
**2019 SECURITIES LAW
SEMINAR**

**Public Investors Advocate Bar Association
1225 W. Main St., Ste. 126
Norman, Oklahoma 73069
Office: 405.360.8776
Fax: 405.360.2063
E-Mail: piaba@piaba.org**

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2019 PIABA Securities Law Seminar

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2019 PIABA Securities Law Seminar Speaker Biographies

Joseph Borg, Esq.
Director, Alabama Securities Commission
Montgomery, Alabama

Joseph Borg has been Director of the Alabama Securities Commission (ASC) since 1994. Borg served as the only three term president of the North American Securities Administrators Association (NASAA). He served as a member on the NASAA Board of Directors, as Chair of the International Committee, Chair of Enforcement, Ombudsman and in several other capacities. He is also a member of the Board of Directors of the National White Collar Crime Center (NW3C), the Investor Protection Institute (IPI) and previously served as a member of the Board of Directors of the Investor Protection Trust (IPT). He has also served as a member of the SIPC Modernization Task Force and the FINRA Dispute Resolution Task Force.

Borg recently (June 2018) testified before the U.S. House Financial Services Committee, Capital Markets Subcommittee hearing entitled “Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement.” He has previously testified before various committees of the U.S. Senate and U.S. House of Representatives including testimony on such areas as Microcap Fraud; Criminal Elements in the Financial Markets; Information Sharing among Financial Regulatory Agencies; Risks Posed to Everyday Investors from IPOs in Private Equity and Hedge Funds; Illegal Investment Sales’ Practices Victimized Senior Citizens; and SIPA and SIPC Modernization.

Borg served as a U.S. delegate to an Intergovernmental Expert Group for the United Nations Commission on International Trade and Law (UNCITRAL).

Borg previously served as in-house corporate counsel to First Alabama Bank (n/k/a Regions Bank, 1979-1984) and has been an adjunct professor of law at Faulkner University Jones School of Law teaching securities law and banking (1982-2002), and has been a Partner in the Montgomery law firm of Capouano, Wampold, Prestwood & Sansone (1984-1994).

He is admitted to practice in Alabama, Florida, New York, U.S. Federal District Courts in Alabama and Florida, the 5th and 11th Circuit Courts of Appeal and the U.S. Supreme Court.

Michael Edmiston, Esq.
Jonathan W. Evans & Associates
Studio City, California

Michael S. Edmiston is an Associate with Jonathan W. Evans & Associates in Studio City, California. He has practiced with the firm since 2006. Prior to entering private practice, Michael served as a Senior Staff Attorney with NASD Dispute Resolution (now FINRA) in Los Angeles, California (1997-2001), and as a Business Manager with JAMS in Dallas, Texas and Orange, California (2001-2005).

His practice focuses on representing investors before FINRA, private commercial arbitration forums, and in state and federal court. His work continues to result in successful recoveries for clients by way direct negotiation, mediation, and contested arbitrations. Since 2006, Michael volunteers his time to the Legal Aid Society of Orange County working with senior citizens in a variety of civil and administrative matters.

In 2015, Michael became a Director of PIABA and currently serves as its Treasurer. He previously served as the organization’s Secretary, and as chair of the Bylaws Committee. Michael has and continues to serve in various capacities with the PIABA Bar Journal from 2011 to 2016, including Editor (2011-2012), Managing Editor (2013), Editor in Chief (2014-2015), and Advisor (2016 to present). He also authored and coauthored articles and materials for the Bar Journal.

Michael is a 1994 graduate of Whittier College, with degrees in Business Administration and Economics. In 1997, he obtained his J.D. from Pepperdine University School of Law, and was admitted to the California Bar later that same year. He received his Master’s Degree in Dispute Resolution from Pepperdine in 2001.

Scott Eichhorn Esq.
University of Miami
Investor Rights Clinic
Coral Gables, Florida

Scott Eichhorn is the Associate Director of the University of Miami School of Law Investor Rights Clinic, where he instructs student interns on the substantive law and practical skills necessary to handle securities arbitration cases before the Financial Industry Regulatory Authority (FINRA) and supervises Clinic representation of investors of modest means in FINRA arbitration proceedings. Mr. Eichhorn also serves as an arbitrator for FINRA and maintains a private law practice. He is currently co-chair of the Legal Clinic and Law Student Subcommittee of the ABA Securities Litigation Committee.

Mr. Eichhorn earned a B.S. in Journalism from the University of Florida. He later received his J.D. from Northwestern University. Prior to joining the University of Miami, he was in private practice for seven years, specializing in securities litigation in state and federal courts and FINRA arbitration.

Elissa Germaine, Esq.
Director, Investor Rights Clinic, Elisabeth Haub School of Law, Pace University
Adjunct Professor of Law
White Plains, New York

Elissa Germaine is the Director of the Investor Rights Clinic at the Elisabeth Haub School of Law at Pace University and an Adjunct Professor of Law. She serves on the Editorial Board of the *PIABA Bar Journal*. Elissa has also taught legal skills and legal writing at Pace Law and New York Law School.

Before entering legal education, Elissa practiced in the areas of securities litigation and arbitration, government investigations, and complex commercial litigation at Latham & Watkins LLP in San Francisco. She also served as a law clerk for the Honorable John S. Rhoades, Sr. in the United States District Court, Southern District of California.

Elissa received her JD from Northwestern University Pritzker School of Law and her BA from Dartmouth College.

Nicole Iannarone, Esq.
Assistant Professor of Law
Drexel University Thomas R. Kline School of Law

Nicole Iannarone is a scholar and leader in the practice community whose work focuses on an array of issues including regulation of financial intermediaries, the consumer's experience in resolving securities disputes, professional ethics, and law and technology.

Before joining the faculty in 2019, Professor Iannarone directed the Investor Advocacy Clinic at Georgia State University College of Law. There, she oversaw students' representation of consumer investors with small claims against their brokers before the Financial Industry Regulatory Authority (FINRA), their efforts to educate investors, and their work representing the voice of retail investors in evaluating and commenting on FINRA and SEC rule proposals.

Previously, Professor Iannarone taught at Mercer Law School and at Vanderbilt Law School.

Professor Iannarone has published extensively on an array of topics that includes financial technology, regulation of financial intermediaries, resolution of securities disputes, technology and ethics in legal practice, as well as experiential education. Her articles have appeared in the *Tennessee Journal of Business Law*, *Chicago Kent Law Review*, and the *University of Toledo Law Review*. Her article, "Finding Light in Arbitration's Dark Shadow," is forthcoming in the *University of Nevada Las Vegas Law Forum*.

She testified about fraudulent schemes targeting retail investors before the U.S. Securities & Exchange Commission Division of Trading and Markets Roundtable on Combating Retail Investor Fraud in 2018 and on the role of security arbitration clinics in ensuring economic justice before the commission's Dodd-Frank Investor Advisory Committee in 2017.

Before entering academe, Professor Iannarone practiced at Bondurant, Mixson & Elmore, where she was deputy general counsel and her practice focused on complex litigation.

Professor Iannarone is the chair-elect of the AALS Section on Employee Benefits and Executive Compensation and a member of the Section on Professional Responsibility. She is also a member of the FINRA National Arbitration and Mediation Committee. The immediate past president of the Atlanta Bar Association, Professor Iannarone previously served on numerous committees and held diverse leadership roles during her years in Georgia. She is a fellow of the American Bar Foundation.

From 2017-2019, she served as chair of the State Bar of Georgia's Professionalism Committee and as a liaison to the Georgia Chief Justice's Commission on Professionalism.

She received her JD from Yale Law School, where she served on the *Yale Journal on Regulation*.

Christopher Kelly, Esq.
Senior Vice President
FINRA Enforcement Department
New York, New York

Christopher Kelly serves as the Senior Vice President of Sales Practice Enforcement within FINRA's Enforcement Department. As Senior Vice President, Mr. Kelly oversees the work of the Enforcement Staff in 14 FINRA District Offices throughout the country. He joined FINRA in 2014 and served as Chief Counsel in FINRA's North Region until early 2018.

Prior to joining FINRA, Mr. Kelly served as Deputy Chief of the Criminal Division at the U.S. Attorney's Office for the District of New Jersey. In that role, Mr. Kelly supervised more than 35 Assistant U.S. Attorneys in the Office's white-collar units, including Economic Crimes, National Security, and Cybercrime.

Prior to his promotion to the position of Deputy Chief, Mr. Kelly served as the Chief of the Economic Crimes Unit at the U.S. Attorney's Office, where he oversaw the Office's prosecution of complex economic crimes, including crimes involving insider trading, securities fraud, tax evasion, corporate fraud and embezzlement. Mr. Kelly also served as the lead prosecutor on numerous criminal prosecutions.

Mr. Kelly graduated from Duke University and Harvard Law School. Prior to joining the U.S. Attorney's Office, he was an associate at the law firm Dechert LLP. Mr. Kelly also clerked for the Honorable Joseph E. Irenas, U.S. District Court Judge for the District of New Jersey.

Christine Lazaro, Esq.
St. John's University School of Law
Queens, New York

Christine Lazaro is an Associate Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. The students in the Clinic represent investors in arbitration claims against brokerage firms and brokers on a pro bono basis. Professor Lazaro also teaches Broker-Dealer Regulation and Business Basics at St. John's, and is a faculty advisor for the Moot Court Honor Society and the Corporate and Securities Law Society. She joined St. John's in 2007 as a Supervising Attorney for the Clinic. Professor Lazaro is also currently Of Counsel to the Law Offices of Brent A. Burns, LLC, where she consults on securities arbitration and regulatory matters.

Professor Lazaro has been a member of the Public Investors Arbitration Bar Association (PIABA) since 2008. She currently serves on the Board of Directors, co-Chairs the Fiduciary Standard Committee, and is a member of the Legislation Committee, the SRO (Self Regulatory Organization) Committee and the Securities Law Seminar Committee. She also serves on the New York State Bar Association's Securities Litigation and Arbitration Committee.

Professor Lazaro holds a B.A. from New York University and a J.D. from Fordham Law School. After graduating from law school and prior to joining St. John's, she was an associate at Davidson & Grannum, LLP, representing broker-dealers and individual brokers in disputes with clients in both arbitration and mediation, and handling employment law cases and debt collection cases. She also advised broker-dealers regarding investment contracts they had with various municipalities and government entities.

She speaks and writes regularly on the topics of securities arbitration and the duties of brokers and brokerage firms.

Darlene Pasieczny, Esq.
Samuels Yoelin Kantor LLP
Portland, Oregon

Darlene Pasieczny (pronounced "Pah-shetch-nee") is a securities and fiduciary litigator and FINRA arbitrator, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. Darlene works all stages of securities litigation and FINRA arbitration, fiduciary litigation in trust and estate disputes, elder financial abuse, and complex civil litigation. She represents investors nationwide to recover investment losses caused by financial advisor misconduct or defective securities products. Previously, Darlene worked at Banks Law Office PC, where she developed her concentration on securities litigation and FINRA arbitration.

Darlene serves on the Board of Directors of the Public Investors Arbitration Bar Association (PIABA) and is a frequent speaker on FINRA arbitration, trust and estate matters, and elder financial abuse prevention, recognition, and recovery. Other professional affiliations include the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, Multnomah Bar Association, and the Gus J. Solomon American Inn of Court. Darlene earned a B.A. from Reed College, *Phi Beta Kappa*, an M.A. from Columbia University, and J.D. from Lewis and Clark Law School, *magna cum laude*. www.InvestorDefenders.com

Michael S. Pieciak, Esq.
Commissioner, Vermont Department of Financial Regulation
Montpelier, Vermont

Michael S. Pieciak is commissioner of the Vermont Department of Financial Regulation. He was first appointed by Governor Peter Shumlin in July 2016 and reappointed by Governor Phil Scott in December 2016.

Commissioner Pieciak serves as the chief regulator of Vermont's financial services sector, including the insurance, captive insurance, banking and securities industries. Commissioner Pieciak previously served as deputy commissioner of the department's Securities Division, where he led the division's investigation into the Jay Peak EB-5 projects. Commissioner Pieciak is president of the North American Securities Administrators Association, a member of the SEC Advisory Committee on Small and Emerging Companies and member of the National Association of Insurance Commissioners.

Prior to his service with the department, Commissioner Pieciak practiced law in New York City at Skadden, Arps, Slate, Meagher and Flom LLP in the Mergers and Acquisitions Group, gaining experience in commercial transactions, corporate governance and investment and financing transactions. Commissioner Pieciak also previously practiced at Downs Rachlin Martin in Burlington in the Business Law Group.

Commissioner Pieciak grew up in Brattleboro and graduated cum laude from Union College with a degree in political science. He received his law degree summa cum laude from the University of Miami School of Law where he served as editor-in-chief of the "Miami Law Review." Commissioner Pieciak is also a member of the Vermont State Colleges Board of Trustees and currently resides in Winooski, Vermont.

Richard Ryder, Esq.
President, Securities Arbitration Commentator
Maplewood, New Jersey

Rick Ryder is the founder and President of Securities Arbitration Commentator, Inc., which publishes newsletters and provides Award and legal research for the securities arbitration community. Mr. Ryder was, in the past, New York District Counsel with NASD; NASD Director of Arbitration; and Associate General Counsel, PaineWebber. In 1988, SAC initiated publication of the *Securities Arbitration Commentator* newsletter; in 1989, he and Samantha Rabin launched SAC's Award Database; and in the aughts of the new Millennium, SAC launched ARBchek, an online arbitrator search facility, created the first PDF Library of securities arbitration Awards, commenced publication of two weekly email Alert services, *Securities Arbitration Alert* and *Securities Litigation Alert* (*nka SOLA: Securities Online Litigation Alert*), and introduced SAC's Award reporting service, *Update: ARBchek (UA)*. Mr. Ryder has written hundreds of articles on arbitration topics, has served as attorney, expert, mediator and arbitrator in the securities arbitration field, and has been a frequent speaker at securities arbitration seminars, conferences and forums. He is currently a member and director of the Securities Experts Roundtable and, in 2019, helped launch SER's quarterly newsletter, *The Expert's Examiner*.

Leo Rydzewski, Esq.
Certified Financial Planner Board of Standards
Washington, DC

Leo Rydzewski is the General Counsel of the Certified Financial Planner Board of Standards (CFP Board). Mr. Rydzewski oversees CFP Board's enforcement of its *Code of Ethics and Standards of Conduct*. Mr. Rydzewski worked with CFP Board's Commission on Standards to develop the revised *Code and Standards*, which goes into effect on October 1, 2019, and is working with CFP Board's Standards Resource Commission to develop guidance materials for the *Code and Standards*. Mr. Rydzewski previously was a partner at the global law firm Holland & Knight LLP and a federal law clerk in Miami, Florida. He received his JD from Florida State University, where he graduated summa cum laude, and a BA in economics from Georgetown University.

Teresa J. Verges, Esq.
Director, Investors Rights Clinic, University of Miami School of Law
Miami, Florida

Teresa J. Verges joined the University of Miami School of Law faculty in the fall of 2011. She is the founding director of Miami Law's Investor Rights Clinic, which launched in January 2012. The Clinic represents investors who have claims against their brokers in arbitration proceedings before FINRA, but whose claims are too small for them to be able to find legal representation.

Professor Verges supervises the students at the Clinic and teaches a seminar on the substantive law of securities arbitration, broker-dealer regulation, professional responsibility and practical skills allowing the students to undertake all aspects of client representation. Prior to joining the School of Law's faculty, Professor Verges served as Assistant Director of Enforcement for the Securities and Exchange Commission at the Miami Regional Office, where she led investigations of potential violations of the federal securities laws, including cases involving financial fraud, pay-to-play and municipal securities offerings, market manipulation, insider trading, offering fraud, violations by broker-dealers and investment advisers, and violations of the Foreign Corrupt Practices Act. Before her appointment as Assistant Director, Professor Verges served as Regional Trial Counsel, where she supervised litigation of civil injunctive actions and administrative proceedings instituted by the SEC's Miami Office.

While at the Commission, Professor Verges led the investigative or litigation teams on some of the most significant cases brought by the SEC, and received awards and recognition for her work, including the SEC's 2011 Arthur F. Matthews Award. Ms. Verges has been recognized as one of "The Top Government Attorneys" in *South Florida Business Guide*, 2004-2009 is a 2009 Recipient of noted "Florida Legal Elite Government Attorney" in *Florida Trend*. Ms. Verges was also selected for *Women of Color Magazine's* 2010 Top Women in Finance.

Prior to joining the Commission in 1998, Ms. Verges was in private practice for 8 years in Chicago and Miami. Ms. Verges has an undergraduate degree from Elmhurst College (1985) and a law degree with highest honors from DePaul University College of Law, Chicago, Illinois (1989).

Ms. Verges has published articles and participated on panels discussing securities arbitration, SEC investigations and enforcement, regulation of financial intermediaries and ethical issues in securities litigation and arbitration. She served on FINRA's National Arbitration and Mediation Committee from 2014-2018.

2019 PIABA BOARD OF DIRECTOR BIOGRAPHIES

Philip M. Aidikoff, Esq., Director Emeritus
Aidikoff, Uhl & Bakhtiari
Beverly Hills, California

Philip M. Aidikoff is a partner in the law firm of Aidikoff, Uhl & Bakhtiari and exclusively represents clients in securities arbitration and litigation. Mr. Aidikoff graduated from the University of California at Berkeley in 1969 where he was on the Dean's List and obtained his Juris Doctor degree from Southwestern University School of Law in 1975 where he was a member of Law Review. He is a past President and Director Emeritus of the Public Investors Arbitration Bar Association (PIABA). He served a five-year term (with three years as chair) on the National Arbitration and Mediation Committee of FINRA (formerly the NASD) which provides recommendations on rules, regulations and procedures governing arbitrations, mediations and dispute resolution. He served as one of three public members of the Securities Industry Conference on Arbitration (SICA), which was created with the support of the Securities and Exchange Commission to help protect the interests of public investors in securities arbitration. He also served as one of two investor advocates on the Securities Investor Protection Corporation (SIPC) Modernization Task Force. He served as a member of the FINRA Arbitration Task Force (2014-2015) which provided recommendations aimed at improving the transparency, impartiality and efficiency of securities arbitration. Mr. Aidikoff was recognized as a 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015 and 2016 Southern California Super Lawyer and was profiled in the February 2012 issue of Southern California Super Lawyers Magazine. He was also named by the National Law Journal as one of the 50 Litigation Trailblazers & Pioneers (2014). His legal rating as an attorney is the highest available "AV".

Mr. Aidikoff has spoken before numerous professional and lay groups on the topic of stockbroker abuse and the handling of arbitration and litigation involving brokers and firms. He has authored or co-authored a number of articles including: *Broker Abuse: Recovering for your Client*, Los Angeles Trial Lawyers Advocate (1993); *Take it or Leave it: Case Evaluation and Retention*, Practising Law Institute Securities Arbitration Handbook (1995); *Recognizing and Evaluating Stockbroker Liability*, Consumer Attorneys Association of Los Angeles Convention (1995); *The Brave New World of Banks Selling Securities: Offline and Online*, Practising Law Institute Securities Arbitration Handbook (1996); *Stockbrokerage Firm Liability: A Pre-Litigation Analysis*, Consumer Attorneys Association of Los Angeles Advocate (1996), reprinted in the Arizona Trial Lawyer Association Advocate (January 1997); *Recognizing and Guarding Against Fiduciary Abuse*, National Guardianship Association Annual Convention (1996); *Control Person Liability in the Securities Industry: A Legal Overview and Practical Applications*, Practising Law Institute Securities Arbitration Handbook (1997); *Liability of Control Persons at Second Tier Firms*, Public Investors Arbitration Bar Association (1997); *Clearing Firm Liability: A Forward Looking Analysis*, Practising Law Institute Securities Arbitration Handbook (1998); *Why Shouldn't Clearing Firms be Liable*, Public Investors Arbitration Bar Association (1998); *Motion Practice in Securities Arbitration: A Claimants Point of View*, Public Investors Arbitration Bar Association (1999); *Selective Recession and the Offset Defense in Securities Cases: A Survey of the Law*, Public Investors Arbitration Bar Association (2000); *After the Correction: Are Your Losses Recoverable?*, American Pathology Foundation (2001); *2001: An Update On Best Execution and Suitability Standards For Online Trading*, Public Investors Arbitration Bar Association (2001); *Arbitration: Can It Be Waived?*, Practising Law Institute Securities Arbitration Handbook (2002); *Comments on The Claimants Bar On Proposed Changes In The Expungement Process*, The Association of the Bar of the City of New York (2002); *Due Diligence or Dont: Pre-Filing Considerations and Claim Drafting*, Public Investors Arbitration Bar Association (2003); *Confidentiality and Compliance Manuals: The Fight for Unfettered Access*, Public Investors Arbitration Bar Association (2004), republished in the Practising Law Institute (2005); *From Wall Street to Main Street: A Guide to Litigation Over Hedge Funds Sold by Brokerage Firms to Retail Investors*, Public Investors Arbitration Bar Association (2005); *I Didn't Say That / Oh Yes, You Did: The Use of Court Reporters in Securities Arbitration*, Public Investors Arbitration Bar Association (2005); *Third Party Money Managers: Brokerage Firms Duty to Monitor and Resulting Liability*, Practising Law Institute (2005); *A Practical Guide To The New NASD Code of Arbitration Procedure For Customer Disputes*, Practising Law Institute Securities Arbitration Handbook (2006); republished Public Investors Arbitration Bar Association (2006); *Trying Asset/Mortgage Backed Securities Cases: A Practical Guide*, Public Investors Arbitration Bar Association (2007); *Wall Street Does It Again: The Auction Rate Securities Fraud*, Public Investors Arbitration Bar Association (2008); *The Prospectus Defense: Defeating It As A Matter of Fact and Law*, PIABA Bar Journal, Vol. 16, No. 4 (2009); *Discovery of Regulatory Documents: Debunking the Myth of the SEC Privilege in Securities Arbitration*, Public Investors Arbitration Bar Association (2010); *Arbitrators Misclassified: Looking Back to Move Forward*, PIABA Bar Journal Vol. 18, No. 1 (2011); *Discoverability Of Wells Submissions: What They Are And How To Get Them*, PIABA Bar Journal Vol. 19, No. 2 (2012); *FINRA Six-Year Eligibility Rule 12206: The Purchase Date is Often Not the Triggering "Occurrence or Event Giving Rise to a Claim"*, PIABA Bar Journal Vol. 20, No. 1 (2013); *Market Adjusted Damages in the FINRA Forum*, PIABA Bar Journal Volume 21, No. 2 (2014), reprinted in the Consumer Attorneys Associations for Southern California Advocate (April 2016);

and most recently published *The Use of Third Party Subpoenas to Determine a Brokerage Firm's Pre-Hiring Due Diligence and Post-Hiring Supervision*, Public Investors Arbitration Bar Association (2015).

Mr. Aidikoff has served on the faculty of the Practising Law Institute (1996, 1997, 2002), NASD Fall Securities Conference (2002, 2004, 2005, 2006), NASAA Enforcement Conference (2002, 2004), NASAA Attorney/Investigator Training Conference (2006), University of Cincinnati School of Law Symposium-Twenty Years after Shearson v. McMahon (2007), SCMA Conference (2005), NERA Securities Litigation Seminar (2004), New York City Bar Securities Arbitration program (2002), Los Angeles County Bar Association Securities Arbitration program (2006, 2011, 2013 and 2015), the NASD faculty for training of discovery arbitrators, and on the JAMS faculty for training of securities arbitrators. He was a member of the NASD Neutral Roster Task Force (2005-2006), the FINRA Arbitrator Training Task Force (2009- 2010), FINRA Discovery Guide Task Force (2010–2013) and National Roundtable on Consumer and Employment Dispute Resolution, Pepperdine University 2012. He has appeared on CNBC, CNN/fn, PBS Nightly Business Report, National Public Radio, CBS Radio, and the Business Channel addressing investor rights topics, and has been quoted on securities matters in the Wall Street Journal, the Dow Jones News Service, Newsweek, Reuters, Fortune Magazine, Business Week, Money Magazine, Bloomberg News Service, Forbes, Medical Economics, Registered Representative, The New York Times, USA Today, The Los Angeles Times, The Washington Post and other national and local press. For five years he wrote a weekly column in the Palm Springs Desert Sun on issues of interest to investors. (www.securitiesarbitration.com)

Robert S. Banks, Jr., Esq., Director Emeritus
Samuels Yoelin Kantor, LLP
Portland, Oregon

Robert Banks leads the securities litigation group at Samuels, Yoelin, Kantor, LLP. He has been practicing law for 33 years, and is a nationally recognized leader in investor rights law. His cases have changed the legal landscape for investors and have been featured in The New York Times, The Wall Street Journal, Investment News, The Business Journal, The Oregonian, Registered Representative (now Wealth Management) and a host of other publications. He is a frequent speaker to lawyers and financial services industry professionals on investment loss recovery issues and professional malpractice. He is also an adjunct professor at Lewis and Clark Law School in Portland, Oregon.

Bob serves on FINRA's National Arbitration and Mediation Committee representing investor interests, and has chaired its Rules and Procedures subcommittee, which writes the rules governing FINRA arbitration. He is past president and current member of the Board of Directors of PIABA, and is one of only a handful of board members that have been honored Director Emeritus status.

Hugh D. Berkson, Esq.
McCarthy, Lebit, Crystal & Liffman Co., LPA
Cleveland, Ohio

Hugh D. Berkson is a Principal attorney with McCarthy Lebit Crystal & Liffman Co., L.P.A., in Cleveland, Ohio, and focuses his practice in securities arbitration and litigation. After gaining extensive trial experience in both business and personal injury litigation, he began representing injured investors. Hugh tries and arbitrates investment cases and performs much of the required technical analysis.

Hugh obtained a business degree in Finance from the University of Texas at Austin and is a graduate of Case Western Reserve University School of Law, where he was a member of the Order of the Barristers and received both the American Jurisprudence Award (National Mock Trial) and the Jonathan M. Ault Mock Trial Prize. He later served as an Adjunct Professor at Case Western Reserve University School of Law, where he taught trial practice. Hugh is "AV Preeminent" rated by Martindale Hubbell, has been ranked as an Ohio "Super Lawyer" every year since 2013, and maintains a 10.0 "Superb" rating on Avvo.

Hugh has served on PIABA's Board of Directors since 2011, and his term as President of PIABA ends with this annual meeting.

Steven B. Caruso, Esq., Director Emeritus
Maddox, Hargett & Caruso P.C.
New York, New York

Steven B. Caruso, the Resident Partner in the New York City office of Maddox Hargett & Caruso, P.C., has concentrated his practice on the representation of individual, high net worth and institutional investors in securities arbitration and litigation proceedings since the firm was founded in 1991. He is a Director Emeritus of the Public

Investors Arbitration Bar Association (“PIABA”), a past President of PIABA and served on the PIABA Board of Directors from 2002 through 2011.

Among his professional recognitions, Mr. Caruso testified before the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, at the hearing entitled “The Securities Investor Protection Corporation: Past, Present and Future” in March 2012; was appointed as a member of FINRA’s National Arbitration and Mediation Committee (“NAMC”) in February 2009 and served as Chairman of the NAMC between January 2011 and June 2013; was appointed as a public member of the Nasdaq OMX BX Arbitration Committee in June 2011; was appointed as a member of FINRA’s Discovery Task Force Committee (“DTFC”) in May 2011 and has served as Chairman of the DTFC since May 2013; testified before the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, at the hearing entitled “Assessing the Limitations of the Securities Investor Protection Act” in September 2010; was appointed to serve as a member of the Securities Investor Protection Corporation (“SIPC”) Modernization Task Force in June 2010; and was recognized as one of the “Top Ten to Watch,” by the Board of Editors of Registered Rep Magazine in August 2007.

Mr. Caruso is the author of *FINRA Six-Year Eligibility Rule 12206: The Purchase Date is Often Not the Triggering Occurrence or Event Giving Rise to the Claim*, PIABA Bar Journal, Volume 20, No. 1 (September 2013); *All Public Arbitrator Panels: A More Level Playing Field*, Practising Law Institute (August 2013); *Arbitrator Challenges Under the FINRA Code of Arbitration Procedure for Customer Disputes*, Practising Law Institute, Securities Arbitration (August 2010); *The Mandatory Industry Arbitrator: An Endangered Species on the Precipice of Extinction*, Practising Law Institute, Securities Arbitration (August 2009); *Sunshine May be the Best Disinfectant for What Ails Securities Arbitration: A Discussion of the 2008 SICA Empirical Study of Fairness*, Practising Law Institute, Securities Arbitration (August 2008); *Effective Closing Statements From the Perspective of Counsel for the Customer-Claimant*, New York State Bar Association, Securities Arbitration 2007 (November 2007); *Essential Principles for Honorable Arbitrators*, Practising Law Institute, Securities Arbitration (August 2007); *Motions to Dismiss: A Predatory Tactic That Must be Extinguished*, Association of the Bar of the City of New York, New York, N.Y. (June 2007); *Ethical Standards for Securities Arbitrators: A Statistical Perspective of Potential Partiality (Bias)*, Practising Law Institute, Securities Arbitration (August 2006); *Arbitrator Training in the Securities Dispute Arena*, The Review of Securities & Commodities Regulation (January 2005); *Discovery Objections Which are Irrelevant, Unduly Burdensome and are Reasonably Calculated to Lead to the Concealment of Admissible Evidence*, New York State Bar Association, Securities Arbitration 2004 (October 2004); *Model Arbitrator Instructions: Luxury or Emerging Necessity*, Practising Law Institute, Securities Arbitration (August 2004); *Ethical Considerations in Settlement Agreements*, Association of the Bar of the City of New York, New York, N.Y. (June 2004); *Examination of the Adverse Broker: Unimpeachable Questions with an Internet Twist*, Practising Law Institute, Securities Arbitration (August 2001); *On-Line Trading: The New Frontier*, Practising Law Institute, Securities Arbitration (July 1999); and *NASD Arbitration Discovery Procedures : Knowing Your Customer From the Securities Professional Perspective*, American Bar Association, Section of Litigation, Committee on Securities Litigation (August 1995).

Jason Doss, Esq., Director Emeritus
The Doss Law Firm
Marietta, Georgia

Jason Doss is the owner of The Doss Firm, LLC, an Atlanta-based law firm devoted to representing consumers across the country in a variety of areas including investment disputes and consumer class action litigation. He has helped recover millions in damages from well-known financial services companies on behalf of individual investors who lost their life savings due to bad investment advice and in some cases, financial fraud.

Notably, Mr. Doss successfully represented a large group of investors who were defrauded in a Ponzi scheme at the Atlanta-based mega-church, New Birth Missionary Baptist Church. The case was deemed as one of the largest church-based affinity fraud schemes in American history, received national media attention, and was featured on the popular ABC show *Nightline*. In addition, Jason Doss was co-lead counsel on two separate consumer class action cases against two of Georgia’s largest natural gas providers, obtaining class settlements totaling \$18.5 million on behalf of over 750,000 Georgia residents for alleged overcharges.

Jason Doss is past-President and a current Board of Directors member of Public Investors Arbitration Bar Association (PIABA). PIABA is an international bar association devoted to protecting the rights of the investing public. Mr. Doss is also a founding board member and current President and CEO of The PIABA Foundation, a charitable organization devoted to promoting investor education.

Jason Doss believes that the best way to avoid becoming a victim of consumer fraud and/or investment abuse is through education. To help prevent investment and consumer abuse, Mr. Doss co-authored a book with best-selling

author and investment adviser Frank Armstrong III, entitled *The Retirement Challenge: Will You Sink or Swim?* It was released in January 2009 and is currently sold at book stores across the country.

In addition, Mr. Doss serves as an adjunct professor at Georgia State University College of Law and helps run the Investor Advocacy Clinic, a law clinic allowing law students the opportunity to provide supervised representation of aggrieved investors who cannot otherwise obtain and/or afford an attorney to represent them in disputes with financial advisors and brokerage firms.

Mr. Doss has also written and lectured on legal topics related to securities arbitration. Jason Doss co-authored his second book entitled, *A Practitioner's Guide To Securities Arbitration*, which was published by the American Bar Association and released in March 2013. That book is used at many law schools across the country as a primary text to teach students about securities arbitration practice and procedure.

Jason Doss co-authored two Georgia Bar Journal articles, *Holmes v. Grubman: The Supreme Court of Georgia Balances Financial Advisor Common Law Liability* (February 2011) and *Georgia Securities Act - Let the Buyer Beware* (June 2005). He has also published several law articles on investment-related topics in the PIABA Bar Journal. Notably, in 2014, while PIABA President, Mr. Doss released two reports entitled *The Inequality of Investor Access To Information* (March 2014) and *The Importance of Arbitrator Disclosure* (October 2014). Both reports received national news coverage from publications such as the *USA Today*, *Wall Street Journal*, the *New York Times*, and *Reuters*. Those publications have also relied on Mr. Doss for analysis of other investment related legal issues.

Jason Doss has also been politically active in Washington D.C. over the last several years in raising awareness and advocating in favor of law designed to protect investing public.

Mr. Doss earned his J.D. from Florida State University in 2002 and his B.A. from the University of Florida in 1997. He is admitted to the bars of Florida and Georgia as well the 11th Circuit and other federal district courts.

Michael S. Edmiston, Esq.
2019 PIABA Treasurer
Jonathan W. Evans & Associates
Studio City, California

Michael S. Edmiston is an Associate with Jonathan W. Evans & Associates in Studio City, California. He has practiced with the firm since 2006. Prior to entering private practice, Michael served as a Senior Staff Attorney with NASD Dispute Resolution (now FINRA) in Los Angeles, California (1997-2001), and as a Business Manager with JAMS in Dallas, Texas and Orange, California (2001-2005).

His practice focuses on representing investors before FINRA, private commercial arbitration forums, and in state and federal court. His work continues to result in successful recoveries for clients by way direct negotiation, mediation, and contested arbitrations. Since 2006, Michael volunteers his time to the Legal Aid Society of Orange County working with senior citizens in a variety of civil and administrative matters.

In 2015, Michael became a Director of PIABA and currently chairs the Bylaws Committee. He is enjoying his first term serving and working with his fellow Directors, Members, and PIABA administrative staff. Michael has and continues to serve in various capacities with the PIABA Bar Journal from 2011 to 2016, including Editor (2011-2012), Managing Editor (2013), Editor in Chief (2014-2015), and Advisor (2016 to present). He also authored and co-authored articles and materials for the Bar Journal.

