8] Coinbase, A Message to Our Customers, available at https://help.coinbase.com/en/coinbase/top-of-mind/top-of-mind/a-message-to-our-customers.

[9] Coinbase, Introducing our Institutional Core Principals. (Aug. 20, 2018) available at https://blog.coinbase.com/introducing-our-institutional-core-principles-58c6f244258f.

Coinbase's promise to its customers is to provide the highest levels of protection to their customers. Coinbase assured its retail customers that they would provide "institutional-grade" features, security, and compliance to them.

Coinbase promises customers that their "compliance programs detect and prevent financial crime…"[10] Coinbase also promises action on their part to keep customers' funds safe. "Coinbase takes extensive security measures to ensure our customer accounts remain as safe as possible."[11] Coinbase elaborates on this a bit more by describing the role of their security team. "At Coinbase, our security team not only monitors the safety of our platform and customers' funds, but also security threats and abuse trends impacting the larger cryptoeconomy."[12] After assuring their customers that Coinbase takes every precaution necessary, Coinbase also publicly reassured its customers in testimony before Congress that their programs for monitoring security.

> We have very strong cybersecurity protections and compliance practices to ensure that we remain the most trusted company in this space. **Our cybersecurity program is state of the art and it is the critical core of our business**.[13]

Coinbase also promises customers that they have "programs and technologies [they] use to keep [their] customers safe and bad actors off [their] platforms,"[14] and that "[Coinbase's] commitment to security goes far beyond what the law requires."[15]

Another major promise Coinbase makes to its customers involves compliance with state and federal regulations. Coinbase reassures customers about how safe their money will be by using Coinbase because of their rigid compliance with all state, federal, and other regulations and laws. Coinbase attests that compliance drives security, so because Coinbase is compliant, customers' funds are even safer. Coinbase explained to the New York Attorney General:

> We are also in the process of enhancing our market operations through the addition of more robust and automated surveillance tools and dedicated compliance staffing. These additional resources will improve our capacity **to detect and prevent fraud and manipulative conduct as part of our commitment towards complying**.[16]

Coinbase makes it very clear that Compliance is something that should be important to all Money Service Businesses, or MSB's. Coinbase claims that "compliance… isn't an option, it's a necessity."[17]

In their Institutional Core Principles, Coinbase also claims that one of their actions to provide the highest levels of protection to their customers includes "comply[ing] with, or

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[10] Melissa Strait, How Coinbase is making Compliance a Driver of Innovation (Sept. 21, 2021), available at https://blog.coinbase.com/how-coinbase-is-making-compliance-a-driver-of-innovation-b33cfec84bb2.
[11] Coinbase, How Can I Make My Account More Secure?, https://help.coinbase.com/en/coinbase/privacy-and-security/data-privacy/how-can-i-make-my-account-more-secure.
[12] (Coinbase Security Team, Security PSA: Ledger Phishing Attacks).
[13] *See* Mike Lempres, Coinbase's written Testimony for the Subcommittee on Capital Markets, Securities, and Investment. (Mar. 13, 2018), available at https://blog.coinbase.com/coinbases-written-testimony-for-the-subcommittee-on-capital-markets-securities-and-investment-47f8a260ce41.
[14] (Melissa Strait, How Coinbase is making Compliance a Driver of Innovation)
[15] (Mike Lempres, Building Trust through Compliance).
[16] *See* Coinbase Voluntary Response to the New York Attorney General Virtual Markets Integrity Initiative.
[17] (Coinbase, How Coinbase is making Compliance a Driver of Innovation).

exceed[ing] state and federal regulation, actively analyz[ing] and participat[ing] in new licensing and compliance activities." Another action Coinbase promises they are taking under their Institutional Core Principles is "prohibit[ing] and actively monitor[ing] for malicious or deceptive trading practices."[18]

Coinbase writes that since "digital currency transactions are irrevocable, […] this creates an attractive target for scammers and digital thieves."[19] Since digital currency transactions are already at such high risk targets for financial crime, Coinbase needs to be doing more to protect their customers (as they have many times promised they would) than just posting generalized articles and public service announcements. Coinbase has the ability to temporarily freeze a customer's account.

Coinbase is also familiar with the types of scams and frauds perpetrated on customers. Coinbase knows how to spot and prevent clients from falling victims to such scams and fraud. Coinbase knows that the scammers are incredibly advanced and "are skilled in social engineering, making false claims to deceive and manipulate their target into providing personal information that will be used for fraudulent purposes".[20] Coinbase acknowledges that many of these scammers "[lure] unsuspecting victims seeking assistance."[21]

Coinbase acknowledges "At first glance (and even at second glance), this email looks plausible, and it's not easy to discern the fact that it is designed to fool you…"[22] The email Coinbase is referencing is a fake email sent by scammers that is made to look like official correspondence. Coinbase acknowledges that it is very difficult to discern that this email is fake, especially to the untrained eye. Because of Coinbase superior knowledge in the field, they have a heightened duty to their customers. Coinbase promised these customers already that Coinbase would "keep bad actors off their platforms,"[23] It would make sense for Coinbase's customers to feel a fake sense of security on Coinbase's platform- Coinbase promised their customers that it was a safe and secure environment to buy and sell cryptocurrency. These customers trusted Coinbase to take every precaution possible to protect them, just like Coinbase advertised they would. Later on in the same article from above, Coinbase suggests going directly to the website link given to investigate -- however Coinbase acknowledges that even the links and websites scammers set up can look very realistic too.

Coinbase has the duty, obligation, and ability to investigate red flags and freeze or halt transfers or activity that might be fraudulent:

> In some instances when we encounter unusual activity, we may be obliged to temporarily freeze a customer's account. This is to protect customers from withdrawing their funds until we have completed a review. For example, this could happen when we suspect a customer is violating our terms of service, or when we

[18] (Coinbase, Introducing our Institutional Core Principles).
[19] (Matt Muller, Anatomy of a Telegram Scam).
[20] See Coinbase, Avoiding Cryptocurrency Scams.
[21] *Id*.
[22] (Coinbase, Security PSA: Ledger Phishing Attacks).
[23] Coinbase, How Coinbase is Making Compliance a Driver of Innovation.

> need more information to meet evolving "know your customer" requirements in a certain jurisdiction.[24]

This isn't the only time Coinbase brings up Know Your Customer requirements. In fact, Coinbase acknowledges they have to follow these rules many times.

> [Coinbase] is licensed to engage in money transmission in most US jurisdictions… Coinbase is also registered as a Money Services Business with FinCEN. Coinbase is **required to comply with** many financial services and consumer protection laws including: **The Bank Secrecy Act**, which requires Coinbase to **verify customer identities**, maintain records of currency transaction for up to 5 years, and **report certain transactions**, **The USA Patriot Act**, which requires Coinbase to designate a compliance officer to ensure compliance with all applicable laws, create **procedures and controls to ensure compliance**, conduct training, and periodically review the compliance program, [and] most states' money transmission laws and corresponding regulations.[25]

Coinbase admits that **they need even more information from customers than a bank would need** to fulfill their legal obligations. Coinbase later acknowledges Know Your Customer, or KYC, laws under the BSA, and how the Patriot Act "strengthened the information gathering necessary at account opening."[26]

"Coinbase uses identity verification in order to comply with KYC regulations. KYC is a way of identifying and confirming that a customer is who they say they are,"[27] Coinbase discloses that "As a regulated financial services company, Coinbase is **required to identify the users** on our platform."[28] They go on to explain in more depth what this requires of the customer and of Coinbase. "This means any customer who signs up for Coinbase, as well as any customer who is currently on our platform who never verified their identity in the past, needs to verify their identity in order to continue using Coinbase."[29] Coinbase makes it very clear that identity verification and data collection is of the utmost importance, and it is their responsibility to keep it updated and accurate to be compliant with such regulations. In the same article, Coinbase elaborates that this data collection is actually crucial to keeping customer accounts secure, so it is critical for them to ask for and collect the proper data in a timely manner:

> This primarily includes data collection that is **mandated by law**- such as when **we must comply with anti-money laundering laws**, or to **verify your identity** and **protect you from potential fraudulent activity**.[30]

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[24] Coinbase, An Update on Improving our Customer Experience (March 24, 2021), available at https://blog.coinbase.com/an-update-on-improving-our-customer-experience-67366fe9b357#.
[25] Coinbase, Coinbase Money Transmission and e-Money Regulatory Compliance. Access: https://help.coinbase.com/en/coinbase/privacy-and-security/other/coinbase-regulatory-compliance and Coinbase, Legal FAQ, accessible at https://www.coinbase.com/legal/faq#.
[26] Jeff C., Why Compliance at an Online MSB is so Challenging, Coinbase Blog (August 16, 2016), available at https://blog.coinbase.com/why-compliance-at-an-online-msb-is-so-challenging-ab113fac3ab6#.
[27] (Coinbase, Identity Verification FAQ).
[28] *Id*.
[29] *Id*.
[30] *Id*.

In fact, Coinbase *claims* it makes customers enter additional information when sending money to third party financial account so Coinbase can maintain a record and verify where the money is being sent:

> When sending money to external accounts we are **required to gather a bit of information before processing the transaction.** Coinbase is federally registered as a Money Service Business (MSB). **In order to comply with federal regulations, we must know if money is sent from a Coinbase account to a financial institution**, in this case a digital currency service or exchange.[31]

Coinbase makes it very clear that just because they are an online MSB, their duties to customers and to the law are no different from any other financial institution. One of Coinbase's main missions as a company is to promote compliance at online MSB's. Coinbase writes "Operating solely online doesn't excuse a company from complying with the same regulations as a brick-and-mortar business,"[32]

> Coinbase's compliance team has **exactly the same responsibilities as the world's largest financial institutions** when it comes to **customer verification**, the **enforcement of anti-money laundering policies** and maintaining internal controls.[33]

The Reality Paints Coinbase as a Picture of A Mess or Active Disaster

Coinbase decided to commit to rapid growth to maximize their profits. Coinbase's commitments to its own profits came at the expense of developing or establishing proper monitoring, supervision, compliance, or an AML program commensurate with Coinbase's high financial crime risk profile.

Coinbase's exponential growth lead to tremendous operational challenges. A small picture of these operational challenges can be seen in complaints filed against Coinbase with the SEC and the California Department of Business Oversight. An investigative expose of Coinbase by the news site *Mashable* reported that "a picture emerged not of a responsible actor in the cryptocurrency space opening the market to new investors, but **rather a company overwhelmed by and underprepared for its own success**."[34] In response to the investigation, Coinbase pointed to increased consumer demand for services of "40X" in one year alone and increased transaction volume from November 2017 to December 2017 of "295 percent." *Id*.

Coinbase's has failed substantially on an ongoing basis in nearly all substantial matters of supervision, compliance, and monitoring. Just earlier this year, on January 4, 2023, Coinbase was subjected to a Sanction from the New York State Department of Financial Services in the form of a Consent Order.[35] The details underlying the Consent Order are disturbing and shocking. The

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[31] Coinbase, "Why do I have to provide extra information when I send money?", Available at https://help.coinbase.com/en/coinbase/other-topics/legal-policies/why-do-i-have-to-provide-extra-information-when-i-send-money.
[32] Jeff C., "Why Compliance at an Online MSB is so Challenging." Coinbase Blog.
[33] (Coinbase, How Coinbase is making Compliance a Driver of Innovation)
[34] Jack Morse, Desperate Coinbase Customers Turn to SEC with Allegations of Fraud, Mashable (June 20, 2018), available at https://mashable.com/article/sec-coinbase-complaints-fraud.
[35] *See* Consent Order from the New York Department of Financial Services in the *In the Matter of Coinbase Inc.* (January 2023).

regulator conducted a "safety and soundness examination" of Coinbase in 2018 and 2019 "and found serious deficiencies in Coinbase's compliance function across multiple areas" and Coinbase was required to assess the many problems identified. However, "Coinbase's compliance system failed to keep up with the dramatic and unexpected growth of Coinbase's business, and by the end of 2021, was overwhelmed, with a substantial backlog of unreviewed transaction monitoring alerts, exposing its platform to risk of exploitation by criminals and other bad actors." *Id*.

The New York Department of Financial Service's examination in 2020 "found **significant deficiencies across Coinbase's compliance program, including its Know-Your Customer/Customer Due Diligence ("KYC/CDD") procedures, its Transaction Monitoring System ("TMS")**, and its OFAC screening program. The Examination also found that **Coinbase failed to conduct adequate annual Anti-Money Laundering ("AML") risk assessments** since 2017, as required by 23 NYRCC 200.15(b), and that Coinbase had not provided evidence of a validation review of its TMS system, as required by 23 NYCRR 504.3(a)." *Id*.

The New York Department of Financial Services in 2021 conducted a further investigation that "uncovered substantial lapses in Coinbase's KYC/CDD program, its TMS, and in its AML and OFAC sanctions control systems, as well as issues concerning Coinbase's retention of books and records, and with respect to meeting certain of its reporting obligations to the Department."

Even after Coinbase began to take "certain steps" to remediate the issues, the New York Department of Financial Services determined that "**substantial weaknesses remained**, and over the course of 2021, **it became clear that Coinbase's compliance system was inadequate to handle the growing volume of Coinbase's business**, a situation that was exacerbated by tremendous growth in its customer base." *Id*.

By the end of 2021, the compliance situation inside Coinbase "reached a critical stage." Coinbase had a backlog of ***unreviewed*** transaction monitoring alerts of "more than 100,000 (many of which were months old), and the backlog of customers requiring enhanced due diligence ("EDD") exceeded 14,000." *Id*. Coinbase simply did not do its job. Coinbase did not fulfill its legal duties. And Coinbase absolutely did the opposite of what it told Customers it would do.

Coinbase "**lacked sufficient personnel, resources, and tools needed to keep up with these alerts, and backlogs rapidly grew to unmanageable levels**. This was compounded by Coinbase's reliance in 2019 through November 2021 on an inadequate case management system for dispositioning alerts and filing." *Id*.

The New York Department of Financial Services found that "Coinbase was not in compliance with laws and regulations concerning Bank Secrecy Act ("BSA") and AML obligations, reporting requirements, and recordkeeping requirements."

Further, the "most serious noncompliance concerns Coinbase's ML/TF compliance program, specifically in its customer onboarding and transaction monitoring obligations. **Coinbase has acknowledged its failures in this respect to the Department**. Furthermore, certain of these **issues have been known to Coinbase since at least 2018**, flagged through both internal assessments and external reviews, including examinations conducted by the Department. Although Coinbase has worked to correct these issues, its progress has been slow: progress in certain areas did not occur until recently, and work remains outstanding to the present." *Id*. Coinbase has admitted its failures and violations of the law.

Coinbase's KYC system was "immature and inadequate" and Coinbase "treated customer onboarding requirements as a simple check-the-box exercise and failed to conduct appropriate due diligence." *Id*. As the Department noted regarding due diligence weaknesses, "the risks to the financial system due to this weakness are not merely theoretical, but have already resulted in suspicious or unlawful conduct being facilitated through Coinbase's platform." *Id*.

Because of Coinbase's failures "Coinbase faced an increased risk of abuse by bad actors." This risk was realized and felt most strongly by many other customers who were subjected to abuse by fraudsters due to Coinbase's total failures.

Ultimately, the New York Department of Financial Services sanctioned Coinbase to the tune of $100 million, which included a requirement that Coinbase spend at least $50,000,000.00 to improve and enhance its compliance program. Notably, the Consent Order was agreed by Coinbase to be BINDING on Coinbase. Thus, Coinbase has effectively admitted and acknowledged its violations of the law, misrepresentations, wrongdoing, and liability.

A Useful Tool for Unauthorized Transfer Situations: Electronic Funds Transfer Act

Cryptocurrency platforms and entities can qualify as a "financial institution" as defined by the EFTA. Customers who have unauthorized transfers made from their accounts may be able to assert claims that their cryptocurrency platform failed to undertake its responsibilities to remedy unauthorized electronic fund transfers under the EFTA and Regulation E by failing to timely credit and/or provisionally recredit, or credit and/or provisionally recredit at all, users' accounts despite obvious signs that users' accounts, including were in "error" as defined by the EFTA.

The EFTA and its corresponding regulations implemented by the Consumer Financial Protection Bureau ("CFPB"), 12 C.F.R. § 1005.1, *et seq.* were designed with the "primary objective" of "the provision of individual consumer rights."[36]

Some of the relevant definitions for consideration include:

a. A "financial institution" includes banks and credit unions, as well as "any other person who, directly or indirectly, holds an account belonging to a consumer."[37]
b. A "person" includes "a natural person or an organization, including a corporation…"[38]
c. An "account" includes any consumer asset account held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes. 15 U.S.C. § 1693a(2); *see also* 12 CFR § 1005.2(j).
d. A "consumer" is defined as a "natural person." 15 U.S.C. § 1693a(6).
e. An "error" includes, *inter alia*, an "unauthorized electronic fund transfer."[39]
f. An "unauthorized electronic fund transfer" is defined as "an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate such transfer and from which the consumer receives no benefit."[40] The CFBP (as well as the Board of Governors of the Federal Reserve System) have specifically stated that "[a]n unauthorized [electronic funds transfer]

[36] 15 U.S.C. § 1693; 12 C.F.R. § 1005.1(b) (the "primary objective of the act and this part is the protection of individual consumers engaging in electronic fund transfers and remittance transfers.").
[37] 15 U.S.C. § 1693a(9).
[38] 12 CFR § 1005.2(j).
[39] 15 § 1693f(f)(1); 12 C.F.R. § 1005.11(a)(vii).
[40] 15 U.S.C. § 1693(a)(12); *see also* 15 C.F.R. § 1005(m).

includes a transfer initiated by a person who obtained the access device from the consumer through fraud or robbery."[41]

g. An "electronic fund transfer" includes any transfer of funds initiated through a computer. While the definition does not include any transfer of funds the primary purpose of which is the purchase or sale of a security or commodity, if the security or commodity is regulated by the Securities and Exchange Commission ("SEC") or the Commodity Futures Trading Commission ("CFTC") or is purchased or sole through a broker-dealer regulated by the SEC or through a future commission merchant regulated by the CFTC, the "primary purpose" of the transfers of funds at issue in this action is not the purchase or sale of a security or commodity, but rather outright theft. Indeed, CFPB has made clear that this "Securities Exemption" applies to, for example, a transfer initiated by a telephone order to a stockbroker to buy or sell securities or to exercise a margin call, but *not* a transfer involving an access device that accesses a securities or commodities account that a consumer uses for purchasing goods or services or for obtaining cash (*i.e.*, a Cryptocurrency account).[42]

The error resolution subpart of the EFTA holds that if within sixty days after having transmitted to a consumer notice of an electronic funds transfer, a financial institution receives oral or written notice in which the consumer (1) sets forth or otherwise enables the financial institution to identify the name and account number of the consumer; (2) indicates the consumer's belief that the documentation, contains an error and the amount of such error; and (3) sets forth the reasons for the consumer's belief that an error has occurred, the financial institution must investigate the alleged error, determine whether an error has occurred, and report or mail the results of such investigation and determination to the consumer within ten business days.[43]

If the financial institution determines that an error did occur, it has the option to either (1) timely correct the error, including the crediting of interest where applicable; or (2) timely provisionally recredit the consumer's account for the amount alleged to be in error pending the conclusion of the institution's investigation of the error within ten business days of being notified of the error.[44] In no circumstance can an investigation be concluded more than forty-five days after receipt of the notice of error, and during the pendency of the investigation, the consumer must be allowed full use of funds provisionally recredited.[45]

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[41] *See* 12 C.F.R. § 205, Supp. I at 2(m) (Board of Governors' Official Interpretation of § 205.2(m)); 12 C.F.R. § 1005, Supp. I at 2(m) (CFPB's Official Interpretation of § 1005.2(m)); *see also Green v. Capital One, N.A.*, 2021 WL 3810750, at *3 (S.D.N.Y., 2021). The definition of "unauthorized electronic fund transfer" under § 1693(a)(12) and §1005(m) excludes any electronic fund transfer initiated by a person other than the consumer who was furnished with the card, code, or other means of access to such consumer's account by such consumer. The CFPB and Board of Governors have confirmed that this exclusion does not encompass situations where a consumer technically furnishes to a third party his or her means of access to an account, but due to fraud, threat, or force.

[42] 12 C.F.R. § 1005, Supp. I at 3(c)(4).

[43] 15 U.S. Code § 1693f(a)(3); see also 12 C.F.R § 205.11; see also Supp. I to § 205 at 11(b)(1) (a notice of error is effective so long as the financial institution is able to identify the account in question); 12 C.F.R. § 1005, Supp. I at 11(b)(1)(1) (same). Notice may be constructive "when the institution becomes aware of circumstances leading to the reasonable belief that an unauthorized transfer to or from the consumer's account has been or may be made." 12 C.F.R. 1005.6(b)(5)(iii).

[44] 15 U.S. Code § 1693f(c); see also 12 C.F.R. § 1005.11.

[45] Id.

Where a financial institution (1) fails to provisionally recredit a consumer's account within the ten-day period specified above, and the financial institution (a) did not make a good faith investigation of the alleged error, or (b) did not have a reasonable basis for believing that the consumer's account was not in error; or (2) knowingly and willfully concludes that a consumer's account was not in error when such conclusion could not reasonably have been drawn from the evidence available to the financial institution at the time of its investigation, then the consumer shall be entitled to treble damages determined under section 1693m(a)(1).

The consumer may be held liable for an unauthorized electronic fund transfer where a financial institution provides the required notices under 15 U.S.C. § 1693c and 12 C.F.R. § 1005.7(b).[46] Liability of the consumer, if applicable, is limited to $50 if the consumer notifies the institution within two business days after learning of the loss, or $500 if the consumer fails to notify the institution within two business days after learning of the loss.[47]

One State Law Case Study: New York Company Codes – A Source of Authority and Regulation That May Come in Handy for Crypto Litigation

While this article will not attempt to address each of the various state laws, rules, and regulations that may be applicable, a brief overview of the New York Company Codes is provided herein as an example. New York and the NY Department of Financial Services have been on the cutting edge of rules, regulation, and enforcement on the state-level.

The New York Company Codes R. and Regulations, require strict compliance procedures. Specifically, entities are "required to comply with all applicable Federal and State laws, rules, and regulations."[48] Further, cryptocurrency platforms are required to "designate a qualified individual or individuals responsible for coordinating and monitoring compliance" with the requirements.[49] In addition, cryptocurrency platforms are required to maintain and enforce strict compliance policies, "including policies with respect to anti-fraud, anti-money laundering, cyber security, privacy and information security, and any other policy required…"[50] The importance of those compliance policies Coinbase was required to create and enforce is underscored by the legal requirement that Coinbase's board of directors review and approve such policies.

Registered entities are also legally obligated to maintain "all of its books and records in their original form or native file format" to ensure that they can confirm compliance "with all applicable laws, rules, and regulations."[51] The requirements included to maintain records such as:

> (1) for each transaction, the amount, date, and precise time of the transaction, any payment instructions, the total amount of fees and charges received and paid to, by, or on behalf of the licensee, and the **names, account numbers, and physical addresses of**:

[46] 15 U.S.C. § 1693g; 12 C.F.R. § 1005.6.
[47] Id.
[48] Section 200.7(a), N.Y. Company Codes.
[49] Section 200.7(b).
[50] Section 200.7(c).
[51] Section 200.12.

(i) the party or parties to the transaction that are customers or accountholders of the licensee; and

(ii) to the extent practicable**, any other parties to the transaction**

(3) bank statements and bank reconciliation records;

(6) records **demonstrating compliance with applicable State and Federal anti-money laundering laws, rules, and regulations**, **including customer identification and verification documents, records linking customers to their respective accounts and balances,** and a record of all compliance breaches;

(7) communications and documentation related to investigations of customer complaints and transaction error resolution or concerning facts giving rise to **possible violations of laws, rules, or regulations**;

Id.

Coinbase was also required to conduct a risk assessment to consider (1) legal, (2) compliance, (3) financial, and (4) reputational risks with Coinbase's activities, services, customers, counterparties, and geographic location. Section 200.15. Coinbase was required to establish, maintain, and enforce an anti-money laundering program based on such assessment and ongoing at least annual or more frequent assessments.

Importantly, Coinbase's anti-money laundering policy required Coinbase to notify the New York Department of Financial Services of any transactions by one person exceeding $10,000 in one day. Section 200.15(2). Coinbase is importantly legally obligated to "Monitor[] for suspicious activity."[52] This included a requirement for Coinbase to "monitor for transactions that might signify money laundering, tax evasion, or other illegal or criminal activity." *Id*.

Coinbase was separately required to file suspicious activity reports ("SARs") in accordance with applicable Federal laws, rules, and regulations. *Id*. Coinbase was explicitly prohibited from engaging in, facilitating, or knowingly allowing the transfer or transmission of virtual currency when the action would obfuscate or conceal the identity of an individual customer or counterparty. *Id*. Coinbase was also legally required to create a "customer identification program." Further, Coinbase was legally obligated to require identification for "large transactions" which was defined as any transaction with a value greater than $3,000.

In this case, the scammers' locations were traced to locations overseas and were at least connected in part to Coinbase accounts or wallets on information and belief. Under §200.15 h.2, this required Coinbase to conduct Enhanced Due Diligence on the accounts of the scammers. If they had done so they would have noticed that the money was being obtained by illegal means.

Coinbase was required to "demonstrate that it has risk-based policies, procedures, and practices to ensure, to the maximum extent practicable, compliance with applicable regulations issued by OFAC." Further, Coinbase was supposed to "have in place appropriate policies and procedures to block or reject specific or impermissible transactions that violate Federal or State laws, rules, or regulations.

[52] Section 200.15(3).

Coinbase was also legally prohibited in ALL advertising and marketing materials from "directly or by implication, mak[ing] any false, misleading, or deceptive representations or omissions." Section 200.18. Coinbase was of course required to comply with "all disclosure requirements under Federal and State laws, rules, and regulations." Coinbase advertised on many occasions and in many different ways that they had "institutional-grade cybersecurity" (Coinbase, Introducing our Institutional Core Principles) to fully protect customers and simply put, "[their] money [was] safe, secure, and [theirs]," (Coinbase, A Message to Our Customers). This was clearly not the case with many other customers, since Coinbase did not take every reasonable precaution necessary to prevent the scams or hacks from occurring.

Coinbase also owed a legal duty to prevent fraud from occurring. Section 200.19. In the Section titled, Prevention of Fraud, Coinbase was instructed that it was:

> prohibited from engaging in fraudulent activity. Additionally, each licensee shall take reasonable steps to detect and prevent fraud, including by establishing and maintaining a written anti-fraud policy. The anti-fraud policy shall, at a minimum, include:
>
> (1) the identification and assessment of fraud-related risk areas;
>
> (2) procedures and controls to protect against identified risks;
>
> (3) allocation of responsibility for monitoring risks; and
>
> (4) procedures for the periodic evaluation and revision of the anti-fraud procedures, controls, and monitoring mechanisms.

Id. The requirement of Coinbase to vigilantly monitor, anticipate, identify, detect, and prevent fraud from occurring is not a mere suggestion: it was Coinbase's legal obligation. All of the above requirements from the New York Company Codes serve as just one example of the many strict obligations Coinbase was required to fully adhere to.

Bank Secrecy Act, Patriot Act, and FinCen

The Currency and Foreign Transactions Reporting Act of 1970 (the legislative framework commonly referred to as the "Bank Secrecy Act" or "BSA") requires U.S. financial institutions to make certain reports or records where such reports "have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings."

Several AML provisions have been enacted to amend and expand the requirements of the BSA. This includes provisions in Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT Act"), which significantly augmented requirements under the BSA.30

Recently, FinCEN issued guidance to reiterate the requirements for convertible virtual currencies.31 FIN-2019-G001 did not establish any new requirements, but it sought to reaffirm requirements that had been set forth in previous guidance notes.

FinCEN and the IRS issued a BSA/AML Examination Manual for Money Services Businesses ("MSBs") published in December 2008 that is utilized for examinations of MSBs. In

fact, that Manual was utilized by the independent consultant who completed Independent Report #2 in the Coinbase Independent AML Compliance Program Review (December 24, 2015).32

It is common in the industry to utilize the Federal Financial Institutions Examination Council ("FFIEC") BSA/AML Examination Manual (dated 2/27/2015.V2) as a reference point, even for MSBs who are not regulated by the Federal Functional regulators, as it sets forth regulatory standards and expectations regarding AML Programs and examination requirements. In fact, this Manual was utilized in the Coinbase Independent AML Compliance Program Review (December 24, 2015).

The BSA and its implementing regulations require entities like Coinbase to develop, implement, and maintain an effective written AML program that is reasonably designed to prevent them from being used to facilitate money laundering and finance terrorist activities. The AML program must, at a minimum:

a. incorporate policies, procedures and internal controls reasonably designed to assure ongoing compliance;
b. designate an individual responsible to assure day-to-day compliance with the program and BSA requirements;
c. provide training for appropriate personnel, including training in detecting suspicious transactions; and
d. provide for independent review to monitor and maintain an adequate program.

These four requirements are commonly referred to as "the Four Pillars" of an AML Compliance Program.

Regulators have made it clear that the AML Program must be **fully implemented** and commensurate with the firm's risk profile. In its first risk assessment, **Coinbase concluded that its risk profile is high.** Thus, Coinbase was aware of its heightened duty and the heightened risk associated with its business.

Under the PATRIOT Act, Coinbase was required to do Enhanced Due Diligence when monitoring foreign accounts and money transfers, and if over $10,000 is transferred in a day MSBs are required to submit a report to a superintendent.

As FinCEN and Federal Functional regulators have made clear, an effective AML Program control environment includes: 1) a detailed risk assessment that was utilized to identify higher risk customer types, geographies, and products/services to allow for the implementation of appropriate controls; 2) documented and fully implemented CDD and EDD Programs, commonly referred to as Know Your Customer ("KYC") rules; 3) ongoing monitoring and controls that manage and mitigate the financial crime risk posed to the firm; and 4) investigative functions and documented procedures to ensure the timely identification and reporting of suspicious activity.[53]

An effective AML Program is required to have established and implemented policies and procedures across the firm to allow for a consistent and systemic program approach and a means to audit the firm against the policies and procedures.

[53] *See* FFIEC BSA/AML Examination Manual 2/27/2015, p. 29-30.

Without the benefit of a detailed risk assessment and relevant written policies and procedures (or proper application of the risk assessment and written policies), Coinbase did not implement an effective due diligence program. Coinbase was not able to sufficiently identify various types of legal entity customers at onboarding, so it could not differentiate higher risk customers and apply proper due diligence. In fact, Coinbase seemed to conduct very little due diligence of customers at onboarding,

Several recent enforcement actions are illustrative of regulatory requirements and expectations as it relates to financial service companies that provide services to customers, such as:

- United States of America, Department of the Treasury, Financial Crimes Enforcement Network, In the Matter of: Bethex Federal Credit Union, Bronx, New York, Number 2016-06.

- United States of America, Department of the Treasury, Financial Crimes Enforcement Network, In the Matter of: North Dade Community Development Federal Credit Union, Miami Gardens, Florida, Number 2014-07.

In 2016, FinCEN assessed a civil monetary penalty against Bethex Federal Credit Union for failing to establish and implement an effective AML Program pursuant to the BSA60 Specifically, FinCEN found that Bethex provided banking services to MSBs for which it did not adequately assess or mitigate the risks of money laundering and terrorist financing. While Bethex's business model expanded and grew riskier as it began to provide services to MSBs, its AML Program remained tailored to a low-risk business model. FinCEN found: a. Bethex failed to conduct a risk assessment that included all of its products and services, and that the risk assessment was inadequate because it did not include its MSB customers. FinCEN noted that Bethex's failure to conduct an adequate risk assessment left it ill-equipped to implement necessary AML controls when its transactional activity quadrupled between 2010-2012. Bethex did not perform the due diligence necessary on its MSBs to determine the money laundering risks on their expected volume and pattern of activity. Bethex failed to require and maintain documentation to identify the business type and use of its MSBs. By not knowing its customers and their profiles, Bethex was incapable of understanding MSB transactional behavior and was unable to place them under appropriate monitoring for suspicious activities.

In 2014, FinCEN assessed a civil money penalty against North Dade Community Development Federal Credit Union for failing to establish and maintain an effective AML Program pursuant to the BSA and its implementing regulations.61 FinCEN found that North Dade's BSAs failures derived mainly from its banking services to certain MSBs. FinCEN found that: a. North Dade was ill-equipped to develop a compliance program that included appropriate processes and procedures to address the specific risks of its business model because it did not conduct a risk assessment, which would have evaluated the financial crime risks given North Dade's location, customers, services offered, size and volume of business.

b. Since North Dade did not adequately assess its own risk, it did not implement procedures designed to address those unique risks, with this control failure particularly evident with the MSB customers.

c. North Dade did not have sufficient written procedures across several AML functions. North Dade did not have procedures to manage and review high risk customers, accounts and transactions.

d. North Dade did not provide sufficient training to ensure its staff had the skills necessary to administer a program to monitor a large number of high-risk customers and transactions.

As FinCEN and Federal Functional regulators have made clear, an effective AML Program control environment includes: 1) a detailed risk assessment that was utilized to identify higher risk customer types, geographies, and products/services to allow for the implementation of appropriate controls; 2) documented and fully implemented customer and enhanced due diligence programs, commonly referred to as Know Your Customer ("KYC") rules; 3) ongoing monitoring and controls that manage and mitigate the financial crime risk posed to the firm; and 4) investigative functions and documented procedures to ensure the timely identification and reporting of suspicious activity. *See* FFIEC BSA/AML Examination Manual 2/27/2015, p. 29-30.

An effective AML Program is required to have established and implemented policies and procedures across the firm to allow for a consistent and systemic program approach and a means to audit the firm against the policies and procedures.

Without the benefit of a detailed risk assessment and relevant written policies and procedures, Coinbase did not implement an effective due diligence programs. Coinbase was not able to sufficiently identify various types of legal entity customers at onboarding, so it could not differentiate higher risk customers and apply proper levels of due diligence. In fact, Coinbase conduct very little if any due diligence of customers at onboarding,

At a minimum, FinCEN states that the compliance expectations associated with onboarding and maintaining accounts for MSBs includes confirming FinCEN registration; confirming compliance with state or local licensing requirements, if applicable; and conducting a basic risk assessment to determine the level of risk associated with the account.[54]

As set forth in the BSA/AML Manual, standard due diligence measures applied at onboarding to MSBs to assess the customer's risk include but are not limited to:

- Types of products and services offered by the NBFI.
- Locations and markets served by the NBFI.
- Anticipated account activity (volume of activity).
- Purpose of the account.

In addition, when conducting an investigation, it is standard to ask the customer for confirming documents to corroborate source of funds or source of wealth, particularly for higher risk customers.

[54] *See FinCEN Guidance and Advisory Issued on Banking Services for Money Services Businesses Operating in the United States*, April 26, 2005.

Training is also a key element of compliance. As the BSA/AML Examination Manual explains:

> Financial Institutions must ensure that appropriate personnel are trained in all applicable aspects of the BSA. Training should include regulatory requirements and internal BSA/AML policies, procedures, and processes. At a minimum, the financial institution training program must provide training for all personnel whose duties require knowledge of the BSA. The training should be tailored to the person's specific responsibilities.[55]

The BSA regulatory framework begins with the expectation that financial institutions will operate under a culture of compliance supported by senior leadership, including owners, boards of directors, and senior executives. This culture of compliance will dictate the basic norms of behavior, knowledge, and transparency under which the management team, employees, and service providers will be held accountable.

Because a transmittal order involving CVC is an instruction to pay "a determinable amount of money," transactions involving CVC qualify as transmittals of funds, and thus may fall within the Funds Travel Rule.37 Under the Funds Travel Rule, a transmittal of funds of $3,000 or more (or its equivalent in CVC) may trigger certain requirements on a money transmitter acting as either the financial institution for the transmittor or recipient, or as an intermediary financial institution.

Strong management commitment to the AML compliance program promotes ongoing compliance and helps prevent the MSB from being used by money launderers. FinCEN further encourages MSBs to adopt policies and procedures that incorporate the Basel Committee Statement of Principles on Money Laundering, which urges:

- Proper identification of all persons conducting financial transactions with the financial institution.
- High ethical standards in financial transactions and compliance with laws and regulations governing financial transactions.
- Cooperation with law enforcement. Information and training for staff to ensure that they can and do carry out these principles.
- Establish Customer Relationships.
- Strict customer identification and verification polices and procedures can be a financial institution's most effective weapon against money laundering.
- Requiring appropriate identification and verifying information in certain cases, and being alert to unusual or suspicious transactions can help an MSB deter and detect money laundering schemes.
- A customer identification and verification policy tailored to the operations of a particular business:
    - Helps detect suspicious activity in a timely manner.
    - Promotes compliance with all state and federal laws applicable to MSB
    - Promotes safe and sound business practices.
    - Minimizes the risk that the MSB will be used for illegal activities.
    - Reduces the risk of government seizure and forfeiture of funds associated with customer transactions (such as outstanding money orders/traveler's checks and outstanding money transfers) when the customer is involved in criminal activity.

[55] *See* 58 FFIEC BSA/AML Examination Manual 2/27/2015.V2 p. 33.

    - Protects the reputation of the MSB.
- File Suspicious Activity Reports: Suspicious Activity Reports (SARs) are among the government's main weapons in the battle against money laundering and other financial crimes. Such reports are also a key component of an effective anti-money-laundering compliance program. Many MSBs are required to file SARs when they suspect that potentially illegal activity has occurred and when the activity has met the relevant reporting threshold.

Congress has made it clear that FinCEN should fulfill the purpose of safeguarding the financial system from illicit activity, counter money laundering and the financing of terrorism, safeguarding the financial system from financial crime, and preventing the moving of virtual currencies for illegal practices by criminals or terrorists.

As a Money Services Business, Coinbase has strict obligations under the Currency and Foreign Transactions Reporting Act of 1970 a/k/a the Bank Secrecy Act (the "BSA") to monitor customer transactions and report any suspicious activities to law enforcement authorities. *See* 31 U.S.C. § 5311; 12 C.F.R. § 208.63. The USA Patriot Act of 2001 (the "Patriot Act") reinforced this obligation and underscored the importance of implementing robust internal systems to detect and report money laundering and other suspicious activities. The regulations promulgated pursuant to the Patriot Act require financial institutions to institute an anti money-laudering ("AML") program that includes four pillars: (i) designating an individual or individuals responsible for managing BSA compliance; (ii) a system of policies, procedures, and internal controls to ensure ongoing compliance; (iii) training for appropriate personnel; and (iv) independent testing of compliance. 12 C.F.R. § 208.63.

For Money Services Businesses to comply with these obligations, the institutions have a legal obligation to fully understand their customer's business. This "know your customer" ("KYC") duty is imposed pursuant to 12 C.F.R. § 208.62. Institutions viewing account activity need a baseline against which to distinguish account activity that may be normal for a particular industry from account activity that might suggest an illegal enterprise. The KYC duty pre-dated the Patriot Act. Not only was it suggested by such guidelines as the Federal Reserve's BSA Examination Manual of 1995 and Supervisory Letter on Private Banking Activities, SR 97-19 (SUP), but it was standard industry practice.

To run their illegal scheme, the fraudsters needed a Money Services Business to: (a) provide a depository for the pilfered Bitcoin, (b) liquidate the stolen Bitcoin, and (c) provide victims with a sense that the fraudsters were operating a legitimate business. What the fraudsters also needed was a Money Services Business that would be hospitable to fraudsters -- that is, an MSB that, for a price, was willing to overlook suspicious activity, ignore the excessive account activity and red flags, and ignore its own obligations under federal law, state law, and relevant regulations.

Under the Bank Secrecy Act, Coinbase has a duty to inquire and/or report if suspicious activity is involved in transmitting money. Such scrutiny is well-deserved, though, as the fraudsters theft would not have succeeded without cooperation and assistance from Coinbase.

In managing its platform and operating and monitoring customer's accounts and activity, an excellent argument can be made that Coinbase met none or very few of the relevant industry standards or regulatory requirements.

A Brief Preview of The Defenses

The defenses you are likely to see are likely to differ from many of the common defenses in the FINRA practice. Many of the defenses that are prohibited by FINRA for its members are baked into the terms of the contracts for the platforms you may be suing. Many of the arbitration agreements specify forums like AAA or JAMS, where the procedural rules and protections may differ drastically compared to the typical FINRA Arbitration.

Continuing with the example of Coinbase, you are likely to run into Coinbase's argument that it should be absolved from liability on all of a customer's claims based on its user agreement, which states "We assume no responsibility for any loss that you may sustain due to compromise of account login credentials **due to no fault of Coinbase and/or failure to follow or act on any notices or alerts that we may send to you.**"[56] Coinbase would be likely to file a Motion for Summary judgment (as their agreement calls for AAA Arbitration where such Motions might be entertained). Of course, whether or not there is "no fault" on the part of Coinbase is the exact kind of triable issue of fact rendering a motion for summary judgment inappropriate.

Section 8.2 of the User Agreement is even more explicit, disclaiming Coinbase's liability, "EXCEPT TO THE EXTENT **OF A FINAL JUDICIAL DETERMINATION** THAT SUCH DAMAGES WERE A RESULT OF COINBASE'S GROSS NEGLIGENCE, FRAUD, WILLFUL MISCONDUCT OR INTENTIONAL VIOLATION OF LAW." (*emphasis added, capitalized text of the original, Id.* at §8.2.) This is not a disclaimer of liability for negligence, gross negligence, or intentional acts. The phrase used by Coinbase does not absolve it for negligence, on its face. Here, again, Coinbase requires a final judicial determination that such damages were a result of Coinbase's gross negligence, fraud, willful misconduct or intentional violation of law. Whether or not Coinbase's activity rose to the level of e.g. gross negligence is likely to be a hotly contested, triable issue of fact directly at the heart of a breach of contract claim or other claims.

Customer's making claims will find support for their position in applicable California law. It is axiomatic under California law that whether a contract is breached is a question of fact not suitable for dismissal on the papers. *Ash v. N. Am. Title Co.*, 223 Cal. App. 4th 1258, 1268 (2014). As such, there is no substantial cause to grant a motion to dismiss claims under AAA Rule 33.

Coinbase would also be likely to argue that any negligence claims would be barred by the economic loss doctrine. The California Supreme Court's decision in *Sheen v. Wells Fargo* is the controlling opinion on the economic loss doctrine in California. *Sheen* expressly discussed the fact that the plaintiff failed to identify any statutory obligation which required Wells Fargo to perform the act for which Mr. Sheen sought to impose a duty.[57] The *Sheen* court discussed at length various statutes which apply to real estate transactions and mortgage processing and held that Plaintiff's failure to connect his claims or the "new" duty he sought to impose on Wells Fargo to any statutory obligations was a deciding factor in applying the economic loss doctrine to Plaintiff's claims. *Id.* In fact, the court discussed the policy implications of its decision at length and that it would not create a **new** duty due to the contract between the parties *and because* imposing that duty is better left to the legislature.[58] The holding in *Sheen* is plainly

[56] (Coinbase User Agreement, §6.6.)
[57] *Sheen* at 920.
[58] *Id.* at 942—944.

inapposite with the facts in the present action. Customers should connect Coinbase's negligence and the duty it owed to them with the vast web of federal and state regulations Coinbase subjects itself to in holding itself out as a money services business (as described in part above).

In his concurring opinion in *Sheen*, Justice Liu clarified exactly what this holding means and what it does not.

> In a future case, we may need to grapple with the boundaries of the [economic loss] rule and its application to contexts where parties cannot "reliably be counted on to protect their interests." Private ordering through contracts as an alternative to negligence liability through tort is generally more compelling with a "more sophisticated class of plaintiffs…e.g., business lenders and investors," as opposed to "the average home buyer who is more akin to the presumptively powerless consumer with little to no means to alter the agreement in the first place." [internal citations omitted]. But today's opinion does not state a broad rule against recovery for pure economic loss in tort in the context of a contractual relationship (maj. Opn. Ante, at 923), and courts should not invoke this rule without considering the basis for its application.[59]

When applied to the facts in most customer cases, the expressed limitation set forth by Justice Liu's concurring opinion rings true. Customers of course no opportunity to bargain in this take-it-or-leave-it User Agreement. Moreover, there are a myriad of statutory and regulatory obligations cited to at length above, which Mr. Sheen failed to do in his.

There are several other relevant and equally authoritative cases that *denied* motions to dismiss based on the economic loss rule. A case "on all fours" is *Ross v. AT&T Mobility, LLC*, 19-cv-06669, 2020 U.S. Dist. LEXIS 166298*36-39 (N.D. Cal. May 14, 2020), where the court *denied AT&T's motion to dismiss in a SIM Swap case* based on the economic loss rule, drawing a distinction between a contract for services, like the Coinbase User Agreement, and a contract for goods.[60] Other jurisdictions agree with the holding in *Ross*. In *Williams v. AT&T Mobility, LLC*, 19-cv-475, 2020 U.S. Dist. LEXIS 52899 (E.D.N.C. March 25, 2020), a SIM-swap case, the court denied AT&T's motion to dismiss on all grounds, including under the economic loss rule. Similarly, in *Edwards v. AT&T Mobility and Coinbase Global Inc.,* 21-cv-00342, (D.C. Utah, August 23, 2021), another SIM-Swap case, the federal district court *denied* AT&T's motion to dismiss the Plaintiff's complaint on all grounds, which included the "economic loss" rule, under Utah law.

Applying this framework to the typical case described above, it is clear that the economic loss rule does not apply. *First*, the duty to monitor customer's account for suspicious activity is found outside the Terms and Conditions. This duty exists independent of the contract through both the federal law and the common law duty owed to customers. *Second*, as made clear in *Ross v. AT&T Mobility*, the economic loss rule does not apply to service contracts, like the Coinbase User Agreement. *Third*, Coinbase's own letters to customers show that Coinbase is aware not only of the *modus operandi* of fraudsters looking to send customer funds to an off-platform wallet but of the very vector of attack these fraudsters use i.e. Coinbase's SMS-based and TOTP MFA features.

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[59] *Sheen*, concurring opinion, at 951-952.
[60] *See also Fraser v. Mint Mobile LLC,* 2022 U.S. Dist. LEXIS 76772 (N.D. Cal. April 27, 2022).

Coinbase may attempt to argue that these regulations cannot form the basis of a negligence claim. However, the law is clear in the 9th Circuit that regulations like those found herein, at a minimum, are evidence of the standard of care.[61]

Coinbase also will likely argue that its conduct does not rise to the level of "gross negligence". However, under California law, whether a defendant's conduct arises to the level of "gross negligence" is an issue of fact that is not suitable for dismissal on the papers.

Although California law does not recognize a separate cause of action for "gross negligence" it does acknowledge degrees of negligence and the determination of whether a defendant's negligence is considered "gross" is a "triable issue of fact whether there has been such a lack of care as to constitute gross negligence."[62] Likewise, "[a]dequate allegations of general negligence suffice to maintain a gross negligence claim."[63]

Coinbase is also likely to argue that claims must be dismissed because customers cannot show Coinbase proximately caused the damages However, as California law makes clear, "proximate causation is generally a question of fact for the jury.[64]

[61] *See Mihara v. Dean Witter Co.*, 619 F.2d 814, 823-24 (9th Cir. 1980) (holding that NASD rules may set brokers' common law duties of care toward clients).

[62] *Decker v. City of Imperial Beach,* 2019 Cal. App. 3d. 349, 358 (1989); and *Crannage v. Gym*, CV 18-08063, 2019 U.S. Dist. LEXIS 226915*10 (C.D. Cal. November 6, 2019).
[63] *Id.* citing *Jimenez v. 24 Hour Fitness USA, Inc.*, 237 Cal. App. 4th 546, 552, n.3 (2015).
[64] *Lawson v. Safeway, Inc.,* 191 Cal.App. 4ht 400, 416 (1st Dist. 2010), citing *Hoyem v. Manhattan Beach City Sch. Dist.* 22 Cal.3d 508, 520 (1978).

DAO ENTITIES: WHAT ARE THEY, WHY DO CARE, AND HOW TO SUE

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"In Colonial times, there were "joint stock corporations," then came our modern-day corporations, then "limited liability companies" (LLCs). Now there are DAOs—"decentralized autonomous organizations."[1]

Introduction

What are these entities, really, and are they relevant to Investors' counsel?

DAOs (pronounced "Dows") are a new kind of entity that run on blockchain software, and are touted by their enthusiasts not as "companies", but as collections of individuals organized around the decentralized , autonomous functioning, transparent, and bottom-up principles that characterize a Web3 digital universe".[2] They theoretically strive to cut out the 'middleman' *(i.e.*, brokers, agents, banks), they do not organize under recognized legal structures, and instead claim to democratize their business on an almost peer to peer basis without employees, officers or a typical board of directors, and without accountability. But – the claim of pure autonomous rule is not really the whole story for most, perhaps all De-Fi DAOs. The DAOs making headlines are neither entirely decentralized nor autonomous.

Matt Levine of Bloomberg writes:

> **DAOs aren't decentralized autonomous organizations. In the early days, people sometimes thought that's what they were. "This company runs automatically through smart contracts with no human intervention," they would say. "It's never been seen before in human history." But, no. The thing that runs automatically through smart contracts with no human intervention *is a smart contract*. A DAO is a way *for people* to get together to vote to control a pot of money or a protocol on the blockchain.**[3]

SEC Chair Gensler similarly observes the fact that DAOs are not purely autonomous organizations as claimed. Rather, they do in fact rely on human decisions for crucial operations.

> **Those trading and lending platforms, whether they're called centralized or decentralized, there's still an operator and something central. *The "*decentralized" ones — they're not that decentralized, actually. It's not just software. There is somebody there who has designed an incentive system, a business model, earning fees, has a governance token, and is setting up the protocol in the middle**.[4]

If there is human control at key points in the DAOs formation or operation, shouldn't the DAO or active participants be accountable to investors, traders? Cyberattacks and security breaches that result in investor losses are nothing new. But if those losses happen through an

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[1] Harvard Governance, *A Primer on DAOs*, at p. 1, September 17, 2022, https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/)
[2] **See** *Id*.
[3] Levine, Matt, "The Only Crypto Story You Need"*, Business Week*, Oct 25, 2022, pp 72-73.
[4] "Gary Gensler on Crypto, SPACs, and Robinhood." *NY Magazine* Sept 13, 2021, https://nymag.com/intelligencer/2021/09/gary-gensler-sec-chair-crypto-spacs-robinhood.html

amorphous DAO with no officers or employees, where can one find recourse? What duties are owed by DAOs that ostensibly have no legal existence? In a DAO that claims to have no legal status, who can an investor or owner sue, if anyone, in the event of negligence or fraud? Are fiduciary duties owed by DAO token holders to traders? Are there active participants who may need to comply with even *de minimis* regulations or taxing authorities in a jurisdiction? Some of these issues are being flushed out currently in private litigation and regulatory enforcement, as discussed below.

Investors' counsel should gain at least some familiarity with DAOs given their explosive growth across various sectors, including those of financial investments.[5] "According to the analytics service DeepDAO, in 2021 the total value of DAO treasuries surged fortyfold, from $400 million to $16 billion, and the number of DAO participants increased by 130 times from 13,000 to 1.6 million."[6] And the **assets held in DAO treasuries has more than doubled from the beginning of 2023** to the end of March 2023.[7] This ecosystem is not going away any time soon. They are on the rise.

While this article focuses on De-Fi (Decentralized Finance) DAOs, it is interesting to note that DAOs can be formed for a wide range of purposes, including charitable , artistic (the PleasrDAO), single purpose acquisitions (the "Constitution DAO") and others.[8]

Because DAOs still live in the Wild West of nascent technologies, needed regulations have not kept up, leading to hacks, negligent supervision of key players/developers, and regulatory run-ins. This space still abounds with pioneers who 'move fast and break things", who grab opportunities and worry about fair play or regulations later. Below are highlights of some regulatory background, followed by current private litigation that may capture more attention and thus help focus the issues more quickly than regulators/legislators may be able to do.

1. A Brief History of the First DAO; the SEC Report Deems Tokens to be Securities

The very first DAO, aptly named "The DAO," is one such example of a Wild West DAO gaining quick and enormous investment interest, only to unravel almost as quickly as it began. Between late April and late May of 2016, more than 10,000 people from across the globe anonymously poured over *$168* million into the DAO (Decentralized Autonomous Organization) for investing purposes, making it the most successful crowdfunded venture ever.[9] The DAO's founders told investors the company would be run solely by investors, and smart contracts, when in reality a select few individuals would determine projects to fund using investor money in order to generate a profit.[10]

In this DAO, there were "curators" who reviewed the proposals from its token-holders. "Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any

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[5] *See*, Decentralized Autonomous Organizations: Beyond the Hype 2022, p.7, https://bdap.wharton.upenn.edu/decentralized-autonomous-organizations-beyond-the-hype-released/
[6] *Id*. at p. 4.
[7] *See*, https://cointelegraph.com/news/dao-treasuries-top-25-billion-for-the-first-time-deepdao.
[8] *See., eg*, Harvard Governance, ***A Primer on DAOs***, at p. 1, September 17, 2022, pp. 6-10, https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/).
[9] *See* Cardozo-Laila Metjahic, "Deconstructing the DAO: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations"**,** 39 **CARDOZO L. REV**. 1533,34 (2018).
[10] *See* **SEC DAO Report**, p 7-8, https://www.sec.gov/litigation/investreport/34-81207.pdf.

proposal for funding originated from an identifiable person or organization; and (2)" confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the "whitelist," which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal."[11]

This conduct was contrary to the representations by the DAO's founders that investors would run the company by democratic votes. In reality a select few individuals would determine projects to fund using investor money in order to generate a profit. All of these structural issues were ultimately overshadowed by a Cyber Attack that drained significant assets from this DAO. The SEC investigated, analyzed the tokens using the *Howey* test, (*see Id*. at pp 10-17), and opined that the tokens did indeed match the characteristics of securities and should be governed as such, and subject to reporting and listing requirements under the securities laws. ***Id.*** However, the SEC did not enforce these requirements, and indeed as a practical matter, questions remained as to who in The DAO could be is responsible for registration and other compliance matters , given the lack of easily identifiable 'managers' or core participants. The SEC took no action against the DAO. Though the SEC opined that the DAO tokens at hand were securities, questions concerning compliance and legal structures remain unanswered.

2. A First of its Kind - The bZx Class Action against the bZx DAO

On March 27, 2023, a federal district court answered some of these novel issues and decided that under California law, the Defendant bZx DAO would be deemed by default to be a General Partnership, and the Defendants holding DAO governance tokens could be jointly and severally liable as individual general partners.[12] Given the bZxDAO's choice not to avail itself of formal legal structures, (and despite the DAO defendants' assertion that it somehow was immune from liability due to this lack of legal structure), the court reasoned that the default status was that of General Partnership.[13]

The court also rejected defendants' argument that the Economic Loss doctrine applied to bar Plaintiffs' negligence claim. In California, liability for negligence generally will not hold if losses are purely economic, unless there is a "special relationship" between the parties. And the court's analysis here demonstrated that the requisite a special relationship did exist between the Plaintiffs and Defendants. Defendants' Motion to Dismiss based on this doctrine was denied.[14]

A. *Overview of Sarcuni Facts*

Plaintiffs in *Sarcuni* were users of the bZx protocol — a DeFi (decentralized finance) platform offering lending and interest-bearing products to users. Thus, "users can engage in complicated transactions using cryptocurrencies, like lending or borrowing, without interacting with banks or other established, regulated intermediaries." DeFi protocols are most commonly "governed" by DAOs.[15]

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[11] *Id*.

[12] *Sarcuni v. bZx Dao*, 22-cv-618-LAB-DEB (S.D. Cal. Mar. 27, 2023), __F. Supp. 3d__ 2023 WL 2657633 (the "*Sarcuni Order"*, copy attached).

[13] ***Id.***

[14] ***Id.***

[15] *See* Am. Cmplt. ¶40, 41 *Sarcuni v. bZx Dao*, 22-cv-618-LAB-DEB (S.D. Cal. Mar. 27, 2023). A copy of the Amended Complaint is attached.

Plaintiffs were not themselves part of the Defendant bZx DAO that ultimately governed the bZx protocol. The DAO's formation follows a byzantine path and appears to have been a strategic move by its founders as a way to avoid liability of any kind. Initially, the bZx Protocol was governed by individuals (Defendants Kistner and Bean) and a bZxLLC, before Defendants announced that the LLC would terminate and become the bZxDAO -- the new controlling entity of the bZx protocol. The Defendant bZx DAO was governed by the holders of the Defendant DAO's BZRXtokens, and bZx protocol users were not necessarily bZx DAO token holders. Thus, Plaintiffs would have no control over the decentralized platform, the products being offered, the development of the bZx protocol, or the system's security. (As a side note - There remains a question for consideration at the class certification stage as to whether any Plaintiffs held any of the Defendants' governance tokens. If so, such Plaintiffs could potentially be excluded from a class.)

The new bZx DAO - one of the Defendants in the class action complaint - was charged with "maintaining the protocol, building new products, marketing the brand, and managing the community." Defendant token holders had the right to suggest and vote on governance proposals that, if adopted, would be implemented by the bZx Protocol. According to Defendant Kistner, as recorded in a public call, and as later highlighted by the CFTC in its enforcement action, the DAOs goal was to avoid any legal structure or oversight by regulators. Kistner said:

> **It's really exciting. We're going to be really preparing for the new regulatory environment by ensuring bZx is future-proof. So many people across the industry right now are getting legal notices and lawmakers are trying to decide whether they want DeFi companies to register as virtual asset service providers or not – and really what we're going to do is take all the steps possible to make sure that when regulators ask us to comply, that we have nothing we can really do because we've given it all to the community**.[16]

At the time of transfer from the Protocol to the Defendant bZxDAO in August 2021, the Protocol held $80 Million in assets. In a related CFTC enforcement proceeding against the bZxDAO and others, CFTC found that these Protocol assets were under the control of the Defendant DAO and the court in *Sarcuni* considered allegations to that effect as true for pleading purposes in the case before it. *See* CFTC Order *supra*. According to the *Sarcuni* Plaintiffs, the bZxDAO and its founders failed to provide basic security over the passkeys and funds. Shortly after all assets were transferred out of an existing bZxLLC to the new bZxDAO in August 2021, a developer of the Protocol (ostensibly withing Defendant DAO's oversight) responded to a common phishing attack . The result was the $55Million dollar theft from the class members.

The pivotal question at the pleading stage was – how can a DAO be responsible if the DAO is a totally faceless, amorphous, automated entity such as Defendants argued? Plaintiffs alleged that the DAO nevertheless must be, by default, a general partnership, with most Defendants jointly and severally liable as general partners. The court analyzed this issue thoroughly and in apparently the first private litigation of its kind, found a DAO to be a general partnership, reasoning in part that:

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[16] ***Sarcuni Order*** 2023 WL 2657633, * 20.
See also *the related CFTC enforcement case,* ***bZeroX, LLC*** *, CFTC Docket No. 22-31,* download available at *https://www.cftc.gov/media/7676/enfbzeroxorder092222/download*

> **Courts do not countenance partnerships which attempt to afford all the advantages of commercial intercourse without corresponding liabilities, and an agreement which contemplates such evasion will be construed and enforced as a general partnership**[17]

The *Sarcuni* case remains pending. In November of 2021, bZxDAO Defendants urged the Protocol participants to move their tokes to the newly formed Ooki DAO. Many did so, and the Sarcuni. In the related CFTC court action, on June 8, 2023, Judge Orrick of the Northern District for California issued and entered an Order on Default Judgment against the Ooki DAO – which is a successor to the bZXDAO. Regarding the issue of legal personhood of a DAO, the judge found the DAO to be a 'person' as reported below:

> **Critically, in a precedent-setting decision, the court held that the Ooki DAO is a "person" under the Commodity Exchange Act and thus can be held liable for violations of the law. The court then held that the Ooki DAO did, in fact, violate the law as charged.**[18]

The CFTC 2022 had also simultaneously filed and settled similar charges against the bZxDAO and individual founders.[19]

B. **Takeaway from Sarcuni and the CFTC cases – and State Law**

The investment DAOs are not immune from liability, contrary to beliefs or hopes of Web3 purists. A group of protocol members in a DAO, despite holding individually modest claims as appears to be the situation for some in the *Sarcuni* case, can potentially bring claims as a group or class, if counsel is not able to economically take on these cases individually. Whether a client suffered large or modest losses when investing or trading through a DAO, the DAO cannot hide behind allegations that it is truly decentralized and totally automated.

However, certain jurisdictions like Wyoming, Tennessee, Utah and Vermont, have passed laws enabling DAOs to form formal business entities, such as LLCs or similar "legal wrapper" .

Some protection from liability may be available and the details need to be studied in each jurisdiction. Of note, and no surprise, California aims to soon define the DAO entities in its corporate code, with the introduction of AB 1229. The bill proposes to amend California's corporations code so as to establish business structures for DAOs, giving them a legal framework for operation and "legitimizing" them in the state. NYS' Attorney General proposes an overall very aggressive investor protection crypto scheme that hopefully should address DAO liability.[20]

More about the evolving status of State and Federal legislation will be presented in person at the PIABA Annual Meeting.

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[17] ***Sarcuni Order*** _ F. supp 3d _ supra**,** *quoting Nat'l Bank of Com.*, 114 Cal. App. at 329–30.
[18] https://www.cftc.gov/PressRoom/PressReleases/8590-22
[19] See https://www.cftc.gov/PressRoom/PressReleases/8590-22
[20] https://ag.ny.gov/press-release/2023/attorney-general-james-proposes-nation-leading-regulations-cryptocurrency.

Regulatory Notice 21-03

Fraud Prevention

FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities

Summary

Low-priced securities[1] tend to be volatile and trade in low volumes. It may be difficult to find accurate information about them. There is a long history of bad actors exploiting these features to engage in fraudulent manipulations of low-priced securities. Frequently, these actors take advantage of trends and major events—such as the growth in cannabis-related businesses or the ongoing COVID-19 pandemic—to perpetrate the fraud.[2]

FINRA has observed potential misrepresentations about low-priced securities issuers' involvement with COVID-19 related products or services, such as vaccines, test kits, personal protective equipment and hand sanitizers. These misrepresentations appear to have been part of potential pump-and-dump or market manipulation schemes that target unsuspecting investors.[3] These COVID-19-related manipulations are the most recent manifestation of this type of fraud.

This *Notice* provides information that may help FINRA member firms that engage in low-priced securities business assess and, as appropriate, strengthen their controls to identify and mitigate their risk, and the risk to their customers, including specified adults and seniors,[4] of becoming involved in activities related to fraud involving low-priced securities. Firms that engage in low-priced securities business should also be aware of a recent SEC Staff Bulletin—Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities—that highlights for broker-dealers various risks arising from illicit activities associated with transactions in low-priced securities through omnibus accounts, particularly transactions effected on behalf of omnibus accounts maintained for foreign financial institutions.[5]

This *Notice* does not create any new requirements or expectations for member firms outside of their existing obligations pursuant to FINRA rules and applicable law, nor does implementing any of the practices cited here create a safe harbor from these obligations.

February 10, 2021

Notice Type

- Special Alert

Suggested Routing

- Anti-Money Laundering
- Compliance
- Financial Crimes
- Fraud
- Internal Audit
- Legal
- Operations
- Risk
- Senior Management

Key Topics

- Anti-Money Laundering
- Fraud
- Low-Priced Securities
- Trading

Referenced Rules & Notices

- Bank Secrecy Act
- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2165
- FINRA Rule 3310
- FINRA Rule 6432
- Regulatory Notice 09-05
- Regulatory Notice 19-18
- Regulatory Notice 20-13
- Securities Act of 1933
- Securities Exchange Act of 1934

Questions regarding this *Notice* should be directed to:

- Greg Ruppert, Executive Vice President, National Cause and Financial Crimes Detection Programs, Member Supervision, at (415) 217-1120 or greg.ruppert@finra.org;
- Sam Draddy, Senior Vice President, Insider Trading, Fraud Surveillance and PIPEs Surveillance, Member Supervision, at (240) 386-5042 or sam.draddy@finra.org; or
- Blake Snyder, Senior Director, Financial Intelligence Unit, Member Supervision, at (561) 443-8051 or blake.snyder@finra.org.

Background and Discussion

Broker-dealers play an important part in identifying and protecting investors from potentially fraudulent activity. A firm's failure to take appropriate steps as a gatekeeper to the public securities markets—for example, by not conducting a reasonable inquiry into a security's eligibility for distribution, where required—may expose that firm to liability risks, for example under Section 5 of the Securities Act of 1933 ("Securities Act").[6] In addition, Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Section 17(a) of the Securities Act, as well as FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) and 3110 (Supervision) establish obligations for member firms in connection with potential fraud. Firms also have obligations under the BSA and FINRA Rule 3310 (Anti-Money Laundering Compliance Program) to maintain appropriate risk-based procedures to conduct ongoing customer diligence and to report suspicious activity to the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury.

This *Notice* provides information to help firms strengthen their controls in four important areas related to potential fraud involving low-priced securities and thereby protect investors from financial harm and the firms themselves from financial, regulatory and reputational damage:

- **Detection:** the *Notice* describes possible red flags of potentially fraudulent low-priced securities activity;
- **Monitoring:** the *Notice* describes selected effective supervisory and other control practices FINRA has observed firms implement;
- **Suspicious Activity Report (SAR) filing:** the *Notice* describes firms' SARs filing obligations; and
- **Fraud Reporting:** the *Notice* describes additional avenues for firms to report potential fraud involving low-priced securities.

FINRA notes that a pattern of involvement in low-priced securities transactions—including soliciting customers, conducting offerings or executing transactions related to low-priced securities—informs FINRA's evaluation of a firm's risk profile. FINRA may examine or otherwise review more frequently the activity of firms that display these elevated risk characteristics.

Detection: Potential Red Flags of Fraud Involving Low-Priced Securities

The red flags discussed below are intended to help inform firms about activity associated with potential fraud involving low-priced securities, including, but not limited to, schemes involving COVID-19 claims.[7] The red flags discussed in this *Notice* may overlap in some instances with red flags of suspicious anti-money laundering activity FINRA identified in *Regulatory Notice 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations). This *Notice* provides firms engaged in low-priced securities business with more detailed information regarding red flags that are specific to potential fraud involving low-priced securities.

Potential Indicators of Fraud Involving Low-Priced Securities

FINRA has observed that the following non-exhaustive list of issuer, third-party or customer activities may be red flags of fraud involving low-priced securities:

- Issuers
  - abrupt or frequent changes of issuer name, ticker symbol or business model, or abrupt expansion of an existing business model, often to benefit from the latest trend such as COVID-19 cures, test kits or prevention-related products (including instances in which the issuer has previously engaged in a business involved with other trends such as e-cigarettes, cannabis or cryptocurrency);
  - currently or previously a shell company;[8]
  - engaging in recapitalization or reorganization activities (*e.g.,* a reverse or forward stock split in conjunction with a reverse merger) that appear to concentrate the shares into the hands of a small number of shareholders, who may be acting in coordination;
  - hiring executive or control persons or service providers—such as attorneys, auditors, transfer agents, consultants and promoters—who have a history of regulatory or criminal violations, or are associated with multiple low-priced stock issuers;
  - not providing current and adequate publicly available financial information[9] in SEC filings or voluntary disclosures on an inter-dealer quotation system;
  - making claims about projected scale and revenue targets that are not supported by the issuer's experience, assets or financial condition (*e.g.,* an issuer that develops cannabinoid-based products announces that it could earn millions in revenue from manufacturing and shipping COVID-19 home test kits);
  - making unsupported claims regarding partnerships, joint ventures or financing agreements with private entities (*e.g.,* an issuer promotes a press release touting the financial benefits of a new business partnership with a company whose financial condition cannot be independently verified);

- conducting increased social media, press release or related investor outreach campaigns after a period of apparent dormancy, particularly if the information is not confirmed on the issuer's website or in financial statements and disclosures filed with the SEC or on an inter-dealer quotation system, and often related to the latest trend; or
- lacking verifiable evidence of the issuer's business activities, such as limited or no operational website, social media accounts, references to issuer on employment websites or other independent reporting on the issuer's business activities.

- Third-Party Promotional Activities
  - hyping and promoting issuers (or their products or services), especially where the information cannot be reliably confirmed;
  - promotional investor email alerts, banner advertisements, dedicated promotional websites or seemingly independent news or research coverage, which prominently feature or advertise the issuer's new potential business prospects that (1) may be related to the latest trend (*e.g.,* winning a large contract or developing a new product or service), (2) may also present recent or projected investment returns, and (3) cannot be reliably confirmed;
  - generating a spike in social media promotions (*e.g.,* on Twitter, Instagram or Facebook), and activity on investor chat rooms or message boards; or
  - conducting unsolicited phone calls or sending text alerts to tout specific stocks to garner interest from registered representatives and investors.

- Firm Customers
  - customers that deposit large blocks of thinly traded low-priced securities, whether the securities are marked with a restrictive legend or not, particularly of issuers that recently changed business models to take advantage of the latest trend;
  - customers that engage in transactions that are consistent with an intent to affect the price of a low-priced stock, such as small purchases executed on behalf of a customer who owns a very large amount of the same low-priced stock, and do not have a legitimate investment rationale for the transactions;
  - customers that engage in a pattern of purchasing a low-priced security right before market close (which may be indicative of an attempt to mark the close);
  - customers or other parties that request the firm file a FINRA Form 211[10] to initiate or resume quotations for an issuer that recently changed business models—often to take advantage of the latest trend—or was recently subject to a trading suspension;
  - current officers, former officers, significant shareholders or family members of these individuals, who trade low-priced securities prior to a corporate announcement or stock promotion campaign;

- one or more customers suddenly trading the securities of a thinly traded issuer—often one that makes claims related to the latest trend—on opposite sides of the market, potentially leading to manipulative trading;
- customers, particularly specified adults[11], who are being solicited to purchase low-priced securities where (1) the customer has not invested in low-priced securities previously; (2) the purchase is outside the customer's investment or risk profile; or (3) the low-priced security constitutes a large concentration of the customer's investments;
- multiple new customers opening accounts (particularly if they reside overseas and communicate with the firm only through electronic means) who either deposit shares of the same issuer or were introduced by the same individual to the firm; or
- customers, including financial institutions, that route high volume or frequent sell orders (with no buys) for low-priced securities to the firm for execution, including customers who maintain an execution-only relationship with the firm, or use omnibus or Delivery versus Payment/Receive versus Payment (DVP/RVP) accounts for such transactions.

Monitoring: Supervisory and Other Controls

Measures that FINRA has observed firms implement in effective supervisory systems to mitigate risks associated with fraud involving low-priced securities include, but are not limited to, the following:

- Supervision of Associated Persons
  - monitoring registered representatives' customers' investments in low-priced securities that are marked "unsolicited" to determine if the trades were in fact solicited;
  - monitoring registered representatives' solicitations to customers to trade low-priced securities for compliance with FINRA rules and applicable laws;
  - monitoring the proprietary and customer accounts of registered representatives who primarily trade in low-priced securities; and
  - enhancing supervision of registered representatives who maintain direct or indirect outside business activities associated with companies with low-priced shares or trade in low-priced securities in their outside brokerage accounts.
- Account and Share Acceptance
  - establishing risk-based criteria to determine the characteristics of securities (*e.g.*, exchange-listed and SEC reporting companies) investors may hold in their accounts or in which they may initiate transactions on the firm's platform;

- establishing controls to identify situations where customers open new accounts and deposit or transfer large blocks of low-priced securities, including in omnibus or DVP/RVP accounts;
- promptly reviewing deposits of physical certificates and electronic transfers of low-priced securities prior to acceptance to identify low-priced securities that are marked as restricted, as well as low-priced securities that are not marked restricted where the restrictive legend may have been inappropriately lifted;
- implementing risk-based acceptance policies regarding physical and electronic deposits of low-priced securities that incorporate factors such as whether the issuer is exchange-listed, the markets or exchanges on which it trades, any compliance flags that exchanges and over-the-counter markets provide regarding the issuer[12] and the existence of other red flags such as those referenced in this *Notice*;
- requiring compliance or AML department approval of exceptions to firm policies on the deposit and trading of low-priced securities by customers; and
- obtaining information regarding the customer's occupation or business and establishing risk-based criteria to request additional information, such as whether the customer is employed by a company that trades on the public markets and whether the customer intends to deposit or trade low-priced securities.

- Account Monitoring
  - monitoring customer accounts for shifts in investment strategy away from listed equities towards unlisted low-priced securities, especially if this is inconsistent with the customer's stated or historic risk tolerance;
  - monitoring accounts held by specified adults and seniors for unusual purchases, or high concentrations, of low-priced securities and, where appropriate, contacting customers to determine if these decisions were the result of solicitation or influence by a third party;
  - monitoring customer accounts, including omnibus or DVP/RVP accounts, that are liquidating low-priced securities to address risks relating to the firm being engaged in, among other things, an unregistered securities offering;
  - establishing risk-based criteria to determine the circumstances under which a firm would consider placing restrictions on or closing an account;
  - monitoring for groups of related accounts trading in the same low-priced security at the same time; and
  - reviewing for indications of stock promotion activity in connection with share acceptance and account monitoring reviews.

- Other Controls
  - conducting education and outreach—which could include providing risk alerts at the time of order entry—to customers, especially specified adults,[13] to inform them about the risks of investing in low-priced securities;[14]
  - identifying and, if necessary, prohibiting customers from opening new accounts with, or depositing in existing accounts, restricted shares of low-priced listed or low-priced OTC securities; and
  - increasing training and coordination between risk, compliance and operational personnel to ensure frontline staff are aware of red flags associated with potential fraud involving low-priced securities and schemes to unlawfully distribute unregistered securities and know how to report their concerns.

Reporting Potential Fraud Involving Low-Priced Securities

FINRA Rule 3310(f) and 31 CFR 1023.210(b)(5) require that member firms' AML programs include appropriate risk-based procedures for conducting ongoing customer due diligence, including procedures for conducting ongoing monitoring to identify and report suspicious transactions. In addition, FINRA Rule 3310(a) requires firms to "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under [the BSA] and the implementing regulations thereunder;" the BSA and its implementing regulations require financial institutions to report suspicious transactions to FinCEN using SARs.[15] FinCEN has issued several notices and advisories noting emerging trends relating to illicit behavior connected to COVID-19, including investment scams and insider trading, and encouraged all financial institutions to enter the term "COVID19" or the specific term provided in a relevant FinCEN notice or advisory in Field 2 of the SAR and provide other requested information in the relevant fields and narrative.[16]

Financial institutions are also required to provide information to FinCEN in response to requests in furtherance of Section 314(a) of the USA PATRIOT Act for information regarding accounts reasonably suspected based on credible evidence of engaging in terrorist acts or money laundering.[17]

Financial institutions subject to an anti-money laundering program requirement under FinCEN regulations, and any qualifying association of such financial institutions, are eligible to share information under Section 314(b) of the USA PATRIOT Act. Section 314(b) provides financial institutions with the ability to share information with one another, under a safe harbor provision that offers protections from civil liability, in order to better identify and report potential money laundering or terrorist financing. Although sharing information pursuant to Section 314(b) is voluntary, FinCEN and FINRA strongly encourage financial institutions to participate to enhance their compliance with anti-money laundering/ counter-financing of terrorism requirements.[18]

Beyond the filing obligations discussed above, FINRA urges firms to protect customers and other firms by immediately reporting potential fraud involving low-priced securities to one or more of the following:

- FINRA's Regulatory Tip Form found on FINRA.org or through FINRA's Whistleblower Tip Line at (866) 96-FINRA;
- U.S. Securities and Exchange Commission's system for tips, complaints and referrals (TCRs) or by phone at (202) 551-4790;
- a local Federal Bureau of Investigation's (FBI) field office; or
- local state securities regulators.[19]

In addition, firms should consider whether circumstances would trigger a reporting obligation pursuant to FINRA Rule 4530 (Reporting Requirements).[20]

Endnotes

1. For the purposes of this *Regulatory Notice*, the term "low-priced securities" refers to those securities that are sometimes referred to as "microcap stocks" or "penny stocks." The term "microcap stock" generally refers to securities issued by companies with a market capitalization of less than $250 to $300 million. *See, e.g.,* U.S. Securities and Exchange Commission (SEC), Microcap Stock: A Guide for Investors (Sept. 18, 2013) and U.S. Securities and Exchange Commission, Investor Bulletin, Microcap Stock Basics (Sept. 30, 2016). The term "penny stock" generally refers to a security issued by a very small company that trades at less than $5 per share. *See* Fast Answers: Penny Stock Rules; Section 3(a)(51) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 3a51-1 thereunder.

2. *See also Regulatory Notice 20-13* (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic).

3. As used here, "fraud involving low-priced securities" can include market manipulation and "pump and dump" schemes.

4. "Specified adult" as defined in FINRA Rule 2165 (Financial Exploitation of Specified Adults) refers to: (A) a natural person age 65 and older; or (B) a natural person age 18 and older who a firm reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.

5. In addition to highlighting the risks described, the SEC Staff Bulletin also reminds brokers-dealers of their associated obligations under the Bank Secrecy Act (BSA), Rule 17a-8 under the Exchange Act, Section 5 of the Securities Act of 1933 ("Securities Act"), and FINRA rules. The Bulletin states that in the view of SEC staff, sufficiently discharging existing anti-money laundering (AML) obligations under the BSA requires broker-dealers to consider, among other things, the risks associated with the multiple layers of accounts through which transactions in low-priced securities may have been routed.

6. *See Regulatory Notice 09-05* (Unregistered Resales of Restricted Securities).

7. FinCEN has advised that as no single financial red flag indicator is necessarily indicative of illicit or suspicious activity, financial institutions should consider all surrounding facts and circumstances before determining if a transaction is suspicious or otherwise indicative of potentially fraudulent activities related to COVID-19. In line with a risk-based approach to compliance with the BSA, financial institutions also are encouraged to perform additional inquiries and investigations where appropriate. *See* Advisory on Unemployment Insurance Fraud During the Coronavirus Disease 2019 (COVID-19) Pandemic.

8. *See* Exchange Act Rule 12b-2 (providing that a shell company is a "registrant . . . that has: (1) No or nominal operations; and (2) Either: (i) No or nominal assets; (ii) Assets consisting solely of cash and cash equivalents; or (iii) Assets consisting of any amount of cash and cash equivalents and nominal other assets.").

9. *See* 17 CFR 230.144(c) (addressing "adequate current public information").

10. *See* FINRA Rule 6432 (Compliance with the Information Requirements of SEA Rule 15c2-11).

11. *See supra note* 4.

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12. For example, the OTC Markets Group provides information on an issuer on the issuer's quote page and in the Group's Compliance Data feeds; these flags may identify an issuer as, for example, a shell company, bankrupt or delinquent in its SEC reporting.

13. *See supra note* 4.

14. Numerous resources are available at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_microcap_1.html

15. 31 U.S.C. 5318(g); 31 C.F.R. 1023.320. Under FinCEN's SAR rule, broker-dealers are required to file a SAR if: (1) a transaction is conducted or attempted to be conducted by, at, or through a broker-dealer; (2) the transaction involves or aggregates funds or other assets of at least $5,000; and (3) the broker-dealer knows, suspects, or has reason to suspect that the transaction –

    (a) involves funds or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law or regulation;

    (b) is designed to evade requirements of the BSA;

    (c) has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts; or

    (d) involves the use of the broker-dealer to facilitate criminal activity.

    31 C.F.R. 1023.320 (a)(2). The SEC maintains a SAR Alert Message Line at (202) 551-SARS (7277), which should only be used when firms have filed a SAR that requires the immediate attention of the SEC.

16. *See generally* FinCEN's coronavirus webpage and FinCEN's March 20, 2020 guidance discussing investment scams and insider trading. For types of suspicious activity related to specific types of conduct, FinCEN has requested more detailed keywords be included in Field 2 of the SAR form and other specific fields as well as the narrative. For general guidance on relevant BSA obligations, *see* Notice Related to the Coronavirus Disease 2019 (COVID-19).

17. 31 C.F.R. 101.520.

18. For updated guidance on the expanded acceptable use of the Section 314(b) information sharing authority, *see* FinCEN's December 10, 2020 press release.

19. *See* NASAA's webpage providing contact information for state securities regulators.

20. For additional information about these requirements, *see* Rule 4530 Frequently Asked Questions.

Regulatory Notice 21-36

Anti-Money Laundering and Countering the Financing of Terrorism

FINRA Encourages Firms to Consider How to Incorporate the Government-wide Anti-Money Laundering and Countering the Financing of Terrorism Priorities Into Their AML Programs

October 8, 2021

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Anti-Money Laundering
- Compliance Programs

Referenced Rules & Notices
- Bank Secrecy Act
- FINRA Rule 3310
- Regulatory Notice 19-18
- Regulatory Notice 21-03

Summary

The Financial Crimes Enforcement Network (FinCEN) has issued the first government-wide priorities for anti-money laundering and countering the financing of terrorism policy,[1] which was mandated by the Anti-Money Laundering Act of 2020 (AML Act).[2] FinCEN also issued a statement to provide covered non-bank financial institutions (NBFIs), including broker-dealers, with guidance on how to approach the AML/CFT Priorities.[3]

FINRA is issuing this *Notice* to inform member firms of the AML/CFT Priorities and the Statement, and to encourage member firms to consider how to incorporate the AML/CFT Priorities into their risk-based anti-money laundering (AML) compliance programs.

Questions concerning this *Notice* should be directed to:

- Victoria Crane, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104 or Victoria.Crane@finra.org;
- Thomas Kimbrell, Associate General Counsel, OGC, at (202) 728-6926 or Thomas.Kimbrell@finra.org;
- Jason Foye, Senior Director, AML Investigative Unit, Member Supervision, at (561) 443-8062 or Jason.Foye@finra.org; or
- Nick Vitalo, Principal Counsel, OGC, at (646) 315-8474 or Nicholas.Vitalo@finra.org.

Background and Discussion

The AML/CFT Priorities

The AML Act became law on January 1, 2021, and, among other amendments to the Bank Secrecy Act (BSA), requires FinCEN to issue the AML/CFT Priorities and update them at least once every four years.[4] On June 30, 2021, FinCEN, the bureau of the Department of the Treasury responsible for administering the BSA and its implementing regulations, issued its first government-wide AML/CFT Priorities. The AML/CFT Priorities are intended to assist covered financial institutions,[5] including broker-dealers, in their efforts to meet their obligations under laws and regulations designed to combat money laundering and counter terrorist financing.[6]

The AML/CFT Priorities focus on threats to the U.S. financial system and national security and reflect longstanding and continuing AML/CFT concerns previously identified by FinCEN and other U.S. government departments and agencies.[7] They include predicate crimes to money laundering that generate illicit proceeds that illicit actors may launder through the financial system.[8] FinCEN set forth eight priorities: (1) corruption; (2) cybercrime, including relevant cybersecurity and virtual currency considerations; (3) foreign and domestic terrorist financing; (4) fraud (including securities and investment fraud and internet-enabled fraud); (5) transnational criminal organization activity; (6) drug trafficking organization activity; (7) human trafficking and human smuggling; and (8) proliferation financing. FinCEN provides details about each of the individual priorities and includes references to prior FinCEN advisories and guidance documents that identify related typologies and red flags that may help broker-dealers comply with their BSA obligations.[9]

Incorporation of AML/CFT Priorities Into Firms' Risk-Based AML Compliance Programs

The BSA, as amended by the AML Act, provides that the "review by a financial institution" of the AML/CFT Priorities and "the incorporation of those priorities, as appropriate" into the risk-based AML compliance programs established by the financial institution "shall be included as a measure on which a financial institution is supervised and examined for compliance."[10]

FinCEN has clarified that the publication of the AML/CFT Priorities does not create an immediate change in the BSA requirements or supervisory expectations for covered NBFIs, including broker-dealers.[11] FinCEN has noted further that covered NBFIs are not required to incorporate the AML/CFT Priorities into their risk-based AML programs until the effective date of final regulations promulgated by it.[12] The BSA, as amended by the AML Act, requires that FinCEN promulgate any appropriate regulations regarding the AML/CFT Priorities within 180 days of their establishment.[13]

FinCEN has stated that the final regulations will specify how financial institutions should incorporate the AML/CFT Priorities into their risk-based AML programs,[14] and that not every priority will be relevant to every covered institution.[15] FinCEN has also stated that covered NBFIs may nevertheless wish to start considering how they will incorporate the AML/CFT Priorities into their risk-based AML programs, such as by assessing the potential risks associated with the products and services they offer, the customers they serve, and the geographic areas in which they operate.[16]

FINRA Rule 3310 requires every member firm to develop and implement a written AML program reasonably designed to achieve and monitor for compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Department of the Treasury. Although the issuance of the AML/CFT Priorities does not trigger an immediate change in the BSA requirements or supervisory expectations for member firms, FINRA encourages member firms to begin to evaluate how they will incorporate and document the AML/CFT Priorities, as appropriate, into their risk-based AML programs. Member firms that are beginning to evaluate how they will do so may wish to begin considering potential updates to the red flags that they have incorporated into their risk-based AML compliance programs in light of the risks presented by factors such as their business activities, size, the geographic locations in which they operate, the types of accounts they maintain, and the types of transactions in which they and their customers engage.

Firms may also wish to begin considering any potential technological changes that may be appropriate in order to incorporate the AML/CFT Priorities into their risk-based AML compliance programs, including changes to the technology that they use to monitor and investigate suspicious activity. Upon the effective date of final regulations addressing the AML/CFT Priorities, member firms should be in a position to review and incorporate, as appropriate, the AML/CFT Priorities into their risk-based AML programs.[17]

FinCEN has acknowledged the need for revised regulations and timely guidance to assist covered NFBIs, including broker-dealers, in complying with the BSA and expressed its commitment to working with federal agencies to develop and publish such guidance.[18]

Additional information about FinCEN's implementation of the AML Act is available on the dedicated AML Act webpage on FinCEN's website.

Endnotes

1. Anti-Money Laundering and Countering the Financing of Terrorism National Priorities (AML/CFT Priorities) (June 30, 2021).

2. 31 U.S.C. § 5318(h)(4)(A) (as amended by AML Act § 6101(b)(2)(C)). The AML Act was enacted as Division F, §§ 6001-6511, of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Cong. (2021) (enacted) (enrolled bill available at *https://www.govinfo.gov/content/pkg/BILLS-116hr6395enr/pdf/BILLS-116hr6395enr.pdf*).

3. Statement on the Issuance of the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) National Priorities (Statement) (June 30, 2021). FinCEN also issued a joint statement with other regulators to provide guidance to banks on the AML/CFT Priorities. *See* Interagency Statement on the Issuance of the AML/CFT Priorities (June 30, 2021).

4. 31 U.S.C. § 5318(h)(4)(A) and (B) (as amended by AML Act § 6101(b)(2)(C)). FinCEN was required to consult with the Attorney General, Federal functional regulators (as defined in section 509 of the Gramm-Leach-Bliley Act (15 U.S.C. 6809)), relevant State financial regulators, and relevant national security agencies to establish the priorities and must continue to consult with these same parties when updating the AML/CFT Priorities. *See Id.*

5. Covered institutions are financial institutions required by BSA regulations to maintain an AML program. *See* 31 CFR §§ 1020.210(a) (banks); 1020.210(b) (banks without a Federal functional regulator); 1021.210 (casinos and card clubs); 1022.210 (money services businesses); 1023.210 (brokers or dealers in securities); 1024.210 (mutual funds); 1025.210 (insurance companies); 1026.210 (futures commission merchants and introducing brokers in commodities); 1027.210 (dealers in precious metals, precious stones, or jewels); 1028.210 (operators of credit card systems); 1029.210 (loan or finance companies); and 1030.210 (housing government sponsored enterprises).

6. AML/CFT Priorities, p. 1.

7. AML/CFT Priorities, pp. 2-3.

8. AML/CFT Priorities, p. 3.

9. AML/CFT Priorities. In *Regulatory Notice 19-18* (May 2019), FINRA provided a non-exhaustive list of red flags that may be applicable to the securities industry. In *Regulatory Notice 21-03* (February 2021), FINRA addressed additional red flags associated with potential fraud involving low-priced securities.

10. 31 U.S.C. § 5318(h)(4)(E) (as amended by AML Act § 6101(b)(2)(C)), 31 U.S.C. §§ 5321, 5324 and 5330(e) (2012); 12 U.S.C. §§ 1829b(j) and 1955 (2012).

11. Statement, p. 2.

12. Statement, p. 2. FinCEN also stated that until the effective date of final regulations, it will not examine covered NBFIs for the incorporation of the AML/CFT Priorities into their risk-based AML programs, and will not request that the staff of the U.S. Securities and Exchange Commission, Commodity Futures Trading Commission, Internal Revenue Service, or state financial regulators, or a self-regulatory organization (SRO) authorized to examine a covered NBFI, examine any covered NBFI for this requirement (or any related state requirement). *Id.*

13. 31 U.S.C. § 5318(h)(4)(D) (as amended by AML Act § 6101(b)(2)(C)).

14. AML/CFT Priorities, p. 2.

15. *Id.*

16. Statement, p. 2.

17. AML/CFT Priorities, p. 2.

18. Statement, p. 2.

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Regulatory Notice 22-21

Heightened Threat of Fraud

FINRA Alerts Firms to Recent Trend in Fraudulent Transfers of Accounts Through ACATS

October 6, 2022

Notice Type
- Special Alert

Suggested Routing
- Compliance
- Financial Crimes
- Fraud
- Internal Audit
- Legal
- Operations
- Risk
- Senior Management
- Trading

Key Topics
- ACATS
- Asset Transfers
- Fraud
- New Accounts

Referenced Rules & Notices
- Bank Secrecy Act
- FINRA Rule 2090
- FINRA Rule 3310
- FINRA Rule 4512
- FINRA Rule 4530
- FINRA Rule 11870
- NSCC Rule 50
- Regulatory Notice 20-13
- Regulatory Notice 20-32
- Regulatory Notice 21-14
- Regulatory Notice 21-18

Summary

FINRA alerts member firms to a rising trend in the fraudulent transfer of customer accounts through the Automated Customer Account Transfer Service (ACATS), an automated system administered by the National Securities Clearing Corporation (NSCC), that facilitates the transfer of customer account assets from one firm to another.

This *Notice* provides an overview of how bad actors effect fraudulent transfers of customer accounts using ACATS (referred to as ACATS fraud), lists several existing regulatory obligations that may apply in connection with ACATS fraud, and provides contact information for reporting the fraud. As FINRA continues to gather additional information related to ACATS fraud, FINRA is committed to providing guidance, updates and other information to help member firms stay informed about the latest developments, and will supplement this *Notice*, as appropriate.

Questions regarding this *Notice* should be directed to Jason Foye, Senior Director, Special Investigations Unit, at (561) 443-8062 or by email at Jason.Foye@finra.org.

Background & Discussion

NSCC Rule 50 established ACATS and sets forth the responsibilities of NSCC and the members that use ACATS. Among other things, the rule establishes the account transfer process and the attendant duties and obligations, and performance timeframes. Complementing ACATS is FINRA Rule 11870 (Customer Account Transfer Contracts), which governs the process by which customers can request a transfer of their securities account assets from one FINRA member firm to another and includes timeframes that align with those in NSCC Rule 50. In particular, FINRA Rule 11870 provides that within one business day of receiving the transfer instruction, the member firm carrying the customer's account (carrying member) must either validate (or accept) or take exception to (or reject) the Transfer Instruction Form (TIF) for reasons specified in the rule.[1] In addition, the rule states that the carrying member must complete the transfer within three business days following the validation of the TIF.[2]

In general, a customer who wishes to transfer securities account assets from the carrying member to another firm must open an account at the new firm that is expecting to receive the customer's account assets (receiving member). The account transfer process begins when the receiving member receives the customer's authorized TIF; the receiving member then initiates the account transfer through ACATS.[3] Typically, a TIF includes the customer's name, date, the account type and account numbers at the receiving member and carrying member, and other personal identifiable information about the customer (*e.g.,* tax identification number or Social Security number).[4]

Overview of ACATS Fraud

In a situation where customer account information is stolen, a bad actor may use this information to effect ACATS fraud. In general, ACATS fraud may unfold in the following manner:

Using the stolen identity of a legitimate customer of a carrying member, a bad actor will open a brokerage account online or through a mobile application in the name of the legitimate customer at the receiving member to create a new account. The bad actor may open the new account solely using stolen information or with a combination of stolen and false information (*e.g.,* false email address or phone number).

Shortly after successfully opening the new account at the receiving member—generally, within a few days or weeks—the bad actor will then provide the receiving member with a TIF to initiate a transfer through ACATS of the legitimate customer's account assets from the carrying member.

Once the ACATS transfer of the assets to the newly established account at the receiving member is completed, the bad actor will (within a short period of time) attempt to move the ill-gotten assets to an external account at another financial institution by:

- transferring the account assets (*i.e.,* cash and securities) to an account at another financial institution;
- liquidating the securities or a portion of the securities transferred into the new account, then transferring any realized proceeds (along with any cash that was transferred to the new account) to an account at another financial institution; or
- purchasing additional securities using the transferred cash and then transferring those securities to an account at another financial institution.

ACATS fraud is related to the growing threat of new accounts being opened online or through mobile applications using stolen or synthetic identities.[5] In connection with the COVID-19 pandemic, FINRA previously advised member firms that bad actors may be "targeting firms offering online account opening services and perhaps especially, firms that recently started offering such services" by using stolen or synthetic identities to establish new accounts at member firms as a way to "divert congressional stimulus funds, unemployment payments or to engage in automated clearing house (ACH) fraud."[6] Similarly, with ACATS fraud, bad actors may be taking advantage of the efficiencies of the account transfer process offered through ACATS to fraudulently transfer assets out of an existing account of a legitimate customer whose identity is stolen to a new account the bad actor established at another broker-dealer using the stolen identity.

Relevant Regulatory Obligations

FINRA reminds its member firms of existing regulatory obligations that may apply in connection with ACATS fraud, including:

- FINRA Rules 2090 (Know Your Customer) and 4512 (Customer Account Information);
- the requirements of the Bank Secrecy Act and its implementing regulations and FINRA Rule 3310 (Anti-Money Laundering Compliance Program), including the requirements to maintain customer identification programs to verify the identity of each customer,[7] establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of Suspicious Activity Reports (SARs) with U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN),[8] and to conduct ongoing customer due diligence, including monitoring to identify and report suspicious transactions;[9]
- the Identity Theft Red Flags Rule (Regulation S-ID); and
- the processing of customer account transfers through ACATS in compliance with FINRA Rule 11870 (Customer Account Transfer Contracts).

Reporting Fraud

In addition to filing any required SARs through the BSA E-Filing system, FINRA also encourages firms to immediately report potential fraud to:

- FINRA using the Regulatory Tip Form found on FINRA.org;
- U.S. Securities and Exchange Commission's tips, complaints, and referral system (TCRs) or by phone at (202) 551-4790;
- the Federal Bureau of Investigation's tip line at 800-CALLFBI (225-5324) or a local FBI office;
- the Internet Crime Compliant Center (IC3) (particularly if a firm is trying to recall a wire transfer to a destination outside the United States); and local state securities regulators.[10]

In situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, broker-dealers should immediately notify by telephone an appropriate law enforcement authority.[11]

Endnote

1. *See* FINRA Rule 11870(b)(1) and Rule 11870(d); *see also* NSCC Rule 50, Section 5.
2. *See* FINRA Rule 11870(e)). Note that some assets may be exempt from this timeframe. *See* FINRA Rule 11870(j).
3. Some transfers may occur outside of ACATS. *See* Rule 11870(a)(2). This *Notice* focuses on the transfers that occur within ACATS.
4. *See, e.g.,* FINRA Rule 11870.03 (Sample Transfer Instruction Form). *See also* DTCC ACATS User Guide (August 2, 2022) (ACATS User Guide) (listing the information the ACATS system sources from the TIF that includes receiving and deliverer (*i.e.,* carrying) broker-dealer; customer name; customer account number; Social Security numbers, among other data).
5. A synthetic identity may include legitimate Social Security numbers with false names, addresses and dates of birth. Without a clearly identifiable victim, a synthetic identity may go undetected for longer periods of time.
6. *See* Regulatory Notice 20-13 (May 2020) (reminding firms to be aware of fraud during the pandemic). *See also* Regulatory Notices 20-32 (September 2020) (reminding firms to be aware of fraudulent options trading in connection with potential account takeovers and new account fraud); Regulatory Notice 21-14 (March 2021) (alerting firms to recent increase in ACH "Instant Funds" abuse); and Regulatory Notice 21-18 (May 2021) (sharing practices firms use to protect customers from online account takeover attempts).
7. *See* FINRA Rule 3310(b) and 31 C.F.R. § 1023.220.
8. *See* FINRA Rule 3310(a) and 31 C.F.R. § 1023.320.
9. *See* FINRA Rule 3310(f) and 31 C.F.R. § 1023.210(a)(5).
10. *See* NASAA, Contact Your Regulator (providing contact information for state securities and provincial securities regulators and other resources those agencies provide).
11. Firms may call FinCEN's Hotline at (866) 556-3974.

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Regulatory Notice 20-13

Heightened Threat of Fraud and Scams

FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic

May 5, 2020

Notice Type
- Special Alert

Suggested Routing
- AML
- Compliance
- Cybersecurity
- Financial Crimes Department
- Fraud Department
- Legal
- New Accounts
- Operations
- Registered Representatives
- Risk Management
- Senior Management

Key Topics
- Cybersecurity
- Fraud

Referenced Rules and Notices
- FINRA Rule 2090
- FINRA Rule 3110
- FINRA Rule 3310
- FINRA Rule 4512
- Information Notice 3/26/20
- Information Notice 4/29/19
- Regulatory Notice 09-64
- Regulatory Notice 12-05
- Regulatory Notice 19-18

Summary

The COVID-19 pandemic is affecting most aspects of our society and daily lives, as well as the U.S. economy and markets. Events with such profound impact routinely create opportunities for financial fraud.

Firms and their associated persons should be aware of and take appropriate measures to address the increased risks and challenges presented during the COVID-19 pandemic. In addition to new scams focusing on COVID-19, previous scams may also find new life as fraudsters adapt to and exploit recent events and related vulnerabilities, especially those related to the remote working environment.

FINRA is committed to providing guidance, updates and other information to help stakeholders stay informed about the latest developments relating to COVID-19, which can be found on FINRA's COVID-19/Coronavirus Topic Page.

FINRA will also continue to inform the industry on emerging cybersecurity trends and related frauds, and reminds firms to review resources on FINRA's Cybersecurity Topic Page, which provides information on how firms can strengthen their cybersecurity programs.

Questions regarding this *Notice* should be directed to:

- Greg Ruppert, Executive Vice President, National Cause and Financial Crimes Detection Programs, Member Supervision, at (415) 217-1120 or *greg.ruppert@finra.org*; or
- Sam Draddy, Senior Vice President, Insider Trading and PIPEs Surveillance, Member Supervision, at (240) 386 5042 or *sam.draddy@finra.org*.

Background and Discussion

FINRA urges firms and associated persons to be cognizant of the heightened threat of frauds and scams to which firms and their customers may be exposed during the COVID-19 pandemic. This *Notice* outlines four common scams—(1) fraudulent account openings and money transfers; (2) firm

imposter scams; (3) IT Help Desk scams; and (4) business email compromise schemes—and describes measures that firms and associated persons may take to mitigate related risks. This information pre-dates the COVID-19 pandemic but may be useful to firms since FINRA has observed that these threats persist in the current environment.

I. Fraudulent Account Openings and Money Transfers

Some firms have reported an increase in newly opened fraudulent accounts, which may otherwise be hard to identify as a result of overall increases in new account openings. Firms should be aware that fraudsters are targeting firms offering online account opening and, perhaps especially, firms that recently started offering such services. These fraudsters may be taking advantage of the pandemic to use stolen or synthetic identities to establish accounts to divert congressional stimulus funds, unemployment payments or to engage in automated clearing house (ACH) fraud.[1]

Common Characteristics of Scams

The specific tactics fraudsters use may vary, but they typically involve some combination of the following steps:

- **Establishing the Account**—Using stolen or synthetic customer identity information to establish a new brokerage account;[2]
- **Funding the Account**—Funding the newly established brokerage account by:
  - using stolen bank account information (routing and account numbers) to transfer money from the customer's bank account to the newly established brokerage account;
  - effecting smaller dollar transfers via ACH or other online payment methods from the customer's bank account; or
  - diverting other customer funds directly to the fraudster's account (*e.g.,* diverting unemployment benefits); and
- **Exfiltrating Funds**—Rapidly moving deposited funds out of the brokerage account by, for example:
  - making ATM withdrawals or purchases on debit cards for the brokerage account; or
  - linking the brokerage account to a third-party bank account or an account at another financial institution that provides pre-paid debit card products and services and then transferring funds to that account.

FINRA has observed that, in some cases, fraudsters emailed firms a falsified voided check to verify the new bank account information. The falsified check included the real customer's home address and looked like a legitimate check for the customer's bank account.

Selected Firm Practices

FINRA has observed firms implement the following practices to address risks relating to fraudulent account openings and money transfers:

- **Customer Identification Program**[3]—Firms that permitted the opening of accounts through electronic means used both documentary and non-documentary methods to verify the identity of customers, including:
  - documentary identification (which included unexpired government-issued identification bearing a photograph, such as drivers' licenses or passports); and
  - non-documentary methods (which included contacting the customer; independently verifying the customer's identity with information obtained from a consumer reporting agency, public database or other source; checking references with other financial institutions; or obtaining a financial statement).
- **Monitoring for Fraud During Account Opening**—Firms used the following methods at the time of account opening to identify potential fraud:
  - limiting automated approval of multiple accounts opened by a single customer;
  - reviewing account application fields—such as telephone number, address, email address, bank routing numbers and account numbers—for repetition or commonalities among multiple applications, but with different customer names or identifiers; and
  - using technology to detect indicators of automated scripted attacks in the digital account application process (*e.g.,* extremely rapid completion of account applications).

Although some firms use micro-deposits as a mean to verify accounts, FINRA notes that other firms are concerned that fraudsters can undermine the utility of this verification method by using social engineering attacks to take over customer accounts at institutions across the financial services industry. As a result, and as discussed further below, these firms carefully watch for rapid withdrawals from accounts that were verified using micro-deposits.

- **Bank Account Verification and Restrictions on Fund Transfers**—Firms confirmed customers' identities with banks and restricted fund transfers in certain situations by, for example:
  - reviewing the IP address of transfer requests made online or through a mobile device to determine if the request was made from a location that is consistent with the customer's home address or locations from which the firm has previously received legitimate customer communications;

- verifying that the identity on the source account for fund transfers matches the customer's identity at the broker-dealer;
- confirming that the identity of the destination bank account for cash transfers matches the customer's identity at the broker-dealer;
- prohibiting the rapid transfer of recently deposited customer funds from customers' brokerage accounts to third party bank accounts (where some firms used risk criteria—*e.g.,* the amount of the transfer in dollar terms—to trigger reviews of transfer requests) by requiring a holding period (which allowed time for the filing of an ACH fraud report by the originating bank);
- implementing a process for customers to obtain exceptions to these restrictions, which required them to complete additional steps to verify their account information, the transfer amount and their identity (such as through the use of third-party providers that leverage customers' credit bureau or other information); and
- creating notifications for changes to bank account information that were sent to the customer via email, text message or instant message—as well as their official street address of record—informing them about the newly established linked bank account and asking them to call the firm if they have any questions.

- **Ongoing Monitoring of Accounts**—Firms continued to evaluate existing accounts for fraud risks where the accounts:
  - were inactive, unfunded and soon to be restricted or closed; and
  - had losses related to credit extensions and were about to be placed into collections or write-off categories.
- **Collaborating with Clearing Firms—**Firms clearly understood the allocation of responsibilities between clearing and introducing firms for handling ACH transactions and implemented policies and procedures to meet those responsibilities effectively, including:
  - defining how instructions related to ACH requests should be conveyed; and
  - understanding the responsible staff at the introducing firm who were authorized to transmit instructions to the clearing firm.
- **Suspicious Activity Report (SAR) Filing Requirements**[4]—Firms confirmed that ACH fraud was covered by their SAR procedures and reported them to the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN).

Relevant Regulatory Obligations

In addition to considering the practices noted above, FINRA encourages firms to assess their compliance programs relating to account opening and money transfers and reminds them to review their policies and procedures related to:

- new account openings to confirm they comply with FINRA Rules 2090 (Know Your Customer) and 4512 (Customer Account Information), as well as the Bank Secrecy Act and its implementing regulations addressed under FINRA Rule 3310 (Anti-Money Laundering Compliance Program);
- handling of ACH transfer requests to "determine the authenticity of transmittal instructions"[5] obligations pursuant to FINRA Rule 3110 (Supervision);
- safeguarding customer "records and information" pursuant to Regulation S-P Rule 30;[6] and
- filing SARs with FinCEN.[7]

Firm Imposter Scams

The expanded use of remote offices and telework arrangements may increase opportunities for fraudsters to impersonate firms and associated persons in communicating with customers or creating a fake online presence or websites.[8] As part of this scam, fraudsters may seek to obtain—via a website, email, text or other communications—customers' personal information, including account information, or trick them into making investments or transferring funds. In some cases, fraudsters may seek to reduce the likelihood that customers will realize they have been the target of a fraud by directing them not to contact the firm by phone due to long wait times.

FINRA has observed firms using a variety of methods to address risks related to imposter scams, including:

- providing staff with training or fraud alerts describing firm imposter scams and the steps associated persons can take to protect the firm and its customers;
- alerting customer-facing staff that fraudsters may use the increase in remote work to engage in social engineering schemes against associated persons and advise them to vet incoming calls purporting to be from known customer numbers—for example by arranging a video call or asking customers questions where only the customers and their registered representative would know the answer; and
- implementing the practices discussed in FINRA *Information Notice 4/29/19* when they become aware of imposter websites.

IT Help Desk Scams

Remote work arrangements also may increase the opportunity for social engineering attacks involving firms' IT Help Desks. In one variant of these attacks, fraudsters pose as associated persons and contact a firm's IT Help Desk to, for example, request a password reset. The fraudsters may use the conversation with the IT Help Desk staff to gain information about a firm's technical infrastructure or business operations, which they subsequently use to attack the firm, for example, by infiltrating the firm's network and possibly stealing funds from the firm.[9]

FINRA has observed firms address risks relating to such scams by training their IT Help Desk staff to verify callers' identities by, for example, asking for employees' identification numbers or other firm-specific information that would be challenging for fraudsters to obtain.

In a second variant of these attacks, fraudsters pose as a member of a firm's IT Help Desk team and contact associated persons in an attempt to harvest user credentials or introduce malware into the associated person's computer, which may then be used to steal credentials, confidential customer or firm data or other valuable information.

FINRA has observed firms address this risk by training associated persons to take extra precautions when receiving unsolicited calls or emails that appear to come from their firm's IT Help Desk, especially if the caller or email asks the associated person to click a link, enter a web address or download software to their computer. Some firms ask employees receiving such calls or emails not to respond and to call back the IT Help Desk on its official number to confirm the veracity of the original communication. In addition, they ask employees to report any suspicious activity to the firm so it can alert other staff that they may be targeted.

II. Business Email Compromise Schemes[10]

Fraudsters may also take advantage of remote working environments to pose, via email or text message, as firm leadership to request one or more fund transfers, for example, related to accounts payable invoices. In another variant on this scam—the gift card procurement scam—fraudsters purporting to be a manager or executive email a subordinate with an urgent request for them to secretly purchase gift cards as a motivational award or one-time surprise for staff.

FINRA has observed firms addressing such risks by alerting staff that can disburse firm funds to:

- monitor for potential red flags of scams, such as requests arriving at an unusual time of day, using atypical language or greetings, requesting a transfer to a new account, requiring privacy or secrecy for the transactions or displaying unusual urgency; and
- confirm the request via telephone prior to acting on any requests, especially those sent via email channels.

FINRA has also observed firms address such risks by including an "external" banner to highlight emails received from outside the firm.

Reporting Fraud

Although there may not be a regulatory requirement to report every incident described in this Notice, FINRA urges firms to protect customers and other firms by immediately reporting scams and any other potential fraud to:

- FINRA's Regulatory Tip Form found on FINRA.org or through FINRA's Whistleblower Tip Line at (866) 96-FINRA or *whistleblower@finra.org*;
- U.S. Securities and Exchange Commission's tips, complaints and referral system (TCRs) or by phone at (202) 551-4790;
- the Federal Bureau of Investigation's (FBI) tip line at 800-CALLFBI (225-5324) or a local FBI office;
- for cyber crimes, the Internet Crime Compliant Center (IC3) (particularly if a firm is trying to recall a wire transfer to a destination outside the United States); and
- local state securities regulators.[11]

In situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, broker-dealers *must* immediately notify by telephone an appropriate law enforcement authority in addition to filing a timely SAR. The firm may call FinCEN's Hotline at (866) 556-3974.

Endnotes

1. A synthetic identity includes legitimate Social Security numbers (SSNs) with false names, addresses and dates of birth. Without a clearly identifiable victim, it may go undetected for longer periods of time.

2. In some cases, fraudsters have also established a new account at a firm where a legitimate customer already has an account and used at least some elements of that customer's identity to establish the new account.

3. *See* 31 C.F.R. 1023.220 (setting forth requirements for customer identification programs for broker-dealers).

4. *See* 31 C.F.R. 1023.320 (setting forth SARs reporting requirements).

5. *See Regulatory Notice 12-05* (Verification of Email Instructions to Transmit or Withdraw Assets From Customer Accounts) and *Regulatory Notice 09-64* (Customer Assets).

6. Rule 30 under Regulation S-P requires firms to have written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information that are reasonably designed to: (1) ensure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. Regulation S-P also requires firms to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their right to opt-out of information sharing. Further, FINRA Rule 3110 (Supervision) requires firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, including Rule 30 under Regulation S-P, and with applicable FINRA rules.

7. *See Regulatory Notice 19-18* (FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations).

8. *See* FINRA *Information Notice 4/29/19* (Imposter Websites Impacting Member Firms).

9. *See* FINRA *Information Notice 3/26/20* (Measures to Consider as Firms Respond to the Coronavirus Pandemic (COVID-19)).

10. *See* FBI Release: FBI Anticipates Rise in Business Email Compromise Schemes Related to the COVID-19 Pandemic (April 6, 2020).

11. *See www.nasaa.org/contact-your-regulator/* (providing contact information for state securities regulators).

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Regulatory Notice 21-18

Cybersecurity

FINRA Shares Practices Firms Use to Protect Customers From Online Account Takeover Attempts

May 12, 2021

Notice Type

- Special Alert

Suggested Routing

- Compliance
- Information Technology
- Legal
- Operations
- Risk Management
- Senior Management

Key Topics

- Access Control
- Authentication
- Cybersecurity
- Fraud

Referenced Rules & Notices

- FINRA Rule 2090
- FINRA Rule 3110
- FINRA Rule 3310
- FINRA Rule 4512
- Information Notice 10/15/20
- Notice to Members 05-48
- Regulatory Notice 20-13
- Regulatory Notice 20-30
- Regulatory Notice 20-32

Summary

FINRA has received an increasing number of reports regarding customer account takeover (ATO) incidents, which involve bad actors using compromised customer information, such as login credentials (*i.e.*, username and password), to gain unauthorized entry to customers' online brokerage accounts.

To help firms prevent, detect and respond to such attacks, FINRA recently organized roundtable discussions with representatives from 20 firms of various sizes and business models to discuss their approaches to mitigating the risks from ATO attacks.

This *Notice* outlines the recent increase in ATO incidents; reiterates firms' regulatory obligations to protect customer information; and discusses common challenges firms identified in safeguarding customer accounts against ATO attacks, as well as practices they find effective in mitigating risks from ATOs—including recent innovations—which firms may consider for their cybersecurity programs.

This *Notice* does not create new legal or regulatory requirements, or new interpretations of existing requirements. A firm's cybersecurity program should be reasonably designed and tailored to the firm's risk profile, business model and scale of operations. There should be no inference that FINRA requires firms to implement any specific practices described in this *Notice*.

Questions regarding this *Notice* should be directed to:

- David Kelley, Director, Member Supervision Specialist Programs, at (816) 802-4729 or by email; or
- Greg Markovich, Senior Principal Risk Specialist, Member Supervision, at (312) 899-4604 or by email.

Background and Discussion

FINRA has received an increasing number of reports regarding ATO incidents, which involve bad actors using compromised customer information, such as login credentials, to gain unauthorized entry to customers' online brokerage accounts. In addition, we have received reports regarding attackers using synthetic identities to fraudulently open new accounts; some of the information addressed here, particularly regarding the opening of online accounts, may help firms mitigate risks in this area.[1]

Customer ATOs have been a recurring issue, but reports to FINRA about such attacks have increased as more firms offer online accounts, and more investors conduct transactions in these accounts, in part due to the proliferation of mobile devices and applications (*i.e.,* "apps")[2] and the reduced accessibility of firm's physical locations due to the COVID-19 pandemic.

Bad actors have taken advantage of these conditions to attempt customer ATOs, often through common attack methods such as phishing emails and social engineering attempts (*e.g.,* fraudsters calling customers, pretending to be registered representatives from customers' firms to acquire their personal information).[3] Other reasons for this increase in attempts may include the large number of stolen customer login credentials available for sale on the "dark web" (*see* Appendix for definitions of cybersecurity terms used in this *Notice*) and the emergence of more sophisticated ATO methods, such as tools that automate ATO attacks at scale (*e.g.,* using mobile emulators to mimic mobile devices that have been compromised to access thousands of online brokerage accounts).

Password Managers for Customer Account Protection

Some firms observed that customers often use the same login information across multiple accounts, making them particularly susceptible to ATOs conducted on a widescale (*e.g.,* credential stuffing).

To mitigate this threat, some firms recommend that customers use a password manager—an application that protects online accounts by suggesting and saving individual, strong passwords for each login. The password manager then automatically fills in the password whenever customers access their accounts online.

Regulatory Obligations

FINRA reminds member firms of their obligations to protect sensitive customer data, as well as verify the identity and know the essential facts concerning every customer:

Regulatory Obligation	Summary
FINRA Rule 2090 (Know Your Customer)	Firms must use reasonable diligence, in regard to the opening and maintenance of every account, to know the "essential facts" concerning every customer. Essential facts are those required to: (1) effectively service the customer's account; (2) act in accordance with any special handling instructions for the account; (3) understand the authority of each person acting on behalf of the customer; and (4) comply with applicable laws, rules and regulations.
SEC Regulation S-P, Rule 30	Firms must have written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information that are reasonably designed to ensure the security and confidentiality of customer records and information; protect against any anticipated threats or hazards to the security or integrity of customer records and information; and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.
SEC Regulation S-ID	Firms must develop and implement a written program to detect, prevent and mitigate identity theft in connection with the opening or maintenance of "covered accounts."[4] In designing those programs, firms should consider, among other things, the methods of accessing covered accounts and the detection of red flags of identity theft in connection with authenticating customers.
Customer Identification Program (CIP)	Firms' anti-money laundering compliance programs must establish, document and maintain a written Customer Identification Program (CIP).[5] Among other requirements, firms' CIPs must include risk-based procedures that enable firms to form a reasonable belief that they know the true identity of each person that opens a new account. These procedures must be based on an assessment of the relevant risks, including those presented by the various types of accounts maintained by the firm and the various methods of opening accounts.[6] The CIPs must also describe when they will use documentary, non-documentary or a combination of both methods for identity verification.[7]

FINRA also encourages firms to assess their compliance programs related to new account openings and funds transfers, and review their policies and procedures related to:

- confirming that new account openings comply with FINRA Rule 4512 (Customer Account Information), as well as the Bank Secrecy Act and its implementing regulations addressed under FINRA Rule 3310 (Anti-Money Laundering Compliance Program);
- handling of ACH and other transmittal requests to "determine the authenticity of transmittal instructions" obligations pursuant to FINRA Rule 3110 (Supervision); and
- filing Suspicious Activity Reports (SARs)[8] with FinCEN.[9]

Common Challenges to Protecting Customer Accounts

During the roundtable discussions with FINRA, firms discussed the following cybersecurity challenges[10] they have encountered when safeguarding customer accounts from ATOs:

- identifying effective methods of verifying the identities of customers who establish accounts online;[11]
- addressing increased volume of attempted customer ATOs;
- preventing bad actors from transferring money in and out of customer accounts;
- identifying when bad actors have taken over customer accounts by modifying customers' critical account information (*e.g.,* email address, bank information) and are attempting fraudulent transactions;
- identifying when login attempts and requests to reset account passwords are actually made by a bad actor who has taken over a customer's email account; and
- balancing security and customer experience considerations.

Noted Practices

During the roundtable, firms discussed a variety of policies, procedures, controls and related tools to mitigate ATO-related risks. The firms typically used a risk-based approach to validating new customers' identities, authenticating logins to firm systems and performing customer-requested actions (*e.g.,* transactions in an account), coupled with strong back-end monitoring and robust procedures to respond quickly to identified customer ATOs.

Verifying Customers' Identities When Establishing Online Accounts

As part of their cybersecurity programs, firms that onboard customers online verified potential customers' identities by:

- validating identifying information or documents that applicants provide (*e.g.,* Social Security number (SSN), address, driver's license), including, for example, through "likeness checks"; and

- asking applicants follow-up questions or requesting additional documents to validate their identities, based on information from credit bureaus, credit reporting agencies or firms providing digital identity intelligence (*e.g.,* automobile and home purchases).

Alternatively, some firms contracted with third-party vendors to perform the above functions, as well as provide additional support (*e.g.,* a database to verify the legitimacy of suspicious information in customers' applications).[12]

Authenticating Customers' Identities During Login Attempts

Firms took a variety of approaches to validating the identities of customers when they access their online accounts:

Multifactor authentication: Most firms embraced multifactor authentication (MFA) as a key control that significantly reduces the likelihood that bad actors can take over a customer's account. Some of these firms required all customers to use MFA; others required customers to use MFA if their account had been compromised, while others simply encouraged customers to adopt it.

Key takeaway: *While not a "silver bullet," most participants believe MFA is currently one of the best ways to protect customers' accounts from ATOs.*

Unlike single-factor authentication (*e.g.,* a password), MFA uses two or more different types of factors or secrets—such as a password and code sent via a Short Message Service (SMS) text message or an authentication app—which significantly reduces the likelihood that the exposure of a single credential will result in account compromise.[13] A number of firms are encouraging customers to adopt MFA by establishing streamlined MFA methods, such as customers entering their login credentials on trusted devices.

Adaptive authentication: Some firms use adaptive authentication techniques to further increase the security of customers' accounts. Adaptive authentication typically assesses both:

- the risk associated with a customer's login (*i.e.,* the authentication system's confidence in the customer's identity, based on various factors associated with the login attempt (such factors are discussed further below)); and
- the risk of the activity the customer wishes to perform (*e.g.,* checking an account balance or initiating a money transfer).

In situations where the authentication system assesses that at least one of these risks exceeds a certain risk threshold, the system will require the customer to provide additional information to confirm their identity. For example, a customer may be required to provide additional information to verify their identity if they:

- attempt to log in to their account from a new device or different location than usual; or
- seek to execute a higher risk transaction such as an abnormally large withdrawal or purchase of a different type of security (*e.g.,* a low-priced unlisted security) than usual, or change a bank account or email address associated with their account.

A risk threshold can be set in a variety of ways. For example, a firm may set relatively simple rules (*e.g.,* transactions exceeding a specific dollar value or percent of account size). Alternatively, a firm may establish policies that assess a broad range of factors to determine whether additional verification is required.

Supplemental authentication factors: There are a variety of factors that firms and vendors may incorporate into their authentication system and processes to verify a customer's identity, including:

- SMS text message codes;
- phone call verifications;
- media access control (MAC) addresses;
- geolocation information;
- third-party authenticator apps; and
- biometrics.

In addition, many firms noted they have transitioned away from using email addresses as authentication factors, due to the prevalence of email account breaches by bad actors.

Back-End Monitoring and Controls

Firms conducted ongoing surveillance of both individual customer accounts and across these accounts to prevent, detect and mitigate ATO threats. (In some cases, the results of such back-end monitoring may feed back into firms' front-end controls.) This included, for example:

- monitoring at the customer account level for anomalies, such as:
  - indications of ATO attempts at the login level (*e.g.,* significant increases in number of failed logins in a brief time period for a specific account); and
  - account activity that could indicate that an ATO has occurred (*e.g.,* large purchases shortly after account opening; changes in email account of record followed by a request for a third-party wire; frequent transfers of funds in and out of an account);

- monitoring across customers' accounts for indications of credential stuffing or other large-scale attacks (*e.g.,* significant increases in the number of login attempts and failed logins across a large number of accounts);
- monitoring emails received from customers for red flags of social engineering (*e.g.,* problems with grammar or spelling; unexpected attachments, apps or links);[14]
- establishing back-end controls to prevent bad actors from moving money out of customer accounts, such as requiring a confirmation phone call with the customer using an established phone number when suspicious activity is detected in their account (*e.g.,* withdrawing money from an online brokerage account into a newly-established bank account); and
- scanning the dark web for keywords or data that could be useful to bad actors in facilitating an ATO (*e.g.,* firm name, customer account numbers, names of firm executives, planted accounts and passwords).

Procedures for Potential or Reported Customer ATOs

Firms discussed methods to proactively address potential or reported customer ATOs by:

- establishing a dedicated fraud group to investigate customer ATOs;
- responding promptly and effectively to customers who report ATOs, frequently updating them on their account status and minimizing the amount of time their accounts are locked or their trading ability is suspended;
- reviewing all of a customer's accounts at the firm for signs of problematic activity, if such activity is identified in one of their accounts;
- providing a method for customers to quickly communicate with someone at the firm, typically through voice or chat channels in a contact center; and
- reminding customers of recommended security practices (*e.g.,* MFA adoption).

Automated Threat Detection

Firms used a variety of automated processes to detect potential malicious actions by bad actors, for example, by:

- using web application firewalls (WAFs) and internally built tools to stop credential stuffing attacks;
- isolating suspicious IPs in a "penalty box"; and
- instituting geographic-based controls (*e.g.,* "impossible travel" or disallowing connections from countries where no customers reside).

Restoring Customer Account Access

Firms noted that secure practices to restore customers' account access—whether because a customer has forgotten their password or because they are otherwise locked out—in a timely fashion are essential. At the same time, however, the process must be well thought out and incorporate appropriate safeguards so that it does not itself become an avenue for ATOs. Practices firms noted in this regard included:

- implementing two-factor authentication for all password resets, for example, requiring input of a time-sensitive code sent to investors by SMS text message (several firms noted that sending a code via email can be risky because customers' email accounts may have been compromised, so firms using this approach may want to ask for additional confirming information, as described in the bullet below); and
- requiring customers to contact call centers, and answer security questions based on less commonly available information (*i.e.,* information less likely to be available through the dark web or a customer's social media posts, and provided by the credit bureaus or firms providing digital identity intelligence) to restore their account access.

Investor Education

Firms noted that they educated and trained their customers on account security by:

- including cybersecurity-related materials in the client onboarding process;
- providing up-to-date cybersecurity information;
- including on the firm's website resources—such as alerts—that customers can opt in to receiving, such as email or SMS text messages for certain types of account activity; and
- adding educational content to statements of older investors.

Reporting Fraud

FINRA urges firms to protect customers and other firms by immediately reporting scams and any other potential fraud to:

- FINRA's Regulatory Tip Form found on FINRA.org;
- U.S. Securities and Exchange Commission's tips, complaints and referral system (TCRs) or by phone at (202) 551-4790;
- the Federal Bureau of Investigation's (FBI) tip line at 800-CALLFBI (225-5324) or a local FBI office;
- the Internet Crime Compliant Center (IC3) for cyber-crimes (particularly if a firm is trying to recall a wire transfer to a destination outside the United States); and
- local state securities regulators.[15]

In addition, firms should consider whether circumstances require that the firm file a SAR[16] or report pursuant to FINRA Rule 4530 (Reporting Requirements).[17]

Conclusion

As noted herein, FINRA has received reports that the prevalence and sophistication of customer ATOs have been increasing. In the face of this threat, firms have implemented a variety of policies, procedures, controls and related tools to prevent, detect and respond to ATOs. FINRA shares practices roundtable participants found to be effective to help other firms mitigate ATO risks. Additional information related to cybersecurity risk management can be found on FINRA's Cybersecurity Topic Page.