Michael is a 1994 graduate of Whittier College, with degrees in Business Administration and Economics. In 1997, he obtained his J.D. from Pepperdine University School of Law, and was admitted to the California Bar later that same year. He received his Master's Degree in Dispute Resolution from Pepperdine in 2001.

Benjamin P. Edwards, Esq.
University of Nevada, Las Vegas William S. Boyd School of Law
Las Vegas, Nevada

Benjamin Edwards joined the faculty of the William S. Boyd School of Law in 2017. He researches and writes about business and securities law, corporate governance, arbitration, and consumer protection. Prior to teaching, Professor Edwards practiced as a securities litigator in the New York office of Skadden, Arps, Slate, Meagher & Flom LLP. At Skadden, he represented clients in complex civil litigation, including securities class actions arising out of the Madoff Ponzi scheme and litigation arising out of the 2008 financial crisis.

His writing has appeared in the Northwestern University Law Review, Washington and Lee Law Review, William & Mary Law Review Online, Virginia Law and Business Review, Michigan Business and Entrepreneurial Law Review, Journal of Business and Securities Law, Virginia Journal of Social Policy and the Law, InvestmentNews, Wall Street Journal, The Hill, The Washington Post, BloombergView, Oxford Business Law Blog, and Columbia Blue Sky Blog.

Samuel B. Edwards, Esq.
2019 Executive Vice President/President Elect
Shepherd, Smith & Edwards, LLP
Houston, Texas

Samuel B. Edwards is a partner in the law firm of Shepherd, Smith, Edwards & Kantas, LLP located in Houston, Texas. Mr. Edwards and the other members of his firm have a nationwide practice devoted to representing investors against brokers, brokerage firms, banks, investment advisors, hedge funds and other financial professionals and companies who defraud and mistreat investors, both large and small. Over the years, Mr. Edwards and his firm have represented thousands of investors, including individuals, families, trusts, smaller banks, credit unions, pension plans, public institutions and state entities in litigation and arbitration across the United States and abroad against Wall Street. In addition to his full time practice, Mr. Edwards is on the Board of Directors of PIABA and the former Editor-in-Chief of the PIABA Bar Journal and a consistent contributing author and lecturer on securities issues. His articles have been printed in the PLI Handbook for Securities Arbitration and other well-known publications. Mr. Edwards is a member of the Texas, Michigan and California Bars as well as licensed to practice before numerous federal courts across the country. Mr. Edwards can be reached at (800) 259-9010 or mail to: sedwards@sselaw.com.

Adam Gana, Esq.
Gana Weinstein LLP
New York City, New York

Adam Gana is the managing partner of Gana Weinstein LLP. His practice focuses on all aspects of securities arbitration, complex commercial and business litigation. Adam's experience includes litigation in both State and Federal Courts as well as in various alternative dispute resolution venues. He has tried more than twenty-five cases to verdict before the state and federal trial and appellate courts, AAA, JAMS, NFA and FINRA.

Mr. Gana was named in the New York Super Lawyers Rising Stars® for five straight years and most recently to Super Lawyers, ranked AV® Preeminent™ by Martindale - Hubbell™ (the highest honor offered), and ranked by the National Trial Lawyers as one of the Top 100 attorneys in the state of New York.

Marnie C. Lambert, Esq.
Lambert Law Firm, LLC
Columbus, Ohio

Marnie C. Lambert is a 1992 graduate of the Pepperdine University School of Law in Malibu, California. She has represented investors across the country in securities disputes with their brokerage firms in FINRA arbitrations (and in court) since 2005, handling hundreds of such cases. She has spent the remainder of her legal career primarily representing consumers in complex civil litigation, commercial litigation and class actions.

Ms. Lambert is the founding member of Lambert Law Firm, LLC, a firm committed to protecting consumers from bad actors of all types and sizes. Ms. Lambert is licensed to practice law in all state courts and federal district courts in Ohio and California.

Christine Lazaro, Esq.
2019 President
St. John's University School of Law
Queens, New York

Christine Lazaro is an Associate Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. The students in the Clinic represent investors in arbitration claims against brokerage firms and brokers on a pro bono basis. Professor Lazaro also teaches Broker-Dealer Regulation and Business Basics at St. John's, and is a faculty advisor for the Moot Court Honor Society and the Corporate and Securities Law Society. She joined St. John's in 2007 as a Supervising Attorney for the Clinic. Professor Lazaro is also currently Of Counsel to the Law Offices of Brent A. Burns, LLC, where she consults on securities arbitration and regulatory matters.

Professor Lazaro has been a member of the Public Investors Arbitration Bar Association (PIABA) since 2008. She currently serves on the Board of Directors, co-Chairs the Fiduciary Standard Committee, and is a member of the Legislation Committee, the SRO (Self Regulatory Organization) Committee and the Securities Law Seminar Committee. She also serves on the New York State Bar Association's Securities Litigation and Arbitration Committee.

Professor Lazaro holds a B.A. from New York University and a J.D. from Fordham Law School. After graduating from law school and prior to joining St. John's, she was an associate at Davidson & Grannum, LLP, representing broker-dealers and individual brokers in disputes with clients in both arbitration and mediation, and handling employment law cases and debt collection cases. She also advised broker-dealers regarding investment contracts they had with various municipalities and government entities.

She speaks and writes regularly on the topics of securities arbitration and the duties of brokers and brokerage firms.

Seth E. Lipner, Esq., *Director Emeritus*
Deutsch & Lipner
Garden City, New York

Seth E. Lipner is a Professor of Law at the Zicklin School of Business of Bernard M. Baruch College (CUNY) in New York City, and a member of the firm Deutsch & Lipner in Garden City, New York. Professor Lipner is the author of numerous scholarly articles and law books, including SECURITIES ARBITRATION DESK REFERENCE, co-authored with Professors Joe C. Long and William Jacobson, and published each year by West Publishing. As a member of Deutsch & Lipner, Mr. Lipner focuses his practice on representing investors and other individuals with grievances against providers of financial services.

Professor Lipner was a founder of PIABA when it was created in 1990. He served as President in 1994-1995, and again in 2000-2001. He served as Secretary to the organization and on its Board of Directors since the organization's inception until 2006, and now holds the title "Director Emeritus." Professor Lipner has appeared on CNN, NPR, BBC and the Wall Street Journal Report, and is often quoted in publications such as Forbes, The New York Times, Reuters, Business Week, Newsweek, the Wall Street Journal, Newsday, the New York Law Journal and the National Law Journal. Professor Lipner speaks often to bar groups, and in continuing legal education programs, including the New York State Bar Association, Practising Law Institute and PIABA. He served on the National Arbitration and Mediation Committee of the NASD from 1998 to 2002, and was at one time a member of the Board of Editors at Securities Arbitration Commentator. He is now on the Editorial Board of the PIABA Bar Journal, and is a regular contributor to the Journal.

Along with Lisa Catalano, he is the author of "The Tort of Giving Negligent Investment Advice," 39 University of Memphis Law Review 663 (2009). His most recent law review article, "The Expungement of Customer Complaint CRD Information Following the Settlement of a FINRA Arbitration," is at 19 Fordham Journal of Corporate & Financial Law 57 (2013). Professor Lipner's numerous columns and other writings can be found at DeutschLipner.com. and Forbes.com.

Thomas D. Mauriello, Esq.
Mauriello Law Firm, APC
San Clemente, California

Tom Mauriello founded the Mauriello Law Firm, APC in 1996 after working at a large national plaintiffs' securities class action firm and several small firms. Tom focuses on investment and consumer disputes, with customer FINRA arbitrations constituting a large part of his practice. He also handles business litigation, consumer class actions, and appeals.

Tom is a member of the California, New Jersey and Pennsylvania bars. He received his BA from Brown University in 1983 and JD from the University of San Diego School of Law in 1988. Prior to law school, he worked as a paralegal in New York City for a law firm registering securities offerings with the SEC and state securities agencies. Following law school, Tom served as a judicial clerk to Judge Robert E. Cowen of the U.S. Court of Appeals for the Third Circuit.

Tom serves on the Administration of Justice Committee and the Mandatory Fee Arbitration Committee (as an attorney-client fee arbitrator) with the Orange County Bar Association. He also serves on the PIABA Legislation Committee and participated in PIABA's "Hill Day" in March 2016. From 2012 through 2015, Tom served as Co-Chair of the Legal Committee of the Angeles Chapter of the Sierra Club.

When he is not working, Tom enjoys spending time with his 17-year old daughter, surfing, wine tasting, fitness boot camp, traveling, and playing keyboards in several rock bands.

David P. Meyer, Esq.
2019 PIABA Secretary
Meyer Wilson Co., LPA
Columbus, Ohio

David P. Meyer is the founding principal of the five attorney law firm Meyer Wilson. He has represented approximately 1,000 individual investors from all across the country in securities arbitration and litigation against all major brokerage firms. His firm has recovered more than \$350 million for its clients. David has the honor of winning the largest jury verdict in Ohio history; a class action verdict against Prudential Securities on behalf of 200 retirees.

He is listed in the Best Lawyers in America® (2011-2017) in multiple categories and has been AV-rated for many years. He is a member of the PIABA Board of Directors.

David holds a business administration degree from Ohio University and a law degree and masters degree in tax law from Ohio's Capital University Law School. He is admitted to practice law in the states of Ohio and Michigan.

David P. Neuman, Esq.
Israels & Neuman PLC
Bellevue, Washington

David Neuman has been representing the interests of investors and consumers for over a decade. Before co-founding Israels & Neuman in the Summer of 2014, Mr. Neuman worked for over seven years at a law firm in Chicago which focused its practice on representing aggrieved and defrauded investors, mostly in FINRA arbitration. Through his years of experience, Mr. Neuman has represented over one thousand investors in hundreds of FINRA and court cases, on behalf of clients from over 40 states as well as investors from the international community. He has represented these clients from the inception of the case to their finish, including several that have gone to an arbitration hearing.

In addition to representing investors in FINRA Arbitration, Mr. Neuman has represented investors in numerous courts throughout the U.S., including victims of a Ponzi scheme in Utah, dozens of investors in Colorado state and federal court who lost money in a bond fund, successfully opposing an action to enjoin an arbitration in Idaho, intervening and opposing class action settlements in Iowa and Texas, opposing motions to vacate arbitration awards in Alabama and California, and representing investors of a failed hedge fund in Illinois. Mr. Neuman has also represented persons deceived by their insurance brokers and parties in shareholder disputes.

Prior to his work representing defrauded investors, Mr. Neuman worked for another law firm in the Chicagoland area which focused on consumer and commercial class action litigation. During law school, he also worked for a law firm that handled a number of NASD arbitrations and personal injury matters.

Mr. Neuman is currently on the Board of Directors of the Public Investors Arbitration Bar Association ("PIABA") and is the chair of the Legislation Committee of PIABA. He is also an arbitrator with FINRA Dispute Resolution.

Mr. Neuman was admitted to practice law in the State of Illinois in November 2005, the State of Florida in April 2010, and the State of Washington in 2014. He has also been admitted to the United States District Courts for the Western District of Washington, the Northern District of Illinois, the Central District of the Illinois, the District of Colorado, and the U.S. Court of Appeals, Seventh Circuit.

Mr. Neuman graduated with Honors from the University of Illinois in December 2001 with a B.S. in Finance. He attended the Northern Illinois University College of Law and graduated Magna Cum Laude in May 2005. While at the NIU College of Law, Mr. Neuman was on Law Review and was an Associate Justice for the Moot Court Society. In addition, during his time at the NIU College of Law, he also was a research assistant for Professor David Gaebler and researched various areas of contract, commercial, and consumer law.

Timothy J. O'Connor, Esq.
The Law Offices of Timothy J. O'Connor
Albany, New York

Timothy J. O'Connor maintains a private practice of law in Albany, New York and is licensed in New York and Florida. He has been representing investors in securities brokerage customer claims since 1985. Mr. O'Connor has been a solo practitioner since 2005, after having been affiliated with Ainsworth Sullivan for 21 years.

A graduate of Middlebury College (A.B. Economics, 1980) and the University of Denver College of Law (J.D. 1984), Mr. O'Connor was nominated in the Fall of 2003 as the Inaugural Visiting Clinical Instructor for the Investor Rights Project Securities Arbitration Clinic of Albany Law School of Union University in Albany, New York, funded through the efforts of New York State Attorney General, Eliot Spitzer, from the proceeds of a settlement obtained against several national securities brokerage firms involving allegations of analyst fraud and wrongdoing. Mr. O'Connor served in this adjunct position through 2005.

In addition to his private practice, he is currently an Adjunct Lecturer at State University of New York at Albany, teaching courses in Law in Financial Market Regulation and Technology in Financial Market Regulation.

He has also widely written on a number of topics relating to the topic of investors rights. Most recently, "Trends in Supervisory and Clearing Firm Liability"(New York State Bar Association Continuing Legal Education Department – "Securities Arbitration and Mediation 2017: The Courage to Simplify" – April 6, 2017).

Darlene Pasieczny, Esq.
Samuels Yoelin Kantor LLP
Portland, Oregon

Darlene Pasieczny (pronounced "Pah-shetch-nee") is a securities and fiduciary litigator and FINRA arbitrator, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. Darlene works all stages of securities litigation and FINRA arbitration, fiduciary litigation in trust and estate disputes, elder financial abuse, and complex civil litigation. She represents investors nationwide to recover investment losses caused by financial advisor misconduct or defective securities products. Previously, Darlene worked at Banks Law Office PC, where she developed her concentration on securities litigation and FINRA arbitration.

Darlene serves on the Board of Directors of the Public Investors Arbitration Bar Association (PIABA) and is a frequent speaker on FINRA arbitration, trust and estate matters, and elder financial abuse prevention, recognition, and recovery. Other professional affiliations include the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, Multnomah Bar Association, and the Gus J. Solomon American Inn of Court. Darlene earned a B.A. from Reed College, *Phi Beta Kappa*, an M.A. from Columbia University, and J.D. from Lewis and Clark Law School, *magna cum laude*. www.InvestorDefenders.com

Joseph C. Peiffer, Esq.
Peiffer Wolf Carr & Kane, APLC
New Orleans, Louisiana

Mr. Peiffer is a partner at Peiffer Wolf Carr & Kane. His practices consist of representing individuals and institutions in FINRA arbitration, prosecuting ERISA class actions, representing victims of labor trafficking and those that have suffered catastrophic injury.

Mr. Peiffer has represented hundreds of individual retirees against their brokers in FINRA arbitration. The highlights of this practice include representing 32 Exxon retirees in a 90-day FINRA arbitration against Securities America that resulted in a \$22 million verdict -- one of the largest ever awarded by a FINRA arbitration panel. He has also represented hundreds of Xerox and Kodak retirees against their broker resulting from the broker's fraudulent advice to retire and subsequent unsuitable investments. He currently represents clients against British Petroleum arising from the oil spill that occurred in the Gulf of Mexico. He was recently part of the legal team that filed a temporary restraining order to stop BP from paying dividends to its shareholders before it could show that it could pay to clean up the Gulf. Also, he currently represents the Louisiana Firefighters Retirement Fund in their case against Northern Trust concerning securities lending. Additionally, he represents the Baylor College of Medicine and about 25 other hospitals and municipalities in cases against their investment banks arising out of their issuance of auction rate securities. He also is on the plaintiffs' steering committee in a nationwide antitrust class action involving the illegal tying of cable set-top boxes to the provision of premium cable services and in the leadership of an ERISA class action arising out of securities lending.

Mr. Peiffer was one of three Louisiana lawyers ranked by Chambers USA for securities litigation. He has been quoted by *USA Today*, *Wall Street Journal*, the Associated Press, *New York Times*, *New York Daily News*, *The Los Angeles Times*, *Business Week*, *Investment News*, and many other publications. Mr. Peiffer has also appeared on CNN. He was named as one of the fifty Leaders in Law by *New Orleans City Business Magazine*.

He has also taught and lectured extensively. He is co-authored a book on Litigating Business Torts for West, a Thomson Reuters Business. He co-created and taught a class entitled Storytelling and Advocacy at Loyola Law School. Also, at Loyola Law School, he has taught a course entitled "The Basics of Arbitration" and he also serves as an adjunct professor teaching Trial Advocacy. He has guest lectured at Tulane Law School in its Securities Regulations class and Syracuse Law School on securities arbitration. He has spoken at many national conventions on a variety of topics including prosecuting large, multi-client claims, broker's deficient advice to retire and FINRA arbitration.

Mr. Peiffer graduated from Tulane School of Law, *cum laude*, in 1999. While at Tulane, he served on the Tulane Law Review and was involved with the Tulane Legal Assistance Program. Prior to attending Tulane, he graduated from Bowling Green State University in 1996 with a major in communications. While at Bowling Green, he worked as the General Manager of the campus radio station and City Editor of the daily newspaper.

Mr. Peiffer has also successfully represented criminal defendants on a pro bono basis. He is a member of the Louisiana State and American Bar Associations. He also is a member of the American Association for Justice where he served as past Chairman for the Business Torts section. He is also a member of the Public Investors Arbitration Bar Association where he serves on the Board of Directors and was recently elected Executive Vice President.

Rosemary J. Shockman, Esq., *Director Emeritus*
Shockman Law Office, P.C.
Scottsdale, Arizona

Rosemary J. Shockman received her B.A. from the University of Minnesota and J.D., magna cum laude, from California Western University. She practices with the firm of Shockman Law Office, P.C. in Scottsdale, Arizona. The firm's practice is devoted primarily to the representation of public investors in actions with broker/dealers and others. The firm has represented hundreds of investors in claims against broker/dealers or stockbrokers.

Ms. Shockman is a past member of the Board of Directors, past President, and past chair of the Arbitrator Recruiting Committee for Public Investors Arbitration Bar Association ("PIABA").

She served two terms as a member of the FINRA (formerly NASD) National Arbitration and Mediation Committee.

Brian N. Smiley, Esq., *Director Emeritus*
Smiley Bishop & Porter LLP
Atlanta, Georgia

Brian Smiley is a partner in the firm of Smiley Bishop & Porter LLP. He was born in Augusta, Georgia, and grew up in Atlanta. He attended Emory College, where he was initiated into Phi Beta Kappa and from which he graduated with highest honors in 1975. Following graduation, he attended Emory University School of Law, where he served on the Board of Editors of the Emory Law Journal and was initiated into the Order of the Coif.

Upon graduation (with distinction) in 1978, Mr. Smiley received an appointment as a Trial Attorney in the United States Department of Justice. While at the Justice Department, Mr. Smiley acted as counsel for the Government in numerous cases that were deemed by the Attorney General to be of unusual importance to the United States, including *Nixon v. United States*, various constitutional cases and litigation involving the NATO treaty.

In 1981, Mr. Smiley returned to Atlanta from Washington, and entered into the private practice of law. As a litigator, Mr. Smiley has handled constitutional and civil rights suits, products liability claims, personal injury litigation, commercial controversies, shareholders' derivative suits, fidelity bond and RICO suits, and securities litigation and arbitration. For over 20 years, Mr. Smiley has concentrated in the securities field, primarily representing investors in FINRA arbitrations.

Mr. Smiley is the author of numerous articles including: "Stockbroker-Customer Disputes-Making a Case for Arbitration," (Georgia State Bar Journal, May 1987); "Spotting Common Forms of Stockbroker Misconduct" (The Verdict, Jan. - Feb. 1991); and, "The Law and Ethics of Witness Preparation" (Practicing Law Institute, 1998). He has

spoken at numerous seminars sponsored by the Public Investors Arbitration Bar Association and has been quoted on securities matters in the national press.

Mr. Smiley is a frequent lecturer on the topics of stockbroker misconduct, the handling of litigation and arbitration involving stockbrokers, and legal ethics. He has testified as an expert at special hearings about the "penny stock" industry conducted by the Secretary of State of Georgia. Mr. Smiley testified before the United States Senate Committee on Banking, Housing and Urban Affairs, Securities Subcommittee, on the topics of "penny stock" fraud and securities industry arbitration.

In 2002, Mr. Smiley was appointed to the National Arbitration and Mediation Committee (NAMC). The 13 members of the NAMC advise the Board of Directors of FINRA, which is the world's largest forum for handling arbitration and mediation of disputes between clients and brokerage firms. The NAMC is actively involved in the drafting of arbitration rules and the recruitment, training and evaluation of arbitrators.

He has been elected to serve on the Board of Directors of PIABA for three terms and was honored to act as PIABA's President in 2008-2009.

Jeffrey R. Sonn, Esq.
Sonn Law Group, PA
Aventura, Florida

Jeffrey Sonn focuses his practice principally on securities litigation and arbitration matters, as well as business litigation, and class actions. Mr. Sonn is the managing partner of Sonn & Erez, and has handled over 1,000 of securities cases in his career. Mr. Sonn is "AV" rated by Martindale Hubbell, the highest rating for ethics and legal ability available by this independent ratings organization.

Mr. Sonn regularly lectures on the topic of securities litigation and securities fraud. Presently, Mr. Sonn is a lecturer at the Miami Dade County Police College on the subject of financial advisor fraud. Mr. Sonn has also served as a guest lecturer on securities fraud at the University of Miami Securities Law Clinic.

Mr. Sonn serves as a Director of the Public Investor Arbitration Bar Association (PIABA). Mr. Sonn is the author of many securities related articles, including *Top Ten Things to Do During a Final Hearing* (PIABA), *Top Ten Mistakes to Avoid in a Final Hearing* (PIABA), *Elder Abuse and the Securities Industry* (PIABA), *Ponzi Schemes, Picking up the Pieces from a Fallen House of Cards* ("Securities Arbitration in the Meltdown Era" Practising Law Institute, 2009), *The ABC's of Mortgage Backed Securities* (PIABA), *The Broker Went Bankrupt—Now What?* (PIABA), *Survey of Arbitrator Misconduct, Group Arbitration Techniques* (PIABA), *How CPAs Can Detect Stockbroker Fraud*, and *Top Ten Mistakes To Avoid In an Arbitration Hearing*, as well as other securities-related publications.

During his career, Mr. Sonn has litigated numerous cases to successful resolution, recovering hundreds of millions of dollars for victims of investment fraud. He won a \$50 million final judgment in *Katz v. MRT Holdings*, one of the few cases under Private Securities Litigation Reform Act passed in 1995 to yield a final judgment on the merits. Mr. Sonn also served on the Plaintiffs' Steering Committee that successfully negotiated a \$70 million dollar settlement for hundreds of investors who were the victims of the Medical Capital and Provident Shale Royalties Ponzi Schemes.

Mr. Sonn has acted as trial counsel to verdict in a number of successful cases, including *First Union vs. the FDIC and Hollywood Associates* (a \$16 million dollar verdict), *Madhany v. Citigroup* (\$11.1 million verdict), *Regas v. Painewebber* (a \$2.2 million dollar verdict), and *Tartell v. Krieger Financial* (\$1.7 million dollar verdict).

Mr. Sonn has also represented United States Bankruptcy Trustees and Court appointed receivers as counsel in securities fraud and Ponzi scheme cases. Mr. Sonn has also served as an expert witness in securities fraud cases on issues involving attorneys fees.

Prior to founding the Firm in 1995, Mr. Sonn was associated with the Miami-based securities-litigation firm Gilbride Heller & Brown; and the bankruptcy law firm of Mishan, Sloto, Hoffman and Greenberg.

Mr. Sonn has served as a legal correspondent and commentator on securities fraud and Ponzi schemes for CNBC, CBS, BBC Radio, ABC and MSNBC. Mr. Sonn served as a CNBC legal contributor on the Bernard Madoff Ponzi Scheme for the CNBC shows "On the Money" and the documentary "Scam of the Century, Bernie Madoff and the \$50 Billion Dollar Heist."

Mr. Sonn also appeared in the television show “American Greed” on CNBC, about representing victims of the \$1 Billion Dollar Ponzi Scheme by convicted Fort Lauderdale attorney Scott Rothstein. Sonn & Erez represented victims in the Rothstein case and pushed the Rothstein law firm into bankruptcy when the fraud was discovered.

Mr. Sonn graduated from the University of Florida in 1984 and from University of Miami Law School in 1988. Mr. Sonn was an Associate Editor of the University of Miami InterAmerican Law Review.

Mr. Sonn is admitted to practice law in the State of Florida, the United States District Courts for the Southern and Middle Districts of Florida, and the 11th Circuit Court of Appeals.

Andrew J. Stoltmann, Esq.
Stoltmann Law Offices
Chicago, Illinois

Andrew Stoltmann, attorney and investor advocate, exclusively concentrates his practice in representing investors who are the victims of investment fraud. He has represented over one thousand individuals in lawsuits and securities arbitration actions against brokerage firms like LPL, Merrill Lynch, Morgan Stanley Dean Witter, Wachovia, Linsco, Prudential, Baird, Edward Jones, AG Edwards and Smith Barney and has tried approximately 80 cases. Previous to opening the Stoltmann Law Offices P.C. he was a partner in a law firm concentrating its practice in the representation of investors in lawsuits, arbitration claims and class actions against brokerage firms.

Mr. Stoltmann is currently an adjunct securities law professor at Northwestern University School of Law in Chicago. Mr. Stoltmann was the Editor-In-Chief of the PIABA (Public Investor Arbitration Bar Association) Bar Journal, a law journal for the national association of securities attorneys who represent investors in claims against brokerage firms and stockbrokers, from 2001 through 2005. Mr. Stoltmann is also the co-author of the book “Investor Rights for the Year 2000 and Beyond.”

After graduating from the University of Wisconsin (Madison) with a Bachelor of Business Administration degree, Mr. Stoltmann worked as a licensed stockbroker for Olde Discount and Merrill Lynch. While in law school at DePaul University, Mr. Stoltmann clerked at the Chicago NASD Dispute Resolution office, where 95% of securities arbitration cases are decided.

Mr. Stoltmann has appeared as a guest providing legal opinions, commentary and analysis on CNN, CNBC, BBC, CBC, CBS, CNN-FN, Bloomberg TV and National Public Radio. Mr. Stoltmann has been quoted in various publications worldwide including the Wall Street Journal, Christian Science Monitor, Business Week, Forbes, Fortune, USA Today, Chicago Tribune, Los Angeles Times, Kiplinger’s, Jerusalem Post, London Post, London Free Press, The Guardian (UK), Daily Telegraph of London, Montreal Gazette, MacClean’s, Calgary Herald, Toronto Globe & Mail, Toronto Star, Mainichi Daily News (Tokyo), China Daily (Beijing), Mail & Guardian (Johannesburg), National Post, and The Scotsman (Edinburgh).

Mr. Stoltmann is a member of PIABA (Public Investor Arbitration Bar Association), ATLA (Association of Trial Lawyers of America), the Chicago Bar Association, Illinois State Bar Association and is admitted to the United States District Court for the Northern District of Illinois and the Eastern District of Wisconsin.

ETHICS: A LAW PRACTICE DIAGNOSTIC

Nicole Iannarone*

INTRODUCTION

When potential clients come to us with a securities arbitration case, in addition to evaluating the merits of their case and the financial costs associated with bringing a claim, we describe the time commitment and emotional strain associated with bringing suit. By virtue of claiming that a professional stockbroker's advice was incorrect, our clients become subject to what several securities arbitration lawyers refer to as a "financial colonoscopy." Every aspect of their financial lives will be investigated and they will have to spend significant time obtaining documents that will be flyspecked to show their alleged sophistication, alleged risky behaviors, and alleged agreement with the investment recommendation of which they complain. Though we often walk our clients through financial document collection checklists, when is the last time that we have conducted such a review of our own affairs? As unpleasant as it sounds, we lawyers must also undertake a review of our law firm practices and procedures to ensure the continued health and success of our practices. This short paper endeavors to create a law firm diagnostic checklist from which we can evaluate whether our firm practices align with best practices and where tweaks can be made to better serve our clients.

A. What's Your [Client] Relationship Status?

In many jurisdictions, a written engagement agreement is not required by ethical norms except when a lawyer's pay is contingent in nature.¹ Indeed, the American Bar Association's (ABA) Model Rules of Professional Conduct merely suggest that a lawyer's contract with her client be reduced to writing.² Though the ABA's model rules require that a lawyer and client communicate about the "basis or rate of the fee and expenses for which the client will be responsible.. preferably in writing," some lawyers shun the idea of a written engagement agreement.³ Nevertheless, it is the best practice for a law firm to have a written engagement agreement with every client, as well as other standard communications with each person who seeks advice from the lawyer, in order to prevent uncertainty should a dispute arise. These documents include a written engagement agreement, a non-engagement letter, and a dis-engagement letter. Though we lawyers often think that our relationship status is clear, unless we take steps to lay out the details to all involved, not clearly updating the relationship status put us at risk.

* Assistant Professor of Law, Drexel University Thomas R. Kline School of Law.

¹In Georgia, for example, lawyers are not required to have a written contract listing the details of the agreement between the lawyer and the client so long as there is not a contingent component to the arrangement. When there is a contingency fee, the ethics rules require a written contract. This ethical provision is also in the ABA's Model Rules of Professional Conduct, which require all contingent fee agreements to be in writing. See ABA Model Rule. 1.5 (c) ("A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined...[listing additional requirements of contingent fee contracts].").

²ABA Model Rule 1.5(b).

³*Id.*

1. Engagement Letters

If your firm already uses a written engagement letter for every client it takes on, check a box off on your to-do list. But don't just stop there. There are several questions you should ask about the form engagement letter that the firm uses to ensure that the practice and clients are adequately protected.

First, does every lawyer in the firm use the same agreement, or are there different forms? Taking the time to work together as a firm to develop a single form will ensure all members of the firm understand what happens if there is ever a dispute.

Second, a consistent form alone is not enough. When is the last time the lawyers in the firm closely looked at the engagement agreement? An engagement letter has several essential components and sections:

- Is the client identified?

Every engagement agreement should start by defining who the client is in the representation. This sounds simple. In practice, the identity of the client is often hard to define. In a securities arbitration claim, for example, a lawyer could be asked to bring a claim by any of the following: the individual owner of the account, joint owners of an account, one of the joint owners of an account, an executor of an estate, a trustee, an entity, or a beneficiary of an account, to name a few. Identifying the exact client and the capacity in which they are being represented is essential.

- What is the lawyer/firm undertaking to do?

After identifying the client, an engagement letter should have a section detailing the scope of the representation. In other words, what is it that the lawyer is undertaking to do for the named client? Has the lawyer agreed to take on the entire securities arbitration matter from investigation to filing of a statement of claim through an in-person hearing? Has the lawyer even decided if it is a viable case? Is the lawyer only interested in helping resolve the matter without initiating an arbitration proceeding? This section should detail what legal services will be provided.

In addition to determining the substance of what the lawyer will do, the scope of the representation should include against whom that work will be undertaken. Is the attorney bringing a claim against the individual broker, the firm, and supervisory personnel? Is the attorney only proceeding against the firm? Are there other potentially liable parties against whom suit will or will not be brought? Limitations on whether the attorney will or will not proceed against all potentially liable parties should be clearly described to the client so she is fully advised of the benefits and risks of not proceeding against every potentially liable party. Absent such client counseling and consent, an attorney puts themselves at risk of a negligence claim for failing to proceed against a party from whom recovery could have been made if full recovery is not received from the parties against whom the attorney did bring suit.

- What is the firm not undertaking to do?

Limitations on the representation should be set out. While it might be clear to you, as a lawyer, that you only represent clients in securities arbitration, for example, and do not go to court to enforce an arbitration award, handle appeals, or provide tax advice, clients often think that when

a lawyer takes their case that everything related to the dispute will be handled by the lawyer. In the event a limitation on the representation is not set forth in a written agreement, a subsequent dispute is likely to be resolved against the attorney, with courts often construing ambiguities against the attorney under the theory that the attorney is best situated to clearly describe what is not included in the representation. So, in addition to covering what the firm is undertaking, best practices also dictate that the scope of the representation include information on what the lawyer and firm are not undertaking as part of the representation. The letter should contain a line stating that any additional legal representation will be the subject of another engagement agreement.

- When does the representation begin and end?

Best practices also dictate that an engagement agreement outline when the representation begins and when it ends. Without temporal limitations, attorneys have been found to be liable in malpractice actions for failing to take action after the attorney believed that the matter had concluded (and also believed, but did not properly document, that the alleged failure to undertake work was outside the scope of the representation).

- What does this cost and how will the lawyer be paid?

An engagement agreement should detail the basis of the attorney's fee and the expenses that the client will be charged. The agreement should also outline how the client will receive bills for the lawyer's services. Contingent fee agreements must be in writing and detail the amount of the contingency, any fees or expenses the client is responsible for, and how the contingency is calculated. In any event, all fees and expenses must be reasonable.

- Was a conflicts check run?

Prior to accepting any representation, an attorney should check for any conflicts that would prevent the attorney from undertaking the representation. Best practices for drafting engagement agreements include detailing that a conflict check was undertaken prior to accepting the representation. If there were no conflicts found, the letter should state that. If conflicts were found, but resolved or waived with informed consent in writing, that should also be detailed. Conflicts can become tricky in multiple client representations, and this section of the engagement agreement in such representations should detail what will happen if a conflict arises between the multiple clients that the attorney represents.

- Is there a withdrawal provision?

Sometimes, a representation does not go as the lawyer and client hope. In the withdrawal section, a lawyer should detail the grounds upon which the lawyer can withdraw. The ethics rules cover withdrawal, and it is only permitted in limited circumstances. Describing what each party to the engagement agreement's responsibilities are help provide clarity to the situations that might cause a lawyer to withdraw from the representation.

- Is there a dispute resolution clause?

An engagement agreement should also discuss how the parties will resolve any dispute. For example, the dispute can be resolved via arbitration or via a traditional court proceeding. Some lawyers allow the client to elect which dispute resolution process that they wish to use. Lawyers

often offer arbitration as an option to the client because it allows the client to keep the substance of the underlying claim confidential. Lawyers should also note that fee disputes can often be arbitrated before special tribunals offered by many bar associations.

- Has each party signed the engagement agreement?

An essential element to any contract is the agreement of all of the parties. Thus, an engagement agreement should typically state that the lawyer does not undertake any responsibility for the matter until a fully signed agreement is received by the attorney.

- Is the engagement agreement client-friendly?