Appendix

The following list defines commonly-used cybersecurity terms that appear in this *Notice*:

Biometrics – the unique physical identifiers (*e.g.,* fingerprint, voice and facial recognition) or behavioral characteristics (*e.g.,* mouse activity and keyboard strokes on computers; touchscreen behavior and device movement on mobile devices) humans display to digitally authenticate their identity.
Credential Stuffing – a cyberattack in which a bad actor uses a large set of illegally-acquired usernames and passwords to attempt to gain unauthorized access to multiple user accounts.
Dark Web – the portion of the Internet that can only be accessed through special types of software and is often used to anonymously conduct illegal activity.
Impossible Travel – a security control that compares the locations of a user's most recent two sign-in attempts to determine if travel between those locations was impossible in the timeframe given (*e.g.*, logging in from Cleveland, Ohio and then, twenty minutes later, from Salt Lake City, Utah).
Likeness Check – an identity verification method where applicants upload a photo or video of themselves, which is then compared with their recently submitted identity documents (and, at times, voice recordings).
Media Access Control (MAC) – a unique identifier used to identify a specific hardware device at the network level.
Penalty Box – a tool that isolates Internet Protocol (IP) addresses that exhibit potentially malicious behavior.
Planted Account – a fake account established by a firm within its customer database. In the context of cybersecurity, firms often monitor the dark web for information related to planted accounts to uncover data breaches.
Short Message Service (SMS) – a system for sending short messages (*e.g.,* text) over a wireless network.
Trusted Device – a device frequently used by a customer to access their online account, such as a mobile phone, tablet or home computer. A customer can designate a device as "trusted" on the Verification Code screen by clicking the box next to "Don't ask again on this computer".
Web Application Firewall (WAF) – a firewall that monitors traffic between a web application and the Internet and filters out any malicious traffic (as defined by its set of policies).

Endnotes

1. *See* *Regulatory Notice 20-32* (FINRA Reminds Firms to Be Aware of Fraudulent Options Trading in Connection With Potential Account Takeovers and New Account Fraud) for definitions of ATOs and synthetic identities.

2. *See* FINRA's 2018 Report on Selected Cybersecurity Practices for effective practices firms have implemented to protect sensitive firm and customer information as the use of mobile devices expands and becomes more widespread.

3. *See* *Regulatory Notice 20-30* (Fraudsters Using Registered Representatives Names to Establish Imposter Websites).

4. *See* 17 CFR 248.201(b)(3), which defines "covered account" as:

   (i) An account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a brokerage account with a broker-dealer or an account maintained by a mutual fund (or its agent) that permits wire transfers or other payments to third parties; and

   (ii) Any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation, or litigation risks.

5. *See* 31 C.F.R. 1023.220 and 31 C.F.R. 1023.100(d). Pursuant to FINRA Rule 3310(b), firms must establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and its implementing regulations, including the CIP Rule.

6. *Ibid.*

7. *See* 31 C.F.R. 1023.220(a)(2)(ii). For firms relying on documents to verify identity, the documents utilized may include an original unexpired government-issued identification evidencing nationality or residence and bearing a photograph, such as a driver's license or passport. Non-documentary methods of verifying customer identity under the CIP Rule may include contacting a customer; independently verifying the customer's identity through comparison of the information the customer provides with information from a consumer reporting agency, public database, or other source; checking references with other financial institution; or obtaining a financial statement.

8. *See* 31 C.F.R. 1023.320 for SARs reporting requirements.

9. *See* FinCEN's July 2020 Advisory on Cybercrime and Cyber-Enabled Crime Exploiting the Coronavirus Disease 2019 (COVID-19) Pandemic for additional guidance on filing SARs.

10. The challenges discussed in this *Notice* may require firms to address regulatory obligations beyond the context of cybersecurity—for example, those related to anti-money laundering compliance programs.

11. *See* FinCEN's July 2020 Advisory and *Regulatory Notice 20-13* (FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic) for recent, common tactics bad actors use to establish fraudulent customer accounts.

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12. Outsourcing an activity or function to a third party does not relieve firms of their ultimate responsibility for compliance with all applicable securities laws and regulations and FINRA and MSRB rules regarding the outsourced activity or function. FINRA has provided substantial guidance regarding firms' responsibilities when outsourcing activities to third-party service providers. *See, e.g.,* *Notice to Members 05-48* (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers).

13. *See* *Information Notice 10/15/20* (Cybersecurity Background: Authentication Methods) for a primer on authentication techniques for firms to consider implementing within their cybersecurity programs.

14. *See* FINRA's 2018 Cybersecurity Report for additional effective practices firms have implemented to mitigate the threat of phishing attacks.

15. *See* North American Securities Administrations Association's Contact Your Regulator.

16. *See supra* note 9. *See also* FinCEN's Frequently Asked Questions (FAQs) regarding the Reporting of Cyber-Events, Cyber-Enabled Crime, and Cyber-Related Information through Suspicious Activity Reports (SARs).

17. For additional information about the requirements of FINRA Rule 4530 (Reporting Requirements), *see* Rule 4530 Frequently Asked Questions.

FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO: 2006004297301

RECEIVED
2006 DEC 31 A 11:09
REGISTRATION & DISCLOSURE

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: E*Trade Securities, LLC (CRD No. 29106) and
E*Trade Clearing, LLC (CRD No. 25025)

Pursuant to Rule 9216 of FINRA's Code of Procedure, Respondents E*Trade Securities, LLC and E*Trade Clearing, LLC (collectively "E*Trade," "Firm," or "Respondent") submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against E*Trade alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Respondent E*Trade Securities, LLC has been a registered broker-dealer and a member of FINRA (f/k/a National Association of Securities Dealers or NASD) since February 19, 1992. E*Trade Securities' principal place of business is New York, New York. The Firm's business primarily consists of providing an on-line, Internet-based platform for customers trading in stocks and options.

E*Trade Clearing, LLC has been a registered broker-dealer and a member of FINRA since April 2002. E*Trade Clearing's principal place of business is also New York, New York. The activities of E*Trade Clearing, as reflected by its name, are primarily related to clearing and are not sales related.

OVERVIEW

During most of the period of January 1, 2003 through May 31, 2007 (the "review period"), E*Trade primarily utilized an automated proprietary system (the "System") to review accounts for potentially suspicious activity. The System employed five filters which queued transactions and accounts for further review by a group of analysts within the Firm's AML/Risk Department. The Firm developed these filters by identifying patterns of abnormal activity in brokerage accounts surrounding money movement. Consequently, E*Trade's AML filter-based System triggered a review of potentially suspicious trading activity primarily when accompanied by money movement activity. Because the Firm's AML System did not flag and cause the review of accounts for suspicious trading activity unless accompanied by suspicious money movement, it was not reasonably designed to achieve compliance with the Bank Secrecy Act and implementing regulations thereunder, in contravention of NASD Conduct Rule 3011(b), and the Firm's written procedures for detecting and reporting suspicious trading activity did not comply with NASD Conduct Rule 3011(a). Since E*Trade is a registered municipal securities dealer, E*Trade also violated MSRB Rule G-41. E*Trade's violations of NASD Rule 3011 and MSRB Rule G-41 also constitute a violation of NASD Rule 2110.

LEGAL STANDARD AND FACTS

A. FINRA's AML Rule

On July 2, 2002, the Department of Treasury, in implementing the Bank Secrecy Act, issued the regulation requiring suspicious transaction reporting for broker-dealers.[1] In accordance with this regulation, FINRA promulgated Rule 3011, which since 2002 has required broker-dealers to, among other things,

> (a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) of the Bank Secrecy Act and the implementing regulations thereunder;
>
> (b) Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder;[2]

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[1] 31 C.F.R §103.19(a)(1) (2002).

[2] NASD Conduct Rule 3011; *see also* Special NASD Notice to Members 02-21, *Anti-Money Laundering*, dated April 2002, at 5.

***

A firm's AML procedures must address a number of areas including monitoring of account activities, including but not limited to, *trading* and the flow of money into and out of accounts.[3] Firms are required to file with Treasury's Financial Crimes Enforcement Network ("FinCEN") "a report of any suspicious transaction relevant to a possible violation of law or regulation."[4] With respect to the monitoring of trading, FinCEN's SAR-SF identifies 20 types of suspicious activity that must be reported including "market manipulation," "pre-arranged or other non-competitive trading," and "wash or other fictitious trading."

A firm's obligation is not a one-size-fits-all requirement and each financial institution should tailor its AML program to fit its business. In this regard, each broker/dealer, in developing an appropriate AML program should consider factors such as its size, location, business activities, the types of accounts it maintains, and the types of transactions in which its customers engage.[5] One of the factors that members are instructed to consider generally when tailoring their supervisory procedures and systems to the business conducted is the technological environment in which the firm operates.[6] On-line firms such as E*Trade have been instructed to "consider conducting computerized surveillance of account activity to detect suspicious transactions and activity.[7]

B. E*Trade's Automated AML System Was Inadequate Because It Focused Primarily on Money Movement

Between January 2003 and May 2007, E*Trade primarily relied upon an automated proprietary filter-based System to review accounts for money laundering activity. That System focused primarily on the review of suspicious money movement. The Firm's System utilized five filters that queued transactions and accounts for further review by analysts. Two of the five filters were designed to flag suspicious patterns of money movement into and out of accounts. Another two of the five filters were designed primarily to flag suspicious patterns of money movement in relation to the number or dollar value of trades executed. Only the fifth filter was focused primarily on potentially

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[3] Special NASD Notice to Members 02-21 at 5 (stating, in relevant part, that firms must determine the manner in which AML procedures that address, among other things, "monitoring of account activities including but not limited to, trading and the flow of money into and out of the account," will apply to various accounts).

[4] 31 C.F.R. §103.19(a)(1) (2002).

[5] Special NASD Notice to Members 02-21 at 4.

[6] NASD Notice to Members 99-45, *NASD Provides Guidance On Supervisory Responsibilities*, at 2.

[7] Special NASD Notice to Members 02-21 at 7.

suspicious trading activity and that was limited to monitoring the trading activity within E*Trade employees' accounts.

Once a filter was triggered, the transaction or account that resulted in the filter "hit" was electronically placed in the queue, resulting in a "System alert." Analysts then manually accessed a variety of other sources and systems to review the account activity, including any suspicious trading activity. These sources included internal systems, internet resources, FinCEN reports, and OFAC alerts from CDC. During the review period, there were approximately 400 to 800 System alerts each day and E*Trade employed three to six analysts who were responsible for reviewing these alerts. Because the alerts were triggered by money movements, it was unlikely that the System analysts reviewed for suspicious trading activity, such as wash or matched trading, in the absence of money movements. Ordinarily, the System analysts only reviewed for potentially manipulative trading activity when they received such a System alert or a referral from another department in the Firm.

During the review period, E*Trade processed, on average, more than 110,000 customer orders daily with little or no human intervention. During this period, E*Trade did not tailor its suspicious activity monitoring program to its business of facilitating investors' self-directed electronic access to the market. For example, the Firm did not conduct computerized surveillance of customer account activity to monitor for matched or washed trading. Instead, it relied on its System analysts and other employees to manually monitor for and detect suspicious trading activity without providing them with sufficient automated tools necessary to monitor for such activity.

Such an approach to suspicious activity detection was unreasonable given E*Trade's business model. By way of example, for a ten month period between January through October 2006, E*Trade customers executed 85,029 matched transactions with the exact same share amount, price, and execution time. While matched trading is not illegal in and of itself, it is expressly prohibited when effectuated "[f]or purposes of creating a false or misleading appearance of active trading in any security[.]"[8] Consequently, a matched trade could be an indication of suspicious activity requiring further review.

E*Trade, however, had no automated systems specifically designed to detect manipulative matched or wash trading. On-line trading firms, such as E*Trade, are required to design and implement systems reasonably designed to detect trading activity in customer accounts that may be manipulative and thus reportable. Based upon the foregoing, E*Trade violated NASD Conduct Rule 3011(b).

C. E*Trade's AML Policies And Procedures Violated NASD Conduct Rule 3011(a)

[8] Securities Exchange Act of 1934 § 9(a)(1) (2002).

E*Trade's AML procedures, called upon employees to view transactions in the context of other account activity to determine whether a transaction was suspicious. The AML procedures defined "transactions" to include "deposits, withdrawals, wire transfers, *securities trading*, and investments."[9] As described above, during the review period the Firm's AML filter-based System triggered review of potentially suspicious trading activity primarily when accompanied by money movement activity. Accordingly, during the review period, because the Firm did not have separate and distinct monitoring procedures for suspicious trading activity in the absence of money movement, E*Trade's AML policies and procedures could not reasonably be expected to detect and cause the reporting of suspicious securities transactions.[10]

These failures constitute a violation of NASD Conduct Rule 3011(a).

Conclusion

As set forth above, E*Trade violated NASD Conduct Rules 3011 and 2110, and MSRB Rule G-41 (1) by failing to establish and implement policies and procedures that could reasonably be expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g), and (2) by failing to establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.

B. Respondent also consents to the imposition, at a maximum, of the following sanctions:

1. A censure; and

2. A fine of $1 million.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

The sanctions set forth above take into account the Firm's prompt corrective action to remediate its AML system and procedures after the initiation of FINRA's investigation, but without prompting by FINRA, including the implementation of automated monitoring systems specifically designed to detect suspicious trading during the review period and the expansion of staff along with the retention of third party vendors dedicated to the monitoring function.

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[9] E*Trade Financial Corporation Domestic Regulated Brokerage Subsidiaries Anti-Money Laundering Policies And Procedures, *Transactions*, at 6 (emphasis added).

[10] Within the Firm's written supervisory procedures and manuals during the review period, there were a total of seven references to "market manipulation", but these were limited in nature and could not reasonably be expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g).

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

A. To have a Formal Complaint issued specifying the allegations against it;

B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review

Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and

C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;

2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-3; and

4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

12-17-08
Date

E*Trade Securities, LLC
E*Trade Clearing LLC
Respondent
E*Trade Securities, LLC
E*Trade Clearing, LLC

By: James E. Ballowe, Jr.
General Counsel

Reviewed by:

Bruce M. Bettigole
Counsel For Respondent
Mayer Brown LLP
1909 K Street, N.W.
Washington, D.C. 20006-1101

Accepted by FINRA:

12/31/08
Date

Signed on behalf of the
Director of ODA, by delegated
authority

Samuel L. Israel
Associate Vice President and Chief
Counsel
FINRA Department of Enforcement
1801 K Street, N.W., Suite 800
Washington, D.C. 20006-1334
(t) 202-974-2868
(f) 202-721-8316

FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2012034423502

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Prudential Annuities Distributors, Inc., Respondent
Member Firm
CRD No. 21570

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Prudential Annuities Distributors, Inc. ("PAD" or the "Firm") submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against the Firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

A. PAD hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

PAD is headquartered in Shelton, Connecticut and has been a FINRA member since 1988. As of March 31, 2016, PAD had approximately 19 branch offices and 692 registered representatives. The Firm primarily acts as the principal underwriter and distributing broker-dealer for life and annuity products issued by certain of PAD's affiliated insurance companies.

OVERVIEW

From July 20, 2010 to September 7, 2012 (the "Relevant Period"), PAD failed to detect and prevent the misappropriation of nearly $1.3 million from an elderly customer's variable annuity ("VA") account. Travis A. Wetzel ("Wetzel"), a former registered sales assistant at LPL Financial ("LPL") and since-convicted

felon,[1] stole the money by submitting to PAD 114 forged annuity withdrawal requests that directed PAD to send funds to a third-party account held in the maiden name of Wetzel's wife.

PAD failed to prevent or detect Wetzel's misappropriation by repeatedly failing to adequately investigate red flags that should have alerted the Firm to Wetzel's misconduct, and by failing to implement adequate supervisory procedures ("WSPs") and controls to review and monitor the transmittal of customer funds to third party accounts. As a result of the foregoing, PAD violated NASD Rules 3010 and 3012(a)(2)(B)(i) and FINRA Rule 2010.

FACTS AND VIOLATIVE CONDUCT

A. Wetzel's Misappropriation Scheme

In July 2010, L.W., an 89-year-old widow owned a Prudential Annuity Life Assurance Corporation ("Prudential") VA that she purchased through her registered representative at LPL. Prudential serviced L.W.'s account through its registered broker-dealer, PAD, which was responsible for, among other things, processing requests to withdraw funds from L.W.'s VA account.

During the Relevant Period, Wetzel, an LPL registered sales assistant who serviced L.W.'s brokerage accounts, misappropriated $1,282,224 from L.W.'s Prudential VA by submitting forged wire transfer requests to PAD to send funds to a third-party account. Wetzel forged the requests by cutting and pasting L.W.'s signature onto the request forms and then faxed or e-mailed them to PAD. The third-party account was in the maiden name of Wetzel's wife and controlled by Wetzel.

Over the 26-month period, Wetzel submitted 114 forged wire transfer requests. On average, he sent PAD 4 to 5 withdrawals a month for almost $50,000. After Wetzel was caught, PAD and LPL reimbursed L.W. in full.

B. PAD Failed to Adequately Investigate Red Flags that Wetzel was Misappropriating Customer Funds

PAD repeatedly failed to adequately investigate red flags that should have alerted the Firm to Wetzel's misappropriation.

The Firm had in place an automated post-transaction review system that generated alerts for withdrawal activity from a customer account. The Firm required

[1] FINRA barred Wetzel in May 2013 in a related matter. Also, in February 2015, Wetzel was sentenced to 42 months in federal prison after pleading guilty to wire fraud and money laundering in connection with the misappropriation described herein. *See United States v. Travis Wetzel*, No. DKC-14-255 (D. Md.).

personnel to manually review each transaction that triggered an alert and confirm the transaction appeared legitimate. Every transfer request Wetzel sent to PAD, 114 in all, triggered an alert putting PAD on notice that the request might be fraudulent. In each instance, however, PAD determined erroneously that the withdrawal activity appeared legitimate. In addition, for 44 transfers, PAD concluded that the withdrawn funds were paid to L.W. when, on the face of the withdrawal request, the money was not being sent to L.W. PAD did nothing further to investigate these alerts.

In addition, the Firm had a quarterly audit program that, among other things, required a supervisor to spot check closed alerts and verify the adequacy of the initial review. Beginning in early 2011, and continuing into 2012, a Firm supervisor reviewed six alerts triggered by Wetzel's fraudulent wire requests as part of the audits. In five of the six cases, the supervisor noted that PAD associated persons had closed the alerts by concluding erroneously that the funds were being sent to L.W. PAD further investigated the wire activity in July 2012 and again concluded that the wire activity appeared to be legitimate. In doing so, PAD unreasonably relied on a single e-mail from Wetzel, sent when he began stealing money from L.W., claiming L.W. was transferring funds to L.W.'s daughter.

In addition, in March 2011, approximately seven months after Wetzel began stealing funds from L.W.'s VA account, a PAD associated person noticed that repeated payments were being made from L.W.'s VA account to the same third-party payee. The associated person escalated the issue to the Firm's designated fraud specialist. By this time, the Firm had processed 27 fraudulent wire requests from Wetzel. In reviewing the withdrawals from L.W.'s VA account, the fraud specialist concluded that the withdrawals appeared legitimate, without sufficiently investigating or determining the relationship between L.W. and the person receiving funds from L.W.'s account.

As a result of the foregoing, PAD violated NASD Rule 3010(a) and FINRA Rule 2010.

C. PAD's Inadequate WSPs and Supervisory Controls For Third-Party Disbursements

During the Relevant Period, PAD failed to establish and maintain reasonable supervisory procedures and controls to supervise third-party distributions and prevent fraudulent withdrawals from VA accounts. In particular, PAD did not have sufficient WSPs or supervisory controls to identify or review repeated transmittals of funds from a customer's account to the same third-party payee. As a result, PAD did not detect Wetzel's pattern of misconduct which involved sending multiple wires of customer funds to a third-party payee.

PAD also failed to establish and maintain sufficient WSPs and supervisory controls to verify signatures for third-party distributions. PAD's WSPs required signature comparison of wire transfers when the funds in a single request exceeded $25,000. The Firm failed to require signature verification based on a pattern of wire activity and whether multiple transmittals triggered the $25,000 threshold. All but five of Wetzel's withdrawals were for less than $25,000 and of the five that exceeded $25,000, the Firm did nothing more than compare the signature on the wire request to L.W.'s signature on file.

As a result of the foregoing, PAD violated NASD Rules 3010 and 3012(a)(2)(B)(i), and FINRA Rule 2010.

B. PAD also consents to the imposition of the following sanctions:

1. A censure;

2. A fine in the amount of $950,000.

PAD agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. PAD has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

PAD specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

PAD specifically and voluntarily waive the following rights granted under FINRA's Code of Procedure:

A. To have a Complaint issued specifying the allegations against it;

B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and

then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, PAD specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

PAD further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

PAD understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against it; and

C. If accepted:

1. this AWC will become part of PAD's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;

2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. PAD may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. PAD may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is

inconsistent with any part of this AWC. Nothing in this provision affects PAD's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. PAD may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. PAD understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that PAD has agreed to its provisions voluntarily; and that no offer, threat, inducement or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce PAD to submit it.

07/11/2016
Date (mm/dd/yyyy)

Prudential Annuities Distributors, Inc.
Respondent

By Rodney Allain

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Accepted by FINRA:

7/18/16
Date

Signed on behalf of the
Director of ODA, by delegated authority

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Accepted by FINRA:

Date

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BSA Timeline **(/resources/statutes-and-regulations/bank-secrecy-act/bsa-timeline)**

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CDD Final Rule (/resources/statutes-and-regulations/cdd-final-rule)

Suspicious Activity Report (SAR) Advisory Key Terms (/resources/suspicious-activity-report-sar-advisory-key-terms)

Reports (/resources/financial-trend-analyses)

BSA Timeline



1970	Large currency deposits of illicit profits	*Bank Secrecy Act (BSA) enacted*
1974	Constitutionality of Bank Secrecy Act questioned	*U.S. Supreme Court holds BSA to be constitutional*
1986	Law Enforcement looks for new weapons to combat drug trafficking	*Enact Money Laundering Control Act*
1990	Insufficient intelligence analysis and resources to support financial investigations	*Create Financial Crimes Enforcement Network (FinCEN)*
1992	Law enforcement needs more information on suspicious transactions to support financial investigations	*Enact Annunzio-Wylie Money Laundering Suppression Act -Suspicious activity reporting required*
1994	Law enforcement focuses on criminal abuse of MSBs CTR exemption process is a burden for financial community	*Enact Money Laundering Suppression Act - MSB registration CTR filing required*
1994	Improve cooperation and coordination between regulatory,financial and law enforcement communities	*Merge Treasury's Office of Financial Enforcement with FinCEN - FinCEN's Mission expanded to include regulatory authority*

Timeline

1970 - Present

1998	Improve coordination of federal, state and local efforts and resources to combat financial crimes	*Enact Money Laundering & Financial Crimes Strategy Act* *- National Money Laundering strategy established* *- HIFCA system created*
2000	Law enforcement needs more information on money transmitters, and issuers, sellers and redeemers of money	*MSBs required to file suspicious Activity Reports (SARs)*
2001	Terrorists attack the World Trade Center & Pentagon; President announces (http://georgewbush-whitehouse.archives.gov/news/releases/2001/11/20011107-4.html) Financial War on Terror at FinCEN	*Enact PATRIOT Act* *- Information Sharing* *- Registration requirements for underground money transmitters*
2002	Institutions are front line against money laundering and terrorist financing	*Most financial institutions receive a new or amended AML Program requirement*
2002	Law enforcement needs more information on casinos	*Casinos required to file SARs*
2002	Importance of information sharing recognized	*Sharing between institutions is protected, and between institutions and government is required*
2002	Foreign shell banks recognized as threat	*Termination of accounts for shell banks and certification by foreign correspondents required*
2002	Financial institutions seek to expedite reporting process, reduce costs in complying with BSA requirements	*PATRIOT Act Communications System (PACS) launched* *- Financial institutions can file BSA reports electronically*
2002	PATRIOT Act expands regulatory definition of "financial institution"	*Brokers and dealers in securities must file SARs*
2003	Need to protect more MSBs from financial crimes	*Currency Dealers and Exchangers required to file SARs*

Timeline

1970 - Present

2003	Identification requirement strengthened	*Customer Identification Programs required for most financial institutions*
2003	Need to protect casinos from money launderers	*Casinos and card clubs required to file SARs - includes those operated on tribal lands*
2003	FinCEN expands regulatory definition of "financial institution"	*Futures commission merchants, introducing brokers in commodities required to report suspicious transactions*
2004	U.S. financial system needs additional protection from risks of financial crime posed by foreign agents	*MSBs receive guidance for dealing with foreign agents and foreign counterparts*
2005	Certain account services need greater scrutiny	*Due diligence requirements for private banking and foreign correspondent*
2005	Improve management of BSA data, from filing and storage to retrieval and analysis	*PACS renamed as BSA E-Filing - 25% of BSA filings and 40% of SARs are e-filed as of March 2005*
2005	Improve collaboration and information sharing between federal and state agencies	*FinCEN, 29 states sign Memoranda of Under- standing (MOU) -established information sharing agreements*
2005	Jewelry industry needs protection against financial crime	*Jewelers, dealers in precious metals and stones required to establish anti-money laundering (AML) programs*
2005	Increased international effort to combat money laundering, terrorist financing	*Egmont Group of financial intelligence units exceeds 100-member mark*

Timeline

1970 - Present

2005	Need to ensure consistent application of BSA to all banking organizations	*Federal banking agencies release BSA/AML Examination Manual*
2005	Need to protect insurance industry from financial crimes	*Certain insurance companies required to establish AML programs, file SARs*
2006	Need to protect mutual funds from financial crimes	*Mutual funds required to file SARs*
2007	Certain account services need greater scrutiny	*Enhanced due diligence is required for certain foreign correspondent banks*
2009	Need to simplify requirements for depository institutions to exempt their eligible customers from currency transaction reporting	*Final Rule on CTR Exemptions takes effect (Jan. 5, 2009)*
2011	Need to enhance efficiency and effectiveness	*Transfer of FinCEN's regulations to 31 CFR Chapter X*
2011	MSB rules amended to establish a more comprehensive regulatory approach for prepaid access	*FinCEN issues prepaid access Final Rule (Effective Date: September 27, 2011; Compliance Date: January 29, 2012)*
2012	Need to combat fraud in the non-bank residential mortgage sector	*Final Rule defines non-bank residential mortgage lenders and originators (RMLOs) as loan or finance companies. RMLOs required to establish AML programs and file SARs (Effective Date: April 16, 2012; Compliance Date: August 13, 2012)*
2014	Law enforcement and regulators need more complete and timely information on suspected mortgage fraud and money laundering	*Housing GSEs required to develop AML programs and file SARs (Effective Date: April 28, 2014; Compliance Date: August 25, 2014)*

Timeline

1970 - Present

2016	Need to clarify and strengthen customer due diligence requirements for banks; brokers or dealers in securities; mutual funds; and futures commission merchants and introducing brokers in commodities	*Final Rule contains explicit customer due diligence requirements and includes a new requirement to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exclusions and exemptions (Effective Date: July 11, 2016; Compliance Date: May 11, 2018)*

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FinCEN ADVISORY

FIN-2022-A002 **June 15, 2022**

Advisory on Elder Financial Exploitation

Amid rampant fraud and abuse targeting older adults, FinCEN urges financial institutions to detect, prevent, and report suspicious financial transactions.

Elder financial exploitation (EFE) is defined as the illegal or improper use of an older adult's funds, property, or assets.[1]

SAR Filing Request:
FinCEN requests that financial institutions reference the advisory by including "**EFE FIN-2022-A002**" in SAR field 2 ("Filing Institution Note to FinCEN"), and mark the check box for elder financial exploitation.

Introduction

The Financial Crimes Enforcement Network (FinCEN) is issuing this advisory to alert financial institutions to the rising trend of EFE targeting older adults[2] and to highlight new EFE typologies and red flags since FinCEN issued the first EFE Advisory in 2011.[3] FinCEN is also issuing this advisory in support of World Elder Abuse Awareness Day, which has been commemorated on June 15 every year since 2006 and provides an opportunity for communities around the world to promote a better understanding of abuse and neglect of older adults by raising awareness of the related cultural, social, economic, and demographic factors.[4]

According to the U.S. Department of Justice, elder abuse, which includes EFE among other forms of abuse, affects at least 10 percent of older adults each year in the United States,[5] with millions of older adults losing more than $3 billion to financial fraud annually as of 2019.[6] Despite the

1. EFE is one type of elder abuse, which includes physical, emotional, and financial abuse. Elder abuse and EFE definitions vary statutorily by state. For more information on the definition of EFE, *see* Consumer Financial Protection Bureau (CFPB) and FinCEN, "Memorandum on Financial Institution and Law Enforcement Efforts to Combat Elder Financial Exploitation," (Memorandum on EFE) (August 30, 2017); *see also*, U.S. Department of Justice (DOJ) webpage, Elder Abuse and Elder Financial Exploitation Statutes.
2. For purposes of this advisory and consistent with other U.S. government agencies' use of the term, an older adult is considered an individual 60 years of age or older. *See* Federal Trade Commission (FTC) Report, "Protecting Older Consumers, 2020-2021," (Older Consumers Report) (October 18, 2021), at p. 1.
3. *See* FinCEN, "Advisory to Financial Institutions on Filing Suspicious Activity Reports Regarding Elder Financial Exploitation," (2011 Advisory) (February 22, 2011).
4. For more information about World Elder Abuse Awareness Day, *see* Administration for Community Living (ACL), World Elder Abuse Awareness Day.
5. For more information on EFE, *see* DOJ, About Elder Abuse.
6. *See* Internet Crime Complaint Center (IC3), "Perpetrators Use Various Methods to Deceive and Defraud Elderly Victims For Financial Gain," (September 19, 2019). Fraud (of all types) is the largest proceeds-generating offense in the United States and is one of the FinCEN June 2021 anti-money-laundering/counter-financing-of-terrorism (AML/CFT) National Priorities.

fact that EFE is the most common form of elder abuse, the majority of incidents go unidentified and unreported as victims may choose not to come forward out of fear, embarrassment, or lack of resources.[7] Older adults are targets for financial exploitation due to their income and accumulated life-long savings, in addition to the possibility that they may face declining cognitive or physical abilities, isolation from family and friends, lack of familiarity or comfort with technology, and reliance on others for their physical well-being, financial management, and social interaction.[8] The COVID-19 pandemic exacerbated these vulnerabilities for many older adults.[9] In 2020, over 62,000 suspicious activity reports (SARs) related to EFE were filed, totaling what the Consumer Financial Protection Bureau (CFPB) estimates to be $3.4 billion in suspicious transactions, an increase from $2.6 billion in 2019. This is the largest year-to-year increase since 2013.[10] This trend has continued with over 72,000 SARs related to EFE filed in 2021 and, according to the Federal Trade Commission (FTC), older adults now account for 35 percent of the victims associated with filed fraud reports in cases when a consumer provided an age.[11]

The U.S. government has multiple initiatives in place to counter perpetrators and facilitators of EFE.[12] In support of this whole-of-government approach, FinCEN collaborates with law enforcement, regulatory agencies, and financial institutions to ensure that SARs appropriately identify and report suspicious activity potentially indicative of EFE. Financial institutions are uniquely situated to detect possible financial exploitation through their relationships with older customers. They therefore play a critical role in helping to identify, prevent, and report EFE to law enforcement and their state-based Adult Protective Services,[13] and any other appropriate first

7. *See* CFPB and FinCEN, Memorandum on EFE, *supra* Note 1. *See also,* FTC Older Consumers Report, *supra* Note 2.
8. *See* CFPB and FinCEN, Memorandum on EFE, *supra* Note 1.
9. *See* DOJ Office of Public Affairs (OPA), "Associate Attorney General Vanita Gupta Delivers Remarks at the Elder Justice Coordinating Council Meeting," (December 7, 2021); *see also,* DOJ OPA, "Statement of Attorney General Merrick B. Garland on World Elder Abuse Awareness Day," (June 15, 2021); and "Associate Deputy Attorney General Paul R. Perkins Delivers Remarks at the ABA/ABA Financial Crimes Enforcement Conference," (December 9, 2020).
10. *See* CFPB, "Suspicious Activity Reports on Elder Financial Exploitation."
11. *See* FinCEN, SAR Stats; and FTC, "Consumer Sentinel Network: Data Book 2021," (February 2022), at p. 13.
12. *See* DOJ's Elder Justice Initiative, Transnational Elder Fraud Strike Force, and Money Mule Initiative. For U.S. government efforts to address romance scams, *see* Dating or Defrauding: A National Awareness Campaign. Additionally, passed in 2010, the Elder Justice Act was the first comprehensive legislation to address the abuse, neglect, and exploitation of older adults at the federal level. The law authorized a variety of programs and initiatives to better coordinate federal responses to elder abuse, promote elder justice research and innovation, support Adult Protective Services systems, and provide additional protections for residents of long-term care facilities. Further, the Elder Justice Act established the Elder Justice Coordinating Committee to coordinate activities related to elder abuse, neglect, and exploitation across the federal government. For more information about the Elder Justice Act and the associated Committee, visit the Administration for Community Living, Elder Justice Act. *See also,* the National Center on Elder Abuse (NCEA).
13. According to the National Adult Protective Services Association (NAPSA), "Adult Protective Services (APS) programs promote the safety, independence, and quality-of-life for vulnerable adults who are, or are in danger of, being abused, neglected by self or others, or financially exploited, and who are unable to protect themselves. APS is a social service program authorized by law in every state to receive and investigate reports of elder or vulnerable adult maltreatment and to intervene to protect the victims to the extent possible." *See* NCEA, NAPSA, and Keck School of Medicine of USC, "Fact Sheet: Adult Protective Services, What You Must Know;" and NCEA, Adult Protective Services; and How APS Works.

responder as well as assisting older customers who fall victim to financial exploitation.[14] The information contained in this advisory is derived from FinCEN's analysis of Bank Secrecy Act (BSA) data, open source reporting, and law enforcement partners.

Trends and Typologies of EFE and Associated Payments

EFE schemes generally involve either theft or scams.[15] Perpetrators of elder theft are often known and trusted persons of older adults, while scams, which can disproportionally affect older adults, frequently involve fraudsters, often located outside of the United States, with no known relationship to their victims.[16] Regardless of the relationship, these criminals can place older adults in financially, emotionally, and physically compromising situations, and the resulting loss of income and life-long earnings can be devastating to the financial security, dignity, and quality of life of the victims.[17]

Elder Theft

Schemes involving the theft of an older adult's assets, funds, or income by a trusted person.

Elder Scams

Scams involving the transfer of money to a stranger or imposter for a promised benefit or good that the older adult did not receive.

Unfortunately, perpetrators of EFE schemes often do not stop after first exploiting their victims. In both elder theft and scams, older adults are often re-victimized and subject to potentially further financial loss, isolation, and emotional or physical abuse long after the initial exploitation due to the significant illicit gains at stake.[18] Scammers may also sell victims' personally identifiable information (PII) on the black market to other criminals who continue to target the victims using new and emerging scam typologies.[19]

Elder Theft

Perpetrators of elder theft are often family members and non-family caregivers who abuse their relationship and position of trust. As identified by FinCEN in 2019 in its analysis of a statistically

14. Reporting EFE to APS, law enforcement, or other authorities is an opportunity to strengthen prevention and response. *See* CFPB, "Reporting of Suspected Elder Financial Exploitation by Financial Institutions," (July 17, 2019); "Suspicious Activity Reports on Elder Financial Exploitation: Issues and Trends," (February 2019); CFPB and FinCEN, Memorandum on EFE, *supra* Note 1; and Federal Reserve, CFTC, CFPB, FDIC, FTC, NCUA, OCC, and SEC, "Interagency Guidance on Privacy Laws and Reporting Financial Abuse of Older Adults," (September 24, 2013).
15. *See* FinCEN Financial Trend Analysis (FTA), "Elders Face Increased Financial Threat from Domestic and Foreign Actors," (December 2019), at p. 4.
16. *Id.*
17. *See* CFPB and FinCEN, Memorandum on EFE, *supra* Note 1.
18. For additional information on re-victimization in EFE schemes, *see* FINRA Investor Education Foundation (FINRA Foundation), American Association of Retired Persons (AARP), and Heart+Mind Strategies, "Addressing the Challenge of Chronic Fraud Victimization," (March 2021).
19. *See* DOJ, "List Brokerage Firm Pleads Guilty to Facilitating Elder Fraud Schemes," (September 28, 2020).

significant, random sampling of SAR narratives, a family member was involved in the theft of assets from older adults in 46 percent of elder theft cases reported between 2013 and 2019.[20] Trusted persons who commit elder theft can also include familiar associates and acquaintances such as neighbors, friends, financial services providers, other business associates, or those in routine close proximity to the victims.

Instances of elder theft often follow a similar methodology in which trusted persons may use deception, intimidation, and coercion against older adults in order to access, control, and misuse their finances. Criminals frequently exploit victims' reliance on support and services and will take advantage of any cognitive and physical disabilities,[21] or environmental factors such as social isolation, to establish control over the victims' accounts, assets, or identity.[22] This can take many forms, including the exploitation of legal guardianships[23] and power of attorney arrangements,[24] or the use of fraudulent investments such as Ponzi schemes[25] to defraud older adults of their income and retirement savings. These relationships enable trusted persons to repeatedly abuse the victims by liquidating savings and retirement accounts, stealing Social Security benefit checks and other income, transferring property and other assets, or maxing out credit cards in the name of the victims until most of their assets are stolen.[26]

Case Study on Elder Theft

Housekeeper and Co-Conspirators Exploit Dementia-afflicted Older Adult

A woman in Charlotte, North Carolina was convicted and sentenced to 97 months in prison and two years of supervised release for conspiracy to commit wire fraud and money laundering conspiracy. Donna Graves, who was the ringleader of the criminal conspiracy, conspired to engage in a scheme to defraud a victim identified in court documents as "K.T." The victim was an elderly widow who lived alone and suffered from dementia and other physical and mental challenges. During the relevant time period, Graves and her co-conspirators (Gerald Maxwell Harrison and Elizabeth Robin Williams) exploited K.T.'s vulnerabilities and defrauded the victim through a web of forged documents, lies, and deceptions. According to evidence presented at Graves' trial, beginning in 2014, Graves and Williams provided housekeeping services for the victim through a business owned and operated by Graves. Over the course of the scheme, the co-conspirators isolated the victim from her friends and family, induced

20. *See* FinCEN FTA, *supra* Note 15, at p. 7.
21. *Id.*
22. *See* DOJ, "Associate Deputy Attorney General Paul R. Perkins Delivers Remarks at the ABA/ABA Financial Crimes Enforcement Conference," (December 9, 2020).
23. *See* DOJ, "Court-Appointed Pennsylvania Guardian and Virginia Co-Conspirators Indicted for Stealing Over $1 Million from Elderly Wards," (June 30, 2021).
24. *See* DOJ, "Franklin, Tennessee Couple Charged With Defrauding Elderly Widow of $1.7 Million," (May 12, 2021); and "Former Waterloo Medicaid Provider Sentenced to More than Five Years in Federal Prison for Defrauding Elderly Victim," (June 28, 2021).
25. *See* DOJ, "Arizona Man Sentenced for Multimillion-Dollar Nationwide Investment Fraud Scheme," (March 15, 2021).
26. *See generally*, DOJ, "Annual Report to Congress on Department of Justice Activities to Combat Elder Fraud and Abuse," (October 18, 2021).

the victim to give them power and control over her personal affairs, and fabricated a power of attorney purporting to give Graves and Williams control over the victim's financial affairs. Once they gained access and control, Graves, Williams, and Harrison moved the victim out of her residence in Indian Land, South Carolina, first to an apartment in Charlotte, and later to a rental home in Mint Hill, refusing to let the victim's friends and family know where she was living. Over the course of the scheme, Graves and her co-conspirators failed to provide the victim with proper medical care, which greatly diminished the victim's health. Furthermore, once the victim's money was depleted, the co-conspirators abandoned the victim, who was later moved to a nursing home in New York, where she passed away in large part due to the mental and physical deterioration she had suffered in the hands of Graves and her co-conspirators.[27]

Elder Scams

In elder scams, criminals defraud victims into sending payments and disclosing PII under false pretenses or for a promised benefit or good the victims will never receive. These scammers are often located outside of the United States and have no known previous relationship to the victims.[28] Elder scams often follow a similar methodology in which scammers contact older adults under a fictitious persona via phone call, robocall, text message, email, mail, in-person communication, online dating apps and websites, or social media platforms. In order to appear legitimate and establish trust with older adults, scammers commonly impersonate government officials, law enforcement agencies, technical and customer support representatives, social media connections, or family, friends, and other trusted persons. Perpetrators often create high-pressure situations by appealing to their victims' emotions and taking advantage of their trust or by instilling fear to solicit payments and PII.[29] Scammers often request victims to make payments through wire transfers at money services businesses (MSBs), but are increasingly requesting payments via prepaid access cards, gift cards, money orders, tracked delivery of cash and high-valued personal items through the U.S. Postal Service, ATM deposits, cash pick-up at the victims' houses, and convertible virtual currency (CVC).[30]

Further, elder scams are sometimes facilitated through money mules[31] who transfer or move illicit funds at the direction of the scammers. A victim of an elder scam can also serve as a money mule: the scammer convinces the victim to set up a bank account or limited liability corporation (LLC)

27. *See* DOJ, "Charlotte Woman And Her Co-Conspirator Are Sentenced To Prison For Stealing $300,000 From An Elderly, Dementia-Afflicted Victim," (May 5, 2021).
28. Nigeria, Jamaica, Ghana, India, the Philippines, and the People's Republic of China are the top foreign-located subject countries in MSB SAR Filings. *See* FinCEN FTA, *supra* Note 15, at p. 9.
29. *See generally*, FTC, Imposter Scams.
30. *See* IC3, "2021 Elder Fraud Report," (March 2022); "Scammers Defraud Victims of Millions of Dollars in New Trend in Romance Scams," (September 16, 2021); "FBI Warns of a Grandparent Fraud Scheme Using Couriers," (July 29, 2021); FTC, "New Twist to Grandparent Scam: Mail Cash," (December 3, 2018); and DOJ, "U.S. Attorney Dena J. King Announces The Successful Forfeiture And Return Of Stolen Cryptocurrency To Elderly Man Victimized By Government Imposter Scam," (March 15, 2022).
31. A money mule is a person (whether witting or unwitting) who transfers or moves illicit funds at the direction of or on behalf of another. *See* IC3, "Money Mules: A Financial Crisis," (December 3, 2021); and Federal Bureau of Investigation (FBI), Money Mules.

in the victim's own name to receive, withdraw, deposit, or transfer multiple third-party payments from other victimized older adults to accounts controlled by the scammer under the illusion of a "business opportunity." In some circumstances, victims of EFE acting as money mules may be prosecuted for this illegal activity and are liable for repaying the victims. They may also be subject to damaged credit and further victimized through their stolen PII.[32]

Common Elder Scam Typologies

- ***Government imposter scams:*** Scammers frequently target older adults by impersonating officials from U.S. government agencies that are often well-known or provide services to older adults, such as the Social Security Administration (SSA),[33] the Department of Health and Human Services/Centers for Medicare and Medicaid Services (HHS/CMS),[34] and the Internal Revenue Service (IRS),[35] among others.[36] The scammers may threaten the individuals with arrest or seizure of their bank accounts for crimes they supposedly committed, such as tax evasion. Scammers may also claim that victims' Social Security numbers are suspended due to suspicious activity and demand PII and payment to resolve the supposed matter with the government.[37]

- ***Romance scams:*** These scams (also referred to as "online dating," "confidence," or "sweetheart" scams) grew to a record level in 2021 with $547 million in reported losses.[38] Romance scams involve fraudsters creating a fictitious profile on an online dating app or website to establish a close or romantic relationship with older adults to exploit their confidence and trust.[39] Online scammers may offer to meet in person (though they almost never do) and ask victims to send money for travel expenses, a sudden "hardship" they experience such as medical costs or legal fees, or a supposed investment or business deal. The scammers often solicit payments over an extended period of time and victims may also send PII as the perpetrators gain the trust of the victims. In some cases, romance scam victims are convinced to open bank accounts and LLCs to receive and send funds as money mules so the scammers can launder their ill-gotten gains from third-party scams.[40]

32. *See* IC3, "Money Mules: A Financial Crisis," (December 3, 2021); "Cyber Actors Use Online Dating Sites To Conduct Confidence/Romance Fraud And Recruit Money Mules," (August 5, 2019); and FBI, Money Mules.
33. *See* FTC, "Growing Wave of Social Security Imposters Overtakes IRS Scam," (April 12, 2019); and Social Security Administration (SSA), Protect Yourself From Social Security Scams.
34. *See* FTC, "Protect Yourself Against Medicare Scams," (March 15, 2019).
35. *See* Internal Revenue Service (IRS), "IRS Reminds Seniors to Remain on Alert to Phone Scams during Tax Season," (March 23, 2017).
36. *See* FTC, "Government Imposter Scams Top the List of Reported Frauds," (July 1, 2019).
37. *See* FTC, "How To Avoid a Government Impersonator Scam," (May 2021); and IC3, "FBI Warns of the Impersonation of Law Enforcement and Government Officials," (March 7, 2022).
38. *See* FTC, "Reports of romance scams hit record highs in 2021," (February 10, 2022).
39. Romance scams can also be perpetrated by scammers who the older adult first meets in-person. These scammers can use romantic overtones to unduly influence an older adult and gain their trust and loyalty before perpetrating the scam.
40. *See* FBI, Romance Scams; and IC3, "Cyber Actors Use Online Dating Sites To Conduct Confidence/Romance Fraud And Recruit Money Mules," (August 5, 2019).

- ***Emergency/person-in-need scams:*** These schemes (also known as "grandparent scams") involve scammers contacting older adults and impersonating a grandchild, another relative, an attorney, emergency medical personnel, or a law enforcement official to deceive victims into believing that a loved one is in an emergency situation (e.g., a car accident, medical emergency, under arrest, or stranded in a foreign country) and needs money sent immediately to resolve the situation.[41]

- ***Lottery and sweepstakes scams:*** These scams are a type of advance-fee scheme in which scammers, typically located in jurisdictions outside of the United States, impersonate lottery or sweepstakes representatives, and lawyers claiming that the victims have won a lottery, prize, or sweepstakes. Scammers may target older adults regardless of whether the victims have previously played the lottery or entered in a sweepstakes. The scammers instruct the victims to pay for supposed shipping, taxes, or other fees in order to claim their prize or lottery winnings. Victims never receive their prize or lottery winnings and are often re-victimized with additional requests for payments throughout the scheme until they run out of money.[42]

- ***Tech and customer support scams:*** These scammers impersonate well-known companies as tech and customer support representatives to falsely claim that a virus or other malware has compromised the victims' computers. Scammers may request remote access to diagnose the alleged problem and will typically attempt to solicit payment for fraudulent software products and tech support services. They also often exploit the remote access to install malware and steal PII and credit card numbers to further defraud the victims.[43] After victims make payments, perpetrators often call back and offer refunds to the victims, claiming their tech and customer support services are no longer available. Perpetrators then will claim to send refund money to the victims' bank accounts but falsely claim that too much money was refunded. The scammers then induce victims to send payments purportedly to reimburse the tech and customer support company for its "over-refund." Victims can lose hundreds or thousands of dollars to such refund schemes. A recent evolution of the refund scheme involves perpetrators claiming to be online retailers and purporting to offer a refund for unauthorized transactions on the victims' accounts.[44]

41. *See* FTC, "Scammers Use Fake Emergencies to Steal Your Money," (May 2021).
42. *See* FTC, "Fake Prize, Sweepstakes, and Lottery Scams," (May 2021); and DOJ, Senior Scam Alert.
43. *See* CFPB, "What you should know about tech support scams," (January 12, 2021); FTC, "How to Spot, Avoid, and Report Tech Support Scams," (February 2019); "Older Adults Hardest Hit By Tech Support Scams," (March 7, 2019); and IC3, "Technical and Customer Support Fraud," (March 16, 2022).
44. *See* DOJ, Transnational Elder Fraud Strike Force; and FTC, "Amazon tops list of impersonated businesses," (October 20, 2021).

Case Study of Elder Scams

India-based Government Imposter Scam

An Indian national was sentenced to 22 years in prison for conspiracy and identity theft in connection with his operation of an overseas robocall scam that defrauded thousands of victims out of more than $10 million. The victims, many of whom are elderly, continue to endure significant financial hardship from the defendant's vast fraud enterprise. According to court documents, Shehzadkhan Pathan, 40, operated a call center in Ahmedabad, India, from which automated robocalls were made to victims in the United States. After establishing contact with victims through these automated calls, Pathan and other "closers" at his call center would coerce, cajole, and trick victims into sending bulk cash through physical shipments and electronic money transfers. Pathan and his conspirators used a variety of schemes to convince victims to send money, including impersonating law enforcement officers from the Federal Bureau of Investigation and Drug Enforcement Administration and representatives of other government agencies, such as the Social Security Administration, to threaten victims with severe legal and financial consequences. Conspirators also convinced victims to send money as initial installments for falsely promised loans. Pathan is the fourth of six defendants in this case to be sentenced for their role in the conspiracy.[45]

Behavioral and Financial Red Flags of EFE and Associated Payments

FinCEN has identified behavioral and financial red flags to help financial institutions detect, prevent, and report suspicious activity connected to EFE. These red flags build off of the red flags in FinCEN's 2011 Advisory, all of which remain relevant, and do not reflect all behavioral and financial red flags of EFE.[46] As no single red flag is determinative of illicit or suspicious activity, financial institutions should consider the surrounding facts and circumstances, such as a customer's historical financial activity, whether the transactions are in line with prevailing business practices, and whether the customer exhibits multiple red flags, before determining if a behavior or transaction is suspicious or otherwise indicative of EFE. In line with their risk-based approach to compliance with the BSA, financial institutions are also encouraged to perform additional due diligence where appropriate. Financial institutions should remain alert to any suspicious activity indicating that their customers are perpetrators, facilitators, or victims of EFE.

45. *See* DOJ, "Leader of International Robocall Scam Sentenced for Defrauding Over 4,000 U.S. Victims Out of More Than $10 Million," (September 16, 2021).
46. *See* 2011 Advisory, *supra* Note 3. For more information on red flags of EFE, *see* DOJ, Red Flags of Elder Abuse; and CFPB, "Recommendations and Report for Financial Institutions on Preventing and Responding to Elder Financial Exploitation," (March, 23, 2016).

Behavioral Red Flags

Victims of EFE may have limited and irregular contact with others. For some, their only outside contact may involve visiting or communicating with their local financial institution, including at the bank branch, check-cashing counter, or MSB. Therefore, it is critical for customer-facing staff to identify and consider the behavioral red flags when conducting transactions involving their older customers, particularly suspicious behavior that also involves the financial red flags highlighted below. Such information should be incorporated into SAR filings and reported to law enforcement as appropriate. Financial institutions are reminded that behavioral red flags of EFE and the names of staff who witnessed them should be included in the SAR narrative to assist future law enforcement investigations. Behavioral red flags of EFE may include:

1. An older customer's account shows sudden and unusual changes in contact information or new connections to emails, phone numbers, or accounts that may originate overseas.
2. An older customer with known physical, emotional, and cognitive impairment has unexplainable or unusual account activity.
3. An older customer appears distressed, submissive, fearful, anxious to follow others' directions related to their financial accounts, or unable to answer basic questions about account activity.
4. An older customer mentions how an online friend or romantic partner is asking them to receive and forward money to one or more individuals on their behalf or open a bank account for a "business opportunity."
5. During a transaction, an older customer appears to be taking direction from someone with whom they are speaking on a cell phone, and the older customer seems nervous, leery, or unwilling to hang up.
6. An older customer is agitated or frenzied about the need to send money immediately in the face of a purported emergency of a loved one, but the money would be sent to the account of a seemingly unconnected third-party business or individual.
7. A caregiver or other individual shows excessive interest in the older customer's finances or assets, does not allow the older customer to speak for himself or herself, or is reluctant to leave the older customer's side during conversations.
8. An older customer shows an unusual degree of fear or submissiveness toward a caregiver, or expresses a fear of eviction or nursing home placement if money is not given to a caretaker.
9. The financial institution is unable to speak directly with the older customer, despite repeated attempts to contact him or her.
10. A new caretaker, relative, or friend suddenly begins conducting financial transactions on behalf of an older customer without proper documentation.

11. An older customer's financial management changes suddenly, such as through a change of power of attorney, trust, or estate planning vehicles, to a different family member or a new individual, particularly if such changes appear to be done under undue influence, coercion, or forgery or the customer has diminished cognitive abilities and is unable to agree to or understand the consequences of the new arrangement.
12. An older customer lacks knowledge about his or her financial status, or shows a sudden reluctance to discuss financial matters.

Financial Red Flags

Identification of financial red flags of EFE and the associated payments are critical to detecting, preventing, and reporting suspicious activity potentially indicative of EFE. In addition to the financial red flags set out in DOJ and CFPB notices,[47] financial red flags of EFE may include:

13. Dormant accounts with large balances begin to show constant withdrawals.
14. An older customer purchases large numbers of gift cards or prepaid access cards.
15. An older customer suddenly begins discussing and buying CVC.
16. An older customer sends multiple checks or wire transfers with descriptors in the memo line such as "tech support services," "winnings," or "taxes."
17. Uncharacteristic, sudden, abnormally frequent, or significant withdrawals of cash or transfers of assets from an older customer's account.
18. An older customer receives and transfers money interstate or abroad to recipients with whom they have no in-person relationship, and the explanation seems suspicious or indicative of a scam or money mule scheme.
19. Frequent large withdrawals, including daily maximum currency withdrawals from an ATM.
20. Sudden or frequent non-sufficient fund activity.
21. Uncharacteristic nonpayment for services, which may indicate a loss of funds or of access to funds.
22. Debit transactions that are inconsistent for the older customer.
23. Uncharacteristic attempts to wire large sums of money.
24. Closing of CDs or accounts without regard to penalties.

47. *Id.*

Reminder of Relevant BSA Obligations and Tools for U.S. Financial Institutions

Suspicious Activity Reporting
Other Relevant BSA Reporting
USA PATRIOT ACT Section 314(b) Information Sharing Authority
Additional Reporting Options

Suspicious Activity Reporting

A financial institution is required to file a SAR if it knows, suspects, or has reason to suspect a transaction conducted or attempted by, at, or through the financial institution involves funds derived from illegal activity, or attempts to disguise funds derived from illegal activity; is designed to evade regulations promulgated under the BSA; lacks a business or apparent lawful purpose; or involves the use of the financial institution to facilitate criminal activity, including EFE.[48] All statutorily defined financial institutions may voluntarily report suspicious transactions under the existing suspicious activity reporting safe harbor.[49]

When a financial institution files a SAR, it is required to maintain a copy of the SAR and the original or business record equivalent of any supporting documentation for a period of five years from the date of filing the SAR.[50] Financial institutions must provide any requested SAR and all documentation supporting the filing of a SAR upon request by FinCEN or an appropriate law enforcement or supervisory agency.[51] When requested to provide supporting documentation, financial institutions should take special care to verify that a requestor of information is, in fact, a representative of FinCEN or an appropriate law enforcement or supervisory agency. A financial institution should incorporate procedures for such verification into its BSA compliance or AML/CFT program. These procedures may include, for example, independent employment verification with the requestor's field office or face-to-face review of the requestor's credentials.

48. *See* 31 CFR §§ 1020.320, 1021.320, 1022.320, 1023.320, 1024.320, 1025.320, 1026.320, 1029.320, and 1030.320. All financial institutions with these SAR filing requirements also may file a SAR regardless of the amount involved (if any) or if the transaction is only attempted.
49. *See* 31 U.S.C. § 5318(g)(3).
50. *See* 31 CFR §§ 1020.320(d), 1021.320(d), 1022.320(c), 1023.320(d), 1024.320(c), 1025.320(d), 1026.320(d), 1029.320(d), and 1030.320(d). 31 CFR §§ 1010.330, 1010.331. A Form 8300 also may be filed voluntarily for any suspicious transaction, even if the total amount does not exceed $10,000.
51. *Id. See also*, FinCEN, "Suspicious Activity Report Supporting Documentation," (June 13, 2007).

SAR Filing Instructions

When filing a SAR, financial institutions should provide all pertinent available information about the activity in the SAR form and narrative. Reporting on how perpetrators of EFE communicate with and target older adults is also useful to law enforcement investigations. **FinCEN requests that financial institutions reference this advisory by including the key term below in SAR field 2 ("Filing Institution Note to FinCEN")** and the narrative to indicate a connection between the suspicious activity being reported and the activities highlighted in this advisory.

"EFE FIN-2022-A002"

Financial institutions that suspect EFE activity should also mark the check box for Elder Financial Exploitation (**SAR Field 38(d)**). FinCEN first added an "Elder Financial Exploitation" checkbox to the SAR Form in 2012 and encourages financial institutions to mark the box when filing an EFE-related SAR. For authorized federal, state, and local law enforcement, the checkbox makes it easier to locate and analyze BSA data related to EFE as detailed above.

Financial institutions should include any and all available information relating to the account and locations involved in the reported activity, identifying information and descriptions of any legal entities or arrangements involved and associated beneficial owners, and any information about related persons or entities involved in the activity. Financial institutions also should provide any and all available information regarding other domestic and foreign financial institutions involved in the activity; where appropriate, financial institutions should consider filing a SAR jointly on shared suspicious activity.[52]

Financial institutions wanting to expedite their report of suspicious transactions that may relate to the activity noted in this advisory may call the Financial Institutions Toll-Free Hotline at (866) 556-3974 (7 days a week, 24 hours a day).[53]

Filers are reminded, as stated in FinCEN's Electronic Filing Instructions, that the narrative section of the report is critical to understanding the nature and circumstances of the suspicious activity. The care with which the narrative is completed may determine whether the described activity and its possible criminal nature are clearly understood by investigators. Filers must provide a clear, complete, and concise description of the activity, including what was unusual or irregular that caused suspicion.[54] Filers are also encouraged to determine their obligations to report suspected EFE under state law and report suspected EFE to law enforcement and their state-based Adult Protective Services.

52. *See* 31 CFR §§ 1020.320(e)(1)(ii)(A)(2)(i), 1021.320(e)(1)(ii)(A)(2)), 1022.320(d)(1)(ii)(A)(2), 1023.320(e)(1)(ii)(A)(2)(i), 1024.320(d)(1)(ii)(A)(2), 1025.320(e)(1)(ii)(A)(2), 1026.320(e)(1)(ii)(A)(2)(i), 1029.320(d)(1)(ii)(A)(2), and 1030.320(d)(1)(ii)(A)(2).
53. The purpose of the hotline is to expedite the delivery of this information to law enforcement. Financial institutions should immediately report any imminent threat to local area law enforcement officials.
54. *See* FinCEN, "SAR Electronic Filing Instructions," (October 2012).

FinCEN notes that the tips below are best practices in regard to filing a SAR for suspected EFE and are not regulatory obligations:

- Provide a statement in the narrative documenting the age and location (county/city) of the target or victim. Provide details about the reporting entity's response, e.g., whether accounts were closed, whether the person was warned that transactions appear to involve fraud, if the person was not permitted to conduct new transactions, etc.
- Provide details about the amounts involved and whether any amounts were refunded to the older customer (as of the submission date of the SAR).
- Reference supporting documentation, including any photos or video footage, in the narrative.
- Cross-report the circumstances leading to the filing of EFE SARs directly to local law enforcement if there is any indication that a) a crime may have been committed and/or b) the older adult may still be at risk for victimization by the suspected abuser. Filers should note that the filing of a SAR is not a substitute for any requirement in a given state to report suspected EFE to law enforcement and Adult Protective Services.
- Take advantage of the law enforcement contact field to indicate if the suspicious activity was also reported to law enforcement or Adult Protective Services, as well as the name and phone number of the contact person.
- Provide direct liaisons or points of contact at the reporting entity related to the SAR so investigators can ask questions and request additional documentation in a timely manner.
- Expedite responses to law enforcement requests for supporting documents.[55]

Other Relevant BSA Reporting Requirements

Financial institutions and other entities or persons also may have other relevant BSA reporting requirements that provide information in connection with the subject of this advisory.[56] These include obligations related to the Currency Transaction Report (CTR),[57] Report of Cash

55. Elder financial exploitation investigations are often complex, time-consuming, and time-sensitive because older victims may be at risk of losing cognitive capacity or passing away before law enforcement has fully investigated the case. Therefore, expedited responses are critical to aiding any investigation.
56. BSA reporting refers to legal requirements that financial institutions and certain businesses and persons report certain financial transactions (such as large-dollar cash transactions), suspicious activity, or other information (such as information on a taxpayer's foreign bank and financial accounts) to FinCEN "that are highly useful in (A) criminal, tax, or regulatory investigations, risk assessments, or proceedings; or (B) intelligence or counterintelligence activities, including analysis, to protect against terrorism;" 31 U.S.C. § 5311(1).
57. A report of each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to the reporting financial institution which involves a transaction in currency of more than $10,000, in aggregate per business day. 31 CFR §§ 1010.310-313, 1020.310-313, 1021.310-313, 1022.310-313, 1023.310-313, 1024.310-313, and 1026.310-313.

Payments Over $10,000 Received in a Trade or Business (Form 8300),[58] Report of Foreign Bank and Financial Accounts (FBAR),[59] Report of International Transportation of Currency or Monetary Instruments (CMIR),[60] Registration of Money Services Business (RMSB),[61] and Designation of Exempt Person (DOEP).[62] These standard reporting requirements may not have an obvious connection to illicit finance, but may ultimately prove highly useful to law enforcement.

Form 8300 Filing Instructions

When filing a Form 8300 involving a suspicious transaction relevant to this advisory, FinCEN requests that the filer select ***Box 1b*** ("suspicious transaction") and include the key term "**EFE FIN-2022-A002**" in the "**Comments**" section of the report.

Information Sharing

Information sharing among financial institutions is critical to identifying, reporting, and preventing EFE, among other illicit activity. Financial institutions and associations of financial institutions sharing information under the safe harbor authorized by section 314(b) of the USA PATRIOT Act are reminded that they may share information with one another regarding activities they suspect may involve possible terrorist financing or money laundering.[63] FinCEN strongly encourages such voluntary information sharing.

Rapid Response Program

Through the Rapid Response Program (RRP), FinCEN helps victims and their financial institutions recover funds stolen as the result of certain cyber-enabled financial crime schemes, including cyber-enabled fraud against older adults. The RRP is a partnership between FinCEN; U.S. law enforcement (including the FBI, the U.S. Secret Service, Homeland Security Investigations, and the U.S. Postal Inspection Service); and foreign partner agencies that, like FinCEN, are the financial intelligence units (FIUs) of their respective jurisdictions. FinCEN

58. A report filed by any U.S. person engaged in a trade or business on the receipt of more than $10,000 in currency in one transaction or two or more related transactions involving the trade or business. Such transactions are required to be reported on joint FinCEN/IRS Form 8300 when not otherwise required to be reported under the CTR requirements. 31 CFR §§ 1010.330, 1010.331. A Form 8300 also may be filed voluntarily for any suspicious transaction, even if the total amount does not exceed $10,000.
59. A U.S. person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year, as specified in 31 CFR § 1010.350 and FinCEN Form 114.
60. Each person (i.e., an individual or legal entity), as defined in 31 CFR § 1010.100(mm), that transports, ships, or mails more than $10,000 of currency or other monetary instruments into or out of the United States must file a CMIR. 31 CFR § 1010.340.
61. Report for a business required to register with FinCEN as a money services business, as defined in 31 CFR § 1010.100(ff), or renewing the registration. 31 CFR § 1022.380.
62. Report for banks, as defined in 31 CFR § 1010.100(d), to exempt certain customers from currency transaction reporting in accordance with 31 CFR § 1010.311.
63. For further guidance related to the 314(b) Program, *see* FinCEN, "Section 314(b) Fact Sheet," (December 20, 2020).

uses its authority to share financial intelligence rapidly with counterpart FIUs and encourages foreign authorities to interdict the fraudulent transactions, freeze funds, and stop and recall payments using their authorities under their own respective legal and regulatory frameworks. A victim of a cyber-enabled crime, or the victim's financial institution, must file a complaint with federal law enforcement to initiate the RRP.

The RRP has been used to confront cyber threats involving over 80 foreign jurisdictions, and has the capacity to reach more than 160 foreign jurisdictions through FIU-to-FIU channels. Through these collaborative efforts, FinCEN has successfully assisted in the recovery of over $1.1 billion. For more information, please see FinCEN's Fact Sheet on the Rapid Response Program (RRP).

Other U.S. Government EFE Reporting Options

In addition to filing a SAR, financial institutions should refer their older customers who may be a victim of EFE to the DOJ's National Elder Fraud Hotline at 833-FRAUD-11 or 833-372-8311 for support, resources, and assistance with reporting suspected fraud to the appropriate government agencies. Filers should immediately report any imminent threat or physical danger to their local FBI office or local law enforcement. FinCEN encourages filers to collaborate with other stakeholders in their communities to enhance responses and engage in professional training opportunities, community education prevention, and awareness activities and initiatives.[64] Filers can find whether there is an existing collaboration on elder fraud prevention and response in their area by contacting Adult Protective Services or their local Area Agency on Aging.[65]

For Further Information

Questions regarding the contents of this advisory should be addressed to the FinCEN Resource Center at frc@fincen.gov.

The mission of the Financial Crimes Enforcement Network is to safeguard the financial system from illicit use, combat money laundering and its related crimes including terrorism, and promote national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence.

64. *See* CFPB, Elder Networks. This webpage provides additional information about collaboration in communities to prevent and respond to elder financial exploitation.
65. *See* U.S. Administration on Aging, Eldercare Locator. The website also provides a list of public services available to older adults.



Remarks by Mary L. Schapiro
Vice Chairman, NASD President, Regulatory Policy and Oversight

SIA Compliance & Legal Conference
JW Marriott Desert Ridge
Phoenix, AZ
March 22, 2004 (Final)

Good morning and thank you so much for the opportunity to join you this morning. Of all the invitations I receive, speaking before the SIA Compliance and Legal Division annual conference ranks as among the most important. It is NASD's opportunity to address the industry's compliance and legal professionals *en masse* and that is never a moment I wish to waste.

You all have, to my way of thinking, the hardest and most important jobs in the financial services industry. While we continue to struggle through very difficult times, I shudder to think of where we might be if dedicated and hardworking compliance professionals were not a part of this industry. I hope you will take my comments this morning in that light and with the understanding that I know how hard you work to do what is right.

Those of you who know me or have heard me speak before know I can be pretty straightforward and the current state of markets and investor confidence are very serious topics. So I apologize at the outset if I leave you a bit troubled when I am done. But on the bright side, the matters we will discuss today bode well for the need to keep all of you-indeed *more* of you-fully employed, and productively occupied.

I think it is fair to say that these are days of intense scrutiny for the financial services industry and that these days are here to stay. More about that in a minute. Yes, the market has been headed determinedly in the right direction, investors have continued to pour money into funds, the IPO market is showing robust signs of life-but from where I sit, most of the news is not quite so good.

I have been a regulator for virtually all of my professional life-more than 20 years. And I have been genuinely saddened, and more than a little discouraged, by the drift in professional conduct in our industry and what I see as refusal to deal systemically with the root causes of the problems, and to put forth the effort to lay the foundation necessary for re-establishing trust with the investing public.

As someone who cares deeply about this industry, and understands what it means for millions of Americans, I've been focused on what needs to happen to lay that foundation and to begin to re-earn the public's confidence.

In fact, it was another time and another scandal that actually prompted me to become a regulator in the first place.
When I was getting ready to graduate from law school, on a date that it serves no purpose to mention, the Hunt Brothers of Texas were making front-page news because of their efforts to corner the silver market. Working with others, they managed to buy about half the world's deliverable silver supply. (As the daughter of

an antiques dealer, I despair to think of all of the magnificent sterling candelabra that were melted down for sale....) But as you all know, the Hunt's ultimately failed at their market manipulation, declared personal bankruptcy and a New York jury found them guilty of conspiring to manipulate the price of silver.

It fascinated me that the Hunt's thought they could get away with this fantastic scheme, and it led me to apply for a job with the Commodity Futures Trading Commission, the federal agency that regulates commodity markets. That spring I was offered several jobs: one with the CFTC and others, paying more than twice as much, with law firms. Much to the initial dismay of my father, I joined the CFTC. And, while I could not have imagined it at the time, a life-long interest and career as a market regulator was born.

From the CFTC to the SEC, back to the CFTC and finally to NASD, I have moved between markets and organizations, but always as a regulator and occasionally in response to the kind of scandals that piqued my interest in the Hunt Brothers nearly 25 years ago.

I tell you this story not because it is particularly interesting, but because it is partly this background that leaves me so surprised and so saddened today, and so determined to bring about the changes necessary to rebuild market integrity.
This should be a good time for the industry, with markets rebounding and investors taking another look. Instead, the news continues to be dominated by new scandals and tales of individuals and firms that appear to have forgotten the investor interest altogether.

What else can one think, when just last week *The New York Times* reported allegations that three major bank/broker-dealers underwrote and sold to the public, billions of dollars of WorldCom debt at a time when their internal credit analysts had decided that WorldCom presented an untenable credit risk?

I consider myself pretty seasoned and hard to surprise and yet scenarios like this leave me shaking my head. I don't need to tell you that the financial impact of the year 2000 market break and its aftermath resulted in losses of capitalization that were depression-era in magnitude. Yet, I believe those financial blows pale in comparison to the regulatory fallout and the industry tremors from laying bare the scope of investor protection compromises by many financial services institutions.

Indeed, recent problems have been so serious and so pervasive that they have informed the thinking of the popular culture. When Martha Stewart was found guilty, one juror remarked upon the verdict being a "victory for the little guy" an apparent reference to the stock trading losses of the masses while insiders became increasingly rich. What's interesting is that no charge that reached the jury dealt with any allegation of trading violations or securities fraud. To me, the comment reflects that average investors don't think they had a fair shot and that their anger still runs deep. That is a sad state of affairs for this industry specifically and I believe it presents a general threat to one of our nation's major strengths: a vibrant capital market structure with a point of entry through the many firms we at NASD regulate.

It has become a standard practice for regulators to recite the litany of scandals of the past three years but I will spare you-I know that you know them well and appreciate the important lessons they teach us. And my greatest hope is that this learning has transformed the thinking of the industry in a lasting manner. I must however admit to a concern that, deep down, many on the business side cling to a belief that "this too shall pass," that at some point we will return to the normalcy of lessened regulatory scrutiny and demand, and that some sense of "business as usual" will be regained.

Such thinking, if it does exist, misperceives the lasting effect of recent events. A tipping point has occurred and this industry will, for the foreseeable future, face increased obligations and heightened scrutiny of regulators. There is no reason to pretend that this change is not permanent and dangerous consequences lie

if we fail to recognize this and act accordingly.

Many of you know of the very tangible fallout from recent corporate and market scandals-the enactment of Sarbanes-Oxley, which has had a galvanizing impact on corporate boards and audit committees, the daily parade in the headlines of SEC and NASD enforcement actions and criminal cases for tainted research, market timing, late trading, illegal sales contests, promotion of unsuitable products and on and on, the activism of State Attorneys General, and the vast array of new rules and regulations-NASD alone has filed 95 new rules with the SEC in the last 2 years.

There has also been a less tangible, but nonetheless transforming impact of these scandals on the relationship of regulator to the regulated. If the bond of trust between investors and the industry has been significantly damaged, and it surely has, then in equal measure there has been damage to the bond of trust between regulators and the industry. This is a serious problem for all regulators, but most especially for NASD, as the largest private sector regulator in the world with a budget of half a billion dollars, our work is a combination of enforcement and the encouragement of self-compliance. If we at NASD fail in our regulatory mission, then self-regulation itself will fail and it will vanish. I have a sense that some in this room may not be driven to tears at that prospect.

Yes, we have burdened your regulatory load significantly over the years and inevitably more is to come. And, it is true that NASD often is not aligned with what the industry perceives as its self interest; nevertheless I believe that the ultimate self interest, indeed the survival of the industry, lies in the promotion of balanced and vigorous self-regulation. Let's review the role of self-regulation for just a moment.

NASD has significant independent authority that at first glance looks a lot like the SEC's. We bring enforcement cases-in fact, more of them every year than the SEC, and all other SROs combined-collecting many millions of dollars in fines and removing, through our enforcement efforts, more than 800 brokers a year from the business. We engage in rulemaking that covers the full range of activity within brokerage firms and promotes integrity and information transparency in markets. We also have authority to define our budget and collect it from the industry, something we do with care but for which we have complete authority nonetheless.

But we are not the SEC and one of our greatest strengths lies in our access to industry expertise.

Ultimately, this industry flourishes best on a promise of fidelity between the interests of the broker and the client. And the realization of that promise is best promoted by ethical standards that are the cardinal principles of self-regulation.

OK, I have described self-regulation, but what is it really? This is not just a rhetorical question and I pose it because I think its role is misperceived even within this room. Self-regulation is not regulation by proxy or referendum of the regulated firms. It is not regulation-light. We are not a trade association and we are not a club. I believe self-regulation is best described as regulation informed and illuminated, but not dictated, by interaction with the industry. Self-regulation is a privilege to be earned and to be cherished.

The benefit to the industry is that self-regulation attempts to incorporate the reality of market and industry practice and operations in rulemaking.

The benefit to investors is that our consultation with brokerage firms should ideally give us a better picture of the risks investors face and the protections they need. We are professional regulators, yet we and the regulatory process itself, benefit greatly from the input and active participation of hundreds of industry contributors. The value of SRO participation in the regulatory process is in realizing targeted responses to

problems in industry practice and conduct. We don't just find a problem, make a rule and ignore operational capacities and market impact.

Even though self-regulation does not operate at the pleasure of regulated firms, this does not mean it can operate effectively in an environment in which it is divorced from firms. I said a moment ago that self-regulation is regulation informed and illuminated by the views of the industry. Unfortunately, however, when we see questionable practices, as widespread as those in the mutual fund operational and sales areas, we must question the value of input received from the industry. Anyone looking objectively at the recent-and continuing-reports would question whether even the basic and most fundamental provisions of the law and commercial honor are being observed within some firms and be left with real doubts about whether they are putting the interests of their clients above all others.

If we cannot assume basic compliance with the rules, what might that mean for self-regulation and for how the industry functions?

Here's one hypothetical. Today we have 600 examiners at the NASD, responsible for inspecting brokerage operations. Our approach to routine examinations, which are in addition to those we do "for cause," is to examine firms on a risk-based cycle-the most concerning each year, all the others every two or four years, resulting in about 2,600 routine exams a year. If instead we felt the need to inspect annually all 5,400 brokerage firms for compliance with every NASD and SEC rule, rather than approaching our task based on a risk assessment, we will need thousands-not hundreds-more examiners, in essence taking up permanent residence inside each firm. We can all recognize that the cost and disruption to business from such an approach would be immense.

We simply must be able to rely on the existence of a basic level of compliance within every firm. But I will tell you that even that statement is probably met with skepticism by some number of investors, media and policymakers. Indeed, based on recent events, I sometimes have my doubts, as well.

So, where does that lead us as we try to find a way forward in this environment of shattered trust? The regulators doubt the commitment of firms to operating at the highest ethical standards. The industry thinks the regulators have gone off the deep end and become competitors in a contest to see who can be toughest. And investors think neither the industry nor the regulators deserve their trust.

Speaking as a regulator, I think you will see us staying in the deep end for quite awhile. That means, above all else, aggressive enforcement of the rules and pushing enforcement of our bedrock ethical rule, **that firms must observe high standards of commercial honor and just and equitable principles of trade**. This means, among other things, that even where there isn't a specific rule tailored to address a specific situation, a firm and its officers should be committed to do the right thing.

It also suggests to me more creative sanctions in our enforcement cases, including taking a firm out of an entire line of business for a period of time when there have been repeated or particularly egregious violations. It is foreseeable that a full-service firm with multiple violations over a period of time in the mutual fund sales practice arena could be prohibited from opening any new mutual fund accounts for a period of time. The impact of such a sanction would be far greater than a fine of many millions of dollars and we have recently amended the NASD Sanction Guidelines to make clearer the capacity to have such sanctions considered.

Similarly, we will consider in the appropriate case, asking Board Compensation Committees of publicly owned broker-dealers to address how major regulatory failures were factored into their compensation decisions.

And, you will continue to see enforcement actions go up the chain of command and hold increasingly senior members of management responsible for the firm's transgressions as we did in September when we charged the national head of retail sales at a major firm for failure to supervise when regional and branch offices of the firm were holding illegal sales contests. Our decision in that case also talked extensively of the failure of the firm's Compliance Department to have any procedures to ensure compliance with the long-standing NASD rule prohibiting this type of sales contest.

This sort of lack of compliance and supervisory procedures has led me to ask our staff to step up the analysis of regulatory data which points to firms that are exhibiting red flags that enhanced compliance or supervision could address BEFORE there is a need for disciplinary action. We will be discussing our findings at face-to-face regulatory conferences with compliance officers and CEOs of firms, where we will also explore what remedial action is expected.

In a similar vein, this week, letters will be going out to firms that employ brokers with multiple customer complaints or other disclosures, reminding each firm of its responsibility to pursue heightened supervision with respect to the activities of these reps.

Recent events will probably control the tempo and tenor of future rulemaking for some time, as well. Most firms, and I would venture to say this is true in most industries, would prefer principle-based regulation in which the detail of policies and procedures is left to the firm to determine. And in principle, I agree this is a good goal for regulation wherever possible. But this approach becomes increasingly less possible when even a few firms demonstrate behavior that not only ignores the animating purpose of our rules but also flouts their express borders.

I think you can also expect to see the regulators demand more self-reporting from firms about their compliance weaknesses. And, as you know we are moving forward with certification from broker-dealers about the state of their compliance processes, not unlike the Sarbanes-Oxley certifications that require sign-off on financial statements and on the effectiveness of internal controls for financial reporting.

I can't predict for you what will happen in Congress, but I don't think anyone should yet count out mutual fund legislation this year, despite the many new requirements already proposed or enacted-and there will be more to come-concerning fund governance, and disclosure surrounding fees, soft dollars, and breakpoints, to name just a few.

On a more specific level, our focus on distribution and compensation issues related to mutual funds will continue through enforcement and rulemaking.

Our focus historically has been on the suitability of the mutual fund share classes that brokers recommend; the sales practices they employ; the disclosures they make to investors; and the compensation they receive from mutual funds. We also have played the lead role in policing whether brokers give customers the proper volume discounts-or breakpoints -off of the front-end "loads" that many funds levy, and we have lead the Task Force charged with developing the operational and regulatory changes necessary to prevent these problems in the future.

We will continue to monitor implementation of the Task Force recommendations and we have now expanded this line of inquiry into "discounts owed but not given," to UIT products and Net Asset Value Transfer programs.
Besides breakpoints, NASD has been highly active in mutual fund enforcement more broadly. Last year alone, we brought some 70 mutual fund cases-and more than 200 over the last three years covering

inappropriate share class sales, suitability and the use of directed brokerage commissions to pay for shelf space. There are nearly 200 ongoing, active investigations at NASD covering these fund-related issues, as well as market timing and late trading.

Let me just mention a couple of other areas where we will be highly focused this year.

I have long had concerns about how variable annuities are marketed to investors. We brought three important cases in the past month alone related to the sale of these products. We ordered Prudential to pay customers $9.5 million and a $2 million fine for variable annuity sales and switches that violated NY State Insurance Department regulations.

We filed a case earlier this year against Waddell & Reed and two of its senior executives charging them with recommending 6,700 variable annuity exchanges to its customers without determining the suitability of the transactions, generating $37 million in commissions and costing their customers $10 million in surrender fees.

The same week, we permanently barred from the industry, a Louisiana broker for unsuitable variable annuity sales.

While we have brought some 75 annuity-related disciplinary actions in the last three years, given the increasing complexity of these products and the impact of tax law changes, we will intensify our scrutiny. We are considering rulemaking in this area that could require pre-approval by a principal of the appropriateness of variable annuities in a manner akin to the process of approval for options trading, and we will consider whether firms must have their customers sign a specific risk disclosure document when considering an exchange of one variable annuity product for another.

Coming out of the Metropolitan case that we filed late last year, we are currently analyzing all securities offerings done over the past two years where a broker/dealer sold its own securities or those of an affiliate. Our examinations cover both registered offerings and private placements and include equity and debt. In case you missed the Metropolitan case, it involved fraud in the sale of debentures, investment certificates and preferred stock issued by two affiliated companies of an NASD member. The BD's sales force made unbalanced presentations to investors and downplayed important investment risk factors, including the risk of loss due to the companies' insufficient earnings, subordination of the securities to other obligations and the absence of an established market for the preferred stock.

We also have a growing concern about the intersection within broker-dealers of mortgage lending and securities investing. As investors have watched the tempting combination of a rising stock market, record low mortgage interest rates and tremendous growth in the equity they have in their homes, they have been tempted by sales pitches to unlock that equity, by refinancing their homes-perhaps through a non-registered affiliate of the broker/dealer-and investing the proceeds in the stock market.
So, I will go out on a limb here and say that 99% of the time, a recommendation that an investor mortgage his or her home in order to speculate in the securities market-IS UNSUITABLE-and subject to potential enforcement action.

We brought three enforcement cases last week against individual brokers for making unsuitable recommendations that included convincing clients to mortgage their houses.

Additional areas of interest that I can forecast for this year include debt and municipal security pricing and markups, retail sales of non-conventional products and an extensive effort, coordinated with the SEC and the NYSE to deal with abusive short-selling, to name just a few.

Before I finish, I'd like to go back to where I began: the role of the industry.

NASD will continue to be extraordinarily busy this year, as we have been for the last several years, but the harder task remains with the industry. I've outlined some of NASD's priorities and approach but in order to restore investor trust, what's truly critical is for brokerage firms to recommit to the principle of putting the investor first.

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Brokers need to truly understand, accept and act on the fact that pursuing short-term profits, at the expense of treating your customers fairly will never be a successful strategy over the long run. Truthfully, I do not understand the failure to grasp and live this dynamic, particularly in the face of a thousand examples where it has been true.

The U.S. capital markets are the most efficient and resilient in the world because we operate in a market economy in which risk-taking that culminates in innovation, efficiency and consumer satisfaction is richly rewarded with profits. Regulators are not at war with profit seeking. But, profit seeking must not prevent any in this industry from honoring the responsibilities that arise from the trust placed in them by investors.

All commercial regulation reflects, at least in part, the understanding that unbridled capitalism can lead to excesses of behavior and harm, that we as a society find unacceptable. This is not a remarkable proposition. I believe I can presume to say that there is not a person in this room who does not believe that in the long term, you do better on the balance sheet by doing better for your customers.

I think that if the industry wants to preserve the privilege of self-regulation and to regain investor confidence and the confidence of regulators, then a cultural change is necessary at many firms.

There is a tendency in life to believe that the way things are is the way they will always be. This is why the end of bull markets are rarely seen. The way things were is not the way things can continue to be. I urge all of you to come to that realization. I believe it is as simple as this: if the industry wishes to be in control of its future it must control its conduct, it must act in the interests of its clients in deeds as well as words, and it must dispense with the notion that what is ethical can be informed by the formula of profit and loss.

This audience is composed of the best and the brightest, all of whom are committed to seeing fair markets thrive, investor interests served and healthy capitalism flourish. I urge you to redouble your efforts today and tomorrow in creating a strong, proactive culture of compliance within your firm that demonstrates that commitment to investors and regulators. There aren't any better uses of your time.



December 5, 2022

OBSERVATIONS FROM BROKER-DEALER AND INVESTMENT ADVISER COMPLIANCE EXAMINATIONS RELATED TO PREVENTION OF IDENTITY THEFT UNDER REGULATION S-ID[1]

I. Introduction

This Risk Alert provides observations from recent examinations of SEC-registered investment advisers ("advisers") and broker-dealers (together with advisers, "firms") related to compliance with Regulation S-ID.[2] The Division of Examinations ("EXAMS") is issuing this Risk Alert in order to assist firms with implementing effective policies and procedures under Regulation S-ID, which requires the development and implementation of an identity theft prevention program ("Program") for firms that offer or maintain covered accounts.[3]

Regulation S-ID applies to SEC-regulated entities that qualify as financial institutions or creditors under the Fair Credit Reporting Act ("FCRA")[4] and requires SEC-regulated financial institutions and creditors to determine whether they offer or maintain covered accounts. SEC-regulated entities that are likely to qualify as financial institutions or creditors and maintain

1 The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

2 Regulation S-ID is set forth at 17 CFR 248.201 et. seq. Identity Theft Red Flags Rule, Joint Final Rules and Guidelines, Securities Exchange Act Release No. 34-69359, Investment Advisers Act Release 3582, Investment Company Act Release 30456 (Apr. 10, 2013), 78 FR 23637 (April 19, 2013) ("Identity Theft Red Flags Rule"), available at: https://www.sec.gov/rules/final/2013/34-69359.pdf.

3 A "covered account" is (i) an account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; and (ii) any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation, or litigation risks. *See* 17 CFR 248.201(b)(3).

4 Fair Credit Reporting Act, 15 U.S.C. 1681.

covered accounts include most registered broker-dealers (e.g., broker-dealers offering margin or custodial accounts) and registered investment companies (e.g., registered investment companies that allow individuals to wire transfers to other parties or that offer check writing privileges),[5] and some registered investment advisers (e.g., registered investment advisers who can direct transfers or payments from individual accounts to third parties based on the individual's instructions or who act as agents on behalf of individuals) if the accounts are primarily for personal, family, or household purposes.[6] If a firm determines that it has such accounts, it must establish a Program that is designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account.

II. Most Frequently Observed Regulation S-ID Compliance Issues

Through its examinations, EXAMS staff identified practices that are inconsistent with the objectives of Regulation S-ID, which may leave retail customers vulnerable to identity theft and financial loss. Below are examples of the most common deficiencies identified by EXAMS staff in connection with the elements of Regulation S-ID.

A. Identification of Covered Accounts

Under Regulation S-ID, firms must determine and then periodically reassess whether they offer or maintain covered accounts.[7] Accordingly, firms must conduct a risk assessment to determine whether they offer or maintain covered accounts, taking into consideration the methods they provide for opening and accessing accounts, as well as their previous experiences with identity theft. Below are examples of observations related to the periodic identification of covered accounts from recent examinations.

- ***Failure to identify covered accounts.*** EXAMS staff observed firms that failed to conduct an assessment of whether any of their accounts were "covered accounts" and as a result

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5 Regulation S-ID applies to any investment company that is registered or required to be registered under the Investment Company Act of 1940, that has elected to be regulated as a business development company under that Act, or that operates as an employees' securities company under that Act, if such investment company otherwise meets the definition of financial institution or creditor and offers or maintains covered accounts.

6 *See* Identity Theft Red Flags Rule for additional examples of SEC-registered entities that may qualify as creditors or financial institution under FCRA. *See also* SEC Small Business Compliance Guide: Identity Theft Red Flags Rule, available at: https://www.sec.gov/info/smallbus/secg/identity-theft-red-flag-secg.htm.

7 17 CFR 248.201(c).

did not identify covered accounts at the firm and failed to implement a Program as required under Regulation S-ID.

- ***Failure to identify new and additional covered accounts.*** Some firms did initially identify, as covered accounts, one category of accounts that they offered, but they failed to conduct periodic assessments, either at all, or those periodic assessments did not identify all categories or new types of accounts that were "covered accounts." For example, firms may have merged with other entities but then never conducted a reassessment to see whether any new accounts should be included in the Program. EXAMS staff observed examples of firms omitting online accounts, retirement accounts, and other special purpose accounts from firms' determination and reassessment of covered accounts. EXAMS staff also observed instances where a firm did not maintain any documentation of their analysis of covered accounts. While not required by Regulation S-ID, such documentation can assist the firm in identifying the basis for their determination to auditors and regulators.
- ***Failure to conduct risk assessments.*** EXAMS staff also observed that while some firms periodically identified covered accounts, the process did not include a risk assessment taking into consideration the methods provided to open, maintain, and closed accounts; methods to access different types of covered accounts; or previous experiences with identity theft.[8] For example, in not periodically conducting a risk assessment of new methods to access accounts, some firms that historically maintained customer accounts at branch locations did not identify online accounts as covered under their Programs. This impacted firms' abilities to develop controls relevant to their red flags.

B. Establishment of the Program

Regulation S-ID requires firms to develop and implement a written Program that is appropriate to the size and complexity of the firm and the nature and scope of its activities.[9] Through recent examinations, EXAMS staff observed the following issues with respect to the establishment of written Programs.

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8 *See* Identity Theft Red Flags Rule at 27 (stating that "each financial institution or creditor must periodically determine whether it offers or maintains covered accounts")..

9 17 CFR 248.201(d)(1).

- ***Programs not tailored to the business***. EXAMS staff observed firms that established a generic Program that was not tailored to or appropriate for their business model. In some cases, firms relied on a template with fill-in-the-blanks that had not been completed. Other firms adopted Programs that simply restated the requirements of the regulation without including processes for complying with the regulation.
- ***Program did not cover all required elements of Regulation S-ID***. Firms represented to staff that other policies and procedures outside of a written Program constituted the firm's process for detecting, preventing, and mitigating identity theft, even though such procedures had not been incorporated directly or by reference into the Program and in many cases did not cover all of the required elements of Regulation S-ID.

C. Required Elements of the Program

Programs under Regulation S-ID must include reasonable policies and procedures to identify, detect, and respond to red flags that are relevant to identity theft. Additionally, the Program must include reasonable policies and procedures to ensure that it is updated periodically to reflect changes in risks to customers and to the safety and soundness of the financial institution or creditor from identity theft.[10] EXAMS staff observed the following instances in which Programs lacked required elements.

***Identification of Red Flags*:** Red flags are patterns, practices, or specific activities that indicate the possible existence of identity theft.[11] Programs must include reasonable policies and procedures to identify relevant red flags for covered accounts offered by the firm and incorporate those red flags into the Program. Supplement A to Regulation S-ID's Appendix A provides illustrative examples of red flags for a firm to consider. EXAMS staff observed firms that did not appear to have reasonable policies and procedures to identify relevant red flags. Specifically, EXAMS staff observed:

[10] 17 CFR 248.201(d)(2).

[11] 17 CFR 248.201(b)(10).

- Firms that failed to identify red flags specific to their covered accounts, and instead listed examples from Appendix A of Regulation S-ID regardless of the flags' relevance to the firm's covered accounts.
- Firms that only offered online accounts listed red flags related to the physical appearance of a customer; and some firms included red flags related to consumer reports even though those firms did not obtain consumer reports for customers.
- Firms that did not have a process or did not follow existing procedures to evaluate actual experiences with identity theft in order to determine if additional red flags should be added to their Programs. For example, EXAMS staff observed firms that experienced ongoing account takeovers over several years and did not consider any red flags related to account takeovers.
- Firms that did not include any identified red flags in their Program. For example, some firms created written Programs that had generic language for identifying, detecting and responding to, and updating red flags but the Programs did not include any actual red flags identified by the firms. As such, the written Programs were merely policy statements without any actionable procedures.

***Detect and Respond to Red Flags*:** Programs must have reasonable policies and procedures incorporated into the Program to detect and to respond appropriately to any red flags that are detected.[12] EXAMS staff observed firms that did not appear to have reasonable policies and procedures to detect and respond to relevant red flags. Specifically, EXAMS staff observed:

- Firms that relied on pre-existing policies and procedures (e.g., anti-money laundering procedures) to satisfy this requirement of its Program, when such procedures were not designed to detect and respond to identity theft red flags. For example, such procedures did not include processes to detect whether the fraud was related to identity theft, such as the use of forged or false credentials.
- Firms that identified procedures for detecting and responding to specific red flags, when the actual procedures did not exist or failed to contain any relevant process related to that

[12] 17 CFR 248.201(d)(2)(ii) and (iii).

red flag.

Periodic Program Updates: Regulation S-ID requires that Programs include reasonable policies and procedures to ensure the Program is updated periodically to reflect changes in risks to customers and the firm from identity theft.[13] In recent examinations, EXAMS staff observed:

- Some firms did not update their identified red flags after making significant changes to the ways in which their customers open and access their accounts, such as providing account access not only through local branch offices, but also through online customer portals.
- Firms that had gone through business changes or reorganizations, such as mergers or acquisitions of other financial firms, but had failed either to incorporate these new business lines into their existing Program or to approve a new Program for these new business lines.

D. Administration of the Program

Firms must provide for the continued administration of the Program through (1) obtaining approval of the initial written Program from either its board of directors, an appropriate committee of the board of directors, or from a designated senior management employee, if the firm does not have a Board; (2) involving the board or senior management in the oversight and administration of the Program; (3) training staff as necessary; and (4) exercising appropriate oversight of service provider arrangements.[14] EXAMS staff observed firms that did not provide for the continued administration of their Programs as required by Regulation S-ID. For example:

- ***Did not appear to provide sufficient information to the board or designated senior management.*** EXAMS staff observed firms that did not appear to provide sufficient information to the board or designated senior management through periodic reports, either by failing to submit any reports or by submitting reports that did not appear to

[13] 17 CFR 248.201(d)(2)(iv).

[14] 17 CFR 248.201(e).

contain sufficient information for the board or senior management to evaluate the effectiveness of the Program.

- ***Inadequate Training***. EXAMS staff observed firms that did not have robust processes to assess which employees should be trained, and some trainings appeared to be insufficient because the training was limited to a single sentence telling employees to be aware of identity theft.[15]
- ***Failure to evaluate controls of service providers***. Some firms that relied on service providers to perform activities in connection with covered accounts did not evaluate the controls in place at the service provider to monitor for identity theft.

III. Conclusion

In sharing these observations, EXAMS encourages registered broker-dealers and investment advisers to review their practices, policies, and procedures with respect to their Programs and to consider whether any improvements are necessary.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[15] 17 CFR 248.201(e)(3) (requiring firms to train staff to effectively implement the Program).

Speech

Anti-Money Laundering: An Often-Overlooked Cornerstone of Effective Compliance

Kevin W. Goodman, National Associate Director, Broker-Dealer Examination Program, Office of Compliance Inspections and Examinations

Securities Industry and Financial Markets Association

June 18, 2015

Introduction

I would first like to thank our hosts, SIFMA, and everyone who worked so diligently to coordinate this conference. Before we begin, I would also like to state that my comments here today are mine and mine alone, and do not necessarily represent the views of the SEC, the Commissioners, or the Staff.[1]

I appreciate the opportunity to speak with you today about the critical importance of broker-dealers' anti-money laundering or "AML" programs. My speech is intended to further elaborate on a speech given by my colleague, Andrew Ceresney, on February 25, at SIFMA's recent AML conference, in which he highlighted the importance of strong AML programs.[2] I want to discuss Mr. Ceresney's remarks in the context of the role of OCIE's examination program, including how we will evaluate your firm's compliance with AML obligations.

As you all know, AML includes far more than just preventing traditional money laundering. Broker-dealers must report large cash transactions and retain records on wire transfers regardless of whether any potential criminal activity is suspected. Broker-dealers must also monitor for and report suspicious activity, including activity that has no business or apparent lawful purpose. This goes beyond activity that implicates drug cartels or terrorist rings – it also includes activity that might indicate fraud, insider trading, or manipulative trading schemes.

As you also know, OCIE expects you and your firms to implement robust compliance programs that are targeted to the specific risks at your firms, and AML is no exception.[3] In fact, implemented properly, I believe an AML compliance program can serve as a cornerstone of a firm's overall compliance program. AML, however, has important implications that proliferate far beyond your firms. Widespread AML lapses threaten our standing in the international community – not only for you as individual firms but for the United States as a whole.

In fulfilling their important AML obligations, broker-dealers play a vital front line role in assisting regulators and law enforcement in identifying and addressing suspicious activities to prevent our financial systems from being used for criminal purposes. Your obligation is a proactive one, not a ministerial one. OCIE strives to be transparent about our focus areas and concerns, so I want to highlight that we take AML very seriously and will take great exception to firms that view AML as a peripheral or unimportant component of their compliance program. Quite the opposite in fact, I believe that a minimal or weak AML program implicates the entire compliance program, while a strong AML program can serve as the cornerstone.

In the absence of regular risk assessments as to how your firm could be used by sophisticated individuals and entities seeking to evade the law, it is difficult to know how you could meet your critically important AML obligations. It isn't enough to say that your firm did not have intent to break the law, that you did not know what a customer was doing, that you relied on a vendor's system that other firms have found useful, or that the information was gathered and reviewed for other surveillance purposes.[4] Your firm must be able to demonstrate that it has an AML program that is tailored to the risks posed by your business and customers.[5] I challenge you here today to think beyond technical compliance and to consider your AML responsibilities as critical to your firm and to our financial system.

With that backdrop, today I plan to discuss the main components of an AML program, what factors you may want to consider in evaluating your program's adequacy, what examiners will be looking for, and where the SEC and other regulators have found deficiencies. In particular, I will highlight innovative methods that we are using to detect weaknesses in broker-dealers' AML programs. I want to encourage you to evaluate your current program against the points I raise today so that when OCIE examiners walk in your door, they will find a robust AML program that is worthy of the important gatekeeper role you play.

Significance of AML [6]

While at first blush AML obligations may seem to be the mechanical process of monitoring and reporting cash flows and securities transactions, AML programs are actually much more. [7] When implemented well, they provide protections against misuse of the nation's financial system for criminal activity – activity that ranges from financial fraud (endangering people's financial security) to profiting from drug businesses to funding terrorist activities. For example, federal authorities have used filed suspicious activity reports ("SARs") to identify fraud schemes such as purported investments in non-existent high yield investments, Ponzi or pyramid schemes, and market manipulation.[8] In describing how the SEC's Enforcement Division will assess SARs, Mr. Ceresney noted that SARS reporting "contributes directly to our work at the SEC to protect investors and ensure that our markets operate fairly," and he identified the many times when SARs played a part in SEC regulatory actions as well as prompted examinations and investigations.

It is therefore understandable that when firms are not meeting their obligations, the consequences are severe. I point to two recent cases that, while not brought against broker-dealers, illustrate lessons that, I believe, can and should be learned by all firms. I would add that the SEC has also brought several actions against broker-dealers for violations in the AML arena, some of which I will discuss in a few minutes.

In 2012, HSBC Bank USA settled claims with regulators, including the Financial Crimes Enforcement Network – or FinCEN, the bureau of Treasury charged with implementing the Bank Secrecy Act or BSA, with penalties exceeding $1.9 billion for failure to have an adequate AML program.[9] Regulators raised concerns of an understaffed AML compliance function, a failure to monitor numerous transactions from high risk jurisdictions, and even the classification of one such jurisdiction as the lowest AML risk category. FinCEN's assessment stated over and over again that HSBC's fundamental flaw was a failure to conduct risk-based evaluations in designing its program – ignoring the need to evaluate the risks of products and services offered, its customer base, and countries from and to which moneys flowed. So, I suggest to you that conducting an overall analysis of the risk posed by your business is a critical step towards implementing an effective AML program where you employ adequate resources and put them where they are needed the most. And, please be sure that you are providing resources commensurate with the risks identified.

In a second more recent case (January 2014), J.P. Morgan paid a $1.7 billion fine for its failures to report suspicious activity relating to the Bernard Madoff Ponzi scheme.[10] Between 1986 and 2008, the scheme was conducted almost exclusively through accounts at J.P. Morgan Chase Bank. Over a multi-year period, multiple red flags were identified. J.P. Morgan was concerned enough that it reduced its financial exposure to Madoff funds in response to those red flags. However, even after J.P. Morgan's UK affiliate reported its concerns to the U.K. authorities, no such report was made in the U.S. In part, this failure appears to have resulted from communication

lapses between business and compliance, and between different compliance groups. So, what is the lesson learned here? Note that having a sophisticated surveillance system alone did not satisfy the firm's obligations. You need to know that all relevant information is flowing through to the employees with responsibility to file SARs.

Now, I'll focus on where broker-dealers have faced regulatory action for failing to meet their AML obligations. The Commission has brought multiple cases against firms such as Hold Brothers, Biremis, Park Financial Group, and Gilford, among others, in which customers or employees of a broker-dealer engaged in manipulative trading schemes – layering,[11] pump and dump schemes,[12] and/or sales of unregistered shares.[13] Each of these cases is fact specific but all have a common theme: broker-dealers had multiple red flags brought to their attention – whether it be a customer's explanation of trading that didn't align with the facts, a large quantity of low-priced shares deposited at the broker-dealer, or the absence of information about the customer – and the firm's personnel essentially ignored red flags, with severe consequences, including bars from the securities industry and significant fines against the firm and firm personnel.

AML Requirements

I would now like to walk through three major AML requirements – the AML compliance program, the customer identification program, and monitoring and reporting suspicious activity. I will provide some color on steps examiners will take in their review. I will also highlight certain regulatory actions that provide examples of where firms have gone wrong. I would suggest as a take-away that firms assume unacceptable risk when they fail to consider the characteristics of the businesses in which they are engaged, and I emphasize the need to evaluate your business activities, the unique risks they present, and what controls would be reasonable to address these risks.

AML Compliance Program

FINRA Rule 3310 requires members to establish a risk-based AML compliance program, which includes at a minimum, reasonably designed policies and procedures, the designation of an AML compliance officer, ongoing AML employee training, and independent testing of the AML program.[14] I also echo Mr. Ceresney's statement that "it is critical to ensure that AML compliance is integrated fully into the other compliance operations of the firm to ensure that suspicious activity detected by other compliance functions makes its way to the AML compliance function and vice versa."

Examiners will begin by evaluating whether your program is reasonably designed. In our examiners' experience, the "reasonably designed" standard is not met where firms rely on boiler-plate language or templates or "off-the-shelf" programs that are not tailored to their customers, products, services, geographic locations, or methods of customer interface. Firms should also be aware of when its automated programs are not operating correctly and should confirm that any technical fixes to the program are appropriate.[15] Examiners assess the capacity of designated compliance officers, including their background and experience and whether they have the resources to perform their jobs adequately. Examiners consider whether the training provided to employees takes into account the function being performed by the employee, the specific business activities of the firm, and the specific AML program of the firm. I would caution against the use of generic training that does not explain to employees the specific roles and responsibilities that they have.[16] OCIE expects that the scope of independent testing reasonably covers the lines of business in which your firm engages.[17] Finally, we expect to see documentation of the independent testing performed on the effectiveness of your AML program. A simple sign-off that the testing occurred is almost never deemed compliant;[18] it should specify the testing conducted and the results.

You might take a look at the Brown Brothers Harriman case settled with FINRA in February 2014, to see the application of FINRA Rule 3310 and, in particular, the need for an AML program tailored to the specific risks that a firm faces.[19] The case involved omnibus accounts being used to conduct penny stock transactions for undisclosed underlying customers of foreign banks, and the broker-dealer's inability to obtain critical information such as the identity of the stock's beneficial owner, how the stock was obtained, and the owner's relationship with

the issuer. I believe this case illustrates the need to identify and address high risk business activities – such as penny stock trading. You might also consider the concerns raised by omnibus accounts or other instances (such as DBA or "doing business as" accounts) in which an entity trades through different names, and how it impacts your ability to monitor trading in a meaningful fashion. Finally, you might also want to consider that FINRA discussed that the firm's failure to review its penny stock activities flowed through multiple aspects of its AML program – with gaps in its monitoring, independent testing, and employee training. So, the cases show that you not only need to identify the high risk areas, you need to tailor each AML control component accordingly.

I also want to point you to a case brought by FinCEN against a broker-dealer, Oppenheimer & Company, in 2005, which settled for $2.8 million.[20] FinCEN charges were based on Oppenheimer's failure to have an adequate AML program, including an absence of procedures for reviewing wire transfer and journal transactions between unrelated and related customer accounts from foreign branch offices; reliance on manual review of transactions by one employee; reports that did not aggregate incoming and outgoing wire transfers by customer, account, branch office, or destination; and a lack of independent testing of the effectiveness of the program. Moving ahead about 10 years, Oppenheimer once again is the subject of significant AML enforcement actions, one brought by FINRA and settled for $1.425 million, and one brought by the SEC and settled for $20 million, both resulting from failing to detect and report suspicious transactions in connection with unregistered sales of penny stock.[21] So please be mindful of regularly assessing and reassessing the risks your firm faces and its compliance with the regulatory framework.

CIP Program

The second fundamental AML obligation is that broker-dealers must implement a customer identification program (or "CIP") to obtain all of the required information – the name, address, date of birth for an individual, and identification number – for each customer and have a method to verify that information.[22] Examiners will review a firm's verification policies and procedures to ensure they are reasonable given the firm's assessment of the risk factors associated with its customer base. Further, examiners will be looking to ensure firms correctly understand and are meeting their CIP obligations for anyone who qualifies as a customer – that is, generally, a person who establishes a formal relationship with your firm to effect transactions in securities.[23] You and your firms should give careful consideration as to whether each of the businesses you're engaging in triggers the CIP requirements. For example, to give some color as to when a person might be a customer for BSA purposes, FINRA has taken action against firms whose CIP programs did not capture persons who purchased securities from the broker-dealers in private placements.[24]

I also refer you to the SEC's settled action against Pinnacle Capital Markets.[25] Pinnacle primarily engaged in providing direct market access to its customers, 99% of which resided outside the United States. Pinnacle's direct customers sometimes offered subaccounts to other entities to trade through Pinnacle. Pinnacle failed to conduct CIP reviews of the subaccount holders. An important point highlighted by this case is that omnibus sub-account holders were considered customers under the CIP rule because Pinnacle treated the sub-account holders in the same manner as it did its regular account holders, allowing them to use direct market access software to enter securities trades with Pinnacle directly and instantly through their own computer. These sub-account holders had direct control over how the trades were made in their accounts and did not require the omnibus account holder to initiate or intermediate the transactions. Again, I would suggest that the takeaway here is that you should carefully evaluate who is covered under your CIP – have you taken into account not just direct customers but other persons who may effect securities transactions directly to or through your firm?

Detecting and Reporting Suspicious Activity

Detecting and reporting suspicious activity is a third fundamental aspect of AML compliance because, as set forth by Mr. Ceresney, the information you and your firms provide to regulators and law enforcement in SARs plays a vital role in helping regulators identify securities violations and bad actors in the markets. The SAR rule requires broker-dealers to report suspicious activity that involves or aggregates funds or other assets of at least $5,000 and

for which the broker-dealer knows, suspects, or has reason to suspect: 1) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade **any Federal law or regulation**, 2) is designed to evade any requirement of the Bank Secrecy Act, 3) has no apparent business or lawful purpose or is not the sort of activity in which the particular customer would normally be expected to engage, or 4) involves the use of the firm to facilitate criminal activity. [26] Once again I note that this goes far beyond traditional money laundering or terrorist financing.

Under this rule, in identifying activity with "no apparent business or lawful purpose," you should question trading activity that does not have a discernible investment or profit objective, companies with complex ownership structures that transfer money between accounts with unclear objectives, or the use of front companies to hide illicit sources of funds. Important red flags include the use of securities accounts for predominantly non-securities related types of transactions (e.g., wire transfers) and customers who seem to not care about high fees or losses in their accounts and appear more focused on the movement of funds.[27] Broker-dealers with significant online access channels may want to take into account the source of login transmissions, particularly use of anonymous Internet nodes.

Examiners will evaluate whether firms are using monitoring processes and tools commensurate with the volume and types of activity occurring in accounts. Examiners will test the thresholds, parameters, and the data that is fed into automated systems for SAR monitoring, as well as look at the process by which AML alerts coming from these automated systems are reviewed and escalated.

For further color on when SARs reporting may be required, you should look to the SEC's actions in Gilford Securities,[28] Hold Brothers On-Line Investment Services,[29] and Bloomfield.[30] In each case, the firm did not file SARs even though firm personnel knew or should have known about activity that indicated potential market manipulation such as a pump and dump scheme, layering, or artificially raising the market price of a thinly traded security. Both the HSBC and JP Morgan actions also included charges of failures to file SARs. I cannot emphasize enough the importance of filing SARs, and it is no coincidence that both Mr. Ceresney's and my remarks highlight this aspect of AML compliance. With that, I will turn to OCIE's efforts to address failures to file SARs.

AML Examination Initiatives

Mr. Ceresney's remarks provided an excellent analysis of how the SEC reviews SARs filings and the concerns raised by filings that do not provide sufficient detail. He also identified statistics that raise red flags for me as well. On average, each firm in the U.S. files about five SARs a year. A large number of firms file zero or one SAR per year. I agree with Mr. Ceresney's statement that it is "hard to believe that the industry as a whole is fulfilling its obligation," and OCIE is looking into whether firms are filing SARs appropriately. Mr. Ceresney in his speech outlined the Enforcement initiatives to address this concern, I will focus now on where the examination program is directing its resources.

Because examiners are forced to be risk-based in their reviews, one particular area of focus will be the AML programs of clearing firms. OCIE believes that those institutions often have the "birds-eye view" of the market and are in the best position to identify patterns of activity engaged in by persons or entities that use more than one introducing broker. Examiners would expect clearing firms to use that high-level view of trading to monitor for suspicious patterns and report the activity on SARs.[31] During examinations of clearing firms, examiners, too, are able to review activity transacted through a large number of broker-dealers. Examiners can then select introducing broker-dealer(s) for targeted, risk-based examinations based on the analysis, which may take into account concerns about whether the introducing firms appropriately reported suspicious activity. Remember, under the legal requirements, both the introducing firm and the clearing firm have responsibilities to detect and report suspicious activity that occurs by, at, or through their firm. Among other concerns, clearing firms should consider whether SARs should be filed if they identify trading patterns that may indicate potentially fraudulent activity such as churning of customer accounts or manipulation of the prices of microcap stock.

In choosing firms to examine for AML compliance, staff uses technology to identify firms that do not file or rarely file SARs, and we assess whether those firms have robust AML programs and monitoring processes in place. We assess the quality of SARs filed to ensure that firms are reporting in a meaningful enough way for the information to be helpful to the regulatory and law enforcement communities. For example, a SAR that identifies a possible Ponzi or insider trading scheme is most helpful when it includes the underlying information or transaction detail on which the firm is raising the concern. As another example, a SAR that reports thinly traded securities being deposited into an account and immediately sold for a large profit is most helpful if the SAR also provides how much the security was purchased for, when it was purchased, and who the shares are being sold to in the reported transaction. Note that FinCEN has provided guidance that stresses the need to file a complete and sufficient SAR. [32]

Examiners are also using enhanced data analytics and pattern recognition to evaluate whether broker-dealers are reasonably monitoring and reporting suspicious activity. The algorithms aren't being used to set a standard but rather to check the reasonableness of the parameters set by firms. We are increasingly incorporating into our reviews enhanced technology and tools to review vast amounts of data so that we can identify suspicious activity from the source trade data rather than relying on the broker-dealer's surveillance reports. We compare the activity we identify to activity identified by the firm, to test for weaknesses in a firm's monitoring and reporting of suspicious activity. Examiners are assessing the tools used by firms, including the firm's ability to detect patterns of customer activity and customers' aggregate activity, taking into account such factors as activity across related business and individual accounts and aggregation based on known beneficial owners. We are also planning to build learning algorithms, or artificial intelligence-like programs, that can help to identify the behavior trends of potentially illicit actors.

Areas of Focus

I would now like to highlight a few business activities that OCIE has identified as potential sources of AML concerns. While some of these products and services or account relationships may not be inherently suspicious or high risk, they do present vulnerabilities that firms need to address from an AML perspective.

Thinly Traded or Low Market Value Securities

Broker-dealers that provide services related to thinly traded or low market value securities need to consider the risks involved in such products. For example, the market price for these securities is often subject to significant fluctuations, and such companies have been in the past the target of spam campaigns to "pump" up the price, with quick sales to take advantage of the inflated market value.[33] Firms should evaluate whether they have controls to identify suspicious activity such as deposits of large quantities of shares followed by immediate sales, frequent transactions between accounts, or ties between the account holder and parties with a relationship to the company. [34] Such activities may require that you file a SAR. Recently, OCIE has issued a National Exam Program Risk Alert that provides insight into issues and risks that broker-dealers might face when their customers actively trade low priced securities.[35] The alert highlights trading patterns that might trigger the need to file a SAR and omnibus account types that appeared to be frequently associated with unregistered sales of low priced securities. I urge you to review this risk alert and consider whether your AML program has appropriately taken into account the concerns raised in designing appropriate controls.

Direct Market Access

OCIE's 2015 Examination Priorities Memo[36] identified as a focus area the AML programs of proprietary trading firms that allow customers to directly access the markets from higher risk jurisdictions. In November 2010, the Commission adopted Exchange Act Rule 15c3-5, which requires broker-dealers that provide customers with direct market access to adopt a system of risk management controls, including restricting access to persons and accounts pre-approved and authorized by the broker-dealer. Broker-dealers offering these services should carefully evaluate how it may impact their CIP and SARs monitoring obligations.[37] Your obligation to report

suspicious activity is based on transactions that are conducted “by, at, or through” the firm, which includes direct market access activity. In addition, as discussed in the Pinnacle action I cited earlier, entities granted trading privileges at your firm may be customers under the CIP rule. So, we would expect to see reasonably designed controls to address these activities.

You may want to read closely the SEC’s action and FINRA’s allegations in its complaint against Wedbush Securities, which provide good sources of potential AML issues to consider for broker-dealers offering direct market access. [38] In particular, broker-dealers should consider whether their AML policies and procedures are tailored to their market access business, including monitoring for layering, spoofing, and other forms of manipulation, and that SARs are appropriately filed to respond to such activity.

Master/Sub Account Relationships

In 2011, OCIE issued a risk alert that identified the master/sub account trading model as a vehicle that could be used to further violations of securities laws as well as other laws and regulations, including AML.[39] The 2014 risk alert that I referenced above on low priced securities identified master/sub accounts as structures that may be used in unregistered sales of low priced securities. OCIE remains concerned about consistent application of suspicious activity monitoring and reporting relating to master/sub account relationships.

In a master/sub account, a company opens up a brokerage account or master account through which numerous individuals or other entities are allowed to trade as sub account holders. In some reviews conducted by staff, as identified in the risk alert, the broker-dealer did not know the identity of the sub account holders. The respective introducing and/or clearing firm holding the master account, although generally aware of the master/sub account structure, may be monitoring solely on the aggregate master account activity and either ignoring red flags or failing to monitor the patterns of sub account activity. Firms that offer master/sub arrangements are reminded that the SAR rule, unlike the CIP rule, is not a customer-driven rule, but rather a transaction-driven rule. Failure to adequately monitor for activity occurring through the firm because such monitoring is done solely on an account or direct customer basis may put firms at risk for AML deficiencies.[40] What this means is that although you may find, based on your analysis of your business, that a person may not be a ‘customer’ of your firm and hence does not trigger the CIP requirement, you are nevertheless obligated to monitor any transaction occurring by, at or through your firm on behalf of that person.

Banking-Oriented Products and Services

Examiners will evaluate the use of brokerage accounts that offer “comprehensive asset management” or “cash management” features. These accounts may present new avenues for potential money laundering. They allow customers to engage in not only securities transactions but also offer products and services traditionally associated with bank accounts, such as check writing ability, journaling among accounts, debit card/ATM access, credit cards, credit-line cash advances, ACH electronic funds transfers, and wire transfers. Firms that offer these services need to account for all of these transactional capabilities when reasonably designing an AML program. [41]

Examiners will assess all transaction methods for movement of cash and securities and testing the SAR monitoring thresholds accordingly to check for consistency with the firm’s obligations. Staff will look for monitoring that captures patterns of activity; aggregate activity; structuring of currency transactions to attempt to evade reporting and recordkeeping obligations; securities accounts that only have money movements and no securities investments; high-frequency check-writing, journaling, and wiring funds; and other activity that is not commensurate with a customer’s stated business or investment objectives.

Examiners have identified certain customers of firms that are using comprehensive asset management accounts as traditional retail banking or demand deposit relationships. Broker-dealers’ transaction monitoring program should, I believe, take into account how such accounts are being used. For example, if the account is being used primarily for banking rather than securities services, the firm should understand why the customer is holding funds

in a securities account rather than a traditional banking account. For business accounts and personal accounts that are being used for commercial purposes, our examiners will determine how much your firms know about the purpose for which the account is being used by the customer (e.g., what products and services your customer is offering). If you do not know enough about your customer's businesses, you may not be in a position to determine if the activity is consistent with that business type, size, and location.

Conclusion

Today, I have highlighted some of the many challenges you all face in designing and implementing effective AML programs and the critical importance of meeting these challenges. Let's recap some of the major considerations in the process:

- You must analyze the risks associated with your business activities – understand which products and services have higher risks and/or require unique controls and consider geographic locations and methods of customer interface – and take this analysis into account in designing your AML program;
- You must have an adequately staffed AML compliance function with appropriate information flows and an effective escalation process;
- You must document your program in written procedures and be able to demonstrate the monitoring and the testing that occurs;
- You must understand the scope of activities that may need to be reviewed and in particular consider that SAR reporting is based on all transactional activities that run through your firm; and your CIP may need to include indirect customers if they have unintermediated ability to direct trading in an account held at your firm;
- For most firms, you must have a well-tailored electronic system to spot red flags among your thousands (or even millions) of daily transactions, and your staff must properly follow-up to determine whether the red flags must be reported on a SAR; and
- Finally, and perhaps most importantly – always consider the need to file SARs. Don't fail to file because you believe that the activity has been reported by someone else or that you don't have definitive proof that illegal activity has occurred or you have reported the activity through other channels – you are still required to file a SAR in these instances. Essentially, if you see activity that raises concerns or which you can't explain, we would encourage you to file a report. Also note that the SEC has established a SAR alert message line to be used when a filed SAR may require immediate attention (202-551-SARs).

Let me close by reiterating that AML compliance is an especially critical component of a firm's overall compliance program, the cornerstone over which all else is built. To design and implement effective AML programs, I encourage all of you to share information and approaches with one another to promote the development of the critical infrastructure that is needed and required. Investors and citizens deserve nothing less.

Please feel free to reach out to Commission staff within the Division of Trading and Markets and OCIE with any issues you want to discuss. We stand ready to do what we can to assist you in meeting your AML obligations.

Thank you again for your time and attention.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

[2] *Available at*: http://www.sec.gov/news/speech/022515-spchc.html.

[3] *See, e.g.,* FINRA Rules 3130 and 3310; 31 C.F.R. 1023.210 (The AML program rule of the Financial Crimes Enforcement Network or FinCEN applicable to broker-dealers) and 31 C.F.R. 1010.810 (FinCEN's rule delegating authority to the SEC to examine broker-dealers for compliance with applicable FinCEN regulations).

[4] *See, e.g.*, In the matter of Park Financial Group, Inc., Exchange Act Release No. 56902 (Dec. 5, 2007), *available at* http://www.sec.gov/litigation/admin/2007/34-56902.pdf (settled matter); In the matter of Hold Brothers On-Line Investment Services, LLC, Exchange Act Release No. 67924 (Sept. 25, 2012), *available at* http://www.sec.gov/litigation/admin/2012/34-67924.pdf (settled matter); In the matter of Biremis Corporation, Exchange Act Release No. 68456 (Dec. 18, 2012), *available at* https://www.sec.gov/litigation/admin/2012/34-68456.pdf (settled matter); FINRA Letter of Acceptance, Waiver and Consent No. 2010025241301 Re: Banorte-Ixe Securities International, Ltd. (Jan. 28, 2014), *available at*: http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=35121; FINRA Letter of Acceptance, Waiver and Consent No. 2012034123501 Re: Wells Fargo Advisors, LLC, and Wells Fargo Advisors Financial Network, LLC (Dec. 18, 2014), *available at:* http://disciplinaryactions.finra.org/Search/ViewDocument/38254. National Money Laundering Risk Assessment 2015 ("NML Risk Assessment") Department of Treasury (June 12, 2015), at pages 82-84, available at: http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.

[5] *See, e.g.*, FINRA Letter of Acceptance, Waiver and Consent No. 2010025241301 Re: Banorte-Ixe Securities International, Ltd. (Jan. 28, 2014), *available at*: http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=35121.

[6] For links to all of the legal and regulatory sources referenced here, see Anti-Money Laundering Source Tool for Broker-Dealers, *available at:* http://www.sec.gov/about/offices/ocie/amlsourcetool.htm#1.

[7] In 1970, the Currency and Foreign Transactions Reporting Act of 1970, commonly known as the "Bank Secrecy Act" was enacted to require certain reports and records that have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The full complement of AML requirements came into effect with the USA Patriot Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism), which amended the Bank Secrecy Act. The Patriot Act was passed shortly after 9/11 to prevent the use of the U.S. financial system to aid terrorist activities. In the securities sector, the Treasury Department, along with the SEC and FINRA, has implemented these requirements by adopting rules addressing broker-dealers' and mutual funds' obligations to combat money laundering and terrorist financing, which require firms to implement a risk-based AML compliance program and a customer identification program, to monitor and report suspicious activity, and to conduct due diligence on foreign correspondent accounts and private banking accounts. 31 CFR Parts 1023 (broker-dealers) and 1024 (mutual funds). Broker-dealers' obligations to file reports and maintain records pursuant to these requirements are also reflected in Exchange Act Rule 17a-8.

[8] Examples of cases identified through the use of SARS available at: http://www.fincen.gov/news_room/rp/sar_case_example_list.html?catid=00002.

[9] FinCEN's assessment is set forth in: In the matter of HSBC Bank USA N.A., Case Number 2012-02 (Dec. 10, 2012), *available at:* http://www.fincen.gov/news_room/ea/files/HSBC_ASSESSMENT.pdf.

[10] FinCEN's assessment is set forth in: In the matter of JPMorgan Chase Bank, N.A., Case Number 2014-1 (Jan. 7, 2014), *available at*: http://www.fincen.gov/news_room/ea/files/JPMorgan_ASSESSMENT_01072014.pdf.

[11] In the matter of Hold Brothers On-Line Investment Services, LLC, Exchange Act Release No. 67924 (Sept. 25, 2012), *available at* http://www.sec.gov/litigation/admin/2012/34-67924.pdf (settled matter); In the matter of Biremis Corporation, Exchange Act Release No. 68456 (Dec. 18, 2012), *available at* https://www.sec.gov/litigation/admin/2012/34-68456.pdf (settled matter).

[12] In the matter of Park Financial Group, Inc., Exchange Act Release No. 56902 (Dec. 5, 2007), *available at* http://www.sec.gov/litigation/admin/2007/34-56902.pdf (settled matter).

[13] In the matter of Gilford Securities, Incorporated, Exchange Act Release No. 65450 (Sept. 30, 2011), *available at* https://www.sec.gov/litigation/admin/2011/33-9264.pdf (settled matter); In the matter of Ronald S. Bloomfield, Robert Gorgia, and John Earl Martin, Sr, Exchange Act Release No. 71632 (Feb. 27, 2014), *available at* http://www.sec.gov/litigation/opinions/2014/33-9553.pdf.

[14] NASD Rule 3011 was adopted in 2002. In 2010, FINRA Rule 3310 replaced NASD Rule 3011.

[15] *See, e.g.,* FINRA Letter of Acceptance, Waiver and Consent No. 2012034123501 Re: Wells Fargo Advisors, LLC, and Wells Fargo Advisors Financial Network, LLC (Dec. 18, 2014), *available at:* http://disciplinaryactions.finra.org/Search/ViewDocument/38254, in which FINRA brought an action under FINRA Rule 3310, later settled for $1.5 million, based on a design flaw in the transaction processing system that resulted in certain customer accounts not being analyzed under the customer identification program.