Finally, even though an engagement agreement contains important legal provisions, it should be viewed as a conversation with the client. The language used for these important provisions should be understandable for lay persons.

2. Non-Engagement Letters

When talking with law students about how attorney client relationships are established, many are shocked to learn that in cases of ambiguity, the subjective opinion of the putative client may control whether a relationship exists, even if a lawyer did not believe she undertook any representation and never followed up with any legal advice. Thus, every potential client who reaches out to the firm should receive a non-engagement letter if they do not become a client of the firm. A non-engagement letter makes clear that the lawyer will not be undertaking to represent the client in any matter. It does not, however, need to be an overly harsh and bland document. It should thank the potential client for reaching out to the lawyer for advice but firmly state that the lawyer will not be providing any legal advice. If a lawyer believes that no case exists and wishes to tell the potential client that there is no legal claim, she can do so; however, she should be aware that if her opinion is incorrect and the potential client relies on the advice that no claim exists to her detriment, a legal malpractice claim may subsequently be brought. Whatever the case, informing the putative client that the passage of time can adversely impact legal claims and that if they would like to further pursue the matter, they should reach out to another lawyer as soon as possible.

3. Disengagement Letters

Finally, every lawyer should make a practice of sending a disengagement letter to every client when a matter concludes and no additional legal work is to be completed. A disengagement letter is a formal way to signify the end of the attorney client relationship. In it, the lawyer should thank the client for the opportunity to provide legal services to the client, inform them that the representation has come to an end, and inform them how they can obtain their files and other materials.

B. Keeping Up to Date

By attending a PIABA Annual meeting, lawyers are able to meet another important ethical requirement – that we keep our substantive legal knowledge up to date so that we ethically serve our clients and provide competent legal advice. The ABA's competence requirement, contained

in ABA Rule 1.1 goes further than many lawyers anticipate, however, requiring knowledge both of substantive law and the way in which we deliver legal services and manage our practices through 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

So, as part of your ethics checkup, don't forget that we need to ensure that our diet is balanced and eat that broccoli – find a way to learn about a new piece of practice technology that can help you better serve your clients. Sound scary? It's not as bad as you think. Bar associations and legal groups also provide significant resources to assist lawyers incorporating technology into their practices and ensuring that they abide by ethical requirements. For example, the American Bar Association maintains a Legal Technology Resource Center that “educates and assists [American Bar Association] members with the latest legal technology, allowing lawyers to boost efficiency and ultimately provide clients with the highest quality service.”⁵ Similarly, Delaware's courts established a Commission on Law and Technology to provide lawyers with information and guides about technology and its impact on practice.⁶ The Commission maintains a webpage with white papers on technological issues including, among others, papers on basic skills, cloud technology, courtroom technology, data security, eDiscovery, and social media.⁷ State and local bar associations likewise emphasize technology and maintain online resources for lawyers and law office staff.⁸ In many jurisdictions, ethics hotlines afford lawyers easy access to guidance on emerging issues and to answer questions that have not formally been answered by ethics experts in advisory opinions.⁹

⁴ABA Model Rule 1.1, Comment [8].

⁵See American Bar Association, Legal Technology Resource Center, http://www.americanbar.org/groups/departments_offices/legal_technology_resources.html (last visited Apr. 6, 2017).

⁶Delaware Commission on Law and Technology, *What is the DECLT*, available at <http://courts.delaware.gov/declt/index.aspx>, (last visited Apr. 7, 2017) (“The Commission was created to develop and publish guidelines and best practices regarding the use of technology and the practice of law.”).

⁷See Delaware Commission on Law and Technology, *Leading Practices*, available at <http://courts.delaware.gov/declt/practices.aspx>.

⁸See, e.g., State Bar of Georgia, *Law Practice Management*, available at <https://www.gabar.org/committeesprogramssections/programs/lpm/> (last visited May 22, 2017) (“Whether you need advice on technology, firm finances, organization or library materials, we have the resources and training to assist you.”).

⁹See, e.g., The State Bar of California, *Ethics Hotline*, available at <http://ethics.calbar.ca.gov/Ethics/Hotline.aspx> (“The Ethics Hotline, a confidential research service for attorneys only, helps lawyers identify and analyze their professional responsibilities.”) (800-238-4427); State Bar of Georgia, *Ethics & Professionalism*, available at <https://www.gabar.org/barrules/ethicsandprofessionalism/> (“Lawyers who would like to discuss an ethics dilemma with a member of the Office of General Counsel staff should contact the Ethics Helpline at 404-527-8741, 800-682-9806 or log in and submit your question by email.”); New York City Bar, *Ethics*

C. Is Your Client's Data Safe in the Cloud?

Speaking of technology, how do you store your client files? You may have your head up in the clouds if you haven't heard the buzz surrounding cloud computing. As clients pressure firms to decrease costs and increase accessibility of data, more and more lawyers are beginning to embrace the technology. Cloud computing technology is not without its risks. The Federal Trade Commission has received complaints concerning inadequate security on the cloud. Even more disconcerting is the FBI's warning to law firms that they were "being specifically targeted by hackers who have designs of accessing the firms' databases."¹⁰ These threats underscore the main ethical concern in cloud computing: confidentiality.

Recognizing the confidentiality concern, the American Bar Association Ethics 20/20 Commission's working group on the "Implications of New Technologies" proposed a series of changes to the Model Rules that were ultimately adopted.¹¹ The first added a comment to the competence rule, making explicit that lawyers must understand "the benefits and risks associated with relevant technologies."¹² In addition, the Model Rules require lawyers to make "reasonable efforts" to ensure that client information is not inadvertently disclosed or that it is not improperly accessed.¹³ While such "reasonable efforts" are not specifically described, a new Comment 18 describes certain "[f]actors to be considered in determining the reasonableness of the lawyer's efforts."¹⁴ Clients may require lawyers to go further or, with informed consent, "forgo security

Hotline, available at <http://www.nycbar.org/member-and-career-services/ethics/hotline> ("New York lawyers faced with ethical questions regarding their own prospective conduct can reach the Ethics hotline through Customer Service at 212.382.6663."); Virginia State Bar, *Ethics Questions and Opinions*, available at <https://www.vsb.org/site/regulation/ethics> ("Any member of the bar may seek informal ethics or unauthorized practice of law advice by calling the Ethics Hotline at (804) 775-0564."); State Bar of Arizona, *Ethics Hotline*, available at <http://www.azbar.org/ethics/ethicshotline/> ("Ethics Hotline Number: 602.340.7284"); Pennsylvania Bar Association, *Ethics Hotline*, available at <http://www.pabar.org/public/Membership/ethics.asp> ("The Ethics Hotline provides free advisory opinions to PBA members based upon a review of a member's prospective conduct by members of the PBA Committee on Legal Ethics and Professional Responsibility. ... The Ethics hotline can be reached at (800) 932-0311, ext. 2214."); State Bar of Texas, *Toll-Free Ethics Helpline for Lawyers*, available at https://www.texasbar.com/Content/NavigationMenu/ForLawyers/GrievanceandEthics/Toll_Free_Ethics_Helpline_for_Lawyers/default.htm (800.532.3947); State Bar of Michigan, *Ethics Article: Ethics Hotline – Frequently Asked Questions*, available at <https://www.michbar.org/opinions/ethics/articles/july98> ("The Ethics Hotline at the State Bar of Michigan (877) 558-4760 receives approximately 20 calls per day from Michigan lawyers seeking guidance on a full array of ethics issues from lawyers."); The Florida Bar, *Ethics Hotline*, available at <https://www.floridabar.org/ethics/ethotline/> ((800) 236-8619).

¹⁰See also Jennifer Smith, *Client Secrets at Risk as Hackers Target Law Firms*, WALL ST. J. LAW BLOG, June 24, 2012, <http://blogs.wsj.com/law/2012/06/25/dont-click-on-that-link-client-secrets-at-risk-as-hackers-target-law-firms/>.

¹¹Catherine S. Reach, Rachel Packer, & Paul Bateman, *Ethical Challenges on the Horizon: Confidentiality, Competence and Cloud Computing*, ABA Section of Litigation Section Annual Conference (April 2013).

¹²MODEL RULES OF PROF'L CONDUCT R. 1.1, cmt. 6.

¹³MODEL RULES OF PROF'L CONDUCT R. 1.6(c).

¹⁴MODEL RULES OF PROF'L CONDUCT R. 1.6, cmt. 18 (these factors "include, but are not limited to, the

measures that would otherwise be required.”¹⁵ Specifically unaddressed by Model Rule 1.1 are two important points that lawyers should consider: (1) duties to protect information and maintain privacy that arise from other laws and (2) notification requirements arising from other sources of law when an unauthorized breach or other data loss occurs.¹⁶

Numerous state bar associations have issued ethical opinions on cloud computing, each permitting its use when reasonable care is exercised.¹⁷ As defined by these jurisdictions, reasonable care¹⁸ and best practices when using cloud computing may include the following steps, each of which should be investigated as part of your law firm diagnostic exam:

- Do you know how the data is stored and secured?¹⁹
- Is a confidentiality agreement being followed?²⁰
- Does your cloud computing vendor comply with emerging technology best practices?²¹
- Do you have the expertise to make these calls, and, if not, have you retained an expert to assist?²²

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).”).

¹⁵*Id.*

¹⁶*See id.*

¹⁷*Cloud Ethics Opinions Around the U.S.*, *supra* note 41.

¹⁸The Pennsylvania Bar Association has gone so far as to list fifteen practices that would meet the “standard of reasonable care.” *See Pa. Bar Ass’n Comm. on Legal Ethics & Prof’l Responsibility, Formal Op. 2011-200 (2011)* (these practices include backing up data, installing firewalls, only providing necessary information to others, avoiding inadvertent disclosure of information, verifying the identity of individuals to whom the attorney provides information and refusing to disclose information without said verification, encrypting data, implementing audit trail procedures to monitor who accesses the data, creating plans to address security breaches, providing training on cloud computing, maintaining a physical copy of the information onsite, creating alternate ways to access the information, as well as a host of suggestions for the agreement between the attorney and provider).

¹⁹*Ala. State Bar Office of General Counsel, Formal Op. 201-02 (2010).*

²⁰*Id.*

²¹*Id.*

²²*State Bar of Calif. Comm. on Prof’l Responsibility & Conduct, Formal Op. 2010-179 (2010).*

- Are “[r]easonable security precautions” in place, such as password protection and encryption?²³
- Does the vendor understand legal confidentiality requirements?²⁴
- Is certain information so sensitive that client consent should be requested?²⁵

The American Bar Association provides further guidance, recommending that lawyers ask and answer a series of questions concerning ethics and security when considering cloud computing.²⁶

D. CALL ME MAYBE?

Ask a bar association’s disciplinary counsel what the number one complaint is that they hear from clients about a lawyer. The answer: “My lawyer won’t return my phone calls/emails/texts.” As part of your law firm audit, check out your standard client communication protocol. At the beginning discussions about the potential representation, let the client know how often you will reach out to them and how. For seasoned lawyers, we are well aware that a case might take years, but for clients, this is a new experience, and many expect much speedier resolutions and regular communication. Share what will be entailed if you accept the representation and the basic timelines. Let the client know how you will reach out to her, and be sure you follow through. A calendar notice reminder is a great way to do this – proactively reach out every week or two even if nothing is happening in the case to let the client know that you have what you need and that everything is under control. Let the client know how she can best contact you and when to contact you. In particular, talk with the client about what to do if she receives any letters, documents, subpoenas, and how to handle any calls that she might receive from the other side. Finally, talk to her about what the attorney client privilege means and that it may be waived if she discusses her case with others and that she should accordingly not talk about the case with others.

²³State Bar of Ariz. Ethics Comm., Formal Op. 09-04 (2009).

²⁴State Bar of Nev. Comm. on Ethics & Prof’l Responsibility, Formal Op. 33 (2006).

²⁵N.H. Bar Ass’n Ethics Comm., Advisory Op. 2012-13/04 (2013).

²⁶These questions include: (1) How does the vendor safeguard the privacy/confidentiality of stored data? (2) How often is the user’s data backed up? Does the vendor backup data in multiple data centers in different geographic locations to safeguard against natural disaster? (3) What is the history of the vendor? Where do they derive their funding? How stable are they financially? (4) Can I get my data “off” their servers for my own offline use/backup? If I decide to cancel my subscription to the software, will I get my data? Is data supplied in a non-proprietary format that is compatible with other software? (5) Does the vendor’s Terms of Service or Service Level Agreement address confidentiality and security? If not, would the vendor be willing to sign a confidentiality agreement in keeping with your professional responsibilities? *Cloud Computing/Software as a Service for Lawyers*, ABA LAW PRACTICE DIVISION, http://www.americanbar.org/groups/departments_offices/legal_technology_resources/resources/charts_fyis/saas.html.

See also Jason M. Rosenthal, *Keeping Your Data, Not Your Head, in the Cloud*, <http://apps.americanbar.org/litigation/committees/insurance/articles/112213-data-cloud-discovery.html>.

While not all clients will broach the issue of information security with their lawyers, lawyers should. In FINRA proceedings, PIABA members most often represent individual customers with claims against their brokers. While not all individual clients will raise the information security and efficiency standards that the most sophisticated corporate clients will request, technology can nevertheless impact their cases, sometimes in an extremely detrimental fashion. The risks can come from oversharing by providing too much access to information or not fully understanding the duty to preserve evidence. Help your clients send sensitive information to you in a secure fashion to protect them.

Securities arbitration practitioners should also be concerned with their clients' use of social media, both pre-existing social media and any use of social media during the course of the matter. Before accepting a case, many lawyers review a potential client's social media accounts and advise them, as permitted in some jurisdictions, to change their social media privacy settings to render information posted on a social networking site non-public.²⁷ It is important to distinguish the deleting of one's content, which could very likely give rise to serious repercussions, such as spoliation sanctions, from changing one's privacy settings.²⁸ Importantly, when a client changes a privacy setting, the client does not delete the material but changes the ability of other social media users to view it.

Some lawyers advise their clients to take a "social media vacation" during the course of a proceeding and not make any postings. Clients should similarly be cautioned about the impact of reaching out to participants in the matter, such as the decision maker(s) or other parties, which could constitute impermissible contacts.

Prudent lawyers should also advise their clients about how their social media use can impact their case even after it concludes. Failure to do so can have a serious impact on a client's interests. In one recent example, a Florida man lost an \$80,000 settlement from his former employer because of his daughter's Facebook post about the confidential settlement.²⁹ According to the Miami Herald, the confidentiality clause of the settlement agreement was breached as a result of the following post: "Mama and Papa Snay won the case against Gulliver'. . . 'Gulliver is now officially paying for my vacation to Europe this summer. SUCK IT.'"³⁰ To prevent our own clients from suffering the same fate, lawyers should have a conversation with their clients concerning the depth and breadth of the confidentiality clauses in a potential settlement agreement to ensure that they do not fall victim to the same fate.

²⁷E.g., PA Eth. Op. 2014-5 (Phila. Bar. Assn. Prof. Guid. Comm.), 2014 WL 3548813.

²⁸Model Rule of Prof. Resp. 3.4(a) provides that a lawyer shall not "unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document or other material having potential evidentiary value." For a general discussion of spoliation in the internet age, see John G. Browning, *Burn After Reading: Preservation and Spoliation of Evidence in the Age of Facebook*, 16 SMU Sci. & Tech. L. Rev. 273 (2013).

²⁹See David Smiley, *Daughter's Facebook Boast Costs Former Gulliver Prep Headmaster \$80,000 Discrimination Settlement*, MIAMI HERALD, Feb. 26, 2014, <http://www.miamiherald.com/2014/02/26/3961605/daughters-facebook-boast-costs.html>.

³⁰*Id.*

Lawyers should also discuss their client's email use prior to communication with the client over that media. Some clients, particularly in older generations, share email accounts with their spouses or even children. If a lawyer sends a client communications via such an account, the attorney-client privilege may be waived if others who have access to the account are not clients. Similarly, lawyers should caution clients about the risks of using a work email account for communicating concerning the case as the client may not have any expectation of privacy when using the employer's account and many work accounts provide access to individuals beyond the client (such as assistants or team members) who are not necessary parties to the representation. At the very least, lawyers should have a discussion with their clients about their email use, who has access to the accounts, and the risks of using a non-private account if the client insists upon doing so.

CONCLUSION

Our clients aren't the only ones who need legal advice. Be sure that your law practice is up to date and in compliance with the ethics rules and recommended best practices so you can provide the best level of service to your clients and protect your practice. An ounce of protection is worth a pound of a cure.

ARBITRATION LAW UPDATE: 2018-2019

Teresa J. Verges & Elissa J. Germaine*

This article summarizes the leading federal and state arbitration cases during the last year that are of particular relevance to the securities arbitration practitioner. The Supreme Court decided three cases related to arbitration involving the “wholly groundless” exception, class arbitration, and arbitrability. Courts also addressed issues concerning arbitrability, vacating arbitration awards, a receiver action on behalf of defrauded investors, the limits of FINRA arbitration over member’s other business activities, and discovery in arbitration.

I. UNITED STATES SUPREME COURT CASES ON ARBITRATION

Henry Schein v. Archer & White Sales, Inc., 139 S. Ct. 524 (2019)

In a unanimous opinion, the Court rejected the “wholly groundless” exception for its inconsistency with the statutory text of the Federal Arbitration Act (“FAA”) and the Court’s precedent, and found that when parties to a contract have agreed to delegate arbitrability issues to an arbitrator, the courts must abide the provisions of the contract.¹

The dispute involved alleged violations of antitrust law against a small business that distributes dental equipment, Archer and White, by the equipment manufacturer, Henry Schein.² After Archer and White sued, Schein invoked the FAA and requested that the district court refer the dispute to arbitration per the contract between the parties.³ Schein contended that the contract’s express incorporation of the AAA’s rules meant that an arbitrator, not the court, had to decide whether the arbitration agreement applied to a particular dispute.⁴ Archer and White responded that when, as here, the defendant’s argument for arbitration is “wholly groundless,” the district court itself may resolve the threshold question of arbitrability.⁵ The district court agreed with Archer and White, denying the motion to compel arbitration as it found Schein’s argument for arbitration to be “wholly groundless.”⁶ The Fifth Circuit affirmed, and the Court granted certiorari light of the disagreement

* Teresa J. Verges is Lecturer in Law and Director for the Investor Rights Clinic at the University of Miami School of Law. Elissa J. Germaine is Adjunct Professor of Law, Director of the Investor Rights Clinic, and Executive Director of John Jay Legal Services at the Elisabeth Haub School of Law at Pace University. The authors would like to thank Matthew Alex (’21 Pace Law candidate), Raphaella Arnaud (’19 Pace Law LLM), Erik Della Catena (’21 Miami Law candidate), Camila Machado (’21 Miami Law candidate), and Karoline Silva (’20 Pace Law LLM candidate) for their research and contributions to this article.

¹*Henry Schein, Inc. v. Archer & White Sales, Inc.* 139 S. Ct. 524, 531 (2019).

²*Id.* at 528.

³*Id.*

⁴*Id.*

⁵*Id.*

⁶*Id.*

in the Courts of Appeals over whether the “wholly groundless” exception is consistent with the FAA.⁷

The court held that the “wholly groundless” exception is inconsistent with the FAA and Supreme Court precedent.⁸ A court cannot override a contract between parties and resolve questions contractually delegated to an arbitrator, even if the court thinks the arbitration agreement applies to a dispute that is “wholly groundless.”⁹ The “wholly groundless” exception confuses the issues of who decides arbitrability and who prevails on arbitrability.¹⁰ When the parties to a contract have agreed to delegate arbitrability issues to an arbitrator, the courts must abide the parties’ decision as embodied in the contract.¹¹ The Court vacated and remanded to the Court of Appeals to decide whether the contract in fact delegated the arbitrability question to the arbitrator.¹²

Lamps Plus, Inc. v. Varela, 139 S. Ct. 1407 (2019)

If an employer seeks to compel class arbitration by relying on an arbitration agreement in an employment contract, but that employment contract is ambiguous concerning the issue of class arbitration, how should the courts interpret that ambiguity? The Supreme Court answered this question in a 5-4 decision, holding that an arbitration agreement’s ambiguity does not provide sufficient basis for compelling classwide arbitration.¹³

An employee of Lamps Plus was tricked by a hacker into disclosing the tax information of approximately 1,300 of his fellow employees.¹⁴ After a fraudulent federal tax income return was filed in his name, Frank Varela filed a putative class action against Lamps Plus for negligence and other claims in federal district court on behalf of employees whose information had been compromised.¹⁵ Lamps Plus relied on the arbitration agreement in Varela’s employment contract, seeking to compel individual arbitration rather than class arbitration and dismiss the suit.¹⁶ The district court rejected the individual arbitration request and authorized class arbitration while dismissing Varela’s claims.¹⁷

⁷*Id.*

⁸*Id.* at 529.

⁹*Id.*

¹⁰*Id.* at 531.

¹¹*Id.*

¹²*Id.*

¹³*Lamps Plus, Inc. v. Varela*, 139 S.Ct. 1407, 1416 (2019) (citations omitted).

¹⁴*Id.* at 1412-13.

¹⁵*Id.* at 1413.

¹⁶*Id.*

¹⁷*Id.*

Lamps Plus appealed, arguing that the district court erred by compelling class arbitration.¹⁸ The Ninth Circuit affirmed, holding that *Stolt-Nielsen* was not controlling precedent because the agreement in that case was silent on the issue of class arbitration, rather than ambiguous.¹⁹

The Supreme Court reversed, holding that absent an affirmative provision in favor of class arbitration, neither silence nor ambiguity provides a sufficient contractual basis for concluding that the parties to an arbitration agreement agreed to submit to class arbitration.²⁰ The FAA only contemplates “traditional individualized arbitration” rather than class arbitration.²¹ Moreover, because of the fundamental difference between class arbitration and individual arbitration, all parties must affirmatively consent to classwide arbitration.²² “[P]arties forgo the procedural rigor” of traditional litigation and realize many benefits when they opt for “private dispute resolution: lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes.”²³ Class arbitration forfeits the “principal advantage of arbitration – its informality – and makes the process slower, more costly, and more likely to generate procedural morass than final judgement.”²⁴ Since arbitration is a matter of consent, and since both parties must affirmatively consent to classwide arbitration, the Ninth Circuit erred when applying the doctrine of *contra proferentem* to interpret the ambiguity in the arbitration agreement against the drafter to compel class arbitration.²⁵

The dissenting justices raise several policy considerations. Justice Kagan points out that the majority opinion disregards the actual contract the parties signed, which she views as authorizing class arbitration, and displaces the neutral and commonplace default rule that would construe the contract against the drafting party.²⁶ In doing so, the Court has continued its recent efforts to reduce the amount of class action litigation.²⁷ Justice Ginsburg’s dissent notes that the FAA was not designed to govern contracts between parties of unequal bargaining power.²⁸ She emphasizes that in recent years the court has relied on the FAA to deny employees and consumers “effective relief against powerful economic entities.”²⁹ She also points out that

¹⁸*Id.*

¹⁹*Id.* (citing *Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.*, 559 U.S. 662 (2010)).

²⁰*Id.* at 1415-16.

²¹*Id.* at 1417.

²²*Id.* at 1416.

²³*Id.*

²⁴*Id.*

²⁵*Id.* at 1417-1418.

²⁶*Id.* at 1435 (Kagan, J. dissenting).

²⁷*Id.*

²⁸*Id.* at 1420 (Ginsburg, J. dissenting) (citations omitted).

²⁹*Id.* (quoting *DIRECTV, Inc. v. Imburgia*, 136 S. Ct. 463, 476 (2015)).

expenses incurred in traditional “individual claims will often far outweigh potential recoveries.”³⁰ Additionally, she criticizes the majority ruling as contrary to the principle that arbitration is strictly a matter of consent because, ironically, it imposes “individual arbitration on employees who surely would not choose to proceed solo.”³¹

New Prime Inc. vs. Oliveira, 139 S. Ct. 532 (2019)

The Supreme Court addressed the issues of: (1) whether a court must leave disputes over the application of FAA § 1’s exception for the arbitrator to resolve when a contract delegates questions of arbitrability to an arbitrator, and (2) whether the term “contracts of employment” covers only contracts between employers and employees or whether it also reaches contracts with independent contractors.³² First, the Supreme Court affirmed the lower courts’ decisions that the court, not an arbitrator, decides whether FAA § 1’s “contracts of employment” exclusion applies before ordering arbitration.³³ Second, the Court held that the term “contracts of employment” should be interpreted using the meaning it had when the FAA was enacted, which covered all agreements to perform work and therefore encompassed the relationship with an independent contractor.³⁴ Thus, the agreement in question fell under § 1’s exemption, and the First Circuit was correct that it lacked authority under the FAA to order arbitration.³⁵

The contracts in question, between an interstate trucking company, New Prime, and its driver, Dominic Oliveira, labeled Oliveira an independent contractor (rather than an employee), and stated that any future disputes should be resolved by an arbitrator, including those involving the scope of the arbitrator’s authority.³⁶ Oliveira sued New Prime in a class action in federal court, alleging that the company called its drivers independent contractors, but treated them as employees and failed to pay them minimum wage.³⁷ In response, New Prime asked the court to compel plaintiffs to resolve any disputes through arbitration according to the agreement.³⁸ Oliveira argued that § 1 of the FAA exempts from arbitration “contracts of employment” of workers engaged in interstate commerce.³⁹ New Prime argued that the arbitrator should resolve any question about § 1’s application, and that the term “contracts of employment” referred only to

³⁰*Id.* at 1421 (quoting *Epic Sys. Corp. v. Lewis*, 138 S. Ct. 1612, 1647 (2018)).

³¹*Id.*

³²*New Prime Inc. v. Oliveira*, 139 S. Ct. 532, 536 (2019).

³³*Id.* at 537.

³⁴*Id.* at 539.

³⁵*Id.* at 543-44.

³⁶*Id.* at 536.

³⁷*Id.*

³⁸*Id.*

³⁹*Id.*

contracts establishing a relationship between employers and employees, not independent contractors.⁴⁰

The Court emphasized the idea that if parties to a contract agree to arbitrate a future dispute, the court should generally compel arbitration if one of the parties decides to not follow the agreement; however, it noted that this authority does not extend to all private contracts even if they express a preference for arbitration.⁴¹ The Court explained that the antecedent statutory provisions limit the scope of the court's power to compel arbitration under §§ 3 and 4, because §§ 1 and 2 exclude from the FAA "contracts of employment" of seamen, railroad employees or any other class of workers engaged in foreign or interstate commerce (because in 1925 Congress had already developed alternative employment dispute resolution mechanisms for many transportation workers).⁴² Thus, the Court agreed with the First Circuit that given the FAA's terms and sequencing, a court should decide for itself whether § 1's "contracts of employment" exclusion applies before ordering arbitration.⁴³

The Court then addressed the second issue of whether the term "contracts of employment" refers only to contracts that reflect an employer-employee relationship or if it also encompasses contracts requiring independent contractors to perform work, thereby exempting Oliveira from the FAA.⁴⁴ If the term does not extend to an individual contractor relationship, § 1's exemption would not apply, and the court could compel arbitration.⁴⁵ The Court affirmed the First Circuit's decision that it lacked authority to compel arbitration because the agreement between New Prime and Oliveira fell within § 1's exception, which it determined covers both employer-employee contracts and contracts involving independent contractors.⁴⁶ Courts should interpret words according to their ordinary meaning at the time Congress enacted the statute in question.⁴⁷ The Court looked at what "contracts of employment" meant at the time the FAA was enacted and determined that it meant nothing more than an agreement to perform work.⁴⁸ In making this determination, the Court relied on dictionaries, state and federal decisions and statutes, and the use of the term "workers" in the FAA itself.⁴⁹ The Court noted that Oliveira was entitled to the benefit of the same understanding of the term "contracts of employment" as referencing agreements to perform work as was in place when Congress enacted the FAA in 1925.⁵⁰

⁴⁰*Id.* at 537.

⁴¹*Id.*

⁴²*Id.* at 537-538.

⁴³*Id.* at 537.

⁴⁴*Id.* at 538-539.

⁴⁵*Id.* at 539.

⁴⁶*Id.* at 544.

⁴⁷*Id.* at 539 (citations and quotations omitted).

⁴⁸*Id.* at 539-41.

⁴⁹*Id.* 539-41.

⁵⁰*Id.* at 544.

II. ARBITRABILITY – CLAUSES, PARTIES, AND CONDUCT

Safra Securities, LLC v. Gonzalez, 764 F. App'x 125 (2nd Cir. 2019)

The Second Circuit concluded that plaintiffs-appellants Safra Securities agreed to arbitrate defendant-appellee Gonzalez's claims, as it signed a FINRA Submission Agreement agreeing to arbitrate and did not prove it was coerced into doing so.⁵¹

Safra Securities and Safra Bank sued Daniela Spinola Gonzalez, asking the district court to enjoin a pending arbitration that Gonzalez had filed before FINRA.⁵² The district court dismissed the complaint.⁵³ Safra Securities and Safra Bank appealed, and the Second Circuit affirmed the district court's opinion.⁵⁴

An order to arbitrate should not be denied "unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute."⁵⁵ Here, the Second Circuit could not say with positive assurance that Safra Securities did not agree to arbitrate Gonzalez's claims against it.⁵⁶ After initially protesting FINRA's jurisdiction over the claim, Safra Securities signed a FINRA Arbitration Submission Agreement that explicitly agreed to arbitrate the claims.⁵⁷ Safra Securities failed to show that it did not freely assent to the Submission Agreement it signed.⁵⁸ It never explained why it could not have maintained its objections to FINRA's jurisdiction and refused to sign the Submission Agreement nor plausibly plead any indicia of coercion by FINRA that could rise to the level of duress and render the Submission Agreement voidable.⁵⁹

Novic v. Credit One Bank, Nat'l Ass'n, 757 F. App'x 263 (4th Cir. 2019)

In this debtor's suit against Credit One Bank alleging a violation of the Fair Credit Reporting Act, the Fourth Circuit reversed the district court's decision to deny the motion to compel arbitration, finding that the cardholder agreement's delegation clause clearly empowered the arbitrator to decide any disputes arising out of the agreement, including the threshold question of arbitrability.⁶⁰

⁵¹*Safra Securities, LLC v. Gonzales*, 764 F. App'x 125, 126-127 (2nd Cir. 2019).

⁵²*Id.* at 125.

⁵³*Id.*

⁵⁴*Id.* at 125, 127.

⁵⁵*Id.* at 126 (citing *AT&T Tech., Inc. v. Commc'ns Works of Am.*, 475 U.S. 643, 650 (1986)).

⁵⁶*Id.* at 126.

⁵⁷*Id.*

⁵⁸*Id.*

⁵⁹*Id.*

⁶⁰*Novic v. Credit One Bank, Nat'l Ass'n*, 757 F. App'x 263, 264 (4th Cir. 2019).

Charleene Novic entered into an agreement to obtain a credit card issued by Credit One.⁶¹ The agreement included an arbitration provision with a delegation clause, which stated that “[c]laims subject to arbitration include, but are not limited to, disputes relating to . . . the *application, enforceability or interpretation* of this Agreement, including this *arbitration provision*.”⁶² Subsequently, Novic accrued a past-due balance, which was eventually transferred to a collection agent.⁶³ Novic claimed that she was not responsible for the past-due balance as it was the result of fraudulent charges made to the account.⁶⁴ The collection agent filed suit in Maryland state court in an attempt to collect from Novic, and the court entered a judgment in favor of Novic.⁶⁵

Novic filed this lawsuit in Maryland state court against Credit One, alleging a violation of the Fair Credit Reporting Act (FCRA) because it failed to reasonably investigate her claim that she did not owe this balance due to identify theft.⁶⁶ The case was removed to federal district court, where Credit One moved to compel arbitration under the delegation clause of arbitration provision in the credit card agreement.⁶⁷ The district court denied Credit One’s motion to compel arbitration, stating that it gave up its right to arbitrate when it transferred the account to the collection agent.⁶⁸

On appeal, Credit One argued that the district court erred in denying its motion to compel arbitration because the delegation clause in the arbitration provision was controlling and “plainly states that an arbitrator, rather than the district court, should decide both the ‘gateway’ question of arbitrability and the merits of the parties’ dispute.”⁶⁹

The court noted that parties, as part of an arbitration agreement, “may consent to arbitrate the ‘gateway’ issue of arbitrability, essentially allowing the arbitrator to determine his or her own jurisdiction.”⁷⁰ When doing so, the parties must agree in “‘clear and unmistakable language’ that an arbitrator will decide which disputes the parties have agreed to arbitrate.”⁷¹ Unless a party challenges the validity of an arbitration provision, courts will not intervene in interpreting the

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* at 264-65.

⁶⁹ *Id.* at 265.

⁷⁰ *Id.*

⁷¹ *Id.*

parties' agreement.⁷² Therefore, a challenge to a different contract provision or the contract as a whole will not prevent a court from submitting to the arbitrator the question of arbitrability.⁷³

The court found that the arbitration provision in question, specifically the delegation clause, met the "clear and unmistakable" standard because of the precise language in the arbitration provision.⁷⁴ The court highlighted Novic's failure to make any argument directly challenging the validity of the delegation clause.⁷⁵ Rather, Novic's arguments simply attacked Credit One's rights under the cardholder agreement; the arguments were irrelevant for making a determination of the validity of the arbitration provision and its delegation clause, which are severable from the rest of the contract.⁷⁶ The court concluded the district court erred in denying Credit One's motion to compel arbitration, and the issues advanced in this case by Novic are for the arbitrator, and not for the court, to decide.⁷⁷

Freeman v. Fid. Brokerage Services, LLC, No.3:18 CV 0947 G, 2019 WL 1040547 (N.D. Tex. Mar. 5, 2019)

The court declined to compel non-signatory trust beneficiaries to arbitrate against a brokerage firm where the beneficiaries did not sign the customer agreement containing the arbitration clause, as there was "no valid and enforceable arbitration clause between the parties."⁷⁸

Nancy Crisler executed a living trust agreement for the benefit of her children (the Freemans).⁷⁹ The agreement called for co-trustees in order to provide oversight and constraints on one of the co-trustees (her husband and stepfather to her children) and for the appointment of a successor co-trustee if one of the co-trustees resigned.⁸⁰ Upon the death of their stepfather, the Freemans learned that he had transferred the assets and accounts of the trust to another trust managed by Fidelity and depleted the trust assets by over \$1 million.⁸¹ He signed a Fidelity account application, which incorporated a customer account agreement with a pre-dispute arbitration clause without the Freemans knowledge or the required involvement of a co-trustee.⁸² He also failed to designate

⁷²*Id.* at 266.