[16] S*ee, e.g.*, Letter of Acceptance, Waiver and Consent No. 2013035821401 re Brown Brothers Harriman & Co. (Feb. 4, 2014), *available at:* http://disciplinaryactions.finra.org/Search/ViewDocument/35225; NML Risk Assessment at pages 82-84, *available at*: http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf; Letter of Acceptance, Waiver and Consent No. 2010021211901 re Firstrade Securities, Inc. (May 7, 2013), *available at*: http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=33515; In the matter of Biremis Corporation, Exchange Act Release No. 68456 (Dec. 18, 2012), *available at* https://www.sec.gov/litigation/admin/2012/34-68456.pdf (settled matter); Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance, FIN-2014-A007 (August 11, 2014), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-A007.pdf.

[17] *See, e.g.*, Letter of Acceptance, Waiver and Consent No. 2013035821401 re Brown Brothers Harriman & Co. (Feb. 4, 2014), *available at::* http://disciplinaryactions.finra.org/Search/ViewDocument/35225.

[18] *See, e.g.*, Letter of Acceptance, Waiver and Consent No. 2010021162202 re Biremis Corp. (June 20, 2012), *available at:* http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=32132.

[19] Letter of Acceptance, Waiver and Consent No. 2013035821401 (Feb. 4, 2014), *available at:* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p443448.pdf.

[20] In the matter of Oppenheimer & Company, Case Number 2005-4 (Dec. 29, 2005), *available at* http://www.fincen.gov/news_room/ea/files/oppenheimerassessment.pdf.

[21] Dept. of Enforcement v. Oppenheimer & Co., Inc., Order Accepting Offer of Settlement (Aug. 5, 2013), *available at:* http://disciplinaryactions.finra.org/Search/ViewDocument/33961; In the matter of Oppenheimer & Co. Inc., Exchange Act Release No. 74141 (Jan. 27, 2015), *available at*: http://www.sec.gov/litigation/admin/2015/33-9711.pdf.

[22] 31 C.F.R. 1023.220.

[23] 31 C.F.R. 1023.100(a)(d)(1). Staffs of the Treasury and the Commission issued a question and answer that identified the following specific fact pattern in which a beneficial owner of an omnibus account or subaccount is not considered a customer: if (1) the omnibus account or relationship is established by or on behalf of a financial intermediary for the purpose of executing transactions that will clear or settle at another financial institution, or the omnibus accountholder provides limited information to the broker-dealer solely for the purpose of delivering assets to the custody account of the beneficial owner at another financial institution; (2) the limited information given to the broker-dealer about the beneficial owner is used primarily to assist the financial intermediary with recordkeeping or to establish sub-accounts that hold positions for a limited duration to facilitate the transfer of assets to another financial institution; (3) all transactions in the omnibus account or sub-accounts at the broker-

dealer are initiated by the financial intermediary; and (4) the beneficial owner has no direct control over the omnibus account or sub-accounts at the broker-dealer. Guidance *available at:* https://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm.

[24] FINRA Letter of Acceptance, Waiver and Consent No. 2012030436201 Re LWBJ Investment Services, LLC (July 10, 2014), *available at: http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=36727*; FINRA Letter of Acceptance, Waiver and Consent No. 2010021128601 Re The Carson Medlin Company (Nov. 30, 2011), *available at:http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=27408*.

[25] In the matter of Pinnacle Capital Markets LLC, Exchange Act Release No. 62811 (Sept. 1, 2010), *available at* http://www.sec.gov/litigation/admin/2010/34-62811.pdf.

[26] 31 C.F.R. 1023.320.

[27] NASD Notice to Members 02-21 (April 2002) http://www.sec.gov/about/offices/ocie/aml2007/nasd-ntm-02-21.pdf.

[28] In the matter of Gilford Securities, Incorporated, Exchange Act Release No. 65450 (Sept. 30, 2011), *available at:* https://www.sec.gov/litigation/admin/2011/33-9264.pdf (settled matter).

[29] In the matter of Hold Brother On-Line Investment Services, Exchange Act Release No. 67924 (Sept. 25, 2012), *available at:* http://www.sec.gov/litigation/admin/2012/34-67924.pdf (settled matter).

[30] In the matter of Ronald S. Bloomfield, Robert Gorgia, and John Earl Martin, Sr, Exchange Act Release No. 71632 (Feb. 27, 2014), *available at:* http://www.sec.gov/litigation/opinions/2014/33-9553.pdf.

[31] Customer Identification Program Rule No-Action Position Respecting Broker-Dealers Operating Under Fully Disclosed Clearing Agreements According to Certain Functional Allocations FIN-2008-G002 (March 4, 2008) ("a clearing firm's anti-money laundering program should contain risk-based policies, procedures, and controls for assessing the money laundering risk posed by its fully disclosed clearing arrangements, for monitoring and mitigating that risk, and for detecting and reporting suspicious activity"), *available at:* http://www.sec.gov/about/offices/ocie/aml/fin-2008-g002.pdf. *See, also*¸ FINRA Letter of Acceptance, Waiver and Consent No. 2007007133001 Re Legent Clearing LLC (Dec. 5, 2008), *available at*: http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=19048.

[32] *See,* Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative (Nov. 2003), *available at:* http://www.fincen.gov/statutes_regs/files/sarnarrcompletguidfinal_112003.pdf.

[33] *See, e.g.,* NML Risk Assessment at pages 81-82, available at: http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.

[34] *See, e.g.,* In the matter of Oppenheimer & Co. Inc., Exchange Act Release No. 74141 (Jan. 27, 2015), *available at:* http://www.sec.gov/litigation/admin/2015/33-9711.pdf (settled matter); In the matter of Gilford Securities, Incorporated, Exchange Act Release No. 65450 (Sept. 30, 2011), *available at* https://www.sec.gov/litigation/admin/2011/33-9264.pdf (settled matter); In the matter of Ronald S. Bloomfield, Robert Gorgia, and John Earl Martin, Sr, Exchange Act Release No. 71632 (Feb. 27, 2014), *available at* http://www.sec.gov/litigation/opinions/2014/33-9553.pdf; In the matter of Ferris, Baker Watts, Inc., Exchange Act Release No. 59372 (Feb. 10, 2009), *available at*: https://www.sec.gov/litigation/admin/2009/34-59372.pdf (settled matter).

[35] ational Exam Program Risk Alert: Broker-Dealer Controls Regarding Customer Sales of Micro-Cap Securities (October 9, 2014), *available at*: http://www.sec.gov/about/offices/ocie/broker-dealer-controls-microcap-securities.pdf.

[36] *Available at: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf*.

[37] *See, e.g.,* In the matter of Pinnacle Capital Markets LLC, Exchange Act Release No. 62811 (Sept. 1, 2010), *available at* http://www.sec.gov/litigation/admin/2010/34-62811.pdf (settled matter); In the matter of Hold Brothers On-Line Investment Services, LLC, Exchange Act Release No. 67924 (Sept. 25, 2012), *available at* http://www.sec.gov/litigation/admin/2012/34-67924.pdf (settled matter).

[38] In the matter of Wedbush Securities Inc., Exchange Act Release No. 73652 (Nov. 20, 2014) (settled action), *available at* http://www.sec.gov/litigation/admin/2014/34-73652.pdf. *See, also,* FINRA's complaint against Wedbush Securities, FINRA Department of Market Regulation and Department of Enforcement v. Wedbush Securities Inc., Disciplinary Proceeding No. 20090206344-01 (August 18, 2014), *available at:* http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=37085.

[39] National Exam Risk Alert on Master/Sub-accounts (Sept. 29, 2011), *available at*: http://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf. *See, also¸* NML Risk Assessment at pages 78-81, available at: http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.

[40] Broker-dealers are required to report suspicious transactions that are "conducted or attempted by, at, or through a broker-dealer", among other criteria. 31 C.F.R. 1023.320. As such, any limitation based on classification of a "customer" is not consistent with the rule.

[41] *See, e.g.,* Letter of Acceptance, Waiver and Consent No. 2013035821401 re Brown Brothers Harriman & Co. (Feb. 4, 2014), *available at*: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p443448.pdf, for the proposition that to be reasonably designed, an AML program must take into account the services offered to customers. *See, also,* Letter of Acceptance, Waiver and Consent No. 2013035109701 re: LPL Financial LLC (May 6, 2015), *available at*: http://disciplinaryactions.finra.org/Search/ViewDocument/48016.

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Effective Mediation Strategies

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Kathy Adams

Advocates like to ask, "How much is that red flag worth?" This is usually a difficult question to answer because normally no single factor drives a settlement. Rather, the value of any one red flag must be measured by how it adds to the broader spectrum of actions and failures. As an advocate, your goal is to present that combination of red flags in a way that works to your client's greatest advantage.

Negotiating in a way that maximizes recovery for your client involves preparation – discerning and conveying your client's story in simple and understandable, yet compelling, terms. Getting to that point involves identifying both the strongest points in your case and the weakest points in your opponent's case and compiling the documentary backup for both. Documents and the data included in them are the most powerful weapons in your arsenal. A pattern of problems or missteps quickly adds up and becomes harder for the other side to explain. Every time you can demonstrate through documents a place where the other side's story falters and, in turn, where your case holds up, you strengthen the credibility of your client's case and its settlement value.

Being prepared is the single most important thing you can do to maximize your client's recovery. Showing the other side that you are prepared immediately places you in stronger bargaining position. Decision-makers on your adversary's side will make determinations about the settlement value of a case based in part on their perception of your case knowledge and preparedness. Displaying up front that you are in command of the key components of your case and have developed your arguments will yield immediate advantages to your client.

This somewhat fictional case study tells the story of Attorney Dan, a lawyer whose preparation and effective use of documents and summary data at mediation results in a high-percentage settlement for his clients, the Smiths. It demonstrates how Attorney Dan's method of gathering, synthesizing and summarizing documents helped him analyze his case and prepare for a successful negotiation. And it shows how Attorney Dan presented his best documents and information in a thoughtful, metered sequence to highlight the strengths of his case and the weaknesses in the other side's story. In the end, his effective use of documents and summary data exponentially increased the settlement value for his clients.

Attorney Dan's Organized Method of Preparation and Analysis

When the Smiths first contacted Attorney Dan about their case, he set up and appointment and asked them to bring along several categories of documents so he could make some preliminary determinations about the strength of their claim and their potential causes of action.

Over time, Attorney Dan developed a system that he liked to use to prepare his cases. As part of his system he had created several checklists and summary charts, which he routinely used to keep track of his cases and to present key data in negotiations or hearing. He would use many of these checklists and charts in preparing the Smiths' case. The morning he was scheduled to meet with

Dan pulled up one of those charts --his “Client Document Checklist.” He used this chart to remind himself of the things he wanted to discuss with the Smiths and to track the categories of documents they brought for him. Attorney Dan’s checklist is reproduced below:

CLIENT DOCUMENT CHECKLIST

Account statements (all accounts): _____

Notes on statements? _____ Online only? _____

Confirmations

Notes on confirmations? _____ Online only? _____

Margin/Other documents: _____

Notes

Calendars

Telephone records: _____ Client telephone number(s): _____

New Account Documents

Consistent with NADs received from firm? _____

Emails: ient email address(es): _____

Broker: _____

C Sales Assistant: _____

l Manager: _____

Other supervisor: _____

Documents received from broker in meetings: _____

Documents received via mail/email from broker/firm: _____

Statements from other firms

Firm 1: _____ Firm 2: _____

Firm 3: _____ Firm 4: _____

Documents from other firms (if applicable): _____

_____ Tax Returns: _____

_____

Interest/Dividends from other brokerage firms? _____

Where? _____ _____ _____

Mortgage/Loan documents/financial statements (if applicable): _____

Resume(s): _____

Other lawsuit documents (if applicable): _____

Client business(es): _____

Business tax returns (if applicable)

Other: _____

When the Smiths arrived at the appointed time, Attorney Dan noted with interest the large pile of documents they brought with them. He was glad to see that they had followed his instructions and was hopeful that this might be a case he would consider taking. When he spoke with the Smiths, he found them to be quite believable and honest about their story, even though they were a little embarrassed about the whole thing. Here is what Attorney Dan found out during the intake interview.

The Smiths and How They Lost Their Retirement Dream Money with Ms. Long and BD, Inc.

The Smiths told Attorney Dan that they saved their money every month and lived an average life in an average middle-class home. They worked at normal jobs and did not have large incomes. They also told him that they had a retirement dream – a family home on the lake where the entire family, along with family friends, could meet to enjoy happy times. Years ago, they opened a savings account and deposited a set amount of money into that account each month. Every time they saved $5,000, they took that amount and open a CD. Three years ago, they had saved enough to be able to take a major step toward realizing their dream. They bought the parcel of land on which they hoped to build their lake home. Their dream in sight, they set a ten-year timeline for beginning construction on the home.

At the urging of trusted friends, the Smiths considered opening a brokerage account. When the Smiths first met Ms. Long, they wanted to be sure they remembered what she said, so they took a pad of paper with them to jot down notes. Ms. Long was engaging and seemed to the Smiths to be a knowledgeable and experienced financial advisor. She asked about their background and about their goals. They told her about their dream of retiring on the lake and explained that they had already purchased the lot. Most importantly, they told her that they were hoping to build, if all went well, in eight years instead of ten – but they weren't willing to take very much risk in order to do it.

Ms. Long showed them historical stock market and sector performance charts. She also showed them some fancy color brochures with pie charts and timelines. The pie charts gave samples of potential asset allocations and the timelines showed about how long it would take them to reach their goal for each allocation. After they talked about the concept of risk and reward, the Smiths pointed to one of the pie charts on the lower end of the risk scale. Ms. Long circled that pie charts and put a big star by it. It wasn't the most conservative allocation but it was definitely one of the choices that carried lower risk. This was the broad asset allocation model that Ms. Long told the Smiths she would use, and she would identify and recommend investments consistent with that model. The Smiths decided to open an account.

Ms. Long asked for some basic financial information – annual income, net worth, and liquid net worth. This information was accurately recorded on the new account forms. When Ms. Long moved on to the return objective, she explained to the Smiths that their choice had to be "growth" because they weren't seeking a stream of income. For risk profile, the Smiths' choices were "conservative," "moderate" and "aggressive." Ms. Long explained to them that the choice had to be "moderate" because they would not be investing solely in treasury securities and money markets. She assured them that these choices were consistent with the asset allocation model they had agreed to. She skipped over the section about years of investment experience, telling them that they did not need to fill out that section because the Smiths never had a brokerage account before. When the forms for the new account were complete, the Smiths signed them and so did Ms. Long. She showed them a list of investments she was recommending and told them that the list was commensurate with the allocation model. The Smiths kept copies of all these documents in a file folder at their house.

For about a year, the Smiths investments steadily grew, as Ms. Long had said they would. She told them that they shouldn't worry much about looking at their statements every month because she had it all under control. The Smiths, unfamiliar with the nature of specific investments, believed that Ms. Long had followed the asset allocation model they agreed to in that initial meeting. They noticed some changes in the names of the investments in their account over time and asked Ms. Long about those changes. She told them that she was simply readjusting the portfolio because there were opportunities with those new investments and their accounts would do better for the changes. Unaware that Ms. Long was not authorized to make "adjustments" without talking to them, the Smiths did not question her actions. They wrote notes on their statements when they had these conversations with Ms. Long.

About a year and a half after they opened their account, the Smiths opened a monthly statement and were stunned at what they saw. Their account value was only one half of what it had been only three short months before. And it looked like the investments they had once held were all gone, replaced several times over with other investments. Ms. Long had never called them to talk about any of this. The Smiths picked up the telephone immediately and placed a call to Ms. Long.

She went over the account statements with them, explaining to the Smiths that there was definitely a market correction going on but that they were going to be just fine. She was on the job and had been readjusting in hopes of "buying on the dip" and "capturing some upside potential." When the Smiths asked Ms. Long why she hadn't contacted them about the market correction and all of the trading, she told them that she didn't want them to worry and that she was still hopeful she could bring the account value back. She just needed more time. The Smiths discussed the matter and closed their account with Ms. Long and BD, Inc.

The Documents the Smiths Brought to Attorney Dan

Attorney Dan was pleased to discover that the Smiths were excellent record-keepers. Ms. Smith's file folders and pile of documents contained the following:

- Bank statements (showing monthly savings and CD purchases)
- Mortgage statements for primary residence (showing modest mortgage)
- Purchase documents for lake lot (showing purchase price and cash purchase)
- Pictures of primary residence and lake lot
- Tax returns (showing no evidence of other brokerage accounts and showing a modest income, showing no unexplained capital loss carryover)
- Smiths' notes of meetings with Ms. Long (with notations about "little risk," "updates," "proven track records," and the Smiths' notes about Ms. Long's explanations of asset allocation goals)
- Brochures about stock market and sector performance (from Ms. Long's initial meeting with the Smiths)
- Asset allocation charts (showing chosen model circled and with big star next to it)
- List of initial investments shown to the Smiths by Ms. Long at initial meeting (showing a list of investments that Attorney Dan knew was much more aggressive than the asset allocation model the Smiths had chosen)
- New Account Documents (as completed at initial meeting)
- Attorney Dan consulted his Client Document Checklist and noted the categories of documents the Smiths had brought him.

Discovery and What Else Attorney Dan Learned

Attorney Dan knew that obtaining the documents he needed to verify his clients' version of events was critical to a successful negotiation, so he had created a checklist of basic discovery documents that he used in each case to determine what he needed in all cases and for various types of claims. He consulted his "Discovery Documents Checklist" and set about obtaining the documents he believed he needed to prove up the Smiths' claims. Some were contained in FINRA's Discovery Guide but others were not.

He thought through his potential causes of action and used his checklist to decide which documents he needed to obtain from BD, Inc. and Ms. Long. Several causes of action came to mind when he reflected on the Smiths' story, but he decided he would focus on: unsuitability, overconcentration, unauthorized trading and failure to supervise.

Attorney Dan received the Discovery Guide documents from BD, Inc. and Ms. Long. He received all the basic documents from the firm. When BD, Inc. responded that they could not locate any documents for certain of his requested categories, Attorney Dan made sure to request the certifications provided for in the Discovery Guide. He knew that the documents that didn't exist were just as important as those that did. As he received documents, he checked them off on his list.

Discovery Documents Checklist:

BASICS

Account Statements for all accounts: _____

Agreements for all accounts (NADs, margin, options, etc.): _____

Discretionary authority documents: _____

Power of Attorney/Trading Authority grants: _____

Confirmations for all accounts: _____

Trade Tickets: _____

Commission Runs: _____

Cross Reference charts by product: _____

Risk Tolerance Questionnaires: _____

COMMUNICATIONS AND NOTES

Telephone records: _____

Email:

Custodian #1 _____ Custodian #2 _____

Custodian #2 _____ Custodian #4 _____

Email monitoring: _____

Broker's Customer File: _____

Branch Customer File: _____

Broker Notes: _____

Broker Calendar (paper and electronic): _____

PRODUCTS (stocks, bonds, funds, private placements, alternatives, etc.)

Marketing materials: _____

Analyst Reports: _____

Term Sheets: _____

Research Reports: _____

Underwriting documents: _____

Prospectuses/Offering documents: _____

Performance Data: _____

Due Diligence files from firm: _____

Due Diligence files from third parties: _____

Private Placement memoranda: _____

Accredited Investor documents: _____

BROKER

BrokerCheck report: _____

Forms U-4, U-5, RE-3: _____

Documents re: heightened supervision: _____

Documents re: internal investigations: _____

Awards against broker: _____

SUPERVISION

Exception Report run, with code sheet: _____

Active Account sheets from branch: _____

Supervisory Notes: _____

Letters (happiness, trading velocity, commissions, concentration): _____

List of branch supervisors: _____

Branch Audit reports: _____

Compliance Bulletins: _____

Sales Practice Manuals: _____

Supervisory Manuals: _____

OTHER

_____

_____

Suitability

The Smith's first cause of action was for unsuitability. He used several categories of documents to analyze this claim, including: new account documents from both the Smiths and BD, Inc., the Smiths' notes, tax returns, the marketing materials Ms. Long gave the Smiths, the asset allocation chart with the circle and the big star on it, the list of initial investments that Ms. Long had told the Smiths were commensurate with the asset allocation, BD, Inc.'s research reports on the securities in the Smiths' accounts, BD, Inc.'s historical ratings on the securities it followed, and the Smiths' account statements.

Attorney Dan knew that analyzing new account documents was critical to this analysis, so he always looked closely at them. He knew that no matter what his clients said now, the brokerage firm would rely on what was in the new account documents because a firm will rely on the information a customer provided to the firm when the account was opened. Attorney Dan had developed a chart to make sure he summarized the information on those documents for himself so he could note any discrepancies within the documents, among documents for other accounts in a customer's portfolio, and with outside documents, such as tax returns. Attorney Dan's "New Account Document Analysis" chart appears below:

New Account Document Analysis

1. Are the documents complete and consistent?
   All parts filled out? _____
   Any changes to forms? _____

   Signed by clients? ____ Signed by broker? ____
   Signed by supervisor? ___ Name: _____

2. Financial information completed _____

   Net worth $_____

   Liquid Net Worth $_____

   Annual Income $_____

   Annual Income match tax returns? _____

   Notes: _____

3. Investment experience completed and correct _____
   Years of experience: stocks _____
   bonds _____
   options (and type) ___
   other _____
   Consistent with other accounts ___

   Consistent with prior firm accounts ___

   Notes: _____

4. Other people with trading authority: _____ Exercised? _____

5. Return Objective: _____

6. Trading consistent with objective? _____

Notes:

_____

7. Risk Profile: _____
8. Trading Consistent with Risk profile? _____
9. Scaled Risk Profile score (0-100 scale): _____

_____

10. Was the account type appropriate?

11. Type of account:
12. Discretionary/Non-discretionary: _____

If discretionary, who had trading authority?

Broker ____ Third Party _____ Who? _____

Proprietary platform? _____

13. Margin or general purpose loan involved? _____

Amount: _____ Call issue? _____

14. Other: _____

_____

The Smiths' new account forms were quite interesting, especially when Attorney Dan compared the ones the Smiths had given him to the ones he received through discovery from BD, Inc. The checkmark in the "moderate" box in the risk profile section had been crossed out and the "aggressive" box had been checked instead. And the investment experience section that was blank on the Smiths' signed copy of the form now showed 15 years of experience investing in stocks and bonds and 5 years of experience trading options. When he faxed this form to the Smiths to review, they were stunned. Attorney Dan was confident that the form had been altered after the Smiths signed it because he had reviewed their tax returns and knew that they had no investment experience because no interest or dividends appeared on the tax returns except for the interest earned from the Smiths' savings bank on their savings account and CDs. He notes all of these areas of concern on his simple chart, which he would consult when preparing for hearing or mediation.

It was plain to him that the investments in the Smiths' account were inconsistent with the asset allocation model Ms. Long told them she would use in recommending investments. He noted from the account statements that the Smiths' account was heavily concentrated in one sector. He also noted that the Smiths' account contained quite a few unproven equities and aggressive, sometimes highly- leveraged, funds. None of the investments was consistent with the asset allocation the Smiths had agreed to when they opened their account. He decided to use his expert for this piece of the analysis and provided the expert with the asset allocation chart, the list of investments that Ms. Long had given the Smiths to show the asset allocation she would use, and the monthly statements. In discovery, he asked BD, Inc. for portfolio summaries (showing distribution of assets in account by percentage), documents showing BD, Inc.'s internal research on the investments in the Smiths' accounts, and the historical ratings for the securities in the Smiths' account that BD, Inc. research department followed. The expert could do a nice job making pie charts comparing the chosen asset allocation and the actual asset allocation and could show the nature of the securities in the account with the research and ratings information.

Overconcentration

Next, Attorney Dan considered his overconcentration claims. While the expert would ultimately also deal with concentration issues as they changed over time, Attorney Dan liked to use a chart he had developed that would remind him of the concentration levels at a given moment in time. He used the chart to measure concentration at account inception or in a given month of a single investment, a sector, an asset class or some other measure.

Concentration Snapshot Analysis

Concentration (single investment, sector, asset

class) Date: _____

Concentration vs. account: _____% Amount invested: _____

Account value: _____

Concentration vs. portfolio: ____%

Firm concentration policy percentage: _____%

As he expected, the sector concentration in the Smiths' account was quite high. But he also discovered that the concentration of securities without lengthy performance records comprised a significant percentage of the account.

Unauthorized Trading

The Smiths had told Attorney Dan that Ms. Long did not consult them when she made "adjustments" to their account, even after she started to trade at a higher velocity as the markets crashed. This information made Attorney Dan consider bringing an unauthorized trading claim. The Smiths definitely had a non-discretionary account – he had checked the type of account against BD, Inc.'s website. And as he looked at the confirmation slips the Smiths had given him, he noted how quickly those per-trade commissions added, giving the Smiths even less chance to recover the losses they had incurred.

He decided he needed documents that showed the trading in the account, the timing of those trades, the communications between the branch and the Smiths and the commissions earned. His list for this claim included: account statements, confirmations, trade tickets, broker file, branch file, telephone records, emails, written correspondence, broker notes and calendar (electronic and hard copy), supervisory files, commission runs and potentially a cross-reference chart to see if the trading scheme that Ms. Long employed was unique to the Smiths or whether it crossed her client base.

Attorney Dan had developed a chart he used to synthesize these documents and to show patterns of unauthorized trading. Attorney Dan's chart template looked like this:

Date	Trade (B/S)	Sol/Unsol	Time of Trade	Call w/time	Meeting w/time	Email w/time	Note w/time	Supervisory	Gain/Loss (realized/ unrealized)	Commission	Bates

In the case of the Smiths' account, it became apparent right away that Ms. Long's trading in their non- discretionary account was done on a largely unauthorized basis. From his chart, Attorney Dan could see that on most dates where Ms. Long executed trades she had no communication with the Smiths. And, curiously, many of those trades were marked unsolicited. On a few of the dates where she executed trades, Ms. Long either communicated with the Smiths or met with them, but the time of trade was always prior to the communication or meeting.

Failure to Supervise

For his supervision claims, Attorney Dan wanted to look at supervisory files, supervisory notes, telephone records, branch correspondence file documents, exception reports and account activity review documents, and supervisory letters (velocity, commission, number of trades, concentration) the branch sent to the Smiths. He found out that nobody from the management team at BD, Inc. ever contacted the Smiths to discuss their altered new account documents or the concentration in their account, even though the account had shown up on a number of exception reports.

How Attorney Dan Used His Key Documents Notebook to Obtain a Great Result for the Smiths

When it came time to mediate the Smiths' case against BD, Inc. and Ms. Long, Attorney Dan's system of tracking, synthesizing and summarizing key documents and date made it fairly easy for him to decide which documents and charts would be the most important. He compiled these critical documents into a key documents notebook that he brought to the mediation with him. And he consulted his notebook as he put together his opening statement. When the day came for the mediation, Attorney Dan was ready.

In the end, Attorney Dan included these items in his key documents book:

- a summary chart showing the Smiths' monthly deposits into their savings accounts
- a summary chart showing the transfers in $5,000 increments into CDs, along with the withdrawals for the lake property and the loan to their son
- the purchase documents for the lake property
- the Smiths' tax returns showing their income and the pages showing that there were no interest or dividends coming from brokerage firms
- the stock market and sector performance charts Ms. Long had given the Smiths
- the asset allocations models with the Smiths' chosen model circled and starred
- the Smiths' notes from their meetings with Ms. Long
- the list of investments that Ms. Long had given to the Smiths when they opened their account
- the telephone records he received from BD, Inc. and the Smiths
- the Smiths' BD, Inc. account statements containing their notes of conversations with Ms. Long
- the unauthorized trading summary chart showing that there were no communications between Ms. Long and the Smiths on most dates when trades were executed
- BD, Inc.'s discovery certification that they located no documents reflecting communications between management or compliance personnel at BD, Inc. and the Smiths
- the concentration snapshot chart
- the concentration pie charts Attorney Dan's expert had created

Here is how (in pertinent part) Attorney Dan presented the Smiths' story during opening statements at mediation:

> Mr. and Mrs. Smith worked hard all their lives and saved diligently every month so they could one day build a retirement home on the lake where the entire family -- kids, grandkids, cousins, and friends -- could visit and enjoy together. It took a long time and involved modest living and sacrifice, but the Smiths always had their goal in mind. Three years ago, they bought the lakefront parcel of land on which they hoped to build. They planned to begin construction within ten years.
>
> Then the Smiths met Ms. Long, a broker at BD, Inc. Ms. Long showed them fancy charts and talked at length about investments and how the stock market is always a better investment than the CDs in which the Smiths had been saving their money. She said she would only recommend investments that had a proven track record and carried just a little bit of risk. That way, if there was a market downturn, the Smiths would not be in jeopardy of losing a significant part of their savings. She said she would talk to them regularly and keep them informed. These things were important to the Smiths, especially because they had never had a brokerage account and were a little bit nervous about the whole idea.
>
> Unfortunately for the Smiths, Ms. Long's actions did not match the promises she made and they found out the hard way that their trust had been misplaced. Ms. Long recommended products that carried much more than the little bit of risk the Smiths had agreed to take. And she placed a large percentage of the Smiths' account in those higher-risk products. Ms. Long's recommended investments and concentrations were inconsistent with BD Inc.'s own policies and asset allocation models and were certainly contrary to the lower-risk asset allocation model that the Smiths had agreed to.
>
> The Smiths received their account statements and looked at them, not every single month but at least quarterly. But given their lack of investment experience, looking at account statements didn't matter because the Smiths were unable to tell just how risky the investments really were and how the concentration of these risky investments could hurt them. To them, all seemed well and Ms. Long seemed to be doing exactly what she promised. But when the markets crashed, the Smiths discovered that their account lost plenty more than the little bit that Ms. Long had promised. And any chance the Smiths might have had to recover from their immediate losses was eliminated when Ms. Long traded their non-discretionary account at increased frequency and without contacting the Smiths, thereby locking in their losses. Unfortunately, there was nobody on site to supervise the trading, and nobody from the remote management team or BD, Inc.'s compliance department contacted the Smiths about any of these issues.
>
> The Smiths bring claims for unsuitability, overconcentration, unauthorized trading and failure to supervise. They are here today to negotiate in good faith but are prepared to prove every statement in this presentation and, accordingly, will be seeking to recoup the full value of their losses, the commissions paid and the benefit of how their account would have performed had it been invested according to the agreed-to asset allocation model.

Several times during the mediation, Attorney Dan was able to use the documents and charts in his key documents notebook to advance his clients' position and to significantly increase the amount of the

settlement. Counsel for BD, Inc. gave an opening statement that portrayed the Smiths as experienced investors who wanted to take shortcuts so they could retire early and live the good life. She said that they instructed Ms. Long, over Ms. Long's prudent advice, to "go for it" and to do whatever it took to maximize their returns. Then, when the markets went into decline, the Smiths wanted to blame someone else for their losses and concocted a story to portray themselves as "conservative" investors. But the Smiths had shown their true colors at the time they opened their account, when they told Ms. Long that they were "aggressive" investors with multiple years of experience even stocks, bonds, and even risky options.

Attorney Dan listened with interest to BD, Inc.'s opening statement and mentally ticked off the documents in his notebook with each PowerPoint slide. He had given a broad brush opening statement, but the other side did not know what he had brought with him to back up the story. He didn't want to throw everything he had at BD, Inc.'s counsel at one time. He needed to pace out the presentation of the document and charts so BD, Inc.'s counsel could digest it a little bit at a time. He wanted the story to build round by round.

Round 1 – The Smiths Were Diligent Savers and Unsophisticated Investors

Round 1 of the negotiations would focus on the Smiths and their true sophistication level. BD, Inc.'s counsel had suggested that the Smiths were experienced and sophisticated investors who called the shots with respect to their account at BD, Inc. Attorney Dan needed to dispel this notion. He went to his key documents notebook and reviewed some documents with the mediator. He started with the Smiths' tax returns, showing her both the Smiths' modest income and the pages demonstrating that they never received dividends or interest from other brokerage accounts. Certainly, experienced and sophisticated investors would have received at least some interest or dividends from a brokerage account over the several years of tax returns that the Smiths had provided to Attorney Dan.

Next, Attorney Dan showed the mediator the statements from the Smiths' savings bank. The monthly deposits were there. And so was the one withdrawal for the lake property. What aggressive investors would invest this diligently, every month, for years, in a basic savings account and in laddered, low- yielding CDs?

The purchase of the lake property came next. Per the purchase documents, this was a cash transaction, the money for which was derived from years of safe, diligent savings. There was no leverage here, even though the Smiths purchased the property in an historically-low interest rate environment. A transaction like this is virtually unheard of these days – and not one taken by people seeking shortcuts.

The mediator went to BD, Inc.'s conference room with copies of these documents in hand and a clear grasp of the Smiths' modest and hardworking lifestyle. BD, Inc.'s counsel was not pleased to see these documents but could not dispute what they showed and the logical conclusions that Attorney Dan had drawn from synthesizing them. She and her businessperson had a private discussion and sent the mediator back with an opening settlement offer that was higher than they had expected to give. But they sent back a message – even if the Smiths had acted more prudently in the past, once they purchased the lake property, they made a conscious decision to take more risk and they adjusted their behavior accordingly. Ms. Long was clear that it was the Smiths who chose the aggressive trading strategy that had been employed in their account.

Round 2 – The Asset Allocation and Trading was Inconsistent with the Smiths' Desires

Attorney Dan knew that it would take time to methodically convince BD, Inc. that the Smiths' story was completely true, and he was a patient lawyer. So he started talking with the mediator about BD's next concern – who made the allocation and trading decisions in the Smiths' BD, Inc. account. In this round of negotiations, Attorney Dan's goal was to paint the true picture of what happened in the initial meetings between the Smiths and Ms. Long and to put the pieces together for BD, Inc.'s attorney to show that, from inception, Ms. Long failed to follow the Smiths' desires.

He began by asking the mediator what backup BD, Inc. had for their allegations that it was the Smiths who "called the shots" with respect to their investments and that it was they who chosen and driven the trading strategy. He hadn't seen any notes, letters or emails to that effect and he knew from his own review of the documents that there were very few telephone calls between Ms. Long and the Smiths. If BD, Inc. had something that he had not seen or had overlooked, he should find out. But the mediator simply replied, "Ms. Long said so." So Attorney Dan again consulted his key documents notebook.

For this round of negotiations, Attorney Dan began by showing the mediator the documents that Ms. Long had presented to the Smiths at their initial meeting – the stock market and sector performance charts and the asset allocation models. It didn't fit that aggressive, experienced investors would have to receive such basic education on investing. More importantly, who circled the lower risk asset allocation and put a big star by it – and why?

Attorney Dan returned to his notebook and came back with the Smiths' notes of their initial meeting with Ms. Long. He went through the Smiths' notes, which indicated that they were rudimentary investors who were learning for the first time the terms that Ms. Long was describing.

He sent the mediator back to BD, Inc.'s room with a counter not much lower than his first offer.

Round 3 – The Altered New Account Documents, the Lack of Supervision and Unauthorized Trading

When the mediator returned, Attorney Dan asked what was going on in the other room. It appeared the BD Inc.'s counsel was becoming frustrated, not with the process but with Ms. Long, whose story seemed more and more questionable based on the documents Attorney Dan had sent over. The mediator relayed BD, Inc.'s counter, which was another sizeable move. Nevertheless, BD, Inc.'s counsel had another question -- why would the Smiths tell Ms. Long that they wanted an aggressive account and why would they tell her that they had years of trading experience, except to manipulate her into agreeing to employ an aggressive trading strategy?

This time, Attorney Dan smiled just a bit as he consulted his notebook. He removed a few different documents. First, he showed the mediator the new account documents produced by BD, Inc., the ones showing the information that BD's counsel had referenced. Then he set next to it the copy of the new account documents from the Smiths' file. Both were signed by the Smiths and Ms. Long, so how could they be different? Of course, there was only one viable explanation. Ms. Long had altered the document sometime after the Smiths left her office.

Attorney Dan also showed the mediator BD, Inc.'s certification that they had no record of communications between supervisory or compliance personnel and the Smiths.

Finally, Attorney Dan showed the mediator his unauthorized trading chart. Attorney Dan gave the mediator the chart and invited her to spot-check its accuracy. He assured her that he had the backup data available for review. Then he sent her back to BD, Inc.'s room with another demand that he said was his last.

The Result and the Lesson – Preparation Will Always Benefit You and Your Client

Presented with all of the documents that Attorney Dan had compiled, reviewed and synthesized, BD, Inc. had to hit the bid. It took a little while because BD, Inc.'s counsel had to make a call and explain all the documentary evidence that she had seen, but Attorney Dan's preparation – and especially his methodical, thoughtful and effective use of documents –won the day. Had Attorney Dan shown up to the mediation and simply talked with the mediator, telling her his clients' story without any documents to present, the mediation would have been a classic "he-said, she-said" situation. In those cases, each attorney is forced to stand by his or her client's story and, accordingly, digs into that position when negotiating. Most of the time, a story-telling stalemate can be broken with a few key documents. The lawyer who takes the time to know a client's case and who can present that case with documentary backup for each assertion, as Attorney Dan did for the Smiths, can obtain the best recovery for that client.

Kathy Adams is a mediator with nationwide practice that focuses on securities disputes of all kinds. She spent several years in private practice and as in-house counsel for a major wirehouse, where she represented advisors and firms in hundreds of arbitrations, regulatory inquiries, customer complaints and associated person/firm disputes. Kathy also advised branches and supervisory personnel about litigation risk and strategies for avoiding such risk.

As part of her case preparation, Kathy often used charts and checklists like the ones presented in this somewhat fictional case study. If you would like to receive templates of the charts and checklists contained herein, please contact her at: kathy@kathyadamsdrs.com.

Trial Skills 101 – Cross-Examination Tips and Techniques

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I. Themes and Theories

A. Defining Terms
   a. Theory – A cogent statement of an advocate's position that justifies the verdict sought
   b. Themes – Recurring thoughts, ideas or catchphrases that summarize and reinforce the theory of the case

B. Embracing the Bad Facts
   a. Most cases boil down to a handful of facts/documents/emails that will be central to the jury's consideration of liability or guilt
   b. Identify the bad facts and devise a theory of the case that allows you to embrace them

C. Organizing your Examination in the Chapter Method
   a. Cross-examination should be a series of small examinations (chapters) on individual topics of importance
      i. DO NOT organize your cross-examination temporally
      ii. You do not want the cross-examination to mirror the direct
   b. Chapter topics:
      i. Affirmative facts that need to be established through a witness – you can use a hostile witness to help prove your case
      ii. Highlighting a fact
      iii. Disputing or weakening a fact
      iv. Affect positively or negatively the credibility of a witness
         1. Prior inconsistent statements or omissions
         2. Bias issues
   c. Organize your cross-examination so that each chapter focuses on one point that you want to establish with that witness
      i. At the end of each chapter, the jury should understand the significance of the point you were trying to make
   d. Consider "bundling" chapters – grouping related chapters together to create a full picture of a topic

II. Types of Cross-Examination Witnesses

A. Friendly, Hostile or Neutral
   a. Identify the witness' relationship to your theory
   b. Know what you need to/can establish with that witness
   c. Do not try to do too much

III. General Impeachment

A. FRE 607, 608 and 609
   a. FRE 607 – Any party, including the party that called the witness, may attack the witness's credibility
   b. FRE 608 – A witness's character for truthfulness or untruthfulness
      i. Witness credibility may be attacked or supported by testimony about the witness's reputation for truthfulness or untruthfulness or by opinion testimony about that character trait
         1. Evidence of truthfulness only admissible after character for truthfulness has been attacked
      ii. Specific instances of conduct are admissible in more limited circumstances – more likely admissible when relevant to truthfulness or untruthfulness
   c. FRE 609 – impeachment by prior conviction
      i. Any felony conviction (subject to 403 analysis)
      ii. Any offense that involves dishonesty

B. Compromise Offers and Negotiations - FRE 408
   a. Prior offers of compromise are not admissible to prove or disprove a claim or to impeach
   b. Except to show bias/prejudice, negate a contention of undue delay or prove obstruction of a criminal investigation or prosecution

IV. Making the Non-Cooperative Witness Answer the Question and Agree with You

A. Leading Questions – FRE 611
   a. Court has significant discretion in controlling mode and order of examining witnesses and presenting evidence

B. Refreshing Recollection v. Recorded Recollection - FRE 612 and 613
   a. FRE 612 – an adverse party is entitled to have the writing produced at the hearing, to inspect it, to cross-examine the witness about it, and to introduce in evidence any portion that relates to the witness's

testimony. Court must review in camera any portion of the writing that includes "unrelated matter" and determine whether it must be produced to opposing party.

i. Purpose of FRE 612 is the same as the Jencks Act, 18 USC § 3500—to promote the search of credibility and memory. Difference may be timing of disclosure – FRE 612(a)(2) allows judges to require early disclosure of witness statements while *Jencks* permits the government to withhold witness statements until after a witness testifies.

ii. Differences between *Jencks* and FRE 612:

1. FRE 612 applies to all cases – *Jencks* is only criminal cases
2. *Jencks* applies only to witness statements – FRE 612 applies to anything used by a witness to refresh recollection

b. FRE 613 – Witness's Prior Statement

i. No requirement that witness be shown prior inconsistent statement but must disclose to opposing counsel upon request

ii. Cannot admit extrinsic evidence of prior inconsistent statement unless witness is given an opportunity to explain or deny the statement and the adverse party is given an opportunity to examine the witness about it

1. Does not apply to statements of opposing party that are not hearsay under 801(d)(2)

c. When to use impeachment vs refreshing recollection

i. Refresh recollection

1. Friendly witness – when you want the witness to be speaking more and explaining their perspective, use refreshing recollection to help them remember and be able to testify from memory
2. Only when witness cannot remember – cannot refresh to get a witness to change their answer

ii. Impeach

1. Hostile witness – not trying to help this witness remember, you want to show they aren't credible
2. When a witness answers a question inconsistent with a prior statement – cannot impeach when a witness testifies that they cannot remember the information asked about

d. Steps to refresh recollection

i. Confirm lack of memory

ii. Ask what might help

iii. Show the witness the document

iv. Take the document back

v. Re-ask the question

e. Steps to impeach
    i. Repeat testimony - get witness to commit to inconsistent statement
    ii. Credit prior statement
        1. Purposes:
            a. Show prior statement more reliable and accurate
            b. Establish foundation that may allow you to use extrinsic evidence of prior inconsistent statement
        2. How to credit prior statement – emphasize the following:
            a. Where the witness was when they made the statement
            b. Prior statement was closer to events – more fresh in mind
            c. Importance of being truthful in prior situation
            d. Prior statement was accurate when made
        3. Impeach
    iii. Confirm witness knew it was important to be truthful when inconsistent statement given (can draw out this part as much as desired)
    iv. Confront with inconsistent statement
f. Tips for Impeachment:
    i. Impeach one fact at a time
    ii. When impeaching with prior sworn testimony, read the question and answers verbatim
    iii. When impeaching with a report of a prior statement, ensure your question reflects the same
    iv. Be mindful of your tone – different tone for a lying witness vs. a forgetful witness – both are unreliable but for different reasons
    v. Do not impeach with facts taken out of context – too easy to clean up on redirect you lose credibility
    vi. Be selective with your impeachment – you lose credibility when you impeach on non-material facts

C. Remainder of or Related Writings and Recorded Statements (Rule of Completeness) - FRE 106
    a. If a party introduces all or part of a writing or recorded statement, an adverse party may require the introduction, at that time, of any other part — or any other writing or recorded statement — that in fairness ought to be considered at the same time.

b. Purpose: (1) correct against any misleading impression created by taking matters out of context; (2) guard against inadequacy of repair work when delayed to later point in trial
c. Applies only to writing and recorded statements – not appliable to conversations
d. Tips:
    i. Request to introduce remainder of writing must be made contemporaneous with introduction of first part – consider conferring with opposing counsel to work these issues out before trial
    ii. Limited to portions of recording/statement that are related and relevant

PIABA ETHICS TRAINING

Introduction

These examples are designed to highlight recent ethics opinions issued by various attorney regulatory bodies and/or the relatively new situations in which PIABA lawyers and other lawyers find themselves operating.

I. Duties owed in the event of a client's death

Situation 1: Client seeks representation to recover investment losses from complex trading over a lengthy period of time. Lawyer is willing to undertake case on a partial contingent fee basis with the client paying the lawyer a $10,000 nonrefundable fee - in part to pay for expert analysis of the trading. Lawyer and client enter into partial contingency engagement agreement. Lawyer hires expert for an upfront nonrefundable fee of $5,000. Before the expert analysis is completed, the client dies. The heirs do not wish to proceed with the case and want all the money back.

Q: Does the Lawyer have an obligation to return the $10,000 nonrefundable fee?

The fact that the fund was designated in the engagement agreement as a nonrefundable fee and was to be deposited in the lawyer's operating account does not matter. Under Model Rule 1.5(a), a lawyer's fees and expenses must be reasonable. Comment 4 of the Model Rules provides "A lawyer may require advance payment of a fee, but is obliged to return any unearned portion." Recently, the ABA addressed this in an advisory opinion:

> Under the Model Rules of Professional Conduct, a fee paid to a lawyer in advance for services to be rendered in the future must be placed in a client trust account and may be withdrawn only as earned by the performance of the contemplated services. This protects client funds and promotes client access to legal services in the event the representation terminates before all contemplated services have been rendered. All fees must be reasonable, and unearned fees must be returned to the client. Therefore, it is not accurate to label a fee "nonrefundable" before it actually has been earned, and labels do not dictate whether a fee has been earned.

ABA Standing Committee on Ethics & Professional Responsibility Formal Opinion 505 (May 3, 2023) (attached).

Whether the lawyer has an obligation to return the fee depends on whether the fee is reasonable. Even if the fee was deposited in the lawyer's operating account as fully earned, the lawyer has an obligation to return any part of the fee that is not reasonable. This situation is also addressed in ABA Formal Opinion 505:

> Some lawyers use labels like "nonrefundable retainer," "nonrefundable fee," or "earned on receipt" in the body or title of a fee agreement. These are not actual types of fees. And use of these descriptors does not, in and of itself, make a fee arrangement a general retainer. In fact, these terms are most often used in an attempt to make an advance fee nonrefundable.

> The Model Rules of Professional Conduct do not allow a lawyer to sidestep the ethical obligation to safeguard client funds with an act of legerdemain: characterizing an advance as "nonrefundable" and/or "earned upon receipt." This approach does not withstand even superficial scrutiny. A lawyer may not charge an unreasonable fee. See Model Rule 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses."). Comment [4] to Rule 1.5 provides this additional guidance: "A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d)." See also, Model Rule 1.15(c) and others discussed in connection with Hypothetical 1 below. Therefore, under the Model Rules, an advance fee paid by a client to a lawyer for legal services to be provided in the future cannot be nonrefundable. Any unearned portion must be returned to the client. Labeling a fee paid in advance for work to be done in the future as "earned upon receipt" or "nonrefundable" does not make it so.

Id. at 5.

Thus, the lawyer may recover for reasonable time and expenses already incurred in the matter. It is reasonable for the lawyer to deduct from the amount returned the amount paid to the expert, if the expert does not return those funds to the lawyer. The lawyer should not have to return that part of the fee that has already been spent on a documented outside expense.

In addition, the lawyer should be able to deduct the reasonable value of work that has already been performed for the client. This is a good reason to record time spent by lawyers and paralegals on any matter, whether contingency, partial contingency, or hourly. If the lawyer had recorded three hours of time and had a usual billing rate of $500/hour (which should be disclosed in the engagement agreement), the lawyer could deduct $1500 from the fee.

In practice, it is a good idea to check with a probate attorney in the deceased client's state of residence to make sure you are properly disbursing funds to the estate. For example, the wife of the deceased client may ask the lawyer to return the funds via check payable to her. Before doing so, you should ensure that is appropriate. The wife may not be the executor of the estate. After ensuring that you have identified the person with authority to handle the estate, you may wish to make the check payable to the estate of the deceased client.

Situation 2: Lawyer represents Client in a lengthy contentious FINRA arbitration. After two weeks of hearings, the parties are waiting for the decision of the three arbitrator panel. Lawyer receives a call from Client's wife that Client has died. Lawyer is engaged in post-hearing settlement negotiations with opposing counsel.

Q1: Does Lawyer have a duty to notify opposing party that Client has died before the parties reach a settlement?

> The issue is whether the death of the client is a "material fact." It is highly likely the lawyer has an obligation disclose the client's death to opposing counsel during negotiations to settle personal injury claims. *See* ABA Formal Opinion 95-397 (September 1995); ISBA

Advisory Opinion No. 96-3 (July 1996). The Illinois State Bar Association ("ISBA") endorsed the ABA's reasoning:

> In Formal Opinion 95-397 (September 18, 1995), the American Bar Association concluded that a lawyer has a duty to disclose the death of a client that occurs during the course of settlement negotiations in a pending personal injury action. The ABA reasoned that because the lawyer was taking part in negotiations pursuant to authorization of the client, continued settlement discussions without disclosure constituted an implied representation that the lawyer still had a living client. Such conduct would be a false statement of material fact contrary to ABA Model Rule 4.1(a), which is substantially similar to Illinois Rule 4.1(a). The ABA also opined that the lawyer must disclose the client's death the next time the lawyer communicates with opposing counsel.

ISBA Op. 96-3. The ISBA further concluded that the death of the claimant would be a "material fact" making disclosure to the adverse party necessary to avoid assisting a fraudulent act by the estate or executor, citing Rules 4.1(a) and 8.4(c). *Id.* Under Model Rule 4.1 (Truthfulness in Statements to Others):

> In the course of representing a client a lawyer shall not knowingly:
>
> (a) make a false statement of material fact or law to a third person; or
>
> (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Moreover, under Model Rule 8.4 (Misconduct), it is professional misconduct for a lawyer to … (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation.

The Supreme Court of Minnesota addressed this issue in a litigated case involving an attorney who failed to disclose the death of his client during settlement negotiations. *In re Lyons*, 780 N.W.2d 629 (Minn. 2010) (relying on Montana and Minnesota rules; attached). Attorney Lyons was indefinitely suspended for failing to disclose to a credit reporting agency during settlement negotiations that his client (the consumer) had died. The court referred to Rule 8.4(c) – which makes it professional misconduct for a lawyer to engage in conduct involving dishonesty, fraud, deceit or misrepresentation. Lyons compounded the problem by making statements during the disciplinary hearing that the hearing officer found were intentionally false and misleading in violation of Rule 3.3(c) requiring candor to the tribunal.

Q2: Does Lawyer have to notify the arbitrators even though the evidentiary hearings are over?

With respect to disclosure to the arbitration panel, while all the facts have come into evidence and the case is already in the arbitrators' hands, the Lawyer probably has an obligation to the tribunal to make "timely disclosure" of the client's death. *See* ISBA Advisory Opinion No. 96-3 (July 1996). *See also* Model Rules 3.3(a)(1) and 3.3(c). The relevant provisions of Rule 3.3 are:

> (a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer.

* * *

(c) The duties stated in paragraphs (a) and (b) ***continue to the conclusion of the proceeding***, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

(emphasis added). Since the arbitration proceeding has not been concluded and the fact of the client's death is likely material, meaning Lawyer likely has an obligation to disclose the death of Client to the arbitration panel in a timely manner.

II. Ethical concerns about work locations

Situation 3: Lawyer licensed in Illinois who has practiced for many years from an office in Illinois moves to Colorado.

Q1: May the Illinois licensed lawyer continue to represent clients including making virtual appearances in Illinois court hearings?

This raises an issue that has become particularly relevant since the beginning of the pandemic in 2020, even for lawyers who do not permanently move to another jurisdiction but appear remotely because of restrictions on travel.

Ordinarily, a lawyer must be licensed to practice in any jurisdiction in which they practice. In what is probably the most restrictive state, California, the California Supreme Court ruled in 1998 that an out-of-state law firm with no physical presence in California violated that state's prohibition against unauthorized practice in its representation of a California client even though the representation did not involve California law. *Birbrower, Montalbano, Condon & Frank, P.C. v. Superior Court*, 949 P.2d 1 (Cal. 1998). But most states—even including California—make an exception for lawyers practicing only federal law, such as immigration. But as for cases involving state law, the Illinois lawyer must consult both Illinois and Colorado rules and law to determine whether they are permitted to make a virtual appearance in an Illinois court while being physically located in Colorado.

To start, Lawyer should first consult the laws of Illinois because it is the state in which they are licensed. The Illinois State Bar Association recently issued an Advisory Opinion addressing the issue, concluding that the lawyer in this hypothetical would not be violating the Illinois Rules of Professional Conduct. Remote practice of law – ISBA Advisory Opinion 22-03 :

"It is difficult to imagine that Illinois lawyers have not handled client matters, *i.e.,* practiced Illinois law, while out of the geographic boundaries of Illinois for as long as Abraham Lincoln was riding the 8th Judicial Circuit. While life under the once and future Covid pandemic has accelerated, expanded, and amplified the prevalence of lawyers' extra-geographical practice, it has not created a new ethics quandary….

> And whether it is transactional work, client interaction, or appearing electronically in court, depositions, or client meetings appears to be irrelevant in our increasingly ethereal practice of law. There is no violation of the Illinois Rules of Professional Conduct for a lawyer to practice Illinois law from a geographic location outside the boundaries of state of Illinois."

Colorado's rules are a little less clear. For an attorney who has not permanently domiciled in Colorado, the Colorado Rules of Civil Procedure allows an out-of-state lawyer to practice in Colorado without limitation ***unless*** they want to appear in court. C.R.C.P 205.1 provides that "[a]n out-of-state attorney may practice law in Colorado except that an out-of-state attorney who wishes to appear in any state court of record must comply with" *pro hac vice* admission procedures. But the Colorado Rules recognize that their intent is to protect the public from lawyers holding themselves out as lawyers in Colorado or authorized to practice law in Colorado.

Q2: Can Lawyer continue to solicit clients in the State of Illinois as long as their license remains valid?

For the same reasons discussed above, Illinois law would allow such a practice. Colorado law, while less clear, appears to also allow it.

The American Bar Association issued a widely cited opinion in December 2020, consistent with the Colorado approach, stating that a lawyer may remotely practice law of jurisdiction where licensed when physically in another jurisdiction where they are not licensed ***as long as*** they do not hold themselves out as being licensed in the residence state or represent themselves as having an office in the jurisdiction.

> ABA Formal Opinion 495 (December 2020):
>
> Words in the rules, unless otherwise defined, are given their ordinary meaning. "Establish" means "to found, institute, build, or bring into being on a firm or stable basis." A local office is not "established" within the meaning of the rule by the lawyer working in the local jurisdiction if the lawyer does not hold out to the public an address in the local jurisdiction as an office and a local jurisdiction address does not appear on letterhead, business cards, websites, or other indicia of a lawyer's presence. Likewise it does not "establish" a systematic and continuous presence in the jurisdiction for the practice of law since the lawyer is neither practicing the law of the local jurisdiction nor holding out the availability to do so. The lawyer's physical presence in the local jurisdiction is incidental; it is not for the practice of law. Conversely, a lawyer who includes a local jurisdiction address on websites, letterhead, business cards, or advertising may be said to have established an office or a systematic and continuous presence in the local jurisdiction for the practice of law. (Footnotes omitted.)
>
> A lawyer practicing remotely from a local jurisdiction may not state or imply that the lawyer is licensed to practice law in the local jurisdiction. Again, information provided on websites, letterhead, business cards, or advertising would be indicia of whether a lawyer is "holding out" as practicing law in the local jurisdiction. If the lawyer's website, letterhead, business cards, advertising, and the like clearly indicate the lawyer's jurisdictional limitations, do not provide an address in the local

jurisdiction, and do not offer to provide legal services in the local jurisdiction, the lawyer has not "held out" as prohibited by the rule.

The purpose of Model Rule 5.5 is to protect the public from unlicensed and unqualified practitioners of law. That purpose is not served by prohibiting a lawyer from practicing the law of a jurisdiction in which the lawyer is licensed, for clients with matters in that jurisdiction, if the lawyer is for all intents and purposes invisible as a lawyer to a local jurisdiction where the lawyer is physically located, but not licensed. The Committee's opinion is that, in the absence of a local jurisdiction's finding that the activity constitutes the unauthorized practice of law, a lawyer may practice the law authorized by the lawyer's licensing jurisdiction for clients of that jurisdiction, while physically located in a jurisdiction where the lawyer is not licensed if the lawyer does not hold out the lawyer's presence or availability to perform legal services in the local jurisdiction or actually provide legal services for matters subject to the local jurisdiction, unless otherwise authorized.

Q3: What if Lawyer is a Wisconsin licensed lawyer who wants to work from their winter vacation home in Florida?

This is essentially the same situation as the above examples, except Lawyer must consult the laws of Florida and Wisconsin.

The Wisconsin Supreme Court addressed the ethics of remote work by an attorney law in a January 2021 opinion. In its introduction to Wisconsin Formal Ethics Opinion EF-21-02, the court noted:

> "Historically, the practice of law has been defined by in-person interactions: between lawyers and their clients, between opposing counsel, and through face-to-face discussions or contested hearings in court with all parties present to resolve clients' matters. Over time, technological advances have replaced many of these personal interactions, as well as other aspects of practice such as the transfer and storage of client information. In addition, it is expected that lawyers, like other professionals, will continue to work remotely in some form after the pandemic."

As a background rule, the opinion emphasizes that "[t]he basic responsibilities that a lawyer owes the client – competence, diligence, communication, and confidentiality - lie at the core of lawyer's professional obligations and remain unchanged irrespective of the lawyer's physical location."

Relying heavily on ABA Formal Opinion 495, the Wisconsin Supreme Court concluded that while a Wisconsin lawyer needs to consult the law of the relevant jurisdiction before practicing in a foreign jurisdiction, Wisconsin does not forbid such a practice.

Similarly, Florida does not proscribe such a remote practice. The Florida Bar addressed the issue with respect to a New Jersey lawyer in FLORIDA BAR RE: ADVISORY OPINION—OUT-OF-STATE ATTORNEY WORKING REMOTELY FROM FLORIDA HOME. No. SC20-1220 (May 20, 2021) (https://www-media.floridabar.org/uploads/2021/06/Order-on-FAO-2019-4-O-O-S-Atty.-Working-Remotely-From-Florida-Home.pdf)

> ...the Petitioner who simply establishes a residence in Florida and continues to provide legal work to out-of-state clients from his private Florida residence under the circumstances described in this request does not establish a regular presence in Florida for the practice of law. Consequently, it is the opinion of the Standing Committee that it would not be the unlicensed practice of law for Petitioner, a Florida domiciliary employed by a New Jersey law firm (having no place of business or office in Florida), to work remotely from his Florida home solely on matters that concern federal intellectual property rights (and not Florida law) and without having or creating a public presence or profile in Florida as an attorney.

Situation 4: Lawyer A decides to move with her paralegal into shared office space. There are multiple lawyers and law firms in the shared office space. Lawyer A will have her own office. Her paralegal will have a cubicle near Lawyer A's office. Lawyer A and paralegal will have calls handled by a receptionist who answers calls for other lawyers. Lawyer A and her paralegal will use common equipment such as the office's wi-fi, copy machines, and fax machines.

Lawyer A is approached by Client to represent her in recovering investment losses against Firm X. Lawyer A is aware that a group of attorneys in the shared office space often represent Firm X in these types of investment loss arbitrations.

Q1: Can Lawyer A represent Client?

> Office sharing is a common practice for lawyers, and perhaps increasingly so. The fixed costs associated with running a law office can be prohibitive for a small firm, not to mention inefficient. In downtown Chicago, there are office buildings for the majority of tenants are solo practitioners or small law firms sharing space with each other.
>
> The most important thing to remember in a shared office setting is that a lawyer's general ethical duties are not relaxed because of the shared office. In fact, the lawyer should be hyper-diligent that they take appropriate measures to ensure they are fulfilling all of their ethical duties. In situations like the hypothetical, the lawyer must take special care to ensure that they are not risking their client's confidentiality.

The ABA addressed this situation in ABA Formal Opinion 507 (July 12, 2023):

> It is generally permissible for lawyers to participate in office sharing arrangements with other lawyers under the ABA Model Rules of Professional Conduct. At the same time, office sharing lawyers should appreciate that such arrangements will require them to take appropriate measures to comply with their ethical duties concerning the confidentiality of information, conflicts of interest, supervision of non-lawyers, and communications about their services. The nature and extent of any additional safeguards will necessarily depend on the circumstances of each arrangement.

Thus, a lawyer entering a shared office space situation should establish certain best practices, including:

> Clear communications with their clients about the lawyer's relationship to other lawyers in the space;
>
> It may be advisable to obtain the client's consent in writing, particularly if there is any risk of inadvertent disclosures of client information.

The possibility of potential conflicts of interest may require the lawyers to adopt an ethical screen if lawyers in the same space are representing opposing clients in same lawsuit or transaction, particularly where the lawyers use a common receptionist and office equipment (where copies and printouts might sit in a tray for extended periods of time).

Q2: What if Lawyer A attempted to market their services to the Client by emphasizing how they work in the same office as Firm X?

While sharing office space may present surmountable hurdles, a lawyer stating or implying that they have some sort of formal relationship with a firm that they do not have likely runs headlong into the type of practice that the ABA, as well as the state bars discussed in Situation 3 above, have said would be impermissible. In fact, if Lawyer A really had a formal relationship with Firm X, the representation would likely involve an impermissible conflict.

The New York Bar Association recently issued an opinion discussing such a situation: NY State Bar Assoc Opinion 1220 (3/31/2022)

> "...lawyers who share office space but have no professional association with each other may not use a designation such as the '777 Lawyers Group' because that would deceive the public about the business status of the lawyers... Rule 7.1(c)(2) provides that an advertisement shall not: (2) include the portrayal of a fictitious law firm, the use of a fictitious name to refer to lawyers not associated together in a law firm, or otherwise imply that lawyers are associated in a law firm if that is not the case."

III. Ethical concerns regarding technology

Situation 5: Lawyer A has a remote receptionist service that permits texting. Lawyer A occasionally receives text messages from prospective or current clients.

Q1: May Lawyer A respond to texts she receives? What about clients who insist that you use WhatsApp or Signal? How should a lawyer handle these requests?

Given the ubiquity of technology involved in the legal profession, a lawyer is not required to simply become knowledgeable about the law or court procedures, but also in the operation of, and dangers involved in, using modern technology. *See* Kulik, To Text, Or Not To Text, Clients: An Ethical Question For A Technological Time, Above the Law (Feb. 11, 2019) https://abovethelaw.com/2019/02/to-text-or-not-to-text-clients-an-ethical-question-for-a-technological-time/

Comment 8 to American Bar Association Model Rules of Professional Conduct Rule 1.1 outlines the duty of "competence" that attorneys must afford their clients, which requires attorneys "[t]o maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, **including the benefits and risks associated with relevant technology**, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject." (emphasis added). Thus, a lawyer cannot escape liability simply because they didn't understand the risks associated with the use of a given technology.

Unfortunately, lawyers routinely engage in risky behavior in communicating with clients using modern forms of technology. For example, although most lawyers and clients have been using email to communicate for their entire professional careers, very little of the communications between clients and their lawyers make use of the heightened standard of security, *i.e.*, encryption, even though most jurisdictions have ethical opinions addressing email communications that require attorneys to consider encryption when communicating highly sensitive information. *See, e.g.,* Northrup, Rethinking Email Encryption, https://www.isba.org/ibj/2015/10/rethinkingemailencryption. No matter how diligent an attorney is, encryption of text messaging may not even be possible.

Text messaging also presents a host of more difficult challenges. One is the attorney's obligation to keep records. For example, most people understand how to customize their email accounts to retain or archive any important conversations, or at least how to avoid having emails get automatically deleted. The same is not true for texting. Text messages are routinely deleted by cellphone providers and an individual user must customize their settings to avoid such routine deletion. Moreover, there may be nothing a user can do to automatically retain text messages indefinitely, requiring a lawyer to periodically download and save the text messages to a different platform. While not usually important for attorney-client communications, such downloads may destroy any metadata associated with the texts.

Platforms such as WhatsApp or Signal may help resolve the confidentiality issues through encryption, and the iMessaging app built into Apple devices may be partially encrypted, use of these platforms requires all participants in the communication to be using the platform, and an attorney still needs to address the obligation to keep accurate and complete records.

The risks involved in text messaging with clients may outweigh any efficiency benefits of such communications. As a result, the best practice for an attorney who considers communicating with clients by text is to set up certain limits on the texting and outline the guidelines with their client ahead of time. For example, requiring that texts be limited to logistical arrangements for meeting or informing the lawyer that the client will be late to a meeting or for a call.

Q2: What if Lawyer A is attending a dinner party with several other attorneys in the industry and happens to leave their phone unattended when a text message from their answering service detailing an important update on their case is received?

Even if an attorney is willing to risk leaving a valuable piece of property unattended, particularly in a risky setting with other attorneys present, by now, everybody should know they should never leave their phone unattended without closing it so it is protected by some sort of security – facial recognition, thumbprint authentication, or password entry. Unfortunately, even password protection would not prevent a possible breach of attorney-client privilege in leaving a phone unattended. That is because most users receive notifications on their devices when they receive a text message, even when it is in a locked state.

The simple answer to this question is that a lawyer should always keep a work phone securely in their possession.

Q3: What if Lawyer A sends Client a text message detailing sensitive information about their case while the Client is showing a nonparty something on their phone?

> This question emphasizes the importance of defining the parameters of how you will communicate with your client at the beginning of the engagement.
>
> While a client will probably understand (and possibly even follow) your advice to not discuss their case or your communications with them with anybody to avoid waiving the attorney-client privilege, most people treat text messages as a much more informal means of communication and may not be nearly as diligent in maintaining the confidentiality.
>
> But this question presents an even greater challenge. People routinely hand their phones to others to view photos or memes or other content on the phone. Given that most people routinely receive notifications on their cell phones, as described in the last question, it might be impossible to prevent possible breaches of confidentiality for such people.

The simple answer to this question is that even if you choose to engage in some text messaging with your clients, you should avoid including ANY sensitive information in such texts.

IV. Ethical concerns regarding related clients

Situation 6: Lawyer A is approached by three clients about filing a FINRA arbitration to recover their losses in a single proceeding. Clients X and Y are married. Client Z is Client X's mother.

Q1: Can Lawyer A undertake this representation of multiple individuals? If so, what must be disclosed?

> It is quite common for potential claimants in FINRA arbitrations to include multiple individuals, typically those who are related to each other. That is because it is common for married couples or parent-children to own the same securities or be joint owners of the same account, and because it is common that individuals related to each other may use the same financial advisor and get the same advice. While nothing *per se* prevents Lawyer A from representing multiple parties in such a situation, special care should be taken to prevent and/or address potential conflicts of interest.
>
> The Illinois Rules of Professional Conduct provides useful guidance. *See* Illinois RPC Rule 1.7. Two sections in particular address how to deal with a potential conflict at the outset of representation. Commentary section 3 lays out the general rule that if a lawyer recognizes there is a conflict of interest, the lawyer must decline the representation.
>
> > The lawyer may represent the client, however, if:
> >
> > > "(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
> > >
> > > (2) the representation is not prohibited by law;
> > >
> > > (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent."

Commentary section 8 cautions a lawyer that even if they do not believe there is a direct conflict of interest, "a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests."

Here Lawyer A may undertake to represent Clients X, Y, and Z but should to the greatest extent possible in the engagement letter address those conflicts of interest that are reasonably foreseeable. One issue that is foreseeable is that the Respondent Firm might make a lump sum settlement offer to resolve the entire case. In that case, there should be preexisting agreement as to how the settlement payment should be allocated between the various clients. Right up front, Lawyer A should discuss and get the clients to agree to a formula for dividing a single payment. The division could be based on the ratio of claimed losses, the amount initially invested, or it could take into account any upfront expenses that one client may cover that benefit all three. It is best to handle this at the beginning.

Q2: Many months into the representation, Client Y asks to speak with you privately. They want to tell you about something from their past that cannot be disclosed to Client X or Client Z. What do you do?

Conflicts of interest can arise after an attorney has already begun representation of a group of clients. Depending on the circumstances of the conflict, the attorney may not be able to even explain to the clients how a conflict has arisen. Rule 1.6 of the ABA Model Rules allows for the disclosure of confidential information during representation with a client's informed consent, but that might be not be possible, depending on the circumstances.

The Illinois Rules of Professional Conduct offer additional guidance for conflicts of interest that may arise after representation has begun. Commentary section 4 to Illinois RPC Rule 1.7 outlines the following:

> If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b) … Where more than one client is involved, whether the lawyer may continue to represent any of the clients is determined both by the lawyer's ability to comply with duties owed to the former client and by the lawyer's ability to represent adequately the remaining client or clients, given the lawyer's duties to the former client.

The Illinois Rules of Procedure are clear that if a conflict arises between multiple clients during representation, the attorney may not continue to represent the conflicting parties. One way to avoid potential conflicts is for an attorney who expects that a conflict could potentially arise between multiple clients to have the concerned parties sign a waiver allowing the attorney to share information between the parties with their informed consent.

Rule 1.6 of the ABA Model Rules allows for disclosure with the clients' informed consent. Courts have confirmed this approach. *See e.g. In re Teleglobe Commc'ns Corp.*, 493 F.3d 345 (3d Cir. 2007); *Robert Bosch LLC v. Pylon Mfg. Corp.*, 263 F.R.D. 142, 145 (D. Del. 2009).

One way of dealing with this issue is to include in the engagement agreement language such as:

> The client consents to Attorney's continued representation of the Other Clients in the event of such withdrawal. No communications made to the Attorney in the course of their representation pursuant to the Contract shall be deemed confidential as to the Other Clients Attorney represents in this matter.

It is important to remember that even after withdrawing from representing a client, an attorney continues to be obliged to maintain the former client's confidentiality, and to avoid further conflicts of interest.

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 505 **May 3, 2023**

Fees Paid in Advance for Contemplated Services

Under the Model Rules of Professional Conduct, a fee paid to a lawyer in advance for services to be rendered in the future must be placed in a client trust account and may be withdrawn only as earned by the performance of the contemplated services. This protects client funds and promotes client access to legal services in the event the representation terminates before all contemplated services have been rendered. All fees must be reasonable, and unearned fees must be returned to the client. Therefore, it is not accurate to label a fee "nonrefundable" before it actually has been earned, and labels do not dictate whether a fee has been earned.

This opinion examines a lawyer's obligations under the ABA Model Rules of Professional Conduct with respect to fees paid in advance for legal work to be performed by the lawyer in the future.[1] In particular, this opinion seeks to clarify the proper handling and disposition of fees paid in advance for legal work to be performed in the future, including where the lawyer must deposit and maintain the funds and when the lawyer may treat them as earned. The opinion also explains when a lawyer must refund all or a portion of fees paid in advance and discusses whether such a payment may be, or can even be labeled, "nonrefundable." The answers are derived from the application of several Model Rules, including: 1.5(a), 1.5(b), 1.15(a), 1.15(c), 1.15(d), and 1.16(d).

Fees for services may be paid after completion of the services, of course. However, for certain matters, many lawyers request or require that funds in a certain amount be paid to the lawyer at the outset of the representation to secure payment for the lawyer's later work. Under the Model Rules such fees must be placed in a Rule 1.15-compliant trust account, to be disbursed to the lawyer only after the fee has been earned. This is to protect the client from the risk that the lawyer may not be able to refund the prepaid fee in the event the representation terminates before the contemplated work is completed. The Model Rules protect the lawyer from the risk of nonpayment by allowing advance fees to be received and protect the client by requiring that the funds are kept safe and separate from the funds of the lawyer or firm.

I. Terminology

As a preliminary matter, it is useful to define terms commonly used to label certain client-lawyer fee arrangements: advances, retainers, flat or fixed fees, and "nonrefundable" or "earned-on-receipt" fees.

[1] This opinion is based on the American Bar Association Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2022. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling. This is especially noteworthy for this opinion as jurisdictions have adopted substantially different rules relating to the management of client property including fees paid in advance for legal work to be performed in the future.

A. Advances v. Retainers

Fees paid by a client to a lawyer in advance for legal work to be performed by the lawyer in the future are sometimes referred to as an "advance fee," an "advanced fee," an "advance fee payment," an "advance fee deposit," a "fee advance," or simply an "advance." Advances are also sometimes called "special retainers," "security retainers," or simply "prepaid fees." To be consistent and clear, this opinion will use the term "advance" when discussing fees paid to the lawyer for legal work to be performed in the future.

When a client pays an advance to a lawyer, the lawyer takes possession – but not ownership – of the funds to secure payment for the services the lawyer will render to the client in the future.

This opinion will also refer to the term "retainer" fee. Neither the term "retainer" nor "retainer fee" is found in the Model Rules of Professional Conduct. Regrettably, many lawyers use the term loosely to mean any sum of money paid to the lawyer at or near the commencement of representation.[2] Whereas an advance is a deposit of money with the lawyer to pay for services to be rendered in the future, there is another type of payment that is not for services. Rather, "[t]he purpose of [a retainer] is to assure the client that the lawyer will be contractually on call to handle the client's legal matters."[3] This type of agreement and payment is variously referred to as a "general retainer," "classic retainer," "true retainer," "availability retainer," or an "engagement retainer."[4] Because all of these terms mean the same thing, this opinion will use the term "general retainer" to refer to this arrangement.[5] A general retainer is paid – and deemed earned – upon the promise of availability to represent a client, whether or not services are actually needed or requested by the client.[6] Thus, a general retainer has been conceptualized as a form of an option

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[2] There is widespread agreement that the word "retainer" has been used so inconsistently that is has practically lost all definable meaning. BLACK'S LAW DICTIONARY (11th ed. 2019) ("Over the years, lawyers have used the term 'retainer' in so many conflicting senses that it should be banished from the legal vocabulary.") (quoting Mortimer D. Schwartz & Richard C. Wydick, PROBLEMS IN LEGAL ETHICS 100, 101 (2d ed. 1988)).

[3] CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 506 (West 1986).

[4] Some jurisdictions have commendably sought to define terms and draw distinctions in their court rules. *See* Ariz. Rules of Prof'l Conduct R. 1.5 cmt. [7] (*"*The 'true' or 'classic' retainer is a fee paid . . . merely to insure the lawyer's availability to represent the client and to preclude the lawyer from taking adverse representation. What is often called a retainer but is in fact merely an advance fee deposit involves a security deposit to insure the payment of fees when they are subsequently earned, either on a flat fee or hourly fee basis. A flat fee is a fee of a set amount for performance of agreed work, which may or may not be paid in advance but is not deemed earned until the work is performed. . . ."). *See also* Fla. State Bar R. 4-1.5(e)(2) (defining "retainer," "flat fee," and "advance fee") and Iowa R. Civ. P. 45.8-10 (defining "general retainer," "special retainer, and "flat fee").

[5] It is sometimes said that retainers come in two varieties: "general retainers" and "special retainers." A special retainer is simply an advance going by another, unfortunately misleading, name. *See* Lester Brickman & Lawrence A. Cunningham, *Nonrefundable Retainers Revisited*, 72 N.C. L. REV. 1, 5-6 (1993) ("A special retainer is an agreement between lawyer and client in which the client agrees to pay the lawyer a specified fee in exchange for specified services to be rendered. The fee may be calculated on an hourly, percentage or other basis and may be payable either in advance or as billed.") (footnotes omitted). The Committee is of the opinion that a special retainer is the same thing as an "advance." To be consistent and clear, this opinion will use the term "advance" when referring to such arrangements, although some of the cited sources and authorities may use the term "special retainer."

[6] "Because the general retainer is not a payment for the performance of services, but rather is compensation for the lawyer's promise of availability, the fee is earned by the lawyer at the time the retainer is paid and thus should not be deposited into a client trust account. The general retainer is not an advance deposit against future legal services, which instead would be separately calculated and charged should the lawyer actually be called upon by the client to

contract.[7] In other words, hourly time is not billed against a general retainer and a general retainer is not a flat fee for a specific amount of the lawyer's time – it is solely to reserve the lawyer's availability. An important result of these related features is that the money paid by the client in connection with a general retainer should not be placed in a trust account since it is considered earned upon the commencement of the contract.[8]

Some authorities treat the term "general retainer" or "true retainer," etc., as synonymous with "nonrefundable." This is not correct. A general retainer may, by custom, be considered earned when paid, but this does not mean that it is forever exempt from scrutiny under the Rules. It may be determined to be an unreasonable fee, or even unearned if the lawyer does not make himself or herself available. For example, if a company retains a lawyer to handle a hostile takeover bid should one arise and the lawyer does not, in fact, accept the engagement, then the fee, which may have been paid many months earlier and treated as the lawyer's own property, may be determined to be unreasonable and/or unearned and therefore the subject of an order requiring it to be returned, refunded, or repaid to the client. Other circumstances requiring refund might include the death, disability, suspension, or disbarment of the lawyer. Like all fees, a general retainer must be reasonable under the circumstances.[9]

General retainers "are quite rare,"[10] and have "largely disappeared from the modern practice of law."[11] However, attempts to cast what is actually an advance payment of fees for services to be performed later as a general retainer are very much present today. Given the rarity and unusual nature of a general retainer, and the fact that very few clients would actually need or benefit from one, the nature of the fee and lawyer's obligations and client's benefits under such an agreement must be explained clearly and in detail, including the fact that fees for legal services performed will be charged in addition to the general retainer,[12] and use of the term should be restricted to its traditional definition.

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perform the legal services in the future." Gregory C. Sisk, *Duties to Effectively Represent the Client*, § 4-4.4(b) (A Retainer for Lawyer Availability), *in* LEGAL ETHICS, PROFESSIONAL RESPONSIBILITY, AND THE LEGAL PROFESSION (West 2016).

[7] Lester Brickman, *The Advance Payment Dilemma: Should Payments be Deposited to the Client Trust Account or to the General Office Account*, 10 CARDOZO L REV. 647, 649 n.13 (1989). *See also In re* O'Farrell, 942 N.E.2d 799, 803 (Ind. 2011).

[8] This opinion does not attempt to exhaustively discuss general retainers. Though they can and do have legitimate uses, for years they have been criticized, disfavored, and narrowly construed based on contract law, public policy, and contemporary ethics principles. *See, e.g.*, Charles J. McClain, Jr., *The Strange Concept of the Legal Retaining Fee*, 8 J. LEGAL PROF. 123 (1983) (common law of retainers "rests on rather shaky conceptual foundations" full of "inconsistencies and contradictions" and "contributing yet another irritant to the already strained relations between the legal profession and the public at large"); Pamela S. Kunen, *No Leg to Stand on: The General Retainer Exception to the Ban on Nonrefundable Retainers Must Fall*, 17 CARDOZO L. REV. 719 (1996) (discussing "historical and descriptive misconceptions" and arguing that, in many instances, such retainers generate the fiduciary obligations attending other lawyer-client fee agreements); and Joseph M. Perillo, *The Law of Lawyers' Contracts Is Different*, 67 FORDHAM L. REV. 443, 449-453 (1998).

[9] MODEL RULES OF PROF'L CONDUCT R. 1.5(a); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 (2001) [hereinafter RESTATEMENT].

[10] Douglas R. Richmond, *Understanding Retainers and Flat Fees*, 34 J. LEGAL PROF. 113, 116 (2009). *See also In re* O'Farrell, 942 N.E.2d at 804 n.5.

[11] Provanzano v. Nat'l Auto Credit, Inc., 10 F. Supp. 2d 44, 51 (D. Mass. 1998).

[12] MODEL RULES OF PROF'L CONDUCT R. 1.5(b); RESTATEMENT, *supra* note 9, § 38.

This opinion focuses on advance fees paid by individual clients, usually for a single legal matter (or related matters) that will not recur on a regular basis. Examples include a divorce, defense of criminal charges, and discharge from employment or other civil matters not handled on a contingent fee basis. However, some clients may need legal services of a certain type on a repeat basis and may contract for such services. For example, the client and lawyer may enter into a renewable one-year agreement providing for a monthly payment to handle any or all collections arising out of one or more of the client's businesses. Some lawyers and clients may use the term "retainer" or "general retainer" to refer to such an arrangement. Such arrangements may be perfectly appropriate although they may not meet the definition of a general retainer even if "availability" is said to be a part of the arrangement. Perhaps the arrangement may best be understood as a fixed fee agreement, except that instead of handling one matter for a set fee no matter what services end up being required, the lawyer is handling several matters (subject to whatever limitations the parties place on the number, type, geography, etc., of the matters).[13]

B. Flat or Fixed Fees

Some lawyers prefer to charge their clients a flat or fixed fee for discrete legal services they provide. Examples include closing the purchase of a single-family home, incorporating a small business, drafting a will, or providing a defined, limited-scope service, such as drafting a motion. A flat fee is one that "embraces all work to be done, whether it be relatively simple and of short duration, or complex and protracted."[14]

If a flat or fixed fee is paid by the client in advance of the lawyer performing the legal work, the fees are an advance. Use of the term "flat fee" or "fixed fee" does not transform the arrangement into a fee that is "earned when paid." "Flat" or "fixed" does not even mean that the fee must be paid at the commencement of the representation, although most lawyers who do not have an existing relationship with a client may want to ensure payment and may, therefore, ask for the fee to be paid in advance before committing to the representation. If they do, as will be emphasized below, then that fee must be placed in a Rule 1.15-compliant trust account, to be disbursed to the lawyer only after the fee has been earned.

Several courts and ethics opinions endorse the option of dividing the representation into segments such that certain portions of a flat fee advance are considered earned before completion

[13] As we have noted, courts scrutinize purported general retainers to ensure that the lawyer is not attempting to circumvent the ethics rules requiring refund of unearned fees upon termination of the representation. The same is true with what are sometimes called "hybrid" fees or retainers. Such a fee is "a putative general retainer that is denominated as both for availability and for services," and it is likely to be considered by courts to be "fully refundable to the extent not earned by services rendered." Lester Brickman & Lawrence A. Cunningham, *Nonrefundable Retainers: A Response to Critics of the Absolute Ban*, 64 U. CIN. L. REV. 11, 22 (1995). *See also* N.Y. City Bar Formal Op. 2015-2 (Nonrefundable Monthly Fee in a Retainer Agreement) (2015), *citing* Agusta & Ross v. Trancamp Contracting Corp., 193 Misc.2d 781, 785-86 (N.Y. Civ. Ct. 2002) for the proposition that "enforcement of a hybrid retainer 'should be subject to close scrutiny, governed by a rebuttable presumption that any moneys retained by counsel are for services, rather than availability.'"

[14] ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1389 (1977).

of all the contemplated work.[15] Some jurisdictions have codified this approach in their rules.[16] Thus, if agreed to, the lawyer may remove such earned portions of a flat fee advance from trust prior to the completion of the full scope of the legal services to be performed as certain "milestones" or stages of the representation are reached or completed. This approach allows the lawyer to be paid in part before the end of the representation and provides some assistance in determining the refund amount in case of early termination. Of course, "extreme 'front-loading' of payment milestones in the context of the anticipated length and complexity of the representation" may not be reasonable.[17]

C. So Called "Nonrefundable" and "Earned Upon Receipt" Fees

Some lawyers use labels like "nonrefundable retainer," "nonrefundable fee," or "earned on receipt" in the body or title of a fee agreement. These are not actual types of fees. And use of these descriptors does not, in and of itself, make a fee arrangement a general retainer. In fact, these terms are most often used in an attempt to make an advance fee nonrefundable.

The Model Rules of Professional Conduct do not allow a lawyer to sidestep the ethical obligation to safeguard client funds with an act of legerdemain: characterizing an advance as "nonrefundable" and/or "earned upon receipt." This approach does not withstand even superficial scrutiny. A lawyer may not charge an unreasonable fee. See Model Rule 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses."). Comment [4] to Rule 1.5 provides this additional guidance: "A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d)." See also, Model Rule 1.15(c) and others discussed in connection with Hypothetical 1 below. Therefore, under the Model Rules, an advance fee paid by a client to a lawyer for legal services to be provided in the future cannot be nonrefundable. Any unearned portion must be returned to the client. Labeling a fee paid in advance for work to be done in the future as "earned upon receipt" or "nonrefundable" does not make it so.[18]

Hypothetical scenarios illustrating these concepts and applying the Model Rules are discussed in Section IV below.

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[15] *See, e.g.*, New Hampshire Bar Assoc. Ethics Committee Practical Ethics Article, *Practical Suggestions for Flat Fees or Minimum Fees in Criminal Cases* (Jan. 17, 2008). *See also In re* Mance, 980 A.2d 1196, 1202, 1204-1205 (D.C. 2009), *citing* Alec Rothrock, *The Forgotten Flat Fee; Whose Money is it and Where Should it be Deposited?*, 1 FLA. COSTAL L.J. 293, 323 (1999) for the proposition that some opinions "allow the lawyer to withdraw fees according to milestones 'based upon passage of time, the completion of certain tasks, or any other basis mutually agreed upon between the lawyer and client.'"

[16] *See, e.g.*, Colo. Rules of Prof'l Conduct R. 1.5(h) (defining a flat fee, explaining proper handling, setting forth required contents of the agreement, and appending an authorized form agreement).

[17] *In re* Mance, *supra* note 15.

[18] *See, e.g., In re* O'Farrell, 942 N.E.2d 799, 803 (Ind. 2011) ("Regardless of the term used to describe a client's initial payment, its type is determined by its purpose, i.e., what it is intended to purchase."); Mo. Sup. Ct. Advisory Comm. Formal Op. 128 (Amended 2018) (labels not conclusive); *In re* Wintroub, 277 Neb. 787, 801; 765 N.W.2d 482 (2009) (citing cases from several jurisdictions for the proposition that "a lawyer may not retain an unearned fee, even if the fee agreement clearly provides that the fee is nonrefundable"); Iowa Sup. Ct. Att'y Disciplinary Bd. v. Turner, 918 N.W.2d 130, 147 (Iowa 2018) (simply labeling payment of advance fees as "nonrefundable" does not relieve attorney from obligation to deposit them into trust accounts).

II. Model Rule of Professional Conduct 1.15: The Anti-commingling Rule and the Need to Protect Client Funds, Including Advances

Rules of professional conduct exist for the protection of the public. That purpose is well served when the rules are designed and enforced to prevent concrete financial harm to clients. The anti-commingling principle, embodied in Rule 1.15, is a longstanding and effective component in the client protection arsenal. This is why, since their inception in 1908, the American Bar Association's model codes and rules of ethics have prohibited lawyers from commingling their property (including funds) with the property of clients and third parties.[19]

Under the general anti-commingling rule, Model Rule 1.15(a), client property, which includes unearned fees paid in advance, must be held in an account separate from the lawyer's own property.[20] In 2002, Model Rule 1.15 was amended to address specifically the issue of advance fees in a new paragraph (c): "A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred." Therefore, advances must be placed into a lawyer's trust account until those fees are earned.

The Commission on Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission"), which recommended the addition of this paragraph, did so in response to reports "that the single largest class of claims made to client protection funds is for the taking of unearned fees."[21] Accordingly, paragraph (c) "provides needed practical guidance to lawyers on how to handle advance deposits of fees and expenses."[22] Stated simply, under the Model Rules advance fees must be placed in a Rule 1.15-compliant trust account, to be disbursed to the lawyer only after the fee has been earned.

Some jurisdictions have authorized lawyers to treat advances as the lawyer's property upon payment, so long as the client signs a fee agreement designating the sum as "nonrefundable" or

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[19] *See* ABA CANONS OF PROFESSIONAL ETHICS, Canon 11 (1908); ABA MODEL CODE OF PROF'L RESPONSIBILITY, DR 9-102 (1969); ABA MODEL RULES OF PROF'L CONDUCT R. 1.15 (1983, revised 2002). One treatise explains the nature and breadth of this key obligation:

> One of the core fiduciary duties of a lawyer is to safeguard the property that the lawyer receives from the client or from other sources but that belongs to the client or third persons. Property received from a client may include funds to be applied to a transaction, a payment in satisfaction of a judgment or settlement, an advance deposit against lawyer's fees, valuable documents to be analyzed, or property of evidentiary value. Under Rule 1.15(a) of the Model Rules of Professional Conduct, "[a] lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property." The lawyer therefore must keep the property in a secure location and segregate those assets from the lawyer's own property. Gregory C. Sisk, Duties to Effectively Represent the Client, § 4-5.6 (The Duty to Safeguard Client Funds and Property), in Legal Ethics, Professional Responsibility, and the Legal Profession (West Academic Publishing, 2016).

[20] *In re* Kendall, 804 N.E.2d 1152, 1161 (Ind. 2004). Also, Rule 1.15(a)'s predecessor was applied to advance fees. Iowa Sup. Ct. Bd. of Prof'l Ethics & Conduct v. Frerichs, 671 N.W.2d 470, 477 (Iowa 2003) (failure to place advance fee in a trust account violated DR 9-102(A)).

[21] A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982–2005 342 (ABA 2006).

[22] *Id.*

"earned on receipt" or some other variation on this theme.[23] This approach departs from the safekeeping policy of the Model Rules described herein and creates unnecessary risks for the client.[24]

III. Model Rule of Professional Conduct 1.16: Declining or Terminating Representation

Model Rule 1.16(d) requires that, upon termination of representation, a lawyer shall refund "any advance payment of fee or expense that has not been earned or incurred." This Rule, and Rule

[23] *See, e.g.*, Or. Rules of Prof'l Conduct R. 1.5(c)(3). That jurisdiction's version of Rule 1.15(c) contains an exception to the anti-commingling rule for advance fees when "the fee is denominated as 'earned on receipt,' 'nonrefundable' or similar terms and complies with Rule 1.5(c)(3)." Or. Rules of Prof'l Conduct R. 1.15-1(c). A considerable minority of U.S. jurisdictions have authorized this variant approach to advances by rule, ethics opinion, or judicial decree. *See, e.g.*, State Bar of Ariz. Op. 99-02 (1999) (non-refundable, earned-upon-receipt fee is ethical if reasonable under Rule 1.5 and client is fully informed about and expressly agrees to such a fee, preferably in writing; such a fee does not go into a lawyer's trust account); Fla. Rules of Prof'l Conduct R. 4-1.5(e)(2)(B) and Comment (nonrefundable flat fee is the property of the lawyer and should not be held in trust); Wash. State Rules of Prof'l Conduct R. 1.5(f)(2) (if agreed to in advance in a writing signed by the client, a flat fee is the lawyer's property on receipt and shall not be deposited into a trust account); and N.Y. St. Bar. Assn. Comm. Prof'l Ethics Op. 816 (2007) (reaffirming 1985 opinion concluding that "fees paid to a lawyer in advance of services rendered are not necessarily client funds and need not be deposited in client trust account"). Such jurisdictions typically provide, via rule or otherwise, that advance fees must be refunded if unreasonable or work remains to be done even if language to the contrary is used and the funds have been taken by the lawyer pursuant to a rule and/or agreement.

[24] See *In re* Long, 368 Or. 452, 455–56, 474-75, 491 P.3d 783, 788–89, 798-99 (2021), cert. denied 142 S. Ct. 2685 (2022), in which the court candidly discussed the rule and its fallout:

> Respondent's limited financial resources also led to his extensive use of fee agreements that allowed him to access advance fees before completing the promised services. . . . The [Oregon] Rules of Professional Conduct allow for alternative fee agreements, under which advance fees become the lawyer's property at the time the fees are received—that is, before the lawyer has performed the promised services. RPC 1.5(c)(3). In those instances, the advance fees are not placed in the lawyer's trust account and are sometimes referred to as "earned on receipt." Fees may be "earned on receipt" only pursuant to a written fee agreement disclosing that "the funds will not be deposited into the lawyer trust account" and that "the client may discharge the lawyer at any time and in that event may be entitled to a refund of all or part of the fee if the services for which the fee was paid are not completed." *Id.* [¶] According to respondent, because he frequently had pressing personal and business costs, he would not have been able to operate his legal practice if he could access a client's fees only after he completed the promised services. . . . [¶] Although respondent's handling of those advance fees did not itself violate a Rule of Professional Conduct, it nevertheless left respondent's clients vulnerable. "Earned on receipt" fee agreements shift the risk of loss to the client. If the client relationship ends before the lawyer has performed the services needed to keep the advance fees, then the lawyer is required to return the fees for the uncompleted work. If the lawyer has already spent the advance fees and has no other financial resources upon which to draw, then the lawyer may be unable to provide the client with the required refund. [¶] That is what happened to many of respondent's clients. . . . [¶] Respondent's misconduct caused extensive injuries, which were not merely financial. Many of respondent's clients had limited financial means and needed their advance fees returned before they could afford to hire new lawyers. When respondent failed to return those advance fees, some clients simply went without legal representation.

1.15, work in tandem to achieve the regulatory objective of protection of the public from financial harm caused by inattentive or unscrupulous lawyers.[25]

Advances are unearned because they are payment today for work to be performed in the future. They were unearned upon receipt and remain unearned until the work is performed. The Model Rules mandate that advances belong to the client, must be preserved until they are actually earned, and must be refunded if the representation terminates before the fees are earned.

As a practical matter it may be somewhat more difficult to determine what has been earned and what is unearned when a representation ends before completion of the contemplated services when the client pays a flat or fixed fee instead of an hourly rate. However, courts routinely apportion the services completed and sum earned when a representation terminates before a lawyer has completed all of the contemplated work.[26]

IV. Hypothetical Scenarios Involving Client Payments at the Commencement of a Specific Representation.

Hypothetical 1 ("Nonrefundable Retainer")

A lawyer is consulted by a client seeking to terminate her marriage. The lawyer informs the client that the lawyer requires a $6,000 "retainer" to cover the filing of a divorce complaint, preparing a motion to enjoin the transfer of assets and a possible motion for a protective order, attending hearings relative to those motions, and any negotiations or related work until the lawyer expends 20 hours. The client was also informed that additional "retainers" may be required to complete the matter, and that the retainers will be credited toward payment for the lawyer's services at the reasonable rate of $300 per hour. The lawyer's fee agreement states, in pertinent part:

> Client agrees to pay Lawyer a nonrefundable retainer fee of $6,000. Client understands that no portion of this fee shall be refunded or returned to Client for any reason.
>
> Client further agrees that should Lawyer expend more than 20 hours on Client's matter, Client shall pay additional retainers as requested by Lawyer which shall be

[25] Nothing tarnishes the profession's reputation like a lawyer who takes an advance fee for legal services to be performed in the future, does not complete the work contemplated by the fee arrangement, and does not refund the money, perhaps because he or she cannot. Once the money has been spent by the lawyer, it may never be recovered by the client (or by the client protection fund which may have reimbursed the client). Even if a civil judgment or disciplinary order of restitution is entered it may do little good if the lawyer is impecunious, judgment-proof, or bankrupt. Discipline in that case may offer a measure of public protection through deterrence, but it does not recompense the client. That client's access to justice may also be impeded. The client may be unable to pay another advance fee and may, therefore, be unrepresented if legal aid or pro bono assistance is unavailable. Model Rules 1.15 and 1.16 exist to protect a client from these consequences.

[26] *See, e.g.*, *In re* O'Farrell, 942 N.E.2d 799, 808 (Ind. 2011) (quantum meruit available upon client termination of flat fee agreement). *Cf.* Plunkett & Cooney, PC v. Capitol Bancorp Ltd, 212 Mich. App. 325, 331; 536 N.W.2d 886 (1995) (discharged lawyer with fixed-fee agreement entitled to compensation for services rendered calculated by percentage of services required under contract, unless lawyer and client have agreed to other terms for valuing work completed).

applied to Lawyer's billing for this matter at a rate of $300 per hour and to any costs or expenses incurred in the representation.

Three weeks after signing the agreement and paying the $6,000, Client notified Lawyer that she wanted to reconcile with her husband and asked for an itemization of Lawyer's time and expenses and a refund of any unearned fees. Lawyer had filed the complaint, but it had not been served. Lawyer had also prepared but had not filed a motion to enjoin the transfer of certain assets. Lawyer had spent 5.5 hours on the file and $150 to file the complaint, but responded to the Client that no refund was due because the $6,000 was a nonrefundable fee.

Question: Does Lawyer owe Client a refund for any of the $6,000 paid to Lawyer and are any rule violations established by this scenario?

Answer: Yes, Lawyer owes Client a refund. First, the $6,000 paid by Client to the Lawyer are fees paid in advance not a general retainer. Under this agreement, Lawyer is rendering legal services at the rate of $300 per hour. This is true from the outset as is established by simply reading the portion of the agreement quoted above and performing some simple math. The $6,000 entitles Client to 20 hours of Lawyer's work on the matter.

Second, lawyer was required to have placed the $6,000 of advanced fees into the Lawyer's client trust account. Model Rule 1.15(c) provides that: "A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by Lawyer only as fees are earned or expenses incurred." The so-called nonrefundable fee here is an advance payment of fees that may only be withdrawn from the client trust account as earned by Lawyer. The facts of this hypothetical are silent as to whether Lawyer placed the $6,000 in the trust, operating, or personal account and as to whether it was spent in whole or in part. Lawyers may be disciplined for treating advance fees as their own property before the fees are earned, i.e., before the contemplated legal services are rendered.[27] Commingling and perhaps misappropriation may have occurred here if Lawyer deposited the $6,000 into an account other than a client trust account and spent it.

In this scenario, assuming that the legal work performed was appropriate and useful, Lawyer has earned $1,650.00 in legal fees. Lawyer also spent $150 for the expense of filing the complaint. Failure to return the balance of $4,200 is a violation of Model Rule 1.16(d) (upon termination of representation, a lawyer shall refund any advance payment of fee or expense that has not been earned or incurred). Comment [4] to Rule 1.16(d) explains the fundamental legal principle underlying this requirement: "A client has a right to discharge a lawyer at any time, with or without cause, subject to liability for payment for the lawyer's services." Lawyer's failure to provide an accounting for the fees paid in advance also constitutes a violation of Rule 1.15(d).

[27] "A lawyer misappropriates client funds in violation of DR 1–102(A)(3), (4), (5), and (6)DR 1–102(A)(3), (4), (5), and (6) when special retainers and flat fees paid in advance are treated as money belonging to the lawyer and not maintained in a trust account until the fee has been earned." Iowa Sup. Ct. Bd. of Pro. Ethics & Conduct v. Frerichs, 671 N.W.2d 470, 475 (Iowa 2003). *See also In re* Fazande, 290 So. 3d 178, 185 (La. 2020) (lawyer violated Rule 1.15(c) by failing to deposit into his client trust account advance fees and costs).

Model Rule 1.5(a) provides: "A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses." Comment [4] to Rule 1.5 states: "A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d)." Thus, keeping the balance ($4,200) violates Rule 1.5(a) on these facts. Because Rule 1.5 precludes a lawyer from agreeing to an unreasonable fee, it is also violated by the Lawyer's inclusion of the following provision in the fee agreement: "Client agrees to pay Lawyer a nonrefundable fee of $6,000. Client understands that no portion of this fee shall be refunded or returned to Client for any reason."[28]

Finally, because a lawyer may, in fact, be required to refund an advance payment of fees in various situations, characterizing such an advance as "nonrefundable" may also amount to a violation of Rule 1.4 (communication) and Rule 8.4(c) (misrepresentation) as the mischaracterization of the funds may have a chilling effect on a client seeking a refund of unearned fees upon termination of the representation.[29]

Lawyer and the fee agreement use the words "retainer" and "fee" interchangeably. In this hypothetical it appears that the word "retainer" is used incorrectly to refer to the advance payment of legal fees at the initiation of a matter, or, really, at any time during the representation as is suggested by the agreement's provision that additional "retainers" may be required.

Hypothetical 2 (Purported General Retainer)

The facts are the same as in Hypothetical 1, except that the lawyer's standard fee agreement states, in pertinent part:

> Client agrees to pay Lawyer a non-refundable engagement fee of $6,000 which shall be deemed earned upon receipt by Lawyer. This engagement fee is for the purpose of retaining Lawyer and assuring the availability of Lawyer in this matter. Client understands that no portion of the engagement fee shall be refunded or returned to Client for any reason.
>
> Client further agrees that should Lawyer expend more than 20 hours, Client shall pay upon request an additional retainer in an amount determined by Lawyer which shall be applied to Lawyer's billing for this matter at a rate of $300 per hour and to any costs or expenses incurred in the representation.

[28] *In re* Kendall, 804 N.E.2d 1152, 1160 (Ind. 2004) ("We hold that the assertion in a lawyer fee agreement that such advance payment is nonrefundable violates the requirement of Prof. Cond. R. 1.5(a) that a lawyer's fee 'shall be reasonable.'"). *See also* N.Y. City Bar Ass'n Formal Opinion 1991-3 (in light of reasonableness requirement, duty to refund unearned fees, and client's "essentially absolute" right to discharge counsel, "a lawyer may not properly denominate or characterize a fee as 'nonrefundable' or otherwise use words that could reasonably be expected to convey to the client the understanding that a fee paid before the services are performed will not be subject to refund or adjustment under any possible circumstance").

[29] *See, e.g.*, *In re* Sather, 3 P.3d 403, 415 (Colo. 2000) (knowing use of misleading language, i.e., describing flat advance fee as "nonrefundable," violated Colo. RPC 8.4(c)) and Ala. State Bar Op. RO-93-21 (1993) ("Any indication by the lawyer that the fee is non-refundable is inaccurate and inherently misleading and would violate Rule 1.4(b) Communication; Rule 1.5(b) Fees; and Rule 8.4(c) Misrepresentation."). *See also* Mo. Sup. Ct. Advisory Comm. Formal Op. 128 (Amended 2018) (in various situations "the description of the fee as 'nonrefundable' is misleading").

Again, the facts are the same: Lawyer spent 5.5 hours and a filing fee for the complaint, and Client reconciles and seeks a refund. Lawyer declines to refund any portion of the fee, claiming it is nonrefundable.

Question: Does Lawyer owe Client a refund for any of the $6,000 paid to Lawyer and are any rule violations established by this scenario?

Answer: Yes. The answer and analysis for Hypothetical 1 apply here as well. The only difference ("retainer" and "engagement fee" language) makes no difference at all. The fee arrangement still has the same basic structure and, for the reasons discussed above, the $6,000 is clearly an advance payment for the future performance of legal services, not an actual "retainer" because the lawyer contemplates billing time against the advance.[30] Accordingly, the $6,000 must be held in trust until earned and any unearned portion properly refunded to the client.

Under the Model Rules, there are no magic words that a lawyer can use to change what is actually an advance payment for fees into a general retainer: "an attorney cannot treat a fee as 'earned' simply by labeling the fee 'earned on receipt' or referring to the fee as an 'engagement retainer.'"[31] Notwithstanding the use of the terms "engagement fee," "retainer," and "availability," the fee in Hypothetical 2 is still not a general retainer fee and is, therefore, not deemed earned on receipt. The purpose of the fee dictates its character and treatment irrespective of labels or terminology used.

Courts examine the transaction and agreement very carefully to ensure that the purported general retainer is not an attempt to charge and retain unearned advance fees.[32] Accordingly, a lawyer claiming to have a general retainer must be prepared to demonstrate a valuable benefit to the client and/or an actual detriment to the lawyer.[33] It is easy to recite that the lawyer is prioritizing the client's work, turning away other work, keeping up on the relevant law, etc. However, it must be shown that such things were not only actually done, but that they were necessary for the representation and not part of the lawyer's basic responsibilities.[34]

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[30] *Cf. In re* Lais, No. 91-O-08572, 1998 WL 391171, at *14-15 (Cal. Bar Ct. July 10, 1998) (characterization as "'fixed, non-refundable retaining fee' paid 'for the purpose of assuring the availability of [respondent] in this matter'" was "not determinative" and the fee was not a "true" (general) retainer, but actually payment for the first 10 hours of lawyer's services).

[31] *In re* Sather, 3 P.3d 403, 412 (Colo. 2000). *See also* note 18, *supra*.

[32] Richmond, *supra* note 10, at 116: "As a practical matter, general retainers are rare. . .. The types of representations that justify or require general retainers are also scarce. Courts hearing fee related controversies are therefore properly skeptical of general retainer claims." *See also* RESTATEMENT, *supra* note 9, § 34 ("Engagement-retainer fees agreed to by clients not so experienced should be more closely scrutinized to ensure that they are no greater than is reasonable and that the engagement-retainer fee is not being used to evade the rules requiring a lawyer to return unearned fees.")

[33] Att'y Grievance Comm'n of Maryland v. Stinson, 428 Md. 147, 183-185, 50 A.3d 1222, 1244-1245 (2012) (purported engagement fee for "willingness and availability" to represent client not a true general retainer where no benefit to client or detriment to lawyer established and lawyer "produced no useable work").

[34] *See Stinson*, 50 A.3d at 1243 (benefits offered to the client in exchange for the nonrefundable fee were "nothing more than the ethical obligation imposed on all lawyers when they agree to provide legal services to a client. . . . A lawyer who agrees to perform legal services also necessarily agrees to be available to perform those services."), *citing* Lester Brickman & Lawrence A. Cunningham, *Nonrefundable Retainers Revisited*, 72 N.C. L. REV. 1, 24 (1993), and Iowa Sup. Ct. Bd. of Pro. Ethics & Conduct v. Frerichs, 671 N.W.2d 470, 477 (Iowa 2003).

Hypothetical 3 (Flat Fee)

A client seeks to hire a lawyer for representation in a criminal matter. The fee agreement provides: "Client shall pay Lawyer the sum of $15,000 for representation in the matter of State v Client, and that no part of the flat fee shall be refunded for any reason. Client understands that the flat fee is the agreed upon amount due Lawyer regardless of the time expended on the matter or how it is resolved." Client signed the agreement and paid the full $15,000. Lawyer deposited the $15,000 into his firm's operating account. Lawyer reviewed the police report, left a message for the prosecutor and law enforcement officer, appeared on behalf of the defendant at the arraignment, and filed an appearance with the court. A few weeks after the arraignment, Client discharged Lawyer and requested an accounting and partial refund. Lawyer refused, stating that the flat fee was earned when it was paid.

As we noted above, flat fees paid in advance of performing the work are subject to Rule 1.15(c) and the other rules set forth in the analyses in Hypotheticals 1 and 2. In other words, the foregoing rules regarding safekeeping, refundability, and reasonableness apply.

Flat fees are not general retainers and must not be treated as such. That the price set for the representation is not based on hours worked but is instead based on the completion of certain described services does not mean that the fee must be considered earned on receipt or nonrefundable when there is work yet to be done. Of course, if the flat fee is paid *after* the work is completed, the funds are earned and are not deposited into the trust account.

V. Conclusion

The Model Rules protect a client's right to terminate the fiduciary relationship with a lawyer and have the money to which the client is entitled available to obtain successor counsel if desired. Rule 1.15 requires that fees paid in advance must be held in a trust account until the services for which the fees will be paid are actually rendered, thereby allocating various risks to lawyer and client. The lawyer does not have to bear the risk of nonpayment after the work is completed; Rule 1.15 provides a process for withdrawal of earned fees and even for disputes, should they arise. And the client does not have to bear the risk that the funds will be spent, attached by the lawyer's creditors, or otherwise dissipated before the legal work is performed due to a lawyer's unwillingness or inability to do so.

Other ethics opinions and resources discuss good billing practices and fee agreement drafting tips. However, we offer the following suggestions in relation to the matters addressed in this opinion. Use plain language. Thus, instead of "retainer" say "advance" and explain that it is a "deposit for fees."[35] Explain that the sum deposited will be applied to the balance owed for work on the matter, and how and when this will happen. For example, the fee agreement could provide

[35] GEOFFREY C. HAZARD, JR., PETER R. JARVIS, TRISHA THOMPSON & W. WILLIAM HODES, THE LAW OF LAWYERING §9.07 (4th ed. 2022-2 Supp. 2014). Of course, the applicable Rules of Professional Conduct must be consulted, and it may be prudent or required to use certain terms. However, accurately translating legal terms of art is not only helpful to the client but also assists with interpretation and enforcement. So, if the term "advance" or "special retainer" is used in the applicable rules, the lawyer will want to use it in the fee agreement. However, consider also adding an explanation that it is functionally a deposit to cover fees for work in the future.

that on a monthly basis the client will be invoiced for the time expended by the lawyer and state when the sum reflected in the invoice will be withdrawn from the trust account. When the arrangement is for hourly billing, explain that if the deposit exceeds the final billing any balance will be remitted to the client. If the advance fee is fixed and the representation may continue for some time or involve several stages, consider dividing the representation into reasonable segments and providing for withdrawal of a reasonable portion of the deposited fee as the representation progresses and the fee becomes partially earned.[36] Finally, it may be wise to recognize the reality that many relationships do not last and include a provision explaining what will happen if the representation is terminated before the matter is completed.[37]

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

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CENTER FOR PROFESSIONAL RESPONSIBILITY: Mary McDermott, Lead Senior Counsel

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[36] *See supra* notes 15 & 16.

[37] Again, see Colo. R. Prof'l Conduct R. 1.5(h) and accompanying flat fee form providing helpful language for dividing a representation into increments and explaining a method of calculating the fees the lawyer has earned should the representation terminate prior to completion of the tasks or events specified in the agreement.

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 95-397 **September 18, 1995**
Duty to Disclose Death of a Client

When a lawyer's client dies in the midst of settlement negotiations of a pending lawsuit in which the client was the claimant, the lawyer has a duty to inform opposing counsel and the court in the lawyer's first communication with either after the lawyer has learned of that fact.

The Committee has been asked whether a lawyer representing the plaintiff in a personal injury action who has received a settlement offer from the defendant and has not yet responded to it has a duty to disclose to the defendant (and the court before whom the action is pending) the fact that the plaintiff has just died.

A preliminary, but by no means minor, question that must be considered by the lawyer in this situation is the extent of her authority to respond to the offer. The general rule in most jurisdictions is that the death of the client terminates the relation of lawyer and client. The lawyer therefore may not take any further steps in connection with the matter unless and until she is authorized to do so by the deceased's duly qualified personal representative. See 7A C.J.S. Attorney & Client ß 224 (1980). Accordingly, unless one of the limited exceptions to this general rule is applicable (and the lawyer should check the law of her own jurisdiction on this), the lawyer cannot accept the settlement offer, or enter into any settlement agreement, without first obtaining the approval of the personal representative.

Turning to the ethical question of disclosure, the Committee notes that this issue has evoked differing responses from state bar association ethics committees. For example, in 1987, the Virginia State Bar Standing Committee on Legal Ethics opined that "the best course of action" is for the lawyer to disclose the death of his client "at the time he accepts the offer of settlement and let the opposing side know that the client authorized the range for settlement prior to his death and that the estate's administrator has also authorized the settlement." The Virginia Committee was of the view that this procedure "avoids the appearance of impropriety later when the attorney must disclose the information pursuant to DR 1-102(A)(4) when the administratrix must sign the release of liability that will be required by the insurance company upon settlement."[1]

1. Virginia State Bar Opinion 952 (1987).

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY, 541 N. Fairbanks Court, Chicago, Illinois 60611 Telephone (312)988-5300 CHAIR: Margaret C. Love, Washington, DC ❑ Richard L. Amster, Roseland, NJ ❑ Deborah A. Coleman, Cleveland, OH ❑ Ralph G. Elliott, Hartford, CT ❑ Lawrence J. Fox, Philadelphia, PA ❑ David B. Isbell, Washington, DC ❑ George W. Jones, Jr., Washington, DC ❑ Marvin L. Karp, Cleveland, OH ❑ Arthur W. Leibold, Jr., Washington, DC ❑ Kim Tayler-Thompson, Stanford, CA ❑ CENTER FOR PROFESSIONAL RESPONSIBILITY: George A. Kuhlman, Ethics Counsel; Joanne P. Pitulla, Assistant Ethics Counsel
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ILLINOIS STATE BAR ASSOCIATION

ISBA Advisory Opinion on Professional Conduct

ISBA Advisory Opinions on Professional Conduct are prepared as an educational service to members of the ISBA. While the Opinions express the ISBA interpretation of the Illinois Rules of Professional Conduct and other relevant materials in response to a specific hypothesized fact situation, they do not have the weight of law and should not be relied upon as a substitute for individual legal advice.

This Opinion was AFFIRMED by the Board of Governors in January 2010. Please see the 2010 Illinois Rules of Professional Conduct 1.13, 4.1, and 8.4. This opinion was affirmed based on its general consistency with the 2010 Rules, although the specific standards referenced in it may be different from the 2010 Rules. Readers are encouraged to review and consider other applicable Rules and Comments, as well as any applicable case law or disciplinary decisions.

Opinion No. 96-3
July, 1996

Topic: Death of a client; truthfulness in statements to others; corporate affiliation.

Digest: A lawyer must make timely disclosure of a client's death in a pending personal injury matter. Where the lawyer represents a corporation in a claim against a third party, the deaths of principal officers or shareholders need not be disclosed unless the information is material to the matter.

Ref.: Illinois Rules of Professional Conduct, Rules 1.13, 4.1 and 8.4
ISBA Advisory Opinion Nos. 95-15 and 95-01
American Bar Association Formal Opinion No. 95-397 (1995).
735 ILCS 5/13-209(a)
735 ILCS 5/2-1008(b)
740 ILCS 180/1

FACTS

The inquiring lawyer has for several years represented a corporation in which a husband and wife were the principal officers and shareholders. Both the husband and wife have recently died. At the time of their deaths, the lawyer was handling a complaint to determine the dischargeability of a debt against a debtor of the corporation who had filed for bankruptcy. The lawyer also represented the

wife in a personal injury claim. The personal injury claim had not proceeded to suit at the time of the wife's death.

QUESTIONS

The inquiring lawyer has asked whether the Rules of Professional Conduct require the lawyer to disclose to the court and opposing counsel in the bankruptcy proceedings, or to the insurance company against whom the personal injury claim has been presented, the deaths of either the wife (as personal injury claimant) or the husband and wife (as principals of the corporation).

OPINION

In the bankruptcy matter, the lawyer's client appears to be the corporation rather than the individual officers or shareholders. Under Rule 1.13(a), the "lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." See ISBA Opinion No. 95-15 (March, 1996) and Opinion No. 95-01 (July, 1995). Generally, a corporation's existence is perpetual, and therefore the death of a principal officer or shareholder would not effect its existence. The Committee assumes that someone qualifying as a "duly authorized constituent" has authorized the lawyer to continue the representation of the corporation in the bankruptcy matter. If that is so, and because the corporation is the client, the Committee believes that the lawyer has no duty under the Rules of Professional Conduct to disclose the deaths of any principal officers or shareholders unless the unique circumstances of the particular matter make the death of the individual officers or shareholders material to the matter. In addition, in responding to discovery requests or to court orders, the lawyer may be required, in accordance with applicable procedural rules, to disclose the deaths of the former shareholders and officers.

The pending personal injury claim involves other considerations. An action for personal injuries survives the death of the claimant and may be commenced by his or her representative. See 735 ILCS 5/13-209(a). If an action had already been filed, the action could be continued only by a personal representative or special administrator. See 735 ILCS 5/2-1008(b). In any event, such a claim generally can not be settled without a release executed by a person having authority to bind the claimant's estate.

If the wife's death resulted from the injuries relating to the subject of the pending claim, a cause of action for wrongful death, in addition to the surviving personal injury action, would accrue to the representative. See 740 ILCS 180/1. If the death were unrelated to the injuries, then recoverable damages would be limited, excluding, for example, such items as future medical expense and future pain and suffering. In either event, the death of the claimant materially alters the nature of the claim existing at her death.

Illinois Rule 4.1 deals with "truthfulness in statements to others" and provides, in pertinent part, that a lawyer in the course of representing a client shall not make a statement of material fact to a third person that the lawyer knows or reasonably should know is false (Rule 4.1(a)) and shall not fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client (Rule 4.1(b)). The Rule dealing with "misconduct," Illinois Rule 8.4(a)(4), states that a lawyer shall not engage in conduct involving dishonesty, fraud, deceit or misrepresentation.

In Formal Opinion 95-397 (September 18, 1995), the American Bar Association concluded that a lawyer has a duty to disclose the death of a client that occurs during the course of settlement negotiations in a pending personal injury action. The ABA reasoned that because the lawyer was taking part in negotiations pursuant to authorization of the client, continued settlement discussions without disclosure constituted an implied representation that the lawyer still had a living client. Such conduct would be a false statement of material fact contrary to ABA Model Rule 4.1(a), which is substantially similar to Illinois Rule 4.1(a). The ABA also opined that the lawyer must disclose the client's death the next time the lawyer communicates with opposing counsel.

The Committee believes that the ABA's conclusion regarding the lawyer's duty under ABA Model Rule 4.1(a) would be the same under Illinois Rule 4.1(a). In addition, if the lawyer is authorized to continue the prosecution of whatever claim or claims exist on behalf of the decedent's estate, the Committee believes that the death of the claimant is a "material fact" within the meaning of Illinois Rule 4.1(b) as well. Therefore, disclosure to the adverse party is necessary to avoid assisting a fraudulent act on the part of the lawyer's new client, the executor or administrator of the decedent's estate. Finally, the failure to make such disclosure might well be considered conduct involving "deceit or misrepresentation" within the meaning of Rule 8.4(a)(4). For these reasons, the lawyer must make timely disclosure of the client's death with respect to the pending personal injury matter.

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In re Lyons

Supreme Court of Minnesota

April 8, 2010, Filed

A09-472

Reporter
780 N.W.2d 629 *; 2010 Minn. LEXIS 184 **

In re Petition for Disciplinary Action against Thomas John Lyons, Jr., a Minnesota Attorney, Registration No. 249646.

Subsequent History: Later proceeding at *In re Petition for Reinstatement of Lyons, 2011 Minn. LEXIS 767 (Minn., Dec. 21, 2011)*

Prior History: **[**1]** Original Jurisdiction.

Core Terms

email, discipline, settlement, referee's findings, replied, recommended, misconduct, settlement agreement, practice of law, exact date, suspended, opposing counsel, reinstatement, disciplinary, indefinitely, responded, defer

Case Summary

Procedural Posture
Petitioner Director filed a petition for disciplinary action against respondent attorney alleging that his failure to disclose his client's death during settlement negotiations, and false and misleading statements regarding the death, constituted unprofessional conduct. Following a hearing, a referee found misconduct warranting discipline had occurred and recommended certain discipline. The state supreme court then reviewed the recommendation.

Overview
A man retained the attorney, a Minnesota attorney, to file a complaint against a credit reporting agency. Since the resulting complaint was filed in Montana federal court, the attorney retained a Montana attorney to serve as local counsel. Settlement discussions occurred. A few weeks later, the Montana attorney informed the attorney that the client was dying. The client then died within a few days. A few weeks later, the attorney settled the matter with the credit reporting agency although he did not inform it that the client had died. As late as a few months later, he still informed the credit reporting agency that the client was hospitalized. He then told it that the client had died and claimed that the settlement had occurred before the client died. The Director filed a disciplinary petition against him. He misrepresented to the Director and a referee that the matter had been settled before the client died. The referee recommended that the attorney be disciplined. The state supreme court found that the attorney's conduct constituted professional misconduct and, along with his seven previous disciplinary incidents, warranted severe discipline in the present case.

Outcome
The state supreme court agreed with the referee's recommendation and ordered that the attorney be indefinitely suspended with no right to petition for reinstatement for a minimum of 12 months.

LexisNexis® Headnotes

Civil Procedure > Appeals > Standards of Review > Clearly Erroneous Review

Evidence > Burdens of Proof > Clear & Convincing Proof

Legal Ethics > Sanctions > Disciplinary Proceedings > Appeals

Legal Ethics > Sanctions > Disciplinary Proceedings > Hearings

HN1[] **Standards of Review, Clearly Erroneous Review**

The Professional Responsibility Director bears the burden of proving misconduct by clear and convincing evidence. That standard requires a high probability that the facts are true. If either party orders a transcript of the hearing, a referee's findings of fact and conclusions of law are not conclusive. *Minn. R. Law. Prof. Resp. 14(e)*. The state supreme court nonetheless gives great deference to the referee's findings and will not reverse those findings unless they are clearly erroneous, especially when the referee's findings rest on disputed testimony or in part on credibility, demeanor, and sincerity. To conclude that a referee's findings are "clearly erroneous," the state supreme court must be left with the definite and firm conviction that a mistake has been made.

Legal Ethics > Sanctions > Disciplinary Proceedings > Appeals

Legal Ethics > Sanctions > General Overview

HN2[] **Disciplinary Proceedings, Appeals**

The sanction recommended by a referee in an attorney discipline case carries great weight, although the state supreme court has the final responsibility for determining the appropriate discipline. In imposing discipline, its purpose is not to punish the attorney, but rather to protect the public, to protect the judicial system, and to deter future misconduct by the disciplined attorney as well as by other attorneys. In deciding the appropriate discipline, it considers the nature of the misconduct, the cumulative weight of the rule violations, and the resulting harm to the public and to the legal profession. In addition, it considers any mitigating or aggravating circumstances. Although its past decisions provide guidance and aid in enforcing consistent discipline, it imposes discipline based on each case's unique facts and circumstances.

Legal Ethics > Professional Conduct > General Overview

Legal Ethics > Professional Conduct > Tribunals

Legal Ethics > Sanctions > General Overview

HN3[] **Legal Ethics, Professional Conduct**

When a lawyer demonstrates a lack of that truthfulness and candor that the courts have a right to expect of their officers, the state supreme court does not hesitate to impose severe discipline.

Syllabus

Indefinite suspension with no right to petition for reinstatement for a minimum of 12 months is the appropriate discipline for a lawyer who was untruthful to opposing counsel about whether his client died before or after counsel reached agreement on terms of a settlement, was untruthful to the Director, to opposing counsel, and during testimony before the referee about when he learned of his client's death, and had a substantial disciplinary history.

Counsel: Martin A. Cole, Director, Timothy M. Burke, Senior Assistant Director, Office of Lawyers Professional Responsibility, St. Paul, Minnesota, for petitioner.

Eric T. Cooperstein, Minneapolis, Minnesota, for respondent attorney.

Opinion

[*631] PER CURIAM.

In March 2009, the Director of the Office of Lawyers Professional Responsibility (Director) served and filed a petition for disciplinary action against respondent Thomas Lyons, Jr. The Director alleged that Lyons' failure to disclose his client's death during settlement negotiations and false and misleading statements made to opposing counsel and to the Director about the client's death constituted unprofessional conduct warranting public discipline. Lyons served and filed a general denial. **[**2]** Pursuant to *Rule 14* of the Minnesota Rules on Lawyers Professional Responsibility (RLPR), a referee hearing was held, after which the referee filed findings of fact, conclusions of law, and a recommendation for discipline with our court. The referee recommended that Lyons be indefinitely suspended from the practice of law in the State of Minnesota with no right to petition for reinstatement for a minimum of 12 months. We adopt the referee's recommended discipline.

Lyons was admitted to practice law in Minnesota on October 28, 1994. At all times relevant to these proceedings, Lyons was engaged in the practice of law

at a law firm known as the Consumer Justice Center, P.A., in Vadnais Heights, Minnesota. Lyons has been disciplined on seven previous occasions. In December of 1998, Lyons was both admonished and placed on private probation for separate incidents of misconduct; in 2001, he was publicly reprimanded and placed on probation for two years; in 2002, Lyons was admonished; and he was again admonished in 2005. In addition, Lyons received two separate amended admonitions in 2007. Lyons' previous discipline resulted from material misrepresentations, prosecuting frivolous claims, and **[**3]** failure to follow appropriate procedure.

In 2006, Lyons was retained by a man who had been erroneously reported by Trans Union, LLC, a credit reporting agency, to be dead. In September 2006, a complaint against Trans Union under the Fair Credit Reporting Act, *15 U.S.C. §§ 1681-1681x (2000)*, was filed in the United States District Court for the District of Montana. Lyons arranged for a Montana attorney, Sean Frampton, to serve as local counsel.