⁷³*Id.*

⁷⁴*Id.* (citing *Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. 63, 71(2010)).

⁷⁵*Id.*

⁷⁶*Id.*

⁷⁷*Id.* at 267.

⁷⁸*Freeman v. Fidelity Brokerage Services, LLC*, No. 3:18 CV 0947 G, WL 1040547, at *6 (N.D. Tex. Mar. 5, 2019).

⁷⁹*Id.* at *1.

⁸⁰*Id.*

⁸¹*Id.* at *3.

⁸²*Id.* at *2-3.

a successor co-trustee as required by the trust agreement.⁸³ The Freemans sued Fidelity in court for breach of fiduciary duty and knowing participation in breach of fiduciary duty.⁸⁴ Fidelity moved to compel arbitration.⁸⁵

The court notes that while there are federal and state policies favoring arbitration, the court must first determine the existence of a valid arbitration agreement.⁸⁶ It applied the Fifth Circuit's two-step inquiry to determine if arbitration should be compelled.⁸⁷ First, the court must analyze whether the parties agreed to arbitrate their dispute, including whether there is a valid agreement and whether the dispute in question is within the scope of the arbitration agreement.⁸⁸ Second, the court must ensure that legal constraints external to the agreement have not foreclosed arbitration of the disputed claims.⁸⁹

Here, the court only needed to apply the first step of the two-step inquiry, and denied Fidelity's motion to compel arbitration because "there exists no value and enforceable arbitration agreement between the parties."⁹⁰ The Freemans were nonsignatories to the agreement, and they did not seek to derive direct benefits from or knowingly exploit the customer agreement.⁹¹ The court also noted that Fidelity permitted the stepfather (acting alone and also in the capacity as a primary beneficiary) to sign the account application, open the account, and deplete the trusts, despite the fact that trust agreement did not provide that his signature alone was sufficient to bind the trusts.⁹²

Reading Health v. Bear Stearns & Co. n/k/a J.P. Morgan Securities LLC, 900 F.3d 87 (3d Cir. 2018)

The Third Circuit held that a broker-dealer agreement's forum selection clause that did not explicitly mention arbitration did not implicitly waive a customer's right to FINRA arbitration.⁹³ The court addressed the tension between a customer's right to resolve substantive claims in FINRA

⁸³*Id.* at *1.

⁸⁴*Id.* at *3.

⁸⁵*Id.* at *4.

⁸⁶*Id.*

⁸⁷*Id.* (citing *OPE International LP v. Chet Morrison Contractors, Inc.*, 258 F.3d 443, 445 (5th Cir. 2001)).

⁸⁸*Id.*

⁸⁹*Id.*

⁹⁰*Id.* at *6.

⁹¹*Id.*

⁹²*Id.*

⁹³*Reading Health System. v. Bear Stearns & Co. n/k/a J.P. Morgan Securities LLC*, 900 F.3d 87, 103 (3d Cir. 2018).

arbitration versus a broker-dealer's contractual right to litigate those claims pursuant to a forum-selection clause.⁹⁴ This decision widens a circuit split over the issue, discussed below.

Reading Health System, a not-for-profit health system, filed an arbitration in FINRA asserting claims against J.P. Morgan relating to ARS offerings and demanding that J.P. Morgan arbitrate the claims.⁹⁵ Reading made this demand pursuant to FINRA Customer Code for Arbitration Rule 12200, which requires a FINRA member to arbitrate any dispute with a customer at the customer's request.⁹⁶ J.P. Morgan objected that the forum-selection clauses in two of four broker-dealer agreements constituted a waiver of Reading's right to arbitrate under FINRA Rule 12200.⁹⁷ The district court agreed with Reading, and J.P. Morgan appealed.⁹⁸

The Third Circuit determined that courts must first address threshold disputes over venue before deciding merits disputes.⁹⁹ Thus, here, the court first addressed which court should decide the question of arbitrability before addressing whether the dispute was arbitrable.¹⁰⁰ The court held that the district court properly declined to transfer Reading's action to compel arbitration as Reading's petition to compel arbitration was an action "arising out of" FINRA Rule 12200, rather than the forum-selection clauses in the broker-dealer agreements and related ARS offerings.¹⁰¹

Finally, the court held that the district court properly required J.P. Morgan to submit to FINRA arbitration, as the forum-selection clause did not waive Reading's right to arbitration under FINRA Rule 12200.¹⁰² The court addressed the competing rights at issue: a customer's right to resolve substantive claims in FINRA arbitration versus a broker-dealer's contractual right litigate those claims pursuant to a forum-selection clause.¹⁰³ In making its determination, the court noted the emerging industry trend of brokerage firms attempting to avoid their obligation to arbitrate pursuant to Rule 12200 by inserting forum-selection clauses in their customer agreements, without mentioning the customer's right to arbitration.¹⁰⁴ The Third Circuit viewed this as "depriv[ing] investors of the benefits associated with using FINRA's arbitral forum to resolve brokerage-related disputes."¹⁰⁵

⁹⁴*Id.* at 100-101.

⁹⁵*Id.* at 91.

⁹⁶*Id.*

⁹⁷*Id.* at 91-92.

⁹⁸*Id.* at 90.

⁹⁹*Id.* at 94.

¹⁰⁰*Id.*

¹⁰¹*Id.* at 96-100.

¹⁰²*Id.* at 100.

¹⁰³*Id.* at 100-101.

¹⁰⁴*Id.* at 90.

¹⁰⁵ *Id.*

This decision widens a circuit split between the Second and Ninth Circuits, and the Fourth (and now) Third Circuits. The Second and Ninth Circuits held that a forum-selection clause materially identical to the one at issue in this case required the parties to litigate in federal court, while the Fourth Circuit (with which the Third Circuit agrees) held that Rule 12200 required the parties to arbitrate, despite the presence of a forum-selection clause.¹⁰⁶

The Ninth Circuit treated Rule 12200 as a “mere ‘default obligation’ to arbitrate.”¹⁰⁷ The Second Circuit “viewed the issue as ‘whether an arbitration agreement remains in force in light of a later-executed agreement,’ concluding that the forum-selection clause in the agreement ‘supersede[d] the background FINRA arbitration rule.’¹⁰⁸

By contrast, the Fourth Circuit reasoned that “an agreement waives the right to arbitrate only if it is ‘sufficiently specific to impute to the contracting parties the reasonable expectation that they are superseding, displacing, or waiving the arbitration obligation created by FINRA Rule 12200.’”¹⁰⁹ While the Fourth Circuit acknowledged that the right to arbitration under FINRA Rule 12200 could be superseded and displaced, the forum-selection clause in question was entirely silent on the issue of arbitration.¹¹⁰

In the present case, the Third Circuit agreed with the Fourth Circuit that the question is one of waiver, and the forum-selection clauses did not implicitly waive Reading’s right to arbitration.¹¹¹ The court determined that a party signing a waiver must know the rights it is waiving, and that strong federal policy embodied in the FAA favors arbitration if doubts arise as to arbitrability.¹¹²

III. VACATING ARBITRATION AWARDS

Interactive Brokers LLC v. Saroop, No. 3:17-CV-127, 2018 WL 6683047 (E.D. Va. Dec. 19, 2018)

The District Court for the Eastern District of Virginia vacated a modified arbitration award on the grounds of manifest disregard of the law, holding that there is no private right of action for a violation of FINRA rules.¹¹³

¹⁰⁶*Id.* at 101.

¹⁰⁷*Id.* at 101 (citing *Goldman, Sachs & Co. v. City of Reno*, 747 F.3d 733, 743 (9th Cir. 2014)).

¹⁰⁸*Id.* at 101 (citing *Goldman, Sachs & Co. v. Golden Empire Schools Fin. Auth.*, 764 F.3d 210, 215 (2d Cir. 2014)).

¹⁰⁹*Id.* at 102 (citing *UBS Fin. Servs. Inc. v. Carilion Clinic*, 706 F.3d 319, 329-329 (4th Cir. 2014)).

¹¹⁰*Id.* at 102 (citing *Carilion Clinic*, 706 F.3d at 328).

¹¹¹*Id.* at 102.

¹¹²*Id.*

¹¹³*Interactive Brokers LLC v. Saroop*, No. 3:17-CV-127, 2018 WL 6683047, at *4-6 (E.D. Va. Dec. 19, 2018).

Claimants, the Saroops and Sofis, opened accounts with an online brokerage firm, Interactive Brokers, in 2012, and hired an independent financial advisor (unaffiliated with Interactive Brokers) to run their accounts with Interactive Brokers and make trades on their behalf.¹¹⁴ They engaged in a high-risk trading strategy, which was initially highly profitable.¹¹⁵ After several days of market volatility, on August 24, 2015, the Dow endured its greatest single-day decline in history.¹¹⁶ Claimants lost 80% of their account value and their accounts to fell into margin deficiency, which triggered Interactive's auto-liquidation procedures and wiped out the remaining balances, leaving them with a significant margin deficiency.¹¹⁷

Claimants initiated arbitration in FINRA, and Interactive Brokers counterclaimed by seeking an award equal to the remaining margin deficiency balance.¹¹⁸ Following an arbitration hearing, the panel issued a monetary award in favor of the Claimants, including attorney's fees, and denied Interactive Broker's counterclaim.¹¹⁹ Claimants moved to confirm the arbitration award in court, and Interactive moved to vacate it.¹²⁰ The court declined both motions and remanded the matter to the arbitration panel to clarify its opinion because the court "could not reconcile the first arbitration decision with any legal theories with which it was familiar."¹²¹ The arbitration panel issued a second, modified decision, which the court viewed as repeating much of the first decision and then adding some text.¹²² Following the second arbitration decision, Interactive Brokers moved to vacate and claimants moved to confirm the modified arbitration award.¹²³

The court recognized its very limited powers to review and vacate arbitration awards.¹²⁴ However, the court concluded that the arbitrators' basis for finding liability against Interactive Brokers on a violation of FINRA Rule 4210 was a manifest disregard of the law because the law is clear that there is no private right of action to enforce FINRA rules; the arbitrators knew and understood this; they found it applicable to the case; and they ignored it.¹²⁵ The court stated that the arbitrators' second award does not expressly state that it is basing its liability finding on any of the causes of action listed in the award, and noted that the only basis for liability cited by the

¹¹⁴*Id.* at *1.

¹¹⁵*Id.* at *2.

¹¹⁶*Id.* at *3.

¹¹⁷*Id.*

¹¹⁸*Id.*

¹¹⁹*Id.*

¹²⁰*Id.* at *4.

¹²¹*Id.* at *5.

¹²²*Id.*

¹²³*Id.* at *7.

¹²⁴*Id.* at *7-8.

¹²⁵*Id.* at 8.

arbitrators in their modified award is a violation of FINRA Rule 4210.¹²⁶ The court held that the law is clear that there is no private right of action under FINRA rules.¹²⁷ It noted that claimants' argument that a violation of FINRA rules can provide the basis for a common law claim is a concession that the arbitrators were relying on a violation of FINRA Rule 4210 to establish liability, but were doing so to establish one of the common law claims.¹²⁸ The court reasoned that while a FINRA rule can be considered in defining the scope of a common law duty, here the arbitrators stated they were rejecting all claims not specifically addressed and only addressed the FINRA rule violation; thus, there is no common law claim upon which they could have based the finding of liability.¹²⁹

The court vacated the modified award and remanded to a new FINRA panel for reconsideration of Interactive's counterclaims.¹³⁰

Claimants filed an appeal in the Fourth Circuit.¹³¹ PIABA filed an amicus brief in support, pointing out that FINRA rules do not require the claimant to specify any cause of action or legal theory in a claim, nor do they require the arbitrators to specify any cause of action or legal theory in an award.¹³² In addition, several law school clinics filed an amicus brief in support, highlighting that FINRA rules simply require claimants to specify relevant facts and remedies to initiate an arbitration claim; requiring heightened pleading would disproportionately impact small investors and is contrary to FINRA's goal of protecting investors by providing a fair and efficient method of resolving disputes.¹³³

Malone v. Credit Suisse Securities (USA), LLC, No. 18 CV 6872, 2019 WL 463434 (S.D.N.Y. Feb. 5, 2019).

The United States District Court for the Southern District of New York denied a petition to vacate an arbitration award when it held that a party waived his procedural challenge to the arbitration

¹²⁶*Id.* at *8-9.

¹²⁷*Id.* at *10-11.

¹²⁸*Id.* at *11.

¹²⁹*Id.*

¹³⁰*Id.* at *14.

¹³¹Brief for Defendants-Appellants, *Interactive Brokers LLC v. Rohit Saroop*, No. 19-1077 (4th Cir. Apr. 12, 2019), 2019 WL 1595772.

¹³²Brief for Public Investors Arbitration Bar Association (PIABA) as Amicus Curiae Supporting Defendants-Appellants, *Interactive Brokers LLC v. Rohit Saroop*, No. 19-1077 (4th Cir. Apr. 18, 2019), 2019 WL 1762717.

¹³³Brief for University of Miami School of Law Investor Rights Clinic, Elisabeth Haub School of Law at Pace University Investor Rights Clinic, and St. John's University School of Law Securities Arbitration Clinic as Amici Curiae Supporting Defendants-Appellants, *Interactive Brokers LLC v. Rohit Saroop*, No. 19-1077 (4th Cir. Apr. 18, 2019), 2019 WL 1762718.

panel's composition by completing the arbitration after he knew or should have known that the panel was improperly constituted.¹³⁴

Daniel Malone filed an arbitration claim with FINRA against Credit Suisse, alleging breach of implied contract, breach of implied covenant of good faith and fair dealing, fraud in the inducement, and promissory estoppel.¹³⁵ FINRA rules require that the arbitration panel be composed of three arbitrators – two public and one non-public.¹³⁶ Per FINRA rules, Malone and Credit Suisse participated in the strike-and-rank selection process after FINRA provided Malone and Credit Suisse with a list of 10 arbitrators for each of the three spots, along with their disclosure reports and their classification as “public” or “nonpublic.”¹³⁷ The parties accepted the panel at the pre-hearing conference; the panel held hearings in February and April 2018; the parties filed post-hearing submissions; and the panel rendered its unanimous decision denying all of Malone's claims.¹³⁸ Between the February and April hearings, FINRA noticed one of the arbitrators had been misclassified as “public” when she should have been classified as “nonpublic.”¹³⁹ FINRA had sent the parties an updated disclosure report for this arbitrator in March.¹⁴⁰ While the purpose of the report was to disclose an additional conflict, it correctly reflected the “non-public” classification.¹⁴¹ Later that month, in an unrelated arbitration matter, Malone's counsel received a letter informing him that the arbitrator had been misclassified.¹⁴² On the third hearing date, FINRA sent the parties another update disclosure similar to the first.¹⁴³ On July 31 – about one month after the award – Malone filed the petition to vacate as exceeding the panel's authority, asserting that the panel was improperly constituted.¹⁴⁴

The court noted that “[t]he Second Circuit has long held that a failure to make a timely objection to the selection of an arbitrator precludes a party from later vacating the arbitral award on the basis that the arbitrator was improperly chosen.”¹⁴⁵ This prevents parties from taking advantage of the process during arbitration, by not objecting and then getting another chance from the

¹³⁴*Malone v. Credit Suisse Securities. (USA), LLC*, No. 18 CV 6872, 2019 WL 463434, at *4 (S.D.N.Y. Feb. 5, 2019).

¹³⁵*Id.* at *1.

¹³⁶*Id.*

¹³⁷*Id.*

¹³⁸*Id.*

¹³⁹*Id.* at *2.

¹⁴⁰*Id.*

¹⁴¹*Id.*

¹⁴²*Id.*

¹⁴³*Id.*

¹⁴⁴*Id.*

¹⁴⁵*Id.* (citing *Cook Indus., Inc. v. C. Itoh & Co. (Am.) Inc.*, 449 F. 2d 106, 107-08 (2d Cir. 1971)).

courts.¹⁴⁶ Here, Malone waited until the last possible time to object the panel's composition though he knew or should have known about the misclassification for months.¹⁴⁷ It was not until one month after the panel denied all of Malone's claims that he filed a petition to vacate, although he and his attorney had been informed about the misclassification in three different ways before the final hearing and months before the decision.¹⁴⁸ Therefore, because Malone knew or should have known of the allegedly uncommunicated information before the panel's decision and continued to acquiesce to the panel's authority, he waived his argument about the composition of the panel.¹⁴⁹ As established in *Cook Industries*, the waiver rule applies if a party fails to timely act on known facts.¹⁵⁰

Stevens v. Jiffy Lube Int'l, 2018 WL 6802644 (9th Cir. Dec. 27, 2018)

Section 12 of the Federal Arbitration Act ("FAA") provides that a petition to vacate an arbitration award must be served upon the adverse party "within three months after the award is filed or delivered." But how should the three-month period be calculated in the absence of any language in the FAA? The Ninth Circuit answered that question in this case, holding that in the absence of any procedural language in the FAA on calculating time periods, Rule 6(a) of the Federal Rules of Civil Procedure ("FRCP") governs the calculation.¹⁵¹

The Stevenses were Jiffy Lube franchisees who filed a court action after Jiffy Lube terminated the franchise agreement.¹⁵² Because the franchise agreement required arbitration, the parties stipulated to dismissal in favor of arbitration. On September 14, 2016, the arbitrator issued an award in favor of Jiffy Lube.¹⁵³ On December 15, 2016, "[t]hree months and one day after [the] arbitrator ruled against them," the franchisees petitioned the United States District Court for the Northern District of California under § 10 of the FAA to vacate the arbitral award.¹⁵⁴ The district court "assumed without deciding" that the motion to vacate the arbitration award had been timely filed and denied the motion on the merits.¹⁵⁵

¹⁴⁶*Id.* at *2.

¹⁴⁷*Id.* at *3.

¹⁴⁸*Id.* at *2 and at *4.

¹⁴⁹*Id.* at *4.

¹⁵⁰*Id.*

¹⁵¹*Stevens v. Jiffy Lube Int'l Inc.*, 911 F.3d 1249, 1249 (9th Cir. 2018).

¹⁵²*Id.* at 1250.

¹⁵³*Id.*

¹⁵⁴*Id.*

¹⁵⁵*Id.* The franchisees then filed a motion attacking the judgment under Rules 59 and 60 of the FRCP, which the district court also denied. *Id.* Jiffy Lube initially challenged the timeliness of the appeal, arguing that the Stevens' motion under Rules 59 and 60 should not have tolled the 30-day time period to file an appeal because a judgment under § 13 of the FAA is not subject to those rules. The Ninth Circuit disagreed, holding that the time period for filing an appeal under Rule 4(a)(4) of the Federal Rules of Appellate Procedure "does not consider the propriety of a post-judgment motion." *Id.* at 1251.

The Ninth Circuit affirmed the district court's opinion denying the franchisees' motion to vacate, but on the grounds that the motion was untimely. The threshold question for the Ninth Circuit was whether the calculation of the FAA's "three month" period within which to file a motion to vacate is governed under the FAA or FRCP 6(a).¹⁵⁶ The Court explained that as a general rule, "the Federal Rules of Civil Procedure apply to FAA proceedings *unless the FAA* 'provide[s] other procedures' for calculating the 'within three months period.'"¹⁵⁷ On this issue, the FAA is silent and, as such, the calculation of the three month period is governed by FRCP 6(a), which provides three steps for computing periods:

- (A) exclude the day of the event that triggers the period;
- (B) count every day, including intermediate Saturdays, Sundays, and legal holidays; and
- (C) include the last day of the period, but if the last day is a Saturday, Sunday, or legal holiday, the period continues to run until the end of the next day that is not a Saturday, Sunday, or legal holiday.

Fed. R. Civ. P. 6(a)(1).¹⁵⁸

Petitioner franchisees disputed only the calculation at step two, arguing that three months from September 15 was December 15, not December 14. The Court disagreed, explaining that "a month beginning on the fifteenth concludes on the fourteenth of the following month – just as the month beginning January 1 concludes on January 31, not February 1; and just as the week beginning on Monday concludes on a Sunday, not the following Monday."¹⁵⁹ Concluding that the Stevenses were one day late, the Ninth Circuit did not reach the merits of the case.

IV. RECEIVER ACTION ON BEHALF OF DEFRAUDED INVESTORS

Interactive Brokers LLC v. Barry, as Receiver for Osiris Fund Ltd. Partnership, 457 N.J. Super. 357, 199 A.3d 829 (App. Div. 2018)

The Superior Court of New Jersey held that a court-appointed receiver over a defrauded hedge fund entity could pursue a FINRA arbitration case against a brokerage firm and its employee for aiding and abetting the fund's founder in a Ponzi scheme, even if the recovered assets would eventually benefit the fund's investors rather than the fund itself.¹⁶⁰

This case relates to the Ponzi scheme Peter Zuck orchestrated through hedge fund Osiris Fund Limited Partnership ("Osiris"). Zuck, a Middletown New Jersey resident, opened a securities trading platform at Interactive Brokers LLC through which he defrauded investors of more than \$6.5 million.¹⁶¹ The New Jersey Attorney General brought suit against Zuck and Osiris and, in that

¹⁵⁶*Id.* at 1252.

¹⁵⁷*Id.* (quoting FRCP 81(a)(6)(B))(emphasis in original).

¹⁵⁸*Id.* (quoting FRCP 6(a)).

¹⁵⁹*Id.* (citing *Minasyan v. Mukasey*, 553 F.3d 1224, 1227-28 (9th Cir. 2009)).

¹⁶⁰*Interactive Brokers LLC v. Barry, ex rel. Osiris Fund Ltd. P'ship*, 457 N.J. Super. 357, 364, 199 A.3d 829, 833 (App. Div. 2018).

¹⁶¹*Id.* at 830.

action, the court appointed Richard Barry as Receiver over Osiris, authorizing him to exercise all powers under N.J.S.A. 49:3-69(c) and (d), and N.J.S.A. 14A:14-1 [to -27].¹⁶²

After his appointment, the Receiver brought a FINRA arbitration action against Interactive Brokers and one of its employees, Kevin Michael Fischer, who had allegedly assisted Zuck in using Interactive Brokers' platform. Among other claims, the Receiver alleged that Interactive Brokers and Fischer aided and abetted Zuck's fraud.¹⁶³ The Receiver asserted that its claims against Interactive Brokers and Fischer were subject to FINRA arbitration under the customer agreement between Osiris and Interactive Brokers.¹⁶⁴

Interactive Brokers and Fischer filed a declaratory and injunctive action in the Chancery Division seeking a declaration that the Receiver's FINRA claims were "beyond his powers in the appointment order;" and injunctive relief to halt the FINRA arbitration.¹⁶⁵ Interactive Brokers argued that the claims were beyond the Receiver's authority because the claims were based "on the damages incurred by Osiris's investors, rather than Osiris itself."¹⁶⁶ In response, the Receiver "moved to compel arbitration and dismiss the complaint."¹⁶⁷ The Chancery judge denied plaintiffs' application for an injunction, granted the Receiver's cross-motion to compel FINRA arbitration and dismissed the complaint, finding that the Receiver's claims were brought on behalf of the Osiris fund itself, not the fund's investors, that the Receiver's authority to file a FINRA claim was authorized by his appointment, and that the Receiver's claims arose from a dispute between Osiris and Interactive Brokers, and thus were required to be resolved in arbitration.¹⁶⁸

On appeal, the superior court held that although the Receiver's authority is limited to bringing claims on behalf of Osiris, in this case the authority "was properly wielded here."¹⁶⁹ In addressing the Receiver's capacity to redress injuries to investors incurred through a Ponzi scheme, the court examined decisions issued by the Seventh and Sixth Circuits, both of which rejected arguments that the receiver lacked authority because the claims would ultimately benefit investors.¹⁷⁰

¹⁶²*Id.* at 830-31. Specifically, the statutory power vested in the Receiver authorized him to "sue for, collect, receive and take into his possession . . . choses in action . . . derived by means of any practice constituting a violation of this act . . ." *Id.* at 830 n.1.

¹⁶³*Id.* at 831. The Receiver brought claims against the firm and employee for: (1) negligence and/or failure to supervise; (2) "breach of implied/express contract, implied duty of good faith and fair dealing and industry rules;" (3) aiding and abetting breach of fiduciary duty; (4) aiding and abetting common law fraud; (5) unsuitability; (6) fraudulent conveyance; and (7) unjust enrichment. *Id.*

¹⁶⁴*Id.*

¹⁶⁵*Id.*

¹⁶⁶*Id.*

¹⁶⁷*Id.* at 831-32.

¹⁶⁸*Id.* at 832.

¹⁶⁹*Id.*

¹⁷⁰*Id.* at 832-33 (*quoting Scholes v. Lehman*, 56 F.3d 750, 753-55 (7th Cir. 1995) (even though corporate entities were "robotic tools" created by the Ponzi scheme operator, they were nevertheless legal entities now "controlled by a receiver whose only object is to maximize the value of the corporations for the benefits of their investors and any creditors") and *Wuliger v. Mfrs. Life In. Co.*, 567 F.3d 787, 795 (6th Cir.

The superior court similarly rejected plaintiffs' claim, concluding that "[t]he Receiver cannot be deprived of standing to pursue Osiris's legal remedies" just because Osiris's investors will be the "recipients of the recovered assets."¹⁷¹ "Here, the [Statement of Claim] lists Osiris as its sole claimant . . . it charges plaintiffs with aiding and abetting Zuck in his fraudulent conduct and details their substantial participation in the wrongdoing. These are claims that belong to Osiris, which was harmed when its funds were removed for unauthorized purposes."¹⁷²

The court also granted *de novo* review on the issue of arbitrability of the Receiver's claims, and held that the claims were subject to FINRA arbitration because (1) Osiris is the customer under the customer agreement with Interactive Brokers, and (2) the Receiver brought claims on Osiris's behalf, not on behalf of the investors.¹⁷³ The dispute therefore fell within the parties' agreement providing for mandatory arbitration to resolve "any' dispute or claims arising between Osiris and plaintiffs . . ."¹⁷⁴

V. THE LIMITS OF FINRA ARBITRATION OVER MEMBER'S OTHER BUSINESS ACTIVITIES

Pictet Overseas Inc. v. Helvetia Trust, 905 F.3d 1183 (11th Cir. 2018)

The Eleventh Circuit affirmed the district court's decision granting an injunction of a FINRA arbitration action brought by two investment trusts against a Canadian broker-dealer because the claims did not arise in connection with the broker-dealer activities.¹⁷⁵ Specifically, the Eleventh Circuit held that Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes only requires an associated person to arbitrate before FINRA if the dispute arises in connection with the business activities of an associated person in his or her capacity as an associated person.¹⁷⁶ The Eleventh's Circuit's broad pronouncement in this decision is sure to be increasingly relied on by counsel on both sides of the aisle to define the parameters of FINRA's reach.

The dispute arose after two investments trusts, Helvetia Trust and AAA Group International Trust (the "Trusts"), hired an independent asset manager to invest their funds. The asset manager

2009) (upholding the receiver's authority to bring claims that would ultimately benefit investors, the Sixth Circuit explained "that is precisely the purpose of a receiver: to marshal the receivership entities' assets, to which several parties assert conflicting claims, so that the assets may be distributed to the injured parties in a manner the court deems equitable.")). The Superior Court also cited the following cases from the Third and Ninth Circuits reaching similar conclusions: *Donell v. Kowell*, 533 F.3d 762, 777 (9th Cir. 2008); *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 348-49 (3d Cir. 2001); *SEC v. Hardy*, 803 F.2d 1034, 1038 (9th Cir. 1986).

¹⁷¹*Id.* at 833.

¹⁷²*Id.*

¹⁷³*Id.*

¹⁷⁴*Id.*

¹⁷⁵*Pictet Overseas Inc. v. Helvetia Trust*, 905 F.3d 1183 (11th Cir. 2018).

¹⁷⁶*Id.* at 1188.

opened custodial accounts with Banque Pictet, a Swiss Bank, which is owned by eight individuals and several corporate entities, including Pictet Overseas, Inc. (“Pictet”), a Canadian broker-dealer and FINRA member.¹⁷⁷ After the asset manager absconded with more than \$1.8 million of the Trusts’ funds, the Trusts brought a FINRA action against Pictet and its partners alleging, among other things, that the Partners aided and abetted the asset manager’s fraud.¹⁷⁸ The Trusts argued that Pictet “was essential to the arbitrability of the Trusts’ claims before FINRA because – unlike Banque Pictet and the Partners – Pictet is a member of FINRA and thus subject to its mandatory arbitration provision” under FINRA Rule 12200.¹⁷⁹

Pictet and the Partners filed suit in District Court for the Southern District of Florida to enjoin the arbitration, arguing that even if Rule 12200 required Pictet Overseas or the Partners “to arbitrate certain claims before FINRA, it did not require Pictet or the Partners to arbitrate the Trusts’ claims.”¹⁸⁰ After a bench trial, the district court enjoined the FINRA arbitration on the grounds that the Trusts had failed to establish that the Trusts were “customers” of Pictet, or that the Trusts’ claims arose in connection with the member’s, or the associated person’s, business activities as required under Rule 12200.¹⁸¹ The Trusts appealed.

On appeal, the Eleventh Circuit noted that there was no written agreement between the Trusts and Pictet and the Partners to arbitrate disputes before FINRA.¹⁸² Notwithstanding the lack of a written agreement between the parties, Pictet could still be compelled to arbitrate by virtue of its membership agreement with FINRA.¹⁸³ As a FINRA member, Pictet is subject to FINRA rules, including its obligation to arbitrate under Rule 12200 “when it is ‘[r]equested by a customer,’ ‘[t]he dispute is between a customer and a member or associated person of a member,’ and ‘[t]he dispute arises in connection with the business activities of the member or associated person.’”¹⁸⁴

The Eleventh Circuit noted that it did not need to consider whether the Trusts were “customers” of Pictet or the Partners, or whether the Partners were “associated persons” of Pictet (two arguments the Trusts raised below, rejected by the district court), because the it found that the Trusts claims “did not arise in connection with [Pictet’s] or the Partners’ business activities.”¹⁸⁵

¹⁷⁷*Id.* at 1185. Pictet is an execution broker and does not hold funds or securities for its clients. *Id.* at 1186.

¹⁷⁸*Id.* at 1185-86.

¹⁷⁹*Id.* at 1185.

¹⁸⁰*Id.*

¹⁸¹*Id.* at 1186-87. See also *Pictet Overseas Inc. v. Helvetia Trust*, No. 13-81088-CIV-MARRA/MATTHEWMAN, 2017 WL 10403345, at *8 (S.D. Fla., April 14, 2017).

¹⁸²*Pictet*, 905 F.3d at 1187.

¹⁸³*Id.*

¹⁸⁴*Id.* (quoting Rule 12200).

¹⁸⁵*Id.* at 1188.

The appellate court explained that the Trusts did not contend that the dispute had any connection to Pictet's business activities, but instead assert that the dispute is arbitrable "because it arose in connection with the business activities of the Partners who, the Trusts claim, are associated persons of [Pictet]."¹⁸⁶ The Trusts and Pictet disagreed about the type of connection a dispute must have to satisfy Rule 12200. The Trusts took the position that a dispute arising out of any business activity of an associated person would be covered by Rule 12200.¹⁸⁷ Pictet argued that only disputes arising out of business activities of an associated person *as an associated person* are covered."¹⁸⁸

The Eleventh Circuit agreed with Pictet, reasoning that Rule 12200 was intended to bind a FINRA member's associated persons to arbitrate only when the dispute arises in connection with the business activities of the associated person *as an associated person* of the FINRA member.¹⁸⁹ The Court explained that "FINRA and its members could not have intended to require FINRA arbitration of any claim that arose out of activities of the associated person that are unrelated to his or her relationship with the FINRA member."¹⁹⁰ By way of example, the Court explained that if an associated person, who is also a real estate agent, was involved in an auto accident while driving a real estate client to see a home, under the Trusts' interpretation the real estate client could sue the real estate broker in FINRA arbitration solely because of the associated person status – yet the underlying suit would have nothing to do with the business activities of a FINRA member.¹⁹¹

In this case, the Eleventh Circuit assumed for purposes of the appeal that the Partners qualified as "associated persons" of Pictet, but nevertheless concluded that the dispute was non-arbitrable because it did not arise out of the Partners' business activities as associated persons of Pictet.¹⁹²

This Eleventh Circuit decision will be relied on by counsel on both sides of the aisle to define the parameters of FINRA's ability to include non-FINRA members firms, affiliated banks, or foreign entities under FINRA's purview. In the Eleventh Circuit, parties attempting to compel non-FINRA members to arbitrate before FINRA will need to make a direct connection between the dispute and the business activity.

INTL FCStone Financial, Inc. v. Johnson, Case. No. 19 C 1438, 2019 WL 2356989 (N.D. Ill. June 4, 2019)

The central issue in this case is whether customers who opened commodities trading accounts at INTL FCStone Financial, Inc. ("FCStone"), a global financial services firm that registered as a futures commission merchant with the National Futures Association ("NFA") and as a broker-

¹⁸⁶*Id.*

¹⁸⁷*Id.*

¹⁸⁸*Id.*

¹⁸⁹*Id.*

¹⁹⁰*Id.* at 1189.