On September 18, 2007, Lyons and counsel for Trans Union engaged in a settlement conference, but no settlement was reached. On October 6, 2007, the client was hospitalized. On October 7, Frampton sent Lyons an email that said the client "is ill and in critical conditions [sic]. Please keep him in your prayers. Call and I will explain." On October 8, Lyons replied, "Are you in the office today or on your cell phone? Should I explore settlement with Defendant?" On October 9, Frampton replied, "The doctors will be pulling the life support today. Sadly, he isn't going to make it. Upon direction of [the client's wife], please settle the lawsuit with [Trans Union]." That same day, Lyons replied, "I will do so and report back to you ASAP. I am totally **[**4]** confused by the series of events leading up to this tragic loss. Please advise when you have more information about the funeral and wake." Lyons then emailed Trans Union, expressing the need to "confirm settlement positions" and requesting that Trans Union respond by telephone. The client died on October 9.

On October 26, 2007, Trans Union sent an email to Lyons offering to settle the claim for $ 19,000. The following day, Lyons accepted the offer by email and requested that opposing counsel "[d]raft the release and order the check made payable to [the Consumer Justice Center] **[*632]** trust account." Lyons did not inform Trans Union of the client's death. On November 6, Trans Union sent Lyons a settlement agreement and release. The following week, Lyons emailed Frampton, asking whether the client's wife could sign the agreement as "power of attorney." Frampton replied that the client's wife could sign the settlement agreement because she was the personal representative of the estate. Although the settlement documents were not yet signed, a stipulation dismissing the case with prejudice was filed electronically with the federal court on December 14, 2007.

In an email to Trans Union dated January **[**5]** 7, 2008, Lyons noted that he was "[s]till working on [the client] who was hospitalized and I think the release is being signed by his wife or power of attorney." Trans Union changed the signature line of the settlement agreement to read "Agent (Attorney-In-Fact)" and instructed Lyons to attach the power of attorney to the agreement as an exhibit. On January 14, 2008, the agreement, signed by the client's wife as personal representative of the estate rather than under a power of attorney, was returned to Trans Union.

Upon receiving the signed settlement agreement, Trans Union emailed Lyons asking if the client had passed away. Two days later, Lyons responded, "Yes - HOW IRONIC." The referee found and Lyons does not dispute that this e-mail on January 31, 2008, was Lyons's first disclosure to Trans Union that the client had died. The day following Lyons' disclosure, Trans Union asked, "When did he die? When did you find out?" Lyons replied, "Unsure. Recently." Trans Union responded by asking, "Did he die before or after we agreed to settle?" Lyons replied, "We settled before I found out he passed away." Trans Union again asked, "Did [the client] die before or after we agreed to settle?" **[**6]** Lyons replied that the client "died after we agreed to settle." Trans Union demanded to know, "On what date did [the client] die? On what date did you find out?" Lyons replied, "Unsure of exact dates -- sorry. I learned about it from local counsel afterwards -- that is why we had to redo the signature block to estate after you sent it to us with only [the client's] name."

Thirteen minutes after this last reply to Trans Union on February 5, 2008, Lyons emailed Frampton and Lyons' legal assistant that Trans Union "is trying to avoid payment on this settlement." Lyons instructed his legal assistant to "pull the file and we will pinpoint to best we can the exact date of settlement" with Trans Union. Despite telling Trans Union's counsel both that the client had not died, and that he had not learned of the client's death until after the case was settled in late October, Lyons wrote to Frampton: "[The client's] date of death was 10/9/07 and I believe that was confirmed in an email the following week by Sean [Frampton]."

Trans Union then sent an email to Frampton, with a copy to Lyons, asking Frampton to fill in the dates as to when

the client died and when his counsel found out. Despite Lyons' **[**7]** earlier email to Frampton acknowledging that Frampton had informed him of the client's death within a week of the client's passing, Lyons emailed Frampton:

> FYI-
> I don't know that it is necessary to respond to him. However if you do here is the sequence as I understand it.
> [The client] passed away 10/9/07
> [Trans Union] offers 19k on 10/26/07
> I accept via email on 10/27/07
> There are no emails from you to me on notification of [the client's] death until after November 1, 2007.
>
> **[*633]** Any questions please call.

Frampton responded to Lyons that the matter was irrelevant as they did not have an obligation to advise Trans Union of the client's death and that he would defer to Lyons' recollection. Lyons replied, "I agree completely. Just defer to me." In response to another inquiry from Trans Union, Lyons wrote, "[THE CLIENT] DIED ON 10/9/07. ACCORDING TO OUR EMAILS WE SETTLED ON 10/27/07. I DID NOT LEARN OF HIS PASSING UNTIL AFTER WE SETTLED - SORRY EXACT DATE UNKNOWN BY MYSELF OR FRAMPTON. SEND THE CHECK AND WE CAN CLOSE OUR FILES." Trans Union then asked Frampton directly when he found out about the client's death; Frampton responded that he found out on the day the client died.

Trans Union indicated that **[**8]** it would not be bound by the settlement and, as a result, Frampton filed an action in Montana state court to enforce the settlement agreement. Trans Union counterclaimed and added Lyons and Frampton as parties. That litigation was resolved when Lyons agreed to pay $ 7,500 to the client's wife.

On April 7, 2008, the Director notified Lyons that an ethics complaint had been filed with respect to the settlement and that Lyons should submit "all documents that evidence, memorialize, or refer or relate in any way to, any communications, whether verbal, written or electronic, you had with any person regarding the death of [the client]." In response, Lyons provided some documentation, including a number of emails. The Director subsequently obtained additional emails from other sources. At the referee hearing, Lyons testified that he had provided the Director with all the information he could locate in his files, that his practice was to print emails he received before deleting the electronic copies, and that his email provider did not provide copies of deleted emails more than 60 days after deletion. The referee found that Lyons' failure to provide the Director with the emails, which were **[**9]** later obtained by the Director from other sources, violated *Rule 25(a), RLPR*. [1] The referee also noted that Lyons had written in an email that he "may have telephone call notes" relating to the client's death, but failed to provide any such notes to the Director.

After Lyons provided his initial response, the Director requested that Lyons "state how and from whom he learned [the client] had died." Lyons replied that it was his recollection that he heard from Frampton sometime in early November, after the settlement had been negotiated. Lyons similarly testified at the referee hearing that he did not recall receiving actual notice of the client's death until after he reached a settlement with Trans Union. However, the client's local counsel in Montana, Frampton, testified in his deposition, which was submitted to the referee in lieu of Frampton's appearance at the referee hearing, that he had a conversation with Lyons notifying him of the client's death "within **[**10]** a short time frame after" the client died, and though he did not recall the exact date, he believed it was within a day or two of death. The referee found that Frampton informed Lyons of the client's death by telephone within a week of the client's death.

At the referee hearing, Lyons testified that when he responded to Trans Union, "Sorry, exact date unknown by myself or **[*634]** Frampton," he meant that neither he nor Frampton knew the exact date that Frampton had notified him of the client's passing. However, the referee found that by that testimony Lyons was falsely indicating uncertainty as to the date of the client's death.

The referee concluded that Lyons' conduct violated *Rules 3.3(a)(1)*, *4.1*, and *8.4(c)* and *(d)* of the Montana Rules of

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[1] *Rule 25(a), RLPR*, requires a lawyer who is the subject of an investigation or disciplinary proceeding to cooperate with the Director and his staff "by complying with reasonable requests," including requests to furnish documents.

Professional Conduct; [2] Rules 8.1(a) and (b) [3] and 8.4(c) and (d) [4] of the Minnesota Rules of Professional Conduct; and Rule 25 of the Minnesota Rules on Lawyers Professional Responsibility. [5] The referee recommended that Lyons be indefinitely suspended with no right to petition for reinstatement for at least 12 months.

I.

Lyons does not challenge the referee's finding that he failed to disclose the client's death to Trans Union before accepting Trans Union's settlement offer. Nor does Lyons challenge the referee's finding that he made a number of misrepresentations **[*635]** to Trans Union regarding when the client died and when he learned of the client's death. Lyons does, however, claim that the referee erred in finding that his communications with the Director and his testimony at the hearing were intentionally false and in finding that he "fail[ed] to make full documentary disclosure of relevant communications" to **[**14]** the Director.

HN1[↑] The Director bears the burden of proving misconduct by clear and convincing evidence. *In re Varriano, 755 N.W.2d 282, 288 (Minn. 2008)*; *In re Gillard, 271 N.W.2d 785, 805 n.3 (Minn. 1978)* (adopting "full, clear and convincing evidence" standard for attorney discipline matters) (internal quotation marks omitted) (citation omitted). This standard requires a high probability that the facts are true. *In re Houge, 764 N.W.2d 328, 334 (Minn. 2009)*; *see also Weber v. Anderson, 269 N.W.2d 892, 895 (Minn. 1978)* (noting that clear and convincing evidence is established by "more than a preponderance of the evidence, but less than proof beyond a reasonable doubt"). If either party orders a transcript of the hearing, as Lyons did here, the referee's findings of fact and conclusions of law are not conclusive. *Rule 14(e), RLPR*; *In Re Ryerson, 760 N.W.2d 893, 901 (Minn. 2009)*. We nonetheless give great deference to the referee's findings and will not reverse those findings unless they are clearly erroneous, especially when the referee's findings rest on disputed testimony or in part on credibility, demeanor, and sincerity. *In re Barta, 461 N.W.2d 382, 382 (Minn. 1990)*. To conclude that **[**15]** a referee's findings are "clearly

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[2] The referee applied the Montana Rules of Professional Conduct because *Rule 8.5(b)(1) of the Minnesota Rules of Professional Conduct* provides **[**11]** in pertinent part that "[i]n any exercise of the disciplinary authority of this jurisdiction, the rules of professional conduct to be applied . . . for conduct in connection with a matter pending before a tribunal [are] the rules of the jurisdiction in which the tribunal sits." The litigation was venued in the United States District Court for the District of Montana, and that court applies the American Bar Association's Model Rules of Professional Conduct and the Montana Rules of Professional Conduct. Rule 83.13, Local Rules of Procedure of the United States District Court for the District of Montana. Therefore, and as the parties agree, the Montana Rules of Professional Conduct apply to Lyons' conduct that occurred in connection with the litigation at issue.

Montana Rule 3.3(a)(1) provides that "[a] lawyer shall not knowingly make a false statement of fact or law to a tribunal or fail to correct a false stat[e]ment of material fact or law previously made to the tribunal by the lawyer."

The referee's ruling refers to *Montana Rule 4.1*. *Montana Rule 4.1(a)* provides that "[i]n the course of representing a client a lawyer shall not knowingly make a false statement of material fact or law **[**12]** to a third person."

Montana Rule 8.4(c) provides that "[i]t is professional misconduct for a lawyer to engage in conduct involving dishonesty, fraud, deceit, or misrepresentation."

Montana Rule 8.4(d) provides that "[i]t is professional misconduct for a lawyer to engage in conduct that is prejudicial to the administration of justice."

However, with regard to Lyons' conduct during this disciplinary proceeding, the Minnesota Rules of Professional Conduct and the Minnesota Rules on Lawyers Professional Responsibility apply.

[3] *Rule 8.1(a) of the Minnesota Rules of Professional Conduct* provides in relevant part that "a lawyer . . . in connection with a disciplinary matter, shall not knowingly make a false statement of material fact." *Rule 8.1(b)* provides in relevant part that "a lawyer . . . in connection with a disciplinary matter, shall not fail to disclose a fact necessary to correct a misapprehension known by the person to have arisen in the matter, or knowingly fail to respond to a lawful demand for information from [a] disciplinary authority."

[4] Minnesota *Rule 8.4(c)*, like Montana's *Rule 8.4(c)*, provides that "[i]t is professional misconduct for a lawyer to engage in conduct involving dishonesty, **[**13]** fraud, deceit, or misrepresentation." *Minnesota Rule 8.4(d)*, like *Montana's Rule 8.4(d)*, provides that "[i]t is professional misconduct for a lawyer to engage in conduct that is prejudicial to the administration of justice."

[5] *Rule 25(a)(1), RLPR*, provides that "[i]t shall be the duty of any lawyer who is the subject of an investigation or proceeding under these Rules to cooperate with the District Committee, the Director, or the Director's staff, the Board, or a Panel, by complying with reasonable requests, including requests to [f]urnish designated papers, documents or tangible objects."

erroneous," we must be "left with the definite and firm conviction that a mistake has been made." Gjovik v. Strope, 401 N.W.2d 664, 667 (Minn. 1987).

Lyons acknowledges that he was "actively tr[ying] to avoid disclosing" the client's death to Trans Union when he wrote to Trans Union's counsel on January 7, 2008, that the client, who had died nearly three months earlier, "was hospitalized." And Lyons now accepts that his "recollection was wrong" and that "he knew prior to October 27, 2007, that [the client] had died." However, Lyons claims that the referee erred in finding that he was untruthful both when he wrote to the Director in May 2008 and when he testified at the referee hearing that he did not recall learning of the client's death until after the settlement agreement was reached. Our careful review satisfies us that the record supports the referee's findings that Lyons was untruthful in statements to the Director and in testimony before the referee. Here, the referee's findings that Lyons was untruthful in his statements to the Director and in the testimony he gave at the hearing were based on the referee's evaluation of Lyons' demeanor, credibility, **[**16]** and sincerity, and we defer to a referee's findings on such matters. In re Moulton, 721 N.W.2d 900, 905 (Minn. 2006) ("Deference to the referee is particularly appropriate when the findings are based on a respondent's demeanor, credibility, or sincerity."). Thus, we conclude that the referee's findings are not clearly erroneous.

Lyons also claims that the referee's findings that he failed to provide all requested emails and telephone notes, and thus failed to cooperate with the Director, are also clearly erroneous. Lyons argues that there is no evidence in the record that would support the conclusion that he had, either in his possession or available to him, any of the missing emails or notes at the time they were requested. Whether the referee erred in finding that Lyons failed to cooperate with the Director's investigation is a closer question, but we need not answer it to determine the appropriate **[*636]** discipline for Lyons' misconduct because, in the end, the discipline we impose would not be any different based on the presence or absence of that finding.

II.

HN2[] The sanction recommended by the referee carries great weight, although we have the final responsibility for determining the appropriate **[**17]** discipline. In re Jagiela, 517 N.W.2d 333, 335 (Minn. 1994). In imposing discipline, our purpose is not to punish the attorney, but rather to protect the public, to protect the judicial system, and to deter future misconduct by the disciplined attorney as well as by other attorneys. In re Plummer, 725 N.W.2d 96, 98 (Minn. 2006); *In re De Rycke, 707 N.W.2d 370, 373 (Minn. 2006)*. In deciding the appropriate discipline, we consider the nature of the misconduct, the cumulative weight of the rule violations, and the resulting harm to the public and to the legal profession. In re Nelson, 733 N.W.2d 458, 463 (Minn. 2007). In addition, we consider any mitigating or aggravating circumstances. In re Houge, 764 N.W.2d 328, 338 (Minn. 2009) (citing In re Nelson, 733 N.W.2d at 463-64). Although our past decisions provide guidance and aid in enforcing consistent discipline, we impose discipline based on each case's unique facts and circumstances. In re Redburn, 746 N.W.2d 330, 334 (Minn. 2008).

Lyons' misconduct is serious. Lyons made false and misleading statements to the Director during the disciplinary investigation when he asserted that he did not learn of the client's death until sometime in **[**18]** early November, after the settlement with Trans Union had been negotiated. In addition, Lyons gave false and misleading testimony on the same subject at the referee hearing. Finally, Lyons' false and misleading statements to opposing counsel about whether he knew of his client's death before the parties reached a settlement concerned a material fact. *See* In re Forrest, 158 N.J. 428, 730 A.2d 340, 345-46 (N.J. 1999) (noting that lawyer's failure to disclose his client's death "deceived both his adversary and the arbitrator about a fact that was crucial to the fair and proper resolution of the litigation" and suspending lawyer for six months); Harris v. Jackson, 192 S.W.3d 297, 306 (Ky. 2006) (noting that the death of the plaintiff left the lawyer "without a party to represent in the action"); *see also* Ky. Bar Ass'n v. Geisler, 938 S.W.2d 578, 579, 44 2 Ky. L. Summary 13 (Ky. 1997) ("When a lawyer's client dies in the midst of the settlement negotiations of a pending lawsuit in which the client was the claimant, the lawyer has a duty to inform opposing counsel and the Court in the lawyer's first communications with either after the lawyer has learned of the fact." (quoting ABA Standing Committee on Ethics and Professional **[**19]** Responsibility, Formal Opinion 95-397 (1995))). HN3[] When "a lawyer demonstrates a lack of that truthfulness and candor that the courts have a right to expect of their officers," we "do not hesitate to impose severe discipline." In re Schmidt, 402 N.W.2d 544, 548 (Minn. 1987).

The referee found that Lyons' disciplinary history substantially aggravates the sanction for his conduct. *See* In re Gherity, 673 N.W.2d 474, 480 (Minn. 2004)

(holding that a lawyer's prior disciplinary history is relevant to determine an appropriate sanction). We agree. Lyons has previously been subject to discipline on seven occasions. The fact that Lyons has been previously disciplined seven times suggests that he has not renewed his "commitment to comprehensive ethical and professional behavior." *See* *In re Isaacs, 451 N.W.2d 209, 212 (Minn. 1990)* (internal quotation marks omitted). The referee also found that Lyons' substantial experience **[*637]** in the practice of law is an aggravating factor. *See* *In re Moeller, 582 N.W.2d 554, 559-60 (Minn. 1998)* (noting the referee's conclusion that a lawyer's substantial experience in the practice of law was an aggravating factor); *see also In re Oberhauser, 679 N.W.2d 153, 160 (Minn. 2004)* **[**20]** (considering the fact that the lawyer was "an experienced attorney"). Again, we agree.

The misconduct here, coupled with Lyons' substantial disciplinary history, warrants significant discipline. The referee recommended that Lyons be suspended indefinitely and that he not be permitted to apply for reinstatement for a minimum of 12 months. We conclude that the discipline recommended by the referee is the appropriate discipline in this case. We therefore adopt the referee's recommendation and indefinitely suspend respondent Thomas John Lyons, Jr., from the practice of law for a minimum of 12 months.

Accordingly, we order that:

1. Respondent Thomas John Lyons, Jr., be indefinitely suspended from the practice of law, effective immediately, and be ineligible to petition for reinstatement for a minimum of 12 months from the date of filing of this opinion.

2. Lyons shall comply with the requirements of *Rule 26, RLPR* (requiring notice of suspension to clients, opposing counsel, and tribunals).

3. If Lyons seeks reinstatement, he must comply with the requirements of *Rule 18(a)-(c), RLPR*.

4. Lyons shall pay $ 900 in costs pursuant to *Rule 24, RLPR*.

So ordered.

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Caution
As of: August 15, 2023 10:08 PM Z

Birbrower, Montalbano, Condon & Frank v. Superior Court

Supreme Court of California

January 5, 1998, Decided

No. S057125.

Reporter
17 Cal. 4th 119 *; 949 P.2d 1 **; 70 Cal. Rptr. 2d 304 ***; 1998 Cal. LEXIS 2 ****; 98 Daily Journal DAR 107; 97 Cal. Daily Op. Service 51

BIRBROWER, MONTALBANO, CONDON & FRANK, P.C., et al., Petitioners, v. THE SUPERIOR COURT OF SANTA CLARA COUNTY, Respondent; ESQ BUSINESS SERVICES, INC., Real Party in Interest.

Subsequent History: [**1]** As Modified, February 25, 1998. Certiorari Denied October 5, 1998, 67 U.S.L. Week 3239. Certiorari Denied October 5, 1998, Reported at: *1998 U.S. LEXIS 6358*.

Prior History: Superior Court of Santa Clara County. Super. Ct. No. CV737595. John F. Herlihy, Judge.

Disposition: We conclude that Birbrower violated *section 6125* by practicing law in California. To the extent the fee agreement allows payment for those illegal local services, it is void, and Birbrower is not entitled to recover fees under the agreement for those services. The fee agreement is enforceable, however, to the extent it is possible to sever the portions of the consideration attributable to Birbrower's services illegally rendered in California from those attributable to Birbrower's New York services. Accordingly, we affirm the Court of Appeal judgment to the extent it concluded that Birbrower's representation of ESQ in California violated *section 6125*, and that Birbrower is not entitled to recover fees under the fee agreement for its local services. We reverse the judgment to the extent the court did not allow Birbrower to argue in favor of a severance of the illegal portion of the consideration (for the California fees) from the rest of the fee agreement, and remand for further proceedings consistent with **[****2]** this decision.

Core Terms

practice of law, arbitration, fee agreement, out-of-state, lawyers, unauthorized practice of law, legal services, parties, state bar, licensed, arbitration proceedings, trained, unauthorized, trial court, proceedings, unlicensed, preparation, cause of action, not licensed, unenforceable, arbitration hearing, render a service, general rule, contingency, competence, settlement, matters, advice, courts, cases

Case Summary

Procedural Posture

Petitioner law firm appealed the decision of the Court of Appeals of California that affirmed the trial court, which granted summary judgment in favor of respondent client in a legal malpractice action. In addition, the court of appeals held that *Cal. Bus. & Prof. Code § 6125* barred petitioner from recovering all legal fees under the written fee agreement.

Overview

Petitioner law firm executed a written fee agreement with respondent client out of state. While representing respondent, petitioner's attorneys traveled to and gave legal advice in California. None of petitioner's attorneys were licensed to practice law in California. Respondent filed suit against petitioner alleging malpractice. The trial court granted partial summary judgment in favor of respondent. Petitioner filed for a writ of mandate in the court of appeals to direct the trial court to vacate the summary judgment order. The court of appeals denied the petition, affirmed the trial court's order, and held that *Cal. Bus. & Prof. Code § 6125* barred petitioner from recovering all legal fees under the fee agreement. Petitioner appealed, contending that *§ 6125* did not apply and the fee agreement was not wholly unenforceable.

The court affirmed in part because petitioner violated § 6125 by practicing law in California and was not entitled to recover legal fees for those illegal services. The court reversed in part and held that petitioner was entitled to recover for legal services rendered outside of California to the extent that they were severable from the illegal services.

Outcome
The court partially affirmed the decision of the lower court that affirmed the trial court's grant of summary judgment in favor of respondent client because petitioner violated the prohibitions against the unauthorized practice of law. The court reversed in part because petitioner was not barred from recovering legal fees on all services rendered, only the services rendered in-state.

LexisNexis® Headnotes

Governments > Police Powers

Legal Ethics > Unauthorized Practice of Law

HN1[] Governments, Police Powers

The general rule is that, although persons may represent themselves and their own interests regardless of State Bar membership, no one but an active member of the State Bar may practice law for another person in California. The prohibition against unauthorized law practice is within the state's police power and is designed to ensure that those performing legal services do so competently.

Legal Ethics > Unauthorized Practice of Law

HN2[] Legal Ethics, Unauthorized Practice of Law

A violation of Cal. Bus. & Prof. Code § 6125 is a misdemeanor. Moreover, no one may recover compensation for services as an attorney at law in this state unless the person was at the time the services were performed a member of the State Bar.

Legal Ethics > Unauthorized Practice of Law

HN3[] Legal Ethics, Unauthorized Practice of Law

The practice of law is the doing and performing services in a court of justice in any matter depending therein throughout its various stages and in conformity with the adopted rules of procedure.

Legal Ethics > Unauthorized Practice of Law

HN4[] Legal Ethics, Unauthorized Practice of Law

Mere fortuitous or attenuated contacts will not sustain a finding that the unlicensed lawyer practiced law in California.

Legal Ethics > Unauthorized Practice of Law

HN5[] Legal Ethics, Unauthorized Practice of Law

Exceptions to Cal. Bus. & Prof. Code § 6125 do exist, but are generally limited to allowing out-of-state attorneys to make brief appearances before a state court or tribunal. They are narrowly drawn and strictly interpreted.

Civil Procedure > Attorneys > Pro Hac Vice

Governments > Courts > Rule Application & Interpretation

Legal Ethics > Unauthorized Practice of Law

HN6[] Attorneys, Pro Hac Vice

With the permission of the California court in which a particular cause is pending, out-of-state counsel may appear before a court as counsel pro hac vice. Cal. R. Ct. 983. A court will approve a pro hac vice application only if the out-of-state attorney is a member in good standing of another state bar and is eligible to practice in any United States court or the highest court in another jurisdiction. Cal. R. Ct. 983(a). The out-of-state attorney must also associate an active member of the California Bar as attorney of record and is subject to the Rules of Professional Conduct of the State Bar. Cal. R. Ct. 983(a), (d).

Legal Ethics > Unauthorized Practice of Law

HN7[] Legal Ethics, Unauthorized Practice of Law

The Cal. R. Ct. 983 does not regulate practice before United States courts.

Governments > Courts > Court Personnel

Legal Ethics > Unauthorized Practice of Law

HN8[] Courts, Court Personnel

Cal. R. Ct. 988 permits the State Bar to issue registration certificates to foreign legal consultants who may advise on the law of the foreign jurisdiction where they are admitted. These consultants may not, however, appear as attorneys before a California court or judicial officer or otherwise prepare pleadings and instruments in California or give advice on the law of California or any other state or jurisdiction except those where they are admitted.

Civil Procedure > ... > Alternative Dispute Resolution > Arbitration > General Overview

International Law > Dispute Resolution > Arbitration & Mediation > General Overview

International Trade Law > Dispute Resolution > International Commercial Arbitration > Arbitration

International Trade Law > Dispute Resolution > General Overview

Legal Ethics > Unauthorized Practice of Law

HN9[] Alternative Dispute Resolution, Arbitration

Pursuant to Cal. Civ. Proc. Code § 1297.11 et seq. the Legislature has recognized an exception to Cal. Bus. & Prof. § 6125 in international disputes resolved in California under the state's rules for arbitration and conciliation of international commercial disputes. Cal. Civ. Proc. Code § 1297.11 et seq. This exception states that in a commercial conciliation in California involving international commercial disputes, the parties may appear in person or be represented or assisted by any person of their choice. A person assisting or representing a party need not be a member of the legal profession or licensed to practice law in California. Cal. Code Civ. Proc. §1297.351. Likewise, the Act does not apply to the preparation of or participation in labor negotiations and arbitrations arising under collective bargaining agreements in industries subject to federal law.

Governments > Legislation > Interpretation

HN10[] Legislation, Interpretation

It is well-settled that, in determining the meaning of a statute, appellate courts look to its words and give them their usual and ordinary meaning.

Criminal Law & Procedure > Counsel > Right to Counsel > General Overview

Legal Ethics > Practice Qualifications

Legal Ethics > Unauthorized Practice of Law

HN11[] Counsel, Right to Counsel

The general rule is that an attorney is barred from recovering compensation for services rendered in another state where the attorney was not admitted to the bar.

Contracts Law > Defenses > Illegal Bargains

Criminal Law & Procedure > Counsel > Right to Counsel > General Overview

Contracts Law > Contract Interpretation > Severability

HN12[] Defenses, Illegal Bargains

The law of contract severability is stated in Cal. Civ. Code § 1599, which defines partially void contracts: Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest.

Headnotes/Summary

Summary
CALIFORNIA OFFICIAL REPORTS SUMMARY

A California corporation sued its New York law firm for

legal malpractice, and the firm filed a counterclaim for attorney fees earned for work performed in both California and New York in the firm's efforts to resolve a dispute between the corporation and a third party. The trial court granted the corporation's motion for summary adjudication of the counterclaim, finding that the parties' fee agreement, which stipulated that California law governed all matters in the representation, was unenforceable, since the firm and its attorneys were not licensed to practice law in California as required by Bus. & Prof. Code, § 6125. (Superior Court of Santa Clara County, No. CV737595, John F. Herlihy, Judge.) The Court of Appeal, Sixth Dist., No. H014880, denied the firm's petition for a writ of mandate, concluding that the firm had violated § 6125 and that therefore the firm was barred from recovering its fees under the agreement for work performed in either California or New York.

The Supreme Court affirmed the judgment of the Court of Appeal to the extent it concluded that the firm's representation in California violated Bus. & Prof. Code, § 6125, and that the firm was not entitled to recover fees under the fee agreement for its services in California, reversed the judgment of the Court of Appeal to the extent it did not allow the firm to argue in favor of a severance of the illegal portion of the consideration (the California fees) from the rest of the fee agreement, and remanded for further proceedings. The court held that the firm violated Bus. & Prof. Code, § 6125, by engaging in extensive unauthorized law practice in California. The court therefore held that the fee agreement was invalid to the extent it authorized payment for the substantial legal services the firm performed in California. However, the court held that the agreement might be valid to the extent it authorized payment for limited services the firm performed in New York. Remand was required to allow the firm to present evidence justifying its recovery of fees for those New York services, and for the client to produce contrary evidence. (Opinion by Chin, J., with George, C. J., Mosk, Baxter, Werdegar, and Brown, JJ., concurring. Dissenting opinion by Kennard, J.)

Headnotes

CA(1)[] **(1)**

Attorneys at Law § 6—Right to Practice—Unauthorized Practice of Law—Unlicensed Practice in California—Association of California Counsel.

--No statutory exception to Bus. & Prof. Code, § 6125 (no person shall practice law in California unless that person is active member of State Bar), allows out-of-state attorneys to practice law in California as long as they associate local counsel in good standing with the State Bar.

CA(2)[] **(2)**

Attorneys at Law § 5—Right to Practice—State Bar Act.

--The California Legislature enacted Bus. & Prof. Code, § 6125, which provides that no person shall practice law in California unless the person is an active member of the State Bar, in 1927 as part of the State Bar Act, a comprehensive scheme regulating the practice of law in the state. Since the passage of the act, the general rule has been that, although persons may represent themselves and their own interests regardless of State Bar membership, no one but an active member of the State Bar may practice law for another person in California. The prohibition against unauthorized law practice is within the state's police power and is designed to ensure that those performing legal services do so competently. A violation of Bus. & Prof. Code, § 6125, is a misdemeanor (Bus. & Prof. Code, § 6126). Moreover, no one may recover compensation for services as an attorney at law in this state unless that person was at the time the services were performed a member of the State Bar.

CA(3)[] **(3)**

Attorneys at Law § 6—Right to Practice—Unauthorized Practice of Law—Unlicensed Practice in California—What Constitutes Practice in California: Words, Phrases, and Maxims—Practice of Law.

--Under Bus. & Prof. Code, § 6125 (no person shall practice law in California unless that person is active member of State Bar), the term "practice law" means the doing and performing services in a court of justice in any matter depending therein throughout its various stages and in conformity with the adopted rules of procedure. This includes legal advice and legal instrument and contract preparation, whether or not rendered in the course of litigation. The practice of law "in California" entails sufficient contact with the California client to render the nature of the legal service a clear legal representation. In addition to a quantitative analysis, a court determining whether a person has violated § 6125 must consider the nature of the unlicensed lawyer's activities in the state. Mere fortuitous or attenuated

contacts is not sufficient. The primary inquiry is whether the unlicensed lawyer engaged in sufficient activities in the state or created a continuing relationship with the California client that included legal duties and obligations. The unlicensed lawyer's physical presence in the state is one factor, but it is not exclusive. For example, one may practice law in the state in violation of § 6125 although not physically present in California by communicating by modern technological means, but a person does not automatically practice law "in California" whenever that person "virtually" enters the state by electronic communication. Each case must be decided on its individual facts. (Disapproving to the extent it is inconsistent: *People v. Ring (1937) 26 Cal.App.2d Supp. 768 [70 P.2d 281]*.)

CA(4)[] (4)

Attorneys at Law § 6—Right to Practice—Unauthorized Practice of Law—Unlicensed Practice in California—Exceptions to Prohibition.

--There are exceptions to *Bus. & Prof. Code, § 6125*, of the State Bar Act, which prohibits the practice of law in California unless the person practicing law is a member of the State Bar, but these exceptions are generally limited to allowing out-of-state attorneys to make brief appearances before a state court or tribunal. They are narrowly drawn and strictly interpreted. For example, an out-of-state attorney not licensed to practice in California may be permitted, by consent of a trial judge, to appear in California in a particular pending action. In addition, the California Rules of Court set forth procedures for allowing out-of-state attorneys to perform certain activities, and the Legislature has recognized an exception to *Bus. & Prof. Code, § 6125*, in international disputes resolved in California under the state's rules for arbitration and conciliation of international commercial disputes (*Code Civ. Proc., § 1297.351*). Furthermore, the act does not regulate practice before federal courts or apply to the preparation of or participation in labor negotiations and arbitrations arising under collective bargaining agreements.

CA(5a)[] (5a) CA(5b)[] (5b)

Attorneys at Law § 6—Right to Practice—Unauthorized Practice of Law—Unlicensed Practice in California—Out-of-state Attorneys Not Licensed to Practice in California.

--A New York law firm whose attorneys were not licensed to practice law in California violated *Bus. & Prof. Code, § 6125* (no person shall practice law in California unless that person is active member of State Bar), in its efforts to resolve a dispute between its California corporate client and a third party. The firm engaged in extensive unauthorized law practice in California. Its attorneys traveled to California to discuss with the client and others various matters pertaining to the dispute, discussed strategy for resolving the dispute and advised the client on this strategy, made a settlement demand to the third party, and traveled to California to initiate arbitration proceedings before the matter was ultimately settled. By its plain terms, § 6125 applies to attorneys licensed in other states; it is not limited to nonattorneys. Since other states' laws may differ substantially from California's, barring out-of-state attorneys from practicing in California furthers the statute's goal of assuring competence of all attorneys practicing in California. Also, there is no exception to § 6125 for attorneys' work incidental to private arbitration or other alternative dispute resolution proceedings, and the Federal Arbitration Act did not preempt § 6125 in this case.

[See 1 Witkin, Cal. Procedure (4th ed. 1996) Attorneys, § 402.]

CA(6)[] (6)

Statutes § 30—Construction—Language—Plain Meaning.

--In determining the meaning of a statute, the court looks to its words and give them their usual and ordinary meaning. If statutory language is clear and unambiguous, there is no need for construction, and courts should not indulge in it.

CA(7a)[] (7a) CA(7b)[] (7b)

Attorneys at Law § 27—Attorney-client Relationship—Compensation of Attorneys—Out-of-state Attorneys Not Licensed to Practice in California—Severability of Work Performed in Other State.

--A fee arrangement between a New York law firm and a California corporate client was invalid, where the firm violated *Bus. & Prof. Code, § 6125* (no person shall practice law in California unless that person is active member of State Bar), in its efforts to resolve a dispute between the client and a third party. A person who violates § 6125 is not entitled to compensation for legal services performed, and no exception applied to this

case. The exception for work performed in federal court did not apply, since none of the firm's work related to federal court practice. Furthermore, California does not recognize exceptions to § 6125 for services not involving courtroom appearances or where the attorney makes full disclosure to the client. Thus, allowing the firm to recover its fees under the arrangement for work performed in California would constitute the enforcement of an illegal contract. However, the firm was entitled to seek recovery for work performed under the agreement in New York that was severable from its work performed in California. The object of the agreement might not have been entirely illegal; the illegality arose from any amount to be paid the firm that included payment for services rendered in violation of § 6125. The portion of the fee agreement might be enforceable to the extent that the illegal compensation could be severed from the rest of the agreement.

CA(8)[] (8)

Contracts § 13—Illegal Contracts—Enforceability—Severability.

--Courts will not ordinarily aid in enforcing an agreement that is either illegal or against public policy. Illegal contracts, however, will be enforced under certain circumstances, such as when only a part of the consideration given for the contract involves illegality. In other words, notwithstanding an illegal consideration, courts may sever the illegal portion of the contract from the rest of the agreement. When the transaction is of such a nature that the good part of the consideration can be separated from that which is bad, the courts will make the distinction, for the law divides according to common reason, and having made void that which is against the law, lets the rest stand. If the court is unable to distinguish between the lawful and unlawful parts of the agreement, the illegality taints the entire contract, and the entire transaction is illegal and unenforceable.

Counsel: Halley, Cornel & Lynch, Roger C. Peters, Hoge, Fenton, Jones & Appel, David P. Eby, William J. Elfving and Scott R. Mosko for Petitioners.

Latham & Watkins, Joseph A. Wheelock, Jr., and Julie V. King as Amici Curiae on behalf of Petitioners.

No appearance for Respondent.

Hopkins & Carley, Jon Michaelson, Denise Y. Yamamoto and Robert W. Ricketson for Real Party in Interest.

Diane C. Yu, Lawrence C. Yee, Mark Torres-Gil and Robert M. Sweet as Amici Curiae on behalf of Real Party in Interest.

Judges: Opinion by Chin, J., with George, C. J., Mosk, Baxter, Werdegar, and Brown, JJ., concurring. Dissenting opinion by Kennard, J.

Opinion by: CHIN

Opinion

[*124] [2] [***306]** **CHIN, J.** Business and Professions Code section 6125 states: "No person shall practice law in California unless the person is an active member of the State Bar." [1] We must decide whether an out-of-state law firm, not licensed to practice law in this state, violated section 6125 when it performed legal services in California for a California-based client under a fee agreement stipulating that California law would govern all matters in the representation.

[**3]** Although we are aware of the interstate nature of modern law practice and mindful of the reality that large firms often conduct activities and serve clients in several states, we do not believe these facts excuse law firms from complying with section 6125. Contrary to the Court of Appeal, however, we do not believe the Legislature intended section 6125 to apply to those services an out-of-state firm renders in its home state. We therefore conclude that, to the extent defendant law firm Birbrower, Montalbano, Condon & Frank, P.C. (Birbrower), practiced **[**3]** law in California without a license, it engaged in the unauthorized practice of law in this state. (§ 6125.) We also conclude that Birbrower's fee agreement with real party in interest ESQ Business Services, Inc. (ESQ), is invalid to the extent it authorizes payment for the substantial legal services Birbrower performed in California. If, however, Birbrower can show it generated fees under its agreement for limited services it performed in New York, and it earned those fees under the otherwise invalid fee agreement, it may, on remand, present to the trial court evidence justifying its recovery of fees for those New York services. **[****4]** Conversely, ESQ will have an opportunity to produce contrary evidence. Accordingly, we affirm the Court of Appeal

[1] All further statutory references are to the Business and Professions Code unless otherwise specified.

judgment in part and reverse it in part, remanding for further proceedings consistent with this opinion.

I. BACKGROUND

The facts with respect to the unauthorized practice of law question are essentially undisputed. Birbrower is a professional law corporation incorporated in New York, with its principal place of business in New York. During 1992 and 1993, Birbrower attorneys, defendants Kevin F. Hobbs and Thomas A. Condon (Hobbs and Condon), performed substantial work in California relating to the law firm's representation of ESQ. Neither Hobbs nor Condon has ever been licensed to practice law in California. None of Birbrower's attorneys were licensed to practice law in California during Birbrower's ESQ representation.

ESQ is a California corporation with its principal place of business in Santa Clara County. In July 1992, the parties negotiated and executed the fee **[*125]** agreement in New York, providing that Birbrower would perform legal services for ESQ, including "All matters pertaining to the investigation of and prosecution of all claims and causes of action **[****5]** against Tandem Computers Incorporated [Tandem]." The "claims and causes of action" against Tandem, a Delaware corporation with its principal place of business in Santa Clara County, California, related to a software development and marketing contract between Tandem and ESQ dated March 16, 1990 (Tandem Agreement). The Tandem Agreement stated that "The internal laws of the State of California (irrespective of its choice of law principles) shall govern the validity of this Agreement, the construction of its terms, and the interpretation and enforcement of the rights and duties of the parties hereto." Birbrower asserts, and ESQ disputes, that ESQ knew Birbrower was not licensed to practice law in California.

While representing ESQ, Hobbs and Condon traveled to California on several occasions. In August 1992, they met in California with ESQ and its accountants. During these meetings, Hobbs and Condon discussed various matters related to ESQ's dispute with Tandem and strategy for resolving the dispute. They made recommendations and gave advice. During this California trip, Hobbs and Condon also met with Tandem representatives on four or five occasions during **[***307]** a two-day period. **[****6]** At the meetings, Hobbs and Condon spoke on ESQ's behalf. Hobbs demanded that Tandem pay ESQ $ 15 million. Condon told Tandem he believed that damages would exceed $ 15 million if the parties litigated the dispute.

Around March or April 1993, Hobbs, Condon, and another Birbrower attorney visited California to interview potential arbitrators and to meet again with ESQ and its accountants. Birbrower had previously filed a demand for arbitration against Tandem with the San Francisco offices of the American Arbitration Association (AAA). In August 1993, Hobbs returned to California to assist ESQ in settling the Tandem matter. While in California, Hobbs met with ESQ and its accountants to discuss a proposed settlement agreement Tandem authored. Hobbs also met with Tandem representatives to discuss possible changes in the proposed agreement. Hobbs gave ESQ legal advice during this trip, including his opinion that ESQ should not settle with Tandem on the terms proposed.

ESQ eventually settled the Tandem dispute, and the matter never went to arbitration. But before the settlement, ESQ and Birbrower modified the contingency fee **[**4]** agreement. [2] The modification changed the fee arrangement **[****7]** from contingency to fixed fee, providing that ESQ would pay Birbrower **[*126]** over $ 1 million. The original contingency fee arrangement had called for Birbrower to receive "one-third (1/3) of all sums received for the benefit of the Clients . . . whether obtained through settlement, motion practice, hearing, arbitration, or trial by way of judgment, award, settlement, or otherwise . . . ."

In January 1994, ESQ sued Birbrower for legal malpractice and related claims in Santa Clara County Superior Court. Birbrower removed the matter to federal court and filed a counterclaim, which included a claim for attorney fees for the work **[****8]** it performed in both California and New York. The matter was then remanded to the superior court. There ESQ moved for summary judgment and/or adjudication on the first through fourth causes of action of Birbrower's counterclaim, which asserted ESQ and its representatives breached the fee agreement. ESQ argued that by practicing law without a license in California and by failing to associate legal counsel while doing so, Birbrower violated *section 6125*, rendering the fee agreement unenforceable. Based on

[2] Birbrower's brief refers to the "Fee Agreement" without specifying whether it means the original contingency agreement or the later modified fixed fee agreement. The operative fee agreement that would be enforced is in dispute, and, as explained below, is subject to clarification on remand. To avoid confusion, we simply refer to one "fee agreement" for purposes of our analysis.

these undisputed facts, the Santa Clara Superior Court granted ESQ's motion for summary adjudication of the first through fourth causes of action in Birbrower's counterclaim. The court also granted summary adjudication in favor of ESQ's third and fourth causes of action in its second amended complaint, seeking declaratory relief as to the validity of the fee agreement and its modification. CA(1)[↑] **(1)** (See. fn. 3.) The court concluded that: (1) Birbrower was "not admitted to the practice of law in California"; (2) Birbrower "did not associate California counsel"; [3] (3) Birbrower "provided legal services in this state"; and (4) "The law is clear that no one may recover compensation for services as an attorney **[****9]** in this state unless he or she was a member of the state bar at the time those services were performed."

Although the trial court's order stated that the fee agreements were unenforceable, at the hearing on the summary adjudication motion, the trial court also observed: "It seems to me that those are some of the issues that this Court has to struggle with, and then it becomes a question of if they aren't allowed to collect their attorney's fees here, I don't think that puts the attorneys in a position from being precluded from collecting all of their attorney's fees, only those fees probably that were generated by virtue of work that they performed in California and **[***308]** not that work that was performed in New York."

[*127] In granting limited summary adjudication, **[****10]** the trial court left open the following issues for resolution: ESQ's malpractice action against Birbrower, and the remaining causes of action in Birbrower's counterclaim, including Birbrower's fifth cause of action for quantum meruit (seeking the reasonable value of legal services provided).

Birbrower petitioned the Court of Appeal for a writ of mandate directing the trial court to vacate the summary adjudication order. The Court of Appeal denied Birbrower's petition and affirmed the trial court's order, holding that Birbrower violated section 6125. The Court of Appeal also concluded that Birbrower's violation barred the firm from recovering its legal fees under the written fee agreement, including fees generated in New York by the attorneys when they were physically present in New York, because the agreement included payment for California or "local" services for a California client in California. The Court of Appeal agreed with the trial court, however, in deciding that Birbrower could pursue its remaining claims against ESQ, including its equitable claim for recovery of its fees in quantum meruit.

[5]** We granted review to determine whether Birbrower's actions and services **[****11]** performed while representing ESQ in California constituted the unauthorized practice of law under section 6125 and, if so, whether a section 6125 violation rendered the fee agreement wholly unenforceable.

II. DISCUSSION

A. *The Unauthorized Practice of Law*

CA(2)[↑] **(2)** The California Legislature enacted section 6125 in 1927 as part of the State Bar Act (the Act), a comprehensive scheme regulating the practice of law in the state. (*J.W. v. Superior Court (1993) 17 Cal. App. 4th 958, 965 [22 Cal. Rptr. 2d 527]* (*J.W.*).) Since the Act's passage, HN1[↑] the general rule has been that, although persons may represent themselves and their own interests regardless of State Bar membership, no one but an active member of the State Bar may practice law for another person in California. (*Ibid.*) The prohibition against unauthorized law practice is within the state's police power and is designed to ensure that those performing legal services do so competently. (*Id.* at p. 969.)

HN2[↑] A violation of section 6125 is a misdemeanor. (§ 6126.) Moreover, "No one may recover compensation for services as an attorney at law in this state unless [the person] was at the time the services were performed **[****12]** a member of The State Bar." (*Hardy v. San Fernando Valley C. of C. (1950) 99 Cal. App. 2d 572, 576 [222 P.2d 314]* (*Hardy*).)

[*128] CA(3)[↑] **(3)** Although the Act did not define the term HN3[↑] "practice law," case law explained it as " 'the doing and performing services in a court of justice in any matter depending therein throughout its various stages and in conformity with the adopted rules of procedure.' " (*People v. Merchants Protective Corp. (1922) 189 Cal. 531, 535 [209 P. 363]* (*Merchants*).) *Merchants* included in its definition legal advice and legal instrument and contract preparation, whether or not these subjects were rendered in the course of litigation. (*Ibid.*; see *People v. Ring (1937) 26 Cal. App. 2d. Supp. 768, 772-773 [70 P.2d 281]* (*Ring*) [holding that single incident

[3] Contrary to the trial court's implied assumption, no statutory exception to section 6125 allows out-of-state attorneys to practice law in California as long as they associate local counsel in good standing with the State Bar.

of practicing law in state without a license violates § 6125]; see also *Mickel v. Murphy (1957) 147 Cal. App. 2d 718, 721 [305 P.2d 993]* [giving of legal advice on matter not pending before state court violates § 6125], disapproved on other grounds in *Biakanja v. Irving (1958) 49 Cal. 2d 647, 651 [320 P.2d 16, 65 A.L.R.2d 1358]*.) *Ring* later determined that **[****13]** the Legislature "accepted both the definition already judicially supplied for the term and the declaration of the Supreme Court [in *Merchants*] that it had a sufficiently definite meaning to need no further definition. The definition . . . must be regarded as definitely establishing, for the jurisprudence of this state, the meaning of the term 'practice law.' " (*Ring*, *supra*, 26 Cal. App. 2d at p. Supp. 772.)

In addition to not defining the term "practice law," the Act also did not define the meaning of "in California." In today's legal practice, questions often arise concerning whether the phrase refers to the nature of the legal services, or restricts the Act's application **[***309]** to those out-of-state attorneys who are physically present in the state.

Section 6125 has generated numerous opinions on the meaning of "practice law" but none on the meaning of "in California." In our view, the practice of law "in California" entails sufficient contact with the California client to render the nature of the legal service a clear legal representation. In addition to a quantitative analysis, we must consider the nature of the unlicensed lawyer's activities in the state. **[****14]** *HN4*[↑] Mere fortuitous or attenuated contacts will not sustain a finding that the unlicensed lawyer practiced law "in California." The primary inquiry is whether the unlicensed lawyer engaged in sufficient activities in the state, or created a continuing relationship with the California client that included legal duties and obligations.

Our definition does not necessarily depend on or require the unlicensed lawyer's physical presence in the state. Physical presence here is one factor we may consider in deciding whether the unlicensed lawyer has violated section 6125, but it is by no means exclusive. For example, one may practice law in the state in violation of section 6125 although not physically present here by advising a California client on California law in connection **[**6]** with a **[*129]** California legal dispute by telephone, fax, computer, or other modern technological means. Conversely, although we decline to provide a comprehensive list of what activities constitute sufficient contact with the state, we do reject the notion that a person *automatically* practices law "in California" whenever that person practices California law anywhere, or "virtually" enters the state **[****15]** by telephone, fax, e-mail, or satellite. (See e.g., *Baron v. City of Los Angeles (1970) 2 Cal. 3d 535, 543 [86 Cal. Rptr. 673, 469 P.2d 353, 42 A.L.R.3d 1036]* (*Baron*) ["practice law" does not encompass all professional activities].) Indeed, we disapprove *Ring, supra, 26 Cal. App. 2d Supp. 768*, and its progeny to the extent the cases are inconsistent with our discussion. We must decide each case on its individual facts.

This interpretation acknowledges the tension that exists between interjurisdictional practice and the need to have a state-regulated bar. As stated in the American Bar Association Model Code of Professional Responsibility, Ethical Consideration EC 3-9, "Regulation of the practice of law is accomplished principally by the respective states. Authority to engage in the practice of law conferred in any jurisdiction is not per se a grant of the right to practice elsewhere, and it is improper for a lawyer to engage in practice where he is not permitted by law or by court order to do so. However, the demands of business and the mobility of our society pose distinct problems in the regulation of the practice of law by the states. In furtherance of the public **[****16]** interest, the legal profession should discourage regulation that unreasonably imposes territorial limitations upon the right of a lawyer to handle the legal affairs of his client or upon the opportunity of a client to obtain the services of a lawyer of his choice in all matters including the presentation of a contested matter in a tribunal before which the lawyer is not permanently admitted to practice." (Fns. omitted.) *Baron* implicitly agrees with this canon. (*Baron, supra, 2 Cal. 3d at p. 543*.)

If we were to carry the dissent's narrow interpretation of the term "practice law" to its logical conclusion, we would effectively limit section 6125's application to those cases in which nonlicensed out-of-state lawyers appeared in a California courtroom without permission. (Dis. opn., *post*, at pp. 142-144.) Clearly, neither *Merchants, supra, 189 Cal. at page 535*, nor *Baron*, *supra*, 22 Cal. 3d at page 543, supports the dissent's fanciful interpretation of the thoughtful guidelines announced in those cases. Indeed, the dissent's definition of "practice law" ignores *Merchants* altogether, and, in so doing, substantially undermines the Legislature's intent **[****17]** to protect the public from those giving unauthorized legal advice and counsel.

CA(4)[↑] **(4)** *HN5*[↑] Exceptions to section 6125 do exist, but are generally limited to allowing out-of-state attorneys to make brief appearances before a state court **[*130]** or tribunal. They are narrowly drawn and

strictly interpreted. For example, an out-of-state attorney not licensed to practice in California may be permitted, **[***310]** *by consent of a trial judge*, to appear in California in a particular pending action. (See *In re McCue (1930) 211 Cal. 57, 67 [293 P. 47]*; 1 Witkin, Cal. Procedure (4th ed. 1996) Attorneys, § 402, p. 493.)

In addition, *HN6*[] with the permission of the California court in which a particular cause is pending, out-of-state counsel may appear before a court as counsel pro hac vice. (Cal. Rules of Court, rule 983.) A court will approve a pro hac vice application only if the out-of-state attorney is a member in good standing of another state bar and is eligible to practice in any United States court or the highest court in another jurisdiction. (Cal. Rules of Court, rule 983(a).) The out-of-state attorney must also associate an active member of the California Bar as attorney of record **[****18]** and is subject to the Rules of Professional Conduct of the State Bar. (Cal. Rules of Court, rules 983(a), (d); see Rules Prof. Conduct, rule 1-100(D)(2) [includes lawyers from other jurisdictions authorized to practice in this state].)

HN7[] The Act does not regulate practice before United States courts. Thus, an out-of-state attorney engaged to render services in bankruptcy proceedings was entitled to collect his fee. (*Cowen v. Calabrese (1964) 230 Cal. App. 2d 870, 872 [41 Cal. Rptr. [**7] 441, 11 A.L.R.3d 903]* (*Cowen*); but see U.S. Dist. Ct. Local Rules, Northern Dist. Cal., rule 11-1(b); Eastern Dist. Cal., rule 83-180; Central Dist. Cal., rule 2.2.1; Southern Dist. Cal., rule 83.3 c.1.a. [today conditioning admission to their respective bars (with certain exceptions for some federal government employees) on active membership in good standing in California State Bar].)

Finally, *HN8*[] California Rules of Court, rule 988, permits the State Bar to issue registration certificates to foreign legal consultants who may advise on the law of the foreign jurisdiction where they are admitted. These consultants may not, however, appear as attorneys before a California court or judicial **[****19]** officer or otherwise prepare pleadings and instruments in California or give advice on the law of California or any other state or jurisdiction except those where they are admitted.

HN9[] The Legislature has recognized an exception to section 6125 in international disputes resolved in California under the state's rules for arbitration and conciliation of international commercial disputes. (*Code Civ. Proc., § 1297.11 et seq.*) This exception states that in a commercial conciliation in California involving international commercial disputes, "The parties may appear in person or be represented or assisted by any person of their choice. A person assisting or representing a party need not be a member of the legal **[*131]** profession or licensed to practice law in California." (*Code Civ. Proc., § 1297.351*.) Likewise, the Act does not apply to the preparation of or participation in labor negotiations and arbitrations arising under collective bargaining agreements in industries subject to federal law. (See e.g., *Teamsters Local v. Lucas Flour Co. (1962) 369 U.S. 95, 103 [82 S. Ct. 571, 576-577, 7 L. Ed. 2d 593]*; see also Labor-Management Relations Act of 1947, *29 U.S.C. § 185(a)*.)

[**20]** B. *The Present Case*

CA(5a)[] **(5a)** The undisputed facts here show that neither *Baron*'s definition (*Baron, supra, 2 Cal. 3d at p. 543*) nor our "sufficient contact" definition of "practice law in California" (*ante*, at pp. 128-129) would excuse Birbrower's extensive practice in this state. Nor would any of the limited statutory exceptions to *section 6125* apply to Birbrower's California practice. As the Court of Appeal observed, Birbrower engaged in unauthorized law practice *in California* on more than a limited basis, and no firm attorney engaged in that practice was an active member of the California State Bar. As noted (*ante*, at p. 125), in 1992 and 1993, Birbrower attorneys traveled to California to discuss with ESQ and others various matters pertaining to the dispute between ESQ and Tandem. Hobbs and Condon discussed strategy for resolving the dispute and advised ESQ on this strategy. Furthermore, during California meetings with Tandem representatives in August 1992, Hobbs demanded Tandem pay $ 15 million, and Condon told Tandem he believed damages in the matter would exceed that amount if the parties proceeded to litigation. Also in California, Hobbs met with ESQ for **[****21]** the stated purpose of helping to reach a settlement agreement and to discuss the agreement that was eventually proposed. Birbrower attorneys also traveled to California to initiate arbitration proceedings before the matter was settled. As the Court of Appeal concluded, ". . . the Birbrower firm's **[***311]** in-state activities clearly constituted the [unauthorized] practice of law" *in California*.

Birbrower contends, however, that *section 6125* is not meant to apply to *any* out-of-state *attorneys*. Instead, it argues that the statute is intended solely to prevent nonattorneys from practicing law. This contention is without merit because it contravenes the plain language of the statute. *Section 6125* clearly states that *no person* shall practice law in California unless that person is a member of the State Bar. The statute does not

differentiate between attorneys or nonattorneys, nor does it excuse a person who is a member of another state bar. CA(6)[↑] **(6)** HN10[↑] It is well-settled that, in determining the meaning of a statute, we look to its words and give them their usual and ordinary meaning. (DaFonte v. Up-Right, Inc. (1992) 2 Cal. 4th 593, 601 [7 Cal. Rptr. 2d 238, 828 P.2d **[****22]** 140]; Kimmel v. Goland (1990) 51 Cal. 3d 202, 208-209 [271 Cal. Rptr. 191, 793 P.2d 524].) "[I]f statutory language is 'clear **[*132]** and unambiguous there is no need for construction, and courts should not indulge in it.' [Citation.]" (Tiernan v. Trustees of Cal. State University & Colleges (1982) 33 Cal. 3d 211, 218 [188 Cal. Rptr. 115, 655 P.2d 317].) CA(5b)[↑] **(5b)** The plain meaning controls our interpretation of the statute here because Birbrower has not shown "that **[**8]** the natural and customary import of the statute's language is either 'repugnant to the general purview of the act' or for some other compelling reason, should be disregarded . . . ." (Id. at pp. 218-219.)

Birbrower next argues that we do not further the statute's intent and purpose--to protect California citizens from incompetent attorneys--by enforcing it against out-of-state attorneys. Birbrower argues that because out-of-state attorneys have been licensed to practice in other jurisdictions, they have already demonstrated sufficient competence to protect California clients. But Birbrower's argument overlooks the obvious fact that other states' laws may differ substantially from California law. **[****23]** Competence in one jurisdiction does not necessarily guarantee competence in another. By applying section 6125 to out-of-state attorneys who engage in the extensive practice of law in California without becoming licensed in our state, we serve the statute's goal of assuring the competence of all attorneys practicing law in this state. (J.W., supra, 17 Cal. App. 4th at p. 969.)

California is not alone in regulating who practices law in its jurisdiction. Many states have substantially similar statutes that serve to protect their citizens from unlicensed attorneys who engage in unauthorized legal practice. Like section 6125, these other state statutes protect local citizens "against the dangers of legal representation and advice given by persons not trained, examined and licensed for such work, whether they be laymen or lawyers from other jurisdictions." (Spivak v. Sachs (1965) 16 N.Y.2d 163 [263 N.Y.S.2d 953, 211 N.E.2d 329, 331].) Whether an attorney is duly admitted in another state and is, in fact, competent to practice in California is irrelevant in the face of section 6125's language and purpose. (See Ranta v. McCarney (N.D. 1986) 391 N.W.2d 161, 163 (*Ranta*) [noting **[****24]** that out-of-state attorney's competence is irrelevant because purpose of North Dakota law against unauthorized law practice is to assure competence *before* attorney practices in state].) Moreover, as the North Dakota Supreme Court pointed out in *Ranta*: "It may be that such an [out-of-state attorney] exception is warranted, but such a plea is more properly made to a legislative committee considering a bill enacting such an exception or to this court in its rule-making function than it is in a judicial decision." (Id. at p. 165.) Similarly, a decision to except out-of-state attorneys licensed in their own jurisdictions from section 6125 is more appropriately left to the California Legislature.

[*133] Assuming that section 6125 does apply to out-of-state attorneys not licensed here, Birbrower alternatively asks us to create an exception to section 6125 for work incidental to private arbitration or other alternative dispute resolution proceedings. Birbrower points to fundamental differences between private arbitration and legal proceedings, including procedural differences relating to discovery, rules of evidence, compulsory process, cross-examination of witnesses, **[****25]** and other areas. (See Alexander v. Gardner-Denver **[***312]** Co. (1974) 415 U.S. 36, 57-58 [94 S. Ct. 1011, 1024-1025, 39 L. Ed. 2d 147] [illustrating differences between arbitration and court proceedings].) As Birbrower observes, in light of these differences, at least one court has decided that an out-of-state attorney could recover fees for services rendered in an arbitration proceeding. (See Williamson v. John D. Quinn Const. Corp. (S.D.N.Y. 1982) 537 F. Supp. 613, 616 (*Williamson*).)

In *Williamson*, a New Jersey law firm was employed by a client's New York law firm to defend a construction contract arbitration in New York. It sought to recover fees solely related to the arbitration proceedings, even though the attorney who did the work was not licensed in New York, nor was the firm authorized to practice in the state. (Williamson, supra, 537 F. Supp. at p. 616.) In allowing the New Jersey firm to recover its arbitration fees, the federal district court concluded that an arbitration tribunal is not a court of record, and its fact-finding process is not similar to a court's process. (*Ibid.*) The court relied on a local state bar report concluding **[****26]** that representing a client in an arbitration was not the unauthorized practice of law. (*Ibid.*; see Com. Rep., Labor Arbitration and the Unauthorized Practice of Law (May/June 1975) 30 Record of the Association **[**9]** of the Bar of the City of New York, No. 5/6, p. 422 et seq.) But as amicus curiae the State Bar of California observes, "While in *Williamson* the federal district court did allow the

New Jersey attorneys to recover their fees, that decision clearly is distinguishable on its facts. . . . [P] In the instant case, it is undisputed that none of the time that the New York attorneys spent in California was" spent in arbitration; *Williamson* thus carries limited weight. (See also *Moore v. Conliffe (1994) 7 Cal. 4th 634, 637-638 [29 Cal. Rptr. 2d 152, 871 P.2d 204]* [private AAA arbitration functionally equivalent to judicial proceeding to which litigation privilege applies].) Birbrower also relies on California's rules for arbitration and conciliation of international commercial disputes for support. (*Code Civ. Proc., § 1297.11 et seq.*) As noted (*ante*, at pp. 130-131), these rules specify that, in an international commercial conciliation or arbitration **[****27]** proceeding, the person representing a party to the conciliation or arbitration is not required to be a licensed member of the State Bar. (*Code Civ. Proc., § 1297.351*.)

We decline Birbrower's invitation to craft an arbitration exception to *section 6125*'s prohibition of the unlicensed practice of law in this state. Any **[*134]** exception for arbitration is best left to the Legislature, which has the authority to determine qualifications for admission to the State Bar and to decide what constitutes the practice of law. (*Baron, supra, 2 Cal. 3d at pp. 540-541*; see also *Eagle Indem. Co. v. Industrial Acc. Com. (1933) 217 Cal. 244, 247 [18 P.2d 341]*.) Even though the Legislature has spoken with respect to *international* arbitration and conciliation, it has not enacted a similar rule for private arbitration proceedings. Of course, private arbitration and other alternative dispute resolution practices are important aspects of our justice system. (See *Moncharsh v. Heily & Blase (1992) 3 Cal. 4th 1, 9 [10 Cal. Rptr. 2d 183, 832 P.2d 899]* [noting a strong public policy in favor of arbitration].) *Section 6125*, however, articulates a strong public policy favoring the **[****28]** practice of law in California by licensed State Bar members. In the face of the Legislature's silence, we will not create an arbitration exception under the facts presented. (See *Baron, supra, 2 Cal. 3d at pp. 540-541* [membership, character, and conduct of attorneys is proper subject of state legislative regulation and control].) [4]

[**29]** **[***313]** In its reply brief to the State Bar's amicus curiae brief, Birbrower raises for the first time the additional argument that the Federal Arbitration Act (FAA) preempted the rules governing the AAA proposed arbitration and *section 6125*. The FAA regulates arbitration that deals with maritime transactions and contracts involving the transportation of goods through interstate or foreign commerce. (*9 U.S.C. § 1 et seq.*) Although we need not address the question under California Rules of Court, rule 29(b)(1), and note the parties' settlement agreement rendered the arbitration unnecessary, we reject the argument for its lack of merit. First, the parties incorporated a California choice-of-law provision in the Tandem Agreement, indicating they intended to apply California law in any necessary arbitration, and they have not shown that California law in any way conflicts with the FAA. Moreover, in interpreting the California Arbitration Act stay provisions (*Code Civ. Proc., § 1281.2, subd. (c)*), the high court observed that the FAA does not contain an express preemptive provision, nor does it "reflect a congressional intent to occupy the entire field of arbitration." (*Volt Info.* **[****30]** *Sciences v. [**10] Leland [*135] Stanford Jr. U. (1989) 489 U.S. 468, 477 [109 S. Ct. 1248, 1255, 103 L. Ed. 2d 488]*.)

Finally, Birbrower urges us to adopt an exception to *section 6125* based on the unique circumstances of this case. Birbrower notes that "Multistate relationships are a common part of today's society and are to be dealt with in commonsense fashion." (*In re Estate of Waring (1966) 47 N.J. 367 [221 A.2d 193, 197]*.) In many situations, strict adherence to rules prohibiting the unauthorized practice of law by out-of-state attorneys would be " 'grossly impractical and inefficient.' " (*Ibid.*; see also *Appell v. Reiner (1964) 43 N.J. 313 [204 A.2d 146, 148]* [strict adherence to rule barring out-of-state lawyers from representing New Jersey residents on New Jersey matters may run against the public interest when case involves inseparable multistate transactions].)

Although, as discussed (*ante*, at pp. 129-130), we recognize the need to acknowledge and, in certain cases, to accommodate the multistate nature of law practice, the

[4] The dissent focuses on an arbitrator's powers in an attempt to justify its conclusion that an out-of-state attorney may engage in the unlicensed representation of a client in an arbitration proceeding. (See dis. opn., *post*, at pp. 144-145.) This narrow focus confuses the issue here. An arbitrator's powers to enforce a contract or "award an essentially unlimited range of remedies" has no bearing on the question whether unlicensed out-of-state attorneys may represent California clients in an arbitration proceeding. (Dis. opn., *post*, at p. 145.) Moreover, any discussion of the practice of law in an arbitration proceeding is irrelevant here because the parties settled the underlying case before arbitration proceedings became necessary. Nonetheless, we emphasize that, in the absence of clear legislative direction, we decline to create an exception allowing unlicensed legal practice in arbitration in violation of *section 6125*.

facts here show that Birbrower's extensive activities within California amounted to considerably more than **[****31]** any of our state's recognized exceptions to section 6125 would allow. Accordingly, we reject Birbrower's suggestion that we except the firm from section 6125's rule under the circumstances here.

C. *Compensation for Legal Services*

CA(7a)[↑] **(7a)** Because Birbrower violated section 6125 when it engaged in the unlawful practice of law in California, the Court of Appeal found its fee agreement with ESQ unenforceable in its entirety. Without crediting Birbrower for some services performed in New York, for which fees were generated under the fee agreement, the court reasoned that the agreement was void and unenforceable because it included payment for services rendered to a California client in the state by an unlicensed out-of-state lawyer. The court opined that "When New York counsel decided to accept [the] representation, it should have researched California law, including the law governing the practice of law in this state." The Court of Appeal let stand, however, the trial court's decision to allow Birbrower to pursue its fifth cause of action in quantum meruit. [5] We agree with the Court of Appeal to the extent it barred Birbrower from recovering fees generated under the fee agreement **[****32]** for the unauthorized legal services it performed in California. We disagree with the same court to the extent it implicitly barred Birbrower **[*136]** from recovering fees generated under the fee agreement for the limited legal services the firm performed in New York.

It is HN11[↑] a general rule that an attorney is barred from recovering compensation for **[***314]** services rendered in another state where the attorney was not admitted to the bar. (Annot., Right of Attorney Admitted in One State to Recover Compensation for Services Rendered in Another State Where He Was Not Admitted to the Bar (1967) 11 A.L.R.3d 907; Hardy, supra, 99 Cal. App. 2d at p. 576.) The general rule, however, has some recognized exceptions.

Initially, Birbrower seeks enforcement **[****33]** of the entire fee agreement, relying first on the federal court exception discussed *ante*, at page 130. (Cowen, supra, 230 Cal. App. 2d at p. 872; In re McCue, supra, 211 Cal. at p. 66; see Annot., supra, 11 A.L.R.3d at pp. 912-913 [citing *Cowen* as an exception to general rule of nonrecovery].) This exception does not apply in this case; none of Birbrower's activities related to federal court practice.

A second exception on which Birbrower relies to enforce its entire fee agreement relates to "Services not involving courtroom appearance." (Annot., supra, 11 A.L.R.3d at p. 911 [citing Wescott v. Baker (1912) 83 N.J.L. 460 [85 A. 315]].) California has implicitly rejected this broad exception through its comprehensive definition of what it means to "practice law." Thus, the exception Birbrower seeks for all services performed outside the courtroom **[**11]** in our state is too broad under section 6125.

Some jurisdictions have adopted a third exception to the general rule of nonrecovery for in-state services, if an out-of-state attorney "makes a full disclosure to his client of his lack of local license and does not conceal or misrepresent **[****34]** the true facts." (Annot., supra, 11 A.L.R.3d at p. 910.) For example, in Freeling v. Tucker (1930) 49 Idaho 475 [289 P. 85], the court allowed an Oklahoma attorney to recover for services rendered in an Idaho probate court. Even though an Idaho statute prohibited the unlicensed practice of law, the court excused the Oklahoma attorney's unlicensed representation because he had not falsely represented himself nor deceptively held himself out to the client as qualified to practice in the jurisdiction. (Id. at p. 86.) In this case, Birbrower alleges that ESQ at all times knew that the firm was not licensed to practice law in California. Even assuming that is true, however, we reject the full disclosure exception for the same reasons we reject the argument that section 6125 is not meant to apply to nonattorneys. Recognizing these exceptions would contravene not only the plain language of section 6125 but the underlying policy of assuring the competence of those practicing law in California.

[*137] Therefore, as the Court of Appeal held, none of the exceptions to the general rule prohibiting recovery of fees generated by the unauthorized practice of law apply to Birbrower's **[****35]** activities in California. Because Birbrower practiced substantial law in this state in violation of section 6125, it cannot receive compensation under the fee agreement for any of the services it performed in California. Enforcing the fee agreement in its entirety would include payment for the unauthorized practice of law in California and would allow Birbrower to enforce an illegal contract. (*See* Hardy, supra, 99 Cal.

[5] We observe that ESQ did not seek (and thus the court did not grant) summary adjudication on the Birbrower firm's quantum meruit claim for the reasonable value of services rendered. Birbrower thus still has a cause of action pending in quantum meruit.

App. 2d at p. 576.)

Birbrower asserts that even if we agree with the Court of Appeal and find that none of the above exceptions allowing fees for unauthorized California services apply to the firm, it should be permitted to recover fees for those limited services it performed exclusively *in New York* under the agreement. In short, Birbrower seeks to recover under its contract for those services it performed for ESQ in New York that did not involve the practice of law in California, including fee contract negotiations and some corporate case research. Birbrower thus alternatively seeks reversal of the Court of Appeal's judgment to the extent it implicitly precluded the firm from seeking fees generated in New York under the fee agreement.

We agree with Birbrower **[****36]** that it may be able to recover fees under the fee agreement for the limited legal services it performed for ESQ in New York to the extent they did not constitute practicing law in California, even though those services were performed for a California client. Because section 6125 applies to the practice of law in California, it does not, in general, regulate law practice in other states. (See *ante*, at pp. 128-131.) **[***315]** Thus, although the general rule against compensation to out-of-state attorneys precludes Birbrower's recovery under the fee agreement for its actions in California, the severability doctrine may allow it to receive its New York fees generated under the fee agreement, if we conclude the illegal portions of the agreement pertaining to the practice of law in California may be severed from those parts regarding services Birbrower performed in New York. (See Annot., supra, 11 A.L.R.3d at pp. 908-909, and cases cited [bar on recovery by out-of-state attorney extends only to compensation for *local* services]; see also *Ranta, supra*, 391 N.W.2d at p. 166 [remanding case to determine which fees related to practice locally and which related to attorney's **[****37]** work in state where he was licensed].)

HN12[↑] The law of contract severability is stated in Civil Code section 1599, which defines partially void contracts: "Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest." In **[*138]** Calvert v. Stoner (1948) 33 Cal. 2d 97 [199 P.2d 297] (*Calvert*), we considered whether a contingent fee contract containing a provision restricting a party's right to compromise a suit **[**12]** without her attorney's consent was void entirely or severable in part. (Id. at p. 103.) We observed that "It is unnecessary . . . to determine whether the particular provision is invalid as against public policy. It is sufficient to observe, assuming such invalidity, that in this state . . . the compensation features of the contract are not thereby deemed affected if in other respects the contract is lawful." (Id. at p. 104.) *Calvert* concluded that the invalid provision preventing the client from compromising the suit could be severed from the valid provision for attorney fees. (*Ibid.*)

The fee agreement **[****38]** between Birbrower and ESQ became illegal when Birbrower performed legal services in violation of section 6125. **CA(8)**[↑] **(8)** It is true that courts will not ordinarily aid in enforcing an agreement that is either illegal or against public policy. (Asdourian v. Araj (1985) 38 Cal. 3d 276, 291 [211 Cal. Rptr. 703, 696 P.2d 95]; Homami v. Iranzadi (1989) 211 Cal. App. 3d 1104, 1109-1110 [260 Cal. Rptr. 6].) Illegal contracts, however, will be enforced under certain circumstances, such as when only a part of the consideration given for the contract involves illegality. In other words, notwithstanding an illegal consideration, courts may sever the illegal portion of the contract from the rest of the agreement. (Keene v. Harling (1964) 61 Cal. 2d 318, 320 [38 Cal. Rptr. 513, 392 P.2d 273] (*Keene*).) " ' "When the transaction is of such a nature that the good part of the consideration can be separated from that which is bad, the Courts will make the distinction, for the . . . law . . . [divides] according to common reason; and having made that void that is against law, lets the rest stand. . . ." ' " (Id. at pp. 320-321, quoting Jackson v. Shawl (1865) 29 Cal. 267, 272.) **[****39]** If the court is unable to distinguish between the lawful and unlawful parts of the agreement, "the illegality taints the entire contract, and the entire transaction is illegal and unenforceable." (Keene, supra, 61 Cal. 2d at p. 321.)

In *Keene*, the defendant agreed to pay the plaintiffs $ 50,000 in exchange for their business involving coin-operated machines. The defendant defaulted on his payments, and the plaintiffs sued. The defendant argued that the sales agreement was void because part of the sale involved machines that were illegal under a California penal statute. The court affirmed the lower court's determination that the price of the illegal machines could be deducted from the amount due on the original contract. "Since the consideration on the buyer's side was money, the court properly construed the contract by equating the established market price of the illegal machines to a portion of the money consideration." (Keene, supra, 61 Cal. 2d at p. 323.) Thus, even though the entire contract was for a fixed sum, the court was able **[*139]** to value the illegal portion of the contract and separate it from the rest of the amount due under the

agreement.

CA(7b)[] **(7b)** In this **[****40]** case, the parties entered into a contingency fee agreement followed by a **[***316]** fixed fee agreement. [6] ESQ was to pay money to Birbrower in exchange for Birbrower's legal services. The object of their agreement may not have been entirely illegal, assuming ESQ was to pay Birbrower compensation based in part on work Birbrower performed in New York that did not amount to the practice of law in California. The illegality arises, instead, out of the amount to be paid to Birbrower, which, if paid fully, would include payment for services rendered in California in violation of section 6125.

[**41]** Therefore, we conclude the Court of Appeal erred in determining that the fee **[**13]** agreement between the parties was entirely unenforceable because Birbrower violated section 6125's prohibition against the unauthorized practice of law in California. Birbrower's statutory violation may require exclusion of the portion of the fee attributable to the substantial illegal services, but that violation does not necessarily entirely preclude its recovery under the fee agreement for the limited services it performed outside California. (Calvert, supra, 33 Cal. 2d at pp. 104-105.)

Thus, the portion of the fee agreement between Birbrower and ESQ that includes payment for services rendered in New York may be enforceable to the extent that the illegal compensation can be severed from the rest of the agreement. On remand, therefore, the trial court must first resolve the dispute surrounding the parties' fee agreement and determine whether their agreement conforms to California law. If the parties and the court resolve the fee dispute and determine that one fee agreement is operable and does not violate any state drafting rules, the court may sever the illegal portion of the consideration **[****42]** (the value of the California services) from the rest of the fee agreement. Whether the trial court finds the contingent fee agreement or the fixed fee agreement to be valid, it will determine whether some amount is due under the valid agreement. The trial court must then determine, on **[*140]** evidence the parties present, how much of this sum is attributable to services Birbrower rendered in New York. The parties may then pursue their remaining claims.

III. DISPOSITION

We conclude that Birbrower violated section 6125 by practicing law in California. To the extent the fee agreement allows payment for those illegal local services, it is void, and Birbrower is not entitled to recover fees under the agreement for those services. The fee agreement is enforceable, however, to the extent it is possible to sever the portions of the consideration attributable to Birbrower's services illegally rendered in California from those attributable to Birbrower's New York services. Accordingly, we affirm the Court of Appeal judgment to the extent it concluded that Birbrower's representation of ESQ in California violated section 6125, and that Birbrower is not entitled to recover fees under the **[****43]** fee agreement for its local services. We reverse the judgment to the extent the court did not allow Birbrower to argue in favor of a severance of the illegal portion of the consideration (for the California fees) from the rest of the fee agreement, and remand for further proceedings consistent with this decision.

George, C. J., Mosk, J., Baxter, J., Werdegar, J., and Brown, J., concurred.

Dissent by: KENNARD

Dissent

KENNARD, J.,

Dissenting.--In California, it is a misdemeanor to practice law when one is not a member of the State Bar. (Bus. & Prof. Code, § 6125, 6126, subd. (a).) In this case, New York lawyers who were not members of the California Bar **[***317]** traveled to this state on several occasions, attempting to resolve a contract dispute between their clients and another corporation through negotiation and private arbitration. Their clients included a New York corporation and a sister corporation incorporated in California; the lawyers had in previous years represented

[6] The parties apparently do not dispute that they modified the original contingency fee arrangement to call for a fixed fee payment of over $ 1 million. They dispute, however, whether the original contingency fee arrangement became operative once again when ESQ failed to make a payment to Birbrower under the fixed fee arrangement. Because the trial court and the Court of Appeal believed the fee agreements to be unenforceable in their entirety, neither court addressed issues relating to the fee agreements themselves or the parties' disputes surrounding those agreements. We agree with the Court of Appeal that issues surrounding the two fee agreements and the applicability of either section 6147 (regulating contents of contingency fee agreements) or the State Bar Rules of Professional Conduct, rules 3-300 and 4-200 (governing fees for legal services), are best resolved by the trial court on remand.

the principal owners of these corporations. The majority holds that the New York lawyers' activities in California constituted the unauthorized practice of law. I disagree.

The majority focuses its attention **[****44]** on the question of whether the New York lawyers had engaged in the practice of law *in California*, giving scant consideration to a decisive preliminary inquiry: whether, through their activities here, the New York lawyers had engaged in the practice of law *at all*. In my view, the record does not show that they did. In reaching a contrary conclusion, the majority relies on an overbroad definition of the term "practice of law." I would adhere to this court's decision in *Baron v. City of* ***[*141]*** *Los Angeles (1970) 2 Cal. 3d 535 [86 Cal. Rptr. 673, 469 P.2d 353, 42 A.L.R.3d 1036]*, more narrowly defining the practice of law as the representation of another in a judicial proceeding or an activity requiring the application of that degree of legal knowledge and technique possessed only by a trained legal mind. Under this definition, this case presents a triable issue of material fact as to whether the New York **[**14]** lawyers' California activities constituted the practice of law.

I

Defendant Birbrower, Montalbano, Condon & Frank, P.C. (hereafter Birbrower) is a New York law firm. Its lawyers are not licensed to practice law in California.

Kamal Sandhu was the **[****45]** sole shareholder of ESQ Business Services Inc., a New York corporation (hereafter ESQ-NY), of which his brother Iqbal Sandhu was the vice-president. Beginning in 1986, Birbrower lawyers represented the Sandhu family in various business matters. In 1990, Kamal Sandhu asked Birbrower lawyer Kevin Hobbs to review a proposed software development and marketing agreement between ESQ-NY and Tandem Computers Incorporated (hereafter Tandem). The agreement granted Tandem worldwide distribution rights to computer software created by ESQ-NY. The agreement also provided that it would be governed by California law and that, according to Birbrower's undisputed assertion, disputes were to be resolved by arbitration under the rules of the American Arbitration Association. ESQ-NY and Tandem signed the agreement.

Thereafter, a second corporation, also named ESQ Business Services, Inc. (hereafter ESQ-CAL), was incorporated in California, with Iqbal Sandhu as a principal shareholder. In 1991, ESQ-CAL consulted Birbrower lawyers concerning Tandem's performance under the agreement. In 1992, ESQ-NY and ESQ-CAL jointly hired Birbrower to resolve the dispute with Tandem, including the investigation and prosecution **[****46]** of claims against Tandem if necessary. ESQ-NY and ESQ-CAL entered into a contingency fee agreement with Birbrower; this agreement was executed in New York but was later modified to a fixed fee agreement in California.

The efforts of the Birbrower lawyers to resolve the dispute with Tandem included several brief trips to California. On these trips, Birbrower lawyers met with officers of both ESQ-NY and ESQ-CAL and with representatives of Tandem; they also interviewed arbitrators and participated in negotiating the settlement of the dispute with Tandem. (Maj. opn., *ante*, at p. 125.) On February 12, 1993, Birbrower initiated an arbitration proceeding against **[*142]** Tandem, on behalf of both ESQ-NY and ESQ-CAL, by filing a claim with the American Arbitration Association in San Francisco, California. Before an arbitration hearing was held, the dispute with Tandem was settled.

In January 1994, ESQ-CAL and Iqbal Sandhu, the principal shareholder, sued Birbrower for malpractice. Birbrower cross-complained to recover its fees under the fee agreement. Plaintiffs ESQ-CAL and Iqbal Sandhu thereafter amended their complaint to add ESQ-NY as a plaintiff. Plaintiffs moved for summary **[****47]** adjudication, asserting **[***318]** the fee agreement was unenforceable because the Birbrower lawyers had engaged in the unauthorized practice of law in California. The trial court agreed, and granted plaintiffs' motion. The Court of Appeal upheld the trial court's ruling, as does a majority of this court today.

II

Business and Professions Code section 6125 states: "No person shall practice law in California unless the person is an active member of the State Bar." The Legislature, however, has not defined what constitutes the practice of law.

Pursuant to its inherent authority to define and regulate the practice of law (see, e.g., *Merco Constr. Engineers, Inc. v. Municipal Court (1978) 21 Cal. 3d 724, 728 [147 Cal. Rptr. 631, 581 P.2d 636]*; *In re Lavine (1935) 2 Cal. 2d 324, 328*; *People v. Turner (1850) 1 Cal. 143, 150)*, this court in 1922 defined the practice of law as follows: " '[A]s the term is generally understood, the practice of the law is the doing and performing services in a court of justice in any matter depending therein throughout its various stages and in conformity with the adopted rules of procedure. But in a larger sense it includes legal

advice **[****48]** and counsel and the preparation of legal instruments and contracts by which the legal rights are secured although such matter may or may not be **[**15]** depending in a court.' " (*People v. Merchants Protective Corp. (1922) 189 Cal. 531, 535 [209 P. 363]* (*Merchants*).) The *Merchants* court adopted this definition verbatim from a decision by the Indiana Court of Appeals, *Eley v. Miller (1893) 7 Ind.App. 529 [34 N.E. 836, 837-838]*. (*Merchants, supra, at p. 535*.)

In 1970, in *Baron v. City of Los Angeles, supra, 2 Cal. 3d 535, 542* (*Baron*), this court reiterated the *Merchants* court's definition of the term "practice of law." We were quick to point out in *Baron*, however, that "ascertaining whether a particular activity falls within this general definition may be a formidable endeavor." (*Id. at p. 543*.) *Baron* emphasized "that it is not the whole spectrum of professional services of lawyers with which the State Bar **[*143]** Act is most concerned, but rather it is the smaller area of activities defined as the 'practice of law.' " (*Ibid*.) It then observed: "In close cases, the courts have determined that the resolution of legal questions **[****49]** for another by advice and action is practicing law 'if difficult or doubtful legal questions are involved which, to safeguard the public, reasonably demand the application of a *trained legal mind*.' [Citations.]" (*Ibid*., italics added.) *Baron* added that "if the application of legal knowledge and technique is *required*, the activity constitutes the practice of law . . . ." (*Ibid*., italics added.) This definition is quite similar to that proposed by Cornell Law School Professor Charles Wolfram, the chief reporter for the American Law Institute's Restatement of the Law Governing Lawyers: "The correct form of the test [for the practice of law] should inquire whether the matter handled was of such complexity that only a person trained as a lawyer should be permitted to deal with it." (Wolfram, Modern Legal Ethics (1986) p. 836.)

The majority asserts that the definition of practice of law I have stated above misreads this court's opinion in *Baron*. (Maj. opn., *ante*, at p. 129.) But what the majority characterizes as "the dissent's fanciful interpretation of the [*Baron* court's] thoughtful guidelines" (*ibid*.) consists of language I have quoted directly **[****50]** from *Baron*.

The majority also charges that the narrowing construction of the term "practice of law" that this court adopted in *Baron* "effectively limit[s] *section 6125*'s application to those cases in which nonlicensed out-of-state lawyers appeared in a California courtroom without permission." (Maj. opn., *ante*, at p. 129.) Fiddlesticks. Because the *Baron* definition encompasses all activities that " 'reasonably demand application of a trained legal mind' " (*Baron, supra, 2 Cal. 3d at p. 543*), the majority's assertion would be true only if there were no activities, apart from court appearances, requiring **[***319]** application of a trained legal mind. Many attorneys would no doubt be surprised to learn that, for example, drafting testamentary documents for large estates, preparing merger agreements for multinational corporations, or researching complex legal issues are not activities that require a trained legal mind.

According to the majority, use of the *Baron* definition I have quoted would undermine protection of the public from incompetent legal practitioners. (Maj. opn., *ante*, at p. 129.) The *Baron* definition provides ample protection from incompetent **[****51]** legal practitioners without infringing upon the public's interest in obtaining advice and representation from other professionals, such as accountants and real estate brokers, whose skills in specialized areas may overlap with those of lawyers. This allows the public the freedom to choose professionals who may be able to provide the public with **[*144]** needed services at a more affordable cost. (See Wolfram, Modern Legal Ethics, *supra*, at p. 831; Rhode, *Policing the Professional Monopoly: A Constitutional and Empirical Analysis of Unauthorized Practice Prohibitions* (1981) 34 Stan.L.Rev. 1, 97-98; Weckstein, *Limitations on the Right to Counsel: The Unauthorized Practice of Law*, 1978 Utah L.Rev. 649, 650.) As this court has recognized, there are proceedings in which nonattorneys "are competent" **[**16]** to represent others without undermining the protection of the public interest. (*Consumers Lobby Against Monopolies v. Public Utilities Com. (1979) 25 Cal. 3d 891, 913-914 [160 Cal. Rptr. 124, 603 P.2d 41]*.)

The majority, too, purports to apply the definition of the practice of law as articulated in *Baron, supra, 2 Cal. 3d 535*. The majority, however, focuses **[****52]** only on *Baron*'s quotation of the general definition of the practice of law set forth in *Merchants, supra, 189 Cal. 531, 535*. The majority ignores both the ambiguity in the *Merchants* definition and the manner in which *Baron* resolved that ambiguity. The majority apparently views the practice of law as encompassing *any* "legal advice and legal instrument and contract preparation, whether or not these subjects were rendered in the course of litigation." (Maj. opn., *ante*, at p. 128.)

The majority's overbroad definition would affect a host of common commercial activities. On point here are comments that Professor Deborah Rhode made in a 1981 article published in the Stanford Law Review: "For

many individuals, most obviously accountants, bankers, real estate brokers, and insurance agents, it would be impossible to give intelligent counsel without reference to legal concerns that such statutes reserve as the exclusive province of attorneys. As one [American Bar Association] official active in unauthorized practice areas recently acknowledged, there is growing recognition that ' "all kinds of other professional people are practicing law almost out of necessity." **[****53]** ' Moreover, since most legislation does not exempt gratuitous activity, much advice commonly imparted by friends, employers, political organizers, and newspaper commentators constitutes unauthorized practice. For example, although the organized bar has not yet evinced any inclination to drag [nationally syndicated advice columnist] Ann Landers through the courts, she is plainly fair game under extant statutes [proscribing the unauthorized practice of law]." (Rhode, *Policing the Professional Monopoly: A Constitutional and Empirical Analysis of Unauthorized Practice Prohibitions, supra*, 34 Stan.L.Rev. at p. 47, fns. omitted.)

Unlike the majority, I would for the reasons given above adhere to the more narrowly drawn definition of the practice of law that this court articulated in *Baron, supra, 2 Cal. 3d 535, 543*: the representation of another in a judicial proceeding or an activity requiring the application of that degree **[*145]** of legal knowledge and technique possessed only by a trained legal mind. Applying that definition here, I conclude that the trial court should not have granted summary adjudication for plaintiffs based on the Birbrower lawyers' California activities. **[****54]** That some or all of those activities related to arbitration does not necessarily establish that they constituted the practice of law, as I shall explain.

[*320]** III

As I mentioned earlier, Birbrower's clients had a software development and marketing agreement with Tandem. The agreement provided that its validity, interpretation, and enforcement were to be governed by California law. It also contained an arbitration provision. After a dispute arose pertaining to Tandem's performance under the agreement, Birbrower initiated an arbitration on behalf of its clients by filing a claim with the American Arbitration Association in San Francisco, and held meetings in California to prepare for an arbitration hearing. Because the dispute with Tandem was settled, the arbitration hearing was never held.

As I explained in part II, *ante*, this court in *Baron, supra, 2 Cal. 3d 535, 543*, defined the term "practice of law" in narrower terms than the court had done earlier in *Merchants, supra, 189 Cal. 531, 535*, which simply adopted verbatim the general definition set forth in an 1893 decision of the Indiana Court of Appeals. Under the narrower definition articulated in *Baron*, **[****55]** the practice of law is the representation of another in a judicial proceeding or an activity requiring the application of that degree of legal knowledge and technique possessed only by a trained legal mind.

[17]** Representing another in an arbitration proceeding does not invariably present difficult or doubtful legal questions that require a trained legal mind for their resolution. Under California law, arbitrators are "not ordinarily constrained to decide according to the rule of law . . . ." (*Moncharsh v. Heily & Blase (1992) 3 Cal. 4th 1, 11 [10 Cal. Rptr. 2d 183, 832 P.2d 899]*.) Thus, arbitrators, " 'unless specifically required to act in conformity with rules of law, may base their decision upon broad principles of justice and equity, and in doing so may expressly or impliedly reject a claim that a party might successfully have asserted in a judicial action.' [Citations.]" (*Id. at pp. 10-11*.) They " 'are not bound to award on principles of dry law, but may decide on principles of equity and good conscience, and make their award *ex aequo et bono* [according to what is just and good].' [Citation.]" (*Id. at p. 11*, original brackets.) For this reason, **[****56]** "the existence of an *error of law* apparent on the face of the [arbitration] award *that causes substantial injustice* does not provide grounds for judicial review." (*Id. at p. 33*, italics added; contra, *id. at pp. 33-40* (conc. and dis. opn. of Kennard, J.).)

[*146] Moreover, an arbitrator in California can award any remedy "arguably based" on "the contract's general subject matter, framework or intent." (*Advanced Micro Devices, Inc. v. Intel Corp. (1994) 9 Cal. 4th 362, 381 [36 Cal. Rptr. 2d 581, 885 P.2d 994]*.) This means that "an arbitrator in a commercial contract dispute may award an essentially unlimited range of remedies, whether or not a court could award them if it decided the same dispute, so long as it can be said that the relief draws its 'essence' from the contract and not some other source." (*Id. at p. 391* (dis. opn. of Kennard, J.).)

To summarize, under this court's decisions, arbitration proceedings are not governed or constrained by the rule of law; therefore, representation of another in an arbitration proceeding, including the activities necessary to prepare for the arbitration hearing, does not necessarily require a trained legal **[****57]** mind.

Commonly used arbitration rules further demonstrate that legal training is not essential to represent another in an

arbitration proceeding. Here, for example, Birbrower's clients agreed to resolve any dispute arising under their contract with Tandem using the American Arbitration Association's rules, which allow any party to be "represented by counsel *or other authorized representative*." (Am. Arbitration Assn., Com. Arbitration Rules (July 1, 1996) § 22, italics added.) Rules of other arbitration organizations also allow for representation by nonattorneys. For instance, the Rules of Procedure of the Inter-American Commercial Arbitration Commission, article IV provides: "The parties may be represented or assisted by persons of their choice." By federal law, this rule applies in all arbitrations between a United States citizen and a citizen of another **[***321]** signatory to the Inter-American Convention on International Commercial Arbitration, unless the arbitrating parties have expressly provided otherwise. (*9 U.S.C. § 303(b)*; Inter-Am. Convention on International Com. Arbitration, art. 3.)

The American Arbitration Association and other major arbitration associations **[****58]** thus recognize that nonattorneys are often better suited than attorneys to represent parties in arbitration. The history of arbitration also reflects this reality, for in its beginnings arbitration was a dispute-resolution mechanism principally used in a few specific trades (such as construction, textiles, ship chartering, and international sales of goods) to resolve disputes among businesses that turned on factual issues uniquely within the expertise of members of the trade. In fact, "rules of a few trade associations forbid representation by counsel in arbitration proceedings, because of their belief that it would complicate what might otherwise be simple proceedings." (Grenig, Alternative Dispute Resolution (1997) § 5.2, p. 81.) The majority gives no adequate justification for its decision to deprive parties of their **[*147]** freedom of contract and to make it a crime for anyone but California lawyers to represent others in arbitrations in California.

[18]** In addressing an issue similar to that presented here, a federal court held that a firm of New Jersey lawyers not licensed to practice law in New York was entitled to recover payment for legal services rendered in **[****59]** a New York arbitration proceeding. (*Williamson v. John D. Quinn Const. Corp. (S.D.N.Y. 1982) 537 F. Supp. 613* (*Williamson*).) In allowing recovery of fees, the court cited a report by the Association of the Bar of The City of New York: "The report states, 'it should be noted that no support has to date been found in judicial decision, statute or ethical code for the proposition that representation of a party in any kind of arbitration amounts to the practice of law.' The report concludes '[t]he Committee is of the opinion that representation of a party in an arbitration proceeding by a nonlawyer or a lawyer from another jurisdiction is not the unauthorized practice of law.' " (*Id. at p. 616*, quoting Com. Rep., Labor Arbitration and the Unauthorized Practice of Law (May/June 1975) 30 Record of the Association of the Bar of The City of New York, No. 5/6, at pp. 422, 428.)

The majority's attempt to distinguish *Williamson, supra, 537 F. Supp. 613*, from this case is unpersuasive. The majority points out that in *Williamson*, the lawyers of the New Jersey firm actually rendered services at the New York arbitration hearing, whereas here the New York lawyers never **[****60]** actually appeared at an arbitration hearing in California. (Maj. opn., *ante*, at pp. 133, 134, fn. 4.) The majority distinguishes *Williamson* on the ground that in this case no arbitration hearing occurred. Does the majority mean that an actual appearance at an arbitration hearing is not the practice of law, but that preparation for arbitration proceedings is?

In this case, plaintiffs have not identified any specific California activities by the New York lawyers of the Birbrower firm that meet the narrow definition of the term "practice of law" as articulated by this court in *Baron, supra, 2 Cal. 3d 535, 543*. Accordingly, I would reverse the judgment of the Court of Appeal and direct it to remand the matter to the trial court with directions to vacate its order granting plaintiff's motion for summary adjudication and to enter a new order denying that motion.

On February 25, 1998, the opinion was modified to read as printed above.

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ISBA Professional Conduct Advisory Opinion

Opinion 22 – 03

October 2022

Subject: Law Firms; Multijurisdictional Practice; Unauthorized Practice of Law.

Digest: It does not violate the Illinois Rules of Professional Conduct for an Illinois-licensed lawyer to practice Illinois law from a geographic location outside of Illinois where the Illinois lawyer is not licensed.

References: Illinois Rules of Professional Conduct, Rule 5.5
Illinois Rules of Professional Conduct, Rule 5.5, Comment [2]
ISBA Advisory Opinion on Professional Conduct No. 02-04 (2002)
American Bar Association Formal Opinion 498 (2021) & 495 (2020)
Delaware State Bar Association Formal Opinion 2021-1 (2021)
Florida Bar Advisory Opinion SC20-1220 (2021)
Florida Supreme Court, *In Re: Amendments to Rule Regulating the Florida Bar 3-5.5,* Case No. SC21-1379
Wisconsin Formal Ethics Opinion EF-21-02
Henry S. Drinker, Legal Ethics (Columbia University Press, 1953) pp. 66-7.

FACTS and QUESTIONS

Numerous fact situations were propounded regarding an Illinois lawyer on vacation or otherwise located outside of Illinois but continuing to provide representation to clients. The fact situations are best summarized by the following questions: May an Illinois licensed lawyer practice law representing clients in a location outside the geographic boundaries of the state of Illinois, including virtual appearance in Illinois courts from the out of Illinois' geographic boundaries?

OPINION

Fundamentally, the question a lawyer's geographic location to practice law of the jurisdiction in which the lawyer is licensed is neither contemplated nor directly addressed in the Illinois Rules of Professional Conduct. Rather, the focus of the Rules is on the jurisdiction in

which the lawyer is admitted to practice and the unauthorized practice of law as delineated in Illinois Rule 5.5.

Illinois Rules of Professional Conduct Rule 5.5 states:

(a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.

(b) A lawyer who is not admitted to practice in this jurisdiction shall not:

(1) except as authorized by these Rules or other law, establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or

(2) hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction.

(c) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:

(1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter;

(2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized;

(3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires pro hac vice admission; or

(4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

(d) A lawyer admitted in another United States jurisdiction or admitted or otherwise authorized to practice in a foreign jurisdiction, and not disbarred or suspended from practice in any jurisdiction or the equivalent thereof, may provide legal services through an office or other systematic and continuous presence in this jurisdiction that:

(1) are provided to the lawyer's employer or its organizational affiliates and are not services for which the forum requires pro hac vice admission; or

(2) are services that the lawyer is authorized by federal or other law or rule to provide in this jurisdiction.

(e) For purposes of paragraph (d), the foreign lawyer must be a member in good standing of a recognized legal profession in a foreign jurisdiction.[1]

Rule 5.5 makes no distinction between "jurisdiction" and "geographically". Analytically and practically, there is no evident consideration of a difference.

Rules and laws prohibiting the "unauthorized practice of law" are intended to protect the residents of a state from both lawyers not licensed to practice in the state and non-lawyers selling legal services. Comment [2] to Rule 5.5 states: [L]imiting the practice of law to members of the bar protects the public against rendition of legal services by unqualified persons." See, Attorneys Act, 705 ILCS 205/1.

1. Bifurcating Unauthorized Practice of Law and Rule 5.5 between Jurisdiction and Geography.

Historically, there was no distinction between where a lawyer was physically practicing law and the jurisdiction in which a lawyer was admitted to practice law. American Bar Association Canon 47 adopted in 1937 provided "[n]o lawyer shall permit his professional services, or his name, to be used in aid of, or to make possible, the unauthorized practice of law by any lay agency, person or corporate *(sic)*."[2] Indeed, the majority of the early opinions and court decisions related to businesses selling legal services or using a lawyer to sell legal services.

There are no direct historic examples discovered discussing the difference between where a lawyer is geographically located versus jurisdictionally admitted to practice. The closest indication is a citation to a New York City Bar opinion saying a lawyer "may supply office space to English solicitors to enable them to meet clients and give advice on English law."[3]

Further, ISBA Advisory Opinion on Professional Conduct No. 02-04 seemed to recognize the legitimacy of bifurcating geography and jurisdiction in analyzing a lawyer's practice. The facts of the inquiry stated:

> A lawyer licensed in Illinois and State X moves out of Illinois and begins practice in State X, while maintaining his Illinois law license and registration. An Illinois couple, known to the attorney, has an automobile accident in State Y, where the attorney is not licensed to practice; however the couple is treated medically in Illinois where the attorney maintains current license registration to practice law.

The Committee concluded there was no unauthorized practice of law:

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[1] https://ilcourtsaudio.blob.core.windows.net/antilles-resources/resources/f12d5e5c-0665-40fa-a145-6a2c28fd35d4/RULE%205.5.pdf

[2] Henry S. Drinker, Legal Ethics (Columbia University Press, 1953) p. 66.

[3] Id. p. 67 citing "N.Y. City B-61; see also N.Y. City 622."

> An attorney licensed in State X who negotiates, from his office in State X, his clients' claim for medical matters in State Y, where no lawsuit has been filed and where the attorney is not licensed, does not engage in the unauthorized practice of law, and need not associate with an attorney in State Y to conduct this negotiation.

However, as a practical matter, the fact that lawyers—even in pre-Internet days—would travel across state geographic lines and work on client files, make telephone calls to clients, and even attend out of state depositions is a reality that only the pandemic expansion of remote practice would require an ethics opinion.

2. Virtual or Remote Practice from Geographic Jurisdictions in which Lawyer is not Licensed.

The ABA and several other states have opined upon the question of lawyers practicing law of their jurisdictional states of admissions (home states) from geographic locations other than their home states.

> ABA Formal Opinion 495 (December 2020):
>
> Lawyers may remotely practice the law of the jurisdictions in which they are licensed while physically present in a jurisdiction in which they are not admitted if the local jurisdiction has not determined that the conduct is the unlicensed or unauthorized practice of law and if they do not hold themselves out as being licensed to practice in the local jurisdiction, do not advertise or otherwise hold out as having an office in the local jurisdiction, and do not provide or offer to provide legal services in the local jurisdiction. This practice may include the law of their licensing jurisdiction or other law as permitted by ABA Model Rule 5.5committee or (d), including, for instance, temporary practice involving other states' or federal laws. Having local contact information on websites, letterhead, business cards, advertising, or the like would improperly establish a local office or local presence under the ABA Model Rules.[4]

The ISBA Standing Committee on Professional Conduct concurs with this 4onclusionn as being an applicable interpretation of the Illinois Rules. We would add that this would not violate the Illinois Rules of Professional Conduct to make any "virtual" appearance in an Illinois proceeding or matter by telephonic, electronic, or visual/computer means from a geographic location outside of Illinois with appropriate notice and approval of the court and parties.

The Florida supreme Court approved an opinion from its Standing Committee on the Unlicensed Practice of Law in May 2021. The opinion concludes that a New Jersey licensed lawyer may properly conduct his federal intellectual property law practice for his New Jersey firm's clients from his Florida home where all activities are run through the New Jersey firms address, emails, telephone numbers, etc., and there is no holding out or identification with

[4] https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/aba-formal-opinion-495.pdf

Florida.[5] In February 2022, the Florida Court incorporated that opinion by amending Florida Rule 4-5.5 to say:

> "[A] lawyer licensed in another United States jurisdiction does not have a regular presence in Florida for the practice of law when the lawyer works remotely while physically located in Florida for an extended period of time if the lawyer works exclusively on non-Florida matters, and neither the lawyer nor any firm employing the lawyer hold out to the public as having a Florida presence."[6]

The Delaware State Bar Association concluded that lawyers licensed in Delaware:

> may ethically engage in the practice of Delaware law, for clients with Delaware matters, while physically present in another jurisdiction in which they are not admitted ("local jurisdiction") unless a statute, rule, case law, or opinion of the local jurisdiction prohibits the conduct, provided that such lawyers may not hold themselves out as being licensed to practice in the local jurisdiction and may not advertise or otherwise hold themselves out as having an office in the local jurisdiction, or provide or offer to provide legal services for matters subject to the local jurisdiction, unless otherwise authorized.[7]

However, other geographic jurisdictions may take a different view and consider the presence and practice of any law—Illinois, federal, tribal, etc.—in that state's geographic location without appropriate jurisdictional admission as a violation of law or disciplinary rules. It would behoove the Illinois lawyer to check the law and professional conduct rules of the geographic location in which the lawyer intends to practice Illinois law.

3. The Big Picture

Two opinions—one from Wisconsin and one from the ABA—address the broader question of geographic location and jurisdictional admission.

Wisconsin Formal Ethics Opinion EF-21-02 illuminates the issues involved in a lawyer practicing remotely in a geographic jurisdiction where the lawyer is not licensed:

> The basic responsibilities that a lawyer owes the client – competence, diligence, communication, and confidentiality - lie at the core of lawyer's professional obligations and remain unchanged irrespective of the lawyer's physical location. What has changed is discharging these responsibilities effectively in a world increasingly dominated by technology and, more recently, in an environment where lawyers are isolated from their

[5] https://www-media.floridabar.org/uploads/2021/06/Order-on-FAO-2019-4-O-O-S-Atty.-Working-Remotely-From-Florida-Home.pdf

[6] ***In Re: Amendments To Rule Regulating The Florida Bar 4-5.5***, Case No. SC21-1379.

[7] Delaware State Bar Association Committee on Professional Ethics, Formal Opinions 2021-1, July 9, 2021, https://media1.dsba.org/public/Committees/Ethics/DSBA%20PEC%20Opinion%202021-1.pdf

clients, their partners, their opponents and the courts in the face of the COVID-19 pandemic.[8]

ABA Formal Opinion 498 (March 2021) echoes this guidance:

> The ABA Model Rules of Professional Conduct permit virtual practice, which is technologically enabled law practice beyond the traditional brick-and-mortar law firm. When practicing virtually, lawyers must particularly consider ethical duties regarding competence, diligence, and communication, especially when using technology. In compliance with the duty of confidentiality, lawyers must make reasonable efforts to prevent inadvertent or unauthorized disclosures of information relating to the representation and take reasonable precautions when transmitting such information. Additionally, the duty of supervision requires that lawyers make reasonable efforts to ensure compliance by subordinate lawyers and non-lawyer assistants with the Rules of Professional Conduct, specifically regarding virtual practice policies.[9]

CONCLUSION

It is difficult to imagine that Illinois lawyers have not handled client matters, i.e., practiced Illinois law, while out of the geographic boundaries of Illinois for as long as Abraham Lincoln was riding the 8th Judicial Circuit. While life under the once and future Covid pandemic has accelerated, expanded, and amplified the prevalence of lawyers' extra-geographical practice, it has not created a new ethics quandary. And whether it is transactional work, client interaction, or appearing electronically in court, depositions, or client meetings appears to be irrelevant in our increasingly ethereal practice of law. There is no violation of the Illinois Rules of Professional Conduct for a lawyer to practice Illinois law from a geographic location outside the boundaries of state of Illinois.

However, other geographic jurisdictions may have different perspectives. Illinois-licensed lawyers should check the law and professional conduct rules of the geographic location in which the lawyer intends to practice Illinois law.

Professional Conduct Advisory Opinions are provided by the ISBA as an educational service to the public and the legal profession and are not intended as legal advice. The opinions are not binding on the courts or disciplinary agencies, but they are often considered by them in assessing lawyer conduct.

[8] https://www.wisbar.org/formembers/ethics/Ethics%20Opinions/EF-21-02%20Working%20Remotely.pdf
[9] https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/aba-formal-opinion-498.pdf

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AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 495 **December 16, 2020**

Lawyers Working Remotely

Lawyers may remotely practice the law of the jurisdictions in which they are licensed while physically present in a jurisdiction in which they are not admitted if the local jurisdiction has not determined that the conduct is the unlicensed or unauthorized practice of law and if they do not hold themselves out as being licensed to practice in the local jurisdiction, do not advertise or otherwise hold out as having an office in the local jurisdiction, and do not provide or offer to provide legal services in the local jurisdiction. This practice may include the law of their licensing jurisdiction or other law as permitted by ABA Model Rule 5.5(c) or (d), including, for instance, temporary practice involving other states' or federal laws. Having local contact information on websites, letterhead, business cards, advertising, or the like would improperly establish a local office or local presence under the ABA Model Rules.[1]

Introduction

Lawyers, like others, have more frequently been working remotely: practicing law mainly through electronic means. Technology has made it possible for a lawyer to practice virtually in a jurisdiction where the lawyer is licensed, providing legal services to residents of that jurisdiction, even though the lawyer may be physically located in a different jurisdiction where the lawyer is not licensed. A lawyer's residence may not be the same jurisdiction where a lawyer is licensed. Thus, some lawyers have either chosen or been forced to remotely carry on their practice of the law of the jurisdiction or jurisdictions in which they are licensed while being physically present in a jurisdiction in which they are not licensed to practice. Lawyers may ethically engage in practicing law as authorized by their licensing jurisdiction(s) while being physically present in a jurisdiction in which they are not admitted under specific circumstances enumerated in this opinion.

Analysis

ABA Model Rule 5.5(a) prohibits lawyers from engaging in the unauthorized practice of law: "[a] lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so" unless authorized by the rules or law to do so. It is not this Committee's purview to determine matters of law; thus, this Committee will not opine whether working remotely by practicing the law of one's licensing jurisdiction in a particular jurisdiction where one is not licensed constitutes the unauthorized practice of law under the law of that jurisdiction. If a particular jurisdiction has made the determination, by statute, rule, case law, or opinion, that a lawyer working remotely while physically located in that jurisdiction constitutes

[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2020. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling.

the unauthorized or unlicensed practice of law, then Model Rule 5.5(a) also would prohibit the lawyer from doing so.

Absent such a determination, this Committee's opinion is that a lawyer may practice law pursuant to the jurisdiction(s) in which the lawyer is licensed (the "licensing jurisdiction") even from a physical location where the lawyer is not licensed (the "local jurisdiction") under specific parameters. Authorization in the licensing jurisdiction can be by licensure of the highest court of a state or a federal court. For purposes of this opinion, practice of the licensing jurisdiction law may include the law of the licensing jurisdiction and other law as permitted by ABA Model Rule 5.5(c) or (d), including, for instance, temporary practice involving other states' or federal laws. In other words, the lawyer may practice from home (or other remote location) whatever law(s) the lawyer is authorized to practice by the lawyer's licensing jurisdiction, as they would from their office in the licensing jurisdiction. As recognized by Rule 5.5(d)(2), a federal agency may also authorize lawyers to appear before it in any U.S. jurisdiction. The rules are considered rules of reason and their purpose must be examined to determine their meaning. Comment [2] indicates the purpose of the rule: "limiting the practice of law to members of the bar protects the public against rendition of legal services by unqualified persons." A local jurisdiction has no real interest in prohibiting a lawyer from practicing the law of a jurisdiction in which that lawyer is licensed and therefore qualified to represent clients in that jurisdiction. A local jurisdiction, however, does have an interest in ensuring lawyers practicing in its jurisdiction are competent to do so.

Model Rule 5.5(b)(1) prohibits a lawyer from "establish[ing] an office or other systematic and continuous presence in [the] jurisdiction [in which the lawyer is not licensed] for the practice of law." Words in the rules, unless otherwise defined, are given their ordinary meaning. "Establish" means "to found, institute, build, or bring into being on a firm or stable basis."[2] A local office is not "established" within the meaning of the rule by the lawyer working in the local jurisdiction if the lawyer does not hold out to the public an address in the local jurisdiction as an office and a local jurisdiction address does not appear on letterhead, business cards, websites, or other indicia of a lawyer's presence.[3] Likewise it does not "establish" a systematic and continuous presence in the jurisdiction for the practice of law since the lawyer is neither practicing the law of the local jurisdiction nor holding out the availability to do so. The lawyer's physical presence in the local jurisdiction is incidental; it is not for the practice of law. Conversely, a lawyer who includes a local jurisdiction address on websites, letterhead, business cards, or advertising may be said to have established an office or a systematic and continuous presence in the local jurisdiction for the practice of law.

Subparagraph (b)(2) prohibits a lawyer from "hold[ing] out to the public or otherwise represent[ing] that the lawyer is admitted to practice law in [the] jurisdiction" in which the lawyer is not admitted to practice. A lawyer practicing remotely from a local jurisdiction may not state or imply that the lawyer is licensed to practice law in the local jurisdiction. Again, information provided on websites, letterhead, business cards, or advertising would be indicia of whether a lawyer is "holding out" as practicing law in the local jurisdiction. If the lawyer's website,

[2] DICTIONARY.COM, https://www.dictionary.com/browse/establish?s=t (last visited Dec. 14, 2020).

[3] To avoid confusion of clients and others who might presume the lawyer is regularly present at a physical address in the licensing jurisdiction, the lawyer might include a notation in each publication of the address such as "by appointment only" or "for mail delivery."

letterhead, business cards, advertising, and the like clearly indicate the lawyer's jurisdictional limitations, do not provide an address in the local jurisdiction, and do not offer to provide legal services in the local jurisdiction, the lawyer has not "held out" as prohibited by the rule.

A handful of state opinions that have addressed the issue agree. Maine Ethics Opinion 189 (2005) finds:

> Where the lawyer's practice is located in another state and where the lawyer is working on office matters from afar, we would conclude that the lawyer is not engaged in the unauthorized practice of law. We would reach the same conclusion with respect to a lawyer who lived in Maine and worked out of his or her home for the benefit of a law firm and clients located in some other jurisdiction. In neither case has the lawyer established a professional office in Maine, established some other systematic and continuous presence in Maine, held himself or herself out to the public as admitted in Maine, or even provided legal services in Maine where the lawyer is working for the benefit of a non-Maine client on a matter focused in a jurisdiction other than Maine.

Similarly, Utah Ethics Opinion 19-03 (2019) states: "what interest does the Utah State Bar have in regulating an out-of-state lawyer's practice for out-of-state clients simply because he has a private home in Utah? And the answer is the same—none."

In addition to the above, Model Rule 5.5(c)(4) provides that lawyers admitted to practice in another United States jurisdiction and not disbarred or suspended from practice in any jurisdiction may provide legal services on a temporary basis in the local jurisdiction that arise out of or reasonably relate to the lawyer's practice in a jurisdiction where the lawyer is admitted to practice. Comment [6] notes that there is no single definition for what is temporary and that it may include services that are provided on a recurring basis or for an extended period of time. For example, in a pandemic that results in safety measures—regardless of whether the safety measures are governmentally mandated—that include physical closure or limited use of law offices, lawyers may temporarily be working remotely. How long that temporary period lasts could vary significantly based on the need to address the pandemic. And Model Rule 5.5(d)(2) permits a lawyer admitted in another jurisdiction to provide legal services in the local jurisdiction that they are authorized to provide by federal or other law or rule to provide. A lawyer may be subject to discipline in the local jurisdiction, as well as the licensing jurisdiction, by providing services in the local jurisdiction under Model Rule 8.5(a).

Conclusion

The purpose of Model Rule 5.5 is to protect the public from unlicensed and unqualified practitioners of law. That purpose is not served by prohibiting a lawyer from practicing the law of a jurisdiction in which the lawyer is licensed, for clients with matters in that jurisdiction, if the lawyer is for all intents and purposes invisible *as a lawyer* to a local jurisdiction where the lawyer is physically located, but not licensed. The Committee's opinion is that, in the absence of a local jurisdiction's finding that the activity constitutes the unauthorized practice of law, a lawyer may practice the law authorized by the lawyer's licensing jurisdiction for clients of that jurisdiction,

while physically located in a jurisdiction where the lawyer is not licensed if the lawyer does not hold out the lawyer's presence or availability to perform legal services in the local jurisdiction or actually provide legal services for matters subject to the local jurisdiction, unless otherwise authorized.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

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Wisconsin Formal Ethics Opinion EF-21-02: Working remotely

January 29, 2021

Synopsis

The basic responsibilities that a lawyer owes the client – competence, diligence, communication, and confidentiality - lie at the core of lawyer's professional obligations and remain unchanged irrespective of the lawyer's physical location. What has changed is discharging these responsibilities effectively in a world increasingly dominated by technology and, more recently, in an environment where lawyers are isolated from their clients, their partners, their opponents and the courts in the face of the COVID-19 pandemic. The role of the partners, managers and supervising attorneys, whose responsibilities include insuring that both attorneys and non-attorneys in the firm, regardless of their location, comply with the requirements of SCR Chapter 20, is of increasing importance. Although certain current modifications in practice may diminish as the pandemic does, many are likely to continue as the profession and technology evolve. This opinion addresses several ways a lawyer's responsibilities are affected.

Introduction

Historically, the practice of law has been defined by in-person interactions: between lawyers and their clients, between opposing counsel, and through face-to-face discussions or contested hearings in court with all parties present to resolve clients' matters. Over time, technological advances have replaced many of these personal interactions, as well as other aspects of practice such as the transfer and storage of client information. In addition, it is expected that lawyers, like other professionals, will continue to work remotely in some form after the pandemic.

The Applicable Rules

Several rules are implicated when lawyers work remotely. These rules are SCR 20:1.1 Competence; SCR 20:1.3 Diligence; SCR 20:1.4 Communication; SCR 20:1.6 Confidentiality; SCR 20:5.1 Responsibilities of partners, managers and supervisory lawyers; SCR 20:5.3 Responsibilities regarding nonlawyer assistance, and SCR 20:5.5 Unauthorized practice of law; multijurisdictional practice of law.

Competence

SCR 20:1.1 requires a lawyer to provide competent representation to a client through reasonably necessary legal knowledge, skill, thoroughness and preparation.[1] When first promulgated as part of the

[1] "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

ABA Model Rules of Professional Conduct in 1983 the rule's focus was on the importance of a command of the substantive[2] and procedural[3] aspects related to resolution of the client's legal problems. See ABA Comments. ¶¶1-6.

In 2012 the ABA modified Comment [8] to Rule 1.1 to reflect the importance of competence in the use of technology:

> To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.[4]

Basic technological competence includes, at a minimum, knowledge of the types of devices available for communication, software options for communication, preparation, transmission and storage of documents and other information, and the means to keep the devices and the information they transmit and store secure and private.[5] Larger firms will often employ expert staff to address these concerns.

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[2] *See Attorney Grievance Comm'n of Maryland v. Narasimhan*, 92 A.3d 512 Conduct 370 (Md. 2014) (inexperienced lawyer failed to properly file and manage client's permanent residency petition); *State ex rel. Counsel for Discipline of Nebraska Supreme Court v. Seyler*, 809 N.W.2d 766 (Neb. 2012) (lawyer mishandled personal injury case with resultant harm to client).

[3] *See In re Kellogg*, 4 P.3d 594 (Kan. 2000) (failure to properly serve out-of-state party in divorce proceeding); *In re Harris*, 180 P.3d 558 (Kan. 2008) (failure to follow required procedures to electronically file documents in bankruptcy court).
Procedural competence has also changed as a result of the pandemic. Many courts are operating under emergency orders subject to frequent modification. Scheduling is in a state of flux and hearings are increasingly conducted by video. At the time of this writing, the Wisconsin Supreme Court has ordered that local judicial districts develop plans to reopen their respective courts. See *In re the Matter of the Extension of Orders and Interim Rule Concerning Continuation of Jury Trial, Suspension of Statutory Deadlines for Non-criminal Jury Trials, and Remote Hearings During the COVID-10 Pandemic*, Wis. S. Ct., May 22, 2020. https://www.wicourts.gov/ . It is likely different counties will adopt different procedures, all of which will be subject to ongoing modification. Counsel must take steps to be familiar with the procedures that control how the client's cases will be processed in the communities in which they practice.

[4] *See ABA Commission on Ethics 20/20 Report 105A* (2012). Wisconsin adopted this change in 2017. Sup. Ct. Order No. 15−03, 2016 WI 76. *See also Wisconsin Formal Ethics Op. EF-15-01 Ethical Obligations of Attorneys Using Cloud Computing*; *ABA Formal Ethics Op. 483* (2018) (ethical duties after a data breach or cyberattack); *District of Columbia Ethics Op. 371*; *Florida Ethics Op. 12-3* (2013); *New Hampshire Ethics Op. 2012-13/4* (2013); *New York County Ethics Op. 749* (2017). These opinions acknowledge that technical knowledge is an integral part of competence. More detailed discussion about the role of technology is included in other sections of this opinion.

[5] See Nicole Black, *7 types of tech tools to help lawyers set up virtual offices,* https://www.abajournal.com/web/article/law-in-the-time-of-coronavirus-what-tools-do-lawyers-need-to-set-up-virtual-offices; Christie, *What Should an Ethical Lawyer Know About Technology?* The Brief, Volume 46 Number 2 (2017).

Smaller firms or sole practitioners may need to retain the services of an expert if they lack the knowledge to personally manage the technological aspects of practice.

Diligence

SCR 20:1.3 requires a lawyer to act with reasonable diligence and promptness in representing a client.[6] Generally, this rule has been viewed as requiring a lawyer to pursue a client's objectives promptly and thoroughly until its conclusion.[7] How this duty is discharged during a pandemic and working remotely presents unique challenges. This duty, however, requires reasonable diligence, which implies that particular circumstances may affect the parameters of this duty.

Notwithstanding the disruption caused by the pandemic, circumstances may delay court hearings or complicate legal and factual investigation. The lawyer must seek to proceed with the representation as to the best of their abilities under the circumstances. Much of the difficulty can be avoided if the lawyer's firm has a system in place to access files, conduct research, and facilitate collaboration with others in the notwithstanding the lawyer's physical isolation from others.

If delay in resolution of the client's case is unavoidable, the lawyer is required by SCR 20:1.4 to explain the circumstances to the client and the likely time frame for resolution.

Moreover, given that the present circumstances constitute a national health emergency of unknown duration, it may be appropriate for the lawyer to consider what steps may be necessary if the lawyer or the client becomes incapacitated.[8] Development of a succession plan is part of the lawyer's duty to provide competent and diligent representation.[9] In the firm context, management should consider which other members of the firm would be responsible for the unavailable lawyer's cases. If the lawyer is a sole practitioner, the lawyer should reach out to other lawyers to develop a plan to protect the clients in the event of the lawyer's impairment.[10]

Communication

SCR 20:1.4 addresses the lawyer's duty to communicate with the client.[11] The current pandemic or any other disaster or emergency makes regular contact with clients more important than ever. The client needs to know how to contact the lawyer just as the lawyer must know how to contact the clients.

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[6] "A lawyer shall act with reasonable diligence and promptness in representing a client."

[7] The duty of diligence will vary depending on what services the lawyer will provide. For example, it will differ if the lawyer is only preparing a document as compared to conducting a trial, pursuing an appeal, or providing services of an ongoing nature. SCR 20:1.2(c).

[8] *See ABA Formal Opinion 482* (2018) (Ethical Obligations Related to Disasters).

[9] See SCR 20:1.3, ABA Comment [5].

[10] See Kaiser, Shattuck, *Lawyer Death or Disability: Who Will Protect Your Clients? 91 Wisconsin Lawyer 3* (March 2018).]

[11] SCR 20:1.4 states:

For example, if telephone calls and e-mails are routed through the firm's communication system, the lawyers must regularly access office voicemail, e-mail and any other methods of client communication regularly used in the office to ensure no communications are missed. If firm lawyers work remotely, they must have a system in place to regularly handle mail – both timely sending and obtaining that which is delivered to the firm office.

The lack of personal contact with the client can create additional communication challenges. Video hearings often will not allow for confidential discussions between the lawyer and client, making advance preparation important. Execution and notarization of documents also present special challenges, which must be communicated to the client.

Issues of concern to clients will vary. Certain topics may be of special importance during a pandemic such as the impact of emergency court operations on the client's case or what steps are appropriate should the client become incapacitated. The latter question may involve discussions about powers of attorney or about identification of whom the lawyer should contact if the client is not able to maintain communication with the lawyer.

Confidentiality

SCR 20:1.6[12] describes the lawyer's duty of confidentiality to the client. Perhaps no professional obligation has been impacted more by technology than the duty of confidentiality. The use of technology has

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(a) A lawyer shall:
(1) Promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in SCR 20:1.0 (f), is required by these rules;
(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;
(3) keep the client reasonably informed about the status of the matter;
(4) promptly comply with reasonable requests by the client for information; and
(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.
(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

[12] SCR 20:1.6 states:
(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in pars. (b) and (c).
(b) A lawyer shall reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary to prevent the client from committing a criminal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or in substantial injury to the financial interest or property of another.
(c) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
(1) to prevent reasonably likely death or substantial bodily harm;
(2) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

increased convenience but has at the same time increased the risk of unauthorized access to an inadvertent disclosure of confidential client information.[13]

The 2012 Model Rule changes included modification of Rule 1.6. The ABA added subsection (d)[14] which states:

> A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

ABA Comment paragraphs [18] and [19] were also modified to address the impact of technology on the duty of confidentiality:

> [18] Paragraph (c) requires a lawyer to act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See Rules 1.1, 5.1, and 5.3. The unauthorized access to, or the inadvertent or unauthorized disclosure of, information relating to the representation of a client does not constitute a violation of paragraph (c) if the lawyer has made reasonable efforts to prevent the access or disclosure. Factors to be considered in determining the reasonableness of the lawyer's efforts include, but are not limited to, the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use). A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to forgo security measures that would otherwise be required by this Rule. Whether a lawyer may be required to take additional steps to safeguard a client's information in order to comply with other law, such as state and federal laws that govern data privacy or that impose notification requirements upon the loss of, or unauthorized access to,

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> (3) to secure legal advice about the lawyer's conduct under these rules;
> (4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
> (5) to comply with other law or a court order; or
> (6) to detect and resolve conflicts of interest, but only if the revealed information would not compromise the attorney−client privilege or otherwise prejudice the client.
> (d) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

[13] *See generally 55 Law. Man. Prof. Conduct* 401-421 (2020).

[14] SCR 20:1.6 differs from the ABA version of the rule in a number of respects, one of which is that the new ABA subsection (c) is renumbered in Wisconsin as subsection (d).

electronic information, is beyond the scope of these Rules. For a lawyer's duties when sharing information with nonlawyers outside the lawyer's own firm, see Rule 5.3, Comments [3]-[4].

[19] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule. Whether a lawyer may be required to take additional steps in order to comply with other law, such as state and federal laws that govern data privacy, is beyond the scope of these Rules.

Wisconsin adopted both of these changes in 2017.[15] The ABA Standing Committee on Ethics and Professional Responsibility, in Formal Opinion 477R (2017), explained that the change does not require specific security steps in all cases nor does it suggest that any breach automatically constitutes a rule violation. Instead, lawyers are required to make "reasonable efforts" to secure client information. What constitutes "reasonable efforts" is fact dependent based on consideration of a range of factors.

What information is protected and the exceptions that require or permit disclosure remain unchanged.[16] What has changed, however, is the variety of circumstances under which the lawyer's responsibility to protect the information from unwarranted disclosure. Compliance with these duties can be complicated, particularly when the lawyer is working remotely, physically separated from co-workers, staff, and the information to be protected.

Responsibilities of partners, managers and supervisory lawyers

SCR 20:5.1 addresses the duties that law firm partners, managers and supervisory lawyers have to provide reasonable assurance that all lawyers in the firm conform to the Rules.[17] Similarly, SCR 20:5.3 addresses

[15] Sup. Ct. Order No. 15−03, 2016 WI 76.

[16] The duty of confidentiality covers all information that relates to the representation of client, whatever it's source. See SCR 20:1.6, ABA Comment [3].

[17] SCR 20:5.1 states:

(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct

the duties that partners, managers and supervisory lawyers have to provide reasonable assurance that the conduct of each nonlawyer, including consultants and vendors, is compatible with the Rules.[18] While the law firm's policies, procedures and supervision must provide reasonable assurance that all lawyers and nonlawyers comply with all of the Rules, the duties of competence, diligence, communication and confidentiality are especially critical when lawyers are working remotely.

Oversight of fellow professionals is challenging under any circumstance. It can be particularly challenging when those supervised are working in different, remote locations, separate from their supervisor and each other. Developing a structure to adhere to a schedule, facilitate collaboration, communication, and conduct regular meetings by videoconference can help achieve the level of supervision envisioned by the rules. Regular mandatory training, review of the circumstances of a remotely-working lawyer, the assignment of experienced mentors to new lawyers, and the creation of teams are also strategies that can facilitate efficiency in the context of remote work.

Unauthorized Practice of Law

Much attention has been given in the last two decades to regulation of unauthorized practice, primarily in the context of multi-jurisdictional work. In 1998 the California Supreme Court held that a New York firm with no physical presence in California violated that state's prohibition against unauthorized practice in its representation of a California client.[19] This decision sparked a national debate eventually leading to modifications of Model Rule 5.5, which became the basis for and is substantially equivalent to Wisconsin's SCR 20:5.5. Subsequently, advances in technology have made it possible for lawyers to easily work remotely and in virtual law practices.[20]

> at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

[18] Similarly, SCR 20:5.3 states:

> With respect to a nonlawyer employed or retained by or associated with a lawyer:
> (a) a partner and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the person's conduct is compatible with the professional obligations of the lawyer.
> (b) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer; and,
> (c) a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:
>
> > (1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or
> > (2) the lawyer is a partner or has comparable managerial authority in the law firm in which the person is employed, or has direct supervisory authority over the person, and in either case knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

[19] See *Birbrower, Montalbano, Condon & Frank, P.C. v. Superior Court*, 949 P.2d 1 (Cal. 1998)

[20] In the late 1990s, the term "virtual office" became a common part of the industry lexicon. "In 2002, FisherBroyles LLP became the first full-service, Pure Virtual Law Firm relying exclusively on cloud-based applications formed in the United States. By 2011, according to Law Firm Suites, there were an estimated 200 to 300 Pure Virtual Law Firms in the U.S., in addition to the hundreds of attorneys practicing virtually and maintaining a virtual law office address.

Lawyers practicing in virtual practices and lawyers working remotely during the pandemic have raised questions about the unauthorized practice of law. Although unauthorized and multi-jurisdictional practice involve a plethora of issues,[21] the focus of this opinion is whether a lawyer, while in a location where the lawyer is not licensed, may conduct a virtual practice in a jurisdiction where the lawyer is licensed.

Both Model Rule 5.5(b)(1) and SCR 20:5.5(b)(1) provide that a lawyer who is not admitted to practice in this jurisdiction shall not "establish an office or maintain a systematic and continuous presence in this jurisdiction for the practice of law." In December 2020, the ABA's Standing Committee issued ABA Formal Opinion 495 to provide guidance.

> Words in the rules, unless otherwise defined, are given their ordinary meaning. "Establish" means "to found, institute, build, or bring into being on a firm or stable basis." A local office is not "established" within the meaning of the rule by the lawyer working in the local jurisdiction if the lawyer does not hold out to the public an address in the local jurisdiction as an office and a local jurisdiction address does not appear on letterhead, business cards, websites, or other indicia of a lawyer's presence. Likewise it does not "establish" a systematic and continuous presence in the jurisdiction for the practice of law since the lawyer is neither practicing the law of the local jurisdiction nor holding out the availability to do so. The lawyer's physical presence in the local jurisdiction is incidental; it is not for the practice of law. Conversely, a lawyer who includes a local jurisdiction address on websites, letterhead, business cards, or advertising may be said to have established an office or a systematic and continuous presence in the local jurisdiction for the practice of law. (Footnotes omitted.)

Similarly, both Model Rule 5.5(b)(2) and SCR 20:5.5(b)(2) prohibit a lawyer who is not admitted to practice in this jurisdiction from "hold[ing] out to the public or otherwise represent[ing] that the lawyer is admitted to the practice of law in this jurisdiction." ABA Formal Opinion 495 provides further guidance.

> A lawyer practicing remotely from a local jurisdiction may not state or imply that the lawyer is licensed to practice law in the local jurisdiction. Again, information provided on websites, letterhead, business cards, or advertising would be indicia of whether a lawyer is "holding out" as practicing law in the local jurisdiction. If the lawyer's website, letterhead, business cards, advertising, and the like clearly indicate the lawyer's jurisdictional limitations, do not provide an address in the local jurisdiction, and do not offer to provide legal services in the local jurisdiction, the lawyer has not "held out" as prohibited by the rule.

The concept and viability of *eLawyering* or a virtual law practice has been around now for about 10 years, more or less. For developers, of course, it has existed much longer than for users. But I think 2003 is a good year to target the time when lawyers began noticing movement to the cloud and the rise of cloud products, aided by the development of the iPad and tablets, smartphones getting smarter, and a general progression toward a device-driven world, wirelessly connected." https://ssensikombi.wordpress.com/2019/10/20/virtual-law-firms-law-firms-of-the-future%E2%80%8A-%E2%80%8Ahow-virtual-law-firms-are-doing-business-part-one/

[21] *See Annotated Model Rules of Professional Conduct* (Eighth Ed. 2015) 518-534; Wolfram, *Modern Legal Ethics* (1986) 824-856.

Based on the language of Model Rule 5.5, ABA Opinion 495 concluded:

> The purpose of Model Rule 5.5 is to protect the public from unlicensed and unqualified practitioners of law. That purpose is not served by prohibiting a lawyer from practicing the law of a jurisdiction in which the lawyer is licensed, for clients with matters in that jurisdiction, if the lawyer is for all intents and purposes invisible as a lawyer to a local jurisdiction where the lawyer is physically located, but not licensed. The Committee's opinion is that, in the absence of a local jurisdiction's finding that the activity constitutes the unauthorized practice of law, a lawyer may practice the law authorized by the lawyer's licensing jurisdiction for clients of that jurisdiction, while physically located in a jurisdiction where the lawyer is not licensed if the lawyer does not hold out the lawyer's presence or availability to perform legal services in the local jurisdiction or actually provide legal services for matters subject to the local jurisdiction, unless otherwise authorized.

Two previous state ethics opinions reached the same conclusion. In Utah Ethics Opinion 19-03 (2019), the Ethics Advisory Committee questioned, "what interest does the Utah State Bar have in regulating an out-of-state lawyer's practice for out-of-state clients simply because he has a private home in Utah?" The Committee reached an emphatic conclusion, "none."

> The Utah Rules of Professional Conduct do not prohibit an out-of-state attorney from representing clients from the state where the attorney is licensed even if the out-of-state attorney does so from his private location in Utah. However, in order to avoid engaging in the unauthorized practice of law, the out-of-state attorney who lives in Utah must not establish a public office in Utah or solicit Utah business.

The Maine Professional Ethics Commission reached the same conclusion in Maine Ethics Opinion 189 (2005).[22]

Like the Utah Ethics Advisory Committee, we found no case where an attorney has been disciplined for practicing law out of a private residence for out-of-state clients located in the state where the attorney is licensed.

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[22] The Maine Ethics Opinion concluded:

> [T]he mere fact that an attorney, not admitted in Maine, is working in Maine does not automatically mean that the attorney is engaged in the unauthorized practice of law. For example, an out-of-state lawyer who has a vacation home in Maine might bring work to Maine to complete while on vacation. Where the lawyer's practice is located in another state and where the lawyer is working on office matters from afar, we would conclude that the lawyer is not engaged in the unauthorized practice of law. We would reach the same conclusion with respect to a lawyer who lived in Maine and worked out of his or her home for the benefit of a law firm and clients located in some other jurisdiction. In neither case has the lawyer established a professional office in Maine, established some other systematic and continuous presence in Maine, held himself or herself out to the public as admitted in Maine, or even provided legal services in Maine while the lawyer is working for the benefit of a non-Maine client on a matter focused in a jurisdiction other than Maine.

Based on the language of SCR 20:5.5, its purpose, and the other ethics opinions, we conclude that the Rule does not prohibit an out-of-state lawyer from representing clients from the state where the attorney is licensed even if the out-of-state lawyer does so from the lawyer's private location in Wisconsin. However, in order to avoid engaging in the unauthorized practice of law, the out-of-state lawyer must not establish a public office in Wisconsin or solicit Wisconsin business unless otherwise authorized by law.

Each state, however, establishes its own laws and rules regulating the practice of law within its borders: there is no nationally uniform rule. Therefore, the question of whether a properly licensed Wisconsin lawyer, representing Wisconsin clients with respect to Wisconsin matters is engaged in unauthorized practice in another jurisdiction is dependent on the rules of the jurisdiction in which the lawyer is physically present. Thus, lawyers need to be mindful of the rules that apply in the jurisdiction in which they are located.

General Guidance

It is impossible to provide specific requirements for working remotely because lawyers' ethical duties are continually evolving as technology changes. It is possible, however, to provide some guidance.

Cybersecurity Practices

Because working remotely relies on technology, competence in technology and cybersecurity practices are essential. The following cybersecurity practices have been recommended by a number of ethics opinions[23] and other resources. None of these practices are new: they are reasonable precautions that have helped lawyers fulfill their ethical obligations, especially the duty of confidentiality, when working in the office and when working remotely, whether at home during evenings and weekends, or during travel for work or vacation.

- **Require strong passwords to protect data and to access devices.** The more complex the password, the less likely that an unauthorized user will be able to access data or devices by using password cracking techniques or software.

- **Use two-factor or multi-factor authentication to access firm information and firm networks.** Although requiring an additional authentication step, such as a six-digit code sent to the lawyer's phone or email, may seem inconvenient or burdensome, it is a reasonable precaution that increases protection and reduces the likelihood of unauthorized access by providing an additional layer of security beyond a strong password.

- **Avoid using unsecured or public WiFi when accessing or transmitting client information.** Hackers can access unencrypted information on unsecured WiFi and can use unsecured WiFi to distribute malware.

[23] See, e.g., Wisconsin Formal Ethics Opinion EF-15-01: Ethical Obligations of Attorneys Using Cloud Computing (Amended September 8, 2017).

- **Use a virtual private network (VPN) when accessing or transmitting client information.** A VPN encrypts information and allows users to create a secure connection to another network.

- **Use firewalls and secure router settings.** A firewall monitors and controls incoming and outgoing network traffic based on predetermined security rules: it establishes a barrier between a trusted network and an untrusted network. A router connects multiple devices to the Internet, and connects the devices to each other.

- **Use and keep current anti-virus and anti-malware software.** Anti-virus and anti-malware both refer to software designed to detect, protect against, and remove malicious software.

- **Keep all software current: install updates immediately.** Updates help patch security flaws or software vulnerabilities, which are security holes or weaknesses found in a software program or operating system.

- **Supply or require employees to use secure and encrypted laptops.** All lawyers and staff should use only firm issued devices with security protections and backup systems and prohibit storage of firm or client information on unauthorized devices. All devices used by the lawyer, such as desktop computers, laptops, tablets, portable drives, phones, and scanning and copy machines, should be protected.

- **Do not use USB drives or other external devices unless they are owned by the firm or they are provided by a trusted source.**

- **Specify how and where data created remotely will be stored and how it will be backed up.**

- **Save data permanently only on the office network, not personal devices.** If saved on personal devices, taking reasonable precautions to protect such information.

- **Use reputable vendors for cloud services.** Transmission and storage of firm and client information through a cloud service is appropriate provided the lawyer has made sufficient inquiry that the service is competent and reputable.[24]

- **Encrypt emails or use other security to protect sensitive information from unauthorized disclosure.** A lawyer should balance the interests in determining when encryption is appropriate.

- **Encrypt electronic records, including backups containing sensitive information such a personally identifiable information.**

- **Do not open suspicious attachments or click unusual links in messages, email, tweets, posts, online ads.**

- **Use websites have enhanced security whenever possible.** Such websites begin with "HTTPS" in their address rather than "HTTP," and encrypt the communication.

[24] Wisconsin Formal Ethics Opinion EF-15-01.

- **Provide adequate security for video meetings or conferences.** The FBI has recommended the following steps: use the up-to-date version of the application; do not make the meetings public; require a meeting password; do not share the link to the video meeting on an unrestricted publicly available social media post; provide the meeting link directly to the invited guests; and manage the screen-sharing options.[25] In selecting a videoconferencing platform, the lawyer should make sure it is sufficiently secure both in its structure and its contractual terms of use, especially any terms on access to user information.[26]

- **Do not have work-related conversations in the presence of smart devices such as voice assistants.** These devices may listen to and record conversations.[27]

Training and Supervision

To comply with the duties required by SCR 20:5.1 and 5.3, partners, managers and supervisory lawyers should consider whether the firm's policies and procedures are adequate to address the specific challenges that may arise when lawyers and nonlawyer assistants are working remotely.

- **Establish and implement policies and procedures for cybersecurity practices.** These policies and procedures should be in writing and provided to all lawyers and nonlawyer assistants, and stress compliance.

- **Establish and implement policies and procedures for the training and supervision of lawyers and nonlawyer assistants in the firm's cybersecurity practices.** Training is the most basic step in avoiding a cyberattack at a law firm. In other words, it is extremely important to develop a culture of awareness. The most serious vulnerabilities of a cybersecurity system are not the hardware or

[25] https://www.fbi.gov/contact-us/field-offices/boston/news/press-releases/fbi-warns-ofteleconferencing-and-online-classroom-hijacking-during-covid-19-pandemic.

[26] Lawyers must understand that if video conferences are recorded the vendor may retain a copy under the terms of service. *See INSIGHT: Zooming and Attorney Client Privilege*, https://www.bloomberglaw.com/exp/eyJjdHh0IjoiQ1ZOVyIsImlkIjoiMDAwMDAxNzEtZWExYy1kMDAwLWE5N2YtZWE3ZTkwYWMwMDAxIiwic2lnIjoidVliaWhQR3J3ZmpWcDBKeE5KY1JYV1c0RlcwPSIsInRpbWUiOiIxNTkwMjQwMzM1IiwidXVpZCI6IndNWHUzdVFGajBEWGxkZFBKcTNSVVE9PU1ZZmVtSkhLU0hBMWtPNG8rTE50eGc9PSIsInYiOiIxIn0=?usertype=External&bwid=00000171-ea1c-d000-a97f-ea7e90ac0001&qid=6912181&cti=LSCH&uc=1320042032&et=SINGLE_ARTICLE&emc=bcvnw_cn%3A7&bna_news_filter=true .

[27] For example, Google and Amazon maintain those recordings on servers and hire people to review the recordings. Although the identities of the speakers are not disclosed to these reviewers, they might hear sufficient details to be able to connect a voice to a specific person. https://www.vox.com/recode/2020/2/21/21032140/alexa-amazon-google-home-siri-applemicrosoft-cortana-recording .

software, but rather the people who use it**.** It is estimated that 90% of cybersecurity breaches are due to human error.[28]

- **Establish and implement policies and procedures regarding remote work spaces to mitigate the risk of inadvertent or unauthorized disclosures of information relating to the representation of clients.** Remote workspaces should be private to ensure that others do not have access to phone conversations, video conferences, or case-related materials.

- **Hold sufficiently frequent remote meetings between supervising attorneys and supervised attorneys, and between supervising attorneys and supervised nonlawyer assistants to achieve effective supervision.**

Preparing Clients

Representing a client remotely may present challenges to competent representation.[29] Consequently, a lawyer should carefully consider whether the lawyer can adequately prepare the client to testify or for interviews while working remotely.

- **The lawyer and the client should have sufficient ability with the technology.**

- **The lawyer and the client should have access to relevant documents.**

- **The lawyer and the client have adequate time and attention to ensure the client's comfort with the communicating by the medium that will be used.**

Conclusion

The COVID-19 pandemic has dramatically changed how lawyers work and represent their clients. Some of these changes may be temporary but others are likely part of a movement towards increased reliance on technology in the practice of law. As working remotely has become the new normal, lawyers must develop new skills and knowledge to comply with their core responsibilities.

[28] https://www.techradar.com/news/90-percent-of-data-breaches-are-caused-by-human-error#:~:text=A%20new%20report%20from%20Kaspersky,carried%20out%20by%20cloud%20providers .

[29] The New York County Lawyers Association Formal Opinion 754-2020 at 3.

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 507 **July 12, 2023**

Office Sharing Arrangements with Other Lawyers

It is generally permissible for lawyers to participate in office sharing arrangements with other lawyers under the ABA Model Rules of Professional Conduct. At the same time, office sharing lawyers should appreciate that such arrangements will require them to take appropriate measures to comply with their ethical duties concerning the confidentiality of information, conflicts of interest, supervision of non-lawyers, and communications about their services. The nature and extent of any additional safeguards will necessarily depend on the circumstances of each arrangement.

I. Introduction[1]

Office sharing among lawyers comes in many forms—lawyers with separate law practices sharing office space, support staff, and equipment; law firms renting unused office space to unaffiliated lawyers; or even lawyers sharing an office suite, receptionist, and conference room as part of a virtual law practice or on a temporary basis. Lawyers participating in these arrangements must take appropriate steps to secure client information and clearly communicate the nature of the relationship to the public and their clients.[2] In addition, there are potential conflicts of interest issues that office sharing lawyers must appreciate, including imputed conflicts for lawyers "associated in a firm," representing clients with adverse interests, and consultations between lawyers. This opinion addresses some minimum ethical requirements and suggested practices arising in the office sharing context, particularly in the areas of confidentiality, conflicts of interest, supervision, and communications concerning a lawyer's services.

[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through February 2023. The laws, court rules and opinions, regulations, and rules of professional conduct, promulgated in individual jurisdictions are controlling.

[2] Compliance with the obligations imposed by the Model Rules of Professional Conduct, as discussed in this opinion, depends on a lawyer's role, level of authority, and responsibility in the law firm's operations. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483, at n. 6 (2018). *See generally* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 467 (2014). *See* MODEL RULES OF PROF'L CONDUCT R. 5.1 (2022) (Responsibilities of Partners, Managers, and Supervisory Lawyers); MODEL RULES OF PROF'L CONDUCT R. 5.2 (Responsibilities of a Subordinate Lawyer); and MODEL RULES OF PROF'L CONDUCT R. 5.3 (Responsibilities Regarding Nonlawyer Assistance).

II. Discussion

A. Protecting Client Information

Confidentiality is central to the practice of law.[3] Maintaining the confidentiality of client information is therefore imperative for lawyers in an office sharing arrangement.[4] The mere sharing of office space does not automatically equate with the disclosure of client information.[5] The physical arrangement of the shared office space, however, must not expose client information to other office-sharing lawyers and their staff. Everyone should also avoid discussing cases in or near common areas, which could lead to the disclosure of client information.[6]

Depending on the specific circumstances of the office sharing arrangement, lawyers may need to consider additional confidentiality safeguards. This could include separate lobby or waiting areas; refraining from leaving client files out on workspaces, conference rooms, or kitchen tables; installing privacy screens on computer monitors and locking down computers when not actively in use; clean desk policies; and regular training and reminders to staff of the need to keep all client information confidential.[7] Office sharing lawyers can also restrict access to client-related information by securing physical client files in locked cabinets or offices and using separate telephone lines and computer systems.[8] Lawyers, however, may overcome confidentiality concerns with shared telephone and computer systems with appropriate security measures, staff training, and client disclosures.[9]

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[3] *See* MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (providing that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b)").

[4] State Bar of Cal. Comm. on Prof'l Responsibility & Conduct Op. 1997-150, 1997 WL 240818, at *3–4 (1997); Conn. Bar Ass'n Prof'l Ethics Comm. 2014-04, 2014 WL 12823983, at *1 (2014); D.C. Bar Ass'n Op. 303, at 1 (2001) [hereinafter D.C. Bar Op.]; La. State Bar Ass'n Rules of Prof'l Conduct Comm. Op. 07-RPCC-013, at 1 (2007); Mich. State Bar Comm. on Prof'l & Judicial Ethics Op. RI-249, 1996 WL 381521, at *2 (1996) [hereinafter Mich. State Bar Op. RI-249]; Mo. Bar Informal Op. 950169, at 1 (1995); N.J. Sup. Ct. Advisory Comm. on Prof'l Ethics Op. 498, 1982 WL 117856, at *1 (1982); Ohio Bd. of Prof'l Conduct Advisory Op. 2022-11, 2022 WL 10219976 (2022); Ohio Bd. of Prof'l Conduct Advisory Op. 2017-05, 2022 WL 10219976, at *1 (2017).

[5] Ill. St. Bar Ass'n Comm. on Prof'l Ethics Advisory Op. 85-14, 1986 WL 378934, at *4 (1986).

[6] State Bar of Cal. Comm. on Prof'l Responsibility & Conduct Op. 1997-150, 1997 WL 240818, at *3–4 (1997); Colo. Bar Ass'n Ethics Comm. Op. 89, at 5 (2018); Mich. State Bar, Comm. on Prof'l & Judicial Ethics Op. RI-313, 1999 WL 406884, at *1 (1999); N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op. 794, 2006 WL 1386607, at *4 (2006).

[7] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 498, at 3–7 (2021) [hereinafter ABA Formal Op. 498] (discussing technologies and related strategies to protect the confidentiality of client information in a virtual practice).

[8] Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 4–7; Ind. State Bar Ass'n Legal Ethics Comm. Op. 8, at 2–3 (1985); D.C. Bar Op. 303, *supra* note 4, at 1; Mo. Bar Informal Op. 980220, at 1 (1998); N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op., 2012 WL 6087183, at *1–2 (2012); Ohio Bd. of Prof'l Conduct Advisory Op. 91-9, 1991 WL 717479, at *2 (1991); Va. State Bar Legal Ethics Comm. Op. 754, 1986 WL 1180470, at *1 (1986).

[9] Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 1, 5; D.C. Bar Op. 303, *supra* note 8, at 1; Mo. Bar Informal Op. 970192 (1997); Ohio Bd. of Prof'l Conduct Advisory Op. 92-13, 1992 WL 739420, at *3 (1992); Or. St. Bar Ass'n Op. 2005-50, 2005 WL 5679639, at *1 (2005). *See also* ABA Formal Op. 498, *supra* note 7, at 3–5 (discussing virtual practice technologies and other security measures to safeguard client information); Ohio Bd. of Prof'l Conduct Adv. Op. 2022-11, 2022 WL 10219976, at *2 (2022) (recommending that computers connected to a shared network "be secured by individual credentials and other security measures to prevent lawyers or staff from accessing the data and files on a network belonging to others").

Lawyers in an office sharing arrangement may decide to share support staff, such as receptionists, administrative assistants, and paralegals. In these situations, maintaining the confidentiality of client information is tested. Instructing all lawyers and employees, and particularly shared employees, on their confidentiality obligations and the office procedures in place to guard sensitive client documents and communications are examples of reasonable measures to protect client confidentiality.[10] Of course, appropriate supervision of shared personnel is also required under Model Rule 5.3.[11]

B. Clear Communication About the Relationship

Lawyers who share offices but do not practice together as a law firm must take appropriate steps to clearly communicate the nature of their relationship to the public and to their clients.

Model Rule 7.1 prohibits any "false or misleading communication about the lawyer or the lawyer's services."[12] Comment [7] to the Rule further explains that lawyers "may not imply or hold themselves out as practicing together in one firm when they are not a firm, as defined in Rule 1.0(c), because to do so would be false and misleading."[13] Accordingly, office-sharing lawyers must ensure that the public is not misled about the nature of their relationship, such as confusion about whether the lawyers are part of a law firm, partnership, or professional corporation when no such affiliation exists.[14]

Lawyers in an office sharing arrangement should use separate business cards, letterhead, and directory listings, as well as office signs, firm names, and advertisements that describe their distinct practices and do not suggest a close association between professionals operating within the same space.[15] It is desirable for lawyers sharing office space to have separate telephone lines, but a

[10] State Bar of Cal. Comm. on Prof'l Responsibility & Conduct Op. 1997-150, *supra* note 4, at *3–4; D.C. Bar Op. 303, *supra* note 4, at 1; Mich. State Bar Op. RI-249, *supra* note 4, at *2; Mo. Bar Informal Op. 950169, *supra* note 4, at 1; Neb. Jud. Ethics Comm. Op. 89-2, 1989 WL 1803035, at *4 (1989); Ohio Bd. of Prof'l Conduct Advisory Op. 2022-11, *supra* note 4, at *3. *But see* Utah State Bar Advisory Op. 125, 1994 WL 631269, at *2 (1994) (finding it "difficult to see how it would be possible for shared secretarial arrangements not to put confidential information at risk").

[11] Model Rule 5.3 addresses both partner and supervisor responsibilities for ensuring that nonlawyer assistants' behavior is compatible with lawyers' professional obligations. MODEL RULES OF PROF'L CONDUCT R. 5.3. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 498, at 3–4 (examining lawyers' supervisory obligations for nonlawyer assistants in a virtual practice); Ohio Bd. of Prof'l Conduct Advisory Op. 2022-11, *supra* note 4, at *3 (discussing the sharing of nonlawyer staff).

[12] MODEL RULES OF PROF'L CONDUCT R. 7.1.

[13] *Id.* at cmt. 7. *See also* MODEL RULES OF PROF'L CONDUCT R. 1.0(c) (defining "firm" or "law firm" as "a lawyer or lawyers in a law partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a legal services organization or the legal department of a corporation or other organization").

[14] MODEL RULES OF PROF'L CONDUCT R. 1.4 & 7.1; State Bar of Cal. Comm. on Prof'l Responsibility & Conduct Op. 1997-150, *supra* note 4, at *1; Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 2; D.C. Eth. Op. 303, *supra* note 4, at 1.

[15] State Bar of Cal. Comm. on Prof'l Responsibility & Conduct Op. 1997-150, *supra* note 4, at *1; Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 6; Conn. Bar Ass'n Prof'l Ethics Comm. Op. 97-9, 1997 WL 700580, at *2 (1997); D.C. Eth. Op. 303, at 1; Mich. State Bar Op. RI-249, *supra* note 4, at * 3; Mo. Bar Informal Adv. Op. 980220, *supra* note 8, at 1; N.Y. City Bar Ass'n Prof'l Ethics Comm. Advisory Op. 680, 1990 WL 677022, at *1 (1990); Ohio Bd. of Comm'rs on Grievances & Discipline Advisory Op. 89-36, 1989 WL 535040, at *2 (1989); Va. State Bar Legal Ethics Comm. Op. 874, 1987 WL 1379105, at *1 (1987).

receptionist may answer a common telephone line with a generic salutation such as "Law Offices" to avoid implying that the lawyers are practicing together in the same firm.[16]

It may not be possible to have separate signage where a law firm subleases excess space to unaffiliated lawyers or to lawyers with whom the firm works on a matter-by-matter basis, or where lawyers work in rented temporary space such as WeWork or Regus™ offices. Nevertheless, unaffiliated lawyers sharing space must take reasonable measures to ensure that clients are not confused about their associations with the other lawyers practicing in the immediate area. Office sharing lawyers must understand the need to clarify for their clients these distinct professional relationships. Any communications to the public should also signal that the law practices are not affiliated with one another, other than in their resource-sharing arrangement.[17]

C. Conflicts of Interest Considerations

Lawyers in shared office arrangements should pay particular attention to (1) avoiding the imputation of conflicts of interest, (2) taking on potential new matters that are adverse to clients represented by other office sharing lawyers, and (3) consulting with fellow office sharing lawyers.

1. Imputation of Conflicts

Model Rule 1.10(a) imputes conflicts of interest to all lawyers "associated in a firm."[18] Thus, imputation of a lawyer's conflict of interest to other lawyers in an office-sharing arrangement will pivot on whether the lawyers are, or appear to the public or their clients as, "associated in a firm."[19]

Under the Model Rules, office sharing lawyers are not automatically treated as a single law firm for conflicts of interest purposes.[20] This determination will depend on the facts and circumstances of each arrangement.[21] Office sharing lawyers who do not protect the confidentiality of their respective clients, regularly consult with each other on matters, share staff who have access to client information, mislead the public about their identity and services, or otherwise fail to keep

[16] State Bar of Ariz. Op. 01-09 (2001); Conn. Bar Ass'n Prof'l Ethics Comm. Op. 97-9, *supra* note 15, at *2; D.C. Bar Op. 303, at 1; Mich. Eth. Op. RI-249, 1996 WL 381521, at *3; Ohio Adv. Op. 95-1, 1995 WL 813784, at *4 (Ohio Bd. of Comm'rs on Grievances & Discipline 1995); Wash. Adv. Op. 1304, at 1 (Wash. State Bar, Comm on Prof'l Ethics 1989).

[17] Conn. Eth. Op. 2014-04, 2014 WL 12823983, at *1; D.C. Bar. Op. 303, *supra* note 4, at 1; Mich. State Bar Op. RI-249, *supra* note 4, at *2; Mo. Bar Informal Op. 950169, *supra* note 4, at 1.

[18] MODEL RULES OF PROF'L CONDUCT R. 1.10(a).

[19] MODEL RULES OF PROF'L CONDUCT R. 1.10(a) & cmt. 1; Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 1; Mich. State Bar Op. RI-249, *supra* note 4, at *5.

[20] Mich. State Bar Op. RI-249, *supra* note 4, at *1; N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op. 794, *supra* note 6, at *1 (2011); *see* MODEL RULES OF PROF'L CONDUCT R. 1.0(c) & cmt. 2 (stating that "two practitioners who share office space and occasionally consult or assist each other ordinarily would not be regarded as constituting a firm," but "if they present themselves to the public in a way that suggests that they are a firm or conduct themselves as a firm, they should be regarded as a firm" under the Model Rules).

[21] *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 88-356, at 2–4 (1988) (explaining that whether a temporary lawyer should be treated as "associated in a firm" for conflicts imputation purposes requires "a functional analysis of the facts and circumstances involved in the relationship," with a particular focus on the temporary lawyer's access to information relating to the representation of other firm clients).

their practices separate, are more likely to be treated as "associated in a firm" for conflict imputation purposes.[22]

2. Representing Clients with Adverse Interests

Where lawyers in an office sharing arrangement properly shield the confidentiality of their respective clients and do not hold themselves out to the public as members of the same firm, it may be permissible under the Model Rules to represent clients with adverse interests—even in the same lawsuit or transaction.[23] Although this determination will ultimately turn on specifics of the office sharing arrangement and the nature of the proposed representations, Model Rules 1.4 and 1.7 may obligate lawyers to disclose the details of the office sharing arrangement to their respective clients, including their efforts to maintain confidentiality, and to obtain each clients' informed consent, confirmed in writing.[24]

In addition, any staff shared by the lawyers should not possess or otherwise have access to information from both adverse clients.[25] Implementing an adequate ethical screen between shared staff members can be an effective measure in this regard, and to avoid the sharing of client information more generally.[26]

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[22] *In re* Sexson, 613 N.E.2d 841, 843 (Ind. 1993); MODEL RULES OF PROF'L CONDUCT R. 1.0(c) & cmt. 2; Ariz. State Bar Comm. on the Rules of Prof'l Conduct Op. 01-09, at 1 (2001); Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 1, 4; D.C. Bar Op. 303, *supra* note 4, at 1; Ky. Bar Ass'n Ethics Comm. Op. E-418, at 4 (2001); Ind. State Bar Ass'n Legal Ethics Comm. Op. 8, *supra* note 8, at 3; La. State Bar Ass'n Rules of Prof'l Conduct Comm. Op. 07-RPCC-013, *supra* note 4, at 3; Mo. Bar Informal Op. 950169, *supra* note 4, at 1; N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op. 794, *supra* note 6, at *4; N.Y. City Bar Ass'n Prof'l Ethics Comm. Advisory Op. 680, *supra* note 15, at *2; Ohio Bd. of Prof'l Conduct Advisory Op. 2022-11, *supra* note 4, at *2; S.C. Bar Ethics Advisory Comm. Op. 08-11, 2008 WL 8089795, at *2 (2008); Utah State Bar Advisory Op. 125, *supra* note 10, at *2; Vt. Bar Ass'n Prof'l Responsibility Comm. Op. 79-22, at 1 (1979).

[23] ABA Comm. on Ethics & Prof'l Responsibility, Informal Op. 1486, at 1 (1982) [hereinafter ABA Informal Op. 1486] (lawyers who share space and represent adverse interests in pending lawsuits should explain fully the relationship to, and obtain the consent of, clients to continue to represent adverse interests).; Md. State Bar Ass'n Op. 1987-43, at 1 (1987); Mo. Bar Informal Adv. Op. 970192, *supra* note 9, at 1; N.J. Sup. Ct. Advisory Comm. on Prof'l Ethics Op. 515, 1983 WL 106225, at *1–2 (1983); Ohio Bd. of Prof'l Conduct Advisory Op. 89-005, 1989 WL 535010, at *1 (1989); Or. St. Bar Ass'n Op. 2005-50, *supra* note 9, at *1; S.C. Bar Ethics Advisory Comm. Op. 08-11, *supra* note 22, at *2 (2008); S.C. Bar Ethics Advisory Comm. Op. 91-37, 1992 WL 810417, at *1–2 (1992); Vt. Bar Ass'n Prof'l Responsibility Comm. Op. 80-15, at 1–2 (1980); Va. State Bar Legal Ethics Comm. Op. 943, 1987 WL 1378998, at *1 (1987); Va. State Bar Legal Ethics Comm. Op. 799, 1986 WL 1180507, at *1 (1986); Wash. State Bar Comm. on Prof'l Ethics Op. 1793, at 1 (1997); Wash. State Bar Comm. on Prof'l Ethics Op. 1559, at 1 (1994).

[24] ABA Informal Op. 1486, *supra* note 23, at 1; Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 4; Md. Eth. Op. 1987-43, at 1; Mich. Eth. Op. RI-249, 1996 WL 381521, at *3; N.J. Eth. Op. 515, 1983 WL 106225, at *1–2; Ohio Adv. Op. 89-005, 1989 WL 535010, at *2 (Ohio Bd. of Comm'rs on Grievances & Discipline 1989); S.C. Bar Ethics Advisory Comm. Op. 91-37, *supra* note 23, at *1–2; Vt. Bar Ass'n Prof'l Responsibility Comm. Op. 80-15, *supra* note 23, at 1–2; Va. State Bar Legal Ethics Comm. Op. 943, *supra* note 23, at *1; Wash. State Bar Comm. on Prof'l Ethics Op. 1793, *supra* note 23, at 1.

[25] Ky. Bar Ass'n Ethics Comm. Op. E-406, at 3 (1998); Me. Bd. of Overseers of the Bar Prof'l Ethics Comm'n Op. 41, at 1 (2019); Or. St. Bar Ass'n Op. 2005-50, *supra* note 9, at *1; S.C. Bar Ethics Advisory Comm. Op. 91-37, *supra* note 23, at *1–2. The Committee does not believe it is possible for lawyers in an office sharing arrangement to maintain this kind of separation when representing clients with adverse interests if the lawyers together share only one staff member.

[26] *See generally* Cal. Lawyers Ass'n Ethics Comm. Formal Op. 2021-1 (2021) (discussing elements of effective ethical screens).

Notwithstanding the ability of office sharing lawyers to represent clients with adverse interests, some state ethics opinions understandably advise lawyers to avoid these situations entirely.[27] Potential pitfalls range from inadvertent disclosures of client information in a shared office to opposing parties coincidentally scheduling meetings at the same time. Before entering an office sharing arrangement, it is prudent for a lawyer to examine the nature of the other lawyers' practices to determine whether conflicts of interest are likely to arise.[28]

3. Consultations Between Office Sharing Lawyers

It is natural for lawyers in office sharing arrangements to informally consult one another about their respective client matters. Merely engaging in informal consultations from time to time, however, does not result in the lawyers being "associated in a firm" under Model Rule 1.10(a).[29] At the same time, lawyers who occasionally consult with other lawyers in shared office arrangements should not disclose "client information that may reveal the identity of a client or privileged information."[30] Lawyers may instead discuss issues using hypothetical facts. As comment [4] to Model Rule 1.6 explains, "[a] lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved."[31]

Consultations between office sharing lawyers can also trigger unanticipated conflicts of interest, restricting a consulted lawyer's ability to represent a current or future client under Model Rule 1.7(a)(2).[32] For instance, if Lawyer A and Lawyer B share office space, and Lawyer A divulges client information to Lawyer B during an informal consultation to help Lawyer A prepare a case for trial, then Lawyer B may assume a responsibility not to use or reveal the information, which could materially limit Lawyer B's ability to represent a current or future client.[33] This situation parallels the confidentiality duties that lawyers owe to prospective clients under Model Rule 1.18 and the conflicts problems that can surface if a lawyer receives too much information from a prospective client during an initial consultation.[34]

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[27] Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 3; S.C. Bar Ethics Advisory Comm. Op. 08-11, *supra* note 22, at *2; Va. State Bar Legal Ethics Comm. Op. 943, *supra* note 23, at *1; *see also* ABA Comm. on Ethics & Prof'l Responsibility, Informal Op. 1474, at 1 (1982) (concluding that "representation of opposing sides by lawyers working in the same military office and sharing common secretarial and filing facilities should be avoided").

[28] Colo. Bar Ass'n Ethics Comm. Op. 89, *supra* note 6, at 3.

[29] Ohio Bd. of Prof'l Conduct Advisory Op. 2022-11, *supra* note 4, at *1.

[30] *Id.*

[31] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 4.

[32] MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2); ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 98-411, at 7 (1998) [hereinafter ABA Formal Op. 98-411].

[33] MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2); ABA Formal Op. 98-411, at 9. *See also* Liebnow v. Boston Enterprises, 296 P.3d 108, 115 (Colo. 2013) (citing ABA Formal Op. 98-411, at 7) (concluding that where "one lawyer has consulted another lawyer and has revealed confidential information about her case, including her theory of the case and trial strategy, that could materially limit the consulted attorney's ability to represent the opposing party ... due to the consulted attorney's potential responsibility to keep the information confidential").

[34] MODEL RULES OF PROF'L CONDUCT R. 1.18. *See also* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 492 (2020) (discussing lawyers' obligations to prospective clients and the conflicts issues that can surface if lawyers receive "significantly harmful" information from a prospective client).

To prevent these issues, Lawyer B can conduct a standard conflict check prior to any informal consultation or collaboration with Lawyer A.[35]

III. Conclusion

The ABA Model Rules of Professional Conduct permit lawyers to participate in office sharing arrangements, but those doing so must fully consider and comply with their applicable ethical responsibilities, including confidentiality, conflicts of interest, supervision, and communications concerning a lawyer's services.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

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[35] *See generally* Conn. Bar Ass'n Prof'l Ethics Comm. Op. 98-11, 1998 WL 993681, at *1–2 (1998).

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New York State Bar Association
Committee on Professional Ethics

Opinion 1220 (03/31/2021)

Topic: Falsely advertising a partnership among law firms

Digest: Separate and independent law firms may not form a PLLC and advertise themselves as members of "ABC Law Group PLLC" because (i) the name would be a false, deceptive or misleading trade name, (ii) the name would be misleading as to the identity of the lawyers practicing under that name, and (iii) the name would falsely imply that the separate firms were practicing law in association with each other.

Rules: 1.0(h), 7.1(c)(2), 7.5(b) & (c)

FACTS

1. The inquirer proposes to bring together separate law firms into a professional limited liability corporation ("PLLC"), which we shall call "ABC Law Group PLLC." The member law firms in ABC Law Group PLLC will sign an operating agreement that will set forth various terms and conditions of membership. Under this proposal, ABC Law Group PLLC will maintain a website describing the services provided by the group as a whole and offering a profile of each separate member firm. Each firm's profile will be linked to the member firm's own website. Visitors to the ABC Law Group PLLC website who click on a link to a member firm's website will be advised that they are leaving the ABC Law Group PLLC website.

2. Each individual PLLC member's letterhead (and other written materials, including engagement letters) will include the words "Member Law Firm" under the name and trademark of ABC Law Group LLC. Client engagement letters will be between the client and the member law firm, not ABC Law Group PLLC. All billing will be done by the member law firms. Member firms may collaborate with each other, and each attorney in a member firm must be insured under a member law firm's malpractice policy.

QUESTION

3. Is ABC Law Group PLLC a permissible name? Will ABC Law Group PLLC be considered a "law firm" for the purpose of conflict-of-interest rules?

OPINION

4. Under Rule 7.5(b) of the New York Rules of Professional Conduct ("Rules") as amended effective June 24, 2020, lawyers are permitted to practice under a trade name so long as the name

is not false, deceptive or misleading. *See* N.Y. State 1207 (2020). Here, we have no reason to conclude that, in isolation, the "ABC" portion of the proposed PLLC name violates Rule 7.5(b). Rather, it is the combination of "Law Group" *and* "PLLC" in the name that violates Rule 7.5(b). This is so because Limited Liability Company Law §1203(b) requires that all members of a PLLC must be individuals who are professionally licensed in New York and who practice their profession within the PLLC.

5. Thus, the combination of "PLLC" together with "ABC Law Group" necessarily implies that it is formed to practice law and that the members of the PLLC are associated for that purpose. As the inquiry makes clear, however, that is not the case. Rather, the PLLC members are not practicing law within the PLLC, the PLLC does not enter into engagement agreements with clients, and the PLLC does not bill clients or undertake legal work on their behalf. Accordingly, by implying that the members of the PLLC are associated in the practice of law when they are not, the use of ABC Law Group PLLC as a firm name violates Rule 7.5(b)(1), which provides that a lawyer or law firm shall not practice under a "false, deceptive or misleading trade name" and Rule 7.5(b)(3), which provides that a lawyer or law firm shall not practice under, "a name that is misleading as to the identity of the lawyer or lawyers practicing under such name."

6. In addition, Rule 7.5(c) provides:

> Lawyers shall not hold themselves out as having a partnership with one or more lawyers unless they are in fact partners.

7. A law "partnership" is a form of law firm. The term "law firm" is defined in Rule 1.0(h) as follows:

> (h) "Firm" or "law firm" includes, but is not limited to, a lawyer or lawyers in a law partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a qualified legal assistance organization, a government law office, or the legal department of a corporation or other organization.

8. Comment [5] to Rule 7.5 builds on Rule 1.0(h) by elaborating on the prohibition against misrepresenting the business relationship among lawyers. Comment [5] states:

> Lawyers may not imply or hold themselves out as practicing together in one firm when they are not a "firm" as defined in Rule 1.0(h) because to do so would be false and misleading. In particular, *it is misleading for lawyers to hold themselves out as having a partnership with one or more lawyers unless they are in fact partners*. It is also misleading for lawyers to hold themselves out as being counsel, associates, or other affiliates of a law firm if that is not a fact, or to hold themselves out as partners, counsel or associates if they only share offices. Likewise, law firms may not claim to be affiliated with other law firms if that is not a fact. [Emphasis added.]

9. Thus, lawyers who share office space but have no professional association with each other may not use a designation such as the "777 Lawyers Group" because that would deceive the public about the business status of the lawyers. *See* N.Y. City 82-44 (1982). (Opinion 82-44 also noted

that the designation "777 Lawyers Group" was at that time an "impermissible trade name" under the predecessor to Rule 7.5(b) – but that objection would not apply today.)

10. Nor would our conclusion change if the proposed PLLC and its website were viewed merely as a vehicle for joint advertising. Rule 7.1(c)(2) provides that an advertisement shall not:

> (2) include the portrayal of a fictitious law firm, the use of a fictitious name to refer to lawyers not associated together in a law firm, or otherwise imply that lawyers are associated in a law firm if that is not the case.

11. Because we have determined that establishing an association of separate law firms in a PLLC to be named "ABC Law Group PLLC" would violate Rules 7.1(c)(2), 7.5(b), and 7.5(c), we do not reach the second issue posed by inquirer, as to whether that association would be deemed to constitute a single law firm for conflict of interest purposes. However, law firms forming associations should be aware that some forms of association among separate firms may be deemed to be a single law firm, and therefore all member firms may be required to check for conflicts with all other firms. *See* N.Y. State 876 (2011) ("Conflicts of interest will be imputed to all lawyers in all firms with which a lawyer is associated as a partner, associate or of counsel"); N.Y. City 2000-4 (2000) ("affiliated" attorneys or law firms "must consider themselves as one unit for conflict clearing purposes").

CONCLUSION

12. Separate and independent law firms may not form a PLLC and advertise themselves as members of "ABC Law Group PLLC" because (i) the name would be a false, deceptive or misleading trade name, (ii) the name would be misleading as to the identity of the lawyers practicing under that name, and (iii) the name would falsely imply that the separate firms were practicing law in association with each other.

(01-21)

RULE 1.7: CONFLICT OF INTEREST: CURRENT CLIENTS

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent.

Adopted July 1, 2009, effective January 1, 2010.

Comment

General Principles

[1] Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client or a third person or from the lawyer's own interests. For specific Rules regarding certain concurrent conflicts of interest, see Rule 1.8. For former client conflicts of interest, see Rule 1.9. For conflicts of interest involving prospective clients, see Rule 1.18. For a definition of "informed consent" see Rule 1.0(e).

[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: (1) clearly identify the client or clients; (2) determine whether a conflict of interest exists; (3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and (4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

[3] A conflict of interest may exist before representation is undertaken, in which event the representation must be declined, unless the lawyer obtains the informed consent of each client under the conditions of paragraph (b). To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and nonlitigation matters the persons and issues involved. See also Comment to Rule 5.1. Ignorance caused by a failure to institute such procedures will not excuse a

lawyer's violation of this Rule. As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.

[4] If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b). See Rule 1.16. Where more than one client is involved, whether the lawyer may continue to represent any of the clients is determined both by the lawyer's ability to comply with duties owed to the former client and by the lawyer's ability to represent adequately the remaining client or clients, given the lawyer's duties to the former client. See Rule 1.9. See also Comments [5] and [29].

[5] Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of the representations in order to avoid the conflict. The lawyer must seek court approval where necessary and take steps to minimize harm to the clients. See Rule 1.16. The lawyer must continue to protect the confidences of the client from whose representation the lawyer has withdrawn. See Rule 1.9(c).

Identifying Conflicts of Interest: Directly Adverse

[6] Loyalty to a current client prohibits undertaking representation directly adverse to that client without that client's informed consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer's ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client's case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer's interest in retaining the current client. Similarly, a directly adverse conflict may arise when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not ordinarily constitute a conflict of interest and thus may not require consent of the respective clients.

[7] Directly adverse conflicts can also arise in transactional matters. For example, if a lawyer is asked to represent the seller of a business in negotiations with a buyer represented by the lawyer, not in the same transaction but in another, unrelated matter, the lawyer could not undertake the representation without the informed consent of each client.

Identifying Conflicts of Interest: Material Limitation

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

Lawyer's Responsibilities to Former Clients and Other Third Persons

[9] In addition to conflicts with other current clients, a lawyer's duties of loyalty and independence may be materially limited by responsibilities to former clients under Rule 1.9 or by the lawyer's responsibilities to other persons, such as fiduciary duties arising from a lawyer's service as a trustee, executor or corporate director.

Personal Interest Conflicts

[10] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. Similarly, when a lawyer has discussions concerning possible employment with an opponent of the lawyer's client, or with a law firm representing the opponent, such discussions could materially limit the lawyer's representation of the client. In addition, a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial interest. See Rule 1.8 for specific Rules pertaining to a number of personal interest conflicts, including business transactions with clients. See also Rule 1.10 (personal interest conflicts under Rule 1.7 ordinarily are not imputed to other lawyers in a law firm).

[11] When lawyers representing different clients in the same matter or in substantially related matters are closely related by blood or marriage, there may be a significant risk that client confidences will be revealed and that the lawyer's family relationship will interfere with both loyalty and independent professional judgment. As a result, each client is entitled to know of the existence and implications of the relationship between the lawyers before the lawyer agrees to undertake the representation. Thus, a lawyer related to another lawyer, *e.g.*, as parent, child, sibling or spouse, ordinarily may not represent a client in a matter where that lawyer is representing another party, unless each client gives informed consent. The disqualification arising from a close family relationship is personal and ordinarily is not imputed to members of firms with whom the lawyers are associated. See Rule 1.10.

[12] A lawyer is prohibited from engaging in sexual relationships with a client unless the sexual relationship predates the formation of the client-lawyer relationship. See Rule 1.8(j).

Interest of Person Paying for a Lawyer's Service

[13] A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.

Prohibited Representations

[14] Ordinarily, clients may consent to representation notwithstanding a conflict. However, as indicated in paragraph (b), some conflicts are nonconsentable, meaning that the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent. When the lawyer is representing more than one client, the question of consentability must be resolved as to each client.

[15] Consentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest. Thus, under paragraph (b)(1), representation is prohibited if in the circumstances the lawyer cannot reasonably conclude that the lawyer will be able to provide competent and diligent representation. See Rule 1.1 (competence) and Rule 1.3 (diligence).

[16] Paragraph (b)(2) describes conflicts that are nonconsentable because the representation is prohibited by applicable law. For example, in some states substantive law provides that the same lawyer may not represent more than one defendant in a capital case, even with the consent of the clients, and under federal criminal statutes certain representations by a former government lawyer are prohibited, despite the informed consent of the former client. In addition, decisional law in some states limits the ability of a governmental client, such as a municipality, to consent to a conflict of interest.

[17] Paragraph (b)(3) describes conflicts that are nonconsentable because of the institutional interest in vigorous development of each client's position when the clients are aligned directly against each other in the same litigation or other proceeding before a tribunal. Whether clients are aligned directly against each other within the meaning of this paragraph requires examination of the context of the proceeding. Although this paragraph does not preclude a lawyer's multiple representation of adverse parties to a mediation (because mediation is not a proceeding before a "tribunal" under Rule 1.0(m)), such representation may be precluded by paragraph (b)(1).

Informed Consent

[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

[19] Under some circumstances it may be impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent. In some cases the alternative to common representation can be that each party may have to obtain separate representation with the possibility of incurring additional costs. These costs, along with the benefits of securing separate representation, are factors that may be considered by the affected client in determining whether common representation is in the client's interests.

[20] Reserved.

Revoking Consent

[21] A client who has given consent to a conflict may revoke the consent and, like any other client, may terminate the lawyer's representation at any time. Whether revoking consent to the client's own representation precludes the lawyer from continuing to represent other clients depends on the circumstances, including the nature of the conflict, whether the client revoked consent because of a material change in circumstances, the reasonable expectations of the other clients and whether material detriment to the other clients or the lawyer would result.

Consent to Future Conflict

[22] Whether a lawyer may properly request a client to waive conflicts that might arise in the future is subject to the test of paragraph (b). The effectiveness of such waivers is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails. The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding. Thus, if the client agrees to consent to a particular type of conflict with which the client is already familiar, then the consent ordinarily will be effective with regard to that type of conflict. If the consent is general and open-ended, then the consent ordinarily will be ineffective, because it is not

reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise, such consent is more likely to be effective, particularly if, *e.g.*, the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. In any case, advance consent cannot be effective if the circumstances that materialize in the future are such as would make the conflict nonconsentable under paragraph (b).

Conflicts in Litigation

[23] Paragraph (b)(3) prohibits representation of opposing parties in the same litigation, regardless of the clients' consent. On the other hand, simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (a)(2). A conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests in civil litigation is proper if the requirements of paragraph (b) are met.

[24] Ordinarily a lawyer may take inconsistent legal positions in different tribunals at different times on behalf of different clients. The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer's action on behalf of one client will materially limit the lawyer's effectiveness in representing another client in a different case; for example, when a decision favoring one client will create a precedent likely to seriously weaken the position taken on behalf of the other client. Factors relevant in determining whether the clients need to be advised of the risk include: where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved and the clients' reasonable expectations in retaining the lawyer. If there is significant risk of material limitation, then absent informed consent of the affected clients, the lawyer must refuse one of the representations or withdraw from one or both matters.

[25] When a lawyer represents or seeks to represent a class of plaintiffs or defendants in a class-action lawsuit, unnamed members of the class are ordinarily not considered to be clients of the lawyer for purposes of applying paragraph (a)(1) of this Rule. Thus, the lawyer does not typically need to get the consent of such a person before representing a client suing the person in an unrelated matter. Similarly, a lawyer seeking to represent an opponent in a class action does not typically need the consent of an unnamed member of the class whom the lawyer represents in an unrelated matter.

Nonlitigation Conflicts

[26] Conflicts of interest under paragraphs (a)(1) and (a)(2) arise in contexts other than litigation. For a discussion of directly adverse conflicts in transactional matters, see Comment [7]. Relevant factors in determining whether there is significant potential for material limitation include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that disagreements will arise and the likely prejudice to the client from the conflict. The question is often one of proximity and degree. See Comment [8].

[27] For example, conflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may be present. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship to the parties involved.

[28] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

Special Considerations in Common Representation

[29] In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. In some situations, the risk of failure is so great that multiple representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adequately served by common representation is not very good. Other relevant factors are whether the lawyer subsequently will represent both parties

on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.

[30] A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege generally does not attach. Hence, it should generally be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

[31] As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. See Rule 1.4. The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

[32] When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances and, thus, that the clients may be required to assume greater responsibility for decisions than when each client is separately represented. Any limitations on the scope of the representation made necessary as a result of the common representation should be fully explained to the clients at the outset of the representation. See Rule 1.2(c).

[33] Subject to the above limitations, each client in the common representation has the right to loyal and diligent representation and the protection of Rule 1.9 concerning the obligations to a former client. The client also has the right to discharge the lawyer as stated in Rule 1.16.

Organizational Clients

[34] A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely

to limit materially the lawyer's representation of the other client.

[35] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Adopted July 1, 2009, effective January 1, 2010.

WHAT CAN BE MEASURED, CAN BE IMPROVED INCORPORATING KPIS INTO YOUR LAW FIRM

Courtney Werning

You know how to practice law, but running a successful law firm can feel elusive without a strategy to get you there. The competition is not relying on intuition alone. The legal industry is evolving rapidly, making it critical for firms to adopt efficient management strategies to stay competitive. KPIs, or key performance indicators, are measurements that show how much progress a company (or in this case, a law firm) is making towards its business objectives. KPIs provide a way to quantify performance - and when performance can be quantified, it can be improved by making more informed decisions and taking targeted actions to improve law firm operations.

Much has been written about KPIs in the context of running a business since their development in the 1990s. In the last decade, we have seen the use of KPIs in the legal industry take off, and now there are innumerable sources, articles, and websites to help lawyers develop the use of KPIs at their firms. For law firms to thrive in today's highly competitive market, they must be run like a business. Understanding and establishing firm KPIs is a good place to start.

How do KPIs Help Attorneys Manage Their Firms?

KPIs can help answer many fundamental questions across many areas – how well is your law firm doing? Which of your staff and attorneys contributes most to your success? How satisfied are your clients? What is the cost for acquiring a new case? By tracking KPIs, law firms can identify areas of strength and weakness, monitor progress toward goals, and make data-driven decisions to optimize performance.

By setting KPI targets and regularly measuring progress, law firms can identify areas where they are performing well and those that require improvement. KPIs can also provide early warning signals if a law firm is not performing as expected, allowing them to take corrective action before it's too late. Running a contingency fee law firm is volatile and risky, but KPIs can help eliminate, or at least give some illumination, to the unknown.

What Should I Be Tracking?

Spend some time choosing KPIs that align with your firm's goals. Not all firms are equal, and what works for one firm may not work for another. Firms can utilize countless KPIs in client acquisition, marketing, client development, client satisfaction, productivity, individual performance, financials, and firm culture. There is no one-size-fits-all strategy for utilizing KPIs, but here are some to consider:

1. Financials

This seems obvious, but tracking financials by practice area, lawyer, or team is critically important, especially for firm operating mostly on contingency fee revenue. With a solid five-year rolling average for several key financials, you can understanding how your law firm is performing and where and how you should allocate your resources.

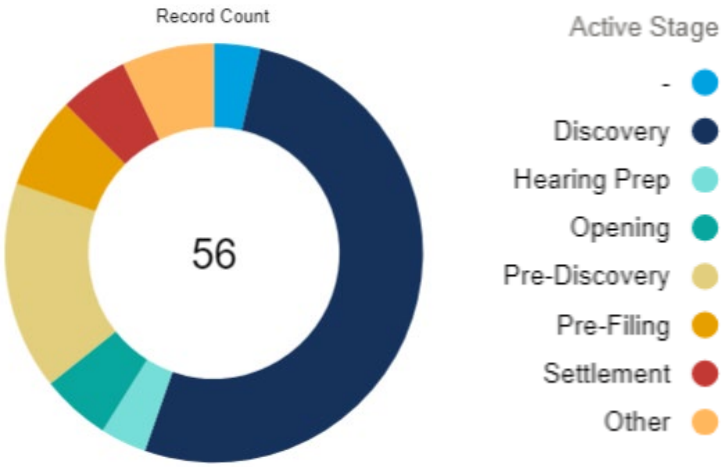
- Revenue
- Expected revenue
- Fixed expenses
- Case expenses

2. Cases

How do you want your clients to perceive your firm? Building trust and nurturing your clients throughout their process can help you build strong relationships. In the long run, this will help your firm bring in referrals and create a strong and trustworthy reputation. One way to go about this is to track client satisfaction by surveys or requests for client reviews. This will help you measure the likelihood of past or existing clients recommending your firm.

Certain KPIs can indicate potential risks to the firm, such as missed deadlines or lack of client communication. Monitoring for these indicators allows firms to take proactive measures to mitigate these risks and prevent negative outcomes.

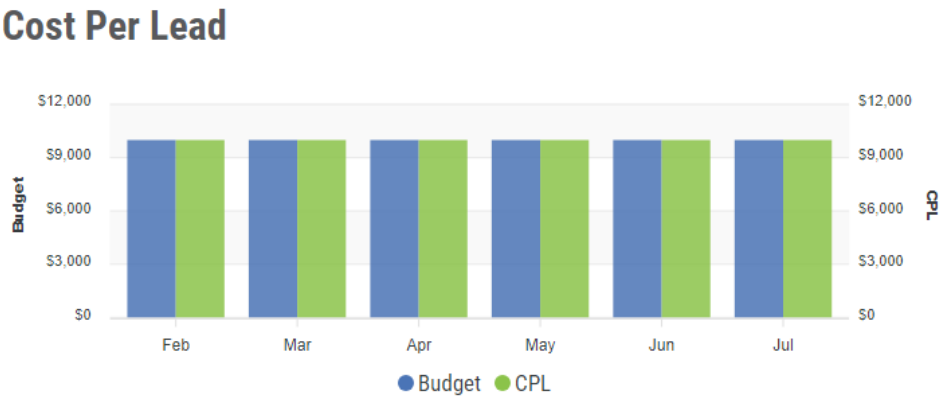
- Number of cases
- Stage of cases
- New client acquisitions
- Time from signing to filing
- Time since last client contact
- Client demographics
- The average value of cases
- Average case duration
- Percentage of cases resolved within a target timeframe
- Client satisfaction
- Client reviews
- Win rate
- Settlement rate
- Average gross recovery as percentage of damages



3. Marketing and Case Acquisition

Maybe your firm is paying an outside firm or consultant to maximize your online marketing strategy and tactics. Maybe you have a sophisticated strategy involving SEO, social media, Google Ads, email marketing, and more. Without turning to KPIs to quantify your efforts, you have no way of knowing how your marketing efforts are paying off. KPIs in this area will let you rate your marketing campaign's performance, tweak it as needed, and improve your strategy as you go.

- Website traffic
- Landing page conversion rates
- Social media engagement
- Source of new cases
- Total leads
- Qualified leads
- Conversation rate
- Time from contact to signing



4. Firm culture

Your people are your most important resource. Your firm's productivity, customer satisfaction, and profitability all come down to your people, and their performance relies on culture. Just like client satisfaction, you'll need to implement a satisfaction survey to track this KPI. Whether it is a formal survey or less formal data gathering, the key is to collect good data and record it in a way that allows you to compare from one period to the next. Although the process of surveying employees can feel a bit risky, it's actually very helpful. The simple fact that you're asking (and that they know you actually care about their answers) has a positive impact on company culture and job satisfaction. Everyone wants to know they are heard.

- Employee satisfaction
- Employee engagement
- Turnover rate
- Average tenure
- Diversity representation
- Overtime hours

- Sick leave rate
- Event attendance

Collect and Review Data

In order for KPIs to be useful, you have to diligently collect the data on a regular basis. This will allow you to track your progress over time and actual use the information to make strategic changes in order to maximize your success. Set up a schedule to regularly analyze the data to identify trends, patterns, and help you put those KPIs to work.

There are countless law firm management software programs that can efficiently and automatically track countless KPIs and produce meaningful reports with very little effort on your part. Even where the expense of a fancy software program is not feasible, you can record and track KPIs in Microsoft Excel, either by building a dashboard yourself or utilizing a template (free or for a small fee).

Mistakes with KPIs

As a final point, there are a few pitfalls to avoid when applying and using KPIs. To prevent wasting your valuable time and resources, here are some words of caution:

- *Not using the right KPIS*: KPIs are only useful if they are aligned to your firm's strategy and inform strategic decision making. Anything else is just meaningless. Sometimes there is a disconnect between the fact that something *can* be measured, and whether it *should* be measured. KPIs are meant to provide you with a sense of focus. Tracking too many data points dilutes that focus and can work against you when you're trying to make decisions. All KPIs you track should be linked directly back to pushing that strategy forward.

- *Not updating KPIs*: Once the right KPIs have been identified or designed, it would be a mistake to never revisit them to challenge their relevance or applicability. It is important to make sure that you are always collecting the right data, collecting it often enough and are using what you collect. Whenever there is a change in strategy or firm priorities, you need to review and update your KPIs to make sure you only measure what really needs to be measured and that the KPIs remain relevant and aligned to the new strategy.

- *Not acting on KPIs*: KPIs can inform fact-based decision making inside firms – but only if those inside the firms act on them. In the end, it doesn't matter how brilliantly you have aligned your KPIs to your strategy, or even how brilliantly you have captured and presented the relevant KPIs, if they are not then used as they were intended. If you are not using your KPIs to inform your decisions and drive performance, then you are wasting your time and effort.

Conclusion

KPIs offer a compass to gauge performance, align goals, and drive accountability, fostering a culture of continuous improvement. As law firms embrace KPIs, they equip themselves with the tools to adapt, innovate, and flourish in an evolving legal industry, ultimately delivering better outcomes for clients, employees, and the firm as a whole.

ETHICALLY MANAGING YOUR CASE LOAD

Sean M. Sweeney

You have your marketing on point, your ability to convince the client to hire you is perfect, but now you realize you must actually do all of the work for each of the cases you brought in. How do we manage that, and how do we make sure we are doing it ethically?

The ABA and various State Bars provide some guidance on these issues. Model Rule 1.1 states:

> *A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.*

But what does this mean?

The ABA, in discussing representing indigent clients, breaks the duties of all lawyers in all matters down as follows:

> *Model Rules of Professional Conduct 1.1, 1.2(a), 1.3, and 1.4 require lawyers to provide competent representation, abide by certain client decisions, exercise diligence, and communicate with the client concerning the subject of representation. These obligations include, but are not limited to, the responsibilities to keep abreast of changes in the law; adequately investigate, analyze, and prepare cases; act promptly on behalf of clients; communicate effectively on behalf of and with clients; control workload so each matter can be handled competently; and, if a lawyer is not experienced with or knowledgeable about a specific area of the law, either associate with counsel who is knowledgeable in the area or educate herself about the area*
>
> ABA Formal Opinion 06-441 (attached)

This means that if we want to be able to ethically discharge our duties while taking on more and more cases, we have to have a system in place for ensuring that we can "control workload so each matter can be handled competently." As the ABA Opinion states, "If a lawyer's workload is such that the lawyer is unable to provide competent and diligent representation to existing or potential clients, the lawyer should not accept new clients." (*Id.* at pg. 9). Most lawyers turn to technology to aid our practices and managing case load. The ABA comments to Rule 1.1 specifically address competence with relevant technology:

> Maintaining Competence
>
> *[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.*

I think this is fairly interpreted to mean that not only can you leverage technology to make sure that you are maintaining an appropriate workload to provide competent representation, but to at least some extent, you are ethically required to keep up with changes in technology to ensure you are doing so.

Remote work is often key in order to leverage technology and your most finite resource, your time, to ensure that you are able to manage your caseload. However, this comes with its own ethical requirements, as the ABA addresses in ABA Formal Opinion 498 (attached).

> *As lawyers increasingly use technology to practice virtually, they must remain cognizant of their ethical responsibilities. While the ABA Model Rules of Professional Conduct permit virtual practice, the Rules provide some minimum requirements and some of the Comments suggest best practices for virtual practice, particularly in the areas of competence, confidentiality, and supervision.*

Some of the key takeaways are the following:

> *Lawyers must take reasonable precautions when transmitting communications that contain information related to a client's representation. At all times, but especially when practicing virtually, lawyers must fully consider and implement reasonable measures to safeguard confidential information and take reasonable precautions when transmitting such information….*
>
> *A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product….*
>
> *Likewise, even in otherwise virtual practices, lawyers still need to make and maintain a plan to process the paper mail, to docket correspondence and communications, and to direct or redirect clients, prospective clients, or other important individuals who might attempt to contact the lawyer at the lawyer's current or previous brick-and- mortar office. If a lawyer will not be available at a physical office address, there should be signage (and/or online instructions) that the lawyer is available by appointment only and/or that the posted address is for mail deliveries only.*

Each of these formal opinions are worth reviewing as you navigate the complex balance of bringing in cases and ensuring that you can competently handle each new case that you bring in for your firm.

We all want to build our practices, ensure we have enough work to keep us busy and keep the lights on, and help as many people as possible. We can do it if we keep in mind that we need to leverage technology to make sure we are discharging our ethical duties. This may be as complex as comprehensive practice management software, or as simple as spreadsheets and notes software used to keep cases on task, but the underlying principal remains the same, we are ethically required to ensure that we can handle all of the cases we take in.

Rule 1.1: Competence

Share:



Client-Lawyer Relationship

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

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Rule 1.1 Competence - Comment

Share:



Client-Lawyer Relationship

Legal Knowledge and Skill

[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

[2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

[3] In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

[4] A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an

unrepresented person. See also Rule 6.2.

Thoroughness and Preparation

[5] Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 1.2(c).

Retaining or Contracting With Other Lawyers

[6] Before a lawyer retains or contracts with other lawyers outside the lawyer's own firm to provide or assist in the provision of legal services to a client, the lawyer should ordinarily obtain informed consent from the client and must reasonably believe that the other lawyers' services will contribute to the competent and ethical representation of the client. See also Rules 1.2 (allocation of authority), 1.4 (communication with client), 1.5(e) (fee sharing), 1.6 (confidentiality), and 5.5(a) (unauthorized practice of law). The reasonableness of the decision to retain or contract with other lawyers outside the lawyer's own firm will depend upon the circumstances, including the education, experience and reputation of the nonfirm lawyers; the nature of the services assigned to the nonfirm lawyers; and the legal protections, professional conduct rules, and ethical environments of the jurisdictions in which the services will be performed, particularly relating to confidential information.

[7] When lawyers from more than one law firm are providing legal services to the client on a particular matter, the lawyers ordinarily should consult with each other and the client about the scope of their respective representations and the allocation of responsibility among them. See Rule 1.2. When making allocations of responsibility in a matter pending before a tribunal, lawyers and parties may have additional obligations that are a matter of law beyond the scope of these Rules.

Maintaining Competence

[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.

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AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 06-441 **May 13, 2006**

Ethical Obligations of Lawyers Who Represent Indigent Criminal Defendants When Excessive Caseloads Interfere With Competent and Diligent Representation

All lawyers, including public defenders and other lawyers who, under court appointment or government contract, represent indigent persons charged with criminal offenses, must provide competent and diligent representation. If workload prevents a lawyer from providing competent and diligent representation to existing clients, she must not accept new clients. If the clients are being assigned through a court appointment system, the lawyer should request that the court not make any new appointments. Once the lawyer is representing a client, the lawyer must move to withdraw from representation if she cannot provide competent and diligent representation. If the court denies the lawyer's motion to withdraw, and any available means of appealing such ruling is unsuccessful, the lawyer must continue with the representation while taking whatever steps are feasible to ensure that she will be able to competently and diligently represent the defendant.

Lawyer supervisors, including heads of public defenders' offices and those within such offices having intermediate managerial responsibilities, must make reasonable efforts to ensure that the other lawyers in the office conform to the Rules of Professional Conduct. To that end, lawyer supervisors must, working closely with the lawyers they supervise, monitor the workload of the supervised lawyers to ensure that the workloads do not exceed a level that may be competently handled by the individual lawyers.

In this opinion,[1] we consider the ethical responsibilities of lawyers, whether employed in the capacity of public defenders or otherwise, who represent indigent persons charged with criminal offenses, when the lawyers' workloads prevent them from providing competent and diligent representa-

1. This opinion is based on the Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2003. The laws, court rules, regulations, rules of professional conduct and opinions promulgated in the individual jurisdictions are controlling.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY, 321 N. Clark Street, Chicago, Illinois 60610-4714 Telephone (312)988-5300 CHAIR: William B. Dunn, Detroit, MI □ Elizabeth Alston, Mandeville, LA □ T. Maxfield Bahner, Chattanooga, TN □ Amie L. Clifford, Columbia, SC □ Timothy J. Dacey, III, Boston, MA □ James A. Kawachika, Honolulu, HI □ Steven C. Krane, New York, NY □ John P. Ratnaswamy, Chicago, IL □ Irma Russell, Memphis, TN □ Thomas Spahn, McLean, VA □ CENTER FOR PROFESSIONAL RESPONSIBILITY: George A. Kuhlman, Ethics Counsel; Eileen B. Libby, Associate Ethics Counsel

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tion to all their clients. Excessive workloads present issues for both those who represent indigent defendants and the lawyers who supervise them.[2]

Ethical responsibilities of a public defender[3] in regard to individual workload

Persons charged with crimes have a constitutional right to the effective assistance of counsel.[4] Generally, if a person charged with a crime is unable to afford a lawyer, he is constitutionally entitled to have a lawyer appointed to represent him.[5] The states have attempted to satisfy this constitutional mandate through various methods, such as establishment of public defender, court appointment, and contract systems.[6] Because these systems have been created to provide representation for a virtually unlimited number of indigent criminal defendants, the lawyers employed to provide representation generally are limited in their ability to control the number of clients they are assigned. Measures have been adopted in some jurisdictions in attempts to control workloads,[7] including the establishment of procedures for assigning cases to lawyers outside public defenders' offices when the cases could not properly be directed to a public defender, either because of a conflict of interest or for other reasons.

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2. For additional discussion of the problems presented by excessive caseloads for public defenders, *see* "Gideon's Broken Promise: American's Continuing Quest For Equal Justice," prepared by the American Bar Association's Standing Committee on Legal Aid and Indigent Defendants 29 (ABA 2004), *available at* http://www.abanet.org/legalservices/sclaid/defender/brokenpromise/fullreport.pdf (last visited June 21, 2006).

3. The term "public defender" as used here means both a lawyer employed in a public defender's office and any other lawyer who represents, pursuant to court appointment or government contract, indigent persons charged with criminal offenses.

4. U.S. CONST. amends. VI & XIV.

5. The United States Supreme Court has interpreted the Sixth Amendment to require the appointment of counsel in any state and federal criminal prosecution that, regardless of whether for a misdemeanor or felony, leads or may lead to imprisonment for any period of time. *See generally,* Alabama v. Shelton, 535 U.S. 654, 662 (2002); Strickland v. Washington, 466 U.S. 668, 684-86 (1984); Scott v. Illinois, 440 U.S. 367, 373-74 (1979); Argersinger v. Hamlin, 407 U.S. 25, 30-31 (1972); Gideon v. Wainwright, 372 U.S. 335, 342-45 (1963); Johnson v. Zerbst, 304 U.S. 458. 462-63 (1938).

6. Most states deliver indigent defense services using a public defender's office (eighteen states) or a combination of public defender, assigned counsel, and contract defender (another twenty-nine states), according to the Spangenberg Group, which developed a report on behalf of the ABA Standing Committee on Legal Aid and Indigent Defendants. *See* The Spangenberg Group, "Statewide Indigent Defense Systems: 2005," *available at* http://www.abanet.org/legalservices/downloads/sclaid/indigentdefense/statewideinddefsystems2005.pdf (last visited June 21, 2006).

7. *See generally*, National Symposium on Indigent Defense 2000, *Redefining Leadership for Equal Justice, A Conference Report* (U.S. Dep't of Justice, Bureau of Justice Assistance, Wash. D.C.) 3 (June 29-30, 2000), *available at* http://www.ojp.usdoj.gov/indigentdefense/symposium.pdf (last visited June 21, 2006) (common problem in indigent defense delivery systems is that "lawyers often have unmanageable caseloads (700 or more in a year")).

Model Rules of Professional Conduct 1.1, 1.2(a), 1.3, and 1.4 require lawyers to provide competent representation, abide by certain client decisions, exercise diligence, and communicate with the client concerning the subject of representation.[8] These obligations include, but are not limited to, the responsibilities to keep abreast of changes in the law; adequately investigate, analyze, and prepare cases; act promptly on behalf of clients; communicate effectively on behalf of and with clients; control workload so each matter can be handled competently; and, if a lawyer is not experienced with or knowledgeable about a specific area of the law, either associate with counsel who is knowledgeable in the area or educate herself about the area. The Rules provide no exception for lawyers who represent indigent persons charged with crimes.[9]

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8. Rule 1.1(a) provides that "[a] lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."
Rule 1.2(a) states:

> [A] lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

Rule 1.3 states that "[a] lawyer shall act with reasonable diligence and promptness in representing a client."
Rule 1.4(a) and (b) states:

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

9. *See* ABA Formal Opinion Op. 347 (Dec. 1, 1981) (Ethical Obligations of Lawyers to Clients of Legal Services Offices When Those Offices Lose Funding), in FORMAL AND INFORMAL ETHICS OPINIONS, FORMAL OPINIONS 316-348, INFORMAL OPINIONS 1285-1495 at 139 (ABA 1985) (duties owed to existing clients include duty of adequate preparation and a duty of competent representation); ABA Informal Op. 1359 (June 4, 1976) (Use of Waiting Lists or Priorities by Legal Service Officer), *id*. at 237 (same); ABA Informal Op. 1428 (Sept. 12, 1979) (Lawyer-Client Relationship Between the Individual and Legal Services Office: Duty of Office Toward Client When Attorney Representing Him (Her) Leaves the Office and Withdraws from the Case), *id*. at 326 (all lawyers, including legal services lawyers, are subject to mandatory duties owed by lawyers to existing clients, including duty of adequate preparation

Comment 2 to Rule 1.3 states that a lawyer's workload "must be controlled so that each matter may be handled competently."[10] The Rules do not prescribe a formula to be used in determining whether a particular workload is excessive. National standards as to numerical caseload limits have been cited by the American Bar Association.[11] Although such standards may be considered, they are not the sole factor in determining if a workload is excessive. Such a determination depends not only on the number of cases, but also on such factors as case complexity, the availability of support services, the lawyer's experience and ability, and the lawyer's nonrepresentational duties.[12] If a lawyer believes that her workload is such that she is unable to meet the basic ethical obligations required of her in the representation of a client, she must not continue the representation of that client or, if representation has not yet begun, she must decline the representation.[13]

A lawyer's primary ethical duty is owed to existing clients.[14] Therefore, a

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and competent representation). *See also* South Carolina Bar Ethics Adv. Op. 04-12 (Nov. 12, 2004) (all lawyers, including public defenders, have ethical obligation not to undertake caseload that leads to violation of professional conduct rules).

The applicability of Rules 1.1, 1.3, and 1.4 to public defenders and/or prosecutors has been recognized by ethics advisory committees in at least one other state. *See* Va. Legal Eth. Op. 1798 (Aug. 3, 2004) (duties of competence and diligence contained within rules of professional conduct apply equally to all lawyers, including prosecutors).

10. Principle 5 of *The Ten Principles of a Public Defense Delivery System* specifically addresses the workload of criminal defense lawyers:

> *Defense counsel's workload is controlled to permit the rendering of quality representation.* Counsel's workload, including appointed and other work, should never be so large as to interfere with the rendering of quality representation or lead to the breach of ethical obligations, and counsel is obligated to decline appointments above such levels. National caseload standards should in no event be exceeded, but the concept of workload (i.e., caseload adjusted by factors such as case complexity, support services, and an attorney's nonrepresentational duties) is a more accurate measurement.

Report to the ABA House of Delegates No. 107 (adopted Feb. 5, 2002), *available at* http://www.abanet.org/legalservices/downloads/sclaid/10principles.pdf (last visited June 21, 2006) (emphasis in original).

11. *Id.*

12. *Id*. *See also* Attorney Grievance Comm'n of Maryland v. Ficker, 706 A.2d 1045, 1051-52 (1998) (supervising lawyer violated Rule 5.1 by assigning too many cases to supervised lawyer, assigning cases day before trial, and assigning cases too complex for supervised lawyer's level of experience and ability).

13. Rule 1.16(a) states that "a lawyer shall not represent a client or, where representation has begun, shall withdraw from the representation of a client if the representation will result in violation of the Model Rules of Professional Conduct or other law."

14. *See* ABA Formal Opinion Op. 96-399 (Jan. 18, 1996) (Ethical Obligations of Lawyers Whose Employers Receive Funds from the Legal Services Corporation to their Existing and Future Clients When Such Funding is Reduced and When Remaining Funding is Subject to Restrictive Conditions), in FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 369 (ABA 2000); ABA Formal Opinion Op. 347, *supra* note 9.

lawyer must decline to accept new cases, rather than withdraw from existing cases, if the acceptance of a new case will result in her workload becoming excessive. When an existing workload does become excessive, the lawyer must reduce it to the extent that what remains to be done can be handled in full compliance with the Rules.

When a lawyer receives appointments directly from the court rather than as a member of a public defender's office or law firm that receives the appointment, she should take appropriate action if she believes that her workload will become, or already is, excessive. Such action may include the following:

- requesting that the court refrain from assigning the lawyer any new cases until such time as the lawyer's existing caseload has been reduced to a level that she is able to accept new cases and provide competent legal representation; and
- if the excessive workload cannot be resolved simply through the court's not assigning new cases, the lawyer should file a motion with the trial court requesting permission to withdraw from a sufficient number of cases to allow the provision of competent and diligent representation to the remaining clients.[15]

If the lawyer has sought court permission to withdraw from the representation and that permission has been denied, the lawyer must take all feasible steps to assure that the client receives competent representation.

When a lawyer receives appointments as a member of a public defender's office or law firm, the appropriate action to be taken by the lawyer to reduce an excessive workload might include, with approval of the lawyer's supervisor:

- transferring non-representational responsibilities within the office, including managerial responsibilities, to others;
- refusing new cases;[16] and
- transferring current case(s) to another lawyer whose workload will allow for the transfer of the case(s).[17]

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15. Whenever a lawyer seeks to withdraw from a representation the client should be notified, even if court rules do not require such notification. *See* Rule 1.4.

16. It should be noted that a public defender's attempt to avoid appointment or to withdraw from a case must be based on valid legal grounds. Rule 6.2(a) provides, in pertinent part, that "[a] lawyer *shall not seek to avoid* appointment by a tribunal to represent a person *except for good cause*, such as representing the client is likely to result in violation of the Rules of Professional Conduct or other law." (Emphasis added). Therefore, a public defender should not claim an excessive workload in an attempt to avoid new cases or to withdraw from current cases unless good cause objectively exists.

17. It is important to note that, for purposes of the Model Rules, a public defender's office, much like a legal services office, is considered to be the equivalent of a law firm. *See* Rule 1.0(c). Unless a court specifically names an individual lawyer within a public defender's office to represent an indigent defendant, the public defender's office should be considered as a firm assigned to represent the client; responsibility for handling the case falls upon the office as a whole. *See* ABA Informal Op. 1428, *supra* note 9 (legal services agency should be considered firm retained by client; responsibility for handling caseload of departing legal services lawyer falls upon office as whole rather than upon lawyer who is departing). Therefore, cases may ethically be reassigned within a public defender's office.

If the supervisor fails to provide appropriate assistance or relief, the lawyer should continue to advance up the chain of command within the office until either relief is obtained or the lawyer has reached and requested assistance or relief from the head of the public defender's office.

In presenting these options, the Committee recognizes that whether a public defender's workload is excessive often is a difficult judgment requiring evaluation of factors such as the complexity of the lawyer's cases and other factors.[18] When a public defender consults her supervisor and the supervisor makes a conscientious effort to deal with workload issues, the supervisor's resolution ordinarily will constitute a "reasonable resolution of an arguable question of professional duty" as discussed in Rule 5.2(b).[19] In those cases where the supervisor's resolution is not reasonable, however, the public defender must take further action.[20]

Such further action might include:

- if relief is not obtained from the head of the public defender's office, appealing to the governing board, if any, of the public defender's office;[21] and
- if the lawyer is still not able to obtain relief, [22] filing a motion with the trial court requesting permission to withdraw from a sufficient number of cases to allow the provision of competent and diligent representation to the remaining clients.[23]

If the public defender is not allowed to withdraw from representation, she must obey the court's order while taking all steps reasonably feasible to insure that her client receives competent and diligent representation.[24]

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18. *See* note 12, *supra*, and accompanying text.

19. *See* Comment [2].

20. *See, e.g.*, Atty. Grievance Comm'n of Maryland v. Kahn, 431 A.2d 1336, 1352 (1981) ("Obviously, the high ethical standards and professional obligations of an attorney may never be breached because an attorney's employer may direct such a course of action on pain of dismissal. ")

21. *See* Michigan Bar Committee on Prof. & Jud. Eth. Op. RI-252 (Mar. 1, 1996) (in context of civil legal services agency, if subordinate lawyer receives no relief from excessive workload from lawyer supervisor, she should, under Rule 1.13(b) and (c), take the matter to legal services board for resolution).

22. Rule 5.2 makes clear that subordinate lawyers are not insulated from violating the Rules of Professional Conduct and suffering the consequences merely because they acted in accordance with a supervisory lawyer's advice or direction unless it was in regard to "an arguable question of professional duty."

23. A public defender filing a motion to withdraw under these circumstances should provide the court with information necessary to justify the withdrawal, while being mindful of the obligations not to disclose confidential information or information as to strategy or other matters that may prejudice the client. *See* Rule 1.16 cmt. 3.

24. Notwithstanding the lawyer's duty in this circumstance to continue in the representation and to make every attempt to render the client competent representation, the lawyer nevertheless may pursue any available means of review of the court's order. *See* Iowa Supreme Court Bd. of Prof. Ethics & Conduct v. Hughes, 557 N.W.2d 890, 894

Ethical responsibility of a lawyer who supervises a public defender

Rule 5.1 provides that lawyers who have managerial authority, including those with intermediate managerial responsibilities, over the professional work of a firm or public sector legal agency or department shall make reasonable efforts to ensure that the other lawyers in the agency or department conform to the Rules of Professional Conduct. Rule 5.1 requires that lawyers having direct supervisory authority take reasonable steps to ensure that lawyers in the office they supervise are acting diligently in regard to all legal matters entrusted to them, communicating appropriately with the clients on whose cases they are working, and providing competent representation to their clients. As an essential first step, the supervisor must monitor the workloads of subordinate lawyers to ensure that the workload of each lawyer is appropriate. This involves consideration of the type and complexity of cases being handled by each lawyer; the experience and ability of each lawyer; the resources available to support her, and any non-representational responsibilities assigned to the subordinate lawyers.

If any subordinate lawyer's workload is found to be excessive, the supervisor should take whatever additional steps are necessary to ensure that the subordinate lawyer is able to meet her ethical obligations in regard to the representation of her clients. These might include the following:

- transferring the lawyer's non-representational responsibilities, including managerial responsibilities, to others in the office;
- transferring case(s) to another lawyer or other lawyers whose workload will allow them to provide competent representation;[25]
- if there are no other lawyers within the office who can take over the cases from which the individual lawyer needs to withdraw, supporting the lawyer's efforts to withdraw from the representation of the client;[26] and finally,
- if the court will not allow the lawyer to withdraw from representation, providing the lawyer with whatever additional resources can be made available to assist her in continuing to represent the client(s) in a manner consistent with the Rules of Professional Conduct.

(Iowa 1996) ("ignoring a court order is simply not an appropriate step to test the validity of the order under our Code of Professional Responsibility"); Utah Bar Eth. Adv. Op. 107 (Feb. 15, 1992) (if grounds exist to decline court appointment, lawyer should not disobey order but should seek review by appeal or other available procedure).

25. *See* note 17, *supra.*

26. *See* In re Order on Prosecution of Criminal Appeals by Tenth Judicial Circuit Public Defender, 561 So.2d 1130, 1138-39 (Fla. 1990) (in context of inadequate funding, court stated that if "the backlog of cases in the public defender's office is so excessive that there is no possible way he can timely handle those cases, it is his responsibility to move the court to withdraw"); *see also* In re Order on Motions to Withdraw Filed by Tenth Circuit Public Defender, 612 So.2d 597 (Fla. App. 1992) (en banc) (public defender's office entitled to withdraw due to excessive caseload from representing defendants in one hundred forty-three cases).

When a supervised lawyer's workload is excessive and, notwithstanding any other efforts made by her supervisor to address the problem, it is obviously incumbent upon the supervisor to assign no additional cases to the lawyer, and, if the lawyer's cases come by assignment from the court, to support the lawyer's efforts to have no new cases assigned to her by the court until such time as she can adequately fulfill her ethical responsibilities to her existing clients.

In dealing with workload issues, supervisors frequently must balance competing demands for scarce resources. As Comment [2] to Rule 5.2 observes, if the question of whether a lawyer's workload is too great is "reasonably arguable," the supervisor of the lawyer has the authority to decide the question. In the final analysis, however, each client is entitled to competent and diligent representation. If a supervisor knows that a subordinate's workload renders the lawyer unable to provide competent and diligent representation and the supervisor fails to take reasonable remedial action, under Rule 5.1(c),[27] the supervisor himself is responsible for the subordinate's violation of the Rules of Professional Conduct.[28]

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27. Rule 5.1(c) states:

> (c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if: (1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or (2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

See also Rules 1.16 (a) and 8.4 (a).

28. *See, e.g.*, Attorney Grievance Comm'n of Maryland v. Ficker, 706 A.2d at 1052, *supra* note 12); Va. Legal Ethics Op. 1798 *supra* note 9 (lawyer supervisor who assigns caseload that is so large as to prevent lawyer from ethically representing clients would violate Rule 5.1); American Council of Chief Defenders, Nat'l Legal Aid and Defender Ass'n Eth. Op. 03-01 (April 2003), *available at* http://www.nlada.org/DMS/Documents/1082573112.32/ACCD%20Ethics%20opinion%20on%20Workloads.pdf (last visited June 21, 2006) ("chief executive of an agency providing public defense services is ethically prohibited from accepting a number of cases which exceeds the capacity of the agency's attorneys to provide competent, quality representation in every case…. When confronted with a prospective overloading of cases or reductions in funding or staffing which will cause the agency's attorneys to exceed such capacity, the chief executive of a public defense agency is ethically required to refuse appointment to any and all such excess cases."); Wisconsin State Bar Prof. Ethics Comm. Op. E-91-3 (1991) (assigning caseload that exceeds recognized maximum caseload standards, and that would not allow subordinate public defender to conform to rules of professional conduct, "could result in a violation of disciplinary standards"); Ariz. Op. No. 90-10 (Sept. 17, 1990) ("when a Public Defender has knowledge that subordinate lawyers, because of their caseloads, cannot comply with their duties of diligence and competence, the Public Defender must take action."); Wisconsin State Bar Prof. Ethics Comm. Op. E-84-11 (1984) (supervisors in public defender's office may not ethically increase workloads of subordinate lawyers to point where subordinate lawyer cannot, even at personal sacrifice, handle each of her clients' matters competently and in non-neglectful manner).

Conclusion

The obligations of competence, diligence, and communication under the Rules apply equally to every lawyer. All lawyers, including public defenders, have an ethical obligation to control their workloads so that every matter they undertake will be handled competently and diligently. If a lawyer's workload is such that the lawyer is unable to provide competent and diligent representation to existing or potential clients, the lawyer should not accept new clients. If the problem of an excessive workload cannot be resolved through the non-acceptance of new clients or by other available measures, the lawyer should move to withdraw as counsel in existing cases to the extent necessary to bring the workload down to a manageable level, while at all times attempting to limit the prejudice to any client from whose case the lawyer has withdrawn. If permission of a court is required to withdraw from representation and permission is refused, the lawyer's obligations under the Rules remain: the lawyer must continue with the representation while taking whatever steps are feasible to ensure that she will be able to provide competent and diligent representation to the defendant.

Supervisors, including the head of a public defender's office and those within such an office having intermediate managerial responsibilities, must make reasonable efforts to ensure that the other lawyers in the office conform to the Rules of Professional Conduct. To that end, supervisors must, working with the lawyers they supervise, monitor the workload of the subordinate lawyers to ensure that the workloads are not allowed to exceed that which may be handled by the individual lawyers. If a supervisor knows that a subordinate's workload renders the lawyer unable to provide competent and diligent representation and the supervisor fails to take reasonable remedial action, the supervisor is responsible for the subordinate's violation of the Rules of Professional Conduct.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 498 **March 10, 2021**

Virtual Practice

The ABA Model Rules of Professional Conduct permit virtual practice, which is technologically enabled law practice beyond the traditional brick-and-mortar law firm.[1] *When practicing virtually, lawyers must particularly consider ethical duties regarding competence, diligence, and communication, especially when using technology. In compliance with the duty of confidentiality, lawyers must make reasonable efforts to prevent inadvertent or unauthorized disclosures of information relating to the representation and take reasonable precautions when transmitting such information. Additionally, the duty of supervision requires that lawyers make reasonable efforts to ensure compliance by subordinate lawyers and nonlawyer assistants with the Rules of Professional Conduct, specifically regarding virtual practice policies.*

I. Introduction

As lawyers increasingly use technology to practice virtually, they must remain cognizant of their ethical responsibilities. While the ABA Model Rules of Professional Conduct permit virtual practice, the Rules provide some minimum requirements and some of the Comments suggest best practices for virtual practice, particularly in the areas of competence, confidentiality, and supervision. These requirements and best practices are discussed in this opinion, although this opinion does not address every ethical issue arising in the virtual practice context.[2]

II. Virtual Practice: Commonly Implicated Model Rules

This opinion defines and addresses virtual practice broadly, as technologically enabled law practice beyond the traditional brick-and-mortar law firm.[3] A lawyer's virtual practice often occurs when a lawyer at home or on-the-go is working from a location outside the office, but a lawyer's practice may be entirely virtual because there is no requirement in the Model Rules that a lawyer

[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2020. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling.

[2] Interstate virtual practice, for instance, also implicates Model Rule of Professional Conduct 5.5: Unauthorized Practice of Law; Multijurisdictional Practice of Law, which is not addressed by this opinion. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 495 (2020), stating that "[l]awyers may remotely practice the law of the jurisdictions in which they are licensed while physically present in a jurisdiction in which they are not admitted if the local jurisdiction has not determined that the conduct is the unlicensed or unauthorized practice of law and if they do not hold themselves out as being licensed to practice in the local jurisdiction, do not advertise or otherwise hold out as having an office in the local jurisdiction, and do not provide or offer to provide legal services in the local jurisdiction."

[3] *See generally* MODEL RULES OF PROFESSIONAL CONDUCT R. 1.0(c), defining a "firm" or "law firm" to be "a lawyer or lawyers in a partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a legal services organization on the legal department of a corporation or other organization." Further guidance on what constitutes a firm is provided in Comments [2], [3], and [4] to Rule 1.0.

have a brick-and-mortar office. Virtual practice began years ago but has accelerated recently, both because of enhanced technology (and enhanced technology usage by both clients and lawyers) and increased need. Although the ethics rules apply to both traditional and virtual law practice,[4] virtual practice commonly implicates the key ethics rules discussed below.

A. Commonly Implicated Model Rules of Professional Conduct

1. Competence, Diligence, and Communication

Model Rules 1.1, 1.3, and 1.4 address lawyers' core ethical duties of competence, diligence, and communication with their clients. Comment [8] to Model Rule 1.1 explains, "To maintain the requisite knowledge and skill [to be competent], a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject." (*Emphasis added*). Comment [1] to Rule 1.3 makes clear that lawyers must also "pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor." Whether interacting face-to-face or through technology, lawyers must "reasonably consult with the client about the means by which the client's objectives are to be accomplished; . . . keep the client reasonably informed about the status of the matter; [and] promptly comply with reasonable requests for information. "[5] Thus, lawyers should have plans in place to ensure responsibilities regarding competence, diligence, and communication are being fulfilled when practicing virtually.[6]

2. Confidentiality

Under Rule 1.6 lawyers also have a duty of confidentiality to all clients and therefore "shall not reveal information relating to the representation of a client" (absent a specific exception, informed consent, or implied authorization). A necessary corollary of this duty is that lawyers must at least "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."[7] The following non-

[4] For example, if a jurisdiction prohibits substantive communications with certain witnesses during court-related proceedings, a lawyer may not engage in such communications either face-to-face or virtually (e.g., during a trial or deposition conducted via videoconferencing). *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 3.4(c) (prohibiting lawyers from violating court rules and making no exception to the rule for virtual proceedings). Likewise, lying or stealing is no more appropriate online than it is face-to-face. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.15; MODEL RULES OF PROF'L CONDUCT R. 8.4(b)-(c).

[5] MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(2) – (4).

[6] Lawyers unexpectedly thrust into practicing virtually must have a business continuation plan to keep clients apprised of their matters and to keep moving those matters forward competently and diligently. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018) (discussing ethical obligations related to disasters). Though virtual practice is common, if for any reason a lawyer cannot fulfill the lawyer's duties of competence, diligence, and other ethical duties to a client, the lawyer must withdraw from the matter. MODEL RULES OF PROF'L CONDUCT R. 1.16. During and following the termination or withdrawal process, the "lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred." MODEL RULES OF PROF'L CONDUCT R. 1.16(d).

[7] MODEL RULES OF PROF'L CONDUCT R. 1.6(c).

exhaustive list of factors may guide the lawyer's determination of reasonable efforts to safeguard confidential information: "the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use)."[8] As ABA Formal Op. 477R notes, lawyers must employ a "fact-based analysis" to these "nonexclusive factors to guide lawyers in making a 'reasonable efforts' determination."

Similarly, lawyers must take reasonable precautions when transmitting communications that contain information related to a client's representation.[9] At all times, but especially when practicing virtually, lawyers must fully consider and implement reasonable measures to safeguard confidential information and take reasonable precautions when transmitting such information. This responsibility "does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy."[10] However, depending on the circumstances, lawyers may need to take special precautions.[11] Factors to consider to assist the lawyer in determining the reasonableness of the "expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement."[12] As ABA Formal Op. 477R summarizes, "[a] lawyer generally may transmit information relating to the representation of a client over the Internet without violating the Model Rules of Professional Conduct where the lawyer has undertaken reasonable efforts to prevent inadvertent or unauthorized access."

3. Supervision

Lawyers with managerial authority have ethical obligations to establish policies and procedures to ensure compliance with the ethics rules, and supervisory lawyers have a duty to make reasonable efforts to ensure that subordinate lawyers and nonlawyer assistants comply with the applicable Rules of Professional Conduct.[13] Practicing virtually does not change or diminish this obligation. "A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product."[14] Moreover, a lawyer must "act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent

[8] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [18].
[9] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [19].
[10] *Id.*
[11] The opinion cautions, however, that "a lawyer may be required to take special security precautions to protect against the inadvertent or unauthorized disclosure of client information when required by an agreement with the client or by law, or when the nature of the information requires a higher degree of security." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017).
[12] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [19].
[13] MODEL RULES OF PROF'L CONDUCT R. 5.1 & 5.3. *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 467 (2014) (discussing managerial and supervisory obligations in the context of prosecutorial offices). *See also* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483 n.6 (2018) (describing the organizational structures of firms as pertaining to supervision).
[14] MODEL RULES OF PROF'L CONDUCT R. 5.3 cmt. [2].

or unauthorized disclosure by the lawyer *or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision*."[15] The duty to supervise nonlawyers extends to those both within and outside of the law firm.[16]

B. Particular Virtual Practice Technologies and Considerations

Guided by the rules highlighted above, lawyers practicing virtually need to assess whether their technology, other assistance, and work environment are consistent with their ethical obligations. In light of current technological options, certain available protections and considerations apply to a wide array of devices and services. As ABA Formal Op. 477R noted, a "lawyer has a variety of options to safeguard communications including, for example, using secure internet access methods to communicate, access and store client information (such as through secure Wi-Fi, the use of a Virtual Private Network, or another secure internet portal), using unique complex passwords, changed periodically, implementing firewalls and anti-Malware/Anti-Spyware/Antivirus software on all devices upon which client confidential information is transmitted or stored, and applying all necessary security patches and updates to operational and communications software." Furthermore, "[o]ther available tools include encryption of data that is physically stored on a device and multi-factor authentication to access firm systems." To apply and expand on these protections and considerations, we address some common virtual practice issues below.

1. Hard/Software Systems

Lawyers should ensure that they have carefully reviewed the terms of service applicable to their hardware devices and software systems to assess whether confidentiality is protected.[17] To protect confidential information from unauthorized access, lawyers should be diligent in installing any security-related updates and using strong passwords, antivirus software, and encryption. When connecting over Wi-Fi, lawyers should ensure that the routers are secure and should consider using virtual private networks (VPNs). Finally, as technology inevitably evolves, lawyers should periodically assess whether their existing systems are adequate to protect confidential information.

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[15] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [18] (emphasis added).

[16] As noted in Comment [3] to Model Rule 5.3:

> When using such services outside the firm, a lawyer must make reasonable efforts to ensure that the services are provided in a manner that is compatible with the lawyer's professional obligations. The extent of this obligation will depend upon the circumstances, including the education, experience and reputation of the nonlawyer; the nature of the services involved; the terms of any arrangements concerning the protection of client information; and the legal and ethical environments of the jurisdictions in which the services will be performed, particularly with regard to confidentiality. See also Rules 1.1 (competence), 1.2 (allocation of authority), 1.4 (communication with client), 1.6 (confidentiality), 5.4(a) (professional independence of the lawyer), and 5.5(a) (unauthorized practice of law).

[17] For example, terms and conditions of service may include provisions for data-soaking software systems that collect, track, and use information. Such systems might purport to own the information, reserve the right to sell or transfer the information to third parties, or otherwise use the information contrary to lawyers' duty of confidentiality.

2. Accessing Client Files and Data

Lawyers practicing virtually (even on short notice) must have reliable access to client contact information and client records. If the access to such "files is provided through a cloud service, the lawyer should (i) choose a reputable company, and (ii) take reasonable steps to ensure that the confidentiality of client information is preserved, and that the information is readily accessible to the lawyer."[18] Lawyers must ensure that data is regularly backed up and that secure access to the backup data is readily available in the event of a data loss. In anticipation of data being lost or hacked, lawyers should have a data breach policy and a plan to communicate losses or breaches to the impacted clients.[19]

3. Virtual meeting platforms and videoconferencing

Lawyers should review the terms of service (and any updates to those terms) to ensure that using the virtual meeting or videoconferencing platform is consistent with the lawyer's ethical obligations. Access to accounts and meetings should be only through strong passwords, and the lawyer should explore whether the platform offers higher tiers of security for businesses/enterprises (over the free or consumer platform variants). Likewise, any recordings or transcripts should be secured. If the platform will be recording conversations with the client, it is inadvisable to do so without client consent, but lawyers should consult the professional conduct rules, ethics opinions, and laws of the applicable jurisdiction.[20] Lastly, any client-related meetings or information should not be overheard or seen by others in the household, office, or other remote location, or by other third parties who are not assisting with the representation,[21] to avoid jeopardizing the attorney-client privilege and violating the ethical duty of confidentiality.

4. Virtual Document and Data Exchange Platforms

In addition to the protocols noted above (e.g., reviewing the terms of service and any updates to those terms), lawyers' virtual document and data exchange platforms should ensure that

[18] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018).

[19] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483 (2018) ("Even lawyers who, (i) under Model Rule 1.6(c), make 'reasonable efforts to prevent the . . . unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client,' (ii) under Model Rule 1.1, stay abreast of changes in technology, and (iii) under Model Rules 5.1 and 5.3, properly supervise other lawyers and third-party electronic-information storage vendors, may suffer a data breach. When they do, they have a duty to notify clients of the data breach under Model Rule 1.4 in sufficient detail to keep clients 'reasonably informed' and with an explanation 'to the extent necessary to permit the client to make informed decisions regarding the representation.'").

[20] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 01-422 (2001).

[21] Pennsylvania recently highlighted the following best practices for videoconferencing security:

- Do not make meetings public;
- Require a meeting password or use other features that control the admittance of guests;
- Do not share a link to a teleconference on an unrestricted publicly available social media post;
- Provide the meeting link directly to specific people;
- Manage screensharing options. For example, many of these services allow the host to change screensharing to "Host Only;"
- Ensure users are using the updated version of remote access/meeting applications.

Pennsylvania Bar Ass'n Comm. on Legal Ethics & Prof'l Responsibility, Formal Op. 2020-300 (2020) (citing an FBI press release warning of teleconference and online classroom hacking).

documents and data are being appropriately archived for later retrieval and that the service or platform is and remains secure. For example, if the lawyer is transmitting information over email, the lawyer should consider whether the information is and needs to be encrypted (both in transit and in storage).[22]

5. Smart Speakers, Virtual Assistants, and Other Listening-Enabled Devices

Unless the technology is assisting the lawyer's law practice, the lawyer should disable the listening capability of devices or services such as smart speakers, virtual assistants, and other listening-enabled devices while communicating about client matters. Otherwise, the lawyer is exposing the client's and other sensitive information to unnecessary and unauthorized third parties and increasing the risk of hacking.

6. Supervision

The virtually practicing managerial lawyer must adopt and tailor policies and practices to ensure that all members of the firm and any internal or external assistants operate in accordance with the lawyer's ethical obligations of supervision.[23] Comment [2] to Model Rule 5.1 notes that "[s]uch policies and procedures include those designed to detect and resolve conflicts of interest, identify dates by which actions must be taken in pending matters, account for client funds and property and ensure that inexperienced lawyers are properly supervised."

a. Subordinates/Assistants

The lawyer must ensure that law firm tasks are being completed in a timely, competent, and secure manner.[24] This duty requires regular interaction and communication with, for example,

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[22] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017) (noting that "it is not always reasonable to rely on the use of unencrypted email").

[23] As ABA Formal Op. 477R noted:

> In the context of electronic communications, lawyers must establish policies and procedures, and periodically train employees, subordinates and others assisting in the delivery of legal services, in the use of reasonably secure methods of electronic communications with clients. Lawyers also must instruct and supervise on reasonable measures for access to and storage of those communications. Once processes are established, supervising lawyers must follow up to ensure these policies are being implemented and partners and lawyers with comparable managerial authority must periodically reassess and update these policies. This is no different than the other obligations for supervision of office practices and procedures to protect client information.

[24] The New York County Lawyers Association Ethics Committee recently described some aspects to include in the firm's practices and policies:

- Monitoring appropriate use of firm networks for work purposes.
- Tightening off-site work procedures to ensure that the increase in worksites does not similarly increase the entry points for a data breach.
- Monitoring adherence to firm cybersecurity procedures (e.g., not processing or transmitting work across insecure networks, and appropriate storage of client data and work product).
- Ensuring that working at home has not significantly increased the likelihood of an inadvertent disclosure through misdirection of a transmission, possibly because the lawyer or nonlawyer was distracted by a child, spouse, parent or someone working on repair or maintenance of the home.

associates, legal assistants, and paralegals. Routine communication and other interaction are also advisable to discern the health and wellness of the lawyer's team members.[25]

One particularly important subject to supervise is the firm's bring-your-own-device (BYOD) policy. If lawyers or nonlawyer assistants will be using their own devices to access, transmit, or store client-related information, the policy must ensure that security is tight (e.g., strong passwords to the device and to any routers, access through VPN, updates installed, training on phishing attempts), that any lost or stolen device may be remotely wiped, that client-related information cannot be accessed by, for example, staff members' family or others, and that client-related information will be adequately and safely archived and available for later retrieval.[26]

Similarly, all client-related information, such as files or documents, must not be visible to others by, for example, implementing a "clean desk" (and "clean screen") policy to secure documents and data when not in use. As noted above in the discussion of videoconferencing, client-related information also should not be visible or audible to others when the lawyer or nonlawyer is on a videoconference or call. In sum, all law firm employees and lawyers who have access to client information must receive appropriate oversight and training on the ethical obligations to maintain the confidentiality of such information, including when working virtually.

b. Vendors and Other Assistance

Lawyers will understandably want and may need to rely on information technology professionals, outside support staff (e.g., administrative assistants, paralegals, investigators), and vendors. The lawyer must ensure that all of these individuals or services comply with the lawyer's obligation of confidentiality and other ethical duties. When appropriate, lawyers should consider use of a confidentiality agreement,[27] and should ensure that all client-related information is secure, indexed, and readily retrievable.

7. Possible Limitations of Virtual Practice

Virtual practice and technology have limits. For example, lawyers practicing virtually must make sure that trust accounting rules, which vary significantly across states, are followed.[28] The

- Ensuring that sufficiently frequent "live" remote sessions occur between supervising attorneys and supervised attorneys to achieve effective supervision as described in [New York Rule of Professional Conduct] 5.1(c).

N.Y. County Lawyers Ass'n Comm. on Prof'l Ethics, Formal Op. 754-2020 (2020).

[25] *See* ABA MODEL REGULATORY OBJECTIVES FOR THE PROVISION OF LEGAL SERVICES para. I (2016).

[26] For example, a lawyer has an obligation to return the client's file when the client requests or when the representation ends. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.16(d). This important obligation cannot be fully discharged if important documents and data are located in staff members' personal computers or houses and are not indexed or readily retrievable by the lawyer.

[27] *See, e.g.*, Mo. Bar Informal Advisory Op. 20070008 & 20050068.

[28] *See* MODEL RULES OF PROF'L CONDUCT R. 1.15; *See, e.g.,* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018) ("Lawyers also must take reasonable steps in the event of a disaster to ensure access to funds the lawyer is holding in trust. A lawyer's obligations with respect to these funds will vary depending on the circumstances. Even before a disaster, all lawyers should consider (i) providing for another trusted signatory on trust

lawyer must still be able, to the extent the circumstances require, to write and deposit checks, make electronic transfers, and maintain full trust-accounting records while practicing virtually. Likewise, even in otherwise virtual practices, lawyers still need to make and maintain a plan to process the paper mail, to docket correspondence and communications, and to direct or redirect clients, prospective clients, or other important individuals who might attempt to contact the lawyer at the lawyer's current or previous brick-and-mortar office. If a lawyer will not be available at a physical office address, there should be signage (and/or online instructions) that the lawyer is available by appointment only and/or that the posted address is for mail deliveries only. Finally, although e-filing systems have lessened this concern, litigators must still be able to file and receive pleadings and other court documents.

III. Conclusion

The ABA Model Rules of Professional Conduct permit lawyers to conduct practice virtually, but those doing so must fully consider and comply with their applicable ethical responsibilities, including technological competence, diligence, communication, confidentiality, and supervision.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

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accounts in the event of the lawyer's unexpected death, incapacity, or prolonged unavailability and (ii) depending on the circumstances and jurisdiction, designating a successor lawyer to wind up the lawyer's practice.").

Rule 1.1: Competence

Share:



Client-Lawyer Relationship

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

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Rule 1.1 Competence - Comment

Share:



Client-Lawyer Relationship

Legal Knowledge and Skill

[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

[2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

[3] In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

[4] A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an

unrepresented person. See also Rule 6.2.

Thoroughness and Preparation

[5] Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 1.2(c).

Retaining or Contracting With Other Lawyers

[6] Before a lawyer retains or contracts with other lawyers outside the lawyer's own firm to provide or assist in the provision of legal services to a client, the lawyer should ordinarily obtain informed consent from the client and must reasonably believe that the other lawyers' services will contribute to the competent and ethical representation of the client. See also Rules 1.2 (allocation of authority), 1.4 (communication with client), 1.5(e) (fee sharing), 1.6 (confidentiality), and 5.5(a) (unauthorized practice of law). The reasonableness of the decision to retain or contract with other lawyers outside the lawyer's own firm will depend upon the circumstances, including the education, experience and reputation of the nonfirm lawyers; the nature of the services assigned to the nonfirm lawyers; and the legal protections, professional conduct rules, and ethical environments of the jurisdictions in which the services will be performed, particularly relating to confidential information.

[7] When lawyers from more than one law firm are providing legal services to the client on a particular matter, the lawyers ordinarily should consult with each other and the client about the scope of their respective representations and the allocation of responsibility among them. See Rule 1.2. When making allocations of responsibility in a matter pending before a tribunal, lawyers and parties may have additional obligations that are a matter of law beyond the scope of these Rules.

Maintaining Competence

[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.

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AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 06-441 **May 13, 2006**

Ethical Obligations of Lawyers Who Represent Indigent Criminal Defendants When Excessive Caseloads Interfere With Competent and Diligent Representation

All lawyers, including public defenders and other lawyers who, under court appointment or government contract, represent indigent persons charged with criminal offenses, must provide competent and diligent representation. If workload prevents a lawyer from providing competent and diligent representation to existing clients, she must not accept new clients. If the clients are being assigned through a court appointment system, the lawyer should request that the court not make any new appointments. Once the lawyer is representing a client, the lawyer must move to withdraw from representation if she cannot provide competent and diligent representation. If the court denies the lawyer's motion to withdraw, and any available means of appealing such ruling is unsuccessful, the lawyer must continue with the representation while taking whatever steps are feasible to ensure that she will be able to competently and diligently represent the defendant.

Lawyer supervisors, including heads of public defenders' offices and those within such offices having intermediate managerial responsibilities, must make reasonable efforts to ensure that the other lawyers in the office conform to the Rules of Professional Conduct. To that end, lawyer supervisors must, working closely with the lawyers they supervise, monitor the workload of the supervised lawyers to ensure that the workloads do not exceed a level that may be competently handled by the individual lawyers.

In this opinion,[1] we consider the ethical responsibilities of lawyers, whether employed in the capacity of public defenders or otherwise, who represent indigent persons charged with criminal offenses, when the lawyers' workloads prevent them from providing competent and diligent representa-

1. This opinion is based on the Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2003. The laws, court rules, regulations, rules of professional conduct and opinions promulgated in the individual jurisdictions are controlling.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY, 321 N. Clark Street, Chicago, Illinois 60610-4714 Telephone (312)988-5300 CHAIR: William B. Dunn, Detroit, MI □ Elizabeth Alston, Mandeville, LA □ T. Maxfield Bahner, Chattanooga, TN □ Amie L. Clifford, Columbia, SC □ Timothy J. Dacey, III, Boston, MA □ James A. Kawachika, Honolulu, HI □ Steven C. Krane, New York, NY □ John P. Ratnaswamy, Chicago, IL □ Irma Russell, Memphis, TN □ Thomas Spahn, McLean, VA □ CENTER FOR PROFESSIONAL RESPONSIBILITY: George A. Kuhlman, Ethics Counsel; Eileen B. Libby, Associate Ethics Counsel

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tion to all their clients. Excessive workloads present issues for both those who represent indigent defendants and the lawyers who supervise them.[2]

Ethical responsibilities of a public defender[3] in regard to individual workload

Persons charged with crimes have a constitutional right to the effective assistance of counsel.[4] Generally, if a person charged with a crime is unable to afford a lawyer, he is constitutionally entitled to have a lawyer appointed to represent him.[5] The states have attempted to satisfy this constitutional mandate through various methods, such as establishment of public defender, court appointment, and contract systems.[6] Because these systems have been created to provide representation for a virtually unlimited number of indigent criminal defendants, the lawyers employed to provide representation generally are limited in their ability to control the number of clients they are assigned. Measures have been adopted in some jurisdictions in attempts to control workloads,[7] including the establishment of procedures for assigning cases to lawyers outside public defenders' offices when the cases could not properly be directed to a public defender, either because of a conflict of interest or for other reasons.

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2. For additional discussion of the problems presented by excessive caseloads for public defenders, *see* "Gideon's Broken Promise: American's Continuing Quest For Equal Justice," prepared by the American Bar Association's Standing Committee on Legal Aid and Indigent Defendants 29 (ABA 2004), *available at* http://www.abanet.org/legalservices/sclaid/defender/brokenpromise/fullreport.pdf (last visited June 21, 2006).

3. The term "public defender" as used here means both a lawyer employed in a public defender's office and any other lawyer who represents, pursuant to court appointment or government contract, indigent persons charged with criminal offenses.

4. U.S. CONST. amends. VI & XIV.

5. The United States Supreme Court has interpreted the Sixth Amendment to require the appointment of counsel in any state and federal criminal prosecution that, regardless of whether for a misdemeanor or felony, leads or may lead to imprisonment for any period of time. *See generally,* Alabama v. Shelton, 535 U.S. 654, 662 (2002); Strickland v. Washington, 466 U.S. 668, 684-86 (1984); Scott v. Illinois, 440 U.S. 367, 373-74 (1979); Argersinger v. Hamlin, 407 U.S. 25, 30-31 (1972); Gideon v. Wainwright, 372 U.S. 335, 342-45 (1963); Johnson v. Zerbst, 304 U.S. 458. 462-63 (1938).

6. Most states deliver indigent defense services using a public defender's office (eighteen states) or a combination of public defender, assigned counsel, and contract defender (another twenty-nine states), according to the Spangenberg Group, which developed a report on behalf of the ABA Standing Committee on Legal Aid and Indigent Defendants. *See* The Spangenberg Group, "Statewide Indigent Defense Systems: 2005," *available at* http://www.abanet.org/legalservices/downloads/sclaid/indigentdefense/statewideinddefsystems2005.pdf (last visited June 21, 2006).

7. *See generally*, National Symposium on Indigent Defense 2000, *Redefining Leadership for Equal Justice, A Conference Report* (U.S. Dep't of Justice, Bureau of Justice Assistance, Wash. D.C.) 3 (June 29-30, 2000), *available at* http://www.ojp.usdoj.gov/indigentdefense/symposium.pdf (last visited June 21, 2006) (common problem in indigent defense delivery systems is that "lawyers often have unmanageable caseloads (700 or more in a year")).

Model Rules of Professional Conduct 1.1, 1.2(a), 1.3, and 1.4 require lawyers to provide competent representation, abide by certain client decisions, exercise diligence, and communicate with the client concerning the subject of representation.[8] These obligations include, but are not limited to, the responsibilities to keep abreast of changes in the law; adequately investigate, analyze, and prepare cases; act promptly on behalf of clients; communicate effectively on behalf of and with clients; control workload so each matter can be handled competently; and, if a lawyer is not experienced with or knowledgeable about a specific area of the law, either associate with counsel who is knowledgeable in the area or educate herself about the area. The Rules provide no exception for lawyers who represent indigent persons charged with crimes.[9]

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8. Rule 1.1(a) provides that "[a] lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."
Rule 1.2(a) states:

> [A] lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

Rule 1.3 states that "[a] lawyer shall act with reasonable diligence and promptness in representing a client."
Rule 1.4(a) and (b) states:

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

9. *See* ABA Formal Opinion Op. 347 (Dec. 1, 1981) (Ethical Obligations of Lawyers to Clients of Legal Services Offices When Those Offices Lose Funding), in FORMAL AND INFORMAL ETHICS OPINIONS, FORMAL OPINIONS 316-348, INFORMAL OPINIONS 1285-1495 at 139 (ABA 1985) (duties owed to existing clients include duty of adequate preparation and a duty of competent representation); ABA Informal Op. 1359 (June 4, 1976) (Use of Waiting Lists or Priorities by Legal Service Officer), *id*. at 237 (same); ABA Informal Op. 1428 (Sept. 12, 1979) (Lawyer-Client Relationship Between the Individual and Legal Services Office: Duty of Office Toward Client When Attorney Representing Him (Her) Leaves the Office and Withdraws from the Case), *id*. at 326 (all lawyers, including legal services lawyers, are subject to mandatory duties owed by lawyers to existing clients, including duty of adequate preparation

Comment 2 to Rule 1.3 states that a lawyer's workload "must be controlled so that each matter may be handled competently."[10] The Rules do not prescribe a formula to be used in determining whether a particular workload is excessive. National standards as to numerical caseload limits have been cited by the American Bar Association.[11] Although such standards may be considered, they are not the sole factor in determining if a workload is excessive. Such a determination depends not only on the number of cases, but also on such factors as case complexity, the availability of support services, the lawyer's experience and ability, and the lawyer's nonrepresentational duties.[12] If a lawyer believes that her workload is such that she is unable to meet the basic ethical obligations required of her in the representation of a client, she must not continue the representation of that client or, if representation has not yet begun, she must decline the representation.[13]

A lawyer's primary ethical duty is owed to existing clients.[14] Therefore, a

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and competent representation). *See also* South Carolina Bar Ethics Adv. Op. 04-12 (Nov. 12, 2004) (all lawyers, including public defenders, have ethical obligation not to undertake caseload that leads to violation of professional conduct rules).

The applicability of Rules 1.1, 1.3, and 1.4 to public defenders and/or prosecutors has been recognized by ethics advisory committees in at least one other state. *See* Va. Legal Eth. Op. 1798 (Aug. 3, 2004) (duties of competence and diligence contained within rules of professional conduct apply equally to all lawyers, including prosecutors).

10. Principle 5 of *The Ten Principles of a Public Defense Delivery System* specifically addresses the workload of criminal defense lawyers:

> *Defense counsel's workload is controlled to permit the rendering of quality representation.* Counsel's workload, including appointed and other work, should never be so large as to interfere with the rendering of quality representation or lead to the breach of ethical obligations, and counsel is obligated to decline appointments above such levels. National caseload standards should in no event be exceeded, but the concept of workload (i.e., caseload adjusted by factors such as case complexity, support services, and an attorney's nonrepresentational duties) is a more accurate measurement.

Report to the ABA House of Delegates No. 107 (adopted Feb. 5, 2002), *available at* http://www.abanet.org/legalservices/downloads/sclaid/10principles.pdf (last visited June 21, 2006) (emphasis in original).

11. *Id.*

12. *Id*. *See also* Attorney Grievance Comm'n of Maryland v. Ficker, 706 A.2d 1045, 1051-52 (1998) (supervising lawyer violated Rule 5.1 by assigning too many cases to supervised lawyer, assigning cases day before trial, and assigning cases too complex for supervised lawyer's level of experience and ability).

13. Rule 1.16(a) states that "a lawyer shall not represent a client or, where representation has begun, shall withdraw from the representation of a client if the representation will result in violation of the Model Rules of Professional Conduct or other law."

14. *See* ABA Formal Opinion Op. 96-399 (Jan. 18, 1996) (Ethical Obligations of Lawyers Whose Employers Receive Funds from the Legal Services Corporation to their Existing and Future Clients When Such Funding is Reduced and When Remaining Funding is Subject to Restrictive Conditions), in FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 369 (ABA 2000); ABA Formal Opinion Op. 347, *supra* note 9.

lawyer must decline to accept new cases, rather than withdraw from existing cases, if the acceptance of a new case will result in her workload becoming excessive. When an existing workload does become excessive, the lawyer must reduce it to the extent that what remains to be done can be handled in full compliance with the Rules.

When a lawyer receives appointments directly from the court rather than as a member of a public defender's office or law firm that receives the appointment, she should take appropriate action if she believes that her workload will become, or already is, excessive. Such action may include the following:

- requesting that the court refrain from assigning the lawyer any new cases until such time as the lawyer's existing caseload has been reduced to a level that she is able to accept new cases and provide competent legal representation; and
- if the excessive workload cannot be resolved simply through the court's not assigning new cases, the lawyer should file a motion with the trial court requesting permission to withdraw from a sufficient number of cases to allow the provision of competent and diligent representation to the remaining clients.[15]

If the lawyer has sought court permission to withdraw from the representation and that permission has been denied, the lawyer must take all feasible steps to assure that the client receives competent representation.

When a lawyer receives appointments as a member of a public defender's office or law firm, the appropriate action to be taken by the lawyer to reduce an excessive workload might include, with approval of the lawyer's supervisor:

- transferring non-representational responsibilities within the office, including managerial responsibilities, to others;
- refusing new cases;[16] and
- transferring current case(s) to another lawyer whose workload will allow for the transfer of the case(s).[17]

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15. Whenever a lawyer seeks to withdraw from a representation the client should be notified, even if court rules do not require such notification. *See* Rule 1.4.

16. It should be noted that a public defender's attempt to avoid appointment or to withdraw from a case must be based on valid legal grounds. Rule 6.2(a) provides, in pertinent part, that "[a] lawyer *shall not seek to avoid* appointment by a tribunal to represent a person *except for good cause*, such as representing the client is likely to result in violation of the Rules of Professional Conduct or other law." (Emphasis added). Therefore, a public defender should not claim an excessive workload in an attempt to avoid new cases or to withdraw from current cases unless good cause objectively exists.

17. It is important to note that, for purposes of the Model Rules, a public defender's office, much like a legal services office, is considered to be the equivalent of a law firm. *See* Rule 1.0(c). Unless a court specifically names an individual lawyer within a public defender's office to represent an indigent defendant, the public defender's office should be considered as a firm assigned to represent the client; responsibility for handling the case falls upon the office as a whole. *See* ABA Informal Op. 1428, *supra* note 9 (legal services agency should be considered firm retained by client; responsibility for handling caseload of departing legal services lawyer falls upon office as whole rather than upon lawyer who is departing). Therefore, cases may ethically be reassigned within a public defender's office.