¹⁹¹*Id.*

¹⁹²*Id.* at 1190.

dealer member of FINRA, could compel FCStone to arbitrate its disputes before FINRA. The District Court for the Northern District of Illinois concluded that the customers could not compel FINRA arbitration under Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes because, among other things, “customer” under that rule means “customer of the member’s FINRA-regulated activities.”¹⁹³

Between October 2016 and July 2018, Defendants opened commodities accounts at FCStone’s futures commission merchant division; the accounts did not permit them to trade securities.¹⁹⁴ Most of the defendants also signed customer agreements with FCStone that contained an arbitration clause providing a process for arbitration before the NFA or another forum chosen by FCStone.¹⁹⁵ After their accounts suffered significant losses, some of the defendants initiated an arbitration action against FCStone alleging, among other things, that FCStone violated § 13(a) of the Commodity Exchange Act.¹⁹⁶ FCStone, in turn, filed an arbitration action before the NFA to collect the account balances due from defendants.¹⁹⁷ After additional defendants filed claims in FINRA arbitration, FCStone filed an action in district court for injunctive and declaratory relief seeking to compel defendants to arbitrate their disputes before the NFA. Defendants filed cross-motions to dismiss and for Rule 11 sanctions.¹⁹⁸

The district court first discussed the issue of subject matter jurisdiction, since § 4 of the FAA – which governs petitions to compel arbitration – does not itself confer jurisdiction.¹⁹⁹ Since FCStone did not plead sufficient facts to establish diversity jurisdiction, the district court considered subject matter jurisdiction under 28 U.S.C. § 1331 (federal question jurisdiction), and held that “[b]ecause all the underlying disputes include claims under § 13(a) of the Commodity Exchange Act, 7 U.S.C. § 13c(a), the disputes present federal questions and this court has jurisdiction.”²⁰⁰

Turning to the merits, the district court first observed that the issue of *where* to arbitrate is an issue of arbitrability, not procedure, and therefore squarely an issue for the court.²⁰¹ The fact that no party proposes litigation and that all agree on arbitration “is irrelevant” because the court must

¹⁹³*INTL FCStone Financial, Inc. v. Johnson*, Case. No. 19 C 1438, 2019 WL 2356989, at *8 (N.D. Ill. June 4, 2019).

¹⁹⁴*Id.* at *1.

¹⁹⁵*Id.* at *1-2.

¹⁹⁶*Id.* at *2.

¹⁹⁷*Id.* Some of the defendants had also filed claims before the AAA, and at some point during the briefing of the pending motions counsel for all defendants notified FCStone that all his clients elected to arbitrate before the AAA. However, the AAA found that FCStone had not agreed to arbitrate before the AAA and dismissed the claims. *Id.* at 2. After failing in their attempts to arbitrate before the AAA, these defendants also filed FINRA arbitration claims.

¹⁹⁸*Id.*

¹⁹⁹*Id.* at *3.

²⁰⁰*Id.*

²⁰¹*Id.* at *4.

review the arbitration agreements to determine where the parties in fact agreed to arbitrate.²⁰² In this case, the court must decide whether (1) defendants agreed to submit this case to the NFA, and (2) FCStone agreed to submit the disputes to FINRA.²⁰³ Moreover, because there are two competing arbitrations, the court reasoned that it would abdicate its responsibility under § 4 of the FAA if it withheld consideration until after arbitration.²⁰⁴

On the first issue, the court reviewed the arbitration agreement between defendants and FCStone, and concluded that defendants agreed to submit their arbitration to the NFA. The arbitration agreement between defendants and FCStone required that the customer notify FCStone of an intent to arbitrate and, upon notice of an intent to arbitrate, FCStone provide the customer with a choice among three forums.²⁰⁵ FCStone provided three choices (the NFA, Chicago Mercantile Exchange, and the AAA) and defendants either failed to choose within the 45 day period specified in the arbitration agreement or rejected the choices by filing an arbitration in FINRA.²⁰⁶ Rejecting the other arguments defendants raised on the interpretation of the arbitration agreement, the district court held that “defendants agreed to submit their disputes to the NFA.”²⁰⁷

The court next turned to the issue of whether FCStone is nevertheless required to arbitrate before FINRA under Rule 12200, which requires FINRA members to arbitrate before FINRA if “[r]equested by the customer” and the “dispute arises in connection with the business activities of the member or the associated person . . .”²⁰⁸ The district court stated that the case turned on whether defendants were “customers” under Rule 12200, even though they did not transact with FCStone any FINRA-regulated activities.²⁰⁹ Noting that the underlying disputes concern accounts and transactions of commodity futures, and that defendants were not even authorized to trade securities through their FCStone accounts, the district court held that “[d]efendants’ relationships and disputes with FCStone do not fall within FINRA’s regulatory ambit.”²¹⁰ The district court also explained that “this interpretation of FINRA rules harmonizes the rules with the carefully hewn balance between SEC and CFTC regulatory authority,” because if it read the rules to *require*

²⁰²*Id.*

²⁰³*Id.*

²⁰⁴*Id.* at *5.

²⁰⁵*Id.*

²⁰⁶*Id.*

²⁰⁷*Id.* at *5-6.

²⁰⁸*Id.* at *6 (quoting FINRA Rule 12200).

²⁰⁹*Id.* at *7.

²¹⁰*Id.* The district court relied on *UBS Fin. Servs., Inc. v. Carillion Clinic*, 706 F.3d 319, 325 (4th Cir. 2013) (“[T]he FINRA Rules do give an informing context by providing that arbitrable disputes must arise in connection with the ‘business activities’ of the FINRA member, thus suggesting that for a person to obtain arbitration, the person must be a customer with respect to a FINRA member’s business activities.”), and observed that the *Carillion* definition of customer had also been adopted by the Ninth Circuit in *Goldman, Sachs & Co. v. City of Reno*, 747 F.3d 733, 741 (9th Cir. 2014). The court noted that the Seventh Circuit had not addressed this issue, and found these other decisions persuasive. *FCStone*, 2019 WL 2356989, at *7.

dually-registered companies to provide FINRA as an option, CFTC Rule 166.5 (allowing its members to offer three arbitral forum choices) “would have no effect as to some of the largest participants in CFTC-regulated markets.”²¹¹

The district court held that “‘customer’ under FINRA Rule 12200 means ‘customer of the member’s FINRA regulated activities,’” and granted FCStone’s motion to compel arbitration.²¹²

VI. DISCOVERY IN ARBITRATION

Next Level Plan. & Wealth Mgmt., LLC v. Prudential Ins. Co. of Am., No. 18-MC-65-PP, 2019 WL 1466049 (E.D. Wis. April 3, 2019)

This case arose out of non-party efforts to quash a discovery subpoena issued by a FINRA arbitrator in a dispute between Prudential Insurance Company of America (“Prudential”) and two of its former brokers. The District Court for the Eastern District of Wisconsin joined the growing majority of Circuit Courts in holding that arbitrators do not have authority under § 7 of the FAA to issue a discovery subpoena to a third party for the production of documents.²¹³

Two brokers previously affiliated with Prudential joined LPL Financial, LLC, the broker-dealer affiliated with Next Level Planning and Wealth Management, LLC (“Next Level”).²¹⁴ About two weeks after their departure, on October 30, 2017, Prudential initiated a FINRA arbitration against the two brokers and Next Level alleging violations of the non-solicitation of customer clauses in their employment agreements with Prudential.²¹⁵ Next Level is not a FINRA member, however, and refused to consent to FINRA jurisdiction.²¹⁶ At Prudential’s request, the FINRA arbitrator issued a non-party subpoena *duces tecum* to Next Level, ordering it “to appear telephonically at an evidentiary hearing . . . [and] also requir[ing] [it] to produce documents within its possession, custody or control in response” to the attached schedule, within thirty days of its receipt of the subpoena.”²¹⁷ Next Level filed the district court action seeking to quash the subpoena; Prudential filed a cross-claim to enforce it.²¹⁸

Before addressing the merits of the case, the Magistrate Judge first considered subject matter jurisdiction, noting that an action regarding enforcement of an arbitrator’s subpoena typically

²¹¹*Id.*

²¹²*Id.* at *8.

²¹³*Next Level Plan. & Wealth Mgmt., LLC v. Prudential Ins. Co. of Am., No. 18-MC-65-PP, 2019 WL 1466049 (E.D. Wis. April 3, 2019) (adopting Magistrate Judge’s Order Denying Petition to Enforce Arbitrator’s Subpoena, 2019 WL 585672 (E.D. Wis. Feb. 13, 2019) (hereafter, “Magistrate’s Order”)).*

²¹⁴Magistrate’s Order, 2019 WL 585672, at *1.

²¹⁵*Id.*

²¹⁶*Id.*

²¹⁷*Id.* at 5.

²¹⁸*Id.* at 1.

arises under § 7 of the FAA, which provides a mechanism for *enforcement* of a subpoena.²¹⁹ Here, Next Level filed a declaratory action seeking a declaration that the subpoena *duces tecum* is invalid.²²⁰ Since the magistrate had concluded (after a hearing) that venue was proper based on the location of the arbitration hearing, the Magistrate Judge was satisfied that venue was proper regardless of whether the action was construed as a declaratory action or an action under § 7.²²¹ The court also considered whether it had federal subject matter jurisdiction, which is not conferred by either the FAA or the Declaratory Judgement Act.²²² After noting that there was complete diversity of citizenship between the parties, and that the amount in controversy (at least from Prudential's perspective) exceeded \$75,000, the court was satisfied that it had proper subject matter jurisdiction.²²³

Turning to the merits of the case, the Magistrate Judge observed that an arbitrator's authority to issue a subpoena is governed by § 7 of the FAA.²²⁴ The clear language of § 7 grants an arbitrator the authority to "compel a non-party witness to appear at a hearing and to bring documents with him."²²⁵ However, the circuit courts of appeal are split on the issue of whether § 7 granted an arbitrator authority to issue a discovery subpoena compelling a non-party to produce documents in advance of a hearing.²²⁶ Both the Sixth and Eighth Circuits have held that an arbitrator has the has implicit authority under § 7 to compel non-parties to produce documents prior to a hearing.²²⁷

However, the Second, Third, and Fourth Circuits have disagreed with the "power-by-implication analysis," reasoning that by expressly conferring the power to compel non-party witnesses to appear and produce at the arbitration hearing, the FAA "implicitly withholds the latter power."²²⁸ Although the Seventh Circuit has not yet addressed the question, the Magistrate Judge noted that

²¹⁹*Id.*

²²⁰*Id.*

²²¹*Id.*

²²²*Id.* at 2.

²²³*Id.*

²²⁴*Id.* at 3 (citing 9 U.S.C. §7).

²²⁵*Id.*

²²⁶*Id.*

²²⁷*Id.* (quoting *Am. Fed'n of TV and Radio Artists v. WJBK-TV*, 164 F.3d 1004, 1009 (6th Cir. 1999) ("the FAA's provision authorizing an arbitrator to compel the production of documents from third parties for purposes of an arbitration hearing has been held to implicitly include the authority to compel the production of documents for inspection by a party prior to the hearing") and *Sec. Life Ins. Co. of Am. v. Ducanson & Holt (in Re Sec. Life Ins. Co. of Am.)*, 228 F.3d 865, 870-71 (8th Cir. 2000) ("implicit in an arbitration panel's power to subpoena relevant documents for production at a hearing is the power to order the production of relevant documents for review by a party prior to the hearing.")).

²²⁸*Id.* (quoting *Hay Grp., Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404, 40 (3d Cir. 2004)). The Magistrate Judge observed that the Second and Fourth Circuits had reached the same conclusion. *Id.* at 4 (citing *Life Receivables Tr. v. Syndicate 102 at Lloyd's of London*, 549 F.3d 210, 216 (2d Cir. 2008); *COMSAT Corp. v. NSF*, 190 F.3d 269, 276 (4th Cir. 1999)).

district courts within the circuit have agreed with the Second and Third Circuits.²²⁹ The Magistrate Judge reasoned that “[i]n the face of an unambiguous statute, it is inappropriate for a court to read in an implied power simply because in the court’s judgment it may make good sense to include such authority.”²³⁰

Although the subpoena at issue compelled Next Level to attend an evidentiary hearing at a time and date to be determined by the arbitrator, it also compelled Next Level to produce documents within thirty days – independent of its obligation to attend the hearing.²³¹ As such, the Magistrate Judge denied Prudential’s petition to enforce the subpoena and dismissed the action.²³² In its Order adopting the Magistrate Judge’s recommendation and dismissing case, the district court held that the Magistrate’s Judge’s reasoning was adopted by three appellate courts, followed by other district courts in the Seventh Circuit, and “based on a reading of the plain language of the FAA.”²³³

To date, the Second, Third, Fourth, and Ninth Circuits have all concluded that the FAA does not grant arbitrators the power to compel production of documents from third parties outside of an arbitration hearing.²³⁴ The Eighth Circuit has taken a broader view, reasoning that while § 7 does not explicitly authorize the arbitration panel to order the production of documents for inspection by a party, the power is implicit because it facilitated efficient resolution of disputes.²³⁵

²²⁹*Id.* at 4 (citing *Ware v. C.D. Peacock, Inc.*, No. 10 C 2587, 2010 WL 1856021, at *2-3 (N.D. Ill. May 7, 2010); *Matria Healthcare, LLC v. Duthie*, 583 F. Supp. 2d 1078, 1083 (N.D. Ill. 2008)).

²³⁰*Id.* at 4.

²³¹*Id.* at 5.

²³²*Id.* at 6.

²³³ 2019 WL 1466049, at *2.

²³⁴ See *Life Receivables Tr. V. Syndicate 102 at Lloyd’s of London*, 549 F.3d 210, 215-16 (2d Cir. 2008); *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404, 407 (3d Cir. 2004), *COMSAT Corp. v. Nat’l Sci. Found.*, 190 F.3d 269, 275 (4th Cir. 1999); and *CVS Health Corp. v. Vividus, LLC*, 878 F.3d 703, 705 (9th Cir. 2017).

²³⁵*In re Security Life Insurance Co.*, 228 F.3d 865 (8th Cir. 2000).

HIGH-RISK BROKER REGULATION & ENFORCEMENT

Scott Eichhorn

Brokers with a history of repeat offenses are much more likely to harm investors again. More than a mere supposition, this assertion finds supporting data in multiple studies.

Equipped with this information, regulators in recent years have taken renewed notice of the threats posed by recidivist brokers, fine tuning and expanding on existing rules, proposing new rules, and reshaping the resources dedicated to protecting investors from high-risk brokers.

What are the chief considerations guiding the new regulatory efforts to target bad brokers? How does the focus on high-risk brokers achieve investor-protection goals or influence the behavior of broker-dealers? What is the outlook for further development of the regulatory landscape?

Background and History

The problem of high-risk brokers is not in any way a new phenomenon or new area of concern for FINRA.¹ FINRA has long recognized that “high-risk brokers cause outsized risk to investors”.² For example, the NASD issued guidance on heightened supervision of recidivist brokers as early as 1997. More recently, in each of its regulatory and examination priorities letters since 2014, FINRA has highlighted high-risk brokers, risk-based examinations, or the related notion of “firm culture”.

Three studies first released in the years 2015 and 2016 offer data and analysis supporting the assertion that high-risk brokers are more likely to harm investors and that firm culture and coworker misconduct increased the likelihood of a broker causing investor harm. These studies analyzed information available through BrokerCheck to determine correlation of misconduct to future investor harm.

In 2015, a study published as a working paper by the FINRA Office of the Chief Economist found that brokers in the highest 20 percent of those with “harm events” (customer complaints resulting in a settlement or arbitration award) cause 55 percent of harm events for a given year on average. The authors based the study on a review of data for the years 2000 to 2013 and found that 1.3 percent of all brokers had at least one investor harm event.³ (For online data reliability reasons, this study excluded brokers first registered before 2000.)

A 2016 study found that almost five percent of all brokers for the years 2000 to 2014 – regardless of the year of initial registration – had at least one harm event and that the highest-risk quintile of brokers for a particular year accounts for approximately 70 percent of all brokers that commit

¹See NASD Notice to Members 97-19.

²FINRA Regulatory and Examinations Priorities Letter (Jan. 6, 2015), at p. 9.

³Hammond Qureshi & Jonathon S. Sokobin, *Do Investors Have Valuable Information About Brokers?* (FINRA Office of the Chief Economist, Aug. 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2652535.

harm events in the subsequent year.⁴ The highest-risk quintile in this study used factors specific to the individual, as well as factors relating to coworker misconduct.

A 2016 study circulated as a National Bureau of Economic Research working paper found that more than seven percent of all brokers over the period of years from 2005 to 2015 had at least one disclosure indicative of “misconduct” (defined more broadly than “harm events” in the 2015 study). The authors also surmised that brokers that engage in misconduct in a given year are almost 20 times more likely than the average broker to engage in misconduct in the subsequent year and that the increased likelihood of misconduct remains elevated for several years.⁵

In 2013, FINRA launched its High Risk Broker Initiative to identify brokers with a pattern of complaints or sales-practice disclosures. In 2014, FINRA created a dedicated Enforcement team as part of its High Risk Broker program. In its regulatory and examination priorities that year, FINRA highlighted its expanded use of analytics and its review of firms’ due diligence on prospective hires identified as high-risk brokers.

Another program currently in place to prevent and deter harm by high-risk brokers is the High-Risk Registered Representative (“HRR”) Program within the FINRA Department of Member Regulation. The HRR program includes a specialized High-Risk Registered Representative Examination Unit to identify, monitor, and examine activities of high-risk brokers. Examiners use quantitative and qualitative review of various criteria and disclosures to create a list of high-risk brokers on an annual basis. During firm examinations, FINRA examiners will notify the firm if it employs an individual deemed to be “high risk” and will conduct a targeted examination of that individual.⁶

In a June 2017 speech at Georgetown University titled “Protecting Investors From Bad Actors”, FINRA President and CEO Robert Cook outlined the regulatory programs in place and under development, including efforts to reinforce FINRA’s focus on high-risk brokers and firms with more targeted efforts for identification and supervision of brokers and firms that pose the highest threat to investors. Since then, FINRA has proposed multiple amendments and rule proposals focused on high-risk brokers and firms, including several measures aimed to prevent the harm caused by high-risk brokers.

FINRA Regulatory Notice 19-17: Restricted Firm Obligations

FINRA’s most recent rulemaking action on high-risk brokers is proposed Rule 4111 (Restricted Firm Obligations), which would permit FINRA to impose restrictions on firms that meet certain threshold criteria relating to high-risk brokers.⁷ The criteria draw on the studies and data that suggest that brokers and firms with a history of misconduct pose a far greater risk of ongoing and future harm to investors.

⁴Craig McCann, Chuan Qin & Mike Yan, How Widespread and Predictable is Stock Broker Misconduct? (June 9, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2768942.

⁵Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct* (Sep. 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170.

⁶See “Finra makes it list to target hundreds of rogue individuals”, Investment News (May 17, 2019) <https://www.investmentnews.com/article/20190517/FREE/190519929/finra-makes-its-list-to-target-hundreds-of-rogue-individuals>.

⁷See FINRA Regulatory Notice 19-17.

In short, the proposed new rule seeks to set objective criteria to identify firms that raise “investor-protection concerns substantial enough to require that it be subject to additional obligations.” FINRA may then impose obligations on those firms that include a requirement to maintain a deposit of cash or qualified securities or conditions or restrictions on a firm’s operations, subject to the firm’s opportunity to consult with FINRA and to request a hearing on the imposed obligations in an expedited proceeding. By means of the required deposit, FINRA intends to incentivize firms to enhance scrutiny of high-risk brokers in the process of both hiring and supervision. Proposed Rule 4111 envisions a multi-step process for identification and oversight of “Restricted Firms”.

First, the Department of Member Supervision (the “Department”) would calculate on an annual basis the score of the firm in six categories to determine whether the firm meets the “Preliminary Criteria for Identification”:

1. Registered Person Adjudicated Events;
2. Registered Person Pending Events;
3. Registered Person Termination and Internal Review Events;
4. Member Firm Adjudicated Events;
5. Member Firm Pending Events; and
6. Registered Person Associated with Previously Expelled Firms.⁸

The Department would then evaluate the firm’s scores against the “Preliminary Identification Metrics Threshold”, which sets numeric thresholds for each of the six categories. The numeric thresholds vary by the size of the firm.⁹ For the first five categories, the proposed metrics are in the form of an average number of events per registered broker (sum of events divided by registered brokers). For the sixth category, the proposed metric is in the form of a percentage concentration of registered brokers associated with expelled firms.

Firm Size Category	Number of Registered Persons In-Scope in Firm Size Category	Preliminary Identification Metrics Thresholds					
		Thresholds for Registered Person Event Metrics:			Thresholds for Member Firm Event Metrics:		Threshold for Expelled Firm Association Metric:
		Registered Person Adjudicated Event Metric	Registered Person Pending Event Metric	Registered Person Termination and Internal Review Event Metric	Member Firm Adjudicated Event Metric	Member Firm Pending Event Metric	Expelled Firm Association Metric
		(1)	(2)	(3)	(4)	(5)	(6)
1	1-4	0.50	0.20	0.10	0.75	0.25	0.75
2	5-9	0.30	0.20	0.10	0.30	0.10	0.50
3	10-19	0.20	0.10	0.10	0.30	0.05	0.50
4	20-50	0.20	0.10	0.10	0.20	0.02	0.50
5	51-150	0.20	0.05	0.10	0.15	0.01	0.25
6	151-499	0.15	0.05	0.10	0.10	0.01	0.10
7	500+	0.10	0.05	0.10	0.05	0.01	0.05

⁸Rule 4111(b); see FINRA Regulatory Notice 19-17, footnotes 16-21, at pp.39-40, for definitions of each category.

⁹See Proposed Rule 4111(i)(11) for firm size categories and Preliminary Identification Metrics Thresholds.

When a firm meets the threshold for two or more categories for its size (and one of the categories is for adjudicated events), the Department would conduct an internal evaluation to determine whether information known to the Department shows that the firm – despite meeting the “Preliminary Criteria for Identification” – does not pose a high degree of risk. If the Department determines that the firm warrants further review, the firm would have a one-time opportunity to reduce its number of associated persons to no longer meet the criteria within 30 days.

Attachment D to Regulatory Notice 19-17 shows that around two percent of firms would have met the “Preliminary Criteria for Identification” in previous years¹⁰:

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification	
		Number of Firms	Percentage of FINRA Registered Member Firms
2013	4,140	89	2.1%
2014	4,068	98	2.4%
2015	3,941	86	2.2%
2016	3,835	67	1.7%
2017	3,721	60	1.6%
2018	3,582	61	1.7%

Second, the Department would next determine the firm’s maximum “Restricted Deposit Requirement” based on the firm’s size, operations, and financial conditions, as well as factors such as the nature of the events counted toward the numeric threshold, the amount of pending arbitration claims or unpaid awards, and concerns raised during FINRA exams. The Department would not follow any specific formula but would aim for a significant enough amount to change the firm’s behavior without forcing the firm out of business.

Third, the Department would consult with the firm to provide the firm an opportunity to rebut two presumptions: (1) that the firm should be designated as a “Restricted Firm”, and (2) that the firm should be subject to the maximum “Restricted Deposit Requirement”.¹¹

Fourth, within 30 days of the Consultation, the Department would render a decision as to designation of the firm as a “Restricted Firm” and the amount of the firm’s “Restricted Deposit Requirement”. The firm would not be able to access the funds set aside without first obtaining permission from the Department. The decision would also include any necessary or appropriate

¹⁰According to FINRA, 90 to 94 percent of these firms were small, four to ten percent were mid-sized, and zero to two percent were large.

¹¹Proposed Rule 4111(d).

conditions or restrictions on the firm's operations and activities to address concerns raised by the "Preliminary Criteria for Identification". The firm would have an opportunity to request an expedited proceeding to contest the Department's decision.¹²

Limitations of Proposed Rule 4111

The effectiveness of the criteria in proposed Rule 4111 may be limited by the sufficiency of information available on the Central Registration Depository (CRD). Investor advocates have noted that routine expungement of disclosures may allow firms to avoid meeting the threshold criteria, and that the proposed rule may encourage firms to pursue expungement of broker disclosures more often. They have also noted that the proposed rule – despite the requirement for designated firms to set aside restricted funds – does very little to address the issue of unpaid arbitration awards.

Other Initiatives Relating to High-Risk Brokers

Consistent with its growing focus on high-risk brokers, FINRA released three regulatory notices relating to high-risk brokers in 2018, including proposed amendments to existing supervision rules.

Regulatory Notice 18-15: Heightened Supervision

In this notice, FINRA reiterated member firms' supervisory obligations regarding brokers with a history of past misconduct. The notice also provides guidance on implementation of heightened supervisory procedures, including recommendations for supervision of brokers with a history of misconduct.

Specifically, FINRA stated that a firm should routinely evaluate its supervisory procedures, taking into account each broker's activities and history, including, among other factors: customer-related regulatory actions, criminal matters, the firm's pre-hire investigation; internal investigations; internal discipline; regulatory discipline; arbitrations; customer complaints; and terminations for cause. Firms must then evaluate whether its standard supervisory procedures are adequate for problematic brokers or whether the firm should instead develop tailored heightened supervisory procedures.

FINRA identified two specific circumstances in which firms should make a heightened supervision determination: (1) heightened supervision of statutorily disqualified brokers during the eligibility review process, and (2) heightened supervision of brokers while a disciplinary case is on appeal.

Regulatory Notice 18-16: High-Risk Brokers

FINRA also proposed amendments to several rules in 2018 to enhance scrutiny of high-risk brokers. These amendments would allow imposition of conditions or restrictions on firms or brokers during the appeal of disciplinary matters and require firms to adopt heightened supervisory procedures for brokers while the appeal is pending. Similarly, the amendments would require firms to adopt heightened supervisory procedures for brokers during review of a broker's statutory disqualification.

¹²Proposed Rule 4111(e).

FINRA also proposed an amendment to require disclosure of firms subject to audio recording under Rule 3170 as “taping firms” on BrokerCheck reports. The recording condition applies to firms that have a certain percentage of brokers previously employed by a firm barred by FINRA or the SEC, depending on the size of the firm.¹³ The rule requires recording and review of all telephone conversations between brokers and existing or potential customers.

Finally, Regulatory Notice 18-16 proposed amending membership application rules to enhance scrutiny of individuals with criminal actions or specified risk events who seek to become owners, control persons, principals, or registered persons of a firm.

Regulatory Notice 18-17: Sanction Guidelines

FINRA revised its *Sanction Guidelines* to include customer complaints that resulted in a settlement or arbitration award as a factor in the disciplinary process. For disciplinary complaints filed since June 1, 2018, the *Sanction Guidelines* advise adjudicators to impose harsher sanctions when customer settlements and awards form a pattern with the firm’s or broker’s disciplinary history and violations.

¹³See Rule 3170(5)(A) for definition of “taping firm”.

RIA STANDARDS OF CONDUCT SURVEYING CALIFORNIA AND FLORIDA

Michael S. Edmiston¹ and Maria E. Vaz Ferreira²

Regulation of Registered Investment Advisers (“RIAs”) starts with the Investment Advisers Act of 1940 (“IAA”).³ The details are left to the states, and while most states have adopted at least part of the IAA addressing the regulation of RIAs in their Blue-Sky laws, there are key state-by-state differences in standards of conduct and available remedies.

This article focuses on California and Florida Blue Sky Laws and remedies available to investors related to RIA Standards of Conduct.⁴ California does not provide a direct remedy for a violation of its rules and regulations governing the activities of RIAs, but leaves room for creativity and thoughtful pleading. Florida is the most aggressive in protecting its citizens by giving them an across the board private cause of action for investment adviser abuses.

I. STANDARD OF CONDUCT UNDER CALIFORNIA’S ANTIFRAUD PROVISION & RELATED REGULATIONS

A. CALIFORNIA ANTIFRAUD STATUTE IN RELATION TO THE INVESTMENT ADVISER ACT OF 1940

California Corporations Code § 25235 adopts the four anti-fraud provisions of § 206(1)-(4) and also § 208(c) of the Investment Advisers Act of 1940. From there, the California Code of Regulations defines the type of conduct which is considered fraudulent and/or deceptive practice.

The four anti-fraud prohibitions of Cal. Corp. Code § 25235 makes unlawful for any investment adviser:

- (a) To employ any device, scheme, or artifice to defraud any client or prospective client.
- (b) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client.
- (c) Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client for whom he is acting as investment adviser, or, acting as broker for a person other than such client, knowingly to effect any

¹Michael S. Edmiston is an attorney with Jonathan W. Evans & Associates.

²Maria E. Vaz Ferreira is a St. John’s University School of Law student. She is expected to graduate from law school in 2021.

³15 U.S.C. § 80b-1 et seq.

⁴The Appendix provides a cross-reference of issues and applicable California and Florida rules.

sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the written consent of the client to such transaction.⁵

(d) To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The commissioner shall, for the purpose of this subdivision, by rule define and prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The “truth-in-title” section of § 25235 makes it unlawful for an investment adviser:

(e) To represent that he is an investment counsel or to use the name “investment counsel” as descriptive of his business unless his principal business consists of acting as investment adviser and a substantial part of his business consists of rendering investment advisory services on the basis of the individual needs of his clients.

The California Code of Regulations brings certain conduct within the meaning of fraudulent and deceptive practices proscribed by the anti-fraud statute.

Cal. Code Regs. tit. 10, § 260.235⁶ details the kinds of advertisements that are considered fraudulent, deceptive or manipulative, and are therefore a violation of investment adviser’s duties. The advertising prohibitions broadly include testimonials; past recommendations; charts and graphs; promises of free analysis of service unless actually free; and untrue statements of material fact. For each type of advertising prohibition, the Regulation provides exceptions and safe harbors.

Failure to disclose compensation schemes and conflicts of interests is also considered “fraudulent, deceptive or manipulative act” within the meaning of Section 25235 of the code, as per Cal. Code Regs. tit. 10, § 260.235.2.⁷

Cal. Code Regs. tit. 10, § 260.235.3(c) requires written disclosure and consent requirements for cross-agency transactions.⁸ The lack of disclosure is considered a “fraudulent, deceptive or manipulative act.” The cross-agency transaction rule is notable since it expressly does not relieve

⁵Most states remove this provision, which was not included in the Uniform Act. Robert N. Rapp, Blue Sky Regulation, Ch. 13, § 13.02 (Matthew Bender) (2019), <https://advance.lexis.com/api/permalink/385fbbd1-bf10-409d-899b-83ea4296d35c/?context=1000516>.

⁶Cal. Code Regs. tit. 10, § 260.235.

⁷Cal. Code Regs. tit. 10, § 260.235.2.

⁸Cal. Code Regs. tit. 10, § 260.235.3.

the adviser “from acting in the best interest of the advisory client” (or from any other disclosure obligations under California laws or regulations).⁹

Finally, Cal. Code Regs. tit. 10, § 260.235.4 attaches liability to failure to disclose material facts with respect to the financial condition or disciplinary history of the adviser that is likely to impact the ability of the adviser to meet the client’s obligations.¹⁰

B. CALIFORNIA STATUTES AND REGULATIONS ESTABLISHING ETHICAL PRINCIPLES OF CONDUCT

The California Corporations Code § 25238 gives the commissioner authority to prescribe rules designed to promote fair, equitable and ethical principles.¹¹

Accordingly, Cal. Code Regs. tit. 10, § 260.238 establishes the standards of conduct for investment advisers.¹² In substance, the regulation adopts the standards articulated in NASAA’s Model Act. However, in a uniquely California fashion, portions of the Model Act are omitted, others are modified, and one entire section is a California-specific creation. Paraphrased, the prohibited practices are:

- (a) Unsuitable investment recommendations;
- (b) Unauthorized trading;
- (c) Trading on the instruction of a third-party without a written grant of authority;
- (d) Discretionary trading without a written grant of authority;
- (e) Excessive trading (size and/or frequency);
- (f) Borrowing money from a client;
- (g) Loaning money to a client;
- (h) Misrepresenting the qualifications of the adviser, the scope of services to be provided, or the fees to be charged for the services provided;
- (i) Providing third-party research or recommendations to the client without disclosing the source (exception for using research for providing advice, or ordering a report in normal course of business);

⁹Cal. Code Regs. tit. 10, § 260.235.3(c).

¹⁰Cal. Code Regs. tit. 10, § 260.235.4.

¹¹Cal. Corp. Code § 25238.

¹²Cal. Code Regs. tit. 10, § 260.238.

- (j) Charging an unreasonable advisory fee in light of services to be provided, adviser's expertise, bargaining power of client, or that lower fees may be available from other sources;
- (k) Failing to disclose conflicts of interest, including commissions received from transactions executed pursuant to advisory service (e.g., 12b-1 fee sharing or kickbacks from dealers);
- (l) Guaranteeing results;
- (m) Failing to maintain client confidentiality;
- (n) Entering into a client-specific advisory contract unless, among other things, it is in writing and defines the services to be rendered, fees to be charged, and whether discretionary trading authority is given to the adviser; and
- (o) Making untrue statements of material fact, or omitting a statement of material fact.

California excludes the following four subsections (paraphrased) of the NASAA Model Act:

- failing to maintain written policies and procedures to ensure compliance with section 204A of the IAA;¹³
- engaging in fraudulent, deceptive or manipulative practices contrary to 206(4) of IAA;
- engaging in unlawful acts indirectly or through other persons; and
- accessing a client's account using a client's unique credentials such as username and password.

Cal. Code Regs. tit. 10, § 260.238 modifies the language of some of NASAA's provisions. For example, in subsection (c) the California regulation eliminates the following Model Act language: "in light of the fact that an investment adviser (...) in such situations can directly benefit from the number of securities transactions effected in a client's account."

In subsection (j), the prohibition adds the following language (indicated in italics):

"(j) Charging a client an advisory fee that is unreasonable in light of the type of services to be provided, the experience and expertise 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."

In subsection (k)(2), it adds (portion in italics):

¹³That Cal. Code Regs. tit. 10, § 260.238 is silent on the obligation to have written supervisory procedures does not give California state-registered RIAs a free pass. They must still have written supervisory procedures and policies pursuant to Rule 206(4) of the IAA.

(k) Failing to disclose to a client in writing before entering into or renewing an advisory agreement with that client any material conflict of interest relating to the adviser, its representatives or any of its employees, which could be reasonably 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 without disclosing that a commission for executing securities transactions pursuant to such advice will be received by the adviser, its representatives or its employees, *or that such advisory fee is being reduced by the amount of the commission earned by the adviser, its representatives or employees for the sale of securities to the client.*

In subparagraph (n):

Entering into, extending or renewing any investment advisory contract, other than a contract for impersonal advisory services, unless such contract is in writing and discloses, in substance, the services to be provided, the term of the contract, the 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, whether the contract grants discretionary power to the adviser or its representatives.

Subparagraph (o) is a California-creation not modeled after the NASAA Model Act. It prohibits “Making any untrue statement of a material fact or omitting a statement of material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading in the solicitation of advisory clients.”

C. CASES DEALING WITH PRIVATE RIGHT OF ACTION FOR INVESTMENT ADVISER MISCONDUCT

The California Securities Laws includes a private right of action for consumers defrauded under the investment adviser portion of the Act at Cal. Corp. Code 25401.¹⁴ California permits civil actions by anyone who received a material misrepresentation or omission in a securities transaction, whether buyer or seller.¹⁵ There are no scienter, reliance, or loss causation requirements in the statute. The scope of the private right of action can include control persons

¹⁴Thompson, *supra* note 1.

¹⁵Cal. Corp. Code § 25401, Robert N. Rapp, Blue Sky Regulation, Ch. 13, § 13.03 (Matthew Bender) (2019), <https://advance.lexis.com/api/permalink/6e13e3cf-c992-448c-8fb0-9ca78d32baae/?context=1000516>.

and officers who provided “material” support.¹⁶ The remedy is rescission if the injured party still holds the securities. Otherwise, the remedy is damages. For misconduct by an adviser, a plaintiff or claimant pursuing a California Securities Law cause of action or claim has to bring it under § 25401.

There is no implied civil liability under the Corporate Securities Law, and outside of § 25401 and 25501, there is no stated private remedy for a violation of Cal. Corp. Code § 25235 or 25238.¹⁷ Conversely, there is no prohibition against using Cal. Evid. Code § 669 *negligence per se* presumption linked to §25238 and the statute’s underlying regulations in a negligence claim for damages.¹⁸

In July 2018, a magistrate judge in the Northern District of California recognized a private cause of action under Sections 25230 and 25235 of the California Corporations Code in *Yokell v. Draper*.¹⁹ The *Yokell* facts are unique in that the plaintiff alleged that the defendant had acted as an unlicensed investment adviser.²⁰ Two of the many causes of action asserted by the Plaintiff were the defendant was an unlicensed investment advisor as defined in Cal. Corp. Code § 25230 and violated the anti-fraud provision of Cal. Corp. Code § 25235.

The court found that a private cause of action for a violation of section 25230 (acting as an investment adviser without a license) was warranted by section 1029.8 of the California Code of Civil Procedure, which provided a right of action for persons harmed by *unlicensed* persons causing injury or damage. The court dismissed the Cal. Corp. Code § 25230 claim, holding that the plaintiff failed to allege that defendant provided investment advice for compensation, and thus to allege that defendant met the definition of investment adviser provided by the statute in Cal. Corp. Code § 25009.²¹

Analyzing the section 25235 claim, the court held that plaintiffs’ cause of action under Cal. Corp. Code § 25235 failed because it was “grounded in fraud,” and plaintiff failed to plead it with sufficient particularity, as required by the heightened pleading standard of Rule 9(b) of the Fed. R. Civ. Proc.²² As a side note, the Court also dismissed the section 25401 claim finding the plaintiff failed to meet the heightened pleading requirements of identifying the false/misleading statement and providing an explanation of why the statement was false/misleading.

¹⁶Cal. Corp. Code § 25504.

¹⁷Cal. Corp. Code § 25510.

¹⁸See, *California Service Station Assn. etc. v. American Home Assurance Co.*, 62 Cal.App.4th 1166, 1175 (1998).

¹⁹*Yokell v. Draper*, No. 18-CV-02124-JSC, 2018 WL 3417514, at 10 (N.D. Cal. July 13, 2018).

²⁰Matkins, Allen, *Implied Private Right of Action and the Corporate Securities Law of 1968*, July 25, 2018, <https://www.jdsupra.com/legalnews/implied-private-right-of-action-and-the-50551/>.

²¹*Id.* at 11.

²²*Id.*

The key distinguishing feature of the *Yokell* decision perhaps comes from the fact the defendant was unlicensed to provide investment advice.²³ In the year since the *Yokell* decision, it does not appear an implied cause of action has been recognized by any other California courts.

II. STANDARD OF CONDUCT UNDER FLORIDA'S ANTIFRAUD PROVISION & RELATED REGULATIONS

A. FLORIDA ANTIFRAUD STATUTE IN RELATION TO THE INVESTMENT ADVISER ACT OF 1940

The Florida Investors Protection Act's antifraud provision adopts the language of only Sections 206(1) and 206(2) of the Investment Advisers Act of 1940.

Florida Statute Section 517.301(1)(a)1 states that it is unlawful for a person offering investment advice to "employ any device, scheme, or artifice to defraud"²⁴ and "[t]o engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a person."²⁵ The antifraud provision also prohibits obtaining "money or property by means of any untrue statement of a material fact or any omission 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."²⁶

B. FLORIDA STATUTES AND RULES ESTABLISHING ADDITIONAL STANDARDS OF CONDUCT

In terms of establishing unethical conduct, Florida incorporated the provisions of NASAA Model Rule 102(a)(4)-1 in Florida Statute Section 517.1215, titled "Requirements, rules of conduct, and prohibited business practices for investment advisors and their associated persons."²⁷ In Section 517.1215, the Florida legislature granted the Financial Services Commission (the "FSC") the authority to (1) specify requirements for investment advisors who have custody of the funds; and (2) establish rules of conduct and prohibited business practices for investment advisors and their associated persons. Notably, the statute directs the FSC to:

...consider general industry standards as expressed in the rules and regulations of the various federal and self-regulatory agencies and regulatory associations, including, but not limited to, the United States Securities and Exchange Commission, the Financial

²³Matkins, *supra* note 13.

²⁴Fla. Stat. Ann. § 517.301(1)(a)1. (West).

²⁵*Id.* § 517.301(1)(a)3 (West).

²⁶*Id.* § 517.301(1)(a)2. (West). The language in 517.301(1)(a)1-3 is modeled after SEC regulation 17 CFR 240.10b-5.

²⁷*Id.* § 517.1215 (West).

Industry Regulatory Authority, and the North American Securities Administrators Association.²⁸

The FSC followed the directive and incorporated many of the standards of conduct established by these entities. Rule 69W-600.0131 defines prohibited business practices for investment advisers and their associated persons, and it provides a *non-exhaustive* list of actions falling within the “demonstrations of unworthiness” by an investment adviser or associated persons under Section 517.161(1)(h), Florida Statutes.²⁹ The rule applies to investment advisers and associated persons with respect to customers, transactions of business “in, to or from” the state, and it brings within its scope investment advisers not registered or not required to register under the IAA.³⁰ Highlights from the list of prohibited activities are:

- the anti-fraud provisions of the Investment Advisors Act of 1940;
- borrowing money from customers;
- loaning money to customers;
- making unsuitable recommendations;
- exercising discretionary trading authority without prior written authorization;
- excessive trading;
- misrepresenting the title(s) or qualifications of the adviser;
- charging unreasonable fees;
- failing to disclose conflicts of interest;
- guaranteeing results;
- recommending a specific securities dealer with which the adviser receives a fee;
- breaching client confidentiality;
- giving false information to a regulator;
- use of hedge clauses in an advisory agreement; and
- (unlike California) failing to have and execute reasonable written supervisory procedures.³¹

1. Comparison with NASAA Model Act

Notably, Rule 69W-600.0131 incorporates almost entirety of NASAA Model Rule 102(a)(4)-1.³² It excludes the following five subsections (paraphrased):

- (h) prohibiting reports or recommendations by third parties without disclosure;
- (q) failing to maintain written policies and procedures to ensure compliance with section 204A of the IAA;

²⁸*Id.*

²⁹Fla. Admin. Code Ann. r. 69W-600.0131.

³⁰*Id.* at (a)

³¹69W-600.0131.

³²NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers Model Rule 102(a)(4)-1, <http://www.nasaa.org/wp-content/uploads/2011/07/1956-Unethical-Practices-Rule-Amended.pdf>.

- (t) engaging in fraudulent, deceptive or manipulative practices contrary to 206(4) of IAA;
- (u) engaging in unlawful acts indirectly or through other persons; and
- (v), accessing a client's account using a client's unique credentials such as username and password.

The substance of many of these prohibitions is incorporated in the statute through other provisions and regulations. For instance, the language of Section 206 of the IAA is incorporated through the antifraud statute, and by reference in Rules 69W-600.0131(1)(a) and 69W-200.002(49) and (51).

Rule 69W-600.0131 adds some additional prohibitions for investment advisers, in the following subsections (paraphrased):

- (m) they cannot recommend dealers that are not registered or exempt from registration;
- (n) they cannot recommend service of dealers who pay a fee or remuneration to an RIA for those services;
- (p) they cannot give false or misleading customer information to any financial institution of regulatory agencies;
- (u) they cannot engage in unethical conduct as described Rule 69W-600.0133, F.A.C., dealing with custody requirements;
- (v) they must send an itemized invoice every time a fee is directly deducted from account, in compliance with rule 69W600.0132(2)(i) (detailing requirements for direct fee deduction); and
- (x) they are prohibited from charging fees greater than the amount specified in the written investment advisory contract.

2. References to SEC Standards of Conduct

Rule 69W-600.012(d)(3) imposes net capital and debt requirements for investment advisers.³³ Subsection (b)(4) imposes on IA a duty to provide clients with copies of any and all contracts between them.

3. Florida Regulations Incorporate Other Industry Standards of Conduct by Reference in Rule 69W-200.002.

Some of the SEC regulations incorporated by reference in rule 69W-600.012 only tangentially mention investment advisers.³⁴

³³Fla. Admin. Code Ann. r. 69W-600.012.

³⁴Incorporated by reference: § 230.501 Definitions and terms used in Regulation D (17 C.F.R. § 230.501); § 275.206(4)-3 Cash payments for client solicitations (17 C.F.R. § 275.206(4)-3); § 230.144A Private resales of securities to institutions (17 C.F.R. § 230.144A); § 77e. Prohibitions relating to interstate commerce and the mails (15 U.S.C.A. § 77e (West)); § 240.17a-3 Records to be made by certain exchange members, brokers and dealers. (17 C.F.R. § 240.17a-3); § 78o. Registration and regulation of brokers and dealers (15 U.S.C.A. § 78o (West)); § 78o. Registration and regulation of brokers and dealers (15 U.S.C.A.

The most relevant are addressed below, but it is also important to note that the FSC introduced proposed amendments to many of these regulations in June 2019.³⁵

Regulation 69W-200.002 subsection (50) and (53) incorporates the Investment Advisers Act by reference.³⁶ The regulation specifically incorporates investment advisory contract requirements through § 80b-5, and the antifraud provisions of § 80b-5 (§206). It also incorporates § 80b-6, Prohibited transactions by investment advisers;³⁷ § 80b-7, Material misstatements;³⁸ and § 80b-8, General prohibitions.³⁹

From the Code of Federal Regulations, it incorporates § 275.204-3 (brochure delivery requirements);⁴⁰ § 275.206(3)-2 (requirements of agency cross transactions for advisory clients;⁴¹ § 275.206(4)-1 (advertisement requirements for investment advisers);⁴² and § 275.206(4)-3 (restrictions on cash payments for client solicitations).⁴³

The regulation incorporates by reference § 78j (manipulative and deceptive devices) setting the standard for pleading investment adviser fraud.⁴⁴

Rule 69W-600.0133: Prohibits the use of self-conferred, marketing-related, and/or non-existent accrediting agency senior-specific designations.

§ 78o (West); § 230.135a Generic advertising (17 C.F.R. § 230.135a); § 78o-4. Municipal securities (15 U.S.C.A. § 78o-4 (West)); § 80b-4. Reports by investment advisers (15 U.S.C.A. § 80b-4 (West)); § 80b-4a. Prevention of misuse of nonpublic information (15 U.S.C.A. § 80b-4a (West)); § 80b-4a. Prevention of misuse of nonpublic information (15 U.S.C.A. § 80b-4a (West)); § 275.206(3)-1 Exemption of investment advisers registered as broker-dealers in connection with the provision of certain investment advisory services (17 C.F.R. § 275.206(3)-1); Records to be made by certain exchange members, brokers and dealers (17 C.F.R. § 240.17a-3); Books and records to be maintained by investment advisers (17 C.F.R. § 275.204-2); Exemption of certain foreign brokers or dealers (17 C.F.R. § 240.15a-6).]

³⁵Footnote 2019 FL REG TEXT 526628 (NS), [https://www.westlaw.com/Document/I1D8A1A72967911E9BB83B7D5FDAAF2AD/View/FullText.html?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=cblt1.0.](https://www.westlaw.com/Document/I1D8A1A72967911E9BB83B7D5FDAAF2AD/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.)]

³⁶Subsection (50) incorporates 15 U.S.C. § 80b-1 through 80b-21; (53) incorporates 15 U.S.C. § 80a-1 through 80a-64.

³⁷15 U.S.C.A. § 80b-6 (West).

³⁸*Id.* § 80b-7 (West).

³⁹*Id.* § 80b-8 (West).

⁴⁰17 C.F.R. § 275.204-3.

⁴¹*Id.* § 275.206(3)-2.

⁴²*Id.* § 275.206(4)-1.

⁴³*Id.* § 275.206(4)-3.

⁴⁴15 U.S.C.A. § 78j (West).

C. CASES DEALING WITH PRIVATE RIGHT OF ACTION FOR INVESTMENT ADVISER MISCONDUCT

Florida's law includes a private right of action for consumers defrauded under the investment adviser portion of the Act.⁴⁵

In *Eaton v. Coal Par*, the court held that the sections 517.241 and 517.211 are the remedial provisions of the Florida Statute, and that they are "inclusive of all the remedies available to private parties under Chapter 517, unless the legislature expressly provides otherwise."⁴⁶

The court identified Section 517.241 as the general remedies provision of the Act, allowing any person to bring any statutory or common-law action in any court for any act involved in the sale of securities.⁴⁷ The court found that 517.211 also provided purchasers and sellers covered by the Act with a cause of action for rescission or damages.⁴⁸

In *Eaton*, Plaintiff charged defendants with fraud under Florida law and sought rescission under section 517.211(2) of the Florida statute for defendants' alleged violations of the anti-fraud provisions of section 517.301. Plaintiff also brought an action under section 517.03(1), which requires that all broker/dealers establish and keep current a set of written supervisory procedures and a system for implementing such procedures which may reasonably be expected to prevent and detect violations of the Florida Securities Act and related rules.⁴⁹ However, the court did not recognize a private right of action under 517.03(1) because it found that private parties have no remedies outside of 517.211 and 517.241.

In *Rushing v. Wells Fargo Bank*, the court held that there was no private right of action for a "holder" of securities under 517.211. The court held that even if the holding was in connection with investment advice, the remedies provide by 517.211 only applied in connection with the purchase or sale of securities. In so doing, the court rejected the decision of California Court of Appeals in *Ward*,⁵⁰ where the court had distinguished the state standard from civil remedies under 517.211 from the federal standard based on section 517.301's prohibition of fraud "in connection with the rendering of any investment advice."⁵¹

In *Hillard*, the court expanded the definition of "seller" to include those who solicit sales of securities and held that the buyer/seller privity requirement for state-law securities claim was

⁴⁵Thompson, *supra* note 1.

⁴⁶*Eaton v. Coal Par of W. Va., Inc.*, 580 F. Supp. 572, 579-80 (S.D. Fla. 1984).

⁴⁷*Id.*

⁴⁸*Id.*

⁴⁹*Id.* at 577.

⁵⁰*Ward v. Atl. Sec. Bank*, 777 So. 2d 1144 (Fla. Dist. Ct. App. 2001).

⁵¹*Rushing v. Wells Fargo Bank*, N.A., 752 F. Supp. 2d 1254, 1263 (M.D. Fla. 2010).

satisfied.⁵² It also defined “solicits” to include one who is “motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”⁵³

In *J.P. Morgan v. Geveran*, the District Court of Appeal of Florida stated that the FSIPA provides for a remedy of rescission for all violations of section 517.301 if the plaintiff still owns the security. [Id. at 324.] In terms of scope of liability, it stated that it extended to any “director, officer, partner or agent of the seller who has personally participated or aided in making the purchase.”⁵⁴

The *J.P. Morgan court* interpreted the decision of the Florida Supreme court in *Rouseff*,⁵⁵ and held that 517.211 does not require privity of contract between parties, but that the “director, officer, partner or agent” in question are “directly involved” in the sale of the security. In other words, 517.211 is narrower than other Florida statutory provisions or common law actions, in that it is “transaction-specific.”⁵⁶

In the words of the J.P. Morgan court, “[t]he Court was distinguishing liability under section 517.211 from liability under federal rule 10b–5, which extends to fraud more generally, whether conducted during the sale of securities or not.²⁴ The Court used “privity” as a short-hand for a direct sale of securities distinct from general corporate malfeasance.”⁵⁷

In *Rouseff*, the Florida Supreme Court analogized claims under section 517.211(3) seeking rescission to claims under section 12 of the Securities Act of 1933, which is codified at 15 U.S.C. § 77(l) (2016), as well as common law claims for rescission. Section 517.211(2) limits liability to persons involved directly in the sale of the security and damages are limited to the consideration paid. 537 So.2d at 981. A claim for rescission under section 517.211 includes: 1) a misrepresentation or omission, 2) of a material fact, 3) on which the buyer relied.⁵⁸ The remedial statute imposes both a materiality requirement and a reliance requirement.⁵⁹

⁵²*Hilliard v. Black*, 125 F. Supp. 2d 1071, 1083 (N.D. Fla. 2000) (holding that sports agent qualified as “seller” under Florida securities statutes). Based on agent’s allegedly self-motivated false statements to athletes concerning safety and lucrative nature of investment offer and concerning agent’s lack of financial interest, agent’s alleged actions constituted solicitation.

⁵³*Id.* at 1083.

⁵⁴*J.P. Morgan Sec., LLC v. Geveran Investments Ltd.*, 224 So. 3d 316, 328 (Fla. Dist. Ct. App. 2017).

⁵⁵*E. F. Hutton & Co. v. Rouseff*, 537 So. 2d 978, 979 (Fla. 1989).

⁵⁶*J.P. Morgan*, 224 So. 3d at 328.

⁵⁷*Id.* at 328.

⁵⁸*Id.* at 324.

⁵⁹*Id.* at 326-27.

Lastly, a note on scope of liability. In *Carran*,⁶⁰ the plaintiff sought a ruling that there is no aiding and abetting liability under Chapter 517 of the Florida Statutes as a matter of law, but the court declined to reach the question under the facts.⁶¹

CONCLUSION

The Investment Advisor Act of 1940 is a cornerstone for state-based RIA regulation. Generally, it is fair to assume a given state's statute will track close to the IAA, but it is equally fair to assume each state will put its own emphasis on what it believes to be the most critical activities to require regulation.

For the purpose of investor protection and private causes of action, the heart of the issue is whether there is an available private cause of action. California requires creativity, and Florida is the most generous in protecting its citizens from unscrupulous advisers. Your state's mileage will vary.

⁶⁰*Carran v. Morgan*, No. 06-80608-CIV, 2007 U.S. Dist. LEXIS 84322 (S.D. Fla. Nov. 13, 2007).

⁶¹*Id.* at Footnote 3.

APPENDIX

**PROVISIONS REGULATING INVESTMENT ADVISER CONDUCT IN CALIFORNIA
AND FLORIDA**

PROHIBITED CONDUCT	CALIFORNIA STATUTE	FLORIDA STATUTE
FRAUD AND MISREPRESENTATION	Cal. Corp. Code § 25235 Cal. Code Regs. tit. 10, § 260.235.1 Cal. Code Regs. tit. 10, § 260.235.2 Cal. Code Regs. tit. 10, § 260.235.3 Cal. Code Regs. tit. 10, § 260.235.4	Fla. Stat. Ann. § 517.301; Fla. Admin. Code Ann. r. 69W-200.002; Fla. Admin. Code Ann. r. 69W-600.012; Fla. Admin. Code Ann. r. 69W- 600.013
STANDARD OF CONDUCT AND ETHICAL BEHAVIOR	Cal. Corp. Code § 25238, Cal. Code Regs. tit. 10, § 260.238.	Fla. Stat. Ann. § 517.1215; Fla. Admin. Code Ann. r. 69W- 600.0131; Fla. Admin. Code Ann. r. 69W-600.012; Fla. Admin. Code Ann. r. 69W-200.002; Fla. Admin. Code Ann. r. 69W-600.014
DECEPTIVE ADVERTISING	Cal. Code Regs. tit. 10, § 260.235	17 C.F.R. § 275.206(4)-1; 17 C.F.R. § 275.204-3(incorporated through Fla. Admin. Code Ann. r. 69W-600.002);
FAILURE TO REGISTER (NOT EXEMPT)	Cal. Corp. Code § 25230; Cal. Corp. Code § 25230.1 (Exemption)	Fla. Stat. Ann. § 517.12; Fla. Stat. Ann. § 517.1205
RESTRICTIONS ON ADVISORY CONTRACTS	Cal. Corp. Code § 25234. Exceptions in 25234 (a)(1).	15 U.S.C.A. § 80b-5; 17 C.F.R. § 275.205-3 (exemptions) (incorporated through Fla. Admin. Code Ann. r. 69W-600.002);
RESTRICTIONS ON CUSTODY OF FUNDS	Cal. Corp. Code § 25237. Cal. Admin. Code tit. 10 §260.237.	Fla. Admin. Code Ann. r. 69W- 600.0132
FAILURE TO MEET QUALIFICATION STANDARDS	Cal. Corp. Code § 25236	N/A
USE OF SENIOR- SPECIFIC DESIGNATION	Cal. Corp. Code § 25243.5	Fla. Admin. Code Ann. r. 69W- 600.0133
REMEDIAL PROVISIONS	Cal. Corp. Code § 25401 and 25501	Fla. Stat. Ann. § 517.211

CFP BOARD

CASE STUDIES
APPLYING THE
CODE OF ETHICS
AND STANDARDS
OF CONDUCT

PURPOSE AND TABLE OF CONTENTS

CFP Board developed these case studies to provide practical guidance to CFP® professionals and their firms on the new *Code of Ethics and Standards of Conduct*, which becomes effective on October 1, 2019. 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* prior to its effective date.

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CASE STUDY 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).

CASE STUDY 2: 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).

CASE STUDY 3: 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. Under other circumstances (such as a Client-directed purchase), a CFP® professional may purchase a stock for a Client without providing Financial Advice. In that case, the CFP® professional does not have a Fiduciary Duty.

Relevant Standards and Definitions: Fiduciary Duty (Standard A.1.); definitions of Client, Financial Advice, and Financial Assets (Glossary).

CASE STUDY 4: 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).

CAST STUDY 5: 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).

CASE STUDY 6: 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).

CASE STUDY 7: 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.).

CASE STUDY 8: 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.).

CASE STUDY 9: 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.).

CASE STUDY 10: 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.).

CASE STUDY 11: 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).

CASE STUDY 12: 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).

CFP Board is committed to providing resources that will help CFP® professionals understand and comply with the new *Code and Standards*. Initial resources, including FAQs, are available on CFP Board's website ([CFP.net/Code](https://www.cfp.net/code)).

As a CFP® professional, you play an important role in this process. CFP Board has assembled a team of professionals — the Standards Resource Commission — that will be developing additional guidance materials to educate and inform CFP® professionals about the *Code and Standards*. If there are resources that you believe would be valuable to you, your firm, or your clients, please email your suggestions to SRC@CFPBoard.org. The Standards Resource Commission will carefully consider your feedback as it develops future guidance materials. Additional resources will be posted to CFP Board's website at the link above as they become available.



CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

1425 K St NW #800 Washington DC 20005

p 800-487-1497 | f 202-379-2299

mail@CFPBoard.org | [CFP.net](https://www.cfp.net)

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.



CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

1425 K St NW #800 Washington, DC 20005
800.487.1497 | f 202.379.2299 | mail@CFPBoard.org | CFP.net

CFP BOARD

FREQUENTLY ASKED QUESTIONS

CODE OF ETHICS AND STANDARDS OF CONDUCT

EFFECTIVE OCTOBER 1, 2019

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"), which takes effect October 1, 2019. CFP Board may provide answers to additional FAQs on a periodic basis.

WHY REVISE THE STANDARDS OF PROFESSIONAL CONDUCT (THE "STANDARDS")?

Question 1: Why did CFP Board revise its Standards?

Answer 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 2: What process did CFP Board follow in revising its Standards?

Answer 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 3: How has CFP Board changed the organizational structure of the Code and Standards?

Answer 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.

FIDUCIARY DUTY

Question 4: 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 4: 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 5: What does CFP Board's fiduciary duty require? (Standard A.1.)

Answer 5: 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 6: 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 6: 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.

FINANCIAL PLANNING

Question 7: How does CFP Board define Financial Planning? (Standard B.1. and Glossary.)

Answer 7: 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.

Question 8: 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 8: 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 9: 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 9: 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 <ul style="list-style-type: none"> • Defining the Scope of the Engagement 	[Moved to section A.10 of the <i>Standards of Conduct</i> (the Duty to “Provide Information to a Client”)]
2. Gathering Client Data <ul style="list-style-type: none"> • 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 <ul style="list-style-type: none"> • Obtaining Qualitative and Quantitative Information • Analyzing Information • Addressing Incomplete Information
	2. Identifying and Selecting Goals <ul style="list-style-type: none"> • Identifying Potential Goals • Selecting and Prioritizing Goals
3. Analyzing and Evaluating the Client’s Financial Status <ul style="list-style-type: none"> • Analyzing and Evaluating the Client’s Information 	3. Analyzing the Client’s Current Course of Action and Potential Alternative Course(s) of Action <ul style="list-style-type: none"> • Analyzing Current Course of Action • Analyzing Potential Alternative Courses of Action
4. Developing and Presenting Financial Planning Recommendations <ul style="list-style-type: none"> • Identifying and Evaluating Financial Planning Alternative(s) 	
4. Developing and Presenting Financial Planning Recommendations <ul style="list-style-type: none"> • Developing the Financial Planning Recommendation(s) 	4. Developing the Financial Planning Recommendation(s)
4. Developing and Presenting Financial Planning Recommendations <ul style="list-style-type: none"> • Presenting the Financial Planning Recommendation(s) 	5. Presenting the Financial Planning Recommendation(s)
5. Implementing the Financial Planning Recommendation(s) <ul style="list-style-type: none"> • Agreeing on Implementation Responsibilities • Selecting Products and Services for Implementation 	6. Implementing the Financial Planning Recommendation(s) <ul style="list-style-type: none"> • 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 <ul style="list-style-type: none"> • Defining Monitoring Responsibilities 	7. Monitoring Progress and Updating <ul style="list-style-type: none"> • Monitoring and Updating Responsibilities • Monitoring the Client’s Progress • Obtaining Current Qualitative and Quantitative Information • Updating Goals, Recommendations, or Implementation Decisions

Question 10: When must a CFP® professional comply with the *Practice Standards* for the Financial Planning Process? (Standard B.3.)

Answer 10: 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 11: 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 11: 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 12: 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 12: 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.

Question 13: Does CFP® Board require a CFP® professional to complete all seven steps of the Financial Planning process? (Standards A.10 and C.)

Answer 13: 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 14: 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 14: 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.

DISCLOSURES REQUIRED WHEN PROVIDING FINANCIAL ADVICE AND FINANCIAL PLANNING

Question 15: 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 15: 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.

Question 16: What is a CFP® professional’s duty under the new *Code and Standards* when representing compensation method? (Standard A.12.)

Answer 16: 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 17: How does CFP Board define Fee-only? (Standard A.12.a.)

Answer 17: 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 18: How does CFP Board address “Fee-Based” in the *Code and Standards*? (Standard A.12.a.)

Answer 18: 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 19: Who does CFP Board consider to be a Related Party? (Standard A.12.c.)

Answer 19: 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 20: What is Sales-Related Compensation? (Standard A.12.b.)

Answer 20: 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 21: When does the Safe Harbor for Related Party compensation apply and what does it require? (Standard A.12.e.)

Answer 21: 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 22: How does the Code and Standards address misrepresentation of compensation method by a CFP® Professional’s Firm? (Standard A.12.f.)

Answer 22: 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 23: The new Code and Standards requires a CFP® professional to document information when complying with the Practice Standards. What is required? (Standard C.)

Answer 23: 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 material 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.

BANKRUPTCY

Question 24: How will CFP Board handle bankruptcies under the new *Code and Standards*? (Standards E.2. and E.3.)

Answer 24: 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.

REPORTING TO CFP BOARD

Question 25: 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 25: 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.

OTHER REGULATIONS

Question 26: 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 26: 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 27: 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 27: No. The new *Code and Standards* applies to all CFP® professionals equally.

HOLDING OUT

Question 28: 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 28: 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*.

FIRM OBLIGATIONS

Question 29: Are firms required to ensure that their employees and representatives who hold the CFP® certification adhere to CFP Board's ethical standards?

Answer 29: 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*.

LIABILITY

Question 30: Does the new *Code and Standards* increase civil liability for CFP® professionals?

Answer 30: 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.



CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

1425 K St NW #800 Washington DC 20005

p 800-487-1497 | f 202-379-2299

mail@CFPBoard.org | CFP.net

CFP BOARD

ROADMAP

TO THE CODE OF ETHICS & STANDARDS OF CONDUCT

EFFECTIVE DATE: OCTOBER 1, 2019

PURPOSE AND TABLE OF CONTENTS

This *Roadmap to the Code of Ethics and Standards of Conduct (Roadmap)* is a tool that CFP® professionals and their firms may use to develop a practical understanding of the revised *Code and Standards*. The *Roadmap* provides an overview of the structure and content of the *Code and Standards* and contains five guidance resources that CFP Board developed to assist CFP® professionals and their firms with implementing the *Code and Standards*: the (1) Financial Advice Engagements Disclosure Guide; (2) Financial Planning Engagements Disclosure Guide; (3) Practice Standards Reference Guide; (4) Financial Advice Engagements Compliance Guide; and (5) Financial Planning Engagements Compliance Guide.

THE *ROADMAP* IS ORGANIZED AS FOLLOWS:

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INTRODUCTION TO THE *CODE AND STANDARDS*

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. The *Code of Ethics* applies at all times, and sets forth principles that guide the behavior of CFP® professionals, with elaboration provided in the *Standards* that follow. The cornerstone of the *Code and Standards* is a CFP® professional's duty to act as a fiduciary and, therefore, act in the best interests of the Client at all times when providing Financial Advice.

CODE OF ETHICS

A CFP® professional must:

Act with honesty, integrity, competence, and diligence.

Act in the client's best interests.

Exercise due care.

Avoid or disclose and manage conflicts of interest.

Maintain the confidentiality and protect the privacy of client information.

Act in a manner that reflects positively on the financial planning profession and CFP® certification.

DUTIES OF A CFP® PROFESSIONAL

The *Code and Standards* sets forth the duties that a CFP® professional owes to Clients, firms and subordinates, and CFP Board. Most duties apply at all times. Additional duties apply when a CFP® professional is providing Financial Advice and when a CFP® professional is providing Financial Advice that requires Financial Planning. The duties that apply at all times also apply when providing Financial Advice and when providing Financial Advice that requires Financial Planning. The duties that apply when providing Financial Advice also apply when providing Financial Advice that requires Financial Planning.