If the supervisor fails to provide appropriate assistance or relief, the lawyer should continue to advance up the chain of command within the office until either relief is obtained or the lawyer has reached and requested assistance or relief from the head of the public defender's office.

In presenting these options, the Committee recognizes that whether a public defender's workload is excessive often is a difficult judgment requiring evaluation of factors such as the complexity of the lawyer's cases and other factors.[18] When a public defender consults her supervisor and the supervisor makes a conscientious effort to deal with workload issues, the supervisor's resolution ordinarily will constitute a "reasonable resolution of an arguable question of professional duty" as discussed in Rule 5.2(b).[19] In those cases where the supervisor's resolution is not reasonable, however, the public defender must take further action.[20]

Such further action might include:

- if relief is not obtained from the head of the public defender's office, appealing to the governing board, if any, of the public defender's office;[21] and
- if the lawyer is still not able to obtain relief, [22] filing a motion with the trial court requesting permission to withdraw from a sufficient number of cases to allow the provision of competent and diligent representation to the remaining clients.[23]

If the public defender is not allowed to withdraw from representation, she must obey the court's order while taking all steps reasonably feasible to insure that her client receives competent and diligent representation.[24]

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18. *See* note 12, *supra*, and accompanying text.

19. *See* Comment [2].

20. *See, e.g.*, Atty. Grievance Comm'n of Maryland v. Kahn, 431 A.2d 1336, 1352 (1981) ("Obviously, the high ethical standards and professional obligations of an attorney may never be breached because an attorney's employer may direct such a course of action on pain of dismissal. ")

21. *See* Michigan Bar Committee on Prof. & Jud. Eth. Op. RI-252 (Mar. 1, 1996) (in context of civil legal services agency, if subordinate lawyer receives no relief from excessive workload from lawyer supervisor, she should, under Rule 1.13(b) and (c), take the matter to legal services board for resolution).

22. Rule 5.2 makes clear that subordinate lawyers are not insulated from violating the Rules of Professional Conduct and suffering the consequences merely because they acted in accordance with a supervisory lawyer's advice or direction unless it was in regard to "an arguable question of professional duty."

23. A public defender filing a motion to withdraw under these circumstances should provide the court with information necessary to justify the withdrawal, while being mindful of the obligations not to disclose confidential information or information as to strategy or other matters that may prejudice the client. *See* Rule 1.16 cmt. 3.

24. Notwithstanding the lawyer's duty in this circumstance to continue in the representation and to make every attempt to render the client competent representation, the lawyer nevertheless may pursue any available means of review of the court's order. *See* Iowa Supreme Court Bd. of Prof. Ethics & Conduct v. Hughes, 557 N.W.2d 890, 894

Ethical responsibility of a lawyer who supervises a public defender

Rule 5.1 provides that lawyers who have managerial authority, including those with intermediate managerial responsibilities, over the professional work of a firm or public sector legal agency or department shall make reasonable efforts to ensure that the other lawyers in the agency or department conform to the Rules of Professional Conduct. Rule 5.1 requires that lawyers having direct supervisory authority take reasonable steps to ensure that lawyers in the office they supervise are acting diligently in regard to all legal matters entrusted to them, communicating appropriately with the clients on whose cases they are working, and providing competent representation to their clients. As an essential first step, the supervisor must monitor the workloads of subordinate lawyers to ensure that the workload of each lawyer is appropriate. This involves consideration of the type and complexity of cases being handled by each lawyer; the experience and ability of each lawyer; the resources available to support her, and any non-representational responsibilities assigned to the subordinate lawyers.

If any subordinate lawyer's workload is found to be excessive, the supervisor should take whatever additional steps are necessary to ensure that the subordinate lawyer is able to meet her ethical obligations in regard to the representation of her clients. These might include the following:

- transferring the lawyer's non-representational responsibilities, including managerial responsibilities, to others in the office;
- transferring case(s) to another lawyer or other lawyers whose workload will allow them to provide competent representation;[25]
- if there are no other lawyers within the office who can take over the cases from which the individual lawyer needs to withdraw, supporting the lawyer's efforts to withdraw from the representation of the client;[26] and finally,
- if the court will not allow the lawyer to withdraw from representation, providing the lawyer with whatever additional resources can be made available to assist her in continuing to represent the client(s) in a manner consistent with the Rules of Professional Conduct.

(Iowa 1996) ("ignoring a court order is simply not an appropriate step to test the validity of the order under our Code of Professional Responsibility"); Utah Bar Eth. Adv. Op. 107 (Feb. 15, 1992) (if grounds exist to decline court appointment, lawyer should not disobey order but should seek review by appeal or other available procedure).

25. *See* note 17, *supra.*

26. *See* In re Order on Prosecution of Criminal Appeals by Tenth Judicial Circuit Public Defender, 561 So.2d 1130, 1138-39 (Fla. 1990) (in context of inadequate funding, court stated that if "the backlog of cases in the public defender's office is so excessive that there is no possible way he can timely handle those cases, it is his responsibility to move the court to withdraw"); *see also* In re Order on Motions to Withdraw Filed by Tenth Circuit Public Defender, 612 So.2d 597 (Fla. App. 1992) (en banc) (public defender's office entitled to withdraw due to excessive caseload from representing defendants in one hundred forty-three cases).

When a supervised lawyer's workload is excessive and, notwithstanding any other efforts made by her supervisor to address the problem, it is obviously incumbent upon the supervisor to assign no additional cases to the lawyer, and, if the lawyer's cases come by assignment from the court, to support the lawyer's efforts to have no new cases assigned to her by the court until such time as she can adequately fulfill her ethical responsibilities to her existing clients.

In dealing with workload issues, supervisors frequently must balance competing demands for scarce resources. As Comment [2] to Rule 5.2 observes, if the question of whether a lawyer's workload is too great is "reasonably arguable," the supervisor of the lawyer has the authority to decide the question. In the final analysis, however, each client is entitled to competent and diligent representation. If a supervisor knows that a subordinate's workload renders the lawyer unable to provide competent and diligent representation and the supervisor fails to take reasonable remedial action, under Rule 5.1(c),[27] the supervisor himself is responsible for the subordinate's violation of the Rules of Professional Conduct.[28]

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27. Rule 5.1(c) states:

> (c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if: (1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or (2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

See also Rules 1.16 (a) and 8.4 (a).

28. *See, e.g.*, Attorney Grievance Comm'n of Maryland v. Ficker, 706 A.2d at 1052, *supra* note 12); Va. Legal Ethics Op. 1798 *supra* note 9 (lawyer supervisor who assigns caseload that is so large as to prevent lawyer from ethically representing clients would violate Rule 5.1); American Council of Chief Defenders, Nat'l Legal Aid and Defender Ass'n Eth. Op. 03-01 (April 2003), *available at* http://www.nlada.org/DMS/Documents/1082573112.32/ACCD%20Ethics%20opinion%20on%20Workloads.pdf (last visited June 21, 2006) ("chief executive of an agency providing public defense services is ethically prohibited from accepting a number of cases which exceeds the capacity of the agency's attorneys to provide competent, quality representation in every case…. When confronted with a prospective overloading of cases or reductions in funding or staffing which will cause the agency's attorneys to exceed such capacity, the chief executive of a public defense agency is ethically required to refuse appointment to any and all such excess cases."); Wisconsin State Bar Prof. Ethics Comm. Op. E-91-3 (1991) (assigning caseload that exceeds recognized maximum caseload standards, and that would not allow subordinate public defender to conform to rules of professional conduct, "could result in a violation of disciplinary standards"); Ariz. Op. No. 90-10 (Sept. 17, 1990) ("when a Public Defender has knowledge that subordinate lawyers, because of their caseloads, cannot comply with their duties of diligence and competence, the Public Defender must take action."); Wisconsin State Bar Prof. Ethics Comm. Op. E-84-11 (1984) (supervisors in public defender's office may not ethically increase workloads of subordinate lawyers to point where subordinate lawyer cannot, even at personal sacrifice, handle each of her clients' matters competently and in non-neglectful manner).

Conclusion

The obligations of competence, diligence, and communication under the Rules apply equally to every lawyer. All lawyers, including public defenders, have an ethical obligation to control their workloads so that every matter they undertake will be handled competently and diligently. If a lawyer's workload is such that the lawyer is unable to provide competent and diligent representation to existing or potential clients, the lawyer should not accept new clients. If the problem of an excessive workload cannot be resolved through the non-acceptance of new clients or by other available measures, the lawyer should move to withdraw as counsel in existing cases to the extent necessary to bring the workload down to a manageable level, while at all times attempting to limit the prejudice to any client from whose case the lawyer has withdrawn. If permission of a court is required to withdraw from representation and permission is refused, the lawyer's obligations under the Rules remain: the lawyer must continue with the representation while taking whatever steps are feasible to ensure that she will be able to provide competent and diligent representation to the defendant.

Supervisors, including the head of a public defender's office and those within such an office having intermediate managerial responsibilities, must make reasonable efforts to ensure that the other lawyers in the office conform to the Rules of Professional Conduct. To that end, supervisors must, working with the lawyers they supervise, monitor the workload of the subordinate lawyers to ensure that the workloads are not allowed to exceed that which may be handled by the individual lawyers. If a supervisor knows that a subordinate's workload renders the lawyer unable to provide competent and diligent representation and the supervisor fails to take reasonable remedial action, the supervisor is responsible for the subordinate's violation of the Rules of Professional Conduct.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 498 **March 10, 2021**

Virtual Practice

The ABA Model Rules of Professional Conduct permit virtual practice, which is technologically enabled law practice beyond the traditional brick-and-mortar law firm.[1] *When practicing virtually, lawyers must particularly consider ethical duties regarding competence, diligence, and communication, especially when using technology. In compliance with the duty of confidentiality, lawyers must make reasonable efforts to prevent inadvertent or unauthorized disclosures of information relating to the representation and take reasonable precautions when transmitting such information. Additionally, the duty of supervision requires that lawyers make reasonable efforts to ensure compliance by subordinate lawyers and nonlawyer assistants with the Rules of Professional Conduct, specifically regarding virtual practice policies.*

I. Introduction

As lawyers increasingly use technology to practice virtually, they must remain cognizant of their ethical responsibilities. While the ABA Model Rules of Professional Conduct permit virtual practice, the Rules provide some minimum requirements and some of the Comments suggest best practices for virtual practice, particularly in the areas of competence, confidentiality, and supervision. These requirements and best practices are discussed in this opinion, although this opinion does not address every ethical issue arising in the virtual practice context.[2]

II. Virtual Practice: Commonly Implicated Model Rules

This opinion defines and addresses virtual practice broadly, as technologically enabled law practice beyond the traditional brick-and-mortar law firm.[3] A lawyer's virtual practice often occurs when a lawyer at home or on-the-go is working from a location outside the office, but a lawyer's practice may be entirely virtual because there is no requirement in the Model Rules that a lawyer

[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2020. The laws, court rules, regulations, rules of professional conduct, and opinions promulgated in individual jurisdictions are controlling.

[2] Interstate virtual practice, for instance, also implicates Model Rule of Professional Conduct 5.5: Unauthorized Practice of Law; Multijurisdictional Practice of Law, which is not addressed by this opinion. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 495 (2020), stating that "[l]awyers may remotely practice the law of the jurisdictions in which they are licensed while physically present in a jurisdiction in which they are not admitted if the local jurisdiction has not determined that the conduct is the unlicensed or unauthorized practice of law and if they do not hold themselves out as being licensed to practice in the local jurisdiction, do not advertise or otherwise hold out as having an office in the local jurisdiction, and do not provide or offer to provide legal services in the local jurisdiction."

[3] *See generally* MODEL RULES OF PROFESSIONAL CONDUCT R. 1.0(c), defining a "firm" or "law firm" to be "a lawyer or lawyers in a partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a legal services organization on the legal department of a corporation or other organization." Further guidance on what constitutes a firm is provided in Comments [2], [3], and [4] to Rule 1.0.

have a brick-and-mortar office. Virtual practice began years ago but has accelerated recently, both because of enhanced technology (and enhanced technology usage by both clients and lawyers) and increased need. Although the ethics rules apply to both traditional and virtual law practice,[4] virtual practice commonly implicates the key ethics rules discussed below.

A. Commonly Implicated Model Rules of Professional Conduct

1. Competence, Diligence, and Communication

Model Rules 1.1, 1.3, and 1.4 address lawyers' core ethical duties of competence, diligence, and communication with their clients. Comment [8] to Model Rule 1.1 explains, "To maintain the requisite knowledge and skill [to be competent], a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject." (*Emphasis added*). Comment [1] to Rule 1.3 makes clear that lawyers must also "pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor." Whether interacting face-to-face or through technology, lawyers must "reasonably consult with the client about the means by which the client's objectives are to be accomplished; . . . keep the client reasonably informed about the status of the matter; [and] promptly comply with reasonable requests for information. "[5] Thus, lawyers should have plans in place to ensure responsibilities regarding competence, diligence, and communication are being fulfilled when practicing virtually.[6]

2. Confidentiality

Under Rule 1.6 lawyers also have a duty of confidentiality to all clients and therefore "shall not reveal information relating to the representation of a client" (absent a specific exception, informed consent, or implied authorization). A necessary corollary of this duty is that lawyers must at least "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."[7] The following non-

[4] For example, if a jurisdiction prohibits substantive communications with certain witnesses during court-related proceedings, a lawyer may not engage in such communications either face-to-face or virtually (e.g., during a trial or deposition conducted via videoconferencing). *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 3.4(c) (prohibiting lawyers from violating court rules and making no exception to the rule for virtual proceedings). Likewise, lying or stealing is no more appropriate online than it is face-to-face. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.15; MODEL RULES OF PROF'L CONDUCT R. 8.4(b)-(c).

[5] MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(2) – (4).

[6] Lawyers unexpectedly thrust into practicing virtually must have a business continuation plan to keep clients apprised of their matters and to keep moving those matters forward competently and diligently. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018) (discussing ethical obligations related to disasters). Though virtual practice is common, if for any reason a lawyer cannot fulfill the lawyer's duties of competence, diligence, and other ethical duties to a client, the lawyer must withdraw from the matter. MODEL RULES OF PROF'L CONDUCT R. 1.16. During and following the termination or withdrawal process, the "lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred." MODEL RULES OF PROF'L CONDUCT R. 1.16(d).

[7] MODEL RULES OF PROF'L CONDUCT R. 1.6(c).

exhaustive list of factors may guide the lawyer's determination of reasonable efforts to safeguard confidential information: "the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use)."[8] As ABA Formal Op. 477R notes, lawyers must employ a "fact-based analysis" to these "nonexclusive factors to guide lawyers in making a 'reasonable efforts' determination."

Similarly, lawyers must take reasonable precautions when transmitting communications that contain information related to a client's representation.[9] At all times, but especially when practicing virtually, lawyers must fully consider and implement reasonable measures to safeguard confidential information and take reasonable precautions when transmitting such information. This responsibility "does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy."[10] However, depending on the circumstances, lawyers may need to take special precautions.[11] Factors to consider to assist the lawyer in determining the reasonableness of the "expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement."[12] As ABA Formal Op. 477R summarizes, "[a] lawyer generally may transmit information relating to the representation of a client over the Internet without violating the Model Rules of Professional Conduct where the lawyer has undertaken reasonable efforts to prevent inadvertent or unauthorized access."

3. Supervision

Lawyers with managerial authority have ethical obligations to establish policies and procedures to ensure compliance with the ethics rules, and supervisory lawyers have a duty to make reasonable efforts to ensure that subordinate lawyers and nonlawyer assistants comply with the applicable Rules of Professional Conduct.[13] Practicing virtually does not change or diminish this obligation. "A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product."[14] Moreover, a lawyer must "act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent

[8] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [18].
[9] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [19].
[10] *Id.*
[11] The opinion cautions, however, that "a lawyer may be required to take special security precautions to protect against the inadvertent or unauthorized disclosure of client information when required by an agreement with the client or by law, or when the nature of the information requires a higher degree of security." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017).
[12] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [19].
[13] MODEL RULES OF PROF'L CONDUCT R. 5.1 & 5.3. *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 467 (2014) (discussing managerial and supervisory obligations in the context of prosecutorial offices). *See also* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483 n.6 (2018) (describing the organizational structures of firms as pertaining to supervision).
[14] MODEL RULES OF PROF'L CONDUCT R. 5.3 cmt. [2].

or unauthorized disclosure by the lawyer *or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision*."[15] The duty to supervise nonlawyers extends to those both within and outside of the law firm.[16]

B. Particular Virtual Practice Technologies and Considerations

Guided by the rules highlighted above, lawyers practicing virtually need to assess whether their technology, other assistance, and work environment are consistent with their ethical obligations. In light of current technological options, certain available protections and considerations apply to a wide array of devices and services. As ABA Formal Op. 477R noted, a "lawyer has a variety of options to safeguard communications including, for example, using secure internet access methods to communicate, access and store client information (such as through secure Wi-Fi, the use of a Virtual Private Network, or another secure internet portal), using unique complex passwords, changed periodically, implementing firewalls and anti-Malware/Anti-Spyware/Antivirus software on all devices upon which client confidential information is transmitted or stored, and applying all necessary security patches and updates to operational and communications software." Furthermore, "[o]ther available tools include encryption of data that is physically stored on a device and multi-factor authentication to access firm systems." To apply and expand on these protections and considerations, we address some common virtual practice issues below.

1. Hard/Software Systems

Lawyers should ensure that they have carefully reviewed the terms of service applicable to their hardware devices and software systems to assess whether confidentiality is protected.[17] To protect confidential information from unauthorized access, lawyers should be diligent in installing any security-related updates and using strong passwords, antivirus software, and encryption. When connecting over Wi-Fi, lawyers should ensure that the routers are secure and should consider using virtual private networks (VPNs). Finally, as technology inevitably evolves, lawyers should periodically assess whether their existing systems are adequate to protect confidential information.

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[15] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [18] (emphasis added).

[16] As noted in Comment [3] to Model Rule 5.3:

> When using such services outside the firm, a lawyer must make reasonable efforts to ensure that the services are provided in a manner that is compatible with the lawyer's professional obligations. The extent of this obligation will depend upon the circumstances, including the education, experience and reputation of the nonlawyer; the nature of the services involved; the terms of any arrangements concerning the protection of client information; and the legal and ethical environments of the jurisdictions in which the services will be performed, particularly with regard to confidentiality. See also Rules 1.1 (competence), 1.2 (allocation of authority), 1.4 (communication with client), 1.6 (confidentiality), 5.4(a) (professional independence of the lawyer), and 5.5(a) (unauthorized practice of law).

[17] For example, terms and conditions of service may include provisions for data-soaking software systems that collect, track, and use information. Such systems might purport to own the information, reserve the right to sell or transfer the information to third parties, or otherwise use the information contrary to lawyers' duty of confidentiality.

2. Accessing Client Files and Data

Lawyers practicing virtually (even on short notice) must have reliable access to client contact information and client records. If the access to such "files is provided through a cloud service, the lawyer should (i) choose a reputable company, and (ii) take reasonable steps to ensure that the confidentiality of client information is preserved, and that the information is readily accessible to the lawyer."[18] Lawyers must ensure that data is regularly backed up and that secure access to the backup data is readily available in the event of a data loss. In anticipation of data being lost or hacked, lawyers should have a data breach policy and a plan to communicate losses or breaches to the impacted clients.[19]

3. Virtual meeting platforms and videoconferencing

Lawyers should review the terms of service (and any updates to those terms) to ensure that using the virtual meeting or videoconferencing platform is consistent with the lawyer's ethical obligations. Access to accounts and meetings should be only through strong passwords, and the lawyer should explore whether the platform offers higher tiers of security for businesses/enterprises (over the free or consumer platform variants). Likewise, any recordings or transcripts should be secured. If the platform will be recording conversations with the client, it is inadvisable to do so without client consent, but lawyers should consult the professional conduct rules, ethics opinions, and laws of the applicable jurisdiction.[20] Lastly, any client-related meetings or information should not be overheard or seen by others in the household, office, or other remote location, or by other third parties who are not assisting with the representation,[21] to avoid jeopardizing the attorney-client privilege and violating the ethical duty of confidentiality.

4. Virtual Document and Data Exchange Platforms

In addition to the protocols noted above (e.g., reviewing the terms of service and any updates to those terms), lawyers' virtual document and data exchange platforms should ensure that

[18] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018).

[19] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483 (2018) ("Even lawyers who, (i) under Model Rule 1.6(c), make 'reasonable efforts to prevent the . . . unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client,' (ii) under Model Rule 1.1, stay abreast of changes in technology, and (iii) under Model Rules 5.1 and 5.3, properly supervise other lawyers and third-party electronic-information storage vendors, may suffer a data breach. When they do, they have a duty to notify clients of the data breach under Model Rule 1.4 in sufficient detail to keep clients 'reasonably informed' and with an explanation 'to the extent necessary to permit the client to make informed decisions regarding the representation.'").

[20] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 01-422 (2001).

[21] Pennsylvania recently highlighted the following best practices for videoconferencing security:

- Do not make meetings public;
- Require a meeting password or use other features that control the admittance of guests;
- Do not share a link to a teleconference on an unrestricted publicly available social media post;
- Provide the meeting link directly to specific people;
- Manage screensharing options. For example, many of these services allow the host to change screensharing to "Host Only;"
- Ensure users are using the updated version of remote access/meeting applications.

Pennsylvania Bar Ass'n Comm. on Legal Ethics & Prof'l Responsibility, Formal Op. 2020-300 (2020) (citing an FBI press release warning of teleconference and online classroom hacking).

documents and data are being appropriately archived for later retrieval and that the service or platform is and remains secure. For example, if the lawyer is transmitting information over email, the lawyer should consider whether the information is and needs to be encrypted (both in transit and in storage).[22]

5. Smart Speakers, Virtual Assistants, and Other Listening-Enabled Devices

Unless the technology is assisting the lawyer's law practice, the lawyer should disable the listening capability of devices or services such as smart speakers, virtual assistants, and other listening-enabled devices while communicating about client matters. Otherwise, the lawyer is exposing the client's and other sensitive information to unnecessary and unauthorized third parties and increasing the risk of hacking.

6. Supervision

The virtually practicing managerial lawyer must adopt and tailor policies and practices to ensure that all members of the firm and any internal or external assistants operate in accordance with the lawyer's ethical obligations of supervision.[23] Comment [2] to Model Rule 5.1 notes that "[s]uch policies and procedures include those designed to detect and resolve conflicts of interest, identify dates by which actions must be taken in pending matters, account for client funds and property and ensure that inexperienced lawyers are properly supervised."

a. Subordinates/Assistants

The lawyer must ensure that law firm tasks are being completed in a timely, competent, and secure manner.[24] This duty requires regular interaction and communication with, for example,

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[22] *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017) (noting that "it is not always reasonable to rely on the use of unencrypted email").

[23] As ABA Formal Op. 477R noted:

> In the context of electronic communications, lawyers must establish policies and procedures, and periodically train employees, subordinates and others assisting in the delivery of legal services, in the use of reasonably secure methods of electronic communications with clients. Lawyers also must instruct and supervise on reasonable measures for access to and storage of those communications. Once processes are established, supervising lawyers must follow up to ensure these policies are being implemented and partners and lawyers with comparable managerial authority must periodically reassess and update these policies. This is no different than the other obligations for supervision of office practices and procedures to protect client information.

[24] The New York County Lawyers Association Ethics Committee recently described some aspects to include in the firm's practices and policies:

- Monitoring appropriate use of firm networks for work purposes.
- Tightening off-site work procedures to ensure that the increase in worksites does not similarly increase the entry points for a data breach.
- Monitoring adherence to firm cybersecurity procedures (e.g., not processing or transmitting work across insecure networks, and appropriate storage of client data and work product).
- Ensuring that working at home has not significantly increased the likelihood of an inadvertent disclosure through misdirection of a transmission, possibly because the lawyer or nonlawyer was distracted by a child, spouse, parent or someone working on repair or maintenance of the home.

associates, legal assistants, and paralegals. Routine communication and other interaction are also advisable to discern the health and wellness of the lawyer's team members.[25]

One particularly important subject to supervise is the firm's bring-your-own-device (BYOD) policy. If lawyers or nonlawyer assistants will be using their own devices to access, transmit, or store client-related information, the policy must ensure that security is tight (e.g., strong passwords to the device and to any routers, access through VPN, updates installed, training on phishing attempts), that any lost or stolen device may be remotely wiped, that client-related information cannot be accessed by, for example, staff members' family or others, and that client-related information will be adequately and safely archived and available for later retrieval.[26]

Similarly, all client-related information, such as files or documents, must not be visible to others by, for example, implementing a "clean desk" (and "clean screen") policy to secure documents and data when not in use. As noted above in the discussion of videoconferencing, client-related information also should not be visible or audible to others when the lawyer or nonlawyer is on a videoconference or call. In sum, all law firm employees and lawyers who have access to client information must receive appropriate oversight and training on the ethical obligations to maintain the confidentiality of such information, including when working virtually.

b. Vendors and Other Assistance

Lawyers will understandably want and may need to rely on information technology professionals, outside support staff (e.g., administrative assistants, paralegals, investigators), and vendors. The lawyer must ensure that all of these individuals or services comply with the lawyer's obligation of confidentiality and other ethical duties. When appropriate, lawyers should consider use of a confidentiality agreement,[27] and should ensure that all client-related information is secure, indexed, and readily retrievable.

7. Possible Limitations of Virtual Practice

Virtual practice and technology have limits. For example, lawyers practicing virtually must make sure that trust accounting rules, which vary significantly across states, are followed.[28] The

- Ensuring that sufficiently frequent "live" remote sessions occur between supervising attorneys and supervised attorneys to achieve effective supervision as described in [New York Rule of Professional Conduct] 5.1(c).

N.Y. County Lawyers Ass'n Comm. on Prof'l Ethics, Formal Op. 754-2020 (2020).

[25] *See* ABA MODEL REGULATORY OBJECTIVES FOR THE PROVISION OF LEGAL SERVICES para. I (2016).

[26] For example, a lawyer has an obligation to return the client's file when the client requests or when the representation ends. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.16(d). This important obligation cannot be fully discharged if important documents and data are located in staff members' personal computers or houses and are not indexed or readily retrievable by the lawyer.

[27] *See, e.g.*, Mo. Bar Informal Advisory Op. 20070008 & 20050068.

[28] *See* MODEL RULES OF PROF'L CONDUCT R. 1.15; *See, e.g.,* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018) ("Lawyers also must take reasonable steps in the event of a disaster to ensure access to funds the lawyer is holding in trust. A lawyer's obligations with respect to these funds will vary depending on the circumstances. Even before a disaster, all lawyers should consider (i) providing for another trusted signatory on trust

lawyer must still be able, to the extent the circumstances require, to write and deposit checks, make electronic transfers, and maintain full trust-accounting records while practicing virtually. Likewise, even in otherwise virtual practices, lawyers still need to make and maintain a plan to process the paper mail, to docket correspondence and communications, and to direct or redirect clients, prospective clients, or other important individuals who might attempt to contact the lawyer at the lawyer's current or previous brick-and-mortar office. If a lawyer will not be available at a physical office address, there should be signage (and/or online instructions) that the lawyer is available by appointment only and/or that the posted address is for mail deliveries only. Finally, although e-filing systems have lessened this concern, litigators must still be able to file and receive pleadings and other court documents.

III. Conclusion

The ABA Model Rules of Professional Conduct permit lawyers to conduct practice virtually, but those doing so must fully consider and comply with their applicable ethical responsibilities, including technological competence, diligence, communication, confidentiality, and supervision.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

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accounts in the event of the lawyer's unexpected death, incapacity, or prolonged unavailability and (ii) depending on the circumstances and jurisdiction, designating a successor lawyer to wind up the lawyer's practice.").

PIABA ANNUAL MEETING

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INVESTMENT ADVISERS AND FIDUCIARY DUTY

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INTRODUCTION

The law concerning investment advisers (Investment Adviser Representatives-IAR's) and their firms (Registered Investment Adviser (RIA's)) is complex and varies from state to state when discussing state registered investment advisers (IA's—includes both IAR's and RIA's). Investment advisers are fiduciaries but the core federal statute does not use the word fiduciary. Courts on the other hand have explicitly stated that IA's are fiduciaries.

In *Transamerica Mortgage Advisors, Inc. v. Lewis*, 100 S. Ct. 242 (1979), the court explained that Section 206 of the investment Advisor Act does establish the application of a fiduciary standard to an IA:

> As we have previously recognized, Section 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers, *Santa Fe Industries, Inc. v. Green*, supra, 430 U.S., at 471, n. 11, 97 S. Ct, at 1300; *Burks v. Lasker*, 441 U.S. 471, 481-482, n. 10, 99 S. Ct. 1831, 1839,
> 60 L.Ed.2d 404; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192, 84 S. Ct. 275, 282-283, 11 L.Ed.2d 237. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations. (citations omitted).

As we gathered the materials for this session, we noticed that most (maybe not all states) define investment advisers as fiduciaries. See Exhibits 1-4 for four state administrative codes that are different in defining Investment advisers as fiduciaries. E.g., Arizona and Illinois administrative rules do not define IA's as fiduciaries but Colorado and Iowa do.

Investment Advisor Act (IAA) does not provide a private right of action by the plaintiffs against IAs.. See *Donelson v. Ameriprise Financial Services, Inc.*, 927 F.3d 499 (8th Cir. 2019) A cause of action against an IA may be brought as a breach of contract claim (to include breach of the duties of an IA if your state law includes the rules for investment advice providers as actionable)—See *Iowa Grain v. Farmers Grain and Feed Co. Inc.*, 293 N.W.2d 22, 24 (1980); or, an action for breach of fiduciary duty law in your state; or negligence using the IAA as an industry standard (there may be other causes of action but these are basic). The scope of fiduciary duties are dictated by the states. As a result, the practitioner should diligently research the law on fiduciary duty and the common law on agency (principal/agent). Your state may have approved jury instruction on fiduciary duty which state the black letter law on fiduciary duty. This paper will discuss some aspects of the IAA, state Investment Adviser Acts (or similar titles) and the legal theory of fiduciary duty. Keep in mind that since *Shearson v. McMahon*, 482 U.S. 220 (1987) the case law in securities has been limited because most cases are directed to arbitration and are not regularly subject to appellate review.

I. INVESTMENT ADVISER.

Investment advisers are governed by the Investment Adviser Act of 1940 (IAA). 15 U.S.C. Sections 80(b)-1 through 80(b)-21. The IAA resulted from the Securities and Exchange Commission's (SEC) study of securities issues as a result of the great depression and the SEC's study of 1935. (The SEC was created in

1934 as the first federal regulator of the securities markets.) The purpose of the act is for investor protection.

The IAA is supplemented by the Code of Federal Regulations (17 CFR Part 275). The states also have statutes covering state registered investment advisers and each state has administrative rules concerning IA's which include references to the IAA.

A financial professional who wishes to become an investment adviser to advise individual investors concerning investments may become an Investment Advisor Representative (IAR) under a Registered Investment Advisor (RIA) firm. An IAR must pass necessary licensing requirements (Series 65) and work within an RIA. Since what has been called the IA Switch that stemmed from Section 410 of the Dodd Frank Wall Street Reform and Consumer Protection Act, an RIA is either registered with the SEC (assets under management of over $100 million) or a state securities agency (AUM less than $100 million). RIA's and IAR's have a **fiduciary duty** to act in your **best interest** and disclose conflicts of interest and other duties.[1] The IA must file Form ADV. See 17 CFR Part 279.1 for information on the various sections of the form.

A fiduciary duty refers to the relationship between a fiduciary and a principal or beneficiary on whose behalf the fiduciary acts. Generally, a fiduciary has legal responsibility for duties of care, loyalty, disclosure, prudence, good faith, confidentiality and more to the investor. Each state defines fiduciary duty with nuances. You should complete a review of your state's investment adviser statutes and administrative regulations before filing an IA case in either arbitration or court. More on fiduciary duty in Part II.

The IAA is supplemented by the Code of Federal Regulations Title 17 Part 275. Case law provides some help but, in the securities arena, there are few cases. A fundamental purpose of the Subchapter on Investment Advisers, 80(b)-1 et. seq., was to substitute a philosophy of full disclosure for one of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, (1963). The federal statute declaring that investment advisers are the subject of national concern did not invalidate an Idaho statute on the registration of broker dealers, sellers, and investment advisers. *Kinsela v. State, Dept. of Finance,* 790 P.2d 1388 (1990). The investment adviser is defined in section 80(b)-2(11) as 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; but does not include (A) a bank…(B) any lawyer, accountant,…whose services are incidental to the practice of his profession ; (C) any broker or dealer …incidental; (D) publisher of any bona fide newspaper, …;(E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of…; (F) such

[1] In general, the primary difference between state and federal RIAs is not the nature of their fiduciary duty but rather the size of the firm and the governing body that regulates them. Advisors with less than $100 million in assets under management are generally required to register with their state securities regulator, while those with more than $100 million in assets under management must register with the SEC. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended provisions in the Investment Advisers Act of 1940 by delegating the responsibility of "Mid-sized" investment adviser to the state level —i.e., firms between $25 million and $100 million of assets under management "AUM"). Regardless of whether an advisor is state or federally registered, the core fiduciary duties remain the same: to act in the best interest of the client, to avoid or disclose conflicts of interest, and to act with the utmost care and integrity. http://www.sec.gov/files/transition-mid-sized-investment-advisers.pdf

other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order. "Person" is defined at Section 80(b)-2 (16) as a natural person or a company. (20) Defines underwriter and issuer. Section 80(b)-3 and 3a define state and federal responsibilities for registration.

Section 80(b)-4 addresses Reports by investment advisors. Section 80(b)-5 discusses Investment advisory contracts. PIABA is currently working with the SEC and others to work toward a standardized investment adviser contract.

Section 80(b)6 addresses prohibited transactions by investment advisers. CFR's supplement the IAA and provide additional information concerning prohibited transactions. See Exhibit 6.

What if the adviser is both an IAR and a broker (dual registered)? See *SEC v. Criterion Wealth Management Services Inc.*, 599 F. Supp. 3d 932, 950 (CDCA 2022) for a discussion of the issue. The decision of which role the adviser takes on will depend on the fact of what role the person was conducting at the time of the trade.

The Registration process for an investment adviser varies slightly between the state and federal levels. The choice between state and federal registration generally depends on the amount of assets the firm manages, with larger firms usually required to register with the Securities and Exchange Commission (SEC) at the federal level, while smaller firms typically register with the state securities authorities.

Federal Registration: Firms that manage over $100 million in assets usually must register with the SEC. The process includes the following steps:[2]

1. Form ADV: The primary document for registering with the SEC is Form ADV, which is filed electronically through the Investment Adviser Registration Depository (IARD), an electronic filing system for investment advisers. An SEC registered investment advisor files Form ADV Part 1A. The form includes information about the firm's business operations, the financial products it offers, its key personnel, any disciplinary events, and its fee schedules and other important disclosures.

2. Form U-4: Each investment adviser representative must also file a Form U-4, which provides personal background and registration information.

3. Policies and Procedures: The firm must also design and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws.

4. Compliance Officer: The firm must designate a chief compliance officer to administer these policies and procedures.

5. Code of Ethics: The firm must adopt a code of ethics that reflects its fiduciary duties.

6. Books and Records: The firm must maintain and preserve certain books and records.

State Registration: Firms that manage less than $100 million in assets generally must register at the state level. The process is similar to federal registration but the requirements can vary from state to state. Here's the general process:[3]

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[2] https://www.sec.gov/divisions/investment/iaregulation/regia.htm

[3] https://www.ilsos.gov/departments/securities/investment_advisers/home.html. Any person who engages in the business of financial planning or who manages $100 million or less in investments is required to register as a state-registered investment

1. Form ADV: Like with federal registration, state-registered advisers must file Form ADV. A state registered advisors files a Form ADV Part 1B which is filed electronically through the IARD for the relevant state securities authorities instead of the SEC.

2. Form U-4: Each IAR must also file a Form U-4.

3. Examinations: Most states require that IARs pass the Uniform Investment Adviser Law Examination (Series 65), or the Securities Industry Essentials (SIE) Exam, the General Securities Representative Exam (Series 7), and the Uniform Combined State Law Examination (Series 66).

4. Surety Bond: Some states require advisers to post a surety bond if they have custody of, or discretionary authority over, client funds.

5. State-Specific Requirements: Depending on the state, there may be additional requirements or exceptions. For example, some states have de minimis exemptions that allow out-of-state advisers to have a certain number of clients in the state before they must register.

Mid-sized advisers, those managing between $25 million and $100 million in assets, can in some cases register either with the SEC or their home state, depending on the laws of the state and the nature of the firm's clientele. The Investment Advisers Act of 1940 provides certain exemptions from registering with the Securities and Exchange Commission (SEC) for investment advisers. These exemptions include:[4]

1. Private Fund Adviser Exemption: Investment advisers who solely advise private funds and have assets under management (AUM) in the United States of less than $150 million may be exempt from SEC registration. Instead, they may be required to register with the state securities authorities where they operate, depending on the state's rules.

2. Venture Capital Exemption: Advisers who solely advise venture capital funds are exempt from SEC registration. To qualify for this exemption, the adviser must meet specific criteria, such as investing primarily in qualifying portfolio companies and not engaging in certain prohibited activities.

3. Foreign Private Adviser Exemption: Investment advisers that have no place of business in the United States, have fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, and have AUM attributable to U.S. clients and investors of less than $25 million are exempt from SEC registration.

4. Family Office Exemption: Family offices, which are entities providing investment advice solely to family members, certain key employees, and charitable organizations affiliated with the family, may be exempt from SEC registration. To qualify, the family office must meet specific criteria outlined in the exemption rule.

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adviser with the Illinois Securities Department. For more information, please refer to Instructions for Registration as an Investment Adviser. Application for registration as a state-registered investment adviser is initiated through the filing of Form ADV on the Investment Adviser Registration Depository (IARD).

[4] https://www.sec.gov/investment/divisionsinvestmentiaregulationmemoiahtm. A person or firm meeting the definition of investment adviser in Section 202(a)(11) does not need to register with the Commission if the person or firm qualifies for one of the exemptions from registration set forth in Section 203(b) of the Advisers Act. Investment advisers exempt from registration under Section 203(b) are still subject to certain anti-fraud provisions included in Section 206 of the Advisers Act. For more information on anti-fraud provisions, refer to the discussion below under "Anti-Fraud Provisions."

5. Charitable Organization Exemption: Investment advisers that exclusively advise charitable organizations may be exempt from SEC registration.

6. Regulatory Assets Under Management (RAUM) Threshold: Investment advisers that have AUM of less than $100 million generally must register with the state securities authorities instead of the SEC.

It's important to note that even if an investment adviser qualifies for one of these exemptions, they may still be subject to certain reporting requirements and other regulatory obligations.

As a practice matter the Form ADV may be very important to your case. See Form **ADV via the SEC's IAPD website.** The Form ADV contains information concerning the adviser and the affiliated firm. There are three major parts of the Form ADV: Part 1-basic facts about the firm (AUM…); Part 2-a narrative of the firms' services; and Part 3-Form CRS (the relationship with customer disclosure). The Form ADV is accompanied by Part 2A which contains the firm's marketing brochure. The ADV can be located at http://adviserinfo.sec.gov The SEC has information on advisers similar to a brokers CRD. Important information in the ADV includes the name of the adviser, address, owners and AUM. The IA's SEC record is titled Investment Adviser Public Disclosure (IAPD) available through the SEC's website or via FINRA broker-check which will link you to the SEC's website.

Investment advisers file Form ADV Part 1 to register with the SEC and /or the states or file certain sections of Form ADV to report as an Exempt Reporting Adviser with the SEC, and must periodically update the information on their forms. Form ADV contains information about an investment adviser and its business operations. Form ADV also contains disclosure about certain disciplinary events involving the adviser and its personnel. The data published in the Investment Adviser Information Reports are a subset of the information that is filed on Form ADV by investment adviser firms.

- The sections of Form ADV included in this report are:
- Item 1 – Identifying Information
- Item 2 – SEC Registration
- Item 3 – Form of Organization
- Item 5 – Information About Your Advisory Business
- Item 6 – Other Business Activities
- Item 7 – Financial Industry Affiliations and Private Fund Reporting
- Item 8 – Participation or Interest in Client Transactions
- Item 9 – Custody
- Item 10 – Control Persons
- Item 11 – Disclosure Information

Recall ADV Part 2A requires the firm to publish its Brochure which has marketing information about the firm. It is recommended that counsel review the brochure to become knowledgeable about what the firm says it offers to investors.

Investor Advisor's Fiduciary Duty to Prospective Clients and Implications of Misrepresentations/Material Omissions

The IAA imposes a fiduciary duty on advisors to act in the best interest of their clients. This duty is not expressly delineated in the Act itself but has been explained and affirmed by the United States Supreme Court in cases such as *SEC v. Capital Gains Research Bureau*, Inc., 375 U.S. 180 (1963). Investment advisers have antifraud liability with respect to claims by clients under section 206 of the Advisers Act, (80b-6) which, among other things, applies to transactions, practices, or courses of business which operate as a fraud or deceit upon prospective clients, including those regarding investment strategy, engaging a sub-adviser, and account type. [5]

> SEC. 206. [80b–6] It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
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> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
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> (3) 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 such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or
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> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

In order to avoid liability under this antifraud provision, an investment adviser should have sufficient information about the client and their objectives to form a reasonable basis for advice before providing any advice about securities matters. At the point in time at which the prospective client becomes a client of the investment adviser (e.g., at account opening), the fiduciary duty applies. Accordingly, while

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[5] *SEC v. Capital Gains Research Bureau*, Inc., 375 U.S. 180, 181 (1963).The action was based on 206(2) of the Investment Advisers Act (15 USC 80b-6(2)), prohibiting an investment adviser from engaging in any practice which "operates as a fraud or deceit upon any client or prospective client." The District Court denied the request for a preliminary injunction, holding that the words "fraud" and "deceit" are used in 206 in their technical sense and that the Commission had failed to show an intent to injure clients or an actual loss of money to clients.

advice to prospective clients about these matters must comply with the antifraud provisions under section 206 of the Advisers Act, the adviser must also satisfy its fiduciary duty with respect to any such advice (e.g., regarding account type) when a prospective client becomes a client.

The fiduciary duty of an investment advisor generally includes two primary components: a duty of care and a duty of loyalty. The duty of care requires the advisor to provide investment advice in the client's best interest, while the duty of loyalty requires the advisor to disclose all material facts and eliminate or disclose all conflicts of interest. The question here is whether this duty applies to prospective clients - i.e., those to whom the advisor is pitching services, but who have not yet signed an agreement or started paying advisory fees. The courts and the SEC have clearly established that fiduciary duties extend to existing clients. (See, **Exhibit 7**, Regulation of Investment Advisers by the U.S. Securities Exchange Commission, March 2013). However, the extension of these duties to prospective clients is a more nuanced issue.

I. Misrepresentations/Material Omissions and Fiduciary Duties

An investment advisor owes a duty of care to provide accurate, honest, and complete information to prospective clients. This duty begins when the advisor starts discussions with the prospective client about a potential advisory relationship. Therefore, making misrepresentations or material omissions when pitching to a prospective client can be considered a breach of this duty of care.[6]

II. Duty of Disclosure and Material Misrepresentations/Omissions

The duty of disclosure obligates the investment advisor to fully disclose all material facts related to the advisory relationship, including potential conflicts of interest. Material omissions or misrepresentations during the initial pitch to a prospective client can violate this duty of disclosure.[7]

III. Legal and Regulatory Implications

Misrepresentations or material omissions made to a prospective client are not only breaches of fiduciary duties, but they can also have serious legal and regulatory implications. Under the anti-fraud provisions of federal securities laws, making false or misleading statements in connection with the purchase or sale of securities can result in civil liability, regulatory penalties, and even criminal charges.

The law on investment advisers registered in the various states will vary. We will review the law of four states: Arizona, Illinois, Iowa and Colorado to demonstrate differences and the need to review your

[6] https://www.fiduciaryregulatory.com/portalresource/TheBraveNewWorldofFiduciaryDutyforBrokerDealersandInvestmentAdvisers : Investment Advisers Act Release No. 1174 (June 19, 1989) (investment adviser found to have defrauded its advisory clients by misrepresenting the nature of their investments, making investments which were contrary to the clients' stated investment desires, failing to disclose the risks their investments involved, and recommending investments which were unsuitable in light of its clients' assets, income and degree of sophistication).

[7] *Rocky Mountain Financial Planning*, *Inc.* (pub. avail. Mar. 28, 1983). "We do not agree that 'an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest.' While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest. The facts concerning the adviser's interest, including its level, may bear upon the reasonableness of any belief that he may have that a transaction is in a client's interest or his capacity to make such a judgment.

state law and state administrative codes prior to filing a case (in arbitration or court) against a state registered investment adviser and firm.

A. ARIZONA

The Arizona legislature created the Investment Management Act in 1994 which outlines the duties of an investment adviser. See A.R.S. sections 44-3101-3325. The Act created licensing requirements (state and federal-notice, Section 44-3151) and antifraud prohibitions against deceptive acts. (See Section 44-3241(A).) Arizona Administrative Code Sections R14-6-202-209 help define responsibilities including: 202, Supervision; 203, Dishonest and Unethical Practices; 205, Information to be furnished to clients ("brochure Rule"); and 206 Prohibited conduct.

The Arizona IMA is very broad and does NOT require a person to be a registered adviser but includes any person who commits a prohibited act in connection with a transaction involving the provision of investment-advisory services. See Slyke v. M L Investor Servs. Inc., No. CV 2009-015120, 2009 WL 7247782 (Ariz. Super. Ct. Nov. 25, 2009) (trial court order denying motion to dismiss where plaintiffs alleged that defendants "were involved in the Plaintiffs; investments").

B. IOWA

The Iowa Investment Advisor statutes are found at Iowa Code 502.403-404 which covers registration and exemptions. The definition section 502.102 defines, among other topics, (6) Federal covered investment adviser; (9) Fraud and deceit are not limited to common law deceit; (15) Investment adviser…the term includes financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation. It does not include: an investment advisor representative, lawyer, accountant …whose performance of investment advice is solely incidental to the practice of the person's profession. (16) Investment adviser representative means an individual employed by or associated with an investment adviser or federal covered investment adviser …but does not include others…Fraud and liabilities are covered by 502.501; Prohibited transactions are covered in 502.502 and by administrative rules. Finally, civil liability (damages) are covered by 502.509 and include joint and several liability which includes "control persons." Subsection 6 covers liability for investment advice.

Administrative rules are defined in Iowa Administrative Code (IAC) 191-50.38 (the 38 refers to the Iowa Code 502 Securities) and sets forth "Dishonest or unethical business practices of investment advisers and investment adviser representatives, or fraudulent or deceptive conduct by federal covered investment advisers. (See **Exhibit 2**.) Examples include unsuitable recommendations, excessive trading, borrowing or loaning money to clients (unless authorized) and more.

C. ILLINOIS

Illinois Investment Advisers are specifically subject to provisions of Section 12J of the Illinois Securities Act of 1953 and the regulations found in Section 130 of the Illinois Administrative Code.

The Illinois Securities Act of 1953 provides in Section 12J:

> Sec, 12. It shall be a violation of the provisions of this Act for any person:

J. When acting as an investment adviser, investment adviser representative, or federal covered investment adviser, by any means or instrumentality, directly or indirectly:

(1) To employ any device, scheme or artifice to defraud any client or prospective client;
(2) To engage in any transaction, practice, or course of business which operates a fraud or deceit upon any client or prospective client; or
(3) To engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative.

815 ILCS 5/12J

The regulations exclusive to Illinois Investment Advisor statutes are found in Part 130 of the Regulations Under the Illinois Securities Law of 1953. 14 Ill. Adm. Code 130 et seq. The regulations in Section 130 et seq may also include regulations related to brokers and to dealers that are also applicable to an investment adviser activity. The regulations that are exclusive applicable to investment advisers are as follows:

1. Section 130.838 through 130.841 providing for the registration of investment advisors and their offices. 14 Ill. Adm. Code 130.838 -130841;
2. Sections 130.842 through 130.843 providing for the examination and education of principals and investment adviser representatives, 14 Ill. Adm. Code 130.842 -130.843;
3. Section 130.845 providing the recording keeping requirements of investment advisers, 14 Ill Ad. Code 130.845;
4. Section 130-846 through 130.847 which provide the required disclosures of investment advisers, 14 Ill. Adm Code 130.846-130.847;
5. Section 130.848 prohibiting as a fraudulent business practice advertisement of an investment adviser that uses testimonials, past recommendations (with some exceptions), representing that a chart, formula or device can be used to determine when to purchase and sell securities, or otherwise includes untrue statements, 14 Ill Adm. Code 130.848;
6. Section 130.852 requiring compensation of investment advisers to be fair and reasonable, and disclosed in writing. Compensation based on a share of the capital gains or appreciation of a client's funds is also prohibited unless it complies with specific provisions, 14 Ill Adm. Code 130.852;
7. Section 853 prohibiting as a fraudulent, deceptive or manipulative practice the effecting or causing of transactions in a clients account that are excessive in size or frequency or unsuitable in view of the financial resources and character of the account. 14 Ill Adm. Code 130.853.; and
8. Section 130.854 and 130.855 prohibiting registered investment advisors from using or representing themselves as an "investment counsel" unless they primarily provide investment supervisory services, claiming certification under certain circumstances, 14 Ill. Adm. Code 130854-130.855.

D. COLORADO

Unlike Arizona, Colorado does not have a state counterpart to the Investment Management Act, but provisions have been incorporated into the Colorado Securities Act over time regarding investment advisers and investment adviser representatives. These include licensing requirements and exceptions (C.R.S. §11-51-401 & 402), operating requirements including custody of client assets and funds and requirements for books and records (C.R.S. § 11-51-407), mandatory disclosures to prospective clients (C.R.S. § 11-51-409.5) and antifraud provisions against deceptive acts (C.R.S. §11-51-501).

The Colorado Securities Act gives broad rule making authority to the Securities Commissioner which has used that authority to enact a comprehensive set of rules (3CCR704-1). As to investment advisers and investment adviser representatives, the IARD is designated to receive and store filings and collect related fees from investment advisers and investment adviser representatives (51-4.1(IA)). The rules set forth the application and licensing process as well as investment adviser representative continuing education requirements (51-4.2(IA)-51-4.4.1(IA)). The rules set forth detailed and comprehensive books and records requirements (51-4.6(IA)). The ADV Part 2 must be given to a prospective advisory client not less than 48 hours prior to entering into a written advisory agreement or at the time of entering into an advisory agreement if the client has the right to terminate the contract without fee or penalty within 5 business days (51-4.7(IA)).

Rule 51-4.8(IA) Dishonest and Unethical Conduct states: "[a] person who is an investment adviser, and investment adviser representative or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients." Other than acting "primarily for the benefit of its clients," the rule does not define the nature and scope of the fiduciary duty. Rather it sets forth a long multi-page laundry list of conduct and actions which are dishonest and unethical, and which would constitute a breach of the fiduciary duty. Many of the acts specified in this rule mirror rules found in the broker-dealer/registered representative context (suitability, exercising discretion without authority, trading excessive in size or frequency, borrowing money from or loaning money to a client, guaranteeing a result, and so forth). Other prohibited acts or conduct include undisclosed conflicts of interest, the use and misuse of professional designations and in particular, senior specific certifications or designations, and the charging of unreasonable fees.

II. FIDUCIARY DUTY[8]

A. Arizona

The case law in Arizona demonstrates a limitation to a fiduciary duty as shown in Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317, 335 (COA, Div. 1, Dept. A, 1996) wherein the court wrote:

Our case law distinguishes a fiduciary relationship from an arm's length relationship. *See, e.g., Brazee v. Morris,* 68 Ariz. 224, 228–29, 204 P.2d 475, 477–78 (1949); *Rhoads v. Harvey Pubs., Inc.,* 145 Ariz 142, 148–49, 700 P.2d 840, 846–47 (App.1984). Mere trust in another's competence or integrity does not suffice; "peculiar reliance in the trustworthiness of another" is required. *Stewart v. Phoenix Nat'l Bank,* 49 Ariz. 34, 44, 64 P.2d 101, 106 (1937); *Rhoads,* 145 Ariz. at 148–49, 700 P.2d 840, 846–47. A fiduciary relationship is a confidential relationship whose attributes include "great intimacy,

[8] If a defendant is an ERISA entity plaintiffs should examine 29 USC Sections 1104 and 1106. Section 1104 defines the Fiduciary Duty as the "Prudent man standard of care". In particular the ERISA fiduciary shall discharge the duties with respect to a plan (A) for the exclusive purpose of benefits and defraying expenses; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; (C) by diversifying the investments; and, (D) in accordance with plan documents. Section 1106 highlights prohibited transactions. These prohibitions are divided into (a) transactions between plan and party in interest; (b) transactions between plan and fiduciary; and (c) transfer of real or personal property by a party in interest to a plan. See **Exhibit 5**.

disclosure of secrets, [or] intrusting of power." *Rhoads,* 145 Ariz. at 149, 700 P.2d at 847 (quoting *Condos v. Felder,* 92 Ariz. 366, 371, 377 P.2d 305, 308 (1962)). In a fiduciary relationship, the fiduciary holds "superiority of position" over the beneficiary. *Id.* This superiority of position may be demonstrated in material aspects of the transaction at issue by a "substitution of [the fiduciary's] will." *Herz & Lewis, Inc. v. Union Bank,* 22 Ariz.App. 437, 439, 528 P.2d 188, 190 (1974) (quoting *In re Guardianship of Chandos,* 18 Ariz.App. 583, 585, 504 P.2d 524, 526 (1972)).

Although the existence of a fiduciary duty is generally a question of fact, "[w]hen the evidence is insufficient to support a verdict, the trial court has a duty to decide the issue." *See Gemstar Ltd. v. Ernst & Young,* 185 Ariz. 493, 504–05, 917 P.2d 222, 233–34 (1996) (quoting *Rhoads,* 145 Ariz. at 148, 700 P.2d at 846).8 We find the evidence insufficient to support a verdict in this case.

In a more recent case, the Arizona Supreme Court answered certified questions from the bankruptcy court concerning duties owed by LLC managers, members and the operating agreement but discussed the duties of a fiduciary. The Court noted:

We have characterized a fiduciary duty as imposing "the obligation of loyalty," *Ghiz v. Millett*, 71 Ariz. 4, 8, 222 P.2d 982 (1950), "the obligation of the utmost good faith in their dealings," *DeSantis v. Dixon*, 72 Ariz. 345, 350, 236 P.2d 38 (1951), and "requiring a high degree of care," *Master Records, Inc. v. Backman*, 133 Ariz. 494, 497, 652 P.2d 1017, 1020 (1982) (quotations omitted). Thus, the nature of the fiduciary relationship for agents includes a duty of loyalty, a duty of good faith, and a duty of care. Partnerships, joint ventures, and corporations are all owed fiduciary duties by those empowered to act on behalf of such businesses. *See DeSantis*, 72 Ariz. at 350, 236 P.2d 38 (describing the fiduciary nature of duties owed by partners to a partnership); *Ghiz*, 71 Ariz. at 8-9, 222 P.2d 982 (describing the fiduciary nature of those involved in a joint venture); *Monterey Water Co. v. Voorhees*, 45 Ariz. 338, 347, 43 P.2d 196 (1935) (describing the fiduciary duties owed by officers to a corporation).

B. Iowa

1. In Iowa the legal elements of fiduciary duty have a long history and those are shared with other states utilizing the Restatement (Second) of Torts, section 874. See Kurth v. Van Horn, 380 N.W.2d 693, 695 (Iowa 1986):

A fiduciary relationship has been generally defined in this way:

A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.
Restatement (Second) of Torts § 874 comment a, at 300 (1979). A fiduciary relationship has also been defined as [a] very broad term embracing both technical fiduciary relations and those informal relations which exist wherever one man trusts in or relies upon another. One founded on trust or confidence reposed by one person in the integrity and fidelity of another. A "fiduciary relation" arises whenever confidence is reposed on one side, and domination and influence result on the other; the relation can be legal, social, domestic, or merely personal. Such relationship exists when there is a reposing of faith, confidence and trust, and the placing of reliance by one upon the judgment and advice of the other. Black's Law Dictionary 564 (5th ed. 1979) (citations omitted).

Some relationships necessarily give rise to a fiduciary relationship. Such relationships would include those between an attorney and client, guardian and ward, principal and agent, executor and heir, trustee and *cestui que trust. Id.*

Some of the indicia of a fiduciary relationship include the acting of one person for another; the having and the exercising of influence over one person by another; the reposing of confidence by one person in another; the dominance of one person by another; the inequality of the parties; and the dependence of one person upon another.
First Bank of Wakeeney v. Moden, 235 Kan. 260, 262, 681 P.2d 11, 13 (1984) (*per curiam*). *See generally* 36A C.J.S. *Fiduciary,* at 386–87 (1961). Because the circumstances giving rise to a fiduciary duty are so diverse, any such relationship must be evaluated on the facts and circumstances of each individual case. Annot., 70 A.L.R.3d 1344, 1347–48 (1976).

2. The analysis dives deeper into the "duty" of a fiduciary in *Baber v. First Republic Group, LLC*, 2008 WL 2356868 when the federal judge, evaluating the Iowa fiduciary standard wrote:

> ***3. Breach of fiduciary duty***
> ***15** In **Count V** of his Second Amended Complaint, Baber alleges breach of fiduciary duty by both First Republic and Parks based on allegations that the defendants abused superior knowledge, trust, and confidence by charging, without Baber's knowledge or consent, unreasonable charges in the form of improper mark ups and mark downs to execute buy and sell orders in Baber's account. The defendants have moved for summary judgment on this claim, and Baber resists.
>
> ***a. Arguments of the parties***
> In support of their motion for summary judgment on this claim, First Republic and Parks argue that the general rule is that a securities broker does not owe a fiduciary duty to a customer in a "nondiscretionary" account relationship, *i.e.,* in an account relationship in which the broker does not have the discretion to make trades in the customer's account without the customer's direction, and that there can be no genuine issue of material fact that Baber's account was "nondiscretionary," because Baber admits that, with only one possible exception, he approved all purchases and sales in his account, and he was an experienced investor. Even supposing that they owed Baber a fiduciary duty, the defendants contend that they are aware of no authority that the fiduciary duty owed to a brokerage customer includes a duty to set commissions according to a particular schedule or judicial determination of "reasonableness."
>
> Baber counters that, under Eighth Circuit precedent, whether the account in question is discretionary or nondiscretionary is only one factor in a court's determination of whether a broker owes an investor a fiduciary duty. Moreover, he argues that fiduciary duty is a matter of state law. Although he admits that he has not found any Iowa case or statute holding that a stockbroker owes an investor a fiduciary duty, he argues that Iowa courts have imposed a fiduciary duty on comparable actors, such as real estate brokers, and that the Eighth Circuit Court of Appeals has noted that there is no significant difference between real estate brokers and securities brokers as to fiduciary duties. Even if there is no general fiduciary duty between a broker and an investor, Baber argues that the circumstances here are sufficient to create such a duty, because of the relationship of confidence and trust between himself and First Republic. More specifically, he argues that he placed his trust in Parks, he thought that Parks was a very persuasive talker, and Parks has admitted that Baber placed his trust in him; he usually followed Park's recommendations and entrusted large sums of money to Parks; and he is an aging gentleman who was influenced by Park's dominance and persuasiveness. Thus, he contends that he has generated genuine issues of material fact on this claim. In reply, the defendants contend that Baber has not identified any unusual facts in this broker investor relationship that might serve to overcome the presumption

that there was no fiduciary duty. Indeed, they contend that Baber offers nothing more than "vanilla" or "boilerplate" allegations of a fiduciary relationship. Also, in light of Baber's extensive investment experience, the defendants contend that there is no evidence that he occupied a significantly different status from other customers with nondiscretionary accounts. The defendants also contend that Baber has not demonstrated that, even if they owed him a fiduciary duty, that duty extended to such arm's-length matters as setting commissions.

" b. Analysis

***16** As this court has explained, under Iowa law, "[t]o establish a breach of fiduciary duty, the plaintiff must demonstrate the following elements: (1) the defendant owed the plaintiff a fiduciary duty; (2) the defendant breached this fiduciary duty; (3) the breach of the fiduciary duty was a proximate cause of the plaintiff's damages; and (4) the amount of damages. *Schuster v. Anderson,* 378 F.Supp.2d 1070, 1108–09 (N.D. Iowa 2005) (citing *Top of Iowa Co-op. v. Schewe,* 149 F.Supp.2d 709, 717 (N.D. Iowa 2001)). In their motion for summary judgment, the defendants challenge the existence of any fiduciary duty in this case and the existence of any evidence that there was a breach of a duty within the scope of any fiduciary duty that may have existed.

i. Existence of a fiduciary duty. The defendants contend, first, that a broker does not owe a fiduciary duty to an investor, such as Baber, who has a "nondiscretionary" account. The Eighth Circuit Court of Appeals rejected such a contention more than a decade-and-a half ago in *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 906 F.2d 1206 (8th Cir.1990). In *Davis,* the court concluded that "[w]hether an account is discretionary or nondiscretionary is only one factor [courts] examine in determining whether a securities broker owes a fiduciary duty to his or her customers." *Davis,* 906 F.2d at 1216. Thus, it is important to examine the entire broker-customer relationship, rather than merely the status of the account. *Id.* Moreover, in *Davis,* the court explained that "[t]he question of whether a fiduciary relationship exists is a question of state law." *Id.* at 1215. As this court subsequently explained, [T]he Iowa Supreme Court has defined a fiduciary duty as follows:

"A fiduciary relationship exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relationship." *Kurth v. Van Horn,* 380 N.W.2d 693, 695 (Iowa 1986) (citing Restatement (Second) of Torts § 874 cmt. a (1979)). We have also noted that a confidential relationship "exists when one person has gained the confidence of another and purports to act or advise with the other's interest in mind.... The gist of the doctrine of confidential relationship is the presence of a dominant influence under which the act is presumed to have been done. [The] [p]urpose of the doctrine is to defeat and protect betrayals of trust and abuses of confidence." *Hoffmann v. Nat'l Med. Enters., Inc.,* 442 N.W.2d 123, 125 (Iowa 1989) (quoting *Oehler v. Hoffman,* 253 Iowa 631, 113 N.W.2d 254, 256 (1962))....

.... [W]e are cognizant of the fact that "[b]ecause the circumstances giving rise to a fiduciary duty are so diverse, any such relationship must be evaluated on the facts and circumstances of each individual case." *Kurth,* 380 N.W.2d at 696.

Oeltjenbrun v. CSA Investors, Inc., 3 F.Supp.2d 1024, 1053 (N.D. Iowa 1998) (quoting *Wilson v. IBP, Inc.,* 558 N.W.2d 132, 138 (Iowa 1996), *cert. denied,* 522 U.S. 810, 118 S.Ct. 52, 139 L.Ed.2d 17 (1997)); *see also Gunderson,* 85 F.Supp.2d at 920–21 (quoting *Oeltjenbrun*);

Corcoran v. Land O'Lakes, Inc., 39 F.Supp.2d 1139, 1154 (N.D. Iowa 1999) (quoting *Oeltjenbrun*). These sentiments are echoed in the Iowa Model Civil Jury Instructions, which direct that ***17** ... a fiduciary relationship is a relationship of trust and confidence on a subject between two persons. One of the persons is under a duty to act for or give advice to the other on that subject. Confidence is placed on one side, and domination and influence result on the other.

Circumstances that may give rise to the existence of a fiduciary relationship include the acting of one person for another, the having and exercising of influence over one person by another, the placing of confidence by one person in another, the dominance of one person by another, the inequality of the parties, and the dependence of one person upon another. None of these circumstances is more important than another.... Iowa Model Civil Jury Instructions 3200.2 (2002); *see also Top of Iowa Co-op.,* 149 F.Supp.2d at 718 (with regard to existence of a fiduciary relationship, instructing the jury, in part, that "[a] fiduciary relationship can therefore exist when the evidence indicates that (1) one of the parties enjoyed superior or excessive influence over the other; (2) the parties had a confidential relationship and one of the parties had greater access to facts and legal resources; or (3) there was a disparity of business experience and an invitation to the party with lesser experience to place confidence in the advice of the other party"). Ultimately, under Iowa law, the " 'circumstances giving rise to a fiduciary duty are so diverse, any such relationship must be evaluated on the facts and circumstances of the individual case.' " *Economy Roofing & Insulating Co. v. Zumaris,* 538 N.W.2d 641, 648 (Iowa 1995) (quoting *Kurth,* 380 N.W.2d at 696). *Schuster v. Anderson,* 378 F.Supp.2d 1070, 1108–09 (N.D. Iowa 2005).

In *Davis,* in which the court applied South Dakota law to a breach of fiduciary duty claim by an investor against a securities broker, the court noted that the parties had not identified any South Dakota cases or statutes deciding whether a fiduciary relationship exists between a securities broker and his or her customers, but that the South Dakota Supreme Court had held that real estate brokers owe a fiduciary duty to their clients. *Davis,* 906 F.2d at 1215. The court then reasoned as follows:

The [court in *Hurney v. Locke,* 308 N.W.2d 764 (S.D.1981),] reasoned that a fiduciary duty should be imposed on real estate agents or brokers because "[a] real estate agent is a licensed professional holding himself out as trained and experienced to render a specialized service ... Clients rely on the agent's expertise and expect the agent to act in their best interests." *Id.* [at 768] (citation omitted). Likewise, securities brokers such as Marks and Ulrich at Merrill Lynch are "licensed professional[s] holding [themselves] out as trained and experienced to render a specialized service." *Id.* Like the clients of real estate agents, securities customers "rely on the agent's expertise and expect the agent to act in their best interests." *Id.* Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers "a duty of utmost good faith, integrity and loyalty." *Id.* ***18** *Davis,* 906 F.2d at 1215. Consequently, the court in *Davis* held that the district court did not abuse its discretion in instructing the jury that a fiduciary relationship exists between licensed securities brokers and their customers. *Id.*

Similarly, Baber has pointed to decisions of the Iowa Supreme Court holding that a real estate broker owes a fiduciary duty to his customer. *See Garren v. First Realty, Ltd.,* 481 N.W.2d 335, 337 (Iowa 1992); *Menzel v. Morse,* 362 N.W.2d 465, 474 (Iowa 1985). This court, like the Eighth Circuit Court of Appeals, "see[s] no significant

difference between real estate brokers and securities brokers," so that this court also "believe[s] that if confronted with the question, the [Iowa] Supreme Court would find that securities brokers are fiduciaries that owe their customers [a fiduciary duty]." *Davis,* 906 F.2d at 1215. To put it more explicitly, there is no doubt that First Republic and Parks were under a duty to act for or to give advice for the benefit of Baber upon matters within the scope of their broker-investor relationship. *Oeltjenbrun,* 3 F.Supp.2d at 1053 (citing *Willson,* 558 N.W.2d at 138). First Republic and Parks were authorized to act on Baber's behalf to make trades in his account, even if they were only to make the trades that Baber expressly authorized; Parks had and exercised influence over Baber, and Baber placed confidence in Parks, as shown by Baber's acting on Parks's advice and Baber's observation that Parks was a "very persuasive talker"; and despite Baber's extensive investment experience, there was an inequality of the parties with regard to information about investments and how transactions were effectuated and a dependence by Baber on Parks (and First Republic) to advise him about investment choices, where Baber has testified that he had no experience with mark ups or mark downs. *Schuster,* 378 F.Supp.2d at 1108–9 (noting these indicia of a fiduciary relationship from Iowa Model Civil Jury Instructions 3200.2 and *Top of Iowa Co-op.,* 149 F.Supp.2d at 718).

In *Davis,* the Eighth Circuit Court of Appeals held that, in comparable circumstances, the district court had not erred in instructing that a fiduciary duty exists between securities brokers and their customers, rejecting the defendant broker's contention that the district court should have required the jury to make certain factual findings before finding a fiduciary relationship. 906 F.2d at 1215–17. Following *Davis,* this court finds, as a matter of law, that First Republic and Parks owed Baber a fiduciary duty. *Id.* Consequently, First Republic and Parks are not entitled to summary judgment on Baber's claim of breach of fiduciary duty in **Count V** on their first ground, that no fiduciary duty existed.

ii. Scope of the duty. In the alternative, First Republic and Parks argue that, even if they owed Baber a fiduciary duty, that duty did not extend to such arm's-length matters as setting commissions. In their reply, the defendants contend that Baber has not responded to this argument. Although the court agrees that Baber made no explicit response to this argument, it is nevertheless clear—among other things from Baber's reliance on *Davis,* 906 F.2d at 1215, which states the applicable duty— that Baber asserts that the fiduciary duty in question required the defendants to act with the utmost good faith, integrity, and loyalty, but that they breached such a duty by charging excessive and secret mark ups and mark downs in a self-serving scheme that defeated the investment objectives of his account.

As explained above, the purpose of the fiduciary duty doctrine "is to defeat and protect betrayals of trust and abuses of confidence." *Schuster,* 378 F.Supp.2d at 1108 (internal quotation marks and citations omitted). Thus, a fiduciary relationship requires the fiduciary to act for or to give advice for the benefit of the dependent party upon matters within the scope of the relationship. *Id.* More specifically, under Iowa law, a duty of loyalty is a fiduciary duty. *See Cookies Food Prods., Inc. v. Lakes Warehouse Distributing, Inc.,* 430 N.W.2d 447, 451 (Iowa 1988) (corporate fiduciary). The fiduciary must also act in the best interests of the dependent party. *See, e.g.,* IOWA CODE § 490.830(1) (fiduciary duty of a director to a corporation). A fiduciary must also avoid self-dealing that is to the detriment of the dependent party. *See, e.g.,* IOWA CODE § 633.155 (duty of fiduciary for an estate). Thus, the Iowa Supreme Court has found a breach of fiduciary duty, for example, where an attorney's conduct reflected self-dealing,

dishonesty, total willingness to compromise the interests of his client, and absolutely no remorse. *See Iowa Supreme Court Bd. of Professional Ethics and Conduct v. Remer,* 646 N.W.2d 91, 96 (Iowa 2002).

The decision of the Eighth Circuit Court of Appeals in *Davis* also presents a more specific example of the scope of the fiduciary duty owed by a broker to a customer. 906 F.2d at 1215. In *Davis,* the court upheld a verdict for an investor on a claim that her broker had breached its fiduciary duty by "churning" the customer's account, that is, directing the volume and frequency of trades for personal gain by initiating transactions that were excessive in view of the character of the account and the customer's objectives as expressed to the broker, and thereby abusing the customer's confidence. *Id.* at 1211 n. 3 (defining "churning"); *id.* at 1215–17 (finding jury instructions proper and upholding a jury verdict on a breach of fiduciary duty claim). If "churning" an account for the broker's personal gain—presumably by generating excessive commissions—is a breach of fiduciary duty, this court has no hesitation in concluding that charging, but failing to disclose, excessive mark ups or mark downs for the broker's personal gain, as Baber has alleged and a reasonable juror could find, would also be an abuse of a customer's confidence and a betrayal of trust. *See Schuster,* 378 F.Supp.2d at 1108 (the purpose of the fiduciary duty doctrine "is to defeat and protect betrayals of trust and abuses of confidence") (internal quotation marks and citations omitted). A reasonable juror could also find that such conduct reflected self-dealing, dishonesty, and a total willingness to compromise the interests of the broker's client, and that repeated instances of such conduct suggest a lack of remorse. *Cf. Remer,* 646 N.W.2d at 96 (finding such conduct by an attorney was a breach of fiduciary duty). Finally, Baber has generated genuine issues of material fact on one incident of unauthorized trading in his case, the unauthorized sale of P.F. Chang stock, on which First Republic and Parks charged a mark down, followed by the purchase of that stock to correct the "mistake," on which First Republic and Parks also charged a markup. Under *Davis,* 906 F.2d at 1215–17, that incident, standing alone, is sufficient to present Baber's breach-of-fiduciary-duty claim to a jury.

***20** Consequently, First Republic and Parks are not entitled to summary judgment on Baber's claim of breach of fiduciary duty in **Count V** on their alternative ground, that no fiduciary duty was violated.

C. COLORADO

- **What is a Fiduciary Duty**

A fiduciary duty is a legal obligation imposed by common law and by Colorado statute.

It requires the fiduciary to:

- act in good faith,
- with the care an ordinary, prudent person in a similar position would exercise under similar circumstances, and
- in a manner the fiduciary reasonably believes to be in the best interests of the person or entity to whom the duty is owed.

The fiduciary must put their personal interests and beliefs aside in favor of acting in the interests of the person or entity to whom the duty is owed.

"A fiduciary relationship exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relationship." *Accident &*

Injury Med. Specialists, P.C. v. Mintz, 279 P.3d 658, 663 (Colo. 2012) (quoting *Moses v. Diocese of Colo.*, 863 P.2d 310, 321 (Colo. 1993)). "A fiduciary duty may arise from a business or confidential relationship impelling or inducing one party to relax the care and vigilance it would and should have ordinarily exercised in dealing with a stranger." *Alexander & Alexander, Inc. v. Frank B. Hall & Co.*, No. CIV. A. 88-A-1621, 1990 WL 8028, at *7 (D. Colo. Jan. 31, 1990) (internal citations omitted). "Colorado courts recognize that a variety of relationships can create fiduciary responsibilities under certain circumstances, even if those relationships are not fiduciary per se." *Atl. Richfield Co. v. Farm Credit Bank of Wichita*, 226 F.3d 1138, 1162 (10th Cir. 2000). Accordingly, the existence of a fiduciary or confidential relationship is generally a question of fact for the jury. Id.

- **What Duties are Owed**

The specific duties that an investment adviser owes to its clients is not addressed by Colorado law. Under federal law, an investment adviser owes two basic fiduciary duties to its clients: the duty of care and the duty of loyalty. Investment Advisers Act of 1940, 17 CFR 276. The intent behind this fiduciary duty is to help eliminate or mitigate all conflicts of interest which might cause an investment adviser to provide investment advice that may not be impartial, whether the investment adviser acted consciously or not.

In managing a discretionary account, a securities broker's fiduciary duties include the duty to keep informed regarding changes in the securities market that affect the customer's interests, the duty to keep the customer informed regarding those changes, and the duty to explain the risks involved.

A securities broker who becomes a fiduciary of his client must act with utmost good faith, reasonable care, and loyalty concerning the customer's account, and owes a duty to keep informed regarding changes in the market which affect his customer's interests, to act responsibility to protect those interests, to keep the customer informed as to each completed transaction, and to explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged. *See Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 819-20 (6th Cir.1981); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F.Supp. 951, 953 (E.D.Mich.1978)

- **Duty of Loyalty**

A fiduciary owes a duty of complete and undivided loyalty to the client.

The duty of loyalty requires the fiduciary to act at all times in the best interests of the client and to place the client's interest above his own interests or the interests of any other person or entity, consistent with applicable laws.

- **Duty of Care**

A fiduciary's obligations include the duty to exercise reasonable care and skill. *Destefano v. Grabrian*, 763 P.2d 275 (Colo. 1988).

The duty of care requires a fiduciary to be reasonably informed with respect to the matters about which he may give the client advice.

The duty of care must be discharged diligently and in good faith as would a "reasonably prudent person" in conducting her own affairs.

- **Breach of Fiduciary Duty**

Under Colorado law, in order to establish a claim for breach of fiduciary duty, a plaintiff must prove: (1) that the defendant was acting as a fiduciary of the plaintiff; (2) that he breached a fiduciary duty to the plaintiff; (3) that the plaintiff incurred damages; and (4) that the defendant's breach of fiduciary duty was a cause of the plaintiff's damages. *Taylor v. Taylor*, 381 P.3d 428, 431 (Colo. App. 2016). The element of

causation is satisfied when the plaintiff proves that the defendant's conduct was a substantial contributing cause of the injury. *Aller v. Law Office of Carole C. Schriefer, P.C.,* 140 P.3d 23, 26 (Colo. App. 2005) (internal citation omitted).

Although evidence of a securities broker's violation of a custom or internal rule adopted for the protection of its customers does not automatically establish liability, a court may consider the custom or rule in a case-by-case determination of whether the broker breached a fiduciary duty to the customer. *See Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817 (6th Cir.1981).

The court determines as a matter of law the nature of the specific duties owed by the fiduciary. *DeBose v. Bear Valley Church of Christ*, 890 P.2d 214 (Colo.App. 1994), *rev'd on other grounds*, 928 P.2d 1315 (Colo. 1996), *cert. denied*, 520 U.S. 1241 and 1248 (1997).

D. ILLINOIS

Illinois Courts have found that an investment advisor owes a fiduciary duty to their clients. The Illinois Supreme Court stated, "In the Adviser Act [Investment Advisers Act of 1940, 15 U.S.C. §80b-6], Congress recognized that investment advisers have a fiduciary relationship with their clients." *Van Dyke v White*, 2019 IL 121452*74, citing *Securities & Exchange Comm'n v Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963). The Illinois Supreme Court went on to conclude that investment advisers owe their clients a fiduciary duty that is more "exacting and higher standard than a suitability standard. *Id.* The Court went on to discuss how the fiduciary relationship arises.

Fiduciary relationships exist where one party reposes trust and confidence in another who gains a resulting influence and superiority over the subservient party. *Khan v Deutsche Bank AG,* 2012 IL 112219*58. The fiduciary relationship may be established as a matter of fact by showing the facts that a relationship existed that gave rise to trust and confidence in the fiduciary. *Id.* A fiduciary relationship may also incur as a matter of law such as the relationship that exists between agent and principal, so that the fiduciary relationship need not be proven factually, but as a fiduciary relationship as a matter of law. *Khan v BDO Seidman, LLP,* 408 Ill App. 3d 564, 592 (2011); *Van Dyke v White*, 2019 IL 121452*75.

The investment advisers fiduciary duty, according to the Illinois Supreme Court, "includes the obligation to act in his client's best interests and to disclose all material facts concerning a recommended investment." *Van Dyke v White*, 2019 IL 121452*75, citing *Connick v Suzuki Motor Co*., 174 Ill 482, 500(1996), (a "duty to disclose material facts may arise out of a situation where plaintiff places trust and confidence in defendant, thereby placing defendant in a position of influence and superiority over plaintiff. The position of superiority may arise by reason of friendship, agency, or experience").

The fiduciary duty preexists the consummation of the agency relationship from which it is formed. In *Martin v Heninhold Commodities Inc.*, 163 Ill 2d 33, 42-43 (1994) a commodities broker held itself out to the public as not charging high commissions and markups when in fact it did do so through the use of fees. The Illinois Supreme Court adopted the *Restatement (Second) of Agency* sec 390, comment e, stating, "where the very creation of agency relationship involves a special trust and confidence on the part of a principal in the subsequent fair dealing of an agent, the prospective agent may be under a fiduciary duty to disclose the terms of his employment as an agent." *Martin v Heninhold Commodities Inc,* 163 Ill. 2d at 45. Thus, the disclosures made in the initial investor agency agreement may give rise to a breach of fiduciary duty where the investment adviser failed to disclose material terms related to the agreement.

To "state a claim for a breach of fiduciary duty, it must be alleged and ultimately established that: (1) a fiduciary duty exists; (2) the fiduciary duty was breached; and (3) such breach proximately caused the injury of which the party complains." *Detterbeck v. Detterbeck*, 2019 IL App (1st) 181113-U (see also *Lawlor v. North American Corp. of Illinois*, 2012 IL 112530, ¶ 69). "One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information if he fails to exercise reasonable care or competence in obtaining or communicating the information." *Khan v. BDO Seidman, LLP*, 408 Ill. App. 3d 564, 594 (2011).

A client that believes that an investment advisor has breached their fiduciary duties may have legal recourse. The client can potentially recover damages resulting from the breach. It's important to note that the statute of limitations for a breach of fiduciary duty in Illinois is typically five years from the date of the breach or three years from the date the breach was or should have been discovered.

III. DATA ON INVESTMENT ADVISORS

1. Terms:

• **Brochure** – The name often used when referring to Part 2 of Form ADV. The brochure, which investment advisers are required to provide to consumers, provides information concerning the fees charged by the adviser, the background of the adviser and its employees (investment adviser representatives), its business practices, and any conflicts of interest that may exist between the adviser and you as a customer.

• **CRD** – The Internet-based registration and licensing system for securities firms also used by state and federal regulators. The CRD system is a joint effort of the Financial Industry Regulatory Authority (FINRA), North American Securities Administrators Association (which includes the Illinois Securities Department as a member), and the federal Securities and Exchange Commission (SEC). The CRD system currently contains information on nearly 7,000 securities firms and more than 600,000 licensed individuals.

• **Disclosure** – The reported disclosure of customer disputes, disciplinary and regulatory actions, as well as any criminal or civil actions. For an investment adviser firm, these items must be disclosed on Form ADV. For individual investment adviser representatives, these items are reported on Form U4.

• **FINRA** – The Financial Industry Regulatory Authority (FINRA) is the largest independent regulator for all securities firms doing business in the United States. FINRA is dedicated to investor protection and market integrity. FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives.

• **Form ADV** – The application form used by investment advisers to apply for registration as either a state- or federal-covered investment adviser. This form discloses information concerning the adviser's ownership, states in which it is registered, the amount of assets under management, disciplinary information, and other detailed information for each investment adviser.

• **Form U4** – The universal form used within the securities industry for the registration of investment adviser representatives by the employing firm with either federal or state regulators. This form provides information concerning an individual's employment history, securities examinations the representative has passed, licensing or registration status within states, and disciplinary history.

• **IARD** – The Internet-based registration system for investment advisers and companion system to the CRD system. The Investment Adviser Registration Depository (IARD) is a joint effort of the Financial Industry Regulatory Authority (FINRA), North American Securities Administrators Association (which includes the Illinois Securities Department as a member), and the federal Securities and Exchange Commission.

• **SEC** – The U.S. Securities and Exchange Commission, the federal agency that has regulatory oversight for investment advisers with $25 million or more in assets under management.

3. [blank]

4. Types of Registered Investment Advisers: SEC registered vs. state registered: • **Registration Thresholds –** Investment Advisers with $110 million or more in assets must register with the SEC. Investment Advisers with assets under $100 million must register with one or more of the states in which they do business. Investment Advisers in the $100-$110 million window may generally register with either the SEC or one or more states in which they conduct business. As recently as 2011 the SEC registration threshold was only $25 million.

• **Number of SEC Registered Investment Advisers** – As of April 2023 there were more than 15,350 SEC Registered Investment Advisers. 10 years prior the number was just over 10,600, a growth of approximately 44% over 10 years.

• **NASAA compiles and publishes data on state Registered Investment Advisers** – the Investment Adviser Section of NASAA publishes on an annual basis a Report which contains statistical data summaries for state Registered Investment Advisers. A link to the complete 2022 report is here: https://www.nasaa.org/wp-content/uploads/2022/06/2022-IA-Section-Report-FINAL-updated-05192022.pdf

Below is the statistical data from the 2022 Report.

STATE-REGISTERED IA STATISTICS 2021



State Registered IA Map

17,371

Total State-Registered IAs [Net Decrease of 83 State-registered IAs from 2020-2021]

27,648

Total State-Registered IA Registrations [Net Increase of 236 Registrations from 2020-2021

322

Average State-Registered IA per Jurisdiction

Top 5 State-Registered IAs Increase from 2020 – 2021

1. Florida – 53
2. Texas – 46
3. Tennessee/ North Carolina – 14
4. Missouri – 12
5. Utah – 10

Top 5 Most State-Registered IAs (Home State) [As of 12/31/21]

1. California – 2,881
2. Texas – 1,386
3. Florida – 1,156
4. New York – 790
5. Illinois – 720

Top 5 Most State-Registered IAs (Total) [As of 12/31/21]

1. Texas – 4,228
2. California – 3,662
3. Florida – 1,867
4. New York – 1,321
5. Illinois – 1,013

Total State-Registered IAs AUM

$412,808,679,777

State-Registered Investment Advisers East/West of the Mississippi



SEC NOTICE-FILED INVESTMENT ADVISER STATISTICS 2021



SEC Registered IA Map

12,278

Total SEC Notice Filed IAs [Net Increase of 895 SEC Notice Filed IAs 2020-2021]

103,668

Total SEC Notice Filed IA Registrations [Net Increase of 6,867 registrations 2020-2021]

227

Average SEC Notice Filed per jurisdiction

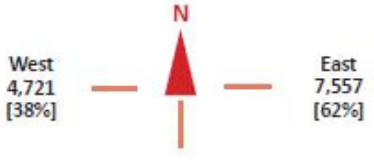
Top 5 Most SEC Notice Filed Investment Advisers [As of 12/31/21]

1. California – 1,772
2. New York – 1,687
3. Texas – 873
4. Florida – 737
5. Massachusetts – 613

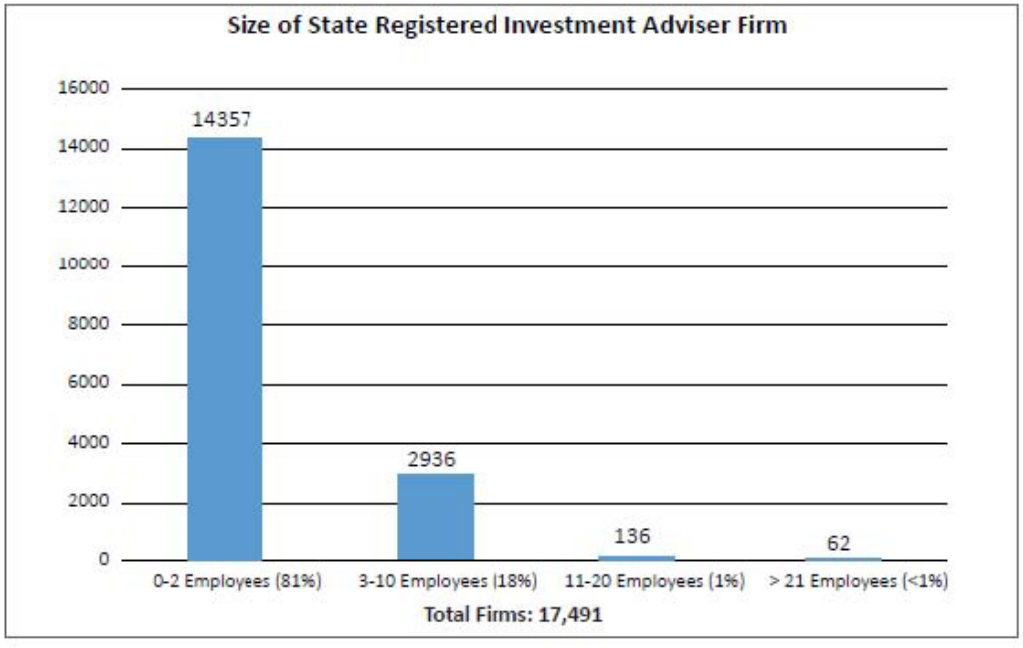
Top 5 SEC Notice Filed Investment Advisers Increase from 2020 – 2021

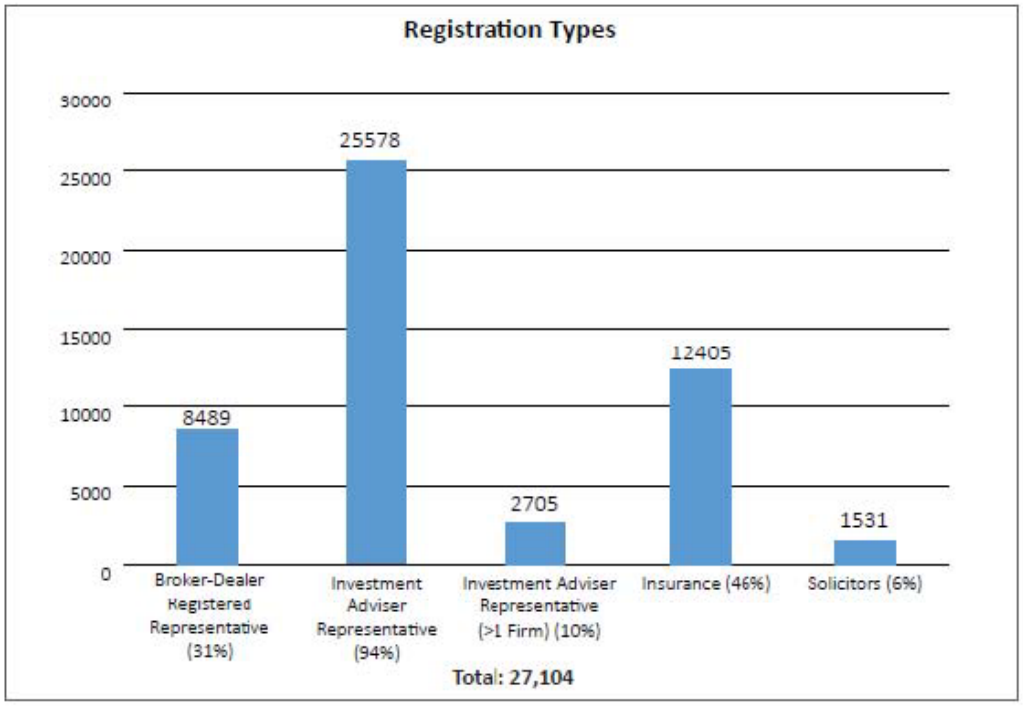
1. Florida – 130
2. California – 106
3. Texas – 94
4. Washington – 41
5. New York – 32

SEC Notice Filed Investment Advisers

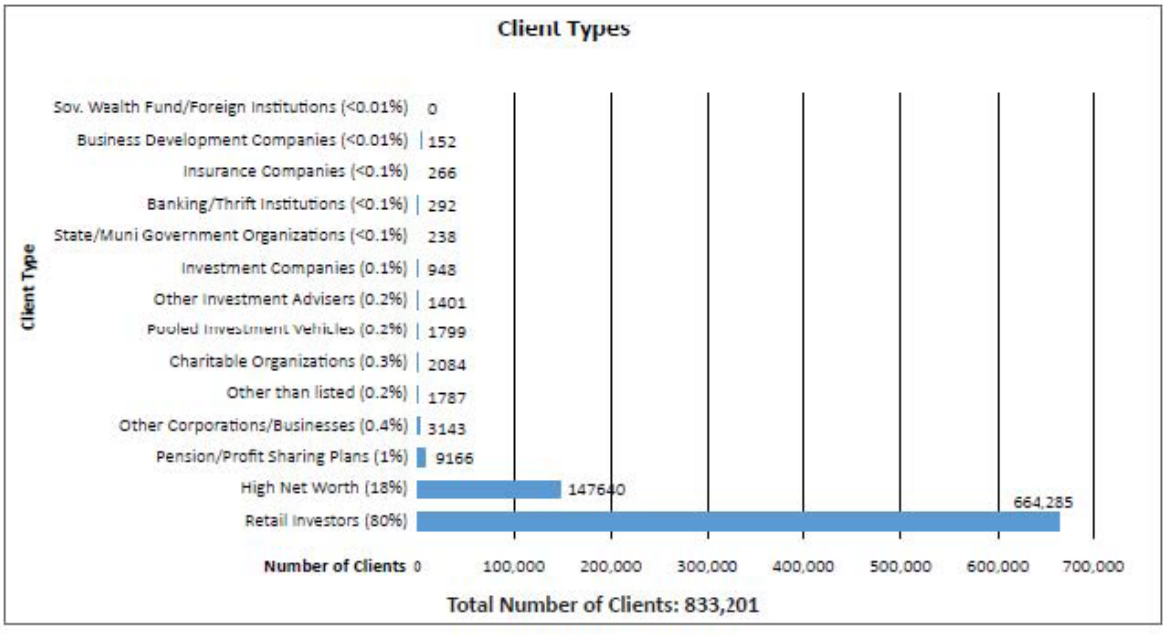


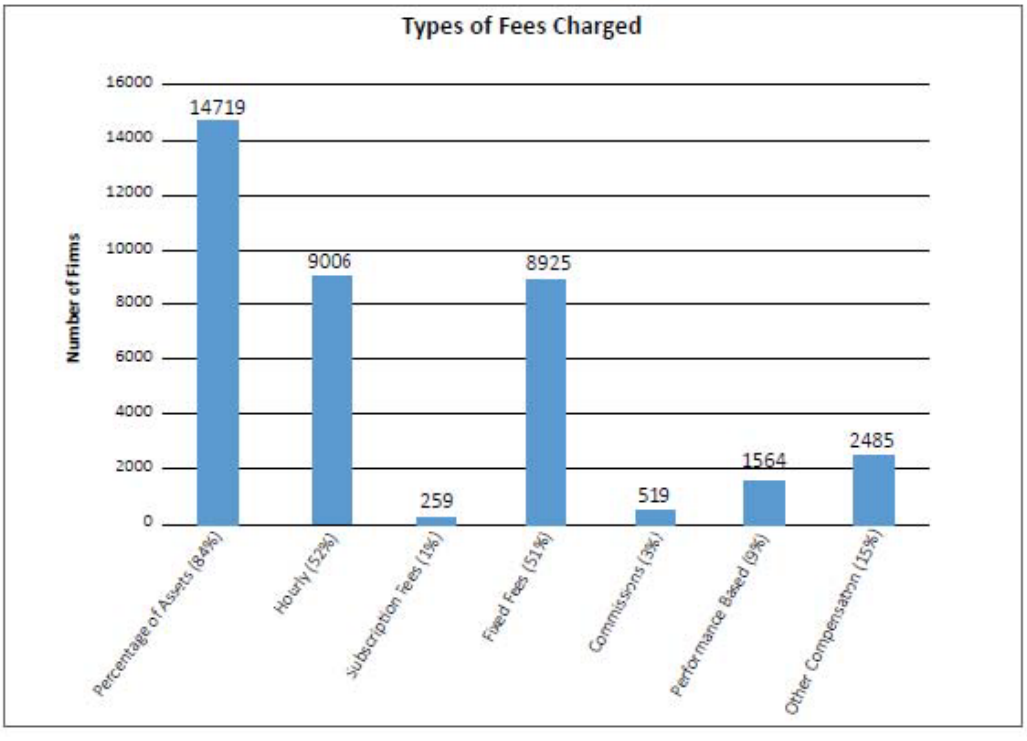
Profile of State-Registered IAs for 2021





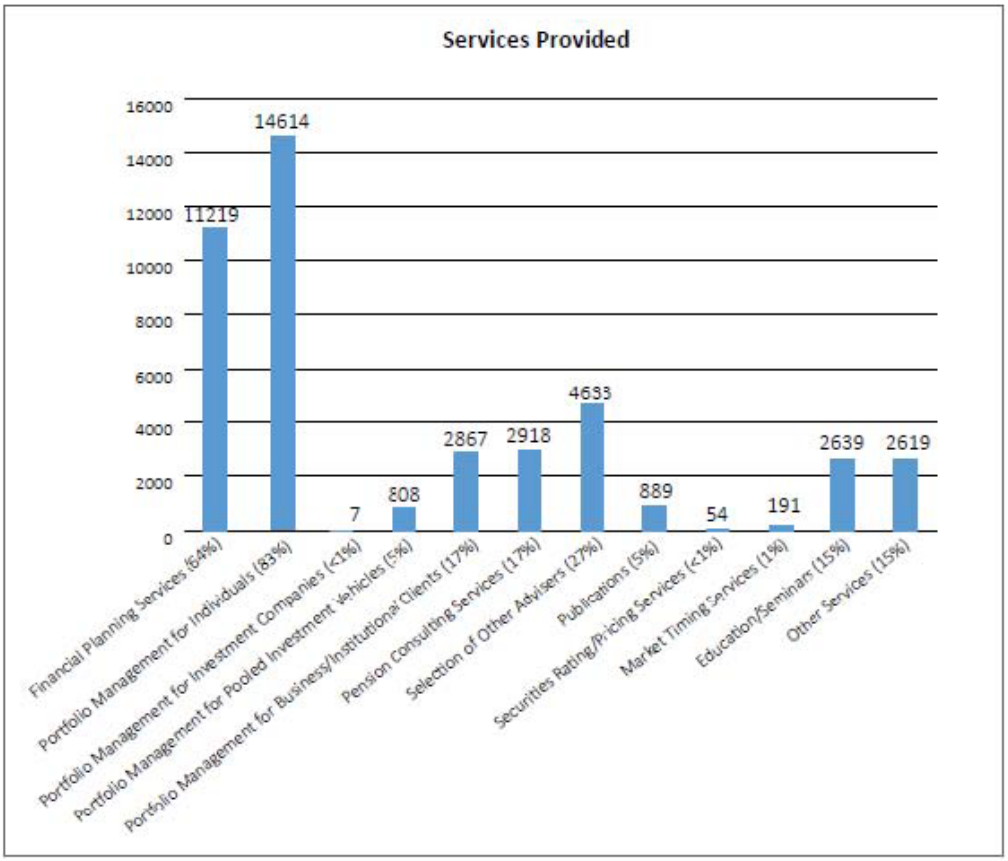
Profile of State-Registered IAs for 2021





Profile of State-Registered IAs for 2021

Compensation				
Type	Yes	No	% Yes	% No
Percentage of Assets Under Management (84%)	14,719	2,772	84%	16%
Hourly (52%)	9,006	8,485	51%	49%
Subscription Fees (1%)	259	17,232	1%	99%
Fixed Fees (51%)	8,925	8,566	51%	49%
Commissions (3%)	519	16,972	3%	97%
Performance Based (9%)	1,564	15,927	9%	91%
Other Compensation (15%)	2,485	15,006	14%	86%



• **Here are the key takeaways**: o 1-2 person shops account for 81% of state Registered Investment Advisers
o Retail investors account for 80% of the client base.
o Duly registered RR/IAR account for 31% of the workforce

o Percentage of assets under management is the predominant type of fee charged, 84%.
• **Some additional data points for SEC registered Investment Advisers (as of 2021):** o More than $128 trillion in asset were managed by SEC Registered Investment Advisers

o SEC Registered Investment Advisers have more than 65 million clients

o Approximately 51 million of the SEC Registered Adviser clients are individuals.

o There are more than 348,000 Investment Adviser Representatives

o More than 307,000 are duly registered IAR-RR

o Approximately 88% of SEC Registered Advisers are small businesses employing 50 or fewer people; the median Investment Adviser employed 8 people.

o Approximately 95% of SEC Registered Investment Advisers charge a fee based on assets under management.

5. Key: Fiduciary Duty…really focus on this concept. How to present and defend; What is FD under state law or other.
6. Advisory Contracts: • **SEC Registered Investment Advisers** – Interestingly, the Investment Advisers Act of 1940 does not require that an advisory contract be in writing. Section 205 of the Act sets forth some basic minimum requirements for content: the advisory contract cannot be assigned without client consent; if the investment adviser is a partnership, the advisory contract must provide that the client will not receive notification of any changes to the partnership within a reasonable time; the advisory contract shall not generally provide for compensation on the basis of sharing of capital gains or performance fees. As a practical matter, SEC Registered Investment Advisers employ elaborate and extensive advisory contracts.

• **State Registered Investment Advisers** – Many states require that investment advisory contracts be written. For example, Colorado Rule 51-1.8(IA) (P) sets forth what firms are required to disclose in investment advisory contracts with their clients. The requirements are succinctly summarized in the Colorado Division of Securities 2023 Investment Adviser Examination Priorities document:

" [I]t will be dishonest and unethical conduct for advisers to enter into or renew any investment advisory unless such contract is in writing and discloses the
services to be provided, the term of the contract, the advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of contract termination or non-performance, whether the contract grants discretionary authority to the adviser and that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract." The Colorado Rule is based on a NASAA Model Rule. Please check your individual states' law.
7. I have a case against a Registered Investment Adviser -- Where do I bring it? • A brief overview of Arbitration in the Securities Industry o Wilko v Swan, 346 U.S. 427 (1953): a claim brought under Section 12(2) of the Securities Act of 1933 was not subject to a Pre-Dispute Arbitration Agreement ("PDAA"). Post Wilko courts consistently held agreements to arbitrate disputes under both the Securities Act of 1933 and Securities Exchange Act of 1934 to be invalid.

o Moses H. Cone Memorial Hospital v. Mercury Construction Corporation 460 U.S. 1 (1983)); the case included a PDAA in a construction contract. The Supreme Court held that the Federal Arbitration Act established "as a matter of federal law" that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability."

o Dean Witter Reynolds, Inc v. Byrd, 147 U.S. 213 (1985): under a PDAA district courts must compel arbitration of pendent state claims even if parallel Federal Securities claims are not arbitrable. Pre-Byrd,

district courts would often exercise their supplemental jurisdiction over pendant state law claims.

o Shearson/American Express, Inc v. McMahon 482 U.S. 220 (1987): A PDAA does apply to disputes involving the Securities Exchange Act of 1934.

o Rodriguez de Quijas v. Shearson/American Express, Inc 490 U.S. 477 (1989): A PDAA does apply to disputes involving claims under the Securities Act of 1933.

o FINRA Rule 2268. REQUIREMENTS WHEN USING PREDISPUTE ARBITRATION AGREEMENTS FOR CUSTOMER ACCOUNTS.

• RESPONSE TO CONGRESS: MANDATORY ARBITRATION AMONG SEC-REGISTERED INVESTMENT ADVISERS June 27, 2023.

o The House Appropriations Committee express concern about the proliferation of mandatory arbitration agreements among SEC-Registered Investment Advisers and ordered it to gather detailed information about those agreements. The June 27, 2023 Report was the result of that process. A link to the full Report is here: https://hastingsgroupmedia.com/MandatoryArbitrationAmongSEC-RegisteredInvestmentAdvisers.pdf

Table 1. Frequency of specific provisions in mandatory arbitration clauses

Agreement designates a particular dispute resolution forum:	92%
When designating a forum, advisers designated the following fora:	
American Arbitration Association (AAA)	83%
Financial Industry Regulatory Authority (FINRA) Dispute Resolution Services	10%
JAMS	6%
Other	1%
Agreement designates particular forum rules:	37%
When designating forum rules, advisers selected the following rules:	
AAA Commercial Rules	83%
JAMS Streamlined Rules and Procedures	3%
JAMS Comprehensive Rules and Procedures	2%
AAA Securities Arbitration Supplementary Procedures	1%
Agreement designates the arbitration venue:	60%
When designating arbitration venue, percent of agreements that did not consider client's location or place of business:	97%
Agreement precludes participation in class action	6%
Agreement limits claims the client may assert	5%
Agreement limits damages that may be awarded	11%
Agreement includes fee-shifting provision	18%

The following tables from the Report summarize key findings:

Table 2. Frequency of mandatory arbitration clauses and key terms[86]

Term	Estimated proportion among all retail advisers	Estimated proportion among retail advisers that have a mandatory arbitration clause
1. Contains a mandatory arbitration clause	61%	N/A
Specific contract clause terms		
2. Designates dispute resolution forum	56%	92%
3. Designates forum rules	23%	37%
4. Designates a venue	37%	60%
5. Includes class action waiver	4%	6%
6. Limits claims that may be asserted	3%	5%
7. Limits damages that may be awarded	7%	11%
8. Contains fee-shifting provision	11%	18%

Table 3. Proportion of designated dispute resolution forums[87]

Forum	Estimated proportion among retail advisers that designated a dispute resolution forum
1. AAA	83%
2. FINRA	10%
3. JAMS	6%

Table 4. Proportion of designated forum rules[88]

Rules	Estimated proportion among retail advisers that designated forum rules
1. Commercial Rules (AAA)	78%
2. Customer Rules (AAA)	1%
3. Comprehensive Arbitration Rules and Procedures (JAMS)	2%
4. Streamlined Arbitration Rules and Procedures (JAMS)	3%
5. Securities Arbitration Supplementary Procedures (AAA)[89]	3%

What will be the impact of the June 27 report?

- SEC Rule mailing under the 40 Act and/or Dodd-Frank?
- Form A SRO for Registered Investment Advisers?

- FINRA Rule making for duly registered RIAs?
- Other?

IV. CONCLUSIONS AND PRACTICE TIPS

Recall ADV Part 2A requires the firm to publish it's Brochure which has marketing information about the firm. It is recommended that counsel review the brochure to become knowledgeable about what the firm says it offers to investors.

This paper provides the reader with information about bringing an action against an investment adviser (individual and firm), both state and federal registered, and the accompanying fiduciary duty accompanying the investment adviser. Major issues include the Investment Adviser Act of 1940 as the basic federal statute covering these advisers. The IAA does not provide a private cause of action but can be used to show industry standards. The IAA is supplemented by administrative regulations defined in the CFR's which contain standards of conduct. Each state we studied has either added investment advisers to their state securities acts or passed legislation addressing investment advisers separately. You must check your state law. You should review your state's administrative rules which supplement the state securities acts (we have provided samples of such rules in Exhibits 1-4). These administrative rules cover dishonest and unethical practices that will be very useful in drafting a legal action or an arbitration case. Some administrative rules cover the basics of "suitability" and excessive trading (both excessive as to size of position and frequent trading—churning). Each state has basic prohibited but unique features adopted by the state agency (usually the state securities department).

There is diverse law on what specific obligations a fiduciary retains. Typically, the explanation is described in your state's statutory and administrative law and supplemented by case law. For example, the basic features of loyalty and disclosure are further defined as "good faith," care, prudence and other terms that your case law will develop.

TITLE 14. PUBLIC SERVICE CORPORATIONS; CORPORATIONS AND ASSOCIATIONS; SECURITIES REGULATION

CHAPTER 6. CORPORATION COMMISSION
INVESTMENT MANAGEMENT

Editor's Note: The Editor's Note below is no longer applicable because all of the rules in this Chapter were reviewed by the Attorney General or the Governor's Regulatory Review Council. The Chapter is printed on white paper (Supp. 01-2).

Editor's Note: The Corporation Commission has determined that rules in this Chapter are exempt from the Attorney General certification provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1044) by a court order (State ex rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216, 848 p.2d 301 (App. 1992)). This exemption means that the rule was not approved by the Attorney General. Because this Chapter was filed under a rulemaking exemption, as determined by the Corporation Commission, other than a statutory exemption, the Chapter is printed on green paper.

(Authority: Article XV, §§ 4,6, and 13, Constitution of Arizona, and A.R.S. § 44-3131)

ARTICLE 1. GENERAL PROVISIONS RELATING TO THE ARIZONA INVESTMENT MANAGEMENT ACT

Article 1, consisting of Sections R14-6-101 thru R14-6-104, adopted effective July 19, 1996 (Supp. 96-3).

Section

R14-6-101. Definitions
R14-6-102. Scope of Provisions
R14-6-103. Severability
R14-6-104. Enforcement of the Arizona Investment Management Act
R14-6-105. Processing of Applications for Investment Adviser and Investment Adviser Representative Licensure
R14-6-106. General Dissemination of Information on the Internet

ARTICLE 2. DUTIES OF INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

Article 2, consisting of Sections R14-6-201 thru R14-6-209, adopted effective July 19, 1996 (Supp. 96-3).

Section

R14-6-201. Books and Records of Investment Advisors
R14-6-202. Supervision
R14-6-203. Dishonest and Unethical Practices
R14-6-204. Required Written Examinations
R14-6-205. Information to be Furnished to Clients ("Brochure Rule")
R14-6-206. Custody of Client Funds or Securities by Investment Advisers
R14-6-207. Suitability of Investment Advisory Services
R14-6-208. Advertisements by Investment Advisors or Investment Advisor Representatives
R14-6-209. Financial and Disciplinary Information that Investment Advisors Shall Disclose to Clients
R14-6-210. Licensure of Investment Adviser Representatives
R14-6-211. Solicitation
R14-6-212. Application, Notice Filing, and Renewal Requirements

ARTICLE 1. GENERAL PROVISIONS RELATING TO THE ARIZONA INVESTMENT MANAGEMENT ACT

R14-6-101. Definitions

A. The definitions set forth in A.R.S. §§ 44-1801 and 44-3101 shall apply to the rules promulgated under A.R.S. Title 44, Chapter 13.

B. The following definitions shall apply to all rules promulgated under A.R.S. Title 44, Chapter 13, unless the context otherwise requires:

1. "Advertisement" means, except as set forth in subsections (B)(1)(d) and (e), any notice, circular, letter, or other written, oral, or electronically generated communication addressed to or reasonably designed by the investment adviser or investment adviser representative to be accessed by more than one person, or any notice or other announcement in any publication or by radio or television, that directly or indirectly offers:
   a. Any analysis, report, or publication that either concerns securities, or 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
   b. 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
   c. Any other investment advisory service with regard to securities.
   d. A communication over a computer online service including but not limited to an electronic bulletin board shall not be deemed to be an advertisement when an investment adviser or an investment adviser representative is either:
      i. Engaged in a discussion regarding securities and does not receive compensation from any person for the discussion; or
      ii. Responds to unsolicited inquiries regarding the provision of investment advisory services.
   e. A communication by one or more investment advisers or investment adviser representatives shall not be deemed to be an advertisement when the communication is addressed solely to or is reasonably designed to be accessed solely by other investment advisers or investment adviser representatives.
2. "Certified public accountant" or "CPA" means an accountant who has been registered or licensed to practice public accounting and is permitted to use the title "certified public accountant" and to use the initials "CPA" after the accountant's name.
3. "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:
   a. Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties), unless received inadvertently and returned to the sender promptly, but in any case within three business days of receiving them;
   b. Any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and

EXHIBIT 1

c. Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or the investment adviser representative legal ownership of or access to client funds or securities.

4. "Federal covered adviser" means an investment adviser registered under the Investment Advisers Act of 1940.
5. "Fixed fee basis" means an investment advisory fee that at any given time can be precisely established in a dollar amount without regard to the investment performance or value of an account and that is not based on the purchase or sale of specific securities.
6. "Form ADV" means the Uniform Application for Investment Adviser Registration, 17 CFR 279.1, as required by A.R.S. § 44-3153.
7. "IM Act" means the Arizona Investment Management Act, A.R.S. § 44-3101 et seq.
8. "Impersonal advisory services" means investment advisory services provided solely:
   a. By means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;
   b. Through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or
   c. Any combination of the foregoing services.
9. "Independent representative" means a person that:
   a. Acts as agent for a client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);
   b. Does not control, is not controlled by, and is not under common control with the investment adviser; and
   c. Does not have, and has not had within the past two years, a material business relationship with the investment adviser.
10. "Internet" means all proprietary or common carrier electronic systems, or similar media.
11. "Internet communication" means the distribution of information on the Internet.
12. "Investment-related" means pertaining to securities, commodities, banking, insurance, or real estate, including but not limited to acting as or being associated with a broker-dealer, investment company, investment adviser, government securities broker or dealer, municipal securities dealer, bank, savings and loan association, entity, or person required to be registered under the Commodity Exchange Act, or a fiduciary.
13. "Involved" means acting or aiding, abetting, causing, counseling, commanding, inducing, conspiring with, or failing reasonably to supervise another in doing an act.
14. "Management person" means a person with power to exercise, directly or indirectly, a controlling influence over the management or policies of an investment adviser that is a company or to determine the general investment advice given to clients.
15. "NASAA" means the North American Securities Administrators Association, Inc., or any successor organization.
16. "NASD" means the National Association of Securities Dealers, Inc., or any successor or subsidiary organization.
17. "Qualified custodian" means:
   a. A bank or a savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;
   b. A broker or dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the client assets in customer accounts;
   c. A futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and
   d. A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the clients' assets in customer accounts segregated from its proprietary assets.
18. "Relative" means any relationship by blood, marriage, or adoption, not more remote than 1st cousin.
19. "Rule 204-2" means United States Securities and Exchange Commission rule 204-2, 17 CFR 275.204-2 (1998), which is incorporated by reference, does not contain any later amendments or editions, and is on file in the Office of the Secretary of State. Copies of Rule 204-2 are available from the Division and from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.
20. "SEC" means United States Securities and Exchange Commission.
21. "Securities Act" means the Securities Act of Arizona, A.R.S. § 44-1801 et seq.
22. "Self-regulatory organization" or "SRO" means any national securities or commodities exchange, registered association, or registered clearing agency.
23. "Unincorporated organization" includes a limited liability company for purposes of the definition of "person," as defined in A.R.S. § 44-1801.
24. "Wrap fee program" means a program under which any client is charged a specified fee or fees not based directly upon transactions in a client's account for investment advisory services, which may include portfolio management or advice concerning the selection of other investment advisers, and execution of client transactions.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Chapter 13 reference updated to reflect current style (Supp. 98-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4). Amended by final rulemaking at 13 A.A.R. 22, effective February 12, 2007 (Supp. 06-4).

R14-6-102. Scope of Provisions

The following Sections are adopted by the Commission under the authority granted pursuant to A.R.S. Title 44, Chapter 13. Such Sections shall be generally applicable to the administration of the IM Act. When not in conflict with these Sections, the applicable

provisions of A.A.C. R14-3-101 through R14-3-113 also shall apply.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Section heading and Chapter 13 reference updated to reflect current style (Supp. 98-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-103. Severability

The provisions of the Sections promulgated under A.R.S. Title 44, Chapter 13, are severable. If any provision of a Section is held to be invalid, such invalidity shall not affect other provisions that can be given effect without the invalid provision.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Chapter 13 reference updated to reflect current style (Supp. 98-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-104. Enforcement of the Arizona Investment Management Act

The provisions relating to investigations and examinations conducted pursuant to and orders issued under the IM Act are contained at A.A.C. R14-4-301 through R14-4-308.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-105. Processing of Applications for Investment Adviser and Investment Adviser Representative Licensure

A. For purposes of this Section, the term "application" includes all documents, information and fees prescribed by the Commission under A.R.S. Title 44, Chapter 13, Articles 4 and 5 and the rules promulgated under those statutes.

B. Within 21 days after receipt of an application for investment adviser or investment adviser representative licensure, the Commission shall notify the applicant, in writing, that the application is either complete or deficient. If the application is deficient, the notice shall specify all deficiencies. Unless otherwise notified by the Commission, an application will be deemed complete 21 days after receipt by the Commission of information in satisfaction of all deficiencies.

C. An applicant with a deficient application shall supply the information in satisfaction of the deficiencies within the time permitted by A.R.S. § 44-3181. If the applicant fails to provide the information, the Commission may abandon the application under A.R.S. § 44-3181. An applicant whose application has been abandoned may reapply by submitting a new application.

D. Within 60 days after receipt of a complete application, the Commission shall approve the application or initiate the denial process by filing a notice of an opportunity for a hearing under A.A.C. R14-4-306. When a notice of an opportunity for a hearing is filed:

1. If the applicant does not request a hearing, the Commission shall approve, deny, or take other appropriate action regarding the application within 70 days after service of the notice.
2. If the applicant requests a hearing, the applicant shall do so within 10 days after receipt of the notice. The Commission shall approve, deny, or take other appropriate action regarding the application within 210 days after the applicant's request is docketed with the Commission.

E. For purposes of A.R.S. § 41-1073, the Commission has established the following time-frames:

1. When the Commission approves an application under subsection (D):
   a. Administrative completeness review time-frame: 42 days;
   b. Substantive review time-frame: 60 days;
   c. Overall time-frame: 102 days.
2. When the Commission initiates the denial process and no hearing is requested under subsection (D)(1):
   a. Administrative completeness review time-frame: 42 days;
   b. Substantive review time-frame: 130 days;
   c. Overall time-frame: 172 days.
3. When the Commission initiates the denial process and a hearing is requested under subsection (D)(2):
   a. Administrative completeness review time-frame: 42 days;
   b. Substantive review time-frame: 280 days;
   c. Overall time-frame: 322 days.

F. If an applicant requests, and is granted, an extension or continuance, the appropriate time-frames shall be tolled from the date of the request for the duration of the extension or continuance.

G. When the period of time prescribed in this Section is less than 11 days, intermediate Saturdays, Sundays, and legal holidays shall not be included in the computation. When the period of time prescribed for a specific time-frame is 11 days or more, intermediate Saturdays, Sundays, and legal holidays shall be included in the computation.

H. The Commission shall renew a license under this Section upon receipt by the Commission of the license fee, as required by A.R.S. § 44-3181.

Historical Note

Adopted effective September 17, 1998 (Supp. 98-3). Chapter 13 reference updated to reflect current style (Supp. 98-3).

R14-6-106. General Dissemination of Information on the Internet

A. Investment advisers and investment adviser representatives who use the Internet to distribute information on products and services directed generally to anyone having access to the Internet shall not be deemed to be transacting business in Arizona for purposes of Article 4 of the IM Act based solely on that activity if the following conditions are observed:

1. The Internet communication includes clear and prominent statements that:

a. The investment adviser or investment adviser representative may only transact business in Arizona if first compliant with or exempt from licensure or notice filing requirements.
b. The investment adviser or investment adviser representative may only communicate with persons in Arizona individually about rendering investment advice for compensation or solicit or negotiate for the sale of investment advisory services if first compliant with or exempt from licensure or notice filing requirements.

2. The investment adviser or investment adviser representative complies with the statements contained in the Internet communication under subsection (A)(1).
3. The Internet communication is subject to a mechanism, policy, or procedure reasonably designed to ensure that, prior to any subsequent, direct communication with prospective customers or clients in Arizona, the investment adviser or investment adviser representative is first compliant with or exempt from the licensure or notice filing requirements of the IM Act.
4. The Internet communication does not involve either the rendering of investment advice for compensation or individualized solicitation or negotiations for the sale of investment advisory services in Arizona.
5. In the case of an investment adviser representative:
   a. The affiliation with an investment adviser is prominently disclosed in the Internet communication.
   b. The investment adviser with whom the investment adviser representative is associated first authorizes the Internet communication.
   c. The investment adviser with whom the investment adviser representative is associated retains responsibility for reviewing and approving the content of any Internet communication.
   d. In distributing information through the Internet, the investment adviser representative acts within the scope of the authority granted by the investment adviser.

B. Compliance with this Section relieves the investment adviser or investment adviser representative of licensure or notice filing requirements only. The investment adviser or investment adviser representative is subject to Article 9 of the IM Act and related regulations.

Historical Note

New Section adopted by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1).

ARTICLE 2. DUTIES OF INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

R14-6-201. Books and Records of Investment Advisers

A. Except as provided in subsection (G), each investment adviser licensed or required to be licensed under the IM Act shall make, maintain, and preserve books and records in accordance with the requirements imposed on federal covered advisers under rule 204-2. The investment adviser shall file with the Commission a copy of any notices or written undertakings required to be filed by federal covered advisers with the SEC under rule 204-2.

B. To the extent that the SEC amends rule 204-2, investment advisers in compliance with the requirements contained in rule 204-2 as amended shall not be deemed to be in violation of this Section and shall not be subject to enforcement action by the Commission for violation of this Section to the extent that the violation results solely from the investment adviser's compliance with the requirements contained in the amended rule 204-2.

C. Except as provided in subsection (G), each investment adviser licensed or required to be licensed under the IM Act shall make, maintain, and preserve for at least 5 years the following additional books and records:
1. A file containing each customer complaint received relating to advisory activities conducted by the investment adviser, its investment advisory representatives, or its employees, and all correspondence relating to such complaint.
2. A file containing all advertisements used by the investment adviser or any investment adviser representative, including any radio or television transcripts and advertisements placed on computer or electronic bulletin boards.
3. In each client file, all correspondence received or sent by the investment adviser, any investment adviser representative, or any employee, that related to any client account, securities, or funds.

D. Books and records that are required to be maintained pursuant to subsection (A) shall be available for inspection by the Commission in accordance with the provisions of rule 204-2. Books and records that are required to be maintained pursuant to subsection (C) shall be readily accessible and may be preserved in accordance with rule 204-2(g). Notwithstanding other record preservation requirements of this Section, the following records or copies shall be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services:
1. Records required to be preserved under rule 204-2(a)(3), (a)(7) through (10), (a)(14) through (15), (b), and (c).
2. Records required to be preserved under subsection (C) of this Section.

E. A record made and kept under a provision of subsections (A) or (C) that contains all of the information required under any other provision of subsections (A) or (C) in a readily accessible format need not be maintained in duplicate in order to meet the requirements of the other provision.

F. Any book or other record made, kept, maintained, and preserved in compliance with A.A.C. R14-4-132 that is substantially the same as the book or other record required to be made, kept, maintained, and preserved under this Section shall be deemed to be made, kept, maintained, and preserved in compliance with this Section.

G. Every investment adviser licensed or required to be licensed in Arizona that has its principal place of business in a state other than Arizona shall be exempt from the requirements of this Section, provided the investment adviser is licensed in such other state and is in compliance with that state's recordkeeping requirements.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-202. Supervision

For purposes of A.R.S. § 44-3201(A)(12), no investment adviser shall be deemed to have failed to reasonably supervise its investment adviser representatives or employees if:

1. The investment adviser has established and maintained written procedures, and a system for applying such procedures, that reasonably may be expected to prevent and detect, insofar as practicable, any violation of the IM Act or any rule adopted thereunder by such investment adviser representatives or employees; and
2. Such investment adviser has discharged reasonably the duties and obligations incumbent upon it by reason of such procedures and system without reasonable cause to believe that the investment adviser representatives or employees are not complying with such procedures and system.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-203. Dishonest and Unethical Practices

"Dishonest and unethical practices," with respect to investment advisers and investment adviser representatives subject to A.R.S. § 44-3201(A)(13), shall include but not be limited to the following:

1. Refusing to allow or otherwise impeding the Commission from conducting an investigation or examination under the IM Act or any rule adopted thereunder.
2. Placing an order to purchase or sell a security for the account of a client without authority to do so.
3. Placing an order to purchase or sell a security for the account of a client upon instruction of a 3rd party without first obtaining a written 3rd-party trading authorization from the client.
4. Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without first obtaining written discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order involving a definite amount of specified securities shall be executed, or both.
5. Inducing trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives, and character of the account.
6. Borrowing money or securities from a client or client's account unless the client has authorized the borrowing in writing and is a dealer, an affiliate, or relative of the investment adviser or investment adviser representative, or a financial institution or other entity engaged in the business of loaning funds or securities.
7. Loaning money to a client unless the investment adviser or investment adviser representative is a financial institution or other entity engaged in the business of loaning funds or the client is an affiliate or relative of the investment adviser or investment adviser representative.
8. Misrepresenting to any client, or prospective client, the qualifications of the investment adviser, the investment adviser representative, or an employee, or misrepresenting the nature of the investment advisory services being offered or fees to be charged for such services, or omitting to state a material fact necessary to make the statements made regarding qualifications, services, or fees, in light of the circumstances under which they were made, not misleading.
9. Providing a report or recommendation to any client prepared by someone other than the investment adviser or investment adviser representative without disclosing that fact. This prohibition does not apply to a situation where the investment adviser or investment adviser representative uses published research reports or statistical analyses to render investment advice or where the investment adviser or investment adviser representative orders such a report in the ordinary course of providing service.
10. Charging a client an investment advisory fee that is unreasonable in light of the type of services to be provided, the experience and expertise of the investment adviser or the investment adviser representative, and the sophistication and bargaining power of the client.
11. Failing to disclose to a client in writing before entering into or renewing an investment advisory agreement with that client, or before any investment advice is rendered, any material conflict of interest relating to the investment adviser, the investment adviser representative, or an employee that could reasonably be expected to impair the rendering of unbiased and objective advice including but not limited to:
    a. Compensation arrangements connected with investment advisory services to clients that are in addition to compensation from such clients for those services; and
    b. Charging a client an investment advisory fee for rendering investment advice without disclosing that compensation for executing securities transactions pursuant to such investment advice will be received by the investment adviser, the investment adviser representative, or an employee.
12. Guaranteeing a client that a gain, loss, or other outcome will be achieved as a result of the investment advice.
13. Disclosing the identity, affairs, or investments of a client to any 3rd party unless required by law to do so or consented to by the client.
14. With respect to any client initially retained after July 19, 1996, entering into, extending, modifying, or renewing any investment advisory contract except a contract for impersonal advisory services unless such contract is in writing and discloses all the material terms of the contract including but not limited to the services to be provided, the investment advisory fee or the formula for computing the fee, the amount or the manner of calculation of the amount of the prepaid fee to be returned in the event of contract termination or nonperformance, and the grant of any discretionary power to the investment adviser.
15. With respect to any client initially retained after July 19, 1996, entering into, extending, modifying, or renewing any investment advisory contract without disclosing, in writing to the client, any affirmative answers to disciplinary questions numbered 11A and 11K in Part I of the Form ADV.
16. Entering into, extending, modifying, or renewing any investment advisory contract that allows the assignment of such contract by the investment adviser without the prior written consent of the client.
17. Committing any act that results in denial, revocation, or suspension by an agency of any state of a license or registration relating to securities, where such denial, revocation, or suspension arises out of any scheme, act, practice, or course of business that operates or would operate as

fraud or deceit, or arises out of a violation of Article 13 of the Securities Act or the rules promulgated thereunder.