	To Clients	To Firms and Subordinates	To CFP Board
At All Times	<ul style="list-style-type: none"> • Integrity • Competence • Diligence • Sound and Objective Professional Judgment • Professionalism • Comply with the Law • Confidentiality and Privacy • Duties When Communicating with a Client • Duties When Representing Compensation Method • Duties When Selecting, Using, and Recommending Technology • Refrain from Borrowing or Lending Money and Commingling Financial Assets 	<ul style="list-style-type: none"> • Use Reasonable Care When Supervising • Comply with Lawful Objectives of CFP® Professional's Firm • Provide Notice of Public Discipline 	<ul style="list-style-type: none"> • Refrain from Adverse Conduct • Reporting • Provide Narrative Statement • Cooperation • Compliance with <i>Terms and Conditions of Certification and Trademark License</i>
Financial Advice	<ul style="list-style-type: none"> • The Duties That Apply At All Times (see above) • Fiduciary Duty • Disclose and Manage Conflicts of Interest • Provide Information to a Client • Duties When Recommending, Engaging, and Working with Additional Persons 		
Financial Planning	<ul style="list-style-type: none"> • The Duties That Apply When Providing Financial Advice (see above) • The Practice Standards for the Financial Planning Process • Information to a Client in Writing 		

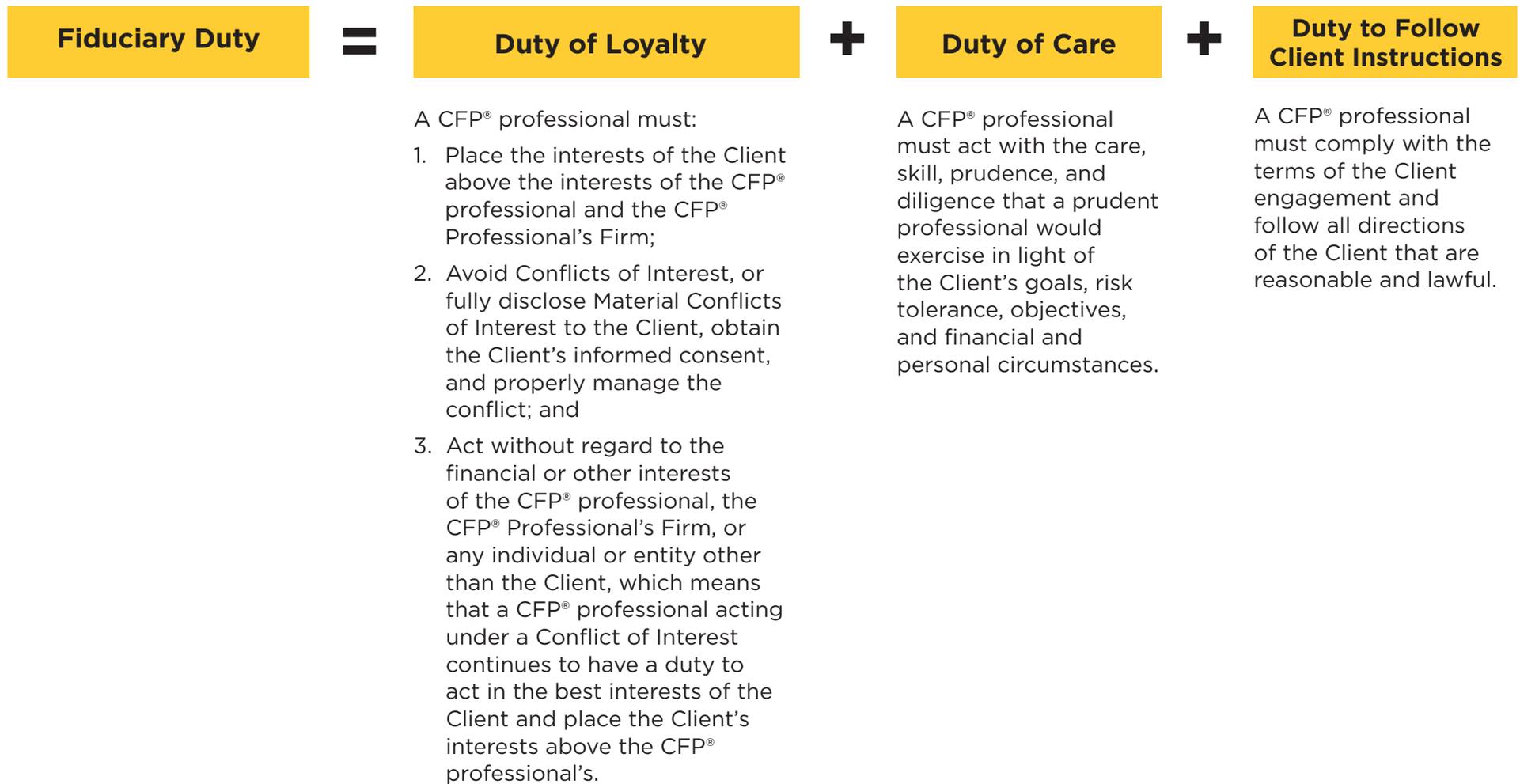
A CFP® Professional Has Duties That Apply:



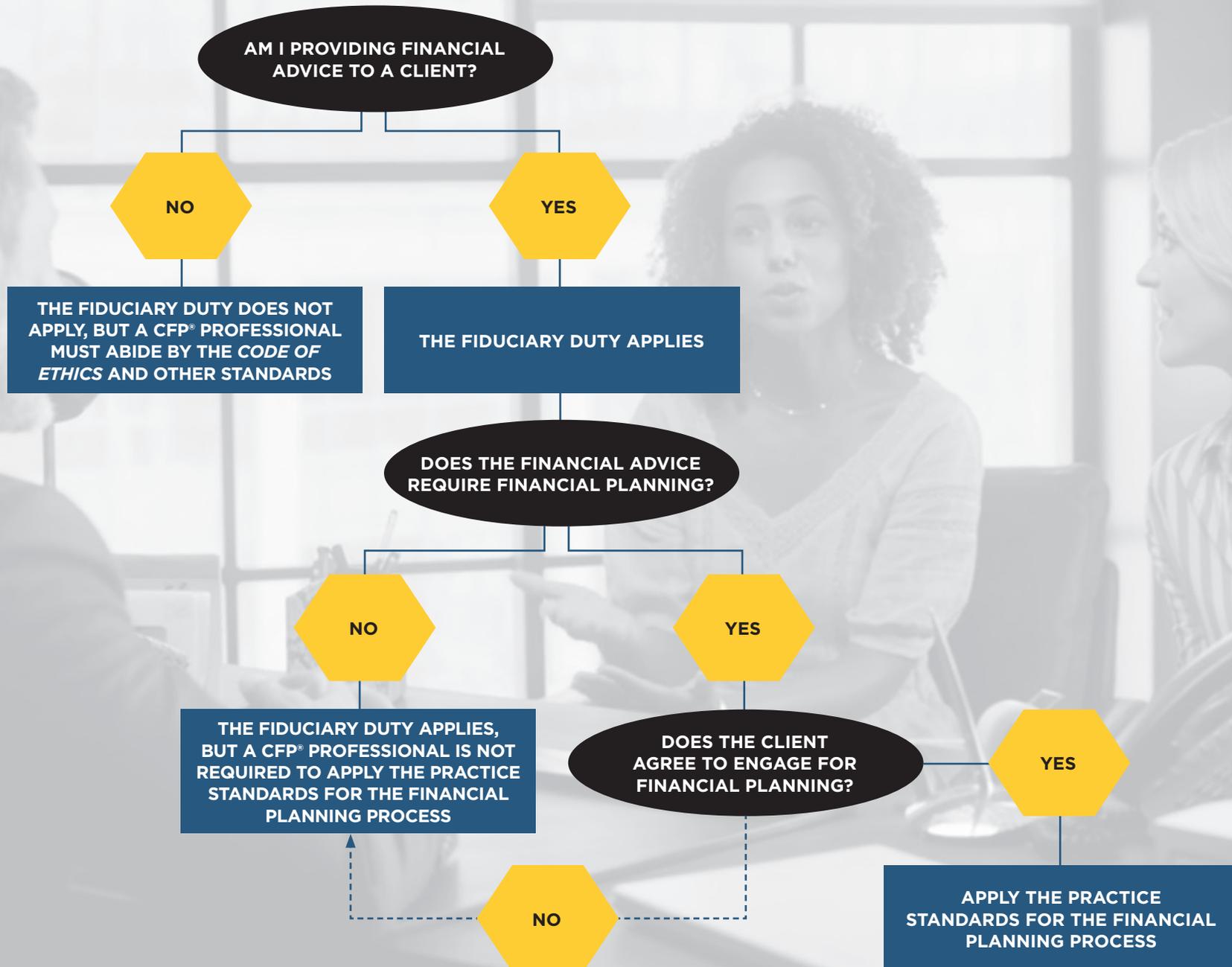
THE FIDUCIARY DUTY

The cornerstone of the *Code and Standards* is the 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.

What does it mean to act as a fiduciary and, therefore, act in the best interests of the Client? A CFP® professional must fulfill the following duties:



THE FINANCIAL ADVICE FRAMEWORK



AM I PROVIDING FINANCIAL ADVICE?

WHAT IS 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 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; or
- The exercise of discretionary authority over the Financial Assets of a Client.

WHAT IS NOT FINANCIAL ADVICE?

- A communication that, based on its content, context, and presentation, would not reasonably be viewed as a recommendation;
- Responses to directed orders; and
- The following, if a reasonable CFP® professional would not view it as Financial Advice:
 - Marketing Materials;
 - General Financial Education; and
 - General Financial Communications.



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.



AM I PROVIDING FINANCIAL PLANNING?

If the answer to any of the following is **YES**, then this is a Financial Planning Engagement, and you must comply with the Practice Standards for the Financial Planning Process. If **NO**, then the engagement for Financial Advice does not require Financial Planning, and you are not required to comply with the Practice Standards for the Financial Planning Process.

Have I agreed to provide or have I provided Financial Planning?

YES **NO**

Does the Financial Advice I agreed to provide require integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests, taking into account the Integration Factors set forth to the right?

YES **NO**

Does the Client have a reasonable basis to believe that I will provide or have provided Financial Planning?

YES **NO**

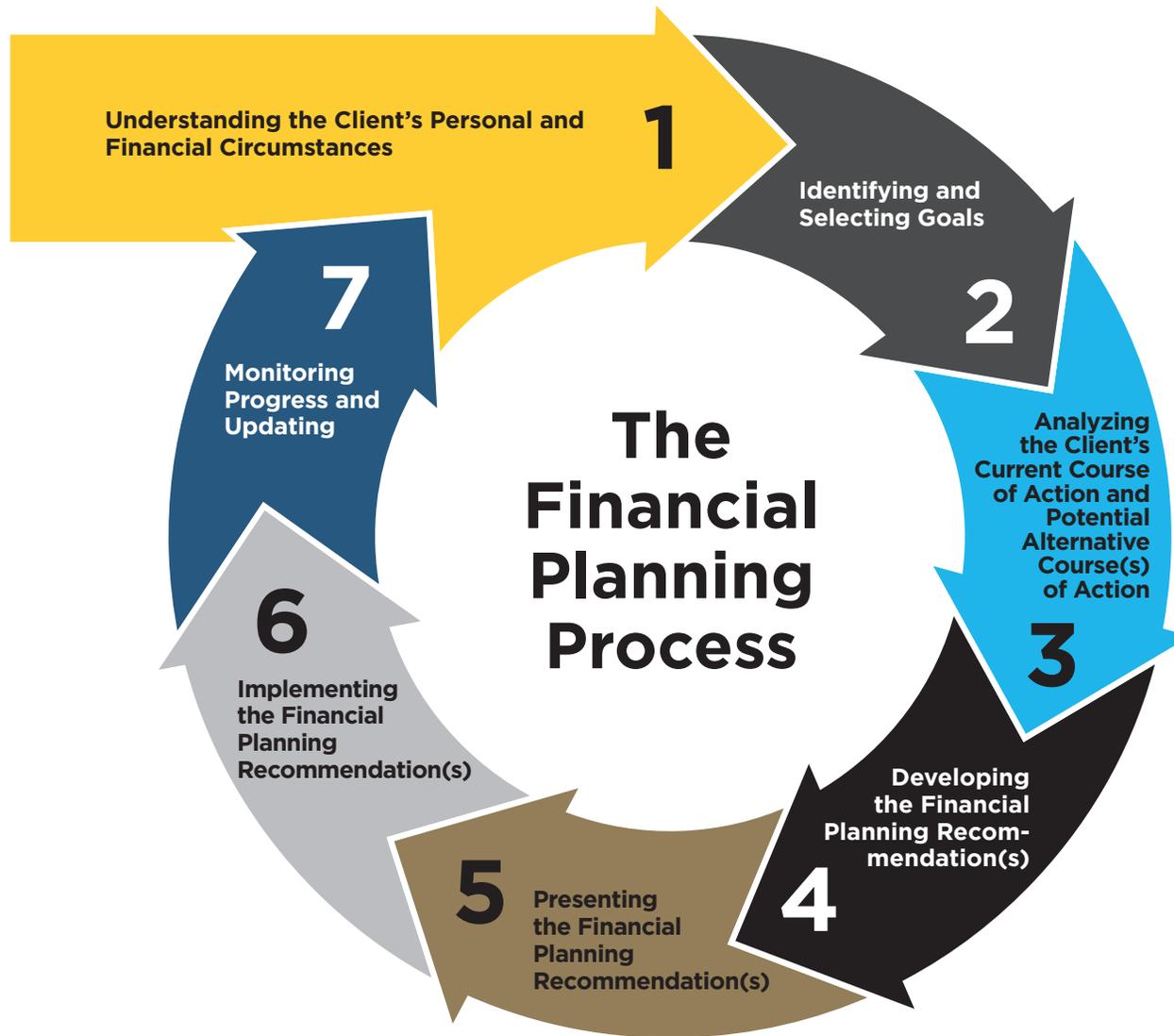
Integration Factors:

- 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.

What do you do if the Client doesn't agree to engage you for Financial Planning? Pick One.

- Not enter into the Engagement; or
- Limit the Scope of Engagement to services that do not require application of the Practice Standards for the Financial Planning Process, and describe to the Client the services the Client requests that the CFP® professional will not be performing; or
- Provide the requested services after informing the Client how Financial Planning will benefit the Client and how the decision not to enter into a Financial Planning engagement may limit the Financial Advice; or
- Terminate the Engagement.

THE PRACTICE STANDARDS FOR THE FINANCIAL PLANNING PROCESS



When to Document:

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 interest; and
- The Firm's policies and procedures.

Acceptable Documentation:

Options include using:

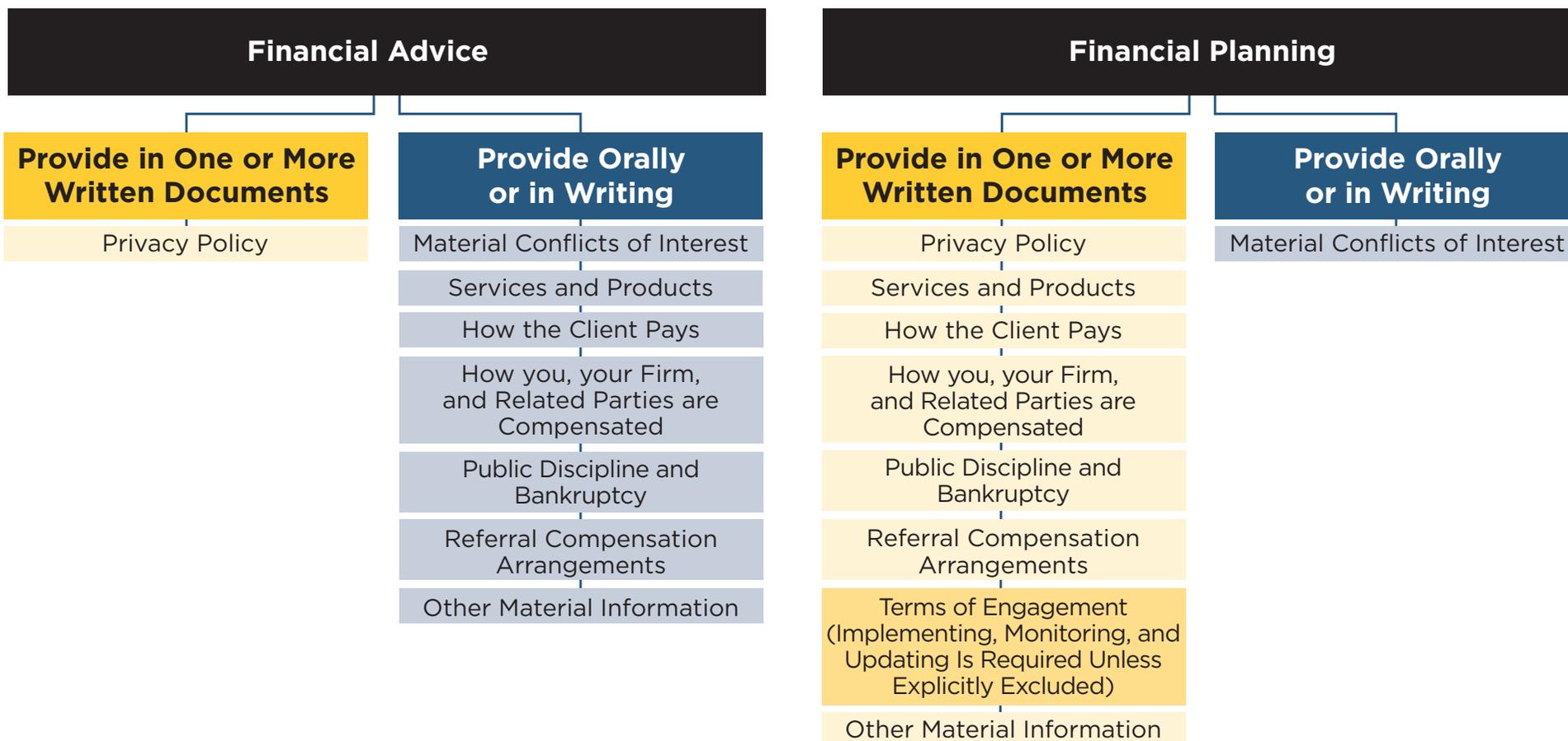
- CRM software;
- Handwritten notes; or
- Emails.

WHEN IN DOUBT, DOCUMENT

DUTY TO PROVIDE INFORMATION TO A CLIENT

A CFP® professional has a duty to provide information to a Client. Whether information may be provided orally or must be provided in writing depends upon whether the Financial Advice that is being provided requires Financial Planning.

CFP Board has prepared a **Financial Advice Engagements Disclosure Guide** and a **Financial Planning Engagements Disclosure Guide**. The Disclosure Guides describe in detail the Duty to Provide Information to a Client. Set forth below is a brief summary of the categories of information that must be shared with the Client, and whether the information must be provided orally or in writing. 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.



APPENDIX (1)

FINANCIAL ADVICE ENGAGEMENTS DISCLOSURE GUIDE

**REFERENCE GUIDE TO PROVIDING INFORMATION
TO A CLIENT IN FINANCIAL ADVICE ENGAGEMENTS**

INFORMATION FOR ALL FINANCIAL ADVICE ENGAGEMENTS (1 OF 3)

Information that must be provided to Clients in all Financial Advice Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the <i>Code and Standards</i> ? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the <i>Code and Standards</i> ? (Applicable Law May Have Additional Requirements)
<p>Services and Products: A description of the services and products to be provided. <i>Code and Standards</i> Section A.10.a.i.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Item 4; • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank Trust Instrument and related documents required under state trust law; • Disclosure documents required by federal banking regulators; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Prior to or at the time of the Engagement. This information is typically provided at the first or second meeting with the Client.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	<p>Orally or in Writing (in one or more documents).</p> <p>If the information is provided orally, the CFP® professional must document the fact that the information was provided.</p> <p>As a best practice, CFP Board recommends that CFP® professionals provide this information in writing.</p>
<p>How the Client Pays: 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. <i>Code and Standards</i> Section A.10.a.ii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 5, 6, 10, 12, and 14; • Form ADV Part 2(B) Brochure Supplement: Items 5 and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank Trust Instrument and related documents required under state trust law; and • Disclosure documents required by federal banking regulators; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 		
<p>How You and Others Are Compensated: How the CFP® professional, the CFP® Professional's Firm, and any Related Party are compensated for providing the products and services. <i>Code and Standards</i> Section A.10.a.iii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 5, 6, 10, 12, and 14; • Form ADV Part 2(B) Brochure Supplement: Items 5 and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; • ERISA Section 408(b)(2) Sponsor disclosures; • Bank Trust Instrument and related documents required under state trust law; and • Disclosure documents required by federal and state banking regulators; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 		

INFORMATION FOR ALL FINANCIAL ADVICE ENGAGEMENTS (2 OF 3)

Information that must be provided to Clients in all Financial Advice Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)
<p>Public Discipline and Bankruptcy: 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. <i>Code and Standards</i> Section A.10.a.iv.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 9, 18.C, and 19.D; • Form ADV Part 2(B) Brochure Supplement: Items 3 and 7; • BrokerCheck Report - www.BrokerCheck.FINRA.org; • IAPD Report - www.AdviserInfor.SEC.gov/IAPD/default.aspx; • CFP Board's Verify-A-CFP® Professional Search Tool - http://www.letsmakeaplan.org/choose-a-cfp-professional/verify-a-cfp-professional; • Public Access to Court Electronic Records (PACER) / Electronic Case Filing (ECF) Database - www.pacer.gov; and • Any other federal court website that contains the bankruptcy information. 	<p>Disciplinary and Bankruptcy Updates: Within 90 days of any Material changes and updates to public disciplinary history or bankruptcy information.</p>	<p>Orally or in Writing (in one or more documents).</p> <p>If the information is provided orally, the CFP® professional must document the fact that the information was provided.</p> <p>As a best practice, CFP Board recommends that CFP® professionals provide this information in writing.</p>
<p>Material Conflicts of Interest: 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. <i>Code and Standards</i> Section A.5.a. and A.10.a.v.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 10, 12, and 14; • Engagement Letter or Agreement; • Investment Advisory Agreement; • ERISA Section 408(b)(2) Sponsor disclosures; • Bank Trust Instrument and related documents required under state trust law; • Bank disclosures pursuant to federal banking regulations; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Before or when providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	
<p>Written Privacy Policies: Written notice of policies regarding the protection, handling, and sharing of a Client's non-public personal information. <i>Code and Standards</i> Section A.9.d. and A.10.a.vi.</p>	<ul style="list-style-type: none"> • Privacy Notice required under SEC's Regulation S-P; • Privacy Notice required under Consumer Financial Protection Bureau regulations; and • State-specific Privacy Notice(s). 	<p>Initially: At the time of the Engagement.</p> <p>Required Updates: Not less than annually (at least once in any 12-month period) unless:</p> <ol style="list-style-type: none"> Your policies have not changed since the last notice sent to the Client; and You do not disclose non-public personal information other than as permitted without a Client's consent. 	<p>In Writing (in one or more documents).</p>

INFORMATION FOR ALL FINANCIAL ADVICE ENGAGEMENTS (3 OF 3)

Information that must be provided to Clients in all Financial Advice Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)
<p>Referral Compensation Arrangement: Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to you, your 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. <i>Code and Standards</i> Section A.13.a.ii. and A.10.a.vii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 10, 11, 12, 14, and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; and • ERISA Section 408(b)(2) Sponsor disclosures. 	<p>Initially: Prior to the Engagement or at the time of the recommendation.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	<p>Orally or in Writing (in one or more documents).</p> <p>If the information is provided orally, the CFP® professional must document the fact that the information was provided.</p> <p>As a best practice, CFP Board recommends that CFP® professionals provide this information in writing.</p>
<p>Other Material Information: 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. <i>Code and Standards</i> Section A.10.a.viii.</p>	<ul style="list-style-type: none"> • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank Trust Agreement and related documents; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Prior to or at the time of the Engagement. This information is typically provided at the first or second meeting with the Client.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p> <p>Disciplinary and Bankruptcy Updates: Within 90 days of any Material changes and updates to public disciplinary history or bankruptcy information.</p>	

APPENDIX (2)

FINANCIAL PLANNING ENGAGEMENTS DISCLOSURE GUIDE

**REFERENCE GUIDE TO PROVIDING INFORMATION
TO A CLIENT IN FINANCIAL PLANNING ENGAGEMENTS**

INFORMATION FOR FINANCIAL PLANNING ENGAGEMENTS (1 OF 4)

Information that must be provided to Clients in all Financial Planning Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)
<p>Services and Products: A description of the services and products to be provided. <i>Code and Standards</i> Section A.10.a.i.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Item 4; • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank Trust Instrument and related documents required under state trust law; • Disclosure documents required by federal banking regulators as set forth in Comptroller's Handbook: Safety and Soundness, Retail Nondeposit Investment Products, FDIC regulations; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Prior to or at the time of the Engagement. This information is typically provided at the first or second meeting with the Client.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	<p>In Writing (in one or more documents).</p>
<p>How the Client Pays: 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. <i>Code and Standards</i> Section A.10.a.ii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 5, 6, 10, 12, and 14; • Form ADV Part 2(B) Brochure Supplement: Items 5 and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank Trust Instrument and related documents required under state trust law; • Disclosure documents required by federal banking regulators; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 		
<p>How You and Others are Compensated: How the CFP® professional, the CFP® Professional's Firm, and any Related Party are compensated for providing the products and services. <i>Code and Standards</i> Section A.10.a.iii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 5, 6, 10, 12, and 14; • Form ADV Part 2(B) Brochure Supplement: Items 5 and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; and • ERISA Section 408(b)(2) Sponsor disclosures; • Bank Trust Instrument and related documents required under state trust law; • Disclosure documents required by federal and state banking regulators; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 		

INFORMATION FOR FINANCIAL PLANNING ENGAGEMENTS (2 OF 4)

Information that must be provided to Clients in all Financial Planning Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)
<p>Public Discipline and Bankruptcy: 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. <i>Code and Standards</i> Section A.10.a.iv.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 9, 18.C, and 19.D; • Form ADV Part 2(B) Brochure Supplement: Items 3 and 7; • BrokerCheck Report - www.BrokerCheck.FINRA.org; • IAPD Report - www.AdviserInfor.SEC.gov/IAPD/default.aspx; • CFP Board's Verify-A-CFP® Professional Search Tool - http://www.letsmakeaplan.org/choose-a-cfp-professional/verify-a-cfp-professional; • Public Access to Court Electronic Records (PACER) / Electronic Case Filing (ECF) Database - www.pacer.gov; and • Any other federal court website that contains the bankruptcy information. 	<p>Disciplinary and Bankruptcy Updates: Within 90 days of any Material changes and updates to public disciplinary history or bankruptcy information.</p>	<p>In Writing (in one or more documents).</p>
<p>Material Conflicts of Interest: Full disclosure of all Material Conflicts of Interest 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. <i>Code and Standards</i> Section A.5.a. and A.10.a.v.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 10, 12, and 14; • Engagement Letter or Agreement; • Investment Advisory Agreement; • ERISA Section 408(b)(2) Sponsor disclosures; • Bank Trust Instrument and related documents required under state trust law; • Bank disclosures pursuant to federal banking regulations (e.g., 12 CFR 343 re: sales of insurance); • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Before or when providing any Financial Advice regarding which the CFP® professional has a Material Conflict of Interest.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	<p>Orally or In Writing (in one or more documents).</p> <p>If the information is provided orally, the CFP® professional must document the fact that the information was provided.</p> <p>As a best practice, CFP Board recommends that CFP® professionals provide this information in writing.</p>

INFORMATION FOR FINANCIAL PLANNING ENGAGEMENTS (3 OF 4)

Information that must be provided to Clients in all Financial Planning Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the <i>Code and Standards</i> ? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the <i>Code and Standards</i> ? (Applicable Law May Have Additional Requirements)
<p>Written Privacy Policies: Written notice of policies regarding the protection, handling, and sharing of a Client's non-public personal information. <i>Code and Standards</i> Section A.9.d. and A.10.a.vi.</p>	<ul style="list-style-type: none"> • Privacy Notice required under SEC's Regulation S-P; • Privacy Notice required under Consumer Financial Protection Bureau regulations; and • State-specific Privacy Notice(s). 	<p>Initially: At the time of the Engagement.</p> <p>Required Updates: Not less than annually (at least once in any 12-month period) unless:</p> <ol style="list-style-type: none"> Your policies have not changed since the last notice sent to the Client; and You do not disclose non-public personal information other than as permitted without a Client's consent. 	<p>In Writing (in one or more documents).</p>
<p>Referral Compensation Arrangement: Any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to you, your 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. <i>Code and Standards</i> Section A.13.a.ii. and A.10.a.vii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 10, 11, 12, 14 and 19.C; • Engagement Letter or Agreement; • Investment Advisory Agreement; and • ERISA Section 408(b)(2) Sponsor disclosures. 	<p>Initially: Prior to the Engagement or at the time of the recommendation.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	
<p>Other Material Information: 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. <i>Code and Standards</i> Section A.10.a.viii.</p>	<ul style="list-style-type: none"> • Engagement Letter or Agreement; • Investment Advisory Agreement; • Bank trust agreement and related documents; • Brokerage Agreement; • Offering Documents; • Prospectus; and • Insurance Illustration(s). 	<p>Initially: Prior to or at the time of the Engagement. This information is typically provided at the first or second meeting with the Client.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p> <p>Disciplinary and Bankruptcy Updates: Within 90 days of any Material changes and updates to public disciplinary history or bankruptcy information.</p>	

INFORMATION FOR FINANCIAL PLANNING ENGAGEMENTS (4 OF 4)

Information that must be provided to Clients in all Financial Planning Engagements			
What Information Must I Share?	Which Documents May Contain This Information?	When Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)	How Must I Provide the Information Under the Code and Standards? (Applicable Law May Have Additional Requirements)
<p>Terms of Engagement: The terms of the Financial Planning Engagement between the Client and the CFP® professional or the CFP® Professional's Firm, including:</p> <ul style="list-style-type: none"> • The Scope of Engagement and any limitations; • The period(s) during which the services will be provided; and • The Client's responsibilities. <p>A CFP® professional is responsible for implementing, monitoring, and updating the Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement. <i>Code and Standards</i> Section A.10.b.ii.</p>	<ul style="list-style-type: none"> • Form ADV Part 2(A): Items 10, 12, and 14; • Bank Trust Agreement and related documents; and • Brokerage Agreement 	<p>Initially: Prior to or at the time of the Engagement. This information is typically provided at the first or second meeting with the Client.</p> <p>Required Updates: Whenever there is a Material change or update to the information.</p>	<p>In Writing (in one or more documents).</p>
<p>Financial Planning Implementation Responsibilities (Unless Specifically Excluded from Scope of Engagement):</p> <ul style="list-style-type: none"> • The recommendations being implemented; and • The responsibilities of the CFP® professional, the Client, and any third party with respect to implementation. <p><i>Code and Standards</i> Section C.6.a.</p>	<ul style="list-style-type: none"> • Engagement Letter or Agreement; • Investment Advisory Agreement; and • Bank Trust Agreement and related documents. 	<p>Prior to or at the time of the Engagement, whenever the CFP® professional has implementation responsibilities (which are assumed unless they have been specifically excluded from the Scope of Engagement).</p>	
<p>Financial Planning Monitoring and Updating Responsibilities (Unless Specifically Excluded from Scope of Engagement):</p> <ul style="list-style-type: none"> • 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; • The Client's responsibility to inform the CFP® professional of any Material changes to the Client's qualitative and quantitative information; • The CFP® professional's responsibility to update the Financial Planning recommendations; and • How and when the CFP® professional will update the Financial Planning recommendations. <p><i>Code and Standards</i> Section C.7.a.</p>	<ul style="list-style-type: none"> • Engagement Letter or Agreement; • Investment Advisory Agreement; and • Bank Trust Agreement and related documents. 	<p>Prior to or at the time of the Engagement, whenever the CFP® professional has monitoring and updating responsibilities (which are assumed unless they have been specifically excluded from the Scope of Engagement).</p>	

APPENDIX (3)

PRACTICE STANDARDS REFERENCE GUIDE

**REFERENCE GUIDE TO THE PRACTICE STANDARDS
FOR THE FINANCIAL PLANNING PROCESS**

STEP 1 - UNDERSTANDING THE CLIENT'S PERSONAL AND FINANCIAL CIRCUMSTANCES

Standards		Tips
<ul style="list-style-type: none"> Obtain qualitative and quantitative information. 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> CFP Board's Practice Standards for the Financial Planning Process provide examples of qualitative and quantitative information that may be needed. Make sure to have necessary information and documents. Confirm with the Client that the information is accurate. Address with the Client any inconsistencies in the information provided.
<ul style="list-style-type: none"> Analyze information. 	<ul style="list-style-type: none"> Analyze the information to assess the Client's personal and financial circumstances. 	
<ul style="list-style-type: none"> Address incomplete information. 	<ul style="list-style-type: none"> If unable to obtain information necessary to fulfill the Scope of Engagement, limit it to those services you are able to provide or terminate the Engagement. 	

Examples of qualitative or subjective information:

- Health
- Life expectancy
- Family circumstances
- Values
- Attitudes
- Expectations
- Earnings potential
- Risk tolerance
- Goals, needs, and priorities
- Current course of action

Examples of quantitative or objective information:

- Age
- Dependents
- Other professional advisors
- Income
- Expenses
- Cash flow
- Savings
- Assets
- Liabilities
- Available resources
- Liquidity
- Taxes
- Employee benefits
- Government benefits
- Insurance coverage
- Estate plans
- Capacity for risk
- Education and retirement accounts and benefits

STEP 2 - IDENTIFYING AND SELECTING GOALS

Standards		Tips
<ul style="list-style-type: none"> Identify potential goals. 	<ul style="list-style-type: none"> Discuss with the Client your assessment of the Client's financial and personal circumstances. Develop reasonable assumptions and estimates. Discuss with the Client and apply reasonable assumptions and estimates. 	<ul style="list-style-type: none"> Consider discussing with the Client how changes to assumptions and estimates may affect the Client's goals. Consider providing to the Client in writing the reasonable assumptions and estimates you have used, such as life expectancy, inflation rates, tax rates, investment returns, and other Material assumptions or estimates.
<ul style="list-style-type: none"> Select and prioritize goals. 	<ul style="list-style-type: none"> Note the impact that selecting a particular goal may have on other goals. Discuss with the Client any goals the Client has selected that you think are unrealistic. 	

Examples of assumptions and estimates:

- Life expectancy
- Inflation rates
- Other material assumptions and estimates
- Tax rates
- Investment returns



STEP 3 - ANALYZING THE CLIENT'S CURRENT COURSE OF ACTION AND POTENTIAL ALTERNATIVE COURSE(S) OF ACTION

Standards		Tips
<ul style="list-style-type: none"> Analyze the current course of action. 	<ul style="list-style-type: none"> Analyze material advantages and disadvantages of the current course of action. Analyze whether the current course maximizes the potential for meeting the Client's goals. 	<ul style="list-style-type: none"> Always determine whether the Client's current course of action maximizes the potential for meeting the Client's goals. Note that a potential alternative course of action does not become a recommendation until the CFP® professional selects it as a recommendation in Step 4 of the process.
<ul style="list-style-type: none"> Analyze potential alternative courses of action. 	<ul style="list-style-type: none"> When appropriate, consider and analyze one or more potential alternative courses of action, including their material advantages and disadvantages, whether they help maximize the potential for meeting the Client's goals, and how they integrate the relevant elements of the Client's personal and financial circumstances. 	



STEP 4 - DEVELOPING THE FINANCIAL PLANNING RECOMMENDATION(S)

Standards		Tips
<ul style="list-style-type: none"> • From the current and potential alternative courses of action, select one or more recommendations designed to maximize the potential for meeting the Client's goals. 	<ul style="list-style-type: none"> • For each recommendation selected, you must consider the following: <ul style="list-style-type: none"> ○ The assumptions and estimates used to develop the recommendation; ○ The basis for making the recommendation, including: <ul style="list-style-type: none"> - 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; ○ The timing and priority of the recommendation; and ○ Whether the recommendation is independent or must be implemented with another recommendation. 	<ul style="list-style-type: none"> • Sometimes no change is necessary; the recommendation may be to continue the Client's current course of action. • Document the basis for your recommendations. • Consider whether to modify previously selected goals.

STEP 5 - PRESENTING THE FINANCIAL PLANNING RECOMMENDATION(S)

Standards		Tips
<ul style="list-style-type: none"> • Present to the Client the selected recommendation(s) and the information that was required to be considered in developing the recommendation(s). 	<ul style="list-style-type: none"> • Present to the Client: <ul style="list-style-type: none"> ○ The recommendation(s); ○ The assumptions and estimates used to develop the recommendation; ○ The basis for making the recommendation, including: <ul style="list-style-type: none"> - 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; ○ The timing and priority of the recommendation; and ○ Whether the recommendation is independent or must be implemented with another recommendation. 	<ul style="list-style-type: none"> • This is an opportunity to engage the Client in a conversation about your recommendations. • Consider whether to modify previously selected goal. • Recommendations may be presented orally, in writing, in person, over the phone, or in another format that enables the Client to understand the recommendations. • Consider the complexity of your recommendations when determining the format in which to present your recommendations. • Document the recommendations. If you present the recommendations in writing, then retain a copy of the presentation. • Tailor the presentation to the Client's level of sophistication.

STEP 6 – IMPLEMENTING THE FINANCIAL PLANNING RECOMMENDATION(S) (UNLESS SPECIFICALLY EXCLUDED FROM SCOPE OF ENGAGEMENT)

Standards		Tips
<ul style="list-style-type: none"> Address implementation responsibilities. 	<ul style="list-style-type: none"> Establish with the Client whether you have responsibilities for implementing the Financial Planning recommendation(s). If you have implementation responsibilities, communicate to the Client the recommendations being implemented and the responsibilities of the CFP® professional, the Client, and any third party with respect to implementation. 	<ul style="list-style-type: none"> Remember: <i>Code and Standards</i> Section A.10.b.ii states that you are responsible for implementing the Client’s Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement. Ensure that the delineation of implementation responsibilities is clear. Third parties involved in implementation could include attorneys or accountants, among others. Consider preparing and providing to the Client a written implementation plan. Consider documenting the selection of actions, products, or services that deviate from your recommendation.
<ul style="list-style-type: none"> If you have implementation responsibilities, identify, analyze, and select actions, products, and services designed to implement the recommendation(s). 	<ul style="list-style-type: none"> Consider the basis for each selection, which must include: <ul style="list-style-type: none"> How the action, product, or service is designed to implement the recommendation; and The advantages and disadvantages relative to reasonably available alternatives. 	
<ul style="list-style-type: none"> If you have implementation responsibilities, recommend one or more actions, products and services for implementation. 	<ul style="list-style-type: none"> Discuss with the Client: <ul style="list-style-type: none"> The basis for selecting the action, product, or service, The timing and priority of implementing the action, product, or service, and Describe any Conflicts of Interest. 	
<ul style="list-style-type: none"> If you have implementation responsibilities, select and implement actions, products, or services. 	<ul style="list-style-type: none"> Discuss with the Client any selection that deviates from your recommendation. 	

STEP 7 - MONITORING PROGRESS AND UPDATING (UNLESS SPECIFICALLY EXCLUDED FROM SCOPE OF ENGAGEMENT)

Standards		Tips
<ul style="list-style-type: none"> Establish monitoring and updating responsibilities. 	<ul style="list-style-type: none"> When you have responsibilities for monitoring and updating, you must communicate to the Client: <ul style="list-style-type: none"> Which actions, products, and services are/are not subject to your monitoring responsibility; How and when you will monitor actions, products, or services; The Client's responsibility to inform you of any Material changes to the Client's qualitative and quantitative information; Your responsibility to update the Financial Planning recommendations; and How and when you will update the Financial Planning recommendations. 	<ul style="list-style-type: none"> Remember: <i>Code and Standards</i> Section A.10.b.ii states that you are responsible for monitoring and updating the Client's Financial Planning recommendation(s) unless specifically excluded from the Scope of Engagement. Consider documenting your implementation, monitoring, and updating efforts. Be realistic and clear in setting monitoring expectations. Monitoring is an ongoing obligation unless the Engagement is terminated. You should document when the Engagement is not ongoing. Ensure that you have appropriate access to or authority to communicate with third parties to gather information to fulfill your monitoring responsibilities.
<ul style="list-style-type: none"> Monitor the Client's progress. 	<ul style="list-style-type: none"> If you have monitoring responsibility, analyze at appropriate intervals the progress toward reaching Client goals and review with the Client the results of your analysis. 	
<ul style="list-style-type: none"> Obtain current qualitative and quantitative information. 	<ul style="list-style-type: none"> If you have monitoring responsibility, collaborate with the Client in an attempt to obtain current qualitative and quantitative information concerning the Client's personal and financial circumstances. 	
<ul style="list-style-type: none"> Update goals, recommendations, or implementation decisions. 	<ul style="list-style-type: none"> If you have updating responsibility, and circumstances warrant changes, update as appropriate in accordance with the Practice Standards for the Financial Planning Process. 	

APPENDIX (4)

FINANCIAL ADVICE ENGAGEMENTS COMPLIANCE GUIDE

FINANCIAL ADVICE ENGAGEMENTS COMPLIANCE GUIDE

CFP Board designed this guide to help CFP® professionals evaluate whether they are providing information and services in accordance with CFP Board's *Code of Ethics and Standards of Conduct* ("Code and Standards") when they are providing Financial Advice. Under certain circumstances, a CFP® professional is required to update the information provided to a Client.

SECTION A: THE 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. (Standard A.1.)

Duty of Loyalty:

- Have I placed the interests of the Client above the interests of me and my firm?
- Have I avoided Conflicts of Interest, or fully disclosed Material Conflicts of Interest to the Client, obtained the Client's informed consent, and properly managed the conflict?
- Have I acted without regard to the interests of me and my firm, and any individual or entity other than the Client?

Duty of Care:

- Have I acted 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?

- Have I complied with all objectives, policies, restrictions, and other terms of the Engagement, and all reasonable and lawful directions of the Client?

SECTION B: IS THIS A FINANCIAL PLANNING ENGAGEMENT?

If the answer to any of the following is yes, then this is a Financial Planning Engagement and you must comply with the Practice Standards for the Financial Planning Process. If no, then the engagement for Financial Advice does not require Financial Planning, and you are not required to comply with the Practice Standards for the Financial Planning Process. (Standards B.3. and B.4.)

- Have I agreed to provide or provided Financial Planning?
- Does the client have a reasonable basis to believe that I will provide or have provided Financial Planning?
- Does the Financial Advice I agreed to provide require integration of relevant elements of the Client's personal and/or financial circumstances in order to act in the Client's best interests, taking into account the following Integration Factors?
 - 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.

If I otherwise must comply with the Practice Standards for the Financial Planning Process, but the Client does not agree to enter into a Financial Planning engagement, have I done one of the following:

- Not enter into the Engagement;
- Limited the Scope of Engagement to services that do not require application of the Practice Standards for the Financial Planning Process and described to the Client the services the Client requests that the CFP® professional will not be performing;
- Provided the requested services after informing the Client how Financial Planning would benefit the Client and how the decision not to enter into a Financial Planning engagement may limit the Financial Advice; or
- Terminated the Engagement.

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SECTION C: PROVIDING INFORMATION TO A CLIENT

Have I provided the following information orally or in writing, in one or more written documents:

Services, Products, Compensation, Disciplinary History, Bankruptcy, and Other Material Information

(Standard A.10.a.i. – v.)

- Have I provided the Client a description of the services and products to be provided?
- Have I explained how the Client pays for the products and services and described the additional types of costs that the Client may incur, including product management fees, surrender charges, and sales loads?
- Have I informed the Client how I, my firm, and any Related Party are compensated for providing the products and services?
- Do I have any public disciplinary history or personal bankruptcy or business bankruptcy where I was a Control Person? If so, have I notified the Client of the existence of the public discipline or bankruptcy and provided the Client with 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 my public disciplinary history or personal or business bankruptcy?

Conflicts of Interest

(Standards A.5.a., A.10.a.v., and A.13.a.)

- Have I provided full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship? Have I provided sufficiently specific facts so that the Client is able to understand the Material Conflicts of Interest and the business practices that give rise to the conflicts?
- Have I obtained the Client's informed consent, either express or implied, to such Conflicts of Interest?
- Have I properly managed any Conflict of Interest by providing Financial Advice that is in the best interests of the Client and places the Client's interests above my own, notwithstanding the conflict, by adopting and following business practices reasonably designed to prevent Material Conflicts of Interest from compromising my ability to act in my Client's best interests?
- Have I disclosed any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to me, my firm, or a Related Party for engaging or recommending the selection or retention of additional persons to

provide financial or Professional Services to the Client?

Confidentiality and Privacy

(Standard A.9.d.)

- Have I or has my firm adopted and implemented policies regarding the protection, handling, and sharing of the Client's non-public personal information?
- Have I or has my firm provided the Client with written notice of the policies regarding the protection, handling, and sharing of the Client's non-public personal information? (This must be provided in writing.)

Other Requirements

(Standards A.10.a. and A.10.a.viii.)

- Have I provided the Client all other information Material to the decision to engage or continue to engage me or my firm?
- Have I documented that I have provided the Client with all of the information set forth above?

APPENDIX (5)

FINANCIAL PLANNING ENGAGEMENTS COMPLIANCE GUIDE

FINANCIAL PLANNING ENGAGEMENTS COMPLIANCE GUIDE

CFP Board designed this guide to help CFP® professionals evaluate whether they are providing information and services in accordance with CFP Board's *Code of Ethics and Standards of Conduct* ("Code and Standards") when they are providing Financial Planning. Under certain circumstances, a CFP® professional is required to update the information provided to a Client.

SECTION A: THE FIDUCIARY DUTY

At all times when providing Financial Planning to a Client, a CFP® professional must act as a fiduciary and, therefore, act in the best interests of the Client. (Standard A.1.)

Duty of Loyalty:

- Have I placed the interests of the Client above the interests of me and my firm?
- Have I avoided Conflicts of Interest, or fully disclosed Material Conflicts of Interest to the Client, obtained the Client's informed consent, and properly managed the conflict?
- Have I acted without regard to the interests of me and my firm, and any individual or entity other than the Client?

Duty of Care:

- Have I acted 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?

- Have I complied with all objectives, policies, restrictions, and other terms of the Engagement, and all reasonable and lawful directions of the Client?

SECTION B: PROVIDING INFORMATION TO A CLIENT

Have I provided the following information in one or more written documents:

Services, Products, Compensation, Disciplinary History, Bankruptcy, and Other Material Information (Standard A.10.a.i. – v.)

- Have I provided the Client a description of the services and products to be provided?
- Have I explained how the Client pays for the products and services and described the additional types of costs that the Client may incur, including product management fees, surrender charges, and sales loads?
- Have I informed the Client how I, my firm, and any Related Party are compensated for providing the products and services?
- Do I have any public disciplinary history or personal bankruptcy or business bankruptcy where I was a Control Person? If so, have I notified the Client of the existence of the

public discipline or bankruptcy and provided the Client with 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 my public disciplinary history or personal or business bankruptcy?

Conflicts of Interest

(Standards A.5.a., A.10.a.v., and A.13.a.)

- Have I provided full disclosure of all Material Conflicts of Interest with the Client that could affect the professional relationship? Have I provided sufficiently specific facts so that the Client is able to understand the Material Conflicts of Interest and the business practices that give rise to the conflicts? (Please note that information about Material Conflicts of Interest is not required to be provided in writing.)
- Have I obtained the Client's informed consent, either express or implied, to such Conflicts of Interest?
- Have I properly managed any Conflict of Interest by providing Financial Advice that is in the best interests of the Client and places the Client's interests above my own, notwithstanding the conflict, by adopting and following business practices reasonably designed to prevent Material Conflicts of Interest

FINANCIAL PLANNING ENGAGEMENTS COMPLIANCE GUIDE

from compromising my ability to act in my Client's best interests?

- Have I disclosed any arrangement by which someone who is not the Client will compensate or provide some other material economic benefit to me, my firm, or a Related Party for engaging or recommending the selection or retention of additional persons to provide financial or Professional Services to the Client?

Confidentiality and Privacy (Standard A.9.d.)

- Have I or has my firm adopted and implemented policies regarding the protection, handling, and sharing of the client's non-public personal information?
- Have I or has my firm provided the Client with written notice of the policies regarding the protection, handling, and sharing of the client's non-public personal information?

Terms of the Engagement (Standard A.10.b.ii.)

- Have I provided to the Client, in writing, the terms of the Engagement between me or my Firm and the Client, including the Scope of Engagement and any limitations, the period(s) during which the services will be provided, and the Client's responsibilities?

- Have I determined with the Client whether I will be responsible for implementing, monitoring, and updating the Financial Planning recommendation(s)? (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.)

Other Requirements

(Standards A.10.a. and A.10.a.viii., and C.)

- Have I provided the Client all other information Material to the decision to engage or continue to engage me or my firm?
- Have I acted 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 my firm's policies and procedures?
- Have I documented that I have provided the Client with all of the information set forth above?

SECTION C: THE FINANCIAL PLANNING PROCESS

Step 1: Understanding the Client's Personal and Financial Circumstances

- Have I described to the Client the qualitative and quantitative

information concerning the Client's personal and financial circumstances needed to fulfill the Scope of Engagement and collaborated with the Client to obtain the information?

Examples of qualitative or subjective information include the Client's:

- Health
- Life expectancy
- Family circumstances
- Values
- Attitudes
- Expectations
- Earnings potential
- Risk tolerance
- Goals, needs, and priorities
- Current course of action

Examples of quantitative or objective information include the Client's:

- Age
- Dependents
- Other professional advisors
- Income
- Expenses
- Cash flow
- Savings

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- Assets
 - Liabilities
 - Available resources
 - Liquidity
 - Taxes
 - Employee benefits
 - Government benefits
 - Insurance coverage
 - Estate plans
 - Education and retirement accounts and benefits
 - Capacity for risk
- Have I analyzed the qualitative and quantitative information to assess the Client's personal circumstances?
- Have I addressed incomplete information, if any?

Step 2: Identifying and Selecting Goals

- Have I discussed with the Client my assessment of the Client's financial and personal circumstances?
- Have I helped the Client to identify goals and noted the effect that selecting a particular goal may have on other goals?

- Have I discussed with the Client, and applied, reasonable assumptions and estimates?
- Examples include:
- Life expectancy
 - Inflation rates
 - Tax rates
 - Investment returns
- Have I helped the Client to select and prioritize goals?
- Have I discussed with the Client any goals that may not be realistic?

Step 3: Analyzing the Client's Current Course of Action and Potential Alternative Course(s) of Action

- Have I analyzed 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 goals?
- Have I analyzed 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?

Step 4: Developing the Financial Planning Recommendation(s)

- Have I selected recommendations designed to maximize the potential for meeting the Client's goals?
- Have I considered whether to recommend that the Client continue the current course of action?
- For each recommendation, have I considered:
 - The assumptions and estimates used to develop the recommendation(s);
 - The basis for making the recommendation(s), 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;
 - The timing and priority of the recommendation(s); and
- Whether the recommendation is independent or must be implemented with another recommendation?

FINANCIAL PLANNING ENGAGEMENTS COMPLIANCE GUIDE

Step 5: Presenting the Financial Planning Recommendation(s)

- Have I presented to the Client the selected recommendation(s) and the information I considered when developing the recommendation(s)?

Step 6: Implementing the Financial Planning Recommendation(s) (Unless Specifically Excluded from Scope of Engagement)

- Have I established with the Client whether I have implementation responsibilities and, if required, communicated to the Client the recommendation(s) being implemented and my responsibilities, the Client's responsibilities, and the responsibilities of any third party with respect to implementation?
- Have I determined whether I need to amend the terms of the Engagement with the Client to reflect accurately the implementation responsibilities?
- If I do not have implementation responsibilities, proceed to Step 7.
- If I have implementation responsibilities, have I:
 - Identified and analyzed actions, products, and services designed to implement the recommendations?
 - Considered the basis for each selection, including:
 - How the action, product, or service is designed to implement the recommendation; and

- The advantages and disadvantages of the action, product, or service relative to reasonably available alternatives?
- Recommended one or more actions, products, and services for implementation and discussed with the Client the basis for selection, the timing and priority of implementation, and disclosed and managed any Conflicts of Interest concerning the action, product, or service?
- Helped the Client to select and implement actions, products, or services and discussed with the Client any selection that deviates from my recommendations?

Step 7: Monitoring Progress and Updating (Unless Specifically Excluded from Scope of Engagement)

- Have I established with the client who has monitoring and updating responsibilities?
- Have I determined whether I need to amend the terms of the Engagement with the Client to reflect accurately the monitoring and updating responsibilities?
- When I have responsibilities for monitoring and updating, have I communicated to the Client:
 - Which actions, products, and services are and are not subject to my monitoring responsibility;

- How and when I will monitor the actions, products, and services;
- That it is the Client's responsibility to inform me of any Material changes to the Client's qualitative and quantitative information;
- My responsibility to update the Financial Planning recommendations; and
- How and when I will update the Financial Planning recommendations?
- If I have monitoring responsibilities, have I monitored the Client's progress toward achieving the Client's goals and reviewed my analysis with the Client?
- If I have monitoring responsibilities, have I collaborated with the Client to obtain current qualitative and quantitative information concerning the Client's personal and financial circumstances?
- If I have updating responsibilities, have I determined whether the circumstances warrant changes to the Client's goals, recommendations, or selections of actions, products, and services, and updated those in accordance with the *Code and Standards*?

CFP BOARD

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

1425 K St NW #800 Washington, DC 20005 | 800-487-1497 | f 202-379-2299 | mail@CFPBoard.org | CFP.net

IS NASAA SHORT-CHANGING INVESTOR PROTECTION FOR RIA CLIENTS BY NEGLECTING ARBITRATION?

Richard P. Ryder*

Introduction -- Two Premises

This article will be underpinned by two basic premises and, so, we should deal with those propositions before offering our views on a better outcome. We start with the notion that state regulators have been appointed the hands-on regulator by Congress of thousands of registered investment advisers (RIAs). Gradually, these RIAs and the traditional stockbrokers who have, for so many years, predominated as intermediaries for securities and commodities investors, are being viewed by the investing public as similar in their functions.

Yet, in the arbitration realm, state regulators have not coordinated a plan for optimal resolution of disputes that arise between RIAs and their clients. Instead, in the dispute resolution arena, [NASAA](#) (the representative organization for state regulators) is best known for its negative views on arbitration. So, first premise: State regulators have so boxed themselves in by distancing themselves from arbitration that they risk sacrificing robust "choice" in the RIA dispute resolution space for the very investors their regulatory objectives seek to protect.

[FINRA](#), on the other hand, as the primary self-regulator of the brokerage community, has long embraced arbitration as both a regulatory detection aid and a specialized alternative for investors harmed by ethical, regulatory and legal violations by their brokers. Like the securities markets in which aggrieved investors have lost money, arbitration is structured to reach an outcome speedily, efficiently and with finality. When contacted by customers who complain about broker (and broker-dealer) conduct, FINRA routinely investigates those complaints and promptly responds that the customer should, if s/he seeks monetary damages, contact its arbitration arm, FINRA Dispute Resolution (FINRA-DR).

Rather than suspiciously discouraging arbitration's use for the resolution of investor disputes, FINRA (and NASD/NYSE and other securities SROs) has regulated arbitration, given it a home, and married it into its investor protection and enforcement programs. FINRA Dispute Resolution supports FINRA Enforcement's objectives by supplying disciplinary referrals from arbitrators, and by gathering for regulatory review investor complaints vetted and refined to a narrative by securities-experienced lawyers. Detection of fraudulent schemes is further aided by concentrating in one forum the "sparks" of hundreds of similar investor disputes that often reveal the smoke and heat of regulatory conflagrations in progress. FINRA's regulatory side, in turn, advances investor protection goals by shaping through rulemaking arbitration procedures that are fair (indeed, often tilted to favor investors) and by ensuring for victorious investors, far better than in court, the payment of Awards and settlements.

** The author is Editor-in-Chief and founder of the Securities Arbitration Commentator newsletter. This article recently appeared in the SAC newsletter (citation: SAC 2019-01(1)) and is re-printed in these PIABA materials with the permission of SAC's publisher.*

Our second premise, then, holds that arbitration has earned standing as a critical building block in broker-dealer regulation's structure and has achieved a sufficient modicum of fairness to be recognized as an investor protection tool -- an integral part of the package. It was one thing for NASAA and its state regulators to criticize SRO arbitration's deficiencies, when they played a tertiary role in broker-dealer regulation and directly regulated only the very smallest of RIAs. Today, NASAA plays a more central role, while the nation's retail investors are increasingly retaining the RIAs that state regulators directly oversee, and, it seems to us, a responsibility exists to foster a plan for investor "choice" when RIA clients claim misconduct by their financial advisers.

NASAA's Historical Stance on Arbitration

The position of the North American Securities Administrators Association on securities arbitration for investors has been relatively consistent, although the emphasis changes periodically. We recall the remarks of A. Heath Abshure, when speaking as NASAA's President to the 2013 SIFMA Compliance and Legal Society's Annual Conference, in which he emphatically condemned mandatory arbitration of investor disputes and promised to lobby the SEC and Congress to do away with pre-dispute arbitration clauses (Ref: SAA 2013-11). That same year, NASAA's Legislative Agenda spoke of empowering "state regulators to curtail the use of mandatory pre-dispute arbitration clauses in contracts between state-registered investment advisers and their clients." Mr. Abshure also went out of his way to speak critically of FINRA's Small Claims program.

Andrea Seidt, Ohio's Securities Commissioner, followed Mr. Abshure and, while keeping the anti-arbitration plank in her platform, de-emphasized it, even intimating "a lack of internal agreement" on the issue (SAA 2013-41). Under the investor protection plank, when we checked NASAA's agenda later in the year, was the priority of causing Congress to "improve the fairness of the securities arbitration process." Stressing statutory authority instead of a ban, we perceived (Ref: SAA 2014-17), would allow NASAA to control the use of the PDAA clause vis-a-vis RIAs with AUM of less than \$100 million and, as we commented at the time, "cement [its] authority over that" group.

Under William Beatty (2014-2015), NASAA's approach displayed a willingness to work within the FINRA system; it commented frequently on FINRA rules changes relating to expungement and arbitrator classifications. NASAA was led by Joe Borg, Alabama's Securities Commissioner during the latter part of 2015 and three-quarters of 2016. Mr. Borg is both highly knowledgeable about securities arbitration and, we believe, more of a moderate on the subject. During his tenure, much of the action was taking place at the CFPB, where class action waivers were about to be banned, and we show little coverage involving NASAA on the securities side.

By 2017, NASAA's legislative priorities did not refer at all to mandatory arbitration as an action item for the year (Ref: SAA 2017-11). NASAA did submit comment letters on fiduciary standards, expungement relief, and unpaid arbitration awards in 2017 and 2018. Mr. Borg returned as President in October 2017 and led a balanced response to FINRA's RN 17-42 proposals for expungement reform. NASAA emphasized its initial partnership with FINRA, its views that the current expungement process remained "flawed," that the proposals represented simply a "first step" or "starting point," and that "correcting these issues" remained NASAA's "continued work." (Ref: SAA 2018-07). The SEC's Investor Advocate Office added its view, after the RN 17-42 comment process had closed, that it would be "a good idea [for FINRA] to work with NASAA." When current NASAA President Michael Pieciak (VT) took the reins in October 2018, we noted that his inaugural address did not mention arbitration at all.

So, while NASAA has been at times militant, at times quiescent in its opposition to so-called "mandatory" arbitration, it has regularly made a spectator sport of criticizing arbitration, by addressing the many ways in which FINRA-DR might improve its arbitration program. Public comments by state regulators over the years have focused on FINRA's operation of a "flawed forum" for investors, because of its standing as a "self"-regulatory organization. Expungement relief, with which state regulators are directly involved due to their reliance on the CRD, and unpaid FINRA Awards have regularly drawn criticism from NASAA and individual state regulators.

Potential Demand vs. Lingering Hostility

Since 2010, however, when NASAA members were accorded primary regulator status over mid-sized RIAs and the ranks of regulated entities rose from \$25 million in assets under management to \$100 million, state regulation has grown in importance and the investing public that accesses markets through state-regulated RIAs has grown dramatically. When NASAA wrote its [IA Switch Report](#) in 2013, it estimated that approximately 3,200 RIAs would "switch from federal to state regulation. However, many other state-regulated RIAs existed at the time, today NASAA estimates that [some 17,500 RIAs](#) are state-registered.

Meanwhile, among state regulators, the attitudes about arbitration remained hostile, especially regarding RIAs, where some regulators conflated their personal views about arbitration's ills with their professional renderings on fiduciary standards and concluded that to recommend arbitration to clients constituted a conflict of interest. The use of PDAs among RIAs is by no means as universal as in the broker-dealer community. Massachusetts Secretary William Gavin, in a study performed in 2013 (ref., SAA 2013-07), found that only about 40% of responding RIAs employed PDAs in client agreements and those naming specific forums most commonly designated AAA as the forum provider.

Clearly, this minority percentage was not the kind of pervasive use seen in the broker-dealer community. And no wonder -- in his cover letter introducing the study, Mr. Galvin opined -- for the benefit of his examining staff and the RIAs subject to his oversight -- that "a clause binding an investor to arbitrate a dispute before its circumstances are established may not be in that client's best interests, nor ... consistent with the fiduciary duty owed to the client by the investment adviser." The occasion of his letter was to urge the SEC publicly to exercise its powers under Dodd-Frank, Section 921, and ban the use of PDAs by broker-dealers and RIAs.

Investor Flow to RIAs Meets Reduced Forum Choice

Retail investors have been making changes in the way they invest and through whom they invest that have sped ahead of adjustments to the current dispute resolution apparatus. Particularly, in the RIA space, gaps exist in terms of affordable and speedy alternatives, when disputes arise. Similarly, while many insist that RIAs eschew pre-dispute arbitration agreements (PDAs) for cynical reasons, it may be that uncertainty plays a role, too. Uncertainty about AAA availability stems from whether Consumer Arbitration Rules will be followed. Uncertainty about FINRA availability relates to FINRA's policy of looking to membership, as opposed to investor standing, as the predicate for its arbitral jurisdiction. NASAA, in our view, as the thought leader for state regulators, could be instrumental in resolving these uncertainties and breaking the current impasse.

At FINRA Dispute Resolution, arbitration claims have been ratcheting steadily down since 2010. CY 2019, based on the first four months' activity, stands to be the slowest year in the past decade for arbitration claims. Perhaps, that's the case, in part, as a function of the stock market's

unprecedented upward arc; perhaps, it relates to the move from commission-based business to fee-based business, with the consequent mitigation of transactional greed; perhaps, more intense compliance and regulatory oversight plays a role. It may, though, also be a function of the migration of accounts from the retail models of old to the various iterations of the RIA model.

American Arbitration Association, which publishes statistics about its Commercial Arbitration cases, has indicated a sharp increase in claims filed in its financial services sector in recent years (e.g., up 87% in 2018). Those are not broker-dealer disputes with customers; those are still headed to FINRA. They may not be all RIA disputes, because the financial services arena includes credit card providers and others, but these figures are consistent with field reports indicating that RIA disputes with clients are rapidly increasing -- in the courts, in AAA arbitration, and everywhere but FINRA. Reports from testifying experts participating in these contests inform us that customers disputes with RIAs are surging, but the disputes are going to AAA, JAMS and mostly to the courts.

One Consequence: Claim Fragmentation at FINRA

The loss of market share may sound bad for FINRA, but it's the RIA investor that is primarily disadvantaged, in our view. Customer disputes involving dually registered brokers -- those who are registered both as registered representatives and as registered investment advisers or investment adviser representatives -- can become fragmented at FINRA by jurisdictional arguments. Arbitrators may find themselves hamstrung from delivering their full judgment on the merits of a dispute by the argument that claimant's accounts are divided between fee-based and commission-based and that the former is subject to RIA regulation. As the RIA non-member managed the fee-based account, losses in that account are arguably not subject to FINRA arbitration.

This kind of claim fragmentation hamstrung arbitrators in *Hansen v. Allegis Investment Services* (FINRA ID #[17-00135](#)), leading to a zero award for the customer -- even though the account under the RIA umbrella and the account under the BD (TD Ameritrade) umbrella were overseen by the same individuals. After TD Ameritrade settled out, the remaining losses were housed in the RIA account and the Allegis Respondents requested dismissal. The Arbitrators complied, writing: "The Panel finds that FINRA lacks jurisdiction of this dispute pursuant to Rules 12200 and 12201 because Claimants were not Customers of ... Allegis ... and the individual Respondents ... were not acting in their capacity as associated persons of a member.... Claimants' claims are dismissed. It is the decision of the Panel that the FINRA dispute resolution forum is not available for resolution of this dispute...."

To be fair, we are told that the larger brokerage houses, which do commonly divide client assets between fee-based and commission-based accounts today, do not make the *Hansen* jurisdictional argument. The defense may be heard that the accounts are subject to different standards (fiduciary vs. suitability), but the kind of claim fragmentation one sees in the *Hansen* Award is more likely to arise in the IBD space -- or in the RIA custody setting, where a pure RIA non-member resides on a broker-dealer's (e.g., Schwab, Pershing, Fidelity) custodial platform. FINRA-DR policies about what RIA-related claims it will accept and whether it will do so on a post-submission basis, rather than honoring a valid PDAA, complicates the picture.

This threat of claim fragmentation, by omitting an account or even a product from the loss equation, only exists at FINRA. That kind of jurisdictional defense would not apply at AAA or JAMS and there's no reason why FINRA arbitrators should be subject to such artificial constraints. FINRA's mission hinges on optimizing investor protection and this frailty or loophole needs

mending. We submit that FINRA could clarify matters significantly by making it express to members that claims duly filed by customers against FINRA members and associated persons extend to the customer's entire in-house portfolio, whether in fee-based or commission-based accounts, and whether in the form of securities, commodities or insurance products. Revising the standard FINRA Submission Agreement could achieve that end.

NASAA Could Play Pivotal Role in Expanding Forum Choice

Of course, this claim fragmentation threatens most the investor with claims against a hybrid RIA or a dually registered salesperson. Investors dealing with RIA non-members are, with limited exceptions, precluded from having their dispute administered by the "largest securities dispute resolution forum in the [world](#)." If arbitration is available to the aggrieved RIA investor in this context, it will generally be at AAA, not at the more securities-experienced FINRA. In most cases, according to the Galvin survey, arbitration will not be available and the RIA client has no choice except the costly route of litigation -- and, for many in that situation, that means no choice or representation by an attorney without securities expertise. Shouldn't NASAA, as the primary regulator (through its members) of the majority of this country's RIAs -- be concerned with that condition?

In an ideal world, what could NASAA do to advance forum choice and add solid arbitration possibilities to the arsenal available to aggrieved RIA clients? It could, to start, recognize the relative virtues of arbitration, in comparison to litigation. NASAA does not have to favor arbitration over litigation, in order to acknowledge, as the U.S. Supreme Court has -- time and again -- that arbitration, fairly constituted, is a viable tool for the vindication of statutory rights. It may also recognize the practical reality that a cadre of specialized lawyers exists in the arbitration arena that will be far more dispersed and less available to RIA clients in the splintered and decentralized litigation environment.

One can readily see why PIABA would be concerned with the lack of an arbitration choice for RIA clients. The Public Investors *Arbitration* Bar Association was built around the need for sophisticated representation of investors with securities claims *in* arbitration. The Association's attorney members network with one another over PIABA's ListServ, building their collective understanding and resources; many have earned an expansive knowledge of securities laws, rules and practices; and they serve the needs of litigating investors around the country and internationally. PIABA, unlike NASAA -- which has criticized from the sidelines -- *participates* in FINRA arbitration. Its members argue the precepts of fiduciary standards in arbitration regularly and have grown, with the trend toward fee-based management, familiar with RIA case law, rules and standards.

Potential Initiatives - Without Rulemaking

NASAA does not have to erect its own arbitration facility in order to preserve these elements. The Association could work with FINRA and the AAA to administer disputes between RIA clients and their advisers and to overcome the inertial resistance at those forums that hampers that prospect today. These parties could be far more receptive to AAA or FINRA arbitration, if the uncertain and unpredictable aspects of forum entry could be resolved and cleared. At AAA, it's the "Lady or the Tiger" that awaits one's submission -- will the streamlined, inexpensive Consumer Arbitration Rules (CAR) be applied or will clients have to arbitrate under the more complex and, sometimes, prohibitively expensive Commercial Arbitration Rules? AAA says the defining criterion is whether the claimant is an individual investor, but Claimant's attorneys quoted in the media, maintain that qualifying for CAR is very unpredictable.

At FINRA, the problem is long-standing. FINRA once spent millions lobbying for the role of RIA self-regulator and lost the political battle. Since that time, the Authority has been wary about moves that might ignite suspicion of an end-run among RIAs and their representative organizations. An invitation to FINRA, coming from NASAA, to open its arbitral facility to the RIA sector and to serve investor protection by expanding its reach to RIA disputants, would have a powerful impact. NASAA would be making the overture, not FINRA; expanding arbitral boundaries to accommodate securities investors, regardless of the service provider, could not be reasonably seen as a tactical move to grab regulatory turf. Working with PIABA and the AAA, NASAA could also lead the way to predictable access to the Consumer Rules at AAA.

Potential Initiatives - With Rulemaking

Just those measures alone would encourage state-regulated RIAs to utilize PDAAs with the assurance that arbitration, when needed, would be available as intended and under the rules stipulated in the agreements. But NASAA could go much further through rulemaking (NASAA creates models for adoption by state authorities). It could enlarge its Unethical Practices guidelines to regulate those agreements that state-qualified RIAs would use and thereby ensure fairness and clarity in the initiation of claims. NASAA could also adopt its own version of Rule 12200, affording RIA clients the right to demand arbitration at AAA or FINRA. It could shape PDAA provisions and even require that PDAAs be voluntary for RIA clients -- as the [commodities side](#) has. NASAA would surely have a more influential role affecting FINRA-DR rulemaking, at least as they pertain to RIA-related disputes. NASAA could share with FINRA its ideas on ameliorating the long-standing problem of unpaid arbitration awards and incorporate those measures into collecting on AAA and FINRA monetary awards against RIA registrants.

Of course, effecting new legislation and state-by-state regulations would be a far more complicated matter, but NASAA does have the opportunity, by assuming a more dominant role on issues relating to RIA-related dispute resolution, to develop greater choice among available forums for aggrieved RIA clients and to help AAA and FINRA overcome uncertainties that are hampering optimal access to those forums. With this resolve, NASAA could also create model rules that would implement in the RIA space measures that NASAA has long recommended for FINRA adoption.

Conclusion

The many improvements that FINRA Dispute Resolution has made to ensure fairness to aggrieved investors who bring disputes against broker-dealers to its forum have sparked the establishment of a cadre of arbitration practitioners who represent customers, who have organized, educated one another, and developed specialized knowledge of the dispute resolution process and the securities industry. The forum has also built into its machinery numerous measures to foster the integrity of its Awards and enforcement of arbitral directives and awards. Investors need to know, when they enter the nation's markets, that they will not only have access to fair and efficient markets where they feel safe in placing their savings, but they also will have fair and efficient means to redress their grievances, should problems arise with those investments.

The AAA serves a larger arbitrating public, but it has recognized, since 2014 and before, that consumers generally require special procedures for the resolution of their disputes. The AAA's Consumer Arbitration Rules cut expenses for consumers dramatically and offer speedy and fair procedures for resolving merchant disputes. RIAs and their clients who want to utilize arbitration are often precluded from FINRA arbitration and investors who do submit disputes to FINRA