18. Failing to comply with any arbitration award issued in connection with doing business as an investment adviser or investment adviser representative or as a dealer or salesman as defined in A.R.S. Title 44, Chapter 12.
19. Requesting or requiring any person to waive compliance with any provision of the IM Act or the rules thereunder. Any such waiver shall be void.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-204. Required Written Examinations

A. Except as otherwise provided in subsections (B) and (C), all natural persons applying for licensure as an investment adviser or an investment adviser representative under A.R.S. Title 44, Chapter 13, Article 4 shall have taken and passed:

1. The Uniform Investment Adviser Law Examination (Series 65 examination); or
2. The Uniform Combined State Law Examination (Series 66 examination) and either the General Securities Registered Representative Examination (Series 7 examination) or the General Securities Representative (nonmember) Examination (Series 2 examination).

B. An applicant who has taken the Uniform Investment Adviser State Law Examination (Series 65 examination) or the Combined State Law Examination (Series 66 examination) prior to December 31, 1999, shall have taken and received a score of at least 70% on:

1. The NASAA Uniform Investment Adviser Law Examination (Series 65 examination) or Combined State Law Examination (Series 66 examination); and
2. The NASD General Securities Registered Representative Examination (Series 7 examination) or the General Securities Representative (nonmember) Examination (Series 2 examination).

C. An applicant shall not be required to comply with subsections (A) or (B) if the applicant currently holds any one of the following professional designations and is currently in good standing with the associated organization:

1. Certified Financial Planner (CFP) designation awarded by the Certified Financial Planner Board of Standards, Inc.;
2. Chartered Financial Analyst (CFA) designation awarded by the Institute of Chartered Financial Analysts;
3. Chartered Financial Consultant (ChFC) designation awarded by the American College, Bryn Mawr, Pennsylvania;
4. Chartered Investment Counselor (CIC) designation awarded by the Investment Counsel Association of America, Inc.; or
5. Personal Financial Specialist (PFS) designation awarded by the American Institute of Certified Public Accountants.

D. An applicant must have satisfied the examination requirements of this Section within 12 months prior to application if the applicant has not been registered or licensed as an investment adviser or investment adviser representative in at least one state during the two-year period preceding application.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Section repealed; new Section adopted by final rulemaking at 6 A.A.R. 472, effective December 30, 1999 (Supp. 99-4).

R14-6-205. Information to be Furnished to Clients ("Brochure Rule")

A. Each investment adviser licensed or required to be licensed under the IM Act shall furnish each client and prospective client with a written disclosure statement that may be either a copy of Part II of its Form ADV or a written document containing at least the information required by Part II of Form ADV.

B. The information required to be disclosed by subsection (A) shall be disclosed to clients not less than 48 hours prior to entering into any written or oral investment advisory contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within 5 business days after entering into the contract.

C. An investment adviser need not deliver the statement required by subsection (A) in connection with entering into an investment company contract or a contract for impersonal advisory services. The investment adviser shall, however, offer in writing to deliver the statement within 7 business days upon receipt of a written request.

D. Without charge and to each of its clients, an investment adviser licensed or required to be licensed under the IM Act shall annually deliver, or offer in writing to deliver within 7 business days upon receipt of a written request, the statement required by this Section.

E. If an investment adviser licensed or required to be licensed under the IM Act renders substantially different types of investment advisory services to different clients, any information required by Part II of Form ADV may be omitted from the statement furnished to the client or prospective client if such information is applicable only to a type of investment advisory service or fee that is not rendered or charged, or proposed to be rendered or charged, to that client or prospective client.

F. Nothing in this Section shall relieve any investment adviser from any obligation pursuant to any provision of the IM Act or the rules and regulations thereunder or other federal or state law to disclose any information to its clients or prospective clients not specifically required by this Section.

G. An investment adviser licensed or required to be licensed under the IM Act that is compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, other investment advisers in the programs, shall, in lieu of the written disclosure statement required by subsection (A) and in accordance with the other subsections of this Section, furnish each client and prospective client of the wrap fee program with a written disclosure statement containing at least the information required by Schedule H of Form ADV. Any additional information included in such disclosure shall be limited to information concerning wrap fee programs sponsored by the investment adviser.

H. If the investment adviser is required under subsection (G) to furnish disclosure statements to clients or prospective clients of more than one wrap fee program, the investment adviser may omit from the disclosure statement furnished to clients and prospective clients of a wrap fee program or programs any information required by Schedule H that is not applicable to

clients or prospective clients of that wrap fee program or programs.

I. An investment adviser need not furnish the written disclosure statement required by subsection (G) to clients and prospective clients of a wrap fee program if another investment adviser is required to furnish and does furnish the written disclosure statement to all clients and prospective clients of the wrap fee program.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-206. Custody of Client Funds or Securities by Investment Advisers

A. Except as otherwise provided in subsection (B), it shall constitute a fraudulent practice within the meaning of A.R.S. § 44-3241(A)(4) for any investment adviser to take or have custody of any securities or funds of any client unless:

1. The investment adviser notifies the Commission in writing that the investment adviser has or may have custody of client funds or securities. Such notification may be given on Form ADV.
2. A qualified custodian maintains those funds and securities:
   a. In a separate account for each client under that client's name; or
   b. In accounts containing only clients' funds and securities, maintained in the name of the investment adviser as agent or trustee for such clients.
3. If opening an account with a qualified custodian, either under the client's name or under the investment adviser's name as agent, the investment adviser notifies the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information.
4. Account statements are sent to clients at least quarterly, either:
   a. By a qualified custodian, if the investment adviser has a reasonable basis for believing that the qualified custodian sends the requisite account statement to each client for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; or
   b. By the investment adviser, to each client for whom it has custody of funds or securities, identifying the amount of funds and of each security of which it has custody at the end of the period and setting forth all transactions in the account during that period if:
      i. An independent certified public accountant verifies all of those client funds and securities by actual examination at least once during each calendar year, at a time chosen by the accountant, without prior notice or announcement to the investment adviser, that is irregular from year to year; and
      ii. The independent certified public accountant files a copy of the auditor's report and financial statements with the Commission within 30 calendar days after the completion of the examination, along with a letter stating that it has examined the funds and securities, describing the nature and extent of the examination; and
      iii. Upon finding any material discrepancies during the course of the examination, the independent certified public accountant notifies the Commission within one business day of the finding, by means of a fax transmission or electronic mail, followed by first-class mail.

B. If the investment adviser is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle), the account statements required under subsection (A)(4) must be sent to each limited partner (or member or other beneficial owner).

C. A client may designate an independent representative to receive, on his behalf, notices and account statements as required under subsections (A)(3) and (A)(4).

D. With respect to shares of an open-end company, the company's transfer agent may be used in lieu of a qualified custodian for purposes of complying with subsection (A).

E. An investment adviser is not required to comply with this Section with respect to certain privately offered securities that are:

1. Acquired from the issuer in a transaction or chain of transactions not involving any public offering; uncertificated, and ownership thereof is recorded only on books of the issuer to its transfer agent in the name of the client; and transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.
2. Notwithstanding subsection (E)(1), the exception provided by subsection (E) is available with respect to securities held for the account of a limited partnership (or limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in subsection (F).

F. The investment adviser is not required to comply with subsections (A)(4) and (B) with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.

G. Compliance with this Section is not required with respect to the account of an investment company registered under the Investment Company Act of 1940.

H. With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4). Amended by final rulemaking at 13 A.A.R. 22, effective February 12, 2007 (Supp. 06-4).

R14-6-207. Suitability of Investment Advisory Services

A. Except as otherwise provided in subsection (B), it shall constitute a fraudulent practice within the meaning of A.R.S. § 44-3241(A)(4) for any person to provide investment advisory services to any client, other than in connection with impersonal advisory services, unless the person:

1. Before providing any investment advisory services, and as appropriate thereafter, makes a reasonable inquiry of the client as to the financial situation, investment experience, and investment objectives of the client; and
2. Reasonably determines that the investment advisory services are suitable for the client based upon the information obtained from the client in accordance with subsection (A)(1) above.

B. With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-208. Advertisements by Investment Advisers or Investment Adviser Representatives

A. Except as otherwise provided in subsection (D), it shall constitute a fraudulent practice within the meaning of A.R.S. § 44-3241(A)(4) for any investment adviser or investment adviser representative, directly or indirectly, to use any advertisement:

1. Which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or investment adviser representative or concerning any advice, analysis, report, or other service rendered by such investment adviser or investment adviser representative.
2. Which refers, directly or indirectly, to past specific recommendations of the investment adviser or investment adviser representative that were or would have been profitable to any person; except that an investment adviser or investment adviser representative may furnish or offer to furnish a list of all recommendations made by the investment adviser or investment adviser representative within the immediately preceding period of not less than one year if the investment adviser or investment adviser representative also furnishes:
   a. The name of each security recommended, the date and nature of each recommendation (for example, whether to buy, sell, or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the most recently available market price of each such security; and
   b. The following legend on the 1st page in prominent print or type: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."
3. Which represents, directly or indirectly, that any graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents, directly or indirectly, that any graph, chart, formula, or other device being offered will assist any person in making that person's own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use.
4. Which represents, directly or indirectly, that any report, analysis, or other service will be furnished for free or without charge, unless such report, analysis, or other service actually is or will be furnished entirely free and without any direct or indirect condition or obligation.
5. Which states that the Commission has approved any advertisement.

B. When requested by the Commission, any advertisement used directly or indirectly in connection with the provision of investment advisory services shall be filed with the Commission at least 10 business days prior to its proposed use.

C. Any advertisement that has been requested by the Commission pursuant to the provisions of subsection (B) but that has not been filed with the Commission shall not be used.

D. With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-209. Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients

A. Except as otherwise provided in subsection (F), it shall constitute a fraudulent practice within the meaning of A.R.S. § 44-3241(A)(4) for any investment adviser to fail to disclose to any client or prospective client all material facts with respect to:

1. A financial condition of the investment adviser that is reasonably likely to impair the ability of the investment adviser to meet contractual commitments to clients, if the investment adviser has discretionary authority (express or implied) or custody over the client's funds or securities, or requires prepayment of advisory fees of more than $500 from such client, 6 months or more in advance.
2. A legal or disciplinary event that is material to an evaluation of the investment adviser's or an investment adviser representative's integrity or ability to meet contractual commitments to clients.
3. A failure to comply with any arbitration award issued in connection with doing business as an investment adviser or investment adviser representative or as a dealer or salesman as defined in A.R.S. Title 44, Chapter 12.

B. It shall constitute a rebuttable presumption that the following legal or disciplinary events involving the investment adviser, an investment adviser representative, or a management person of the investment adviser (any of the foregoing being referred to hereafter as a "person") that were not resolved in the person's favor or subsequently reversed, suspended, or vacated are material within the meaning of subsection (A)(2) for a period of 10 years from the time of the event. No affirmative or negative presumption of materiality shall be created under subsection (A)(2) for events not specifically set forth in this subsection.

1. A criminal or civil action in a court of competent jurisdiction in which the person:

a. Was convicted or pleaded guilty or nolo contendere ("no contest") to a felony or misdemeanor, or is the named subject of a pending criminal proceeding (any of the foregoing referred to hereafter as "action"), and such action involved: an investment-related business; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion;
b. Was found to have been involved in a violation of an investment-related statute or rule; or
c. Was the subject of any order, judgment, or decree permanently or temporarily enjoining the person or otherwise limiting the person from engaging in any investment-related activity.

2. An administrative proceeding before the SEC, the Commission, or any federal or state agency (any of the foregoing being referred to hereafter as "agency") in which the person:
a. Was found to have caused an investment-related business to lose its authorization to do business; or
b. Was found to have been involved in a violation of an investment-related statute or rule, and was the subject of an order by the agency denying, suspending, or revoking the authorization of the person to act in, or barring or suspending the person's association with, an investment-related business; or otherwise significantly limiting the person's investment-related activities.

3. SRO proceedings in which the person:
a. Was found to have caused an investment-related business to lose its authorization to do business; or
b. Was found to have been involved in a violation of the SRO's rules and was the subject of an order by the SRO barring or suspending the person from membership or from association with other members, or expelling the person from membership; fining the person more than $2,500; or otherwise significantly limiting the person's investment-related activities.

C. The information required to be disclosed by subsection (A) shall be disclosed to clients within 30 calendar days after the occurrence of the event requiring disclosure, and to prospective clients not less than 48 hours prior to entering into any written or oral investment advisory contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within 5 business days after entering into the contract.

D. For purposes of calculating the 10-year period during which events are presumed to be material under subsection (B), the date of the reportable event shall be the date on which the final order, judgment, or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments, or decrees lapsed.

E. Compliance with subsection (B) shall not relieve any investment adviser from the disclosure obligations of subsection (A); compliance with subsection (A) shall not relieve any investment adviser from any other disclosure requirement under the IM Act, the rules thereunder, or under any other state or federal law. Investment advisers may disclose this information to clients and prospective clients in their "brochure," the written disclosure statement to clients under R14-6-205, provided, that the delivery of the brochure satisfies the timing of disclosure requirements described in subsection (C).

F. With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

Historical Note

Adopted effective July 19, 1996, under a court-ordered exemption as determined by the Arizona Corporation Commission (Supp. 96-3). Amended by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). At the request of the Corporation Commission, the preceding entry in this Historical Note is amended: the Commission intended the rulemaking action to reflect that the Section was repealed and a new Section was made at 7 A.A.R. 739, effective January 17, 2001 (Supp. 02-4).

R14-6-210. Licensure of Investment Adviser Representatives

A. The definition of investment adviser representative in A.R.S. § 44-3101 includes an individual employed by a federal covered adviser only if the individual has a place of business in Arizona and either:
1. Is a supervised person and meets all of the following conditions:
a. Has more than 5 clients who are natural persons, other than excepted persons.
b. Has clients more than 10% of whom are natural persons, other than excepted persons.
c. On a regular basis, solicits, meets with, or otherwise communicates with clients of the investment adviser or provides other than impersonal advisory services.
2. Is not a supervised person.

B. For purposes of this Section:
1. "Excepted person" means a natural person who:
a. Immediately after entering into the investment advisory contract with the investment adviser has at least $750,000 under management with the investment adviser, or
b. The investment adviser reasonably believes, immediately prior to entering into the advisory contract, has a net worth, together with assets held jointly with a spouse, at the time the contract is entered into of more than $1,500,000.
2. "Supervised person" means any partner, officer, director, or other person occupying a similar status or performing similar functions, or employees of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.
3. "Place of business" means:
a. An office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, or
b. 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.

C. A person who employs one or more investment adviser representatives who solicit, offer, or negotiate for the sale of or sell investment advisory services on behalf of an investment adviser shall comply with A.R.S. § 44-3151 unless each investment adviser representative is also employed by the investment adviser on whose behalf the activity is conducted.

Historical Note

New Section adopted by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1). Subsection (C) amended from "that employees 1" to "who employs one" to correct text submitted by the Corporation Commission (Supp. 01-2).

R14-6-211. Solicitation

A. An individual shall not be included in the definition of investment adviser representative under A.R.S. § 44-3101(3)(d) if that individual meets both of the following conditions:
1. The individual does not on a regular basis give advice regarding, or recommend the services of, an investment adviser or an investment adviser representative.
2. The individual does not accept or receive directly or indirectly any commission, fee, or other remuneration in connection with a referral to or recommendation of the services of an investment adviser or an investment adviser representative.

B. The term "remuneration" shall be broadly construed, but shall not include the exchange of client referrals between professionals without an exchange of additional compensation.

Historical Note
New Section adopted by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1).

R14-6-212. Application, Notice Filing, and Renewal Requirements

A. An application for licensure as an investment adviser under A.R.S. § 44-3153(B) shall include the following:
1. Form ADV with all information and exhibits required by the form.
2. An audited balance sheet if the investment adviser will have custody of client funds or if the investment adviser requires the payment of advisory fees six months or more in advance and in excess of $500 for each client. The audited balance sheet shall be based on the investment adviser's fiscal year end, shall be prepared in accordance with generally accepted accounting principles, and shall be audited by an independent certified public accountant. The notes to the balance sheet shall state the principles used to prepare the balance sheet, the basis of included securities, and any other explanation required for clarity.
3. A notarized affidavit of any officer, director, partner, member, trustee, or manager of the applicant stating:
   a. That a review of the records of the investment adviser has been conducted.
   b. Whether any investment adviser activity has been conducted with residents of Arizona prior to licensure as an investment adviser.
4. If the applicant intends to have a branch office in Arizona, the address and name of a contact individual located at such branch.
5. If part II of the Form ADV is not used as a disclosure brochure, the applicant shall submit a copy of the disclosure brochure the applicant gives or will give to clients.
6. The documents and fees required for each investment adviser representative as described in subsection (C).
7. The annual licensure fee required by A.R.S. § 44-3181(A).

B. A notice filing under A.R.S. § 44-3153(D) shall include the following:
1. Form ADV, part 1.
2. The documents and fees required for each investment adviser representative as described in subsection (C).
3. The annual notice filing fee required by A.R.S. § 44-3181(A).

C. An application for an investment adviser representative licensure under A.R.S. § 44-3156 shall include the following:
1. A complete Form U-4.
2. Proof of successful completion of required examinations in accordance with A.A.C. R14-6-204.
3. The annual licensure fee required by A.R.S. § 44-3181(A).

D. For purposes of A.R.S. § 44-3158(A), a license of an investment adviser or an investment adviser representative shall be renewed upon receipt of the nonrefundable license fee prescribed in A.R.S. § 44-3181.

E. For purposes of A.R.S. § 44-3153(E), a notice filing shall be renewed upon receipt of the nonrefundable license fee prescribed in A.R.S. § 44-3181.

Historical Note
New Section adopted by final rulemaking at 7 A.A.R. 739, effective January 17, 2001 (Supp. 01-1).

191—50.38(502) Dishonest or unethical business practices of investment advisers and investment adviser representatives, or fraudulent or deceptive conduct by federal covered investment advisers. An investment adviser, investment adviser representative, or a federal covered investment adviser has a fiduciary duty to act for the benefit of its clients. The federal statutory and regulatory provisions referenced in this rule apply to investment advisers and federal covered investment advisers, to the extent permitted by the NSMIA. This rule applies to federal covered investment advisers to the extent that the alleged conduct is fraudulent, deceptive, or as otherwise prohibited by the NSMIA.

50.38(1) An investment adviser, investment adviser representative, or a federal covered investment adviser shall not engage in dishonest or unethical business practices or fraudulent and deceptive conduct including, but not limited to:

a. Recommending to a client to whom supervisory, management, or consulting services are provided the purchase, sale, or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser;

b. Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten business days after the date of the first transaction placed pursuant to discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order for a definite amount of a specified security shall be executed, or both;

c. Inducing in a client's account trading that is excessive in size or frequency compared to the financial resources, investment objectives, and character of the account;

d. Placing an order to purchase or sell a security for a client account without authority to do so;

e. Placing an order to purchase or sell a security for a client account upon instruction of a third party without first obtaining a written third-party trading authorization from the client;

f. Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds;

g. Loaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser;

h. Misrepresenting to any advisory client, or prospective advisory client, the qualifications of the investment adviser or any employee of the investment adviser, or misrepresenting the nature of the advisory services being offered or fees to be charged for such service, or omitting to state a material fact necessary to make the statements made regarding qualifications, services or fees, in light of the circumstances under which they are made, not misleading;

i. Providing a report or recommendation to any advisory client prepared by someone other than the investment adviser without disclosing that fact. This prohibition does not apply when the investment adviser uses published research reports or statistical analyses to render advice or when an investment adviser orders such a report in the normal course of providing service;

j. Charging a client an unreasonable advisory fee;

k. Failing to disclose to clients in writing before any advice is rendered any material conflict of interest regarding the investment adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice including, but not limited to:

(1) Compensation arrangements connected with advisory services to clients which are in addition to compensation from such clients for such services; and

(2) Charging a client an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice will be received by the investment adviser or its employees;

l. Guaranteeing a client that a specific result will be achieved (gain or no loss) as a result of the investment adviser's services;

m. Disclosing the identity, affairs, or investments of any client unless required by law to do so, or unless disclosed with the client's consent;

EXHIBIT 2

n. Taking any action, directly or indirectly, regarding securities or funds in which any client has any beneficial interest when the investment adviser is in violation of the custody requirements provided by rule 191—50.39(502);

o. Entering into, extending or renewing any investment advisory contract unless such contract is in writing and discloses:

(1) The services to be provided;

(2) The term of the contract;

(3) The advisory fee;

(4) The formula for computing the fee;

(5) The amount of prepaid fee to be returned in the event of contract termination or nonperformance;

(6) Whether the contract grants discretionary power to the investment adviser; and

(7) That no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract;

p. Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information in violation of Section 204A of the Investment Advisers Act of 1940;

q. Entering into, extending, or renewing any advisory contract in violation of Section 205 of the Investment Advisers Act of 1940. This provision applies to all advisers and investment adviser representatives registered or required to be registered under this Act, notwithstanding whether such adviser or investment adviser representative would be exempt from federal registration pursuant to Section 203(b) of the Investment Advisers Act of 1940;

r. Providing in an advisory contract any condition, stipulation, or provisions which purport to bind any person to waive compliance with any provision of this Act or of the Investment Advisers Act of 1940 or any other practice contrary to Iowa Code section 502.509(12) or Section 215 of the Investment Advisers Act of 1940;

s. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in violation of Section 206(4) of the Investment Advisers Act of 1940, regardless of whether the investment adviser or investment adviser representative is not registered or required to be registered pursuant to Section 203 of the Investment Advisers Act of 1940;

t. Engaging in conduct or any act, indirectly or through or by any other person, which is unlawful for such person to do directly under the provisions of this Act, its implementing rules, or order of the administrator;

u. Failing to disclose or providing incomplete disclosure to a client regarding any securities-related activities, or engaging in deceptive practices;

v. Soliciting or accepting a gift, directly or indirectly, from an unrelated customer that in the aggregate exceeds $250 in a calendar year. A gift accepted by an immediate family member from an unrelated client shall be included in the aggregate limit. An investment adviser shall not solicit or accept from a client a gift transferred through a relative or third party to the investment adviser's benefit that would have the effect of evading this paragraph;

w. Soliciting or accepting being named as a beneficiary, executor, or trustee in a will or trust of an unrelated customer; and

x. Evading or otherwise negating the requirements of paragraph 50.38(1)*"f," "g," "v,"* or *"w"* by terminating the customer relationship for the purpose of soliciting or accepting a loan or gift or being named as a beneficiary, executor or trustee in a will or trust that the agent is otherwise not permitted to solicit or accept. An investment adviser or investment adviser representative will not be in violation of this rule if the investment adviser or investment adviser representative has made a bona fide termination of the client relationship and conducted no securities-related business or other business for a period of three years with the client.

y. Engaging in conduct deemed dishonest or unethical in rule 191—50.54(502).

50.38(2) Except as otherwise provided in subrule 50.38(3), it shall constitute a dishonest or unethical practice within the meaning of Iowa Code section 502.412(4)*"m"* for any investment adviser

or investment adviser representative, directly or indirectly, to use any advertisement that does any one of the following:

a. Refers to any testimonial of any kind concerning the investment adviser or investment adviser representative or concerning any advice, analysis, report, or other service rendered by such investment adviser or investment adviser representative.

b. Refers to past specific recommendations of the investment adviser or investment adviser representative that were or would have been profitable to any person, except that an investment adviser or investment adviser representative may furnish or offer to furnish a list of all recommendations made by the investment adviser or investment adviser representative within the immediately preceding period of not less than one year if the advertisement or list also includes both of the following:

(1) The name of each security recommended, the date and nature of each recommendation, the market price at that time, the price at which the recommendation was to be acted upon, and the most recently available market price of each such security.

(2) A legend on the first page in prominent print or type that states that the reader should not assume that recommendations made in the future will be profitable or will equal the performance of the securities in the list.

c. Represents that any graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents, directly or indirectly, that any graph, chart, formula, or other device being offered will assist any person in making that person's own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to the use of any graph, chart, formula or device.

d. Represents that any report, analysis, or other service will be furnished for free or without charge, unless such report, analysis, or other service actually is or will be furnished entirely free and without any direct or indirect condition or obligation.

e. Represents that the administrator has approved any advertisement.

f. Contains any untrue statement of a material fact, or any statement that is otherwise false or misleading.

50.38(3) With respect to federal investment covered advisers, the provisions of this rule apply only to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

50.38(4) For the purposes of this rule, the term "advertisement" shall include any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any electronic or paper publication, by radio or television, or by any medium, that offers any one of the following:

a. Any analysis, report, or publication concerning securities.

b. Any analysis, report, or publication that is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell.

c. 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.

d. Any other investment advisory service with regard to securities.

This rule is intended to implement Iowa Code section 502.412(4)*"m."*

I. Every investment adviser licensed or required to be licensed in this state and that has its principal place of business in a state other than this state shall be exempt from the requirements of this Rule, provided the investment adviser is licensed or registered in such state and is in compliance with such state's recordkeeping requirements.

51-4.7(IA) Mandatory Disclosure

A. An investment adviser and its investment adviser representative shall furnish each advisory client and prospective advisory client a written disclosure statement which may be either a copy of Part II of the investment adviser's Form ADV or a written document containing at least the information then so required by Part II of Form ADV.

B. An investment adviser and its investment adviser representative, except as provided in section (C), shall deliver the disclosure statement required by this section to an advisory client or prospective advisory client:

1. not less than 48 hours prior to entering into any written or oral investment advisory contract with such client or prospective client, or

2. at the time of entering into any such contract, if the advisory client has a right to terminate the contract without penalty within five business days after entering into the contract.

C. Delivery of the statement required by section (A) need not be made in connection with entering into a contract for impersonal advisory services.

D. Nothing in this rule shall relieve any investment adviser or investment adviser representative from any obligation pursuant to any provision of the Act or the rules and regulations thereunder or other federal or state law to disclose any information to its advisory clients or prospective advisory clients not specifically required by this rule.

51-4.8(IA) Dishonest and Unethical Conduct

Introduction

A person who is an investment adviser or an investment adviser representative is a fiduciary and has a duty to act primarily for the benefit of its clients. While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser and its clients and the circumstances of each case, an investment adviser or investment adviser representative shall not engage in dishonest or unethical conduct including the following:

A. Recommending to a client, to whom investment supervisory, management or consulting services are provided, the purchase, sale, or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser.

B. Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order involving a definite amount of a specific security that shall be executed, or both.

EXHIBIT 3

C. Inducing trading in a client's account that is excessive in size or frequency in view of the client's financial resources, investment objectives and the character of the account in light of the fact that an adviser in such situations can directly benefit from the number of securities transactions effected in a client's account.

D. Placing an order to purchase or sell a security for the account of a client without authority to do so.

E. Placing an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained a written third-party trading authorization from the client.

F. Borrowing money or securities from a client, unless the client is a broker-dealer, an affiliate of the investment adviser, a family member, or a financial institution engaged in the business of loaning funds.

G. Loaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser or a family member.

H. To misrepresent to any advisory client, or prospective advisory client, the qualifications of the investment adviser or any employee of the investment adviser, or to misrepresent the nature of the advisory services being offered or fees to be charged for such service, or to omit to state a material fact necessary to make the statements made regarding qualifications, services, or fees, in light of the circumstances under which they are made, not misleading.

I. Providing a report or recommendation to any advisory client prepared by someone other than the adviser without disclosing that fact. This prohibition does not apply to a situation where the adviser uses published research reports or statistical analyses to render advice or where an adviser orders such a report in the normal course of providing service.

J. Charging a client an advisory fee that is unreasonable in light of the type of services to be provided, the experience of the adviser, the sophistication and bargaining power of the client, and whether the adviser has disclosed that lower fees for comparable services may be available from other sources.

K. Failing to disclose to clients, in writing, before any advice is rendered, any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice, including:

1. Compensation arrangements connected with advisory services to clients which are in addition to compensation from such clients for such services; and

2. Charging a client an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice will be received by the adviser or its employees,

L. Guaranteeing a client that a specific result will be achieved (gain or no loss) with advice to be rendered.

M. Publishing, circulating, or distributing any advertisement which does not comply with Rule 206 (4)-1 under the 40 Act.

N. Disclosing the identity, affairs, or investments of any client, unless required by law to do so, or unless consented to by the client.

O. Taking any action, directly or indirectly, with respect to those securities or funds in which any client has any beneficial interest, where the investment adviser has custody or possession of such securities or funds when the adviser's action is subject to and does not comply with the requirements of Reg. 206 (4) -2 under the 40 Act.

P. Entering into, extending, or renewing any investment advisory contract, unless such contract is in writing and discloses, in substance, the information required by Part II of Form ADV. The information required by Part II of Form ADV may be disclosed in a document other than the investment advisory contract, so long as it is disclosed at the time the contract is entered into, extended or renewed.

Q. Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information in violation of Section 204A of the 40 Act.

R. Entering into, extending, or renewing any investment advisory contract contrary to the provisions of Section 205 of the 40 Act. This provision shall apply to all advisers and investment adviser representatives registered or required to be registered under this Act notwithstanding whether such adviser would be exempt from federal registration pursuant to section 203(b) of the 40 Act

S. To indicate, in an advisory contract any condition, stipulation, or provision binding any person to waive compliance with any applicable provision of this Act, any rule promulgated thereunder or the 40 Act, or any rule promulgated thereunder, or to engage in or any other practice that would violate Section 215 of the 40 Act.

T. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions of Section 206(4) of the 40 Act notwithstanding the fact that such investment adviser is not registered or required to be registered under Section 203 of the 40 Act.

U. Engaging in any conduct or any act, indirectly or through or by any other person, which would be unlawful for such person to do directly under the provisions of this act or any rule thereunder. Such conduct or act includes, but is not limited to, that conduct set forth in this Rule. Engaging in other conduct such as forgery, embezzlement, theft, exploitation, non-disclosure, incomplete disclosure or misstatement of material facts, manipulative or deceptive practices, or aiding or abetting any unethical practice, shall be deemed an unethical business practice and shall be grounds for denial, suspension or revocation of a license. The federal statutory and regulatory provisions referenced herein shall apply to all investment advisers and investment adviser representatives only to the extent permitted by the National Securities Markets Improvement Act of 1996.

V.

1. The use of a senior specific certification or designation by any person in connection with the offer, sale, or purchase of securities, or the provision of advice as to the value of or the advisability of investing in, purchasing, or selling securities, either directly or indirectly or through publications or writings, or by issuing or promulgating analyses or reports relating to securities, that indicates or implies that the user has special certification or training in advising or servicing senior citizens or retirees, in such a way as to mislead any person shall be a dishonest and unethical practice in the securities, commodities, and investment business within the meaning of the Colorado Securities Act. The prohibited use of such certifications or professional designation includes, but is not limited to, the following:

    a. use of a certification or professional designation by a person who has not actually earned or is otherwise ineligible to use such certification or designation;

b. use of a nonexistent or self-conferred certification or professional designation;

c. use of a certification or professional designation that indicates or implies a level of occupational qualifications obtained through education, training, or experience that the person using the certification or professional designation does not have; and

d. use of a certification or professional designation that was obtained from a designating or certifying organization that:

(1) is primarily engaged in the business of instruction in sales and/or marketing;

(2) does not have reasonable standards or procedures for assuring the competency of its designees or certificants;

(3) does not have reasonable standards or procedures for monitoring and disciplining its designees or certificants for improper or unethical conduct; or

(4) does not have reasonable continuing education requirements for its designees or certificants in order to maintain the designation or certificate.

2.

a. There is a rebuttable presumption that a designating or certifying organization is not disqualified solely for purposes of paragraph 1(d) above when the organization has been accredited by:

(1) The American National Standards Institute; or

(2) The National Commission for Certifying Agencies.

b. Certifications or professional designations offered by an organization that is on the United States Department of Education's list entitled "Accrediting Agencies Recognized for Title IV Purposes" may qualify when the certification or professional designation program also specifically meets the paragraph 1(d) requirements listed above.

3. In determining whether a combination of words (or an acronym standing for a combination of words) constitutes a certification or professional designation indicating or implying that a person has special certification or training in advising or servicing senior citizens or retirees, factors to be considered shall include:

a. use of one or more words such as "senior," "retirement," "elder," or like words, combined with one or more words such as "certified," "registered," "chartered," "adviser," "specialist," "consultant," "planner," or like words, in the name of the certification or professional designation; and

b. the manner in which those words are combined.

4. For purposes of this rule, a certification or professional designation does not include a job title within an organization that is licensed or registered by a state or federal financial services regulatory agency, when that job title:

a. indicates seniority or standing within the organization; or

b. specifies an individual's area of specialization within the organization

For purposes of this subsection, financial services regulatory agency includes, but is not limited to, an agency that regulates broker-dealers, investment advisers, or investment companies as defined under the Investment Company Act of 1940.

5. Nothing in this rule shall limit the Securities Commissioner's authority to enforce existing provisions of law.

51-4.9(IA) Payment of Cash Fees for Solicitation

A. It shall be unlawful for any investment adviser licensed under the Act to pay a cash fee, directly or indirectly, in connection with solicitation activities unless:

1.

(a) The investment adviser in licensed under the Act;

(b) The solicitor to whom a cash fee is paid for such referral is not a person:

(i) subject to an order of the SEC issued under section 203(f) of the '40 Act, or an order of the Commissioner pursuant to section 11-51-410(I)(e), C.R.S.;

(ii) convicted within the previous ten years of any felony or any misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the '40 Act, or as provided in section 11-51-410(I)(c), C.R.S., or

(iii) who has been found by the SEC to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the '40 Act, or is subject to an order issued by the Commissioner pursuant to sections 11-51-410 (I)(a),(f),or(i),C.R.S.; or

(iv) subject to an order, judgment or decree described in section 203(e)(4) of the '40 Act, or pursuant to section II-51-410(I)(d), C.R.S.; and

(c) Such cash fee is paid pursuant to a written agreement to which the adviser is a party; and

[Note: The investment adviser shall retain a copy of each written agreement required by this paragraph as part of the records required to be kept under Rule 51-4.6(IA).A.15.]

2. The cash fee is paid to a solicitor:

(a) with respect to solicitation activities for the provision of impersonal advisory services only;

(b) who is:

(i) a partner, officer, director or employee of such investment adviser; or

14 Ill. Adm. Code 130.806

IL - Illinois Administrative Code > TITLE 14. COMMERCE > SUBTITLE A. REGULATION OF BUSINESS > CHAPTER I. SECRETARY OF STATE > PART 130. REGULATIONS UNDER ILLINOIS SECURITIES LAW OF 1953 > SUBPART H. REGISTRATION OF DEALERS, SALESPERSONS, INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

§ 130.806 Acts Not Requiring a Notification Filing of a Federal Covered Investment Adviser or Registration as an Investment Adviser or Investment Adviser Representative Under Section 8 of the Act

Notwithstanding any other provision of the Act or this Part, an investment adviser or a federal covered investment adviser who transmits or distributes information on available products and services via the nonproprietary, public computer network (commonly known as the "Internet") shall not be deemed to be acting as an investment adviser, a federal covered investment adviser or an investment adviser representative in this State for purposes of Section 8 of the Act provided that:

a) The communication contains a legend clearly stating that the investment adviser, the federal covered investment adviser or investment adviser representative may only transact business in those states where he, she or it is registered or otherwise excluded or exempted from state registration;

b) The sender of the communication has taken reasonable measures to insure that any subsequent interaction between prospective customers or clients residing in states where the investment adviser, the federal covered investment adviser or investment adviser representative is not registered or is not subject to notification filing is limited so as to not otherwise require state investment adviser or investment adviser representative registration or notification filing;

c) The communication does not involve the actual effecting of securities transactions or trades or the rendering of investment advice for compensation over the Internet but is limited to the dissemination of information on products or services; and

d) In the case of an investment adviser representative or a federal covered investment adviser representative, the affiliation with an investment adviser or federal covered investment adviser is prominently disclosed within the communication; the investment adviser or federal covered investment adviser retains the responsibility of reviewing and approving the content of the Internet communication; the investment adviser or federal covered investment adviser has authorized the distribution or dissemination of information on products and services via the Internet communication; and the investment adviser representative or federal covered investment adviser representative is acting within the scope of his, her or its authority in distributing or disseminating the Internet communication.

History

SOURCE:

Added at 21 Ill. Reg. 15892, effective December 1, 1997.

Annotations

EXHIBIT4

Research References & Practice Aids

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

14 Ill. Adm. Code 130.821

This document is current through August 18, 2023

IL - Illinois Administrative Code > TITLE 14. COMMERCE > SUBTITLE A. REGULATION OF BUSINESS > CHAPTER I. SECRETARY OF STATE > PART 130. REGULATIONS UNDER ILLINOIS SECURITIES LAW OF 1953 > SUBPART H. REGISTRATION OF DEALERS, SALESPERSONS, INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

§ 130.821 Reporting of Dealer Branch Office Locations and Required Fees

a) Each applicant for registration as a dealer shall file Form BR on the CRD system setting forth the address of each branch office in this State as defined in Section 130.280. The applicant for registration as a dealer shall pay the fee in the amount specified in Section 130.110 for each branch office in this State.

b) Each registered dealer shall file or have filed Form BR on the CRD system on or before December 31 annually setting forth the address of each branch office and pay to the Securities Department in Springfield a fee in the form and amount specified in Section 130.110 for each branch office in this State.

c) No registration of a dealer shall become effective until a separate Form BR of the dealer's branch offices in this State, if any, has been filed on the CRD system and the fee, if any, has been paid.

d) The registered dealer shall amend its application for registration by filing on the CRD system an amended Form BR or initial Form BR within 10 business days after:

1) the opening of any branch office in this State not previously reported; and

2) the closing of any branch office in this State.

History

SOURCE:

Amended at 14 Ill. Reg. 884, effective December 30, 1989.

Amended by emergency rulemaking at 30 Ill. Reg. 13009, effective July 11, 2006,

for a maximum of 150 days.

Amended at 30 Ill. Reg. 18211, effective October 31, 2006.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

14 Ill. Adm. Code 130.822

This document is current through August 18, 2023

IL - Illinois Administrative Code > TITLE 14. COMMERCE > SUBTITLE A. REGULATION OF BUSINESS > CHAPTER I. SECRETARY OF STATE > PART 130. REGULATIONS UNDER ILLINOIS SECURITIES LAW OF 1953 > SUBPART H. REGISTRATION OF DEALERS, SALESPERSONS, INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

§ 130.822 Examinations Deemed Satisfactory for Purposes of Determining Sufficient Knowledge of Each Principal Under Section 8.B(9)(a) of the Act Prior to Registration as a Dealer

a) Passage of the Series 24 (formerly Series 40 or Series 00) (General Securities Principal Examination) together with either the Series 63 (Uniform Securities Act Law Examination) or Series 66 (Uniform Combined State Law Examination) conducted by FINRA shall qualify a principal or principals of legal age in this State on behalf of a registered dealer without limitation in this State.

b) Passage of the Series 26, 39 or 53 Examination together with either the Series 63 Examination (Uniform Securities Act Law Examination) or Series 66 (Uniform Combined State Law Examination) conducted by FINRA shall qualify by examination a principal or principals of legal age in this State on behalf of a registered dealer for registration in a limited capacity in this State.

1) The Series 26 Examination (Investment Company/Variable Contracts Products (ICVC) Principal Examination) together with either the Series 63 (Uniform Securities Act Law Examination) or Series 66 (Uniform Combined State Law Examination) shall qualify the registered dealer to offer or sell variable annuities or securities issued by investment companies.

2) The Series 39 (Direct Participation Programs Principal (DPP) Examination) together with either the Series 63 (Uniform Securities Act Law Examination) or Series 66 (Uniform Combined State Law Examination) shall qualify the registered dealer to offer or sell direct participation programs in the form of limited partnerships or joint venture interests in tax shelter programs.

3) The Series 53 (Municipal Securities Principal Examination) together with either the Series 63 (Uniform Securities Act Law Examination) or Series 66 (Uniform Combined State Law Examination) shall qualify the registered dealer to offer or sell securities of municipalities or industrial development revenue obligations.

c) Passage of the Series 8 (General Securities Sales Supervisor Examination or Branch Office Manager (NYSE) Examination) conducted by FINRA shall qualify a principal or principals of legal age in this State on behalf of a registered dealer pursuant to the limitations set forth by FINRA.

d) All scheduling for the examinations referred to in subsections (a), (b) and (c) shall be made with, and fees paid to, an office of FINRA. The applicant for registration as a dealer shall submit in writing satisfactory evidence of passing the examination prior to registration in this State if that information is not available to the Securities Department through the CRD.

History

SOURCE:

§ 130.822 Examinations Deemed Satisfactory for Purposes of Determining Sufficient Knowledge of Each Principal Under Section 8.B(9)(a) of t he Act Prior to Regis....

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Amended at 20 Ill. Reg. 14185, effective October 21, 1996.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

14 Ill. Adm. Code 130.823

This document is current through August 18, 2023

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§ 130.823 Procedure for Requesting Waiver of Dealer, Salesperson, Investment Adviser, Investment Adviser Representative, or Principal Examination Requirements

a) If a person applying for registration as a dealer, salesperson, investment adviser, investment adviser representative, or principal seeks a waiver of the examination requirements as provided in Section 8 of the Act, the request for the waiver shall be in writing on a form and in the manner prescribed by the Secretary.

b) The request for the waiver of the examination requirement shall contain the following information:

1) The business name and address of the dealer (or investment adviser for investment adviser and investment adviser representative applicants or federal covered investment adviser for investment adviser representative applicants) with which the applicant is or will be associated;

2) The official title and connection of the applicant with the dealer (or federal covered investment adviser or investment adviser);

3) The applicant's legal name;

4) The applicant's business address and telephone number;

5) The applicant's residential address and telephone number;

6) The applicant's date of birth;

7) A list of any other names the applicant has used including the dates used, the reason for the name change, and the date the applicant's present name was adopted;

8) The amount of ownership of capital stock or partnership interest of the dealer (or investment adviser) with which the applicant is associated;

9) The nature and tenure of each job the applicant currently holds or has held for 10 years prior to the date of the waiver request. In addition, investment adviser applicants must provide the total aggregate dollar value of investment advisory accounts serviced, whether the applicant had discretionary authority over the accounts, and the total percentage of institutional accounts the applicant serviced of those entities enumerated in Section 4.C of the Act;

10) The applicant's educational history including degrees received;

11) Any professional certifications or designations;

12) Any FINRA or related examinations taken by the applicant;

13) The name, address and business affiliation of three persons to whom the Secretary may address inquiries regarding experience, qualification and standing of the applicant; and

14) A list of where the applicant has been licensed or registered as a dealer, salesperson or investment adviser, including the state or licensing agency, the type of license or registration and the period during which the registration was effective.

c) The request shall be signed and notarized. By signing the waiver request, the applicant is attesting to the following (unless a detailed explanation is attached):

1) The applicant has never had any license or registration as a dealer, investment adviser, investment adviser representative or salesperson, suspended, cancelled or revoked after notice and opportunity for hearing;

2) The applicant has never been temporarily or permanently enjoined from acting as an investment adviser, investment adviser representative, federal covered investment adviser, federal covered investment adviser representative, dealer, salesperson or employee thereof or from engaging in or continuing any conduct or practice in connection with activity as an investment adviser, investment adviser representative, federal covered investment adviser, federal covered investment adviser representative, dealer, salesperson, employee thereof or employee of any investment company, financial institution or insurance company after notice and opportunity for hearing;

3) The applicant has never been convicted of any felony or misdemeanor involving the purchase or sale of any securities or arising out of any conduct as an investment adviser, investment adviser representative, federal covered investment adviser, federal covered investment adviser representative, dealer, salesperson, employee thereof or employee of any investment company, financial institution or insurance company;

4) The applicant has never been permanently or temporarily enjoined from the issuance, offering for sale, sale, promotion, negotiation, advertising or distribution of securities;

5) The applicant has never been named as a defendant in any proceeding arising from a complaint alleging a fraudulent act in any transaction of any kind or character;

6) The applicant has never been found by any state or federal board, body, department or commission to have willfully made any untrue statement of a material fact in any application for registration or license as a dealer, investment adviser or salesperson or in any report required to be filed with the subject body, board, department or commission or under the Federal 1934 Act or to have willfully omitted to state in the application or report any material fact that is required to be stated in an application or report; and

7) The applicant has never been disbarred or suspended from the practice of any profession.

d) After the Securities Department receives the request, the request shall be granted or denied based upon criteria that includes, but is not limited to, education, years of experience in the securities business, past disciplinary history, and prior registration with the SEC, any state securities regulator, or FINRA. The applicant shall be informed in writing of the Securities Department's decision.

History

SOURCE:

Added at 14 Ill. Reg. 5188, effective March 26, 1990.

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.824

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§ 130.824 Financial Statements to be Filed by a Registered Dealer

a) Each dealer registered by the Secretary that is not required to file a financial statement with a registered self-regulatory organization shall file a financial statement containing the information required by the Secretary as follows:

1) the financial statement shall be prepared as of an audit date selected by the dealer within each calendar year;

2) the financial statement shall be filed no later than the first day of the fourth month days after the selected audit date;

3) the time period covered by the statement shall be the twelve month period immediately following the date of the most recent audited statement; and

4) should a dealer elect to change its audit date, a written request for variance in accordance with Section 130.190 of this Part from the filing period covered by the statement shall be filed with the Securities Department in Springfield, Illinois. The request shall include the reason or reasons for the change and an affirmation that the dealer is currently in compliance with the requirements set forth under Section 130.826 of this Part. An unaudited statement, which includes a balance sheet and computations showing compliance with the requirements set forth under Section 130.826 of this Part, shall be filed with the Securities Department and shall be as of a current date. The audited statement when filed shall encompass the entire period of time which has elapsed since the date of the most current filing of an audited statement.

b) Each financial statement filed pursuant to subsection (a) of this Section shall be audited by an independent certified public accountant and shall include the following:

1) a signed independent auditor's report;

2) a balance sheet;

3) an income statement;

4) a statement of cash flow;

5) notes to the financial statements, if any;

6) a computation of net capital calculated pursuant to either the aggregate indebtedness or the alternative method;

7) a statement of changes in liabilities subordinated to the claims of general creditors, if any; and

8) a statement of computation for determination of reserve requirements for dealers computed in accordance with 17 CFR 240.15c3-3, as in effect on August 1, 1997 (no subsequent amendments or editions), if any. The statement shall be accompanied by the cover page, if any, designated by the Securities Department.

c) The Secretary may, require any dealer to file an interim financial statement as of a date selected by the Secretary. The Secretary shall specify whether or not the statement is to be audited by an independent certified public accountant in circumstances including, but not limited to: the company has been in violation of its net capital requirement

prescribed in Section 130.826 of this Part; an officer or employee has been convicted of embezzlement or theft of the dealer's funds; the dealer has been charged by a federal or state securities regulator or SRO of falsifying its books and records; and the dealer has merged with another dealer which has a record of past violations of its net capital requirements.

d) If an unaudited interim financial statement is required to be filed by a dealer, the statement shall contain an oath or affirmation that, to the best of the knowledge and the belief of the person making the oath or affirmation:

1) the financial statement and supporting schedules are true and correct, and

2) neither the dealer, nor any partner, officer or director, as the case may be, has a proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall be made before a person duly authorized to administer oaths or affirmations. If the dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by the general partner in charge of the dealer's financial affairs; or if a corporation, by the dealer's chief financial officer.

e) Each financial statement, except the independent auditors' report, the balance sheet and notes, if any, shall be deemed confidential when filed with the Securities Department. The independent auditors' report, the balance sheet and notes, if any, shall be a matter of public record and available to the public upon written request.

f) Anything to the contrary notwithstanding, all of the information contained in any financial statement shall be available to any federal, state or local law enforcement agency, any state or federal regulator or any self-regulatory organization registered under any federal law upon written request to the Securities Department.

History

SOURCE:

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.825

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§ 130.825 Records Required of Dealers and Customer Fees.

a) Every dealer registered by the Secretary of State shall keep the following books and records:

1) blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. The record shall show the account for which each transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered;

2) ledgers (or other records) reflecting all assets and liabilities, income, and expense and capital accounts;

3) ledger accounts itemizing separately as to each cash and margin account of every customer and of the dealer and partners thereof, all purchases, sales, receipts and deliveries of securities and commodities for the account and all other debits and credits to the account;

4) ledgers (or other records) reflecting the following:

A) securities in transfer

B) dividends and interest received

C) securities borrowed and securities loaned

D) monies borrowed and monies loaned (together with a record of the collateral thereof and any substitutions in the collateral)

E) securities failed to receive and failed to deliver;

5) a securities record or ledger reflecting separately for each security as of the clearance dates, all "long" or "short" positions (including securities in safekeeping) carried by the dealer for its account or for the account of its customers or partners and showing the location of all securities long and offsetting position to all securities short and in all cases the name or designation of the account in which each position is carried;

6) a memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry, the price at which executed and, to the extent feasible, the time of execution or cancellation. Orders entered pursuant to the exercise of discretionary power by the dealer, or any employee thereof, shall be so designated. The term "instruction" shall be deemed to include instructions between partners and employees of a dealer. The term "time of entry" shall be deemed to mean the time when such dealer transmits the order or instruction for execution, or, if it is not so transmitted, the time when it is received;

7) a memorandum of each purchase and sale of securities for the account of the dealer showing the price and, to the extent feasible, the time of execution;

8) copies of confirmations of all purchases and sales of securities and copies of notices of all other debits and credits for securities, cash and other items for the account of customers and partners of the dealer;

9) a record in respect of each cash and margin account with the dealer containing the name and address of the beneficial owner; provided that, in the case of a joint account or an account of a corporation, the records are required only in respect of the person or persons authorized to transact business for the account;

10) a record of all puts, calls, spreads, straddles and other options in which the dealer has any direct or indirect interest or which the dealer has granted or guaranteed, containing, at least, an identification of the security and the number of units involved.

b) This Section shall not be deemed to require a member of a national securities exchange to make or keep records of transactions cleared for the member by another member as are customarily made and kept by the clearing member.

c) Every dealer registered by the Secretary of State shall preserve, for a period of not less than 3 years, the first 2 years in an easily accessible place:

1) all check books, bank statements, cancelled checks and cash reconciliations;

2) all bills receivable or payable (or copies thereof), paid or unpaid, relating to the business of the dealer;

3) originals of all communications received and copies of all communications sent by the dealer (including interoffice memoranda and communications) relating to the business of the dealer;

4) all trial balances, computation of aggregate indebtedness and net capital (and working papers in connection therewith), financial statements, branch office reconciliations and internal audit working papers relating to the business of the dealer;

5) all guarantees of accounts and all powers of attorney and other evidence of the granting of any discretionary authority given in respect of any account, and copies of the resolution empowering an agent to act on behalf of a corporation;

6) all written agreements (or copies thereof) entered into by a dealer relating to business of the dealer, including agreements with respect to any account.

d) For a period of not less than 3 years after the closing of any customer's account, any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account shall be preserved by every registered dealer.

e) Every registered dealer shall preserve during the life of the enterprise and of any successor enterprise all partnership agreements, certificates or articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books.

f) After a record or other documents have been preserved for 2 years, a photograph thereof on film may be substituted therefor for the balance of the required time.

g) Every dealer registered by the Secretary of State shall maintain within this State, in an easily accessible place, all records required by this Section. A written request for the waiver of the provisions of this Section may be made to the Secretary of State to permit any registered dealer to maintain any of the records required by this Section, in some place other than the State of Illinois. In determining whether or not the provisions of this Section should be waived, the Secretary of State shall consider, among other things, whether the main office of the dealer is in a place outside the State of Illinois or whether the dealer clears all or some of its transactions and uses all or some of the bookkeeping facilities of some other dealer whose main office is outside the State of Illinois.

h) The records (or a copy thereof) required by this Section must be maintained in each office in this State, if any, from which the transaction with respect to those records occurred.

i) Every dealer shall disclose in writing to customers at the time of opening an account, any custody, service, maintenance or similar fee that may be charged to the customer and the basis upon which each charge is determined. Customers shall receive written notice at least 45 days prior to the imposition of any new custody, service, maintenance or similar fee, or any changes to existing fees of that nature.

History

SOURCE:

Amended at 20 Ill. Reg. 14185, effective October 21, 1996.

Annotations

Research References & Practice Aids

Authority & General Source

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§ 130.826 Registered Dealer Net Capital Requirements

a) Each dealer registered under Section 8 of the Act shall at all times have and maintain net capital no less than the greater of the higher minimum requirement applicable to its ratio requirement under 17 CFR 240.15c3-1 (May 31, 2011). No dealer electing to use the alternative standard shall permit its net capital to be less than the greater of the amount set forth in 17 CFR 240.15c3-1 (May 31, 2011) or 2 percent of the aggregate debit items computed in accordance with 17 CFR 240.15c3-3 (May 31, 2011).

b) In addition to meeting the requirement set forth in subsection (a), a dealer subject to the aggregate indebtedness standard of net capital computation shall maintain the amount specified in 17 CFR 240.15c3-1 (May 31, 2011).

c) Each dealer shall make the applicable computations set forth in subsection (a) in accordance with the provisions of 17 CFR 240.15c3-3 (May 31, 2011) and shall preserve the computations as part of the records required by Section 130.825.

d) The Secretary may exempt a dealer from the requirements of this Section because of the special nature of business or financial position of the dealer and the safeguards that have been established for the protection of customers' funds and securities, and it is not necessary in the public interest or for the protection of investors for the dealer to be subject to the requirements of this Section.

History

SOURCE:

Amended at 14 Ill. Reg. 884, effective December 30, 1989.

Amended at 21 ill. Reg. 7770, effective May 23, 1997.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.827

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§ 130.827 Confirmations

Every dealer, at or before the completion of each transaction with the dealer's customer, shall give or send to the customer written confirmation disclosing:

a) whether the dealer is acting as agent for the customer, or as a dealer for the dealer's own account, or as an agent for some other person;

b) either the name of the person from whom the security was purchased or to whom it was sold for the customer, and the date and time when the transaction took place or the fact that the information will be furnished upon the request of the customer and the source and amount of any commission or other remuneration received or to be received by the dealer in connection with the transaction; and

c) in the case of transactions effected in securities that are non National Market System OTC Securities in reliance upon Section 4(N) of the Act, a statement to the effect that the transaction was effected pursuant to an unsolicited order or offer to buy by the customer, and requesting that the customer return to the dealer a written acknowledgment that the order or offer to buy was unsolicited.

History

SOURCE:

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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§ 130.828 Notice of Materially Adverse Financial Condition Required to Be Filed with the Securities Department by a Registered Dealer.

Each registered dealer which discovers it is no longer in compliance thereof with the requirements under Section 130.826 of this Part shall file a notice with the Securities Department within 24 hours of the discovery of such non-compliance. Such notification shall be made by telegraphic communication, facsimile transmission or such other means of delivery.

History

SOURCE:

Added at 14 Ill. Reg. 5188, effective March 26, 1990.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.829

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§ 130.829 Investor Protection Requirement of a Dealer Registered Under Section 8 of the Act

a) Each dealer registered or re-registered with the Secretary under Section 8.B of the Act shall be a member in good standing of FINRA, as evidenced by not being under suspension or revocation or having failed to pay dues or assessments; or

b) Each dealer registered or re-registered with the Secretary under Section 8.B of the Act shall be a member in good standing of the Securities Investor Protection Corporation as established in the Securities Investor Protection Act of 1970 (15 USC 78aaa et seq.), as amended, as evidenced by not being under suspension or revocation or having failed to pay dues or assessments, or other equivalent instrumentality of or corporation chartered by the United States that provides investor protection as authorized under federal law, except for the following dealers if they do not hold clients' cash or securities:

1) A dealer whose principal business in the Securities Investor Protection Corporation's determination is conducted outside the United States, its possessions and territories;

2) Any bank (other than a bank organized under the banking laws of the State of Illinois or of the United States) registered as a municipal securities dealer with the SEC, pursuant to 17 CFR 240.15Ba2-1, (May 31, 2011);

3) A government securities dealer registered under 17 CFR 240.15Ca1-1, (May 31, 2011); and

4) A dealer whose business consists exclusively of one or more of the following:

A) the distribution of shares of registered open end investment companies or unit investment trusts registered under Section 8 of the Federal 1940 Investment Company Act, as defined in Section 130.200 of this Part, Section 5 of the Federal 1933 Act, as defined in Section 130.200 of this Part, and Section 5 or 7 of the Act;

B) the sale of variable annuities;

C) the business of insurance; or

D) the business of rendering investment advisory services to one or more investment companies registered under the Federal 1940 Investment Company Act, as defined in Section 130.200, or to insurance company separate accounts.

History

SOURCE:

Added at 14 Ill. Reg. 5188, effective March 26, 1990.

Amended at 20 Ill. Reg. 14185, effective October 21, 1996.

§ 130.829 Investor Protection Requirement of a Dealer Registered Under Section 8 of the Act

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

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14 Ill. Adm. Code 130.838

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§ 130.838 Procedures for Federal Covered Investment Adviser Notification Filing and Fees Under Section 8.C-5 of the Act

a) Federal covered investment advisers shall file with FINRA, utilizing the IARD, Form ADV. The federal covered investment adviser shall also pay the filing fee specified in Section 130.110.

b) For purposes of annual notification filing, a federal covered investment adviser shall file with FINRA, utilizing the IARD. The federal covered investment adviser shall also pay the filing fee specified in Section 130.110.

c) Amendments to Form ADV shall be filed with FINRA, utilizing the IARD.

d) In the event the federal covered investment adviser changes the form of its organization, it shall pay the fee specified in Section 130.110.

e) A federal covered investment adviser that is no longer eligible for SEC registration shall file an amendment to Form ADV with the SEC and FINRA, utilizing the IARD, indicating it is no longer eligible for SEC registration.

f) In the event the notification or the full amount of fees required by this Section is not filed with or paid to the Secretary of State, the Secretary of State shall notify the federal covered investment adviser of the deficiency in writing, or by facsimile or electronic transmission (provided that the Securities Department can demonstrate in the normal course of its business that the notice was delivered or transmitted to and received by the federal covered investment adviser or its designee). In the event the federal covered investment adviser fails to remedy the deficiency within 10 business days after receiving notice of the deficiency from the Secretary of State, the Secretary of State may deem the failure to remedy as a refusal and require the federal covered investment adviser to register pursuant to Section 8.A and 8.D of the Act.

g) For the limited purpose of this Section and solely for the filings and/or fees submitted to the IARD, the terms "with the Secretary of State" as used in Section 8.C-5, 8.D, 8.D-5 and 8.H of the Act and "with the Securities Department" as used in this Section shall include a filing and/or fee made with FINRA, utilizing the IARD.

h) Annual Notifications

All annual notifications shall expire at the end of the day on December 31 annually.

History

SOURCE:

Added by emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Added at 21 Ill. Reg. 15892, effective December 1, 1997.

§ 130.838 Procedures for Federal Covered Investment Adviser Notification Filing and Fees Under Section 8.C-5 of the Act

Amended by emergency rulemaking at 25 Ill. Reg. 973, effective January 1, 2001, for a maximum of 150 days.

Amended at 25 Ill. Reg. 8817, effective July 6, 2001.

Amended at 26 Ill. Reg. 14843, effective September 30, 2002.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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§ 130.839 Procedures for Registration as an Investment Adviser Representative Under Section 8.D-5 of the Act

a) Effective October 1, 2002, each new applicant filing as an investment adviser or federal covered investment adviser shall file with FINRA, utilizing the CRD, a complete Form U4 for each investment adviser representative and pay the filing fee specified in Section 130.110.

b) For purposes of the annual re-registration of investment adviser representatives, each investment adviser and federal covered investment adviser shall file with FINRA, utilizing the CRD, and pay the filing fee specified in Section 130.110.

c) For the purposes of this Section, an investment adviser representative of a federal covered investment adviser shall mean any partner, officer, director (or other person occupying a similar status or performing similar functions), or an employee of a federal covered investment adviser, or any other person who provides investment advice on behalf of the federal covered investment adviser and is subject to the supervision and control of the federal covered investment adviser, if more than 10 percent of the person's clients are natural persons, other than sophisticated clients; and the person has a place of business in the State of Illinois. As used in this subsection, the term "sophisticated client" shall mean a natural person who, immediately after entering into the investment advisory contract with the federal covered investment adviser, has at least $ 500,000 under management with the federal covered investment adviser or the federal covered investment adviser reasonably believes, immediately prior to entering into the advisory contract, the person has a net worth (together with assets held jointly with a spouse) at the time the contract is entered into of more than $ 1,000,000.

d) The application on file with the Securities Department shall be amended whenever a change occurs that renders inaccurate any information contained in the application. The amendment shall be filed with FINRA, utilizing the CRD, within 10 business days after the occurrence of the change.

e) In the event the investment adviser representative's activities are terminated, the investment adviser shall file a Form U5 with FINRA, utilizing the CRD, within 30 days after the termination.

f) In the event the investment adviser representative transfers registration from one investment adviser or federal covered investment adviser to another investment adviser or federal covered investment adviser, the new investment adviser or federal covered investment adviser shall file a Form U4 with FINRA, utilizing the CRD, and pay the filing fee specified in Section 130.110.

g) For the limited purpose of this Section and solely for filings and/or fees submitted to the CRD or IARD, the terms "with the Secretary of State", as used in Section 8.C-5, 8.D, 8.D-5 and 8.H of the Act and "with the Securities Department", as used in this Section, shall include a filing and/or fee made with FINRA, utilizing the CRD or IARD.

h) Re-registration

All annual re-registrations of investment adviser representatives shall expire at the end of the day on December 31 annually.

History

SOURCE:

Added by emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Added at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended by emergency rulemaking at 25 Ill. Reg. 973, effective January 1, 2001, for a maximum of 150 days.

Amended at 25 Ill. Reg. 8817, effective July 6, 2001.

Amended at 26 Ill. Reg. 14843, effective September 30, 2002.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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§ 130.840 Procedures for Registration as an Investment Adviser Under Section 8.D of the Act

a) Effective October 1, 2002, each new applicant for registration as an investment adviser shall file with FINRA, utilizing the IARD, a complete and current application and pay the filing fee and branch office fee, if any, specified in Section 130.110. The application shall consist of the following:

1) The Revised Uniform Application for Investment Adviser Registration required by 17 CFR 279.1 (May 31, 2011) including Schedule D, which lists all branch offices in this State, if any;

2) One copy of Form U4 for each investment adviser representative on behalf of the applicant and pay the fee specified in Section 130.110.

b) Each applicant for registration as an investment adviser, in addition to the filings required under subsection (a), shall file with the Securities Department the following:

1) A balance sheet for the investment adviser as of a date not more than 60 days prior to the date of the filing of the application. The balance sheet shall be verified and executed by the chief financial officer of the investment adviser, if any, or other person performing a similar function and must contain:

A) an affirmation that the information is true and correct; and

B) a statement disclosing whether the investment adviser retains, or during the term of registration will retain, custody of any client's cash or securities or accept pre-payment of fees in excess of $ 500 per client and six or more months in advance;

2) One copy of page one of the applicant's most recent Articles of Incorporation or, if a partnership, certificate of assumed name or similar document evidencing the legal name of the applicant;

3) At or prior to registration of the investment adviser, there shall be on file with the Securities Department, whether through the CRD, IARD or otherwise, the following:

A) Proof of passing one or more of the requisite examinations, certifications or designations listed in Section 130.842 for each required principal, unless the Secretary issues an order waiving this requirement pursuant to Section 8.D of the Act; and

B) Any amendments to the application and documents filed pursuant to subsection (a), whether as a result of a change in the information provided since the date of filing or otherwise;

4) One copy of Form U4 for each investment adviser representative who renders investment advice in this State on behalf of the applicant and the fee specified in Section 130.110;

5) One copy of the Illinois Form containing an attestation that the investment adviser has not previously rendered investment advice for compensation in this State, or setting forth a claim of exemption or exclusion;

6) One copy of a written statement manually executed by an officer, partner or principal of the registered dealer consenting to the dual registration as investment adviser and salesperson, if registered as a salesperson in this State; and

7) One copy of Part II of the Revised Uniform Application for Investment Adviser Registration (Form ADV) required by subsection (a)(1).

c) The application and documents on file with the Securities Department with respect to the investment adviser shall be amended from time to time whenever a change occurs that renders any material information contained in those documents not accurate in any material respect. The amendment shall be filed with FINRA, utilizing the IARD, within 10 business days after the occurrence of the change.

d) For purposes of this Section, material information includes, but is not limited to:

1) the name and address of the investment adviser;

2) type of business organization of the investment adviser;

3) disciplinary action concerning the investment adviser;

4) whether the investment adviser has custody of clients' funds or securities or accepts pre-payment of in excess of $ 500;

5) whether the investment adviser has discretion over clients' portfolios; or

6) whether the investment adviser will give clients Part II of the Uniform Application for Investment Adviser Registration required by subsection (a)(1) or another document containing the same information.

e) For the limited purpose of this Section and solely for the filings and/or fees submitted to the IARD, the terms "with the Secretary of State", as used in Section 8.C-5, 8.D, 8.D-5 and 8.H of the Act, and "with the Securities Department", as used in this Section, shall include a filing and/or fee submitted to FINRA, utilizing the IARD.

f) Annual Re-registration

All new registration applications and re-registration applications shall expire at the end of the day on December 31 annually.

History

SOURCE:

Amended at 14 Ill. Reg. 884, effective December 30, 1989.

Amended at 20 Ill. Reg. 14185, effective October 21, 1996.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended by emergency rulemaking at 25 Ill. Reg. 973, effective January 1, 2001, for a maximum of 150 days.

Amended at 25 Ill. Reg. 8817, effective July 6, 2001.

Amended at 26 Ill. Reg. 14843, effective September 30, 2002.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

§ 130.840 Procedures for Registration as an Investment Adviser Under Section 8.D of the Act

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

14 Ill. Adm. Code 130.841

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§ 130.841 Reporting of Investment Adviser Branch Office Locations and Required Fees

a) Each investment adviser shall file with the Securities Department with its application for registration a schedule setting forth the address of each branch office in this State as defined in Section 130.280. A Schedule D of the Revised Uniform Application for Investment Adviser Registration required by Section 130.840(a)(1) disclosing each branch office in this State shall be accompanied by the payment of the fee in the form and amount specified in Section 130.110 for each branch office in this State.

b) Each registered investment adviser shall file or have filed with the Securities Department prior to re-registration a schedule setting forth the address of each branch office and pay to the Securities Department in Springfield a fee in the form and amount specified in Section 130.110 for each branch office in this State.

c) No registration or re-registration of an investment advisor shall become effective until theschedule of the investment adviser's branch office has been filed with the Securities Department and the fee, if any, has been paid.

d) The registered investment adviser shall amend its application for registration by filing with the Securities Department in Springfield within 10 business days after:

1) the opening of any branch office in this State not previously reported, setting forth the address of that branch office; and

2) the closing of any branch office in this State, setting forth the address of that branch office.

e) For the limited purpose of this Section and solely for the filings and/or fees submitted to the IARD, the terms "with the Secretary of State" as used in Section 8.C-5, 8.D, 8.D-5, and 8.H of the Act, and "with Securities Department", as used in this Section, shall include a filing and/or fee submitted to FINRA, utilizing the IARD.

f) Annual Re-registration

All new registration applications and re-registration applications shall expire at the end of the day on December 31 annually.

History

SOURCE:

Amended at 14 Ill. Reg. 884, effective December 30, 1989.

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended by emergency rulemaking at 25 Ill. Reg. 973, effective January 1, 2001, for a maximum of 150 days.

Amended at 25 Ill. Reg. 8817, effective July 6, 2001.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

14 Ill. Adm. Code 130.842

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§ 130.842 Examinations and Education Programs Deemed Satisfactory for Purposes of Determining Sufficient Knowledge for Each Principal Under Section 8.D.(9) of the Act Prior to Registration as an Investment Adviser

a) Examination Requirements. Any person applying to be registered as an Investment Adviser principal under the Act shall provide the Secretary of State with proof of obtaining a passing score on one of the following examinations:

1) The Uniform Investment Adviser Law Examination (Series 65 examination); or

2) The General Securities Representative Examination (Series 7 examination) and the Uniform Combined State Law Examination (Series 66 examination).

b) Grandfathering:

1) Any person who is registered as an investment adviser in any jurisdiction in the United States on May 1, 2000 shall not be required to satisfy the examination requirements for continued registration, except that the Secretary of State may require additional examinations for any person found to have violated any state or federal securities law.

2) Any person who has not been registered in any jurisdiction for a period of two years shall be required to comply with the examination requirements of this Section.

c) Waivers. The examination requirements shall not apply to any person who currently holds one of the following professional designations:

1) Certified Financial Planner (CFP) awarded by the Certified Financial Planner Board of Standards, Inc.;

2) Chartered Financial Consultant (ChFC) awarded by the American College, Bryn Mawr, Pennsylvania;

3) Personal Financial Specialist (PFS) awarded by the American Institute of Certified Public Accountants;

4) Chartered Financial Analyst (CFA) awarded by the Institute of Chartered Financial Analysts;

5) Chartered Investment Counselor (CIC) awarded by the Investment Adviser Association; or

6) Any other professional designation as the Secretary of State may recognize by rule or by an order under Section 8 of the Act.

d) Scheduling of the Series 7, 65 or 66 examination shall be arranged by the applicant and fees paid to FINRA.

e) The applicant shall submit in writing to the Securities Department satisfactory proof of the designation or certification referred to in subsection (c) prior to registration as an investment adviser.

f) No person shall be deemed to have sufficient knowledge to act as principal of an investment adviser in this State unless and until he or she is 18 years of age.

§ 130.842 Examinations and Education Programs Deemed Satisfactory for Purposes of Determining Sufficient Knowledge for Each Principal Unde r Section 8.D.(9) of ....

History

SOURCE:

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Emergency amendment at 24 Ill. Reg. 341, effective December 31, 1999, for a maximum of 150 days.

Amended at 24 Ill. Reg. 7401, effective May 1, 2000.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.844

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§ 130.844 Statement of Financial Condition to Be Filed by a Registered Investment Adviser Which Retains Custody of Client's Cash or Securities or Accepts Pre-Payment of Fees in Excess of $ 500.00 per Client and Six (6) or More Months in Advance and Interim Financial Statements.

a) Each registered investment adviser which retains custody of client's cash or securities or accepts pre-payment of fees in excess of $ 500.00 per client and six (6) or more months in advance shall file a statement of financial condition (balance sheet) and interim financial statements, in such detail as will disclose the nature and amount of assets and liabilities and the net worth of the investment adviser, as follows:

1) the statement shall be filed annually as of the date of its fiscal year end or of an audit date selected by and reported to the Securities Department;

2) the statement shall be filed no later than the first day of the fourth month after the date of its fiscal year end or of the selected audit date;

3) the time period covered by the statement shall be the twelve month period immediately following the date of the most recent audited statement; and

4) should an investment adviser elect to change its audit date, a written request for variance from the filing period covered by the statement shall be filed in accordance with Section 130.190 of this Part with the Securities Department in Springfield, Illinois. The request shall include each reason for the change. An unaudited statement shall be filed with the Securities Department and be as of the date of the investment adviser's selected audit date. If the investment adviser is required to file an audited statement it shall encompass the entire period of time which has elapsed since the most current filing of an audited statement.

5) For purposes of this Section, the term "audit date" shall mean the date selected and reported to the Securities Department by the investment adviser for fulfilling the filing requirement of this Section.

b) The statement of financial condition shall consist of a signed independent auditors' report, a balance sheet and notes to the financial statement, if any. The statement of financial condition shall be accompanied by the cover page, if any, designated by the Securities Department.

c) The Secretary may, at his or her discretion, require any investment adviser to file an interim statement of financial condition as of a date selected by the Secretary. Such statements shall be audited by an Independent Certified Public Accountant if the investment adviser retains custody of any client's cash or securities or accepts pre-payment of fees in excess of $ 500.00 per client and six (6) or more months in advance.

d) If an unaudited statement of financial condition is filed, the statement shall contain the following oath or affirmation: "I hereby attest that the information contained in this statement of financial condition is true and correct to the best of my knowledge."

1) The oath or affirmation filed by an investment adviser shall be deemed acceptable even though it varies from the language set forth above unless the oath or affirmation does not contain a specific reference that the information is true and correct and unless the Securities Department notifies the investment adviser in writing of its objection.

2) The oath or affirmation shall be made before a person duly authorized to administer oaths or affirmations. If the investment adviser is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

e) Each statement of financial condition, except the independent auditors' report, the balance sheet and notes, if any, shall be deemed confidential when filed with the Securities Department. The independent auditors' report, the balance sheet and notes, if any, shall be a matter of public record and available to the public upon written request.

f) Anything to the contrary notwithstanding, all of the information contained in any statement of financial condition shall be available to any federal, state or local law enforcement agency, any state or federal financial regulator or any self-regulatory organization registered under any federal law upon written request to the Securities Department.

History

SOURCE:

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Annotations

Research References & Practice Aids

Authority & General Source

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End of Document

14 Ill. Adm. Code 130.845

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§ 130.845 Records Required of Investment Advisers

a) Except as provided in subsection (d) of this Section, every investment adviser registered by the Secretary of State shall keep the books and records set out in this Section unless otherwise designated by the Secretary of State:

1) ledgers (or other records) reflecting all assets and liabilities, income and expense, and capital accounts;

2) a record showing all payments received, including date of receipt, purpose and from whom received, and all disbursements, including date paid, purpose and to whom made;

3) a record showing all receivables and payables;

4) records showing separately for each client the securities purchased or sold, and, to the extent it has been made available to the investment adviser, the date and amount of and price at which such purchases or sales were executed. If available to the investment adviser, this record should also show the name of the security dealer who handled the transaction;

5) records showing separately all securities acquired by the clients of the investment adviser and indicating thereon the proper identification of this individual account, the date, amount and price at which such securities were purchased or sold by or for each client; or, in the alternative, a record showing all securities (other than securities enumerated in Section 3.A of the Act) bought or sold by or for the accounts of all clients of the investment adviser in each month, the total number of shares or principal amount of each security bought or sold and the lowest and highest price at which purchases or sales were made during the month;

6) copies of dealer's confirmations of all transactions placed by the investment adviser for any account, and the other dealer's confirmations as may be supplied to the investment adviser by a client or dealer;

7) a list showing all accounts in which the investment adviser is vested with discretionary power, unless the records required by subsections (a)(4) and (5) of this Section are maintained in such manner as to disclose which are discretionary accounts, provided that the provisions of subsections (a)(4) and (5) of this Section shall not apply:

A) to any securities with respect to which the investment adviser renders no services of a supervisory or other nature; or

B) to any securities or transactions which a client declines to disclose to the investment adviser; and provided further that the provisions of subsections (a)(4), (5), (6) and (7) above shall not apply to the accounts of any investment adviser where the services consist solely of the distribution of written or printed publications on a subscription basis.

b) Additional Records

1) Every investment adviser registered by the Secretary of State shall preserve for a period of not less than 3 years, the first 2 years in an easily accessible place, all records required by subsection (a) of this Section and the following additional records:

A) all check books, bank statements, cancelled checks and cash reconciliations;

B) all bills or statements (or copies thereof), paid or unpaid, relating to the business of such investment adviser;

C) originals of all communications received and copies of all communications sent by such investment adviser relating to the business of the investment adviser;

D) all power of attorneys and other evidence of the granting of any discretionary authority in any account, and copies of resolutions empowering an agent to act on behalf of any client;

E) all written agreements (or copies thereof), entered into by an investment adviser relating to the business of the investment adviser, including agreements with respect to any account, which agreements shall set forth the fees to be charged and the manner of computation and method of payment thereof.

2) For a period of not less than 3 years after the closing of any client's account, all required records relating to such account shall be preserved by every registered investment adviser.

3) Every registered investment adviser shall preserve, during the life of the enterprise and of any successor enterprise, all partnership agreements, certificates or articles, or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books.

4) After a record or other document has been preserved for 2 years, a photograph thereof on film may be substituted for the balance of the required time.

c) Any records required by this Section may be maintained:

1) in such manner that the identity of any client or clients to whom a registered investment adviser renders investment supervisory service is indicated by numerical, alphabetical, code or similar designations, or

2) in duplicate with one set of the records having the identity of any client or clients to whom a registered investment adviser renders investment supervisory service deleted or indicated by numerical, alphabetical, code or similar designation, as may be appropriate to the record required.

d) This Section shall not apply to any investment adviser that is registered or licensed as such in the state in which it maintains its principal place of business and is in compliance with the applicable books and records requirements of the state in which it maintains its principal place of business.

History

SOURCE:

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.846

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§ 130.846 Written Disclosure Statements of a Registered Investment Adviser

a) General Requirement

Unless otherwise provided in this Section, an investment adviser, registered or required to be registered pursuant to Section 8.D of the Act, shall, in accordance with the provisions of this Section, furnish each advisory client and prospective advisory client with a written disclosure statement required by 17 CFR 275.204-3 (May 31, 2011).

b) Delivery

1) An investment adviser, except as provided in subsection (b)(2), shall deliver the statement required by this Section to an advisory client or prospective advisory client:

A) not less than 48 hours prior to entering into any written or oral investment advisory contract with a client or prospective client; or

B) at the time of entering into a contract, if the advisory client has a right to terminate the contract without penalty within five business days after entering into the contract.

2) Delivery of the statement required by subsection (b)(1) need not be made in connection with entering into:

A) an investment company contract; or

B) a contract for impersonal advisory services.

c) Offer to Deliver

1) An investment adviser, except as provided in subsection (c)(2), annually shall, without charge, deliver or offer in writing to deliver upon written request to each of its advisory clients the statement required by this Section.

2) The delivery or offer required by subsection (c)(1) need not be made to advisory clients receiving advisory services solely pursuant to:

A) an investment company contract; or

B) a contract for impersonal advisory services requiring a payment of less than $ 200.

3) With respect to an advisory client entering into a contract or receiving advisory services pursuant to a contract for impersonal advisory services which requires a payment of $ 200 or more, an offer of the type specified in subsection (c)(1) shall also be made at the time of entering into an advisory contract.

4) Any statement requested in writing by an advisory client pursuant to an offer required by this subsection (c) must be mailed or delivered within seven days after the receipt of the request.

d) Omission of Inapplicable Information

If an investment adviser renders substantially different types of investment advisory services to different advisory clients, any information required may be omitted from the statement furnished to an advisory client or prospective

advisory client if the information is applicable only to a type of investment advisory service or fee that is not rendered or charged, or proposed to be rendered or charged, to that client or prospective client as provided by 17 CFR 275.204-3 (May 31, 2011).

e) Other Disclosures

Nothing in this Section shall relieve any investment adviser from any obligation under the Act or this Part or other federal or State law to disclose any information to its advisory clients or prospective advisory clients not specifically required by this Section.

f) Definitions. For the purpose of this Section:

1) "Contract for impersonal advisory services" means any contract relating solely to the provision of investment advisory services:

A) by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;

B) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

C) any combination of the services listed in subsections (f)(1)(A) and (B);

2) "Entering into," in reference to an investment advisory contract, does not include an extension or renewal without material change of any contract that is in effect immediately prior to the extension or renewal; and

3) "Investment company contract" means a contract with an investment company registered under the Federal 1940 Investment Company Act that the requirements of section 15(c) of that Act, as defined in Section 130.200 of this Part.

History

SOURCE:

Added at 14 Ill. Reg. 884, effective December 30, 1989.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.847

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§ 130.847 Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients.

a) It shall constitute a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 12(J)(3) of the Act for any investment adviser to fail to disclose to any client or prospective client all material facts with respect to:

1) A financial condition of the investment adviser such as insolvency or embezzlement, that impairs the ability of the investment adviser to meet contractual commitments to clients, if the investment adviser has discretionary authority (express or implied) or custody over such client's funds or securities, or requires prepayment of advisory fees of more than $ 500.00 from such client and six (6) months or more in advance; or

2) A legal or disciplinary event that is material to an evaluation of the investment adviser's integrity or ability to meet contractual commitments to clients.

b) It shall constitute a rebuttable presumption that the following legal or disciplinary events involving the investment adviser or a management person of the investment adviser (any of the foregoing being referred to hereafter in this Section as "person") that were not resolved in the person's favor or subsequently reversed, suspended or vacated are material within the meaning of subsection (a)(2) of this Section for a period of ten (10) years from the time of the event:

1) A criminal or civil action in a court of competent jurisdiction in which the person:

A) was convicted, pleaded guilty or nolo contendere ("no contest") to a felony or misdemeanor, or is the named subject of a pending criminal proceeding (any of the foregoing referred to hereafter in this Section as "action"), and such action involved an investment related business; or fraud, false statements, or omissions; or wrongful taking of property; or bribery, forgery, counterfeiting or extortion;

B) was found to have violated or caused the violation of an investment related statute or regulation; or

C) was the subject of any order, judgment or decree permanently or temporarily enjoining the person from, or otherwise limiting the person from, engaging in any investment related activity.

2) Administrative proceedings before the SEC, any other federal regulatory agency or any state agency (any of the foregoing being referred to hereafter in this Section as "agency") in which the person:

A) was found to have caused an investment related business to lose its authorization to do business; or

B) was found to have violated or caused the violation of an investment related statute or regulation and was the subject of an order by the agency denying, suspending or revoking the authorization of the person to act in, or barring or suspending the person's association with, an investment related business.

3) Self Regulatory Organization (SRO) proceedings in which the person:

A) was found to have caused an investment related business to lose its authorization to do business; or

B) was found to have violated or caused the violation of the SRO's rules and was the subject of an order by the SRO barring or suspending the person from membership or from association with other members, or expelling the person from membership, fining the person more than $ 2,500.00.

c) The information required to be disclosed by subsection (a) of this Section shall be disclosed to clients promptly, and to prospective clients not less than 48 hours prior to entering into any written or oral investment advisory contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within five (5) business days after entering into the contract.

d) For purposes of this Section:

1) "Management person" means a person with power to exercise, directly or indirectly, a controlling influence over the management or policies of an investment adviser which is a company or to determine the general investment advise given to clients.

2) "Found" means determined or ascertained by adjudication or consent in a final SRO proceeding, administrative proceeding or court action.

3) "Investment related" means pertaining to securities, commodities, banking, insurance or real estate (including, but not limited to, acting as of being associated with a broker, dealer, investment company, investment adviser, government securities broker or dealer, municipal securities dealer, bank, savings and loan association, entity or person required to be registered under the Federal 1974 Act, as defined in Section 130.200 of this Part, or fiduciary).

4) "Involved" means acting or aiding, abetting, causing, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

5) "Self Regulatory Organization" or "SRO" means any national securities or commodities exchange, registered association or registered clearing agency.

e) For purposes of calculating the ten (10) year period during which events are presumed to be material under subsection (b) of this Section, the date of a reportable event shall be the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments or decrees lapsed.

f) Compliance with subsection (b) of this Section shall not relieve any investment adviser from the disclosure obligations of subsection (a) of this Section; compliance with subsection (a) of this Section shall not relieve any investment adviser from any other disclosure requirement under this Part or the Act, or under any other federal or state law.

g) Registered investment advisers may disclose the information required by this Section to clients and prospective clients with the information required by Section 130.846 of this Part; provided that the delivery of the information satisfies the timing of disclosure requirements described in subsection (c) of this Section.

History

SOURCE:

Added at 14 Ill. Reg. 884, effective December 30, 1989.

Annotations

Research References & Practice Aids

Authority & General Source

§ 130.847 Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients.

ILLINOIS ADMINISTRATIVE CODE

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14 Ill. Adm. Code 130.852

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§ 130.852 Compensation

a) No registered investment adviser or its representatives shall charge or receive compensation in connection with the giving of investment advice unless the compensation is fair and reasonable and is determined on an equitable basis adequately disclosed to each client in writing.

b) No registered investment adviser or its representatives shall charge or receive compensation in connection with the giving of investment advice that provides for compensation to the investment adviser or its representative on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client, unless the fees are charged in conformance with the provisions set forth in 17 CFR 275.205-3 (September 19, 2011)

History

SOURCE:

Amended at 14 Ill. Reg. 5188, effective March 26, 1990.

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Amended at 36 Ill. Reg. 2852, effective February 8, 2012.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.853

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§ 130.853 Account Transactions

Effecting or causing to be effected by or for any client's account, any transactions of purchase or sale which are excessive in size or frequency or unsuitable in view of the financial resources and character of the account, shall constitute an act, practice, or course of business on the part of the registered investment adviser or its representative effecting such transactions or causing the transactions to be effected that is fraudulent, deceptive or manipulative.

History

SOURCE:

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Annotations

Research References & Practice Aids

Authority & General Source

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14 Ill. Adm. Code 130.854

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§ 130.854 Use of the Term "Investment Counsel"

No registered investment adviser or its representative shall use the title "Investment Counsel" in the conduct of its business nor represent that it is an "investment counsel" nor use the term "investment counsel" as descriptive of its business unless the person is primarily engaged in the business of rendering investment supervisory services.

History

SOURCE:

Emergency amendment at 21 Ill. Reg. 9828, effective July 8, 1997, for a maximum of 150 days.

Amended at 21 Ill. Reg. 15892, effective December 1, 1997.

Annotations

Research References & Practice Aids

Authority & General Source

ILLINOIS ADMINISTRATIVE CODE

End of Document

see section 7882 of Pub. L. 101–239, set out as a note under section 401 of Title 26, Internal Revenue Code.

Amendment by section 7891(a)(1) of Pub. L. 101–239 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99–514, to which such amendment relates, see section 7891(f) of Pub. L. 101–239, set out as a note under section 1002 of this title.

Section 7894(e)(1)(B) of Pub. L. 101–239 provided that: ''The amendments made by subparagraph (A) [amending this section] shall take effect as if included in section 410 of the Multiemployer Pension Plan Amendments Act of 1980 [Pub. L. 96–364].''

Amendment by section 7894(e)(3) of Pub. L. 101–239 effective, except as otherwise provided, as if originally included in the provision of the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, to which such amendment relates, see section 7894(i) of Pub. L. 101–239, set out as a note under section 1002 of this title.

EFFECTIVE DATE OF 1980 AMENDMENT

Amendment by Pub. L. 96–364 effective Sept. 26, 1980, except as specifically provided, see section 1461(e) of this title.

Amendment by section 410(a) of Pub. L. 96–364 effective Jan. 1, 1975, except with respect to contributions received by a collectively bargained plan maintained by more than one employer before Sept. 26, 1980, see section 410(c) of Pub. L. 96–364, set out as a note under section 401 of Title 26, Internal Revenue Code.

REGULATIONS

Secretary authorized, effective Sept. 2, 1974, to promulgate regulations wherever provisions of this part call for the promulgation of regulations, see sections 1031 and 1114 of this title.

APPLICABILITY OF AMENDMENTS BY SUBTITLES A AND B OF TITLE I OF PUB. L. 109–280

For special rules on applicability of amendments by subtitles A (§§ 101–108) and B (§§ 111–116) of title I of Pub. L. 109–280 to certain eligible cooperative plans, PBGC settlement plans, and eligible government contractor plans, see sections 104, 105, and 106 of Pub. L. 109–280, set out as notes under section 401 of Title 26, Internal Revenue Code.

§ 1104. Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III.

(2) In the case of an eligible individual account plan (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Indicia of ownership of assets outside jurisdiction of district courts

Except as authorized by the Secretary by regulations, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) Control over assets by participant or beneficiary

(1)(A) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

(i) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(ii) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control, except that this clause shall not apply in connection with such participant or beneficiary for any blackout period during which the ability of such participant or beneficiary to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary.

(B) If a person referred to in subparagraph (A)(ii) meets the requirements of this subchapter in connection with authorizing and implementing the blackout period, any person who is otherwise a fiduciary shall not be liable under this subchapter for any loss occurring during such period.

(C) For purposes of this paragraph, the term ''blackout period'' has the meaning given such term by section 1021(i)(7) of this title.

(2) In the case of a simple retirement account established pursuant to a qualified salary reduction arrangement under section 408(p) of title 26, a participant or beneficiary shall, for purposes of paragraph (1), be treated as exercising control over the assets in the account upon the earliest of—

(A) an affirmative election among investment options with respect to the initial investment of any contribution,

(B) a rollover to any other simple retirement account or individual retirement plan, or

(C) one year after the simple retirement account is established.

No reports, other than those required under section 1021(g) of this title, shall be required with respect to a simple retirement account established pursuant to such a qualified salary reduction arrangement.

(3) In the case of a pension plan which makes a transfer to an individual retirement account or annuity of a designated trustee or issuer

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under section 401(a)(31)(B) of title 26, the participant or beneficiary shall, for purposes of paragraph (1), be treated as exercising control over the assets in the account or annuity upon—

(A) the earlier of—

(i) a rollover of all or a portion of the amount to another individual retirement account or annuity; or

(ii) one year after the transfer is made; or

(B) a transfer that is made in a manner consistent with guidance provided by the Secretary.

(4)(A) In any case in which a qualified change in investment options occurs in connection with an individual account plan, a participant or beneficiary shall not be treated for purposes of paragraph (1) as not exercising control over the assets in his account in connection with such change if the requirements of subparagraph (C) are met in connection with such change.

(B) For purposes of subparagraph (A), the term ''qualified change in investment options'' means, in connection with an individual account plan, a change in the investment options offered to the participant or beneficiary under the terms of the plan, under which—

(i) the account of the participant or beneficiary is reallocated among one or more remaining or new investment options which are offered in lieu of one or more investment options offered immediately prior to the effective date of the change, and

(ii) the stated characteristics of the remaining or new investment options provided under clause (i), including characteristics relating to risk and rate of return, are, as of immediately after the change, reasonably similar to those of the existing investment options as of immediately before the change.

(C) The requirements of this subparagraph are met in connection with a qualified change in investment options if—

(i) at least 30 days and no more than 60 days prior to the effective date of the change, the plan administrator furnishes written notice of the change to the participants and beneficiaries, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant or beneficiary to the contrary, the account of the participant or beneficiary will be invested in the manner described in subparagraph (B),

(ii) the participant or beneficiary has not provided to the plan administrator, in advance of the effective date of the change, affirmative investment instructions contrary to the change, and

(iii) the investments under the plan of the participant or beneficiary as in effect immediately prior to the effective date of the change were the product of the exercise by such participant or beneficiary of control over the assets of the account within the meaning of paragraph (1).

(5) DEFAULT INVESTMENT ARRANGEMENTS.—

(A) IN GENERAL.—For purposes of paragraph (1), a participant or beneficiary in an individual account plan meeting the notice requirements of subparagraph (B) shall be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant or beneficiary, are invested by the plan in accordance with regulations prescribed by the Secretary. The regulations under this subparagraph shall provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.

(B) NOTICE REQUIREMENTS.—

(i) IN GENERAL.—The requirements of this subparagraph are met if each participant or beneficiary—

(I) receives, within a reasonable period of time before each plan year, a notice explaining the employee's right under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election by the participant or beneficiary, such contributions and earnings will be invested, and

(II) has a reasonable period of time after receipt of such notice and before the beginning of the plan year to make such designation.

(ii) FORM OF NOTICE.—The requirements of clauses (i) and (ii) of section 401(k)(12)(D) of title 26 shall apply with respect to the notices described in this subparagraph.

(d) Plan terminations

(1) If, in connection with the termination of a pension plan which is a single-employer plan, there is an election to establish or maintain a qualified replacement plan, or to increase benefits, as provided under section 4980(d) of title 26, a fiduciary shall discharge the fiduciary's duties under this subchapter and subchapter III in accordance with the following requirements:

(A) In the case of a fiduciary of the terminated plan, any requirement—

(i) under section 4980(d)(2)(B) of title 26 with respect to the transfer of assets from the terminated plan to a qualified replacement plan, and

(ii) under section 4980(d)(2)(B)(ii) or 4980(d)(3) of title 26 with respect to any increase in benefits under the terminated plan.

(B) In the case of a fiduciary of a qualified replacement plan, any requirement—

(i) under section 4980(d)(2)(A) of title 26 with respect to participation in the qualified replacement plan of active participants in the terminated plan,

(ii) under section 4980(d)(2)(B) of title 26 with respect to the receipt of assets from the terminated plan, and

(iii) under section 4980(d)(2)(C) of title 26 with respect to the allocation of assets to participants of the qualified replacement plan.

(2) For purposes of this subsection—

(A) any term used in this subsection which is also used in section 4980(d) of title 26 shall have the same meaning as when used in such section, and

(B) any reference in this subsection to title 26 shall be a reference to title 26 as in effect immediately after the enactment of the Omnibus Budget Reconciliation Act of 1990.

(e) Safe harbor for annuity selection

(1) In general

With respect to the selection of an insurer for a guaranteed retirement income contract, the requirements of subsection (a)(1)(B) will be deemed to be satisfied if a fiduciary—

(A) engages in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase such contracts;

(B) with respect to each insurer identified under subparagraph (A)—

(i) considers the financial capability of such insurer to satisfy its obligations under the guaranteed retirement income contract; and

(ii) considers the cost (including fees and commissions) of the guaranteed retirement income contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under such contract; and

(C) on the basis of such consideration, concludes that—

(i) at the time of the selection, the insurer is financially capable of satisfying its obligations under the guaranteed retirement income contract; and

(ii) the relative cost of the selected guaranteed retirement income contract as described in subparagraph (B)(ii) is reasonable.

(2) Financial capability of the insurer

A fiduciary will be deemed to satisfy the requirements of paragraphs (1)(B)(i) and (1)(C)(i) if—

(A) the fiduciary obtains written representations from the insurer that—

(i) the insurer is licensed to offer guaranteed retirement income contracts;

(ii) the insurer, at the time of selection and for each of the immediately preceding 7 plan years—

(I) operates under a certificate of authority from the insurance commissioner of its domiciliary State which has not been revoked or suspended;

(II) has filed audited financial statements in accordance with the laws of its domiciliary State under applicable statutory accounting principles;

(III) maintains (and has maintained) reserves which satisfies all the statutory requirements of all States where the insurer does business; and

(IV) is not operating under an order of supervision, rehabilitation, or liquidation;

(iii) the insurer undergoes, at least every 5 years, a financial examination (within the meaning of the law of its domiciliary State) by the insurance commissioner of the domiciliary State (or representative, designee, or other party approved by such commissioner); and

(iv) the insurer will notify the fiduciary of any change in circumstances occurring after the provision of the representations in clauses (i), (ii), and (iii) which would preclude the insurer from making such representations at the time of issuance of the guaranteed retirement income contract; and

(B) after receiving such representations and as of the time of selection, the fiduciary has not received any notice described in subparagraph (A)(iv) and is in possession of no other information which would cause the fiduciary to question the representations provided.

(3) No requirement to select lowest cost

Nothing in this subsection shall be construed to require a fiduciary to select the lowest cost contract. A fiduciary may consider the value of a contract, including features and benefits of the contract and attributes of the insurer (including, without limitation, the insurer's financial strength) in conjunction with the cost of the contract.

(4) Time of selection

(A) In general

For purposes of this subsection, the time of selection is—

(i) the time that the insurer and the contract are selected for distribution of benefits to a specific participant or beneficiary; or

(ii) if the fiduciary periodically reviews the continuing appropriateness of the conclusion described in paragraph (1)(C) with respect to a selected insurer, taking into account the considerations described in such paragraph, the time that the insurer and the contract are selected to provide benefits at future dates to participants or beneficiaries under the plan.

Nothing in the preceding sentence shall be construed to require the fiduciary to review the appropriateness of a selection after the purchase of a contract for a participant or beneficiary.

(B) Periodic review

A fiduciary will be deemed to have conducted the periodic review described in subparagraph (A)(ii) if the fiduciary obtains the written representations described in clauses (i), (ii), and (iii) of paragraph (2)(A) from the insurer on an annual basis, unless the fiduciary receives any notice described in paragraph (2)(A)(iv) or otherwise becomes aware of facts that would cause the fiduciary to question such representations.

(5) Limited liability

A fiduciary which satisfies the requirements of this subsection shall not be liable following the distribution of any benefit, or the investment by or on behalf of a participant or beneficiary pursuant to the selected guaranteed retirement income contract, for any losses that may result to the participant or beneficiary

due to an insurer's inability to satisfy its financial obligations under the terms of such contract.

(6) Definitions

For purposes of this subsection—

(A) Insurer

The term ''insurer'' means an insurance company, insurance service, or insurance organization, including affiliates of such companies.

(B) Guaranteed retirement income contract

The term ''guaranteed retirement income contract'' means an annuity contract for a fixed term or a contract (or provision or feature thereof) which provides guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan.

(Pub. L. 93–406, title I, § 404, Sept. 2, 1974, 88 Stat. 877; Pub. L. 96–364, title III, § 309, Sept. 26, 1980, 94 Stat. 1296; Pub. L. 101–508, title XII, § 12002(b)(1), (2)(A), Nov. 5, 1990, 104 Stat. 1388–565, 1388–566; Pub. L. 104–188, title I, § 1421(d)(2), Aug. 20, 1996, 110 Stat. 1799; Pub. L. 107–16, title VI, § 657(c)(1), June 7, 2001, 115 Stat. 136; Pub. L. 107–147, title IV, § 411(t), Mar. 9, 2002, 116 Stat. 51; Pub. L. 109–280, title VI, §§ 621(a), 624(a), Aug. 17, 2006, 120 Stat. 978, 980; Pub. L. 110–458, title I, § 106(d), Dec. 23, 2008, 122 Stat. 5107; Pub. L. 116–94, div. O, title II, § 204, Dec. 20, 2019, 133 Stat. 3165.)

Editorial Notes

REFERENCES IN TEXT

The enactment of the Omnibus Budget Reconciliation Act of 1990, referred to in subsec. (d)(2)(B), is the enactment of Pub. L. 101–508, which was approved Nov. 5, 1990.

AMENDMENTS

2019—Subsec. (e). Pub. L. 116–94 added subsec. (e).

2008—Subsec. (c)(5). Pub. L. 110–458 substituted ''participant or beneficiary'' for ''participant'' wherever appearing.

2006—Subsec. (c)(1). Pub. L. 109–280, § 621(a)(1), designated existing provisions as subpar. (A), redesignated former subpars. (A) and (B) as cls. (i) and (ii), respectively, of subpar. (A), in cl. (ii), inserted '', except that this clause shall not apply in connection with such participant or beneficiary for any blackout period during which the ability of such participant or beneficiary to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary'' before period at end, and added subpars. (B) and (C).

Subsec. (c)(4). Pub. L. 109–280, § 621(a)(2), added par. (4).

Subsec. (c)(5). Pub. L. 109–280, § 624(a), added par. (5).

2002—Subsec. (c)(3)(A). Pub. L. 107–147, § 411(t)(1), struck out ''the earlier of'' after ''the earlier of'' in introductory provisions.

Subsec. (c)(3)(B). Pub. L. 107–147, § 411(t)(2), substituted ''a transfer that'' for ''if the transfer''.

2001—Subsec. (c)(3). Pub. L. 107–16 added par. (3).

1996—Subsec. (c). Pub. L. 104–188 designated existing provisions as par. (1), redesignated former pars. (1) and (2) as subpars. (A) and (B), respectively, and added par. (2).

1990—Subsec. (a)(1)(D). Pub. L. 101–508, § 12002(b)(2)(A), substituted ''and subchapter III'' for ''or subchapter III''.

Subsec. (d). Pub. L. 101–508, § 12002(b)(1), added subsec. (d).

1980—Subsec. (a)(1)(D). Pub. L. 96–364 inserted reference to subchapter III of this chapter.

Statutory Notes and Related Subsidiaries

EFFECTIVE DATE OF 2008 AMENDMENT

Amendment by Pub. L. 110–458 effective as if included in the provisions of Pub. L. 109–280 to which the amendment relates, except as otherwise provided, see section 112 of Pub. L. 110–458, set out as a note under section 72 of Title 26, Internal Revenue Code.

EFFECTIVE DATE OF 2006 AMENDMENT

Pub. L. 109–280, title VI, § 621(b), Aug. 17, 2006, 120 Stat. 979, provided that:

''(1) IN GENERAL.—The amendments made by this section [amending this section] shall apply to plan years beginning after December 31, 2007.

''(2) SPECIAL RULE FOR COLLECTIVELY BARGAINED AGREEMENTS.—In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act [Aug. 17, 2006], paragraph (1) shall be applied to benefits pursuant to, and individuals covered by, any such agreement by substituting for 'December 31, 2007' the earlier of—

''(A) the later of—

''(i) December 31, 2008, or

''(ii) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after such date of enactment), or

''(B) December 31, 2009.''

Pub. L. 109–280, title VI, § 624(b), Aug. 17, 2006, 120 Stat. 980, provided that:

''(1) IN GENERAL.—The amendments made by this section [amending this section] shall apply to plan years beginning after December 31, 2006.

''(2) REGULATIONS.—Final regulations under section 404(c)(5)(A) of the Employee Retirement Income Security Act of 1974 [29 U.S.C. 1104(c)(5)(A)] (as added by this section) shall be issued no later than 6 months after the date of the enactment of this Act [Aug. 17, 2006].''

EFFECTIVE DATE OF 2002 AMENDMENT

Amendment by Pub. L. 107–147 effective as if included in the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16, to which such amendment relates, see section 411(x) of Pub. L. 107–147, set out as a note under section 25B of Title 26, Internal Revenue Code.

EFFECTIVE DATE OF 2001 AMENDMENT

Amendment by Pub. L. 107–16 applicable to distributions made after Mar. 28, 2005, see section 657(d) of Pub. L. 107–16, set out as a note under section 401 of Title 26, Internal Revenue Code.

EFFECTIVE DATE OF 1996 AMENDMENT

Amendment by Pub. L. 104–188 applicable to taxable years beginning after Dec. 31, 1996, see section 1421(e) of Pub. L. 104–188, set out as a note under section 72 of Title 26, Internal Revenue Code.

EFFECTIVE DATE OF 1990 AMENDMENT

Amendment by Pub. L. 101–508 applicable to reversions occurring after Sept. 30, 1990, but not applicable to any reversion after Sept. 30, 1990, if (1) in the case of plans subject to subchapter III of this chapter, notice of intent to terminate under such subchapter was provided to participants (or if no participants, to Pension Benefit Guaranty Corporation) before Oct. 1, 1990, (2) in the case of plans subject to subchapter I of this chapter (and not subchapter III), notice of intent to reduce future accruals under section 1054(h) of this title was pro-

vided to participants in connection with termination before Oct. 1, 1990, (3) in the case of plans not subject to subchapter I or III of this chapter, a request for a determination letter with respect to termination was filed with Secretary of the Treasury or Secretary's delegate before Oct. 1, 1990, or (4) in the case of plans not subject to subchapter I or III of this chapter and having only one participant, a resolution terminating the plan was adopted by employer before Oct. 1, 1990, see section 12003 of Pub. L. 101–508, set out as a note under section 4980 of Title 26, Internal Revenue Code.

EFFECTIVE DATE OF 1980 AMENDMENT

Amendment by Pub. L. 96–364 effective Sept. 26, 1980, except as specifically provided, see section 1461(e) of this title.

REGULATIONS

Pub. L. 109–280, title VI, § 625, Aug. 17, 2006, 120 Stat. 980, provided that:

"(a) IN GENERAL.—Not later than 1 year after the date of the enactment of this Act [Aug. 17, 2006], the Secretary of Labor shall issue final regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary—

"(1) is not subject to the safest available annuity standard under Interpretive Bulletin 95–1 (29 CFR 2509.95–1), and

"(2) is subject to all otherwise applicable fiduciary standards.

"(b) EFFECTIVE DATE.—This section shall take effect on the date of enactment of this Act [Aug. 17, 2006]."

Secretary authorized, effective Sept. 2, 1974, to promulgate regulations wherever provisions of this part call for the promulgation of regulations, see sections 1031 and 1114 of this title.

PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1998

For provisions directing that if any amendments made by subtitle D [§§ 1401–1465] of title I of Pub. L. 104–188 require an amendment to any plan or annuity contract, such amendment shall not be required to be made before the first day of the first plan year beginning on or after Jan. 1, 1998, see section 1465 of Pub. L. 104–188, set out as a note under section 401 of Title 26, Internal Revenue Code.

§ 1105. Liability for breach of co-fiduciary

(a) Circumstances giving rise to liability

In addition to any liability which he may have under any other provisions of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

(1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;

(2) if, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

(3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

(b) Assets held by two or more trustees

(1) Except as otherwise provided in subsection (d) and in section 1103(a)(1) and (2) of this title, if the assets of a plan are held by two or more trustees—

(A) each shall use reasonable care to prevent a co-trustee from committing a breach; and

(B) they shall jointly manage and control the assets of the plan, except that nothing in this subparagraph (B) shall preclude any agreement, authorized by the trust instrument, allocating specific responsibilities, obligations, or duties among trustees, in which event a trustee to whom certain responsibilities, obligations, or duties have not been allocated shall not be liable by reason of this subparagraph (B) either individually or as a trustee for any loss resulting to the plan arising from the acts or omissions on the part of another trustee to whom such responsibilities, obligations, or duties have been allocated.

(2) Nothing in this subsection shall limit any liability that a fiduciary may have under subsection (a) or any other provision of this part.

(3)(A) In the case of a plan the assets of which are held in more than one trust, a trustee shall not be liable under paragraph (1) except with respect to an act or omission of a trustee of a trust of which he is a trustee.

(B) No trustee shall be liable under this subsection for following instructions referred to in section 1103(a)(1) of this title.

(c) Allocation of fiduciary responsibility; designated persons to carry out fiduciary responsibilities

(1) The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.

(2) If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that—

(A) the named fiduciary violated section 1104(a)(1) of this title—

(i) with respect to such allocation or designation,

(ii) with respect to the establishment or implementation of the procedure under paragraph (1), or

(iii) in continuing the allocation or designation; or

(B) the named fiduciary would otherwise be liable in accordance with subsection (a).

(3) For purposes of this subsection, the term "trustee responsibility" means any responsibility provided in the plan's trust instrument (if any) to manage or control the assets of the plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 1102(c)(3) of this title.

(d) Investment managers

(1) If an investment manager or managers have been appointed under section 1102(c)(3) of

(Aug. 22, 1940, ch. 686, title II, § 205, 54 Stat. 852; Pub. L. 86–750, § 7, Sept. 13, 1960, 74 Stat. 887; Pub. L. 91–547, § 25, Dec. 14, 1970, 84 Stat. 1432; Pub. L. 96–477, title II, § 203, Oct. 21, 1980, 94 Stat. 2290; Pub. L. 100–181, title VII, § 703, Dec. 4, 1987, 101 Stat. 1263; Pub. L. 104–290, title II, § 210, Oct. 11, 1996, 110 Stat. 3436; Pub. L. 111–203, title IV, § 418, title IX, §§ 921(b), 928, July 21, 2010, 124 Stat. 1579, 1841, 1852; Pub. L. 115–141, div. S, title VIII, § 802(b)(1), Mar. 23, 2018, 132 Stat. 1140.)

Editorial Notes

AMENDMENTS

2018—Subsec. (b)(3). Pub. L. 115–141 substituted ''section 80a–60(a)(4)(B)(iii) of this title'' for ''section 80a–60(a)(3)(B)(iii) of this title'' and ''section 80a–60(a)(4)(B) of this title'' for ''section 80a–60(a)(3)(B) of this title''.

2010—Subsec. (a). Pub. L. 111–203, § 928, in introductory provisions, substituted ''registered or required to be registered with the Commission'' for '', unless exempt from registration pursuant to section 80b–3(b) of this title,'' and struck out ''make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to'' after ''shall'' and ''to'' after ''in any way''.

Subsec. (e). Pub. L. 111–203, § 418, inserted at end ''With respect to any factor used in any rule or regulation by the Commission in making a determination under this subsection, if the Commission uses a dollar amount test in connection with such factor, such as a net asset threshold, the Commission shall, by order, not later than 1 year after July 21, 2010, and every 5 years thereafter, adjust for the effects of inflation on such test. Any such adjustment that is not a multiple of $100,000 shall be rounded to the nearest multiple of $100,000.''

Subsec. (f). Pub. L. 111–203, § 921(b), added subsec. (f).

1996—Subsec. (b)(4), (5). Pub. L. 104–290, § 210(1), added pars. (4) and (5).

Subsec. (e). Pub. L. 104–290, § 210(2), added subsec. (e).

1987—Pub. L. 100–181 completely revised and expanded provisions on investment advisory contracts, changing structure of section from a single unlettered paragraph to one consisting of four subsections lettered (a) to (d).

1980—Pub. L. 96–477 provided that par. (1) of this section was not to apply with respect to any investment advisory contract between an investment adviser and a business development company so long as the compensation provided for in such contract did not exceed 20 per cent of the realized capital gains upon the funds of the business development company and such business development company did not have outstanding any option, warrant, or right issued pursuant to section 80a–60(a)(3)(B) of this title and did not have a profit-sharing plan.

1970—Pub. L. 91–547 substituted reference to section ''80b–3(b)'' for ''80b–3'' of this title in first sentence, redesignated as second sentence former third sentence, designating existing provisions as cl. (A) and adding cl. (B) and items (i) and (ii) and provision respecting compensation based on asset value of company or fund under management averaged over a specified period in relation to investment record of an index of securities or such other measure of investment performance specified by Commission rules, regulations, or orders, inserted third sentence provision respecting point from which compensation is to be measured, substituted in fourth, formerly third, sentence ''paragraphs (2) and (3) of this section'' for ''this section'' and in definition of ''investment advisory contract'' the words ''account of another person other than an investment company registered under subchapter I of this chapter'' for ''account for a person other than an investment company''.

1960—Pub. L. 86–750 substituted ''unless exempt from registration pursuant to'' for ''registered under''.

Statutory Notes and Related Subsidiaries

EFFECTIVE DATE OF 2010 AMENDMENT

Amendment by sections 921(b) and 928 of Pub. L. 111–203 effective 1 day after July 21, 2010, except as otherwise provided, see section 4 of Pub. L. 111–203, set out as an Effective Date note under section 5301 of Title 12, Banks and Banking.

Amendment by section 418 of Pub. L. 111–203 effective 1 year after July 21, 2010, except that any investment adviser may, at the discretion of the investment adviser, register with the Commission under the Investment Advisers Act of 1940 during that 1-year period, subject to the rules of the Commission, and except as otherwise provided, see section 419 of Pub. L. 111–203, set out as a note under section 80b–2 of this title.

EFFECTIVE DATE OF 1970 AMENDMENT

Amendment by Pub. L. 91–547 effective on expiration of one year after Dec. 14, 1970, see section 30(1) of Pub. L. 91–547, set out as a note under section 80a–52 of this title.

Executive Documents

TRANSFER OF FUNCTIONS

For transfer of functions of Securities and Exchange Commission, with certain exceptions, to Chairman of such Commission, see Reorg. Plan No. 10 of 1950, §§ 1, 2, eff. May 24, 1950, 15 F.R. 3175, 64 Stat. 1265, set out under section 78d of this title.

§ 80b–6. Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) 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 such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

(Aug. 22, 1940, ch. 686, title II, § 206, 54 Stat. 852; Pub. L. 86–750, §§ 8, 9, Sept. 13, 1960, 74 Stat. 887; Pub. L. 111–203, title IX, § 985(e)(2), July 21, 2010, 124 Stat. 1935.)

Editorial Notes

AMENDMENTS

2010—Par. (3). Pub. L. 111–203 inserted ''or'' at end.

EXHIBIT 6

Regulation of Investment Advisers

by the

U.S. Securities and Exchange Commission

March 2013

Staff of the Investment Adviser Regulation Office
Division of Investment Management
U.S. Securities and Exchange Commission

EXHIBIT 7

Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*

I. Introduction

Money managers, investment consultants, and financial planners are regulated in the United States as "investment advisers" under the U.S. Investment Advisers Act of 1940 ("Advisers Act" or "Act") or similar state statutes. This outline describes the regulation of investment advisers by the U.S. Securities and Exchange Commission ("SEC").

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 Act is based on a congressionally-mandated study of investment companies, including consideration of investment counsel and investment advisory services, carried out by the SEC during the 1930s.[1] The SEC's report traced the history and growth of investment advisers and reflected the position that investment advisers could not properly perform their function unless all conflicts of interest between them and their clients were removed. The report stressed that a significant problem in the industry was the existence, either consciously or, more likely, unconsciously, of a prejudice by advisers in favor of their own financial interests.

The SEC's report culminated in the introduction of a bill that, with some changes, became the Advisers Act. The Act, as adopted, reflects congressional recognition of the delicate fiduciary nature of the advisory relationship, as well as Congress' desire to eliminate, or at least expose, all conflicts of interest that might cause advisers, either consciously or unconsciously, to render advice that is not disinterested.[2]

The outline that follows is divided into five sections, each of which addresses a different question: Who is an "investment adviser?" Which investment advisers must register with the SEC? Who must register under the Act? How does an investment adviser register under the Act? What are the requirements applicable to an investment adviser registered under the Act?

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* The U.S. Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed in this outline are those of the staff of the Investment Adviser Regulation Office, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission or others on the staff of the U.S. Securities and Exchange Commission. The Investment Adviser Regulation Office would like to thank Robert E. Plaze, the original author of this outline, for his substantial contribution.

1 *See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services*, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

2 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189, 191-192 (1963).

II. Who is an Investment Adviser?

A. Definition of Investment Adviser

Section 202(a)(11) of the Act defines an investment adviser as any person or firm that:

- for compensation;
- is engaged in the business of;
- providing advice to others or issuing reports or analyses regarding securities.

A person must satisfy all three elements to fall within the definition of "investment adviser," which the SEC staff has addressed in an extensive interpretive release explaining how the Act applies to financial planners, pension consultants and other persons who, as a part of some other financially related services, provide investment advice.[3] Published in 1987, Investment Advisers Act Release No. 1092 represents the views of the Division of Investment Management, which is primarily responsible for administering the Act.

1. *Compensation.* The term "compensation" has been broadly construed. Generally, the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination, satisfies this element.[4] The person receiving the advice or another person may pay the compensation.

2. *Engaged in the Business.* A person must be engaged in the business of providing advice. This does not have to be the sole or even the primary activity of the person. Factors used to evaluate whether a person is engaged are: (i) whether the person holds himself out as an investment adviser; (ii) whether the person receives compensation that represents a clearly definable charge for providing investment advice; and (iii) the frequency and specificity of the investment advice provided.[5] Generally, a person providing advice about specific securities will be "engaged in the business" unless specific advice is rendered only on a rare or isolated occasion.[6]

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3 *Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) ("Release 1092").

4 *Id.*; *see also Kenisa Oil Company*, SEC Staff No-Action Letter (May 6, 1982); *SEC v. Fife*, 311 F. 3d 1 (1st Cir. 2002) (a person provides advice "for compensation" if it understands that successful investment will yield it a commission); *In the Matter of Alexander V. Stein*, Investment Advisers Act Release. No. 1497 (June 8, 1995) (a person receives "compensation" if it fraudulently converts client funds to its own use).

5 *Zinn v. Parish,* 644 F.2d 360 (7th Cir. 1981); Release 1092, *supra* note 3.

6 For instance, the SEC staff would not view an employer providing advice to an employee in connection with an employer-sponsored employee benefit program to be in the business of providing advice, *see Letter to Olena Berg*, *Assistant Secretary*, *Department of Labor, from Jack W. Murphy, Chief Counsel, Division of Investment Management, SEC* (Feb. 22, 1996). *See also Zinn, supra* note 5 at 364 ("isolated transactions with a client as an incident to the main purpose of his management contract to negotiate football contracts do not constitute engaging in the business of advising others on investment securities.").

3. *Advising Others about Securities*

a. *Advice about Securities*. A person clearly meets the third element of the statutory test if he provides advice to others about specific securities, such as stocks, bonds, mutual funds, limited partnerships, and commodity pools. The SEC staff has stated that advice about real estate, coins, precious metals, or commodities is not advice about securities.[7] The more difficult questions arise with less specific advice, or advice that is only indirectly about securities. The SEC staff has stated in this regard:

(i) advice about market trends is advice about securities;[8]

(ii) advice about the selection and retention of other advisers is advice about securities;[9]

(iii) advice about the advantages of investing in securities versus other types of investments (*e.g.*, coins or real estate) is advice about securities;[10]

(iv) providing a selective list of securities is advice about securities even if no advice is provided as to any one security;[11] and

(v) asset allocation advice is advice about securities.[12]

b. *Advising Others.* Questions about whether a person advises "others" usually arise when a client is not a natural person. The SEC staff generally looks to the substance of the arrangement rather than its form:

(i) A general partner of a limited partnership that provides advice with respect to the investments of partnership assets is advising others (the limited partners) even where the general partner may have legal title to these assets.[13]

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7 *Robert R. Champion*, SEC Staff No-Action Letter (Sept. 22, 1986).

8 *Dow Theory Forecasts*, SEC Staff No-Action Letter (Feb. 2, 1978). Thus, market-timing advice is advice about securities. *See Maratta Advisory, Inc.*, SEC Staff No-Action Letter (July 16, 1981).

9 Release 1092, *supra* note 3; *FPC Securities Corp.*, SEC Staff No-Action Letter (Dec. 1, 1974). *See also SEC v. Bolla,* 401 F.Supp. 43 (D.D.C. 2005), *aff'd. in relevant part, SEC v. Washington Investment Network,* 475 F.3d 392 (D.C. Cir. 2007) (person selecting investment advisers for clients meets the Advisers Act's definition of "investment adviser").

10 Release 1092, *supra* note 3.

11 *RDM Infodustries, Inc.,* SEC Staff No-Action Letter (Mar. 25, 1996). The SEC staff takes the position that providing information about securities in a report does not constitute providing advice about the securities if: (i) the information is readily available to the public in its raw state; (ii) the categories of information presented are not highly selective; and (iii) the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security. *See id.*

12 *Maratta Advisory, Inc.*, *supra,* note 8. *See also SEC v. Bolla*, *supra,* note 9.

13 *Abrahamson v. Fleschner,* 566 F.2d 862, 870 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978); *SEC v. Haligiannis*, 470 F. Supp. 2d 373, 383 (S.D.N.Y. 2007).

(ii) A wholly-owned corporate subsidiary exclusively advising the parent or another wholly owned corporate subsidiary would not generally be considered advising "others."[14]

c. *Investment Banking.* The SEC staff does not believe that the Act applies to persons whose activities are limited to advising issuers concerning the structuring of their securities offerings (although such advice may technically be about securities).[15]

d. *Non-U.S. Clients*. The Act is silent regarding whether the clients must be U.S. persons. The SEC takes the position that a U.S. person providing advice exclusively to non-U.S. persons would still be subject to the Act.[16]

B. Exclusions from Definition

There are several exclusions from the investment adviser definition available to persons who presumably (or at least arguably) satisfy all three elements of the definition. A person eligible for one of the exclusions is not subject to any provisions of the Act.

1. *Banks and Bank Holding Companies*. This exclusion is generally limited to U.S. banks and bank holding companies.[17] The SEC staff has stated that the exclusion is unavailable to non-U.S. banks,[18] credit unions, and investment adviser subsidiaries of banks or bank holding companies.[19]

2. *Lawyers, Accountants, Engineers, and Teachers*. The professional exclusion is available only to those professionals listed, and only if the advice given is incidental to the practice of their profession. Factors considered by staff to evaluate whether advice is incidental to a profession are: (i) whether the professional holds himself out as an investment adviser; (ii) whether the advice is reasonably related to the professional services provided; and (iii) whether the charge for advisory services is based on the same factors that

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14 *See Zenkyoren Asset Management of America Inc.*, SEC Staff No-Action Letter (June 30, 2011).

15 *See, e.g., The Applicability of the Investment Advisers Act of 1940 to Financial Advisors to Municipal Bond Issuers, Division of Investment Management*, SEC Staff Legal Bulletin No. 11 (Sept. 19, 2000), *available at* http://www.sec.gov/interps/legal.shtml.

16 *See* Release 3221, *infra* note 46, at n.76.

17 The term "bank" is defined in section 202(a)(2) of the Act. In 2001, the Act's definition of "investment adviser" was amended so that banks and bank holding companies are not eligible for this exclusion to the extent that they serve or act as an investment adviser to a registered investment company. However, if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, is deemed to be the investment adviser. The term "separately identifiable department or division" is defined in section 202(a)(26).

18 *Letter to Rep. William J. Hughes from Stanley B. Judd, Deputy Chief Counsel, Division of Investment Management,* SEC (June 4, 1980).

19 *First Commerce Investors, Inc.*, SEC Staff No-Action Letter (Jan. 31, 1991); *Southwest Corporate Federal Credit Union*, SEC Staff No-Action Letter (May 31, 1983).

determine the professional's usual charge.[20]

3. *Brokers and Dealers*. A broker or dealer that is registered with the SEC under the Securities and Exchange Act of 1934 ("Exchange Act") is excluded from the Act if the advice given is: (i) solely incidental to the conduct of its business as broker or dealer, and (ii) it does not receive any "special compensation" for providing investment advice.

   a. *Solely Incidental.* The SEC has stated that investment advice is "solely incidental" to brokerage services when the advisory services rendered are "in connection with and reasonably related to the brokerage services provided."[21] If advice is not "solely incidental," a broker-dealer is subject to the Advisers Act regardless of the form of compensation it receives.

   b. *Special Compensation.* Generally, to avoid receiving "special compensation," a broker or dealer relying on this exclusion must receive only commissions, markups, and markdowns.[22]

      Bundled Fees. The SEC has stated a broker or dealer that receives a fee based on a percentage of assets that compensates the broker or dealer for both advisory and brokerage services receives "special compensation."[23]

      Separate or Identifiable Charge. The SEC has stated that a broker-dealer charges "special compensation" when it charges its customer a separate fee for investment advice, or when it charges its customers different commission rates, one with advice and one without, because the difference represents a clearly definable charge for investment advice.[24]

      Broker-Dealer Agents. The SEC staff has stated that a registered representative of a broker-dealer can rely on the exclusion if she is: (i) giving advice within the scope of her employment with the broker-

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20 Release 1092, *supra* note 3; *Henry S. Miller Companies of Dallas, Texas*, SEC Staff No-Action Letter (Feb. 21, 1975).

21 *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Investment Advisers Act Release No. 2376 (Apr. 12, 2005) ("Release 2376"), *available at* http://www.sec.gov/rules/final/34-51523.pdf.

22 Section 202(a)(11)(C). *See* S. Rep. No. 76-1775 at 22; H.R. Rep. No. 76-2639 at 28 (the term "investment adviser" was "so defined as specifically to exclude . . . brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.")).

23 In Release 2376, the SEC adopted a rule that, among other things, deemed brokers charging asset-based brokerage fees (rather than commissions, mark-ups, or mark-downs) not to be investment advisers based solely on their receipt of special compensation. The rule was vacated for other reasons by a federal court in March 2007. *Financial Planning Association v. SEC*, 482 F.3d (D.C. Cir. 2007). *See also National Regulatory Services*, SEC Staff No-Action Letter (Dec 2, 1992) at n.3.

24 *Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers*, Investment Advisers Act Release No. 626 (Apr. 27, 1978) ("Release 626"). *See also, Opinion of the General Counsel Relating to Section 203(b)(3)of the Investment Advisers Act of 1940*, Investment Advisers Act No. 2 (Oct. 28, 1940). The Commission proposed to codify this interpretation in a rule. *See Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, Investment Advisers Act Release No. 2652 (Sept. 24, 2007).

dealer; (ii) the advice is incidental to her employer's brokerage activities; and (iii) she receives no special compensation for her advice.[25]

Brokerage Customers. The SEC has stated that a broker-dealer does not have to treat its brokerage customers to whom it provides investment advice as advisory clients simply because it is registered under the Advisers Act. It must treat as an advisory client only those accounts for which it provides advice (*i.e.*, non-incidental advice) or receives compensation (*i.e.*, special compensation) that subjects the broker-dealer to the Advisers Act.[26]

4. *Publishers.* Publishers are excluded from the Act, but only if a publication: (i) provides only impersonal advice (*i.e.,* advice not tailored to the individual needs of a specific client);[27] (ii) is "bona fide," (containing disinterested commentary and analysis rather than promotional material disseminated by someone touting particular securities); and (iii) is of general and regular circulation (rather than issued from time to time in response to episodic market activity).[28]

5. *Government Securities Advisers.* This exclusion is available to persons and firms whose advice is limited to certain securities issued by or guaranteed by the U.S. government.[29]

6. *Credit Rating Agencies*. This exclusion is available to any rating agency regulated under section 15E of the Exchange Act as a "nationally recognized statistical rating organization."[30]

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25 *Institute of Certified Financial Planners*, SEC Staff No-Action Letter (Jan. 21, 1986).

26 Release 626, *supra* note 24. The Commission has proposed to codify this interpretation in a rule. *See Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, *supra* note 24.

27 *See Weiss Research, Inc., et al*, Investment Advisers Act Release No. 2525 (June 22, 2006) (newsletter publisher deemed to be an investment adviser providing personalized investment advice whose "auto-trading" program sent signals to broker-dealer, which automatically traded subscriber/customer securities consistent with signals).

28 Section 202(a)(11)(D). *See Lowe v. SEC*, 472 U.S. 181 (1985); *SEC v. Gun Soo Oh Park, A/K/A Tokyo Joe, and Tokyo Joe's Societe Anonyme Corp.*, 99 F. Supp. 2d 889 (N.D. Ill. 2000). If a publisher is required to register as a result of some other advisory activity, the adviser is subject to all of the provisions of the Act and SEC rules with respect to the publication. *See* Investment Advisers Act Release No. 870 (July 15, 1983)("Release 870").

29 Section 202(a)(11)(E). The scope of the exception includes persons whose advice is limited to: (i) direct obligations of the Federal government (*e.g.*, U.S. Treasury obligations); (ii) securities subject to guarantees from the Federal government; and (iii) securities issued by or guaranteed by corporations whose securities are designated by the Secretary of the Treasury as exempt from the Exchange Act. The SEC staff has stated that advice about repurchase agreements collateralized by U.S. government securities does not fall within the exception. *J.Y. Barry Arbitrage Management, Inc*., SEC Staff No-Action Letter (Oct. 18, 1989). *See also In the Matter of Rauscher Pierce Refsnes, Inc., et al.*, Investment Advisers Act Release No. 1863 (Apr. 6, 2000) ("Because Rauscher's advice was not limited to Treasury securities or other government securities as described in section 202(a)(11)(E), that provision did not operate to exclude Rauscher from the definition of investment adviser.").

30 Section 202(a)(11)(F), containing this exclusion for rating agencies, was added to the Act by the Credit Rating Agency Reform Act of 2006. Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

7. *Family Offices.* A family office that manages the wealth and other affairs of a single family is excluded from the investment adviser definition if it: (i) provides investment advice only to family clients; (ii) is wholly owned by family clients and exclusively controlled by family members and/or certain family entities; and (iii) does not hold itself out[31] to the public as an investment adviser.[32]

   a. *Family Members.* A family office's "family members" include all lineal descendants (including adopted children, stepchildren, foster children, and, in some cases, persons who were minors when a family member became their legal guardian) of a common ancestor (no more than 10 generations removed from the youngest generation of family members), and such lineal descendants' spouses or spousal equivalents.[33]

   b. *Family Clients.* The family office's clients generally may include family members; key employees; any non-profit or charitable organization funded exclusively by family clients; any estate of a family member, former family member, key employee, or subject to certain conditions, a former key employee; certain family client trusts; and any company wholly owned by and operated for the sole benefit of family clients.[34]

8. *Governments and Political Subdivisions.* The Act does not apply to the U.S. government, state governments and their political subdivisions, and their agencies or instrumentalities, including their officers, agents, or employees acting in their official capacities.[35]

9. *Non-U.S. Advisers.* There is no exemption for non-U.S. advisers. Non-U.S. persons advising U.S. persons are subject to the Act and must register under the Act[36] unless eligible for one of the exemptions discussed below (*e.g.*, the "foreign private adviser" registration exemption).[37] The SEC does not accept "home state registration" of non-U.S. advisers in lieu of SEC

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31 *See infra* notes 69 to 72 and accompanying text for discussion of "holding out."

32 Rule 202(a)(11)(G)-1(b)(defining "family office" for purpose of section 202(a)(11)(G), which was added to the Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act")). Family offices that do not meet these conditions must register with the SEC unless another exemption is available. Rule 202(a)(11)(G)-1(e)(2).

33 Rule 202(a)(11)(G)-1(d)(6).

34 Rule 202(a)(11)(G)-1(d)(4). Key employees include executive officers, directors, trustees, general partners, or any person serving in a similar capacity for the family office or its affiliated family office, and certain employees who have participated in the investment activities of the family office or its affiliated family office for at least 12 months. Rule 202(a)(11)(G)-1(d)(8).

35 Section 202(b).

36 *In the Matter of Banco Espirito Santo S.A.*, Investment Advisers Act Release No. 3304 (Oct. 24, 2011) (The SEC brought an enforcement action against a commercial bank headquartered in Portugal for violating section 203(a) by marketing its portfolio of financial services, including offering securities and providing advice regarding those securities, to U.S. residents who were primarily Portuguese immigrants without registering with the Commission.).

37 *See* Section III. B. 3 of this outline for discussion of the foreign private adviser exemption.

registration.[38]

The SEC has authority to designate, by rule or order, other persons who are not within the intent of the definition of investment adviser.[39]

III. Which Investment Advisers Must Register Under the Advisers Act?

A firm that falls within the definition of "investment adviser" (and is not eligible for one of the exclusions) must register under the Advisers Act, unless it (i) is prohibited from registering under the Act because it is a smaller firm regulated by one or more of the states or (ii) qualifies for an exception from the Act's registration requirement.[40] All advisers, registered or not, are subject to the Act's anti-fraud provisions.

A. Prohibitions from Registration

Until 1996, most investment advisers were subject to regulation by both the SEC *and* one or more state regulatory agencies. The Act was amended in 1996 and again in 2010 to allocate regulatory responsibility between the SEC and the states.[41] Today, most small advisers and "mid-sized advisers" are subject to state regulation of advisers and are *prohibited* from registering with the SEC.[42] Most large advisers (unless an exemption is available) must register with the SEC, and state adviser laws are preempted for these advisers.[43]

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38 On June 12, 2007, the SEC held a "roundtable discussion" at which the possibility of revising its approach to mutual recognition was discussed. The SEC press release concerning the roundtable stated that "selective mutual recognition would involve the SEC permitting certain types of foreign financial intermediaries to provide services to U.S. investors under an abbreviated registration system, provided those entities are supervised in a foreign jurisdiction under a securities regulatory regime substantially comparable (but not necessarily identical) to that in the United States." *See* http://www.sec.gov/spotlight/mutualrecognition.htm.

39 Section 202(a)(11)(H). *See, e.g., International Bank for Reconstruction and Development and International Development*, Investment Advisers Act Release Nos. 1971 (Sept. 4, 2001) (notice) and 1955 (July 27, 2001) (order) (declaring World Bank instrumentalities not to be investment advisers under the Act). Section 202(a)(11)(H) had been designated as section 202(a)(11)(F) until 2006, and as 202(a)(11)(G) until 2011, when it was re-designated by the Dodd-Frank Act.

40 Section 203(a).

41 *National Securities Markets Improvements Act of 1996* ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996); Dodd-Frank Act, *supra* note 32. Most of the provisions amending the Advisers Act to allocate regulatory responsibilities between the SEC and state governments have been codified in section 203A.

42 Section 203A(a). Section 203A creates a *prohibition*, not an exemption. *See In the Matter of Matthew P. Brady*, Investment Advisers Act Release No. 2178 (Sept. 30, 2003); *In the Matter of Warwick Capital Management Inc*., Initial Decision Release No. 327 (Feb. 15, 2007); *Credit Agricole Asset Management Alternative Investments, Inc*., SEC Staff No-Action Letter (Aug. 7, 2006). *See also In the Matter of Royal Oak Capital Management, LLC*, Investment advisers Act Release No. 3354 (Jan. 17, 2012) (cancelling the registration of an adviser that did not have required amount of assets under management to remain registered with the SEC).

43 *See* Sections 203(a) (registration required) and 203A(b) (preemption of state law).

1. *Operation of Section 203A of the Advisers Act*

a. *Small Advisers.* Advisers with less than $25 million of assets under management are regulated by one or more states *unless* the state in which the adviser has its principal office and place of business has not enacted a statute regulating advisers.[44] Thus, unless an exemption is available (discussed below), only a small adviser with its principal office and place of business in Wyoming (which has not enacted a statute regulating advisers) may register with the SEC.

b. *Mid-Sized Advisers.* Generally advisers with between $25 million and $100 million of assets under management[45] are regulated by one or more states if (i) the adviser *is registered* with the state where it has its principal office and place of business (*e.g.*, it cannot take advantage of an exemption from state registration), and (ii) the adviser is "subject to examination" by that state securities authority.[46] Unless an exemption is available, a mid-sized adviser with its principal office and place of business in New York or Wyoming is not "subject to examination" and must register with the SEC.[47]

c. *Non-U.S. Advisers.* Advisers whose principal office and place of business is outside the United States are not prohibited from registering with the SEC and thus are not subject to the assets under management thresholds.[48] A non-U.S. adviser giving advice to U.S. persons[49] must register with the SEC (and thus may avoid registration with state regulators), unless an exemption from registration is

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44 Section 203A(a)(1) prohibits any adviser from registering with the SEC that is *regulated or is required to be regulated* in the state in which it maintains its principal office and place of business. The SEC interprets this provision to mean the prohibition applies only to an adviser that maintains its principal office and place of business in a state that has enacted an investment adviser statute. *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) ("Release 1633") at n.83 and accompanying text.

45 The Dodd-Frank Act raised the threshold for advisers to register with the SEC to $100 million of assets under management. *See* section 410 of Dodd-Frank Act. A mid-sized adviser *may* register when it acquires $100 million of assets under management and *must* register once it obtains $110 million of assets under management, unless some other exemption is available. Rule 203A-1(a)(1). Once registered with the SEC, a mid-sized adviser is not required to withdraw from SEC registration and register with the states until the adviser has less than $90 million of assets under management. *Id.*

46 Section 203A(a)(2) prohibits a mid-sized adviser from registering with the SEC if the adviser is required to be registered as an adviser in the state where it has its principal office and place of business and is subject to examination by that state. *See Rule Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221 (June 22, 2011) ("Release 3221").

47 *See* Instructions for Item 2 of Part 1A of Form ADV; Division of Investment Management: Frequently Asked Questions Regarding Mid-Sized Advisers, *available at* www.sec.gov/divisions/investment/midsizedadviserinfo.htm. New York and Wyoming did not advise the SEC staff that advisers registered with them are subject to examination. *See* Release 3221 at n.152, *supra* note 46.

48 *See* Release 1633, *supra* note 44 at Section II. E. An adviser with a principal office and place of business in another country does not have a principal office and place of business in a U.S. state that regulates investment advisers.

49 *See infra* note 64 for discussions of the definition of a "U.S. person."

available (in which case it may be subject to state registration requirements).[50]

2. *Exceptions to Prohibition.* Section 203A and SEC rules carve out several exceptions from the assets under management tests.

   a. *Advisers to Investment Companies.* Advisers to investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act") must register with the SEC.[51] The exception is not available to an adviser that simply gives advice about investing in investment companies.[52]

   b. *Advisers to Business Development Companies*. Advisers with at least $25 million of assets under management that advise a company which has elected to be a business development company pursuant to section 54 of the Investment Company Act must register with the SEC.[53]

   c. *Pension Consultants*. Advisers providing advisory services to employee benefit plans having at least $200M of assets may register with the SEC (even though the consultant does not itself have those assets under management).[54]

   d. *Related Advisers.* Advisers that control, are controlled by, or are under common control of an SEC-registered adviser may register with the SEC, but only if they have the same principal office and place of business.[55]

   e. *Newly-Formed Advisers.* Advisers that are not registered, and have a reasonable expectation that they will be eligible for SEC registration within 120 days of registering, may register with the SEC.[56]

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50 *See* Section III. A. 3 of this outline for discussion of exemption from registration for foreign private advisers.

51 Sections 203A(a)(1)(B); 203A(a)(2)(A).

52 *See* Instructions for Item 2 of Part 1A of Form ADV.

53 Section 203A(a)(2)(A). *See also* Item 2.A.(6) of Part 1A of Form ADV.

54 Rule 203(A)-2(a). In June 2011, the SEC increased the plan assets threshold required for pension consultants from $50 million to $200 million. *See* Release 3221, *supra* note 46. In May 2005, the SEC staff published a report detailing concerns with conflicts of pension fund consultants who help pension managers evaluate money managers. *See Staff Report Concerning Staff Examinations of Certain Select Pension Fund Consultants*, *available at* www.sec.gov/news/studies/pensionexamstudy.pdf. The SEC settled an administrative proceeding with a pension consultant that breached its fiduciary obligations by failing to disclose conflicts of interest. *In the Matter of Yanni Partners, Inc.*, Investment Advisers Act Release No. 2643 (Sept. 4, 2007) (pension consultant held itself out to be "independent" of money managers sold subscriptions to data base to money managers it was evaluating).

55 Rule 203A-2(b).

56 Rule 203A-2(c). An adviser relying on this exception must file an amendment to its Form ADV at the end of the 120 days indicating whether it has become eligible for SEC registration, or must withdraw its SEC registration. An adviser that expects to be eligible for SEC registration because of the amount of its assets under management must have $100M or more of assets under management no later than 120 days after its registration is declared effective. *See* Instructions for Item 2 of Part 1A of Form ADV.

f. *Multi-State Advisers*. Advisers that would otherwise be obligated to register with 15 or more states may register with the SEC.[57]

g. *Internet Advisers.* Certain advisers who provide advice though an interactive web site may register with the SEC.[58]

3. *State Law Still Applicable to SEC-Registered Advisers.* Although state investment adviser statutes do not apply to SEC-registered advisers, other state laws, including other state securities laws, do apply. In addition, state laws may (and most state laws continue to) require an SEC-registered adviser to:

a. comply with state anti-fraud prohibitions;

b. provide the state regulator with a copy of its SEC registration;

c. pay state licensing and renewal fees; and

d. license persons giving advice on behalf of the adviser, but only if the person has a place of business in the state.[59]

4. *Federal Anti-Fraud Law Still Applicable to State-Registered Advisers*. The SEC continues to institute enforcement actions against state-registered advisers charging violations of section 206 of the Act.[60]

B. Exemptions from Registration

The Advisers Act provides several exemptions from registration. The exemptions are voluntary; advisers eligible for them can nonetheless register with the SEC.[61]

1. *Intrastate Advisers*. Available to an adviser (i) all of whose clients are residents of the state in which the adviser maintains its principal office and place of business and (ii) that does not give advice about securities on any

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57 Section 203A(a)(2)(A); Rule 203A-2(d).

58 Rule 203A-2(e). *Exemption for Certain Investment Advisers Operating Through the Internet*, Investment Advisers Act Release No. 2091 (Dec. 12, 2002), *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2002.shtml.

59 SEC-registered advisers can comply with state requirements that they provide states with a copy of their registration (so-called "notice filings"), pay state registration fees, and license advisory personnel (in most states) through the electronic filing system (IARD) discussed below.

60 *See*, *e.g.*, *In the Matter of James William Fuller*, Investment Advisers Act Release No. 1842 (Oct. 4, 1999); *In the Matter of Robert Radano*, Investment Advisers Act Release No. 2750 (June 30, 2008); *SEC v. Aaron Donald Vallett and A.D. Vallett & Co., LLC*, Litigation Release No. 21557 (June 16, 2010). Most of the anti-fraud rules adopted by the SEC pursuant to its authority under section 206(4) of the Act (and discussed below) are not applicable to state-registered advisers. States have, however, adopted similar rules in many cases.

61 Persons who voluntarily register under the Advisers Act, in circumstances where their registration may not be required, are subject to all of the provisions and rules under the Advisers Act applicable to persons required to register. *See* Release 870, *supra* note 28. State regulatory law is not preempted for an adviser taking advantage of one of the exceptions from registration and thus the adviser may be required to register with one or more state securities regulators. *See* discussion of state preemption in Section III. A. of this outline.

national exchange.[62]

Updated →2. *Advisers to Insurance Companies*. Available to an adviser whose only clients are insurance companies.[63]

3. *Foreign Private Advisers.* Available to an adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States *and investors* in the United States in private funds advised by the adviser; (iii) has aggregate assets under management attributable to these clients and investors of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[64]

The exemption for foreign private advisers was added by the Dodd-Frank Act and replaces the private adviser exemption (i.e., an exemption for any adviser with fewer than 15 clients) previously provided by the same section of the Act, which was repealed. The SEC incorporated many of the rules from "old" section 203(b)(3).

a. *Counting Clients*

(i) *Multiple Persons as a Single Client.* Rule 202(a)(30)-1 provides that the following can be considered a single client:[65]

(A) a natural person and (i) any minor child of the natural person; (ii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person with the same principal residence; and (iii) all accounts or trusts of which the persons described above are the only primary beneficiaries; or

(B) a corporation, general or limited partnership, limited liability company, trusts or other legal organization that receives investment advice based on its investment objectives (rather than the individual investment objectives of its owners),[66]

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62 Section 203(b)(1). The SEC staff takes the position that advice regarding investment companies involves advice about "listed securities" if the investment company invests in listed securities. *Roy Heybrock*, SEC Staff No-Action Letter (Apr. 5, 1992).

63 Section 203(b)(2). *See also TACT Asset Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 24, 2012) (stating that the staff would not recommend enforcement proceedings if a U.S. investment adviser whose only client is a foreign insurance company does not register with the SEC).

64 Section 203(b)(3) (exempting "any investment adviser that is a foreign private adviser"); Section 202(a)(30) (defining a "foreign private adviser"). Rule 202(a)(30)-1 defines the term "in the United States" by reference to the definitions of a "U.S. person" and the "United States" in Regulation S under the Securities Act, except that the rule treats as "in the United States" any discretionary account owned by a U.S. person and managed by a non-U.S. affiliate of the adviser. An adviser must assess whether a person is "in the United States" at the time the person becomes a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund. *See* rule 202(a)(30)-1, at note to paragraph (c)(3)(i).

65 Rule 202(a)(30)-1. The rule provides a non-exclusive safe harbor for counting clients for purposes of section 203(b)(3). *See* rule 202(a)(30)-1, at note to paragraphs (a) and (b).

66 An adviser must count an owner (*e.g.*, a limited partner) as a client if it provides advice to that owner "separate and apart" from the advice provided to the entity. Rule 202(a)(30)-1(b)(1). *Cf. Latham &*

and two or more of these entities that have identical owners.

(ii) "*Look through" private funds.* An adviser must count both its direct clients and each investor in any "private fund" it advises.

No Double Counting. An adviser may treat as a single investor any person who is an investor in two or more of the adviser's private funds.[67]

Nominal Holders. An adviser may be required to also "look through" persons who are nominal holders of a security issued by a private fund to count the investors in the nominal holder when determining if the adviser qualifies for the exemption. For example, holders of the securities of any feeder fund in a master-feeder arrangement may be deemed to be the investors of the master fund.[68]

b. *Holding Out.* The SEC staff views a person as holding himself out as an adviser if he advertises as an investment adviser or financial planner, uses letterhead indicating activity as an investment adviser, or maintains a telephone listing or otherwise lets it be known that he will accept new advisory clients,[69] or hires a person to solicit clients on his behalf.[70]

(i) *Participation in Non-Public Offerings*. Foreign private advisers will not be deemed to be holding themselves out generally to the public in the United States as an investment adviser solely because they participate in a non-public offering in the United States of securities issued by a private fund pursuant to an exemption from registration under the Securities Act of 1933.[71]

(ii) *Use of the Internet.* An adviser using the Internet to provide information about itself ordinarily would be "holding itself out" as an adviser. However, the SEC has stated that it will not consider a non-U.S. adviser, including foreign private advisers, to be holding itself out as an adviser if:

(A) *Prominent Disclaimer.* The adviser's web site includes a

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Watkins, SEC Staff No-Action Letter (Aug. 24, 1998); *Burr, Egan, Deleage & Co., Inc*., SEC Staff No-Action Letter (Apr. 27, 1987).

67 Rule 202(a)(30)-1, at note to paragraph (c)(2).

68 *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.3222 (June 22, 2011)("Release 3222") at Section II.C.2.

69 *See, e.g.*, *William Bloor*, SEC Staff No-Action Letter (Feb. 15, 1980); *Richard J. Shaker*, SEC Staff No-Action Letter (Aug. 1, 1977); *Al O'Brien Associates*, SEC Staff No-Action Letter (Oct. 6, 1973).

70 Investment Advisers Act Release No. 688 (July 15, 1979) at n.9. *See also Lamp Technologies, Inc*., SEC Staff No-Action Letter (May 29, 1997) (investment adviser not "holding itself out generally to the public as an investment adviser" solely by virtue of posting information about certain private funds (*e.g*., hedge funds) on a password-protected web site that is accessible only by accredited investors).

71 Rule 202(a)(30)-1(d).

prominent disclaimer making it clear that its web site materials are not directed to U.S. persons; and

(B) *Procedures.* The adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. persons (*e.g.*, obtaining residency information before sending further information).[72]

4. *Charitable Organizations and Plans.* Available to an adviser that is a charitable organization or a charitable organization's employee benefit plan, including a trustee, officer, employee, or volunteer of the organization or plan to the extent that the person is acting within the scope of his employment or duties.[73]

5. *Commodity Trading Advisors*

   a. *Generally.* Available to any adviser that is registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor and whose business does not consist primarily of acting as an investment adviser and that does not advise a registered investment company or a business development company.[74]

   b. *Commodity Trading Advisors to Private Funds.* Available to any adviser registered with the CFTC as a commodity trading advisor that advises a private fund, provided that the adviser must register with the SEC if its business becomes predominantly the provision of securities-related advice.[75]

6. *Private Fund Advisers*. Available to an adviser solely to private funds that has less than $150 million in assets under management in the United States.[76] An adviser that has any other type of client is not eligible for the exemption.[77]

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72 *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Investment Advisers Act Release No. 1710 (Mar. 23, 1998) section VI, *available at* http://www.sec.gov/rules/interp/interparchive/interparch1998.shtml.

73 Sections 203(b)(4) and (5) were added by the *Philanthropy Protection Act of 1995*, Pub. L. No. 104-62, 109 Stat. 682 (1995). *See also Sisters of Mercy*, SEC Staff No-Action Letter (Oct. 1, 2009).

74 Section 203(b)(6) (re-designated as 203(b)(6)(A) by Dodd-Frank Act) was added by the *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763 (2000), which also amended the Act's definition of "security" in section 202(a)(18) of the Act to include certain "securities futures." The Act repealed the ban on single stock or narrow-based stock index futures and established a framework for shared jurisdiction over the trading of these instruments and market participants. *See* Exchange Act Release No. 44288 (May 9, 2001), *available at* http://www.sec.gov/rules/proposed/34-44288.htm.

75 Section 203(b)(6)(B) of the Advisers Act (added by the Dodd-Frank Act).

76 Section 203(m) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(m)-1 on June 22, 2011 to implement the section. *See* Release 3222, *supra* note 68.

77 Two nominally separate but related advisers may be considered to be one adviser (and their assets aggregated) if they do not operate sufficiently independent of one another.

a. *Private Funds.* A "private fund" is an issuer of securities that would be an investment company "but for" the exceptions provided for in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[78]

(i) Section 3(c)(1) is available to a fund that does not publicly offer its securities and has 100 or fewer beneficial owners of its outstanding securities.

(ii) Section 3(c)(7) is available to a fund that does not publicly offer its securities and limits its owners to qualified purchasers.[79]

b. *Calculating Private Fund Assets*

(i) *Method of Calculation*. Generally, advisers must include the value of all private funds managed, including the value of any uncalled capital commitments.[80] Value is based on market value of those assets, or the fair value of those assets where market value is unavailable, and must calculate the assets on a gross basis, *i.e.,* without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.[81]

(ii) *Annual Assessment.* An adviser must assess annually whether it has $150 million or more of private fund assets under management. An adviser that meets or exceeds the $150 threshold must register with the Commission.[82]

c. *Non-U.S. Advisers.* An adviser with a principal office and place of business outside the United States may exclude consideration of non-U.S. clients, *i.e.*, it may rely on the exemption if (a) *all* of its clients that are United States persons[83] are qualifying private funds; and (b) any management at a U.S. place of business by the adviser is solely

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78 Section 202(a)(29) of the Advisers Act.

79 The term "qualified purchasers" is defined in section 2(a)(51) of the Investment Company Act.

80 Form ADV: Instructions for Part 1A, instr. 5.b.(4). Proprietary assets, *i.e*, those of the adviser or its principals may not be excluded. Form ADV: Instructions for Part1A, instr. 5.b.(1).

81 *Id.* The SEC has recognized that, although many advisers will calculate the fair value of their private fund assets in accordance with Generally Accepted Accounting Principles ("GAAP") or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard. Release 3222, *supra* note 68 at nn.364-365 and accompanying text. Consistent with this good faith requirement, the SEC expects that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id.* at n.365.

82 Rule 203(m)-1(c). A private fund adviser that had complied with all SEC reporting requirements applicable to an exempt reporting adviser, but reported in its annual updating amendment that fund assets exceeded $150 million, has up to 90 days after filing the annual updating amendment to apply for SEC registration, and may continue doing business as a private fund adviser during this time. General Instruction 15 to Form ADV.

83 Similar to the foreign private adviser exemption, a "United States person" generally is a "U.S. person," as defined in Regulation S under the Securities Act, except that a discretionary or other fiduciary account also is a "United States person" if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser. Rule 203(m)-1(d)(8).

attributed to $150 million of private fund assets.[84]

d. *Annual Report.* An adviser relying on the private fund adviser exemption must annually file a report on Form ADV to the SEC [85] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. The SEC refers to these advisers as "exempt reporting advisers."

7. *Venture Capital Advisers.* Available to an adviser that solely advises one or more "venture capital funds" as defined by SEC rule (regardless of the amount of assets managed).[86]

a. *Definition*. To qualify as a "venture capital fund," a fund must be a "private fund"[87] that:

(i) represents to investors that the fund pursues a venture capital strategy;[88]

(ii) does not provide investors with redemption rights;[89]

(iii) holds no more than 20% of the fund's assets in non-"qualifying investments" (excluding cash and certain short-term holdings)

Qualifying investment means generally directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) and that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (*i.e.*, have not been acquired in a leveraged buy-out transaction); and

(iv) does not borrow (or otherwise incur leverage) more than 15% of the fund's assets, and then only on a short-term basis (*i.e.*, for no more than 120-days).[90]

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84 Rule 203(m)-1(b)(1) and (2). The term "place of business" has the same meaning as in the exemption for foreign private advisers, discussed above. *See* Section III. B. 3. of this outline. Rule 203(m)-1(d)(2).

85 Rule 204-2. The report must be filed within 60 days of relying on the private fund adviser exemption. Only portions of Form ADV must be completed. General Instruction 13 to Form ADV. An exempt reporting adviser is not required to deliver a brochure to its clients. General Instruction 3 to Form ADV.

86 Section 203(l) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(l)-1 on June 22, 2011 to implement the section. *See* Release 3222, *supra* note 68.

87 Rule 203(l)-1(a)(5). In addition, the fund cannot be registered under the Investment Company Act or have elected to be treated as a business development company as defined by that Act. Rule 203(l)-1(a)(5).

88 Rule 203(l)-1(a)(1).

89 Rule 203(l)-1(a)(4) (the rule permits exceptions in extraordinary circumstances).

90 Rule 203(l)-1 contains a grandfathering provision for certain private funds that have sold their initial interests in the fund by December 31, 2010, provided that they have represented to their investors that

b. *Non-U.S. Advisers.* The exemption is available to a non-U.S. adviser, but (unlike the private fund adviser exception) such an adviser may not disregard its non-U.S. advisory activities.[91] Thus, all of an adviser's clients, including non-U.S. clients, must be venture capital funds.[92]

c. *Annual Reporting.* An adviser relying on the venture capital adviser exemption must annually file a report on Form ADV to the SEC, [93] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. The SEC also refers to these advisers as "exempt reporting advisers."

8. *Advisers to Small Business Investment Companies ("SBICs").* SBICs, licensed by the Small Business Administration, are privately owned and managed investment firms that provide venture capital to small businesses from the SBIC's own capital and from funds the SBIC is able to borrow at favorable rates through the federal government.[94]

IV. Who Must Register Under the Advisers Act?

A. The Advisory Firm

Although many individuals who are employed by advisers fall within the definition of "investment adviser," the SEC generally does not require those individuals to register as advisers with the SEC. Instead, the advisory firm must register with the SEC. The adviser's registration covers its employees *and* other persons under its control, provided that their advisory activities are undertaken on the adviser's behalf.[95]

B. Affiliates

1. *Integration.* The SEC staff takes the view that advisers and their affiliates cannot circumvent the disclosure and other requirements of the Act by separately registering under the Act if they are operationally integrated, *e.g.*, have the same personnel, capital structures, and investment decision-making functions.[96]

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they pursue a venture capital strategy and that they do not issue any interests to any person after July 21, 2011.

91 Release 3222, *supra* note 68.

92 Rule 203(l)-1 contains a note the effect of which is to permit a non-U.S. adviser to treat a foreign fund it advises as a "private fund" even if the fund does not meet the Act's definition of a private fund because it is not relying on a statutory exemption from the Investment Company Act, but is rather relying on the lack of jurisdiction of the U.S. Release 3222, *supra* note 68.

93 Rule 204-2. *See supra* note 85 for a summary of reporting requirements.

94 Section 203(b)(7) (added by the Dodd-Frank Act).

95 Investment Advisers Act Release No. 688 (July 12, 1979) (persons associated with registered adviser need not separately register as investment advisers solely as a result of their activities as associated persons). *See also Kevin J. Hughes*, SEC Staff No-Action Letter (Dec. 7, 1983).

96 The determination of whether an advisory business of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Release 3222, *supra* note 68. *See Richard*

For example, an adviser managing $200 million of private fund assets could not simply reorganize as two separate advisers each of which purported to rely on the private fund adviser exemption from registration.[97]

2. *Participating Non-U.S. Affiliates*. The SEC staff takes the view that, under certain conditions, a non-U.S. adviser (a "participating affiliate") does not have to register under the Act if it provides advice to U.S. persons through a registered affiliate.[98] The conditions that must be satisfied include the following:

   a. an unregistered adviser and its registered affiliate must be separately organized;

   b. the registered affiliate must be staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice;

   c. all personnel of the participating affiliate involved in U.S. advisory activities must be deemed "associated persons"[99] of the registered affiliate; and

   d. the SEC must have adequate access to trading and other records of the unregistered adviser and to its personnel to the extent necessary to enable the SEC to monitor and police conduct that may harm U.S. clients or markets.[100]

   The Commission affirmed these staff positions in the context of the private adviser exemptions.[101]

3. *Joint Registration of Affiliates.*

   a. *Special Purpose Vehicles.* The SEC staff takes the position that a special purpose vehicle ("SPV") set up by a registered investment adviser to serve as the general partner of a pooled investment vehicle (*e.g.*, a hedge fund) does not have to separately register as an investment adviser if all of the activities of the SPV are subject to the registered adviser's supervision and control,[102] its employees are

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Ellis, SEC Staff No-Action Letter (Sept. 17, 1981); *Kenneth Levanthal*, SEC Staff No-Action Letter (Feb. 7, 1983). *See also Price Waterhouse*, SEC Staff No-Action Letter (Nov. 22, 1988).

97 Release 3222, *supra* note 68, at Section II.D.

98 *See Uniao de Bancos de Brasilerios, S.A.*, SEC Staff No-Action Letter (July 28, 1992); *Mercury Asset Management*, SEC Staff No-Action Letter (Apr. 16, 1993); *Kleinwort Benson Investment Management Ltd.*, SEC Staff No-Action Letter (Dec. 15, 1993); *Murray Johnston Holdings Ltd.*, SEC Staff No-Action Letter (Oct. 7, 1994). *See also* Section II. C. of Release 3222 and Section III. B. 3 of this outline regarding the exemption for foreign private advisers.

99 *See* Section V. A. 1 of this outline for the definition of "person associated with an investment adviser."

100 *See id.*

101 Release 3222, *supra* note 68, at Section II.D.

102 For guidance regarding application of the staff's position with respect to directors of an SPV that are independent of the investment adviser, *see American Bar Association Subcommittee on Hedge Funds*, SEC Staff Letter (Jan. 18, 2012) ("ABA Letter 2012"), Question 3, *available at* http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

treated as "supervised persons" of the registered adviser and reported as such on its Form ADV, and the SPV is subject to examination by the SEC.[103] The SEC staff takes the view that this analysis is not limited to a registered adviser with a single SPV.[104]

b. *Multiple Entities in Control Relationships.* The SEC staff has taken the position that an investment adviser may file (or amend) a single Form ADV on behalf of itself and each other adviser that is under common control with the filing adviser where the filing adviser and each relying adviser collectively conduct a "single advisory business."[105]

V. How Does an Investment Adviser Register Under the Advisers Act?

A. Procedure

Applicants for registration under the Act must file Form ADV with the SEC. Within 45 days the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied.

1. *Denial of Registration*. The SEC may deny registration if the adviser is subject to a "Statutory Disqualification," that is, if the adviser or any "person associated with the adviser" makes false or misleading statements in its registration application, has within the past 10 years been convicted of a felony, or if it has been convicted by a court or found by the SEC to have violated a securities-related statute or rule, or have been the subject of a securities-related injunction, or similar legal action.[106]

Person Associated with An Investment Adviser. These include employees (other than clerical employees) of the advisers as well as any persons who directly or indirectly control the investment adviser or are controlled by the adviser.[107] The SEC can deny registration if, for example, the parent company of an adviser has been convicted of securities fraud even if the adviser and its employees have not.

Non-U.S. Based Offenses. Statutory Disqualifications include convictions in

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103 *American Bar Association Subcommittee on Private Entities*, SEC Staff Letter (Dec. 8, 2005) ("ABA Letter 2005"), Question G1, *available at* http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

104 ABA Letter 2012, Question 2. Similarly, under certain circumstances, the staff has indicated that an exempt reporting adviser to which a private fund's day-to-day management responsibility has been delegated may satisfy the Form ADV reporting obligations of one or more special purpose entities. *See* "FAQs" regarding Reporting to the SEC as an Exempt Reporting Adviser ("ERA FAQs") *available at* http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#exemptreportingadviser.

105 *See id.* Question 4 (outlining the circumstances under which a filing adviser and one or more relying advisers would, in the staff's view, collectively conduct a single advisory business absent other factors suggesting that they conduct different businesses). Likewise, under certain circumstances, the staff has indicated that an exempt reporting adviser may satisfy the Form ADV reporting obligations of one or more special purpose entities under its control. *See* ERA FAQs.

106 Sections 203(c)(2) and (e).

107 Section 202(a)(17).

non-U.S. courts, and by findings of violations by "foreign financial regulatory authorities" enforcing non-U.S. laws.[108]

2. *Qualifications.* There are no "fit and proper" or educational requirements for registration as an investment adviser, although certain employees of the adviser may have to pass securities examinations in the states in which they have a principal place of business. Instead, advisers must disclose to clients the background and qualifications of certain of their personnel.[109]

B. Form ADV

Form ADV sets forth the information that the SEC requires advisers to provide in an application for registration. Once registered, an adviser must update the form at least once a year, and more frequently if required by instructions to the form.[110] Form ADV consists of two parts.[111]

1. *Part 1.* Part 1 is primarily for SEC use. It requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC uses information from this part of the form to make its registration determination and to manage its regulatory and examination programs. Part 1 is organized in a check-the-box, fill-in-the-blank format.

   On June 22, 2011, the SEC amended Part 1A to expand the information collected, primarily from advisers to hedge funds and other private funds in order to improve the SEC's ability to oversee registered advisers. Amended Part 1A requires advisers to provide additional information about three areas of their operations: (i) additional information about private funds they advise; (ii) expanded data provided by advisers about their advisory business (including the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest; (iii) additional information about advisers' non-advisory activities and their financial industry affiliations.[112]

2. *Part 2.* Amended in 2010, Part 2 is divided into Part 2A and Part 2B and sets forth information required in client brochures and brochure supplements.[113]

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108 Sections 203(c)(2) and (e). Non-U.S. based offenses were added to section 203(e) in 1990 by the International Securities Enforcement Cooperation Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713 (Nov. 15, 1990).

109 Form ADV, Part 2B.

110 Rule 204-1(a).

111 Both Part 1 and Part 2A of the Form ADV are filed by registered advisers through the IARD system and are available to the public on the Investment Adviser Public Disclosure Website at http://www.adviserinfo.sec.gov/(S(hdqosw4svnoutoxsmgo4mizx))/IAPD/Content/IapdMain/iapd_SiteMap.aspx.

112 Release 3221, *supra* note 46.

113 On July 28, 2010, the SEC adopted amendments to Part 2 of Form ADV. Investment Advisers Act Release No. 3060 (July, 2010), *available at* http://www.sec.gov/rules/final/2010/ia-3060.pdf ("Part 2

Brochure Part 2A requires an adviser to prepare a narrative "brochure" that includes plain English disclosures of, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[114] Part 2B requires an adviser to prepare a "brochure supplement" that contains information about each advisory employee that provides investment advice to its clients, including her educational background, business experience, other business activities, and disciplinary history. To satisfy the "brochure rule" (discussed below),[115] the adviser must deliver the brochure (and updates to that brochure) to its clients annually and the brochure supplement about a supervisory employee to a client at the time the employee begins to provide advisory services to that client.[116] In addition, the adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.[117]

C. Electronic Filing

All applications for registration as an adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository ("IARD").[118] The IARD is operated by the Financial Industry Regulatory Authority ("FINRA"), the broker-dealer self-regulator (formerly, NASD).[119]

D. Public Availability

All current information from advisers' Form ADVs filed with the SEC is publicly available through an SEC web-site: www.adviserinfo.sec.gov.

E. Withdrawal of Registration

Advisers withdraw from registration by filing Form ADV-W.[120] An adviser may withdraw from registration because it: (i) ceases to be an investment adviser; (ii) is entitled to an exception from the registration requirements; or (iii) no longer is eligible for SEC registration (*e.g.*, it no longer has the requisite amount of assets

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Adopting Release"). For staff responses to frequently asked questions about the amended Part 2, visit the SEC's website at http://www.sec.gov/divisions/investment/form-adv-part-2-faq.htm ("Part 2 FAQs").

114 Prior to the 2010 amendments, Part II of Form ADV was in a check-the-box, fill-in-the-blank format.

115 Rule 204-3.

116 Rule 204-3(b)(3). For specific delivery requirements under the brochure rule, see Section VI. B. 12 below.

117 Rule 203-1(a); Rule 204-1(b)(1).

118 Rule 203-1(b). FINRA charges advisers filing fees to defray the cost of maintaining and operating the IARD. To pay the fees, advisers must establish and fund an account with FINRA before making a filing. A fee schedule is available at www.sec.gov/divisions/investment/iard/iardfee.shtml.

119 Rule 204-1(b). For information about electronic filing by advisers, *see* www.sec.gov/iard. FINRA does not act as a self-regulatory organization with respect to investment advisers.

120 Rule 203-2. Form ADV-W filings are made electronically through the IARD, and are effective immediately. There are no filing fees for Form ADV-W.

under management).[121] The SEC also has the authority under section 203(f) of the Advisers Act to revoke the registration of an adviser under certain enumerated circumstances.

F. Successor Registrations

An unregistered person that assumes and continues the business of a registered investment adviser (which then ceases to do business) may rely on the registration of the investment adviser by filing an application for registration within 30 days of the succession.[122]

VI. What Are the Requirements Applicable to a Registered Investment Adviser?

The Advisers Act does not provide a comprehensive regulatory regime for advisers, but rather imposes on them a broad fiduciary duty to act in the best interest of their clients. As the Commission explained:

> Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts.[123]

There are five types of requirements on an adviser: (i) fiduciary duties to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection.

A. Fiduciary Duties to Clients

Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss.[124] The landmark

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121 Before withdrawing from registration, an adviser must arrange for the preservation of records it is required to keep under the Act. Rule 204-2(f).

122 Section 203(g). *See* Instruction 4 to Part 1A of Form ADV; *Registration of Successors to Broker-Dealers and Investment Advisers*, Investment Advisers Act Release No. 1357 (Dec. 28, 1992) (the provision in rule 203-1 referred to in Release 1357 that addressed successions was moved by the SEC to Instruction 4 to Form ADV in 2000). A succession resulting from a change in the place or form of organization, or composition of a partnership, *i.e.*, a succession that does not involve a change of control, may be completed by amending the predecessor's Form ADV promptly after the succession. *Id.*

123 *See Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (Mar. 3, 2008).

124 *SEC v. Capital Gains Research Bureau, supra* note 2, at 191-192.

court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:

> Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[125]

These concepts are embodied in the anti-fraud provisions of the Advisers Act. As the Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, its seminal decision on the fiduciary duties of an adviser under the Act:

> [t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.[126]

The duty is not specifically set forth in the Act, established by SEC rules, or a result of a contract between the adviser and the client (and thus it cannot be negotiated away). Rather, fiduciary duties are imposed on an adviser by operation of law because of the nature of the relationship between the two parties.[127] It is made enforceable by section 206 of the Act,[128] which contains the Act's anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements discussed below.[129]

Several obligations flow from an adviser's fiduciary duties.

1. *Full Disclosure of Material Facts*. Under the Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser to its clients, as well as a duty to avoid misleading them.[130] Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to its clients whenever failure to do so would defraud or operate as a fraud or deceit upon any client.

   Conflicts of Interest. This disclosure of material facts is particularly pertinent whenever the adviser is faced with a conflict—or a potential

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125 164 N.E. 545, 546 (N.Y. 1928).

126 *SEC v. Capital Gains Research Bureau, supra* note 2, at 190-192.

127 *See In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb 18, 1948).

128 *Transamerica Mortgage Advisors v. Lewis,* 444 U.S. 11 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

129 *See Morris v. Wachovia Securities, Inc.,* 277 F. Supp. 2d 622 (E.D. Va. 2003) ("§206(2) is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers."). The scope of the fiduciary duties is determined by reference to federal court and administrative decisions rather than state common law analogies. *Laird v. Integrated Resources, Inc.,* 897 F.2d 826 (5th Cir. 1990) ("[B]ecause state law is not considered, uniformity is promoted.").

130 *See In the Matter of Arleen W. Hughes, supra* note 127.

conflict— of interest with a client. As a general matter, the SEC has stated that the 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, or take some action to protect himself or herself against the conflict.[131]

Disciplinary Events and Precarious Financial Condition. The SEC requires a registered adviser to disclose to clients and prospective clients material facts about:

a. a financial condition of the adviser that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients;[132] and

b. certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material.[133]

2. *Suitable Advice.* Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.[134]

3. *Reasonable Basis for Recommendations*. An adviser must have a

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131 Part 2 Adopting Release, *supra* note 113. *See also SEC v. Capital Gains Research Bureau*, *supra* note 2, at 191-192 ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.").

132 Item 18 of Part 1A, Form ADV. This requirement is applicable to advisers that have discretionary authority with client accounts, or have custody of client assets, or require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance.

133 Form ADV: Item 11 of Part 1A; Item 9 of Part 2A, and Item 3 of Part 2B.

134 *See Suitability of Investment Advice Provided by Investment Advisers,* Investment Advisers Act Release No. 1406 (Mar. 16, 1994). In that release, the SEC proposed a rule under the Act's anti-fraud provisions requiring advisers give clients only suitable advice. Although the rule was never adopted, SEC staff believes that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act. Suitability obligations do not apply to impersonal investment advice, and compliance with the obligation is evaluated in the context of a client's overall portfolio. *Id*. "Thus, inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable." *Id*. The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. *See In the Matter of George E. Brooks & Associates, Inc*., Investment Advisers Act Release No. 1746 (Aug. 17, 1998) (adviser failed to appropriately diversify, and effected unsuitable trades of speculative high risk stocks in, the discretionary accounts of customers with conservative investment objectives, many of whom were elderly and had little investment experience); *In the Matter of Philip A. Lehman,* Investment Advisers Act Release No. 1831 (Sept. 22, 1999) (alleging adviser recommended risky investment for customer's individual retirement account, despite customer's conservative investment objective and age).

reasonable, independent basis for its recommendations.[135]

4. *Best Execution.* Where an adviser has responsibility to direct client brokerage, it has an obligation to *seek* best execution of clients' securities transactions.[136] In meeting this obligation, an adviser must seek to obtain the execution of transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.[137] In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided.[138]

   Interpositioning. An adviser will generally not obtain best execution if it interposes a broker that does not make a market in the security when it could have avoided the unnecessary commission payments by dealing directly with market makers.[139]

   Directed Trades. An adviser is relieved of this obligation when a client directs the adviser to use a particular broker. An adviser may, however, be required to make additional disclosure to clients when it receives some benefit from the direction of the trade.[140]

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135 *In the Matter of Alfred C. Rizzo*, Investment Advisers Act Release No. 897 (Jan 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer); *In the Matter of Baskin Planning Consultants, Ltd*., Investment Advisers Act Release 1297 (Dec. 19, 1991) (adviser failed adequately to investigate recommendations to clients).

136 *In the Matter of Kidder Peabody & Co., Inc*., Investment Advisers Act Release No. 232 (Oct. 16, 1968). *See also* rule 206(3)-2(c) (acknowledging adviser's duty of best execution of client transactions).

137 This obligation is different from a broker-dealer's best execution obligation, which typically focuses on the price at which an order is executed and does not consider the broker's compensation, whereas an adviser's duty requires it to consider the total transaction cost to its client. The SEC has brought enforcement actions against advisers alleging failure to seek best execution. *See, e.g., In the Matter of Renberg Capital Management, Inc.*, Investment Advisers Act Release No. 2064 (Oct 1, 2002); *In the Matter of Portfolio Advisory Services, LLC*, Investment Advisers Act Release. No. 2038 (June 30, 2002).

138 *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"). To fulfill this duty, an investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients. *Id.* The scope of the duty evolves as changes occur in the market that give rise to improved execution, including opportunities to trade at more reasonable prices. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 135 F.3d 266, 270-271 (3d Cir. 1998). *See also, In the Matter of Jamison, Eaton & Wood, Inc.,* Investment Advisers Act Release No. 2129 (May 15, 2003); *In the Matter of Portfolio Advisory Services, LLC, supra* note 137.

139 *In the Matter of Delaware Management Company, Inc*., Securities Exchange Act Release No. 8128 (July 19, 1967).

140 *See In the Matter of Mark Bailey & Co*., Investment Advisers Act Release No. 1105 (Feb. 24, 1988) (adviser failed to disclose that it did not negotiate commissions on directed trades, and failed to disclose that the adviser would be in a better position to negotiate commissions in bunched transactions for non-directed trades, and violated anti-fraud provisions of Advisers Act); *Jamison, Eaton & Wood, Inc*., *supra* note 138.

Use of Brokerage Affiliate. The Act does not prohibit advisers from using an affiliated broker to execute client trades. However, use of an affiliate involves a conflict of interest that must be disclosed to client.[141] For example, use of an affiliated broker may give the adviser incentive to "churn" the account.

Soft Dollars. Section 28(e) of the Exchange Act provides a safe harbor from liability for breach of fiduciary duties when advisers purchase brokerage and research products and services with client commission dollars under specified circumstances. In July 2006, the SEC issued a revised interpretation as to the scope of the safe harbor.[142]

Under section 28(e), an adviser that exercises investment discretion may lawfully pay commissions to a broker at rates higher than those offered by other brokers, as long as the services provided to the adviser by the broker-dealer: (i) are limited to "research" or "brokerage;" (ii) constitute lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities, and (iii) the adviser determines in good faith that the commission payments are reasonable in light of the value of the brokerage and research services received.

a. *Research Services.* "Research" services generally include the furnishing of advice, analyses, or reports concerning securities, portfolio strategy and the performance of accounts, which means the research must reflect the expression of reasoning or knowledge relating to the statutory subject matter bearing on the investment decision-making of the adviser. The SEC does not believe that products or services with "inherently tangible or physical attributes" meet this test.

    (i) Products or services generally falling within the safe harbor include traditional research reports, market data, discussions with research analysts, meetings with corporate executives, software that provides analysis of securities, and publications (other than mass-marketed publications).

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141 *Folger Nolan Fleming Douglas Capital Management, Inc.*, Investment Advisers Act Release No. 2639 (Aug. 23, 2007) (adviser entered into agreements with clients to direct trades to affiliated broker without disclosing commission rates were twice as high as non-directed trades). *See also* Investment Advisers Act Release 1092, *supra* note 3 (if an investment adviser recommends that a client effect transactions through its broker-dealer employer, the anti-fraud provisions of the Advisers Act require that the adviser make full disclosure of the nature and extent of all adverse interests, including the amount of any compensation the advisers will receive from its broker-dealer employer in connection such transactions); *Don P. Matheson*, SEC Staff No-Action Letter (Aug. 2, 1976) (investment advisers that are also broker-dealers or registered representatives have a duty to inform their investment advisory clients of their ability to seek executions of transactions recommended through other broker-dealers firms); *David P. Atkinson*, SEC Staff No-Action Letter (Aug. 1, 1977).

142 *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 34-54165 (July 18, 2006) ("2006 Soft Dollar Release"), *available at* http://www.sec.gov/rules/interp/2006/34-54165.pdf. The 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, which discusses an investment adviser's disclosure obligations.

(ii) Products or services not within the safe harbor include computer hardware, telephone lines, peripherals; salaries, rent, travel, entertainment, and meals; software used for accounting, recordkeeping, client reporting, or other administrative functions; and marketing seminars and other marketing costs.

(iii) Where a product or service has uses both inside and outside the safe harbor, the SEC believes that an adviser should make a reasonable allocation of the cost of the product or service according to its use and keep adequate books and records concerning allocations so as to be able to make the required good faith showing.[143]

b. *Brokerage Services.* "Brokerage" generally includes activities related to effecting securities transactions and incidental functions. According to the SEC, brokerage begins when the order is transmitted to the broker-dealer and ends when funds or securities are delivered to the client account.[144]

c. *Commissions*. The SEC interprets the safe harbor of section 28(e) as being available for research obtained in relation to commissions on agency transactions, and certain riskless principal transactions.[145]

d. *Disclosure Obligations.* Advisers are required to disclose to clients any soft dollar arrangements, regardless of whether the arrangements fall within the section 28(e) safe harbor.[146] Failure to disclose the receipt of products or services purchased with client commission dollars may constitute a breach of fiduciary duties and/or violation of specific provisions of the Advisers Act and other federal laws.[147]

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143 *See id.*, at Section F, n. 148.

144 *Id.*

145 Exchange Act Release No. 45194 (Dec. 27, 2001) ("Release No. 45194"), *available at* http://www.sec.gov/rules/interp/interparchive/interparch2001.shtml. In Release No. 45194, the SEC concluded with respect to riskless principal transactions that "[t]he term 'commission' in Section 28(e) . . . include[s] a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction prices subject to self-regulatory oversight." The SEC staff had previously interpreted the safe harbor as being available only to agency transactions. *Letter to Charles Lerner, Esq., Director of Enforcement, Pension and Welfare Benefit Administration, U.S. Department of Labor, from Richard Ketchum, Director, Division of Market Regulation, SEC* (July 25, 1990).

146 Form ADV, the registration form for advisers, requires that advisers disclose soft dollar arrangements. *See* Form ADV, Part 1A, Item 8; Part 2A, Item 12A.1. *See also SEC Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998), *available at* http://www.sec.gov/news/studies/softdolr.htm.

147 *See, e.g., In the Matter of S Squared Technology Corporation*, Investment Advisers Act Release No. 1575 (Aug. 7, 1996) (adviser's failure to disclose its receipt of benefits in exchange for benefits received in exchange for direction of client brokerage violated section 206 of the Act); *In the Matter of Schultze Asset Management*, Investment Advisers Act Release No. 2633 (Aug. 15, 2007) (adviser

5. *Proxy Voting*. The SEC has stated that an adviser delegated authority to vote client proxies has a fiduciary duty to clients to vote the proxies in the best interest of its clients and cannot subrogate the client's interests to its own.[148]

B. Substantive Requirements

The Act contains other, more specific prohibitions designed to prevent fraud. In addition, the SEC has adopted several anti-fraud rules, which apply to advisers registered with the SEC.

1. *Client Transactions*

a. *Principal Transactions.* Section 206(3) of the Act prohibits an adviser, acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate[149]) is acting and obtaining the client's consent before the completion of the transaction.[150] The SEC staff has stated that notification and consent must be obtained separately for each transaction, *i.e.,* a blanket consent for transactions is not sufficient.[151]

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misrepresented to clients that it would restrict its use of soft dollars to cover only those expenses covered by section 28(e) when it used them to pay for operating expenses).

148 *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003), *available at* http://www.sec.gov/rules/final/ia-2106.htm. In this release, the SEC adopted rule 206(4)-6, which requires, among other things, each registered investment adviser that has voting authority over client securities to adopt and implement policies and procedures reasonably designed to ensure that client securities are voted in the best interest of clients. The SEC has instituted enforcement action against an adviser that failed to disclose to clients its conflicts before voting their shares in a hotly contested proxy fight. *In the Matter of Deutsche Asset Management, Inc.*, Investment Advisers Act Release No. 2160 (Aug. 19, 2003). *See also* Section VI. B. 6 of this outline.

149 The SEC 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. *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1732 (July 17, 1998)("Release 1732"), at n.3, *available at* http://www.sec.gov/rules/interp/interparchive/interparch1998.shtml. The SEC has instituted enforcement actions when advisers have effected principal transactions through affiliates without complying with section 206(3), s*ee, e.g., In the Matter of Calamos Asset Management,* Investment Advisers Act Release No. 1589 (Sept. 30, 1996), including "riskless principal" transactions; *In the Matter of Rothschild Investment Corporation*, Investment Advisers Act Release No. 1714 (Apr. 13, 1998); *In the Matter of Concord Investment Co*., Investment Advisers Act Release No. 1585 (Sept. 27, 1996).

150 Section 206(3). The SEC interprets "completion of the transaction" to mean by settlement of the transaction. Release 1732, *supra* note 149, *available at* http://www.sec.gov/rules/interp/ia-1732.htm. But the SEC believes that, 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. *Id.* While the notice must be in writing, the SEC staff has stated that oral consent is sufficient under the Act. *Dillon, Reed & Co*., SEC Staff No-Action Letter (Aug. 6, 1975). The notice and consent provisions of section 206(3) do not apply if the adviser is giving only impersonal advisory services. Rule 206(3)-1.

151 *Opinion of Director of Trading and Exchange Division*, Investment Advisers Act Release No. 40 (Jan. 5, 1945). The SEC has instituted enforcement actions against investment advisers for violating section

Pooled Investment Vehicles. The SEC staff has stated that section 206(3) may apply to client transactions with a pooled investment vehicle in which the adviser or its personnel may have interests depending on the facts and circumstances, including the extent of the interests held by the adviser and its affiliates.[152] The SEC staff, however, believes that section 206(3) does not apply to 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.[153]

Statutory Exception. The restrictions on principal transactions do not apply to transactions by a client where the adviser (or an affiliate) is also a broker-dealer, but "is not acting as an investment adviser with respect to the trade," *e.g.*, it has not given the advice to buy or sell the security.[154]

Updated →

Rule 206(3)-3T. The SEC has adopted a temporary rule, set to expire on December 31, 2014, that permits advisers that are also registered with the SEC as broker-dealers to comply with section 206(3) by providing oral (instead of written) notice of principal transactions so long as certain conditions are met.[155] Specifically, rule 206(3)-3T permits an adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Act by, among other things:

(i) providing written prospective disclosure regarding the conflicts arising from principal trades;

(ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;

(iii) making certain disclosures either orally or in writing and

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206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. *See In the Matter of Stephens, Inc.,* Investment Advisers Act Release No. 1666 (Sept. 16, 1997); *In the Matter of Clariden Asset Management (New York) Inc.*, Investment Advisers Act Release No. 1504 (July 10, 1995).

152 ABA Letter 2005, *supra* note 103 at II.A.1. The SEC has instituted enforcement actions based on claims of violations of section 206(3) against 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 In the Matter of SEC v. Beacon Hill Asset Management, LLC, et al.*, Litigation Release No. 18950 (Oct. 28, 2004); *In the Matter of Gintel Asset Management, et al.*, Investment Advisers Act Release No. 2079 (Nov. 8, 2002).

153 *Gardner Russo & Gardner*, SEC Staff No-Action Letter (June 7, 2006).

154 Section 206(3) provides that the section's "prohibitions…shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

155 Rule 206(3)-3T. *Temporary Rule Regarding Principal Trades with Certain Advisory Clients,* Investment Advisers Act Release No. 2653 (Sep. 24, 2007) (adopting rule 206(3)-3T), *available at* http://www.sec.gov/rules/final/2007/ia-2653.pdf; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release 3522 (Dec. 20, 2012) (extending expiration date to Dec. 31, 2014), *available at* http://www.sec.gov/rules/final/2012/ia-3522.pdf.

obtaining the client's consent before each principal transaction;

(iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and

(v) delivering to the client an annual report itemizing the principal transactions.

With certain limited exceptions (for non-convertible investment-grade debt securities underwritten by the adviser or a person who controls, is controlled by, or is under common control with the adviser (a "control person")), the rule generally is not available for principal trades of securities issued or underwritten by the investment adviser or a control person of the adviser.[156]

Fiduciary Obligations. Compliance with the disclosure and consent provisions of section 206(3) or rule 206(3)-3T alone does not satisfy an adviser's fiduciary obligations with respect to a principal trade. The SEC has expressed the view that section 206(3) must be read together with sections 206(1) and (2) of the Act 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.[157]

b. *Agency Cross Transactions*. Section 206(3) also prohibits an adviser from knowingly acting as broker for both its advisory client and the party on the other side of the transaction without obtaining its client's consent before each transaction.[158]

Rule 206(3)-2. The SEC has adopted a rule permitting these "agency cross-transactions" without transaction-by-transaction disclosure if, among other things:

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

(ii) the adviser provides a written confirmation to the client before the completion of each transaction providing, among other

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156 The rule also requires that each account for which the adviser relies on the rule be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which it is a member.

157 Release 1732, *supra* note 149. *See also Rocky Mountain Financial Planning, Inc*., SEC Staff No-Action Letter (Feb. 24, 1983) ("While section 206(3) of the Investment Advisers Act of 1940 requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest.").

158 Section 206(3). The SEC staff has expressed the view that the provisions of section 206(3) do not apply when the adviser/broker effects the trade without charging a commission or other fee. Release No. 1732, *supra* note 149.

things, the source and amount of any remuneration it received; and

(iii) the disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.[159]

c. *Cross-Trades.* Effecting cross-trades between clients (where a third-party broker is used) is not specifically addressed by the Act, but is subject to the anti-fraud provisions of the Act.[160] Cross-trades involve potential conflicts of interest (because the adviser could favor one client over another), and thus many advisers follow the methodology required by a rule under the Investment Company Act when one of the clients is an investment company.[161]

d. *Aggregation of Client Orders*. The SEC staff has stated that in directing orders for the purchase or sale of securities, an adviser 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 systematically advantaged or disadvantaged by the bunching.[162]

Advisers that aggregate orders of securities face conflicts when they disaggregate the orders to client accounts since, for example, not all securities may have been acquired at the same price. Advisers should have procedures in place that are designed to ensure that the trades are allocated in such a manner that all clients are treated fairly and equitably.[163] For example, advisers can allocate orders based on a *pro rata*, rotational, or random basis.

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159 Rule 206(3)-2. The rule does not apply to a transaction when the adviser has discretionary authority to act for the purchaser and seller. Paragraph (c) of the rule admonishes advisers that the rule does not relieve them of the duty to act in the best interests of their clients, including the duty to obtain best price and execution for any transaction. *See Agency Cross Transactions for Advisory Clients,* Investment Advisers Act Release No. 589 (May 31, 1977) (adopting rule 206(3)-2).

160 *See* In *the Matter of Renberg Capital Management, Inc. and Daniel H. Renberg*, Investment Advisers Act Release No. 2064 (Oct. 1, 2002).

161 Rule 17a-7. Merely following the procedures set forth in rule 17a-7 may not satisfy an adviser's fiduciary obligations to clients. The staff has explained that it must be in the interest of both clients to enter into a cross trade and thus, for example, an adviser should not cause a client to enter into a cross-trade if it could obtain a better price in the markets. *Federated Municipal Funds*, SEC No-Action Letter (Nov. 20, 2006).

162 *Pretzel & Stouffer*, SEC Staff No-Action Letter (Dec. 1, 1995).

163 The SEC has instituted numerous enforcement actions against advisers that unfairly allocated client trades without making adequate disclosure. *See In the Matter of John McStay Investment Counsel, L.P*, Investment Advisers Act Release No. 2153 (July 31, 2003) (adviser failed to disclose change in its method of allocating initial public offerings among accounts to a method that favored mutual fund account); *In the Matter of McKenzie Walker Investment Management, Inc., et al*., Investment Advisers Act Release No. 1571 (1996) (adviser allocated profitable trades to accounts charged a performance-based fee); *In the Matter of Nicholas-Applegate Capital Management*, Investment Advisers Act Release No. 1741 (Aug. 12, 1998) (adviser failed to supervise trader who allocated profitable trades to own personal account); *In the Matter of Ark Asset Management Co., Inc*., Investment Advisers Act Release No. 2962 (Dec. 14, 2009) (adviser allocated profitable trades to the proprietary hedge fund accounts at the expense of the client accounts without disclosing this practice).

2. *Advertising*. The anti-fraud provisions of the Act apply with respect to both clients and *prospective* clients. The SEC has adopted rule 206(4)-1, which prohibits any adviser registered with the SEC from using any advertisement that contains any untrue statement of material fact or is otherwise misleading.[164]

Specific Restrictions. An advertisement may not:

a. use or refer to testimonials, which staff views as including any statement of a client's experience with, or endorsement of, an adviser;[165]

b. refer to past specific recommendations made by the adviser, unless the advertisement sets out a list of all recommendations made by the adviser during the preceding year;

c. represents that any graph, chart, or formula can, in and of itself, be used to determine which securities to buy or sell; and

d. refer to any report, analysis, or service as free, unless it really is.

Performance Advertising. Advertisements containing information about the performance of client accounts must not be misleading. The SEC 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.[166] Advisers registered with the SEC must maintain records substantiating any performance claimed in an advertisement.[167]

Definition of Advertisement. While no communications to clients may be misleading, the specific restrictions discussed above apply only to "advertisements" by advisers, which the SEC defines generally as communications (in writing or electronic form) to more than one person that offer advisory services.[168] The SEC staff does not believe that a written

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164 Rule 206(4)-1. *See also SEC v. C.R. Richmond & Co*., 565 F.2d 1101, 1104 (9th Cir. 1977) (an adviser's advertising "must be measured from the viewpoint of a person unskilled and unsophisticated in investment matters"); *In the Matter of Jesse Rosenblum*, Investment Advisers Act Release No. 913 (May 17, 1984) (an investment adviser's advertisement that contained materially misleading statements was "not cured by the disclaimers buried in the [smaller print] text [of the advertisement]").

165 For further discussion, *see DALBAR, Inc.,* SEC Staff No-Action Letter (Mar. 24, 1997).

166 *Edward F. O'Keefe*, SEC Staff No-Action Letter (Apr. 13, 1978); *Anametrics Investment Management*, SEC Staff No-Action Letter (May 5, 1977). *See also Clover Capital Management, Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986).

167 Rule 204-2(a)(16). *See In the Matter of Warwick Capital Management, Inc.*, Initial Decision Release No. 327 (Feb. 15, 2007). ("Respondent blamed a series of dubious calamities for their inability to produce records that would support the inflated numbers and created after-the-fact documents concerning the inflated numbers.").

168 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 (2) any graph, chart, formula or other device to be used in making any determination as to

communication by an adviser that does no more than respond to an unsolicited request by a client is an advertisement even if it received multiple requests for the same information, *e.g.*, in multiple RFPs.[169]

Use of Social Media. Use of social media to communicate with clients and prospective clients may implicate rule 206(4)-1.[170]

3. *Custody of Client Assets*. A registered adviser with custody of client funds or securities ("client assets") is required by rule 206(4)-2 to take a number of steps designed to safeguard those client assets.[171] These requirements were amended in December 2009.[172]

   a. *Definition of Custody.* Custody means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." An adviser has custody if an affiliate has custody of its client funds or securities in connection with advisory services it provides to clients.

      Custody includes:

      (i) Possession of client funds or securities;

      (ii) 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

      (iii) 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 or trustee of a pooled investment vehicle).[173]

   b. *Qualified Custodians.* An adviser with custody must maintain client funds and securities with "qualified custodians" either under the client's name or under the adviser's name as agent or trustee for its clients. Qualified custodians are:

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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. *Spear & Staff*, 42 S.E.C. 549 (1965).

169 *Investment Counsel Association of America*, SEC Staff Letter (Mar. 1, 2004).

170 The SEC staff has made observations regarding advisers' use of social media. *Investment Adviser Use of Social Media*, National Examination Risk Alert, Vol. II, Issue 1 (Jan. 4, 2012), *available at* http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

171 Rule 206(4)-2. The staff of the SEC's Division of Investment Management has published responses to "FAQs" (frequently asked questions) on the custody rule ("Custody Rule FAQs"), *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

172 *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) ("Release 2968"), *available at* http://www.sec.gov/rules/final/2009/ia-2968.pdf.

173 Rule 206(4)-2(d)(2).

(i) broker-dealers, banks, savings associations, futures commission merchants, and

(ii) non-U.S. financial institutions that customarily hold financial assets for their customers, if the institutions keep the advisory assets separate from their own.

c. *Quarterly Account Statements.* The adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements directly to the client.[174]

d. *Notification*. The adviser must notify the client as to where and how the funds or securities will be maintained, promptly after opening an account for the client and following any changes to this information.[175] If the adviser also sends its own account statements to clients, this notice and subsequent account statements from the adviser must contain a statement urging the client to compare account statements from the custodian with those from the adviser.[176]

e. *Surprise Examinations.* An adviser that has custody of client assets generally must undergo an annual surprise examination by an independent public accountant to verify the client's funds and securities.[177] One exception from this requirement is if it has custody *solely* because it has authority to deduct advisory fees directly from client accounts.[178]

Updated → f. *Pooled Investment Vehicles.* If the adviser is the general partner of a limited partnership (or holds a similar position with another form of pooled investment vehicle such as a hedge fund)[179]:

(i) the adviser is deemed to have complied with the annual surprise examination requirement and need not form a reasonable belief regarding delivery of account statements if the pool's financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the Public

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174 A common method of forming a reasonable belief acceptable to the SEC is receipt of a copy of an account statement sent to the client. Release No. 2968, *supra* note 172.

175 Notice need not be given if the client opens the account himself.

176 Rule 206(4)-2(a)(2).

177 The timing of exams must be irregular from year to year. Rule 206(4)-2(a)(4). *See also, In the Matter of Kaufman, Bernstein, et al.,* Investment Advisers Act Release No. 2194 (Nov. 20, 2003) (independent auditor began examination the same date each year). The accountant conducting the examination must file a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the examination. Rule 206(4)-2(a)(4)(i). The SEC has issued guidance for accountants performing an examination pursuant to this rule. *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 2969 (Dec. 30, 2009).

178 Rule 206(4)-2(b)(3).

179 The SEC staff takes the position that a state-created 529 plan may be treated as a pooled investment vehicle for these purposes. *See Investment Company Institute*, SEC Staff No-Action Letter (Sept. 5, 2012).

Company Accounting Oversight Board ("PCAOB"),[180] and the audited statements are distributed to the pool's investors;[181] or

(ii) the qualified custodian must send quarterly account statements to each investor in the pool and the adviser must obtain a surprise examination of the pool's assets.[182]

g. *Adviser or "Related Person" as Custodian.*[183] If the adviser or its related person maintains client assets as the qualified custodian in connection with the adviser's advisory services, the adviser must:

(i) have an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB perform the required annual surprise examination, unless the related person is "operationally independent" of the adviser;[184] and

(ii) obtain, or receive from the affiliate, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[185]

4. *Use of Solicitors*. An adviser generally is prohibited by rule 206(4)-3 from paying a cash fee, directly or indirectly, to a third party (a "solicitor") unless it meets the requirements of the rule:

a. *Registered*. The adviser must be registered under the Act.

b. *Not Disqualified*. An adviser may not pay solicitation fees to a solicitor that would itself be subject to Statutory Disqualification as an investment adviser.[186]

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180 The audited financial statements must be prepared according to, or reconciled to, U.S. GAAP.

181 The audited financial statements must be distributed to investors within 120 days after the close of the pool's fiscal year. In 2006, the Division of Investment Management issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)-2 against an adviser of a "fund of funds" relying on the annual audit provision of rule 206(4)-2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the end of its fiscal year. *See ABA Committee on Private Investment Entities*, SEC Staff Letter (Aug. 10, 2006); Release 2968, *supra* note 172, at n. 45. *See also* Custody Rule FAQs, *supra* note 171.

182 Rule 206(4)-2(a)(5) and (a)(4).

183 A "related person" includes any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control.

184 The surprise examination is not required of the adviser if it can demonstrate that the related person acting as qualified custodian is operationally independent. This determination is made by examining the relationship between the adviser and the related person, including whether there are common employees, shared premises, and common supervision. *See* rule 206(4)-2(d)(5).

185 Rule 206(4)-2(a)(6).

186 *See supra* notes 106-108 and accompanying text. Through a series of no-action letters, however, the SEC staff expressed the view that statutorily disqualified persons may act as solicitors if the disqualifying conduct is disclosed in a separate written document to be given to each solicited person (i) at least 48 hours before such solicited person enters into an advisory contract, or (ii) at the time the

c. *Written Agreement.* The solicitation fee must be paid pursuant to a written agreement that:

(i) describes the solicitation activities and the compensation to be paid;

(ii) contains an undertaking by the solicitor to perform his duties according to the agreement and in compliance with the Act; and

(iii) requires the solicitor to provide a prospective client a copy of:

(A) the adviser's disclosure statement (brochure), and

(B) a separate disclosure statement describing the terms of the solicitation arrangement, including that the solicitor is being compensated by the adviser.[187]

Solicitors. The rule defines a solicitor as anyone who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser. The Commission believes that a solicitor would be a "person associated with an adviser" under the Act. The adviser has an obligation to supervise the activities of solicitors.[188]

Client Referrals. Rule 206(4)-3 does not apply to the direction of brokerage in return for client referrals. But the adviser directing brokerage to brokers referring clients to it has a significant conflict of interest. Accordingly, an adviser may be obligated to disclose to clients material information regarding conflicts arising from the arrangement, including any affect on the adviser's ability to obtain best execution.[189]

Pooled Investment Vehicles. The SEC staff has stated that the rule does not apply to payments by an adviser to solicit investments in a pooled investment vehicle sponsored by the adviser.[190]

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solicited person enters into the advisory contract, *if* the solicited person has the right to terminate the advisory contract within five days. Accordingly, the staff no longer issues no-action letters of this type, except if the facts raise novel or unusual circumstances. *See Dougherty & Company LLC*, SEC Staff No-Action Letter (July 3, 2003).

187 If the solicitor is an employee of the adviser, however, the solicitor is not required to provide prospective clients a copy of the adviser's brochure or the separate disclosure statement.

188 For discussion of an adviser's obligation to supervise cash solicitors acting on its behalf, *see Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Investment Advisers Act Release No. 615 (Feb. 2, 1978) (proposing release); *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Investment Advisers Act Release No. 688 (July 12, 1979) (adopting release).

189 *In the Matter of Jamison, Eaton and Wood, Inc.*, *supra* note 138; *In the Matter of Portfolio Advisory Services LLC*, *supra* note 137; *In the Matter of Founders Asset Management*, Investment Advisers Act Release No. 1953 (July 20, 2001); *In the Matter of Fleet Investment Advisers, Inc. (successor to Shawmut Investment Advisers, Inc.)*, Investment Advisers Act Release No. 1821 (Sept. 9, 1999).

190 *Mayer Brown, LLP*, SEC Staff No-Action Letter (July 15, 2008). In its response, however, the staff noted that the solicitor may itself be an adviser subject to the antifraud provisions of the Act. The staff's response was amended on July 28, 2008 but indicates that the response letter should be deemed

5. *Pay to Play Rule*. On July 1, 2010, the Commission adopted rule 206(4)-5 to address so-called "pay to play" practices in which investment advisers make campaign contributions to elected officials of state or municipal governments in order to influence the award of contracts to manage public pension plan assets and other government investment accounts.[191] The rule applies to SEC-registered investment advisers, certain exempt reporting advisers, and foreign private advisers, who provide investment advisory services, or are seeking to provide investment advisory services, to state and municipal government entities.[192]

   a. *Prohibitions.* The rule contains three main prohibitions:

      (i) *Two-Year Time Out*. An investment adviser is prohibited from receiving compensation for providing advice to a government entity, either directly or through a "covered investment pool", within two years after a contribution by the adviser, or by any of its "covered associates" (which include the adviser's general partner or managing member, executive officers or other individuals with a similar status or function, solicitors, and political action committees they control) to an official of that government entity who can influence the award of advisory business.[193]

      (ii) *Third Party Solicitor Ban.* Neither an investment adviser nor any of its covered associates may provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for the adviser unless such person is a "regulated person."[194]

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to have been issued on July 15. *See also* rule 206(4)-5 and Section VI. B. 5 of this outline regarding solicitation of government clients.

191 *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 3043 (July 1, 2010)("Pay to Play Release"), *available at* http://www.sec.gov/rules/final/2010/ia-3043.pdf. For staff responses to frequently asked questions about the rule, visit the SEC's website at http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

192 Rule 206(4)-5(a).

193 Rule 206(4)-5(a)(1). An adviser subject to the rule is not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to such client during the time out. This enables an adviser to act consistently with its fiduciary obligations and provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser. *See also* Section VI. B. 4 regarding the cash solicitation rule that applies to all SEC-registered advisers.

194 Rule 206(4)-5(a)(2)(i). "Regulated persons" include (i) SEC-registered investment advisers that have not, and whose covered associates have not, within two years of soliciting a government entity, made a contribution to an official of that government entity; or bundled any contribution to an official or payment to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity; (ii) registered broker-dealers that are subject to a pay to play rule adopted by the Financial Industry Regulatory Authority that the Commission, by order, finds substantially equivalent or more stringent than rule 206(4)-5; and (iii) a "municipal adviser" registered with the Commission and subject to rules adopted by the Municipal Securities Rulemaking Board that the Commission, by order, finds substantially equivalent or more stringent than rule 206(4)-

(iii) *Bundling Ban.* Rule 206(4)-5 prohibits an adviser and its covered associates from "bundling" others' contributions -- *i.e.* coordinating or soliciting any person or political action committee to make (A) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services; or (B) any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.[195]

b. *Catch-All Provision.* Rule 206(4)-5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.

c. *Covered Investment Pools.* Rule 206(4)-5 includes a provision that applies each of the prohibitions of the rule to an adviser that manages assets of a government entity through a "covered investment pool" defined as (i) any investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity;[196] or (ii) any company that would be an investment company under section 3(a) of the Investment Company Act but for the exclusions from that definition provided by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act.[197]

d. *Recordkeeping.* Rule 204-2 was amended to require registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity is an investor, to make and keep certain records related to the pay to play rule.

6. *Proxy Voting.* A registered adviser that exercises voting authority over client securities is required to vote them in the best interest of the client and not in its own interest. Rule 206(4)-6 requires advisers with voting authority over client securities to:

a. adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes in the clients' best interests, and which must specifically address conflicts of interest that may arise between the adviser and its clients;

b. describe their 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

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5. This prohibition is limited to third-party solicitors. Thus, the prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive.

195 Rule 206(4)-5(a)(2)(ii).

196 A plan or a program of a government entity includes participant-directed plans, such as college savings plans like 529 plans and retirement plans like 403(b) and 457 plans.

197 Rule 206(4)-5(f)(3).

c. keep certain records relating to voting of client securities.[198]

7. *Supervision.* An adviser has a continuing responsibility to supervise all persons acting on its behalf.[199] The SEC may sanction an adviser that "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."[200]

   a. *Supervisor*. Whether a person has responsibility as a "supervisor" depends on whether, under the facts and circumstances of a particular case, the person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.[201]

   b. *Safe Harbor*. Under the Act, a person (*e.g.*, an adviser or an officer of the adviser) will not be deemed to have failed to supervise a person if (i) the adviser had established procedures and a system for applying such procedures that are reasonably expected to prevent and detect the conduct, and (ii) the person reasonably discharged his supervisory duties and had no reasonable cause to believe that the procedures were not being complied with.[202]

8. *Compliance Program.* Under rule 206(4)-7 each registered adviser must establish an internal compliance program that addresses the adviser's performance of its fiduciary and substantive obligations under the Act.

   a. *Chief Compliance Officer*. Each adviser must designate a chief

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198 See also Section VI. A. 5 of this outline.

199 The SEC has stated that the "delicate fiduciary relationship" between an investment adviser and a client imposes an obligation on an adviser to review and to monitor its activities and the activities of its employees. *Shearson Lehman Brothers, Inc. and Stein Roe & Farnham*, Exchange Act Release No. 23640 (Sept. 24, 1986). The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. *See In re Rhumbline Advisers*, Investment Advisers Act Release. No. 1765 (Sept. 29, 1998); *In re Scudder Kemper Investments, Inc.*, Investment Advisers Act Release. No. 1848 (Dec. 22, 1999) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees' unauthorized trading in client accounts); *In re Nicholas-Applegate Capital Management*, Investment Advisers Act Release. No. 1741 (Aug. 12, 1998) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from engaging in improper personal trading); *In re Van Kampen American Capital Asset Management, Inc.*, Investment Advisers Act Release. No. 1525 (Sep. 29, 1995) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from mispricing fund securities). Both registered and unregistered advisers have an obligation to supervise persons acting on their behalf. *In the Matter of Wilfred Mickel and Robert A. Littell*, Investment Advisers Act Release No. 2203 (Dec. 15, 2003). *See also In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc.*, Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (adviser has a duty to supervise a sub-adviser); *TBA Financial Corporation*, SEC Staff No-Action Letter (Nov. 7, 1983) (duty to supervise employees who are also "registered representatives").

200 Section 203(e)(6).

201 *See In re John H. Gutfreund*, 51 S.E.C. 93, 113 (1992).

202 Section 203(e)(6).

compliance officer ("CCO").[203] The CCO must be knowledgeable about the Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser. The CCO need not be an employee who does not have other duties.[204]

b. *Policies and Procedures.* Each adviser must also adopt and implement written policies and procedures reasonably designed to prevent the adviser or its personnel from violating the Act.[205] The SEC explained that each adviser, in designing its policies and procedures, should identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.[206] The SEC has stated that these policies and procedures should cover, at a minimum, the following areas to the extent applicable to the adviser:

(i) 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;

(ii) 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;

(iii) Proprietary trading of the adviser and personal trading activities of supervised persons;

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203 Rule 206(4)-7(c). The Commission has stated that having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities so that an adviser's chief compliance officer would not necessarily be subject to a sanction for failure to supervise other advisory personnel. Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Release 2204") at n. 73 *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2003.shtml.

204 Release 2204, *supra* note 203 at Section II. C. However, the SEC recently settled an enforcement action alleging that a dually-registered broker-dealer and investment adviser violated section 206(4) of the Advisers Act and rule 206(4)-7 thereunder by failing to adopt and implement compliance policies and procedures specific to its advisory business when its CCO spent about 95% of his time on compliance-related issues for the firm's brokerage business and only about 5% of his time on compliance-related issues for the advisory business. *In the Matter of Feltl & Company, Inc.*, Investment Advisers Act Release No. 3325 (Nov. 28, 2011).

205 Rule 206(4)-7(a). The SEC has brought enforcement actions against advisers for failing to adopt and implement adequate policies and procedures as required by rule 206(4)-7. *See, e.g., In the Matter of OMNI Investment Advisors Inc. and Gary R. Beynon*, Investment Advisers Act Release No. 3323 (Nov. 28, 2011); *In the Matter of The Buckingham Research Group, Inc., Buckingham Capital Management, Inc., and Lloyd R. Karp*, Investment Advisers Act Release No. 3109 (Nov. 17, 2010); *In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, Investment Advisers Act Release No. 2669 (Oct. 4, 2007).

206 The SEC has settled an enforcement action against an adviser that adopted a "pre-packaged" policies and procedures manual that failed to reflect the risk factors or conflicts of interest of the adviser; the SEC found that the adviser violated rule 206(4)-7 by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by that adviser's supervised persons. *In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 205.

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

(v) Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

(vi) 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;

(vii) Marketing advisory services, including the use of solicitors;

(viii) Processes to value client holdings and assess fees based on those valuations;

(ix) Safeguards for the privacy protection of client records and information; and

(x) Business continuity plans.[207]

c. *Annual Review.* The adviser must review the adequacy and effectiveness of its policies at least annually.[208]

9. *Code of Ethics.* All advisers registered with the SEC must adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients.[209] At a minimum, the adviser's code of ethics must:

a. *Standards of Conduct.* Set forth a minimum standard of conduct for all supervised persons;

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

c. *Personal Securities Transactions.* Require each of an adviser's access persons[210] to report his 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;[211]

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207 Release 2204, *supra* note 203.

208 Rule 206(4)-7(b).

209 Rule 204A-1. *See also, In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 205 (adviser failed to timely adopt and accurately document ethics code).

210 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 purchase or sale of securities.

211 Rule 204A-1(b) (1) (holdings reports), and (2) (transaction reports). Access persons do not have to report holdings of or transactions in: (i) direct obligations in of the U.S. government; (ii) certain bank instruments, commercial paper, and agreements; (iii) shares of money market funds; (iv) shares in open-end investment companies (mutual funds) that are not advised by either the adviser or an entity in a control relationship with the adviser); and (v) shares of a (US) unit investment trust that invests exclusively in an unaffiliated mutual fund. *See* rule 204A-1(j). *See also, M&G Investment*

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

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

f. *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 receipt of a copy of the code; and

g. *Recordkeeping.* Require the adviser 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.

10. *Fraud Against Investors in Pooled Investment Vehicles*. Rule 206(4)-8 prohibits advisers from defrauding investors and prospective investors in pooled investment vehicles they advise.[212] The anti-fraud provisions of the Act (section 206(1) and (2)) prohibit advisers from defrauding "clients." A 2006 court decision created doubt about whether an investor in a pooled investment vehicle (*e.g.*, a hedge fund) advised by an adviser is a "client," and thus whether the SEC could enforce these provisions against an adviser that defrauds the investors, but not the fund.[213]

a. *Prohibition on False or Misleading Statements*. Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective investors in those pools.

b. *Prohibition of Other Frauds.* In addition, the rule prohibits advisers to pooled investment vehicles from otherwise defrauding the investors or prospective investors in those pools. This provision is designed to apply more broadly to fraudulent conduct that may not involve statements.

Management Ltd., SEC Staff No-Action Letter (Mar. 1, 2007) (permitting access persons of U.K.-based registered adviser to exclude from reports certain analogous instruments).

212 Rule 206(4)-8. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles,* Investment Advisers Act Release No. 2628 (Aug. 3, 2007), *available at* http://www.sec.gov/rules/final/2007/ia-2628.pdf. *See also*, *SEC v. Rabinovich & Associates, LP, Alex Rabinovich and Joseph Lovaglio*, 07 Civ. 10547(GEL) (S.D.N.Y.) (Nov. 17, 2008); *SEC v. Moises Pacheco, et al*., Civil Action No. 09-CV-1355-W-RBB (Nov. 19, 2009) *(*discussed in *In the Matter of Moises Pacheco,* Investment Advisers Act Release No. 2960 (Dec. 11, 2009)); *SEC v. Thomas J. Petters, et al*, Civil Action No. 09 SC 1750 ADM/JSM (D. Minn.) (Oct. 5, 2010) (discussed in *SEC v. Thomas J. Petters, et al*, Litigation Release No. 21687 (Oct. 18, 2010)); *SEC v. Donald Anthony Walker Young, et al,* Civil Action No. 09-1634 (E.D. Penn.)(Apr. 12, 2011); *SEC. v. Imperium Investment Advisors, LLC, et al*, 8:10-CV-02859-JDW-MAP (M.D.F.L) (June30, 2011) (discussed in *In the Matter of Imperium Investment Advisors, LLC*, Administrative Proceeding File No. 3-14471 (July 20, 2011)).

213 *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

c. *No Fiduciary Duty.* Rule 206(4)-8 does not create a fiduciary duty to investors or potential investors in a pooled investment vehicle not otherwise imposed by law, nor does it alter any duty or obligation an adviser has under the Advisers Act, or any state law or requirement to investors in a pooled vehicle.[214] In adopting the rule, the SEC explained that rule 206(4)-8 would, however, permit the SEC to enforce an adviser's fiduciary duty created by other law if the adviser fails to fulfill that duty by negligently or deliberately failing to make the required disclosure.

d. *Pooled Investment Vehicles.* Pooled investment vehicles include hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities as well as investment companies that are registered with the SEC under the Investment Company Act.[215]

11. *Insider Trading.* Section 204A of the Act requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the adviser or any of its associated persons,[216] including the misuse of material, non-public information about the adviser's securities recommendations and client securities holdings and transactions.[217]

12. *Brochure Rule.*

a. *Firm Brochure.* Rule 204-3, as amended in 2010, requires a registered adviser to prepare and deliver to clients a plain English, narrative brochure that contains all information required by Part 2A of Form ADV, including, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[218] The adviser must deliver the brochure to a client before or at the time of entering into an advisory contract with the client, and must annually deliver to the client an updated brochure which contains or is accompanied by a summary of material changes, or a summary of

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214 An adviser to a hedge fund may have a separate relationship with an investor in a hedge fund that it advises that gives rise to fiduciary obligations. *U.S. v. Lay,* 566 F. Supp. 2d 652 (N.D. Ohio May 13, 2008).

215 Rule 206(4)-8(b) provides that a "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either Section 3(c)(1) or section 3(c)(7) of that Act.

216 The SEC has brought enforcement proceedings against advisers for violating section 204A. *See, e.g., In the Matter of Gabelli & Co. Inc*., Investment Advisers Act Release No. 1457 (Dec. 8, 1994).

217 *See also*, *Investment Adviser Code of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004), *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2004.shtml ("We … remind advisers that they must maintain and enforce policies and procedures to prevent the misuse of material, non-public information, which we believe includes misuse of material, non-public information about the adviser's securities recommendations, and client securities holdings and transaction.").

218 As stated in Section V.B.2, the adviser must also file with the SEC the brochure that it delivered to its client to satisfy its registration requirements under rules 203-1 and 204-1.

material changes with an offer to deliver the updated brochure upon request. [219]

(i) *Non-Required Information.* Delivery of a brochure meeting the requirements of Part 2A does not necessarily satisfy an adviser's full disclosure obligation under the anti-fraud rules.[220] Accordingly, many advisers include additional information in their brochures.

(ii) *Exceptions to Delivery.* Advisers are not required to deliver a brochure to investment company clients or to clients for whom they provide only impersonal services for less than $500.[221]

(iii) *Electronic Delivery.* Advisers may deliver brochures electronically with client consent.[222]

b. *Brochure Supplement.* Rule 204-3 also requires the adviser to deliver a brochure supplement that contains information about an advisory employee, including the employee's educational background, business experience, other business activities, and disciplinary history, to a client before or at the time the employee begins to provide advisory services to that client.[223]

(i) *Covered employees*. An employee must deliver a brochure supplement to clients, if the employee formulates investment advice for the client and has direct client contact; or makes discretionary investment decisions for the client even if the employee has no direct client contact.[224]

(ii) *Exceptions to delivery.* Advisers are not required to deliver a brochure supplement to a client: (i) to whom the adviser is not required to deliver a brochure; (ii) who receives only impersonal service; or (iii) who is an officer, employee or other persons related to the adviser that would be "qualified client" under rule 205-3(d)(1).[225]

(iii) *Electronic Delivery.* Advisers may deliver brochure supplements

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219 Rule 204-3(b)(1) and (2).

220 *See* Part 2 Adopting Release, *supra* note 113, at n. 7.

221 Rule 204-3(c).

222 *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) (publishing Commission interpretive guidance with respect to use of electronic media to fulfill investment advisers' disclosure delivery obligations).

223 Rule 204-3(b)(3).

224 *Id.* Note that if the investment advice is provided by a team comprised of more than 5 employees, only the 5 employees that have the most significant responsibility for the day-to-day advice to a client need to provide brochure supplements to that client. For more information, see Part 2 FAQs, *supra* note 113.

225 Rule 204-3(c)(2).

electronically with client consent.

13. *Systemic Risk Reporting on Form PF.* In October 2011, the SEC adopted rule 204(b)-1 requiring registered advisers with at least $150 million in private fund assets under management to submit regular reports on new Form PF. Advisers must file Form PF electronically on a confidential basis. Form PF is designed, among other things, to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system.[226]

    a. *Smaller private fund advisers.* Advisers that manage at least $150 million of private fund assets, but less than the amounts that make them "large private fund advisers," complete only section 1 of Form PF. They file annually within 120 days of the end of their fiscal year.

       Section 1 requires, for each private fund, limited information about the size, leverage, investor types, investor concentration, liquidity and fund performance. This section also requires information regarding strategy, counterparty exposures, and use of trading and clearing mechanisms for each private fund that is a hedge fund.

    b. *Larger Private Funds Advisers.* Three types of "Large Private Fund Advisers" that meet certain thresholds for assets under management based on investment strategy type are required to complete additional sections of Form PF.[227]

       (i) *Large Hedge Fund Advisers.* Advisers managing at least $1.5 billion in hedge fund assets must file quarterly within 60 days of their quarter end and, in addition to Section 1, must complete Section 2 of Form PF.

       Section 2a requires information about aggregate hedge fund assets the adviser manages, such as the value of investments in different types of assets, the duration of fixed income holdings, the value of turnover for certain asset classes and the geographical breakdown of investments. Section 2b requires, for each hedge fund that has net assets of at least $500 million, more granular information about the fund's exposures, leverage, risk profile and liquidity.

       (ii) *Large Private Equity Fund Advisers.* Advisers managing at least $2 billion in private equity fund assets must file annually within 120 days of the end of their fiscal year (same as smaller advisers) and, in addition to Section 1, must complete section 4 of Form PF.

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226 *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*. Investment Advisers Act Release No. 3308 (Oct. 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3308.pdf ("Form PF Adopting Release"). The staff of the Division of Investment Management has published responses to frequently asked questions on Form PF, *available at* http://www.sec.gov/divisions/investment/pfrd.pfrdfaq.shtml.

227 Form PF Adopting Release, *supra* note 226, at 21.

Section 4 requires information about the extent of leverage incurred by funds' portfolio companies, use of bridge financing, funds' investments in financial institutions, and geographical and industry breakdowns of funds' investments in portfolio companies.

(iii) *Large Liquidity Fund Advisers.* Advisers managing at least $1 billion in combined unregistered and registered money market fund assets must file quarterly within 15 days of their quarter end and, in addition to Section 1, must complete section 3 of Form PF

Item 3 requires information about each liquidity fund's portfolio, certain information relevant to the risk profile of the fund and the extent to which the fund has a policy of complying with all or aspects of rule 2a-7 under the Investment Company Act.

c. *Non-US. Advisers*. A registered adviser with a principal office and place of business outside the U.S. may omit reporting of any private fund that, during the preceding fiscal year: (i) was not organized in the U.S.; (ii) was not beneficially owned by one or more U.S. persons; and (iii) was not offered in the U.S.[228]

14. *Privacy Rules*. Title V of the Gramm-Leach-Bliley Act protects the privacy interests of consumers of financial services, including clients of SEC-registered investment advisers.[229] SEC rules implementing the statute protect only individuals' personal privacy interests, and not those of businesses or individuals who seek to obtain the services of an adviser for business purposes.[230]

a. *Notices*. An adviser must provide clients an *initial* and an *annual* notice of the adviser's privacy policies. The initial notice must be provided no later than when the client enters into an advisory contract.[231]

Content of Notice. Notices must be clear and conspicuous, *i.e.,* reasonably understandable and designed to call attention to the nature and significance of the notice. They must include, among other things: (i) categories of non-public personal information the adviser collects; (ii) categories of information the adviser shares; (iii) categories of

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228 General Instruction 1 (last paragraph) to Form PF.

229 Title V is not codified as part of the Advisers Act. It is codified at 15 U.S.C. 6801-6827.

230 *See* rule 248.3(g)(1). The SEC's implementing rules can be found at 17 CFR Part 248 ("Regulation S-P"). The rules apply to SEC-registered advisers. Rule 248.1(b). Advisers that are unregistered or are registered only with the states are subject to privacy regulations overseen by the Consumer Financial Products Board. Regulation S-P was adopted under the Securities Exchange Act, the Investment Company Act, and the Advisers Act; therefore the SEC has the remedies available under those statutes as applicable in enforcing the privacy rules. The SEC staff has posted responses to frequently asked questions about Regulation S-P at www.sec.gov/divisions/investment/guidance/regs2qa.htm.

231 Rules 248.4(a), 248.5(a).

affiliates and non-affiliates with which the adviser shares the information; and (iv) the adviser's policies and practices for protecting the confidentiality and security of information.

Model Form. The SEC has adopted a model form that advisers may choose to use to satisfy the initial and annual notice disclosure requirements. Use of the form provides advisers with a "safe harbor" for the content of the required notice under the privacy rules.[232]

b. *Opt-Out.* An adviser must provide clients with an opportunity to "opt out" or block the adviser from sharing "non-public" personal financial information with nonaffiliated third parties.[233]

Exceptions. An adviser does not have to provide an opt-out right in three circumstances:

(i) the information is provided to an affiliate;[234]

(ii) the adviser shares the information in the course of providing advisory services to the client (*e.g.,* with a broker, transfer agent, or lawyer) with the client's consent, or as required by law;[235] or

(iii) the adviser shares the information with a nonaffiliate that performs services, including marketing, for the adviser, but the adviser must have entered into a contract with the nonaffiliate that prohibits the nonaffiliate from using the information except for the purpose for which it received it.[236]

c. *Safeguarding and Properly Disposing of Client Information.*[237] An

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232 17 CFR 248.2, *adopted in, Final Model Privacy Form under the Gramm-Leach-Bliley Act*, Investment Advisers Act Release No. 2950 (Nov. 16, 2009), *available at* http://www.sec.gov/rules/final/2009/34-61003.pdf.

233 Rule 248.10.

234 Subpart B of Regulation S-P governs the use of certain information received by affiliates. This subpart, Regulation S-AM, allows a consumer, in certain limited situations, to block affiliates of advisers from soliciting the consumer, if the solicitation is derived from certain private information that the adviser has shared with an affiliate. Subpart B (Regulation S-AM) differs from Subpart A of Regulation S-P in that it does not restrict the *sharing* of certain information, only the actual *use* of the information to solicit. *See Regulation S-AM: Limitations on Affiliate Marketing*, Investment Advisers Act Release No. 2911 (August, 4, 2009) *available at* http://www.sec.gov/rules/final/2009/34-60423.pdf.

235 Rules 248.14, 248.15.

236 Rule 248.13.

237 The SEC has proposed additional amendments to its privacy rules. In 2012, the SEC proposed rules, including those that could require certain advisers who have custody or client assets or that otherwise qualify as financial institutions to (i) develop a program to identify "red flags" associated with identity theft, and (ii) have policies and procedure designed to prevent and mitigate identity theft in connection with its consumer accounts. *Identity Theft Red Flags Rules*, Investment Company Act Release No. 29969 (Feb. 28, 2012) *available at* http://www.sec.gov/rules/proposed/2012/ic-29969.pdf. In 2008, the SEC proposed amendments to its rules, including (i) a requirement that individuals be notified under certain circumstances in the event of a breach of security, (ii) additional guidance as to information that must be included in the safeguard and disposal polices, and (iii) a limited exception to the notice and opt-out requirements to allow a departing registered representative to take certain client

adviser must adopt written procedures reasonably designed to protect client records and information and to dispose of consumer report information properly.[238]

d. *"Non-public personal information"* includes "personally identifiable financial information" (a defined term) and any list, description, or other grouping of clients derived using "personally identifiable financial information" (*e.g.*, a client list):[239]

(i) "Personally identifiable financial information" includes information a client provides an adviser, information that results from services the adviser provides to the client, and information an adviser otherwise obtains about the client in connection with providing advisory services.[240]

(ii) "Non-public personal information" does not include "publicly available information"— *i.e.*, information the adviser reasonably believes is lawfully made available to the general public from government records, widely distributed media, or disclosures to the general public required by law.[241]

15. *Form 13F Disclosure*. An SEC-registered investment adviser that exercises investment discretion over at least $100 million in "section 13(f) securities" must periodically file Form 13F with the SEC.[242] This requirement was designed "to create a central depository of historical and current data about the investment activities of institutional investment managers" to assist investors and regulators.[243]

"Section 13(f) securities" generally include equity securities that trade on an exchange (including the NASDAQ National Market System).[244] Form 13F must be filed electronically, via the SEC's Electronic Data Gathering,

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information when leaving a firm. *Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information,* Investment Advisers Act Release No. 2712 (Mar. 4, 2008).

238 Rule 248.30(a); 248.30(b). The SEC has settled an enforcement action against an investment adviser that failed to adopt procedures reasonably designed to protect client records and information. *See In the Matter of LPL Financial Corporation*, Investment Advisers Act Release No. 2775 (Sept. 11, 2008).

239 Rule 248.3(t)(1).

240 Rule 248.3(u)(1).

241 Rule 248.3(t)(2).

242 Section 13(f) of the Exchange Act; rule 13f-1(a) under the Exchange Act. *See In the Matter of Quattro Global Capital, LLC.*, Investment Advisers Act Release No. 2634 (Aug. 15, 2007) (adviser failed to File Form 13F); *In the Matter of Cabot Money Management Inc.*, Investment Advisers Act Release No. 1577 (Aug. 15, 1996).

243 S. Rep. No. 94-75, 94th Cong., 2d Sess. 82-85 (1975). Each quarter, the SEC publishes a list of section 13(f) securities to assist institutional investment managers in the preparation of their Form 13F filings, *available at* http://www.sec.gov/divisions/investment/13flists.htm.

244 "Section 13(f) securities" also include certain equity options and warrants, shares of closed-end investment companies, and some convertible securities. Shares of open-end investment companies are not "section 13(f) securities." Rule 13f-1(c). The SEC publishes an official list of section 13(f) securities, *available at* http://www.sec.gov/divisions/investment/13flists.htm.

Analysis and Retrieval ("EDGAR") system, within 45 days after the end of the March, June, September, and December calendar quarters. Form 13F reports must identify, among other things: (i) the name of the issuer; (ii) the number of shares owned; and (iii) the fair market value, as of the end of the quarterly filing period, of the reported securities.[245]

Non-U.S. Advisers. Non-US investment advisers must file Form 13F if they (i) use any means or instrumentality of United States interstate commerce in the course of their business; and (ii) exercise investment discretion over $100 million or more in section 13(f) securities.[246]

16. *Large Trader Reporting*. An investment adviser that qualifies as a "large trader" must obtain a large trader identification number from the SEC, file and periodically update Form 13H, and disclose to each SEC-registered broker-dealer through which it trades its large trader identification number and all accounts to which that number applies.[247] These requirements were designed to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity.[248]

    An adviser is a "large trader" if it exercises investment discretion over one or more accounts through which transactions in "national market system securities" are effected through one or more registered broker-dealers in amounts that, in the aggregate, amount to either: (i) 2 million shares or shares with a fair market value of $20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of $200 million during a calendar month.[249]

    National market system securities. These securities include listed options and equity securities listed on an exchange (including the NASDAQ National Market System).[250] The scope of securities that fall under this definition is narrower than the scope of securities that trigger Form 13F filing.[251]

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245 The Division of Investment Management has published a "FAQ" regarding Form 13F ("13F FAQs"), *available at* http://www.sec.gov/divisions/investment/13ffaq.htm.

246 *See also* 13F FAQs *at* FAQ #4.

247 *See Large Trader Reporting*, Exchange Act Release No. 34-64976 (July 27, 2011) ("LTR Release"). The Commission adopted rule 13h-1 and related Form 13H, as directed by section 13(h) of the Exchange Act, on July 27, 2011. The rule also requires registered broker-dealers to monitor accounts for the purpose of identifying "unidentified large traders," capture certain information relating to all transactions on behalf of large traders and unidentified large traders that are effected directly or indirectly by or through them, and make such information available to the Commission through the already-established trade-reporting infrastructure, commonly referred to as the "electronic blue sheets." *See id*.

248 *Id.*

249 *See id.*

250 *See* Regulation NMS, rule 600(b)(46), (47) and (82).

251 *See supra* note 244 and accompanying text.

To comply, a large trader must file a Form 13H initial filing (via EDGAR) generally within 10 days after effecting aggregate transactions equal to or greater than the identifying activity level.[252] A large trader must then submit an annual filing within 45 days after the end of each calendar year, and must file an amendment no later than the end of the calendar quarter in which information became stale.[253]

Non-U.S. Advisers. Non-U.S. investment advisers that are "large traders under the rule" (*i.e.*, trade through SEC-registered broker-dealers) must comply with the rule's filing and disclosure requirements.[254]

C. Contractual Requirements

The Act does not require advisory contracts to be written[255] and the existence of a contract and the interpretation of its terms is generally a matter for state law. Section 205 of the Act, however, requires all advisory contracts to include certain provisions and prohibits the contracts from including other provisions entered into by advisers registered with, or required to be registered with, the SEC.

1. *Advisory Fees.* Advisers and clients are free to mutually agree to the amount of the adviser's compensation for its services, and the method by which it will be paid.[256]

Performance Fees. With significant exceptions discussed below, section 205(a)(1) of the Act prohibits advisers from entering into a contract with a client that varies with the adviser's success in managing the client's money, *i.e.,* a fee based on a share of the capital gains or appreciation of a client's

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252 The form requires disclosure of, among other things, the large trader's contact information, its and its affiliates companies businesses, the forms it and its securities affiliates file with the Commission, its organizational structure and legal form, and a list of broker-dealers with which it maintains accounts. *See id.*

253 *See* LTR Release. A large trader may avoid updating filings if it obtains "inactive status" through a Form 13H filing by not having effected aggregated transactions in excess of the thresholds at any time during the previous full calendar year. *See id.*

254 Where the laws of a foreign jurisdiction prevent a non-U.S. large trader (whether itself a broker-dealer or adviser) from disclosing certain personal identifying information of an underlying principal, foreign large traders or representatives of foreign large traders may request an exemption from the SEC pursuant to section 36 of the Exchange Act and subsection (g) of rule 13h-1. *See id.*

255 However, section 15(a) of the Investment Company Act requires advisory contracts with investment companies to be in writing.

256 The SEC staff has taken the position that an investment adviser that charges fees which substantially exceed those charged by other investment advisers may violate section 206 of the Act, unless it discloses to existing and prospective clients that such a fee is higher than that charged by other advisers that provide the same or similar services. The staff had indicated that it will consider an advisory fee greater than 2% of the total assets under management as excessive and would violate section 206 unless the adviser disclosure is made that the fee is higher than that normally charged in the industry. *See Equitable Communications Co.*, SEC Staff No-Action Letter (Feb. 26, 1975); *Consultant Publications, Inc*., SEC Staff No-Action Letter (Jan. 29, 1975); *Financial Counseling Corporation*, SEC Staff No-Action Letter (Dec. 7, 1974); *John G. Kinnard & Co.,* Inc., SEC Staff No-Action Letter (Nov. 30, 1973).

funds.[257] Congress included this provision in the Act because of its concern that a performance fee would encourage undue speculation with clients' investments.

a. *Assets Under Management.* The commonly charged fee based on an amount of assets under management is specifically excepted.[258]

b. *Fulcrum Fee.* The Act excepts from the performance fee prohibition a type of fee known as a "fulcrum fee." This is a fee for "big players" where the investment advisory contract involves registered investment companies or clients with over $1 million of assets.[259] The fee must be based on the asset value of the funds under management over a "specified period" and must increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices."[260]

c. *Non-U.S. Clients.* The Act also excepts contracts with persons who are not residents of the United States.[261] Congress added this exception in 1996 in recognition that the common use of performance fee arrangements in other countries placed U.S. advisers at a competitive disadvantage.

d. *Qualified Clients*. Rule 205-3 permits an adviser to enter into a performance fee contract with certain "qualified clients." A qualified client is a:

(i) natural person or company that has at least $1,000,000 under management with the adviser immediately after entering into the

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257 Section 205(a)(1). The SEC staff has taken the position that section 205(a)(1)'s prohibition of investment advisory contracts that contain performance fees extends to 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.

258 Section 205(b)(1).

259 Section 205(b)(2). The SEC has published a release discussing factors that investment companies considering entering into a fulcrum fee should consider. Investment Advisers Act Release No. 113 (Apr. 18, 1972).

260 Rules 205-1 and 205-2 define the terms in the text. *But see Royce Value Trust*, SEC Staff No-Action Letter (Dec. 22, 1986) (the SEC staff stated it would not object if an advisory agreement contained a performance fee that decreased at a greater rate than it increased and provided for no compensation if the net asset value per share declined). The SEC has instituted several enforcement cases against advisers who entered into advisory contracts with investment companies that charge performance fees that did not comply with section 205(b). In each case, the adviser charged the fund more that it could charge under section 205(b). *In the Matter of Gartmore Mutual Fund Capital Trust*, Investment Advisers Act Release No. 2548 (Sept. 7, 2006); *In the Matter of Putnam Investment Management*, LLC, Investment Advisers Act Release No. 2547 (Sept. 7, 2006); *In the Matter of Numeric Investors LLC*, Investment Advisers Act Release No. 2546. (Sept. 7, 2006); *In the Matter of Kensington Investment Group, Inc.*, Investment Advisers Act Release No. 2545 (Sept. 7, 2006).

261 Section 205(b)(5).

contract;[262]

(ii) natural person or company that the adviser reasonably believes has a net worth of more than $2 million at the time the contract is entered into,[263] or is a "qualified purchaser";[264] or

(iii) natural person who is an officer, director, trustee, or general partner (or a person serving in a similar capacity) of the adviser, or an employee who participates in investment decisions of the adviser and has done so for at least 12 months.[265]

e. *Qualified Purchaser Funds*. The Act also excepts contracts with certain funds not registered under the Investment Company Act because they are offered only to certain wealthy or sophisticated investors.[266] The funds, which include many hedge funds, rely on the exception from the definition of "investment company" provided by section 3(c)(7) of the Investment Company Act.

f. *Other Funds.* Rule 205-3 excepts contracts with other types of funds, but only if *each* equity owner of the company is a qualified client with whom the adviser could otherwise enter into a performance fee contract under the rule.[267] This exception is available to (i) public investment companies registered under the Investment Company Act of 1940, (ii) business development companies, and (iii) private investment companies that rely on the exception provided by section

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262 Section 418 of Dodd-Frank Act directed the SEC to periodically adjust for inflation the dollar amount threshold for a "qualified client" every five years. In 2011, SEC issued an order to increase the minimum amount of assets under management threshold from $750,000 to $1,000,000. *See Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3236 (July 12, 2011) (the "Performance Fee Order"). The SEC then amended rule 205-3 to codify the order in the rule. *See Investment Adviser Performance Compensation*, Investment Advisers Act Release No. 3372 (Feb. 15, 2012) ("Release 3372").

263 The Performance Fee Order increased the dollar amount for the threshold from $1.5 million to $2 million. The SEC then amended rule 205-3 to codify the order in the rule and to exclude the value of a person's primary residence and certain property-related debts from the test of whether a person has sufficient net worth to be considered a "qualified client." *See* Release 3372, *supra* note 262.

264 A "qualified purchaser" is defined in the rule by reference to section 2(a)(51) of the Investment Company Act, which generally defines a "qualified purchaser" to include: (i) a natural person who owns not less than $5,000,000 in investments; (ii) a trust that meets certain requirements; and (iii) any person (including an investment adviser) who in the aggregate owns and invests on a discretionary basis not less than $25,000,000 in investments.

265 Rule 205-3(d)(1)(iii).

266 Section 205(b)(4).

267 For a discussion of some of the contours of this exception, *see Seligman New Technologies Fund II, Inc.*, SEC Staff No-Action Letter (Feb. 7, 2002). The adviser itself and any equity owner not charged a performance fee need not be qualified clients. Rule 205-3(b). In an arrangement involving multiple tiers of funds, the analysis of whether a performance fee may be charged must be repeated at each tier. *Exception to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Investment Advisers Act Release No. 1731 (July 15, 1998).

3(c)(1) of the Investment Company Act.[268]

Non-U.S. Funds. The SEC staff has stated that if the fund is organized under the laws of a non-U.S. country, only the equity owners that are U.S. residents must be qualified clients.[269]

2. *Assignments of Advisory Contracts.* Advisory contracts must contain a provision prohibiting their assignment without consent of the client.[270] 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 adviser's outstanding voting securities.[271] A transaction that does not result in a change of actual control or management of the adviser (*e.g.*, a corporate reorganization) would not be deemed to be an assignment for these purposes.[272]

3. *Notification of Partnership Changes*. If the adviser is organized as a partnership, each of its advisory contracts must provide that the adviser will notify the client of a change in its membership.[273]

4. *Hedge Clauses*. The Act voids any provision of a contract that purports to waive compliance with any provision of the Act.[274] The SEC staff takes the position that an adviser that includes any such provision in a contract misleads its clients in violation of the Act's anti-fraud provisions by creating in the mind of the client the belief that a legal right or remedy under the Act is not available.[275]

Indemnification Clauses. Historically, the SEC staff has taken the position that prohibition would, for example, preclude an adviser from purporting to limit its culpability to acts involving gross negligence or willful malfeasances,[276] even if the hedge clause explicitly provides that rights

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268 Rule 205-3(b) and (d)(3).

269 *See Lazard Frères Asset Management*, SEC Staff No-Action Letter (Feb. 12, 1996).

270 Section 205(a)(2).

271 Section 202(a)(1).

272 Rule 202(a)(1)-1. While rule 202(a)(1)-1 was adopted primarily to deal with intra-corporate reorganizations and reorganizations resulting from changes in domicile, the Division of Investment Management explained in a staff no-action letter that the rule is not so limited. *Zurich Insurance Company, Scudder Kemper Investments*, SEC Staff No-Action Letter (Aug. 31, 1998). Zurich involved a complex corporate transaction, the substance of which the Division did not address. Instead, the Division stated that the adviser must itself evaluate whether a particular transaction involves a change of actual control or management.

273 Section 205(a)(3).

274 Section 215(a).

275 *Opinion of the General Counse*l, Investment Advisers Act Release No. 58 (Apr. 10, 1951). The SEC has instituted enforcement actions against advisers that have utilized hedge clauses in their advisory contracts. *In the Matter of William Lee Parks*, Investment Advisers Act Release No. 736 (Oct. 27, 1980); *In the Matter of Olympian Financial Services*, Inc. Investment Advisers Act Release No. 659 (Jan 16. 1979).

276 *Auchincloss & Lawrence Inc*., SEC Staff No-Action Letter (Feb. 8, 1974).

under federal or state law cannot be relinquished.[277] More recently, the SEC staff has stated that whether such an indemnification clause would violate the Act's anti-fraud provisions, 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."[278]

5. *Termination Penalties.* The SEC staff takes the position that certain fees that may have the effect of penalizing a client for ending the advisory relationship, or that may make the client reluctant to terminate an adviser, may be inconsistent with the adviser's fiduciary duties and may violate section 206.[279] Thus, the SEC staff interprets the anti-fraud provisions of the Act to require an adviser receiving its fee in advance to give a client terminating a contract a *pro rata* refund of pre-paid fees (less reasonable expenses),[280] unless the adviser is to receive a pre-determined amount upon termination for services already performed, and the client is provided adequate disclosure.[281]

D. Recordkeeping Requirements

The SEC generally requires a registered adviser to maintain two types of books and records: (i) typical accounting and other records that any business would normally keep; and (ii) certain additional records the SEC believes necessary in light of the adviser's fiduciary duties.[282]

The requirement to keep records does not turn on the medium in which a document is created or maintained. Thus, electronic documents, including e-mails, must be maintained if they meet the required record described below.

1. *Typical Records*

   a. All checkbooks, bank statements, and reconciliations.

   b. All written agreements entered into by the adviser with any client or otherwise relating to the business of the adviser, *e.g.,* rental and service agreements, mortgages, employment contracts, advisory contracts.

   c. All invoices or statements relating to the adviser's business.

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277 *Omni Management Corp*. SEC Staff No-Action Letter (Dec. 13, 1975); *First National Bank of Akron*, SEC Staff No-Action Letter (Feb. 27. 1976).

278 *Heitman Capital Management, LLC*, *et al.*, SEC Staff No-Action Letter (Feb. 12. 2007).

279 *See, e.g., National Deferred Compensation*, SEC Staff No-Action Letter (Aug. 31, 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment").

280 *National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992). The staff does not see this view altered by the decision *Transamerica v. Lewis*, 444 U.S. 11 (1979), that clients do not have a private right of action under section 206 of the Act, because they continue to have rights to sue for equitable damages under section 215 of the Act.

281 *BISYS Fund Services, Inc.,* SEC Staff No-Action Letter (Sept. 2, 1999).

282 Rule 204-2.

d. All cash receipts and disbursement journals, other journals, appropriate ledger accounts, all trial balances, financial statements, and internal audit working papers relating to the business of the adviser.

2. *Additional Records*

a. A record of the personal securities transactions of the adviser and its employees.

b. Copies of each report of personal securities holdings made by an access person under the adviser's code of ethics.

c. Documents supporting an adviser's decision to approve an access person's personal securities transactions.

d. A list of all persons who currently are "access persons" and who have been access persons within the last five years.

e. A memorandum of each order given by the adviser for the purchase or sale of any security and any instruction from the client concerning such purchase and sale.

f. A cross reference of securities held by client and by issuer.

g. All written communications received and copies of all written communications sent by the adviser relating to:

(i) any recommendation made or proposed to be made, and any advice given or proposed to be given;

(ii) any receipt, disbursement or delivery of funds or securities; or

(iii) the placing or executing of any order to purchase or sell any security.

h. Copies of all circulars, advertisements, newspaper articles, etc., sent to 10 or more persons.

i. A list of all accounts over which the adviser has discretionary authority.

j. Copies of any power of attorney.

k. A copy of each written statement given to any client in compliance with the brochure rule and any document prepared in compliance with the requirements of Form ADV.

l. Clients' acknowledgement of receipt of a solicitation agreement.

m. Documents substantiating any performance advertised.[283]

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[283] Rule 204-2(a)(16). *See* Investment Advisers Act Release No. 1135 (Aug. 17, 1988) (adopting paragraph (a)(16)); *see also Salomon Brothers Asset Management Inc. and Salomon Brothers Asset Management Asia Pacific Limited*, SEC Staff No-Action Letter (July 23, 1999) (explaining that records needed to be retained to substantiate performance). In addition, rule 204-2(e)(3)(ii) provides that advisers that had relied on the exemption from registration under section 203(b)(3) of the Act before

n. Certain additional records if the adviser has custody or possession of clients' cash or securities.[284]

o. Copies of the code of ethics and amendments thereto.

p. Records of violations of the code by supervised persons and of any actions taken against violators of the code of ethics.

q. Copies of each supervised person's written acknowledgment of receipt of a copy of the code of ethics.

r. Certain additional records regarding political contributions and advisory services to any government entity.[285]

3. *Other Requirements Regarding Recordkeeping*

a. All books and records required to be kept by the rule must be maintained and preserved in any easily accessible place for a period of no less than five years.[286]

b. Records required to be kept may be kept in micrographic media (*e.g.*, microfilm or microfiche) or in electronic storage media (*e.g.*, optical storage discs, CD ROMs).[287]

c. There are special recordkeeping rules for non-resident investment advisers.[288]

E. Applicability to Non-U.S. Advisers.

The SEC has stated that most of the requirements (discussed above) do not apply with respect to the non-U.S. clients of an SEC registered adviser whose principal place of business is not in the U.S.[289] For example, a non-U.S. adviser is not

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July 21, 2011 (the private adviser exemption) will not be subject to the requirement of maintaining records to support their calculation of the performance, or rate of return, of the accounts they managed or securities they recommended for any period prior to their registration with the SEC, provided that they continue to preserve any records in their possession that pertain to such performance or rate of return.

284 Rule 204-2(a)(17)(iii) and (b).

285 Rule 204-2(a)(18) and (h).

286 Rule 204-2(e). The first two years, the records must be kept in the offices of the adviser.

287 Rule 204-2(g). An adviser storing records in electronic storage media must establish and maintain procedures: (i) to preserve the records and safeguard them from loss, alteration or destruction; (ii) limit access to authorized personnel; and (iii) reasonably assure that any reproduction of paper records onto electronic media is accurate. *See In the Matter of Anthony Fields, CPA, et al.*, Investment Advisers Act Release No. 3348 (Jan. 4, 2012) (The SEC has instituted administrative proceedings alleging that adviser violated section 204 of the Advisers Act and rules 204-2(a)(11) and 204-2(e)(3)(i) thereunder by utilizing several email and online communication providers, each of which routinely deletes emails and online communications after six months, and doing nothing to retain these communications).

288 Rule 204-2(j).

289 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2266 (July 20, 2004) at §II.C.(3)(c)(this rule was vacated by a federal court in 2006, *see supra* note 213). *See also* section 203(b)(3) of the Advisers Act amended by the Dodd-Frank Act,

required to maintain non-U.S. person client assets in accordance with the custody rule.

The SEC staff has stated that a non-U.S. adviser registered with the SEC is subject to examination by SEC staff and must maintain certain records with respect to all of its clients, including non-U.S. clients.[290]

F. Administrative Oversight

All records of a registered adviser (and not only those required to be created or maintained pursuant to SEC rule) are subject to examination by SEC staff.[291] Personnel in the SEC's Office of Compliance Inspections and Examinations located at SEC headquarters and various regional offices usually conduct inspections. All examinations are confidential.[292]

1. *Types of Inspections.* There are generally three types of inspections.

   a. *Examinations of High-Risk Investment Advisers*. The SEC staff utilizes a risk-based process, identifying higher-risk investment advisers for examination consideration and focusing examination resources on certain higher-risk activities at selected investment advisers, including conflicts of interest, portfolio management, valuation, performance, advertising and asset verification. Typically, higher-risk investment advisers are identified based on (i) information contained in regulatory filings; (ii) assessments made during past examinations; and/or (iii) other criteria and available information.[293]

Release 3222, *supra* note 68 and Section III. B. 3 of this outline for discussion regarding foreign private adviser exemption.

290 The SEC staff has provided guidance in a series of no-action letters regarding the recordkeeping obligations of registered advisers that are located offshore. Under that analysis, the registered adviser must, in order to rely on the no-action relief, comply with the Act's recordkeeping rules, other than (i) rules 204-2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of United States clients or related securities transactions; and (ii) rules 204-2(a)(8), (9), (10), (11), (14), (15) and (16) and 204-2(b) with respect to transactions involving, or representations or disclosures made to, offshore clients. *See*, *e.g., Royal Bank of Canada*, SEC Staff No-Action Letter, (June 3, 1998). The Dodd-Frank Act added section 214(b) to the Advisers Act, which provides extraterritorial jurisdiction to U.S. federal courts regarding actions or proceedings brought by the Commission or the United States for violation of section 206 of the Act involving (i) conduct within the United States even if the violation is committed by a foreign adviser and involves only foreign investors; or (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

291 *See* section 204 ("All records (as so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations." (emphasis added)).

292 Section 210(b) of the Act generally prohibits the SEC or the SEC staff from disclosing publicly either the existence of an examination or investigation conducted under the Act, or the results of or any facts ascertained during an examination or investigation.

293 *See Study on Enhancing Investment Adviser Examinations* (Jan. 19, 2011), *available at* http://sec.gov/news/studies/2011/914studyfinal.pdf (staff study required by section 914 of the Dodd-Frank Act, which directed the Commission to review and analyze the need for enhanced examination and enforcement resources for investment advisers); Commissioner Elisse B. Walter, *Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IV of the Dodd-*

b. *Special Purpose Reviews*. The SEC staff conducts risk-targeted examination sweeps regarding specific areas of concern within the financial services industry covering a broad sample of regulated entities regarding those areas. These sweeps are typically limited in scope. In addition, the SEC staff conducts limited scope examinations of an investment adviser's general business activities and a targeted set of the adviser's books and records to help OCIE better assess the risk profile of an investment adviser.[294]

c. *Cause Examinations.* These may be based on receipt of a complaint from a client or a competitor, press reports of problems, rumors, or anonymous tips.

In addition, OCIE launched a presence exams initiative in 2012 to conduct focused, risk-based examinations of investment advisers to private funds that registered with the Commission following the repeal of the private adviser exemption.[295] The presence exams include three phases: (i) an initial phase of industry outreach and education; (ii) followed by a coordinated series of examinations of a significant percentage of newly registered advisers focusing on the highest risk areas of their businesses; and (iii) culminating in the publication of a series of "after action" reports, reporting to the industry on the broad issues, risks and themes identified during the course of the examinations.[296]

2. *Focus of Inspections.* Examiners will generally focus on the various activities at an investment adviser deemed by the staff to be high risk. Among other things, the staff is seeking to detect violations of the federal securities laws, including the requirement that the adviser have effective compliance policies and procedures. When the SEC adopts new rules that are applicable to investment advisers, examiners may inquire about the areas affected by such rules and review relevant documentation to assess how the adviser is complying with the new requirements. Other examination focus areas are determined by the purpose for conducting the exam, business activities of the investment adviser, and the compliance controls surrounding those activities.[297]

3. *Results of Inspection.* Generally, there are three possible results from an examination.

a. The SEC staff finds no problems and sends the adviser a letter stating that the inspection is finished (a rare event!).

Frank Wall Street Reform and Consumer Protection Act) (Jan. 19, 2011), *available at* http://sec.gov/news/speech/2011/spch011911ebw.pdf.

294 *Id.*

295 *See Letter to Newly Registered Investment Advisers from Drew Bowden, Deputy Director, Office of Compliance Inspections and Examinations, SEC* (Oct. 9, 2012), *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

296 *See* Norm Champ, "*What SEC Registration Means for Hedge Fund Advisers*" (May 11, 2012), *available at* http://sec.gov/news/speech/2012/spch051112nc.htm.

297 *See Study on Enhancing Investment Adviser Examinations, supra note* 293.

b. The SEC staff sends an "exam summary letter," which informs the adviser of any violations or possible violations found and requests the adviser promptly to take any necessary corrective steps and submit a written response to the SEC staff of the corrective actions taken.

c. The SEC staff refers the inspection to the SEC's Division of Enforcement for further consideration and possible commencement of an enforcement proceeding—not common as a first step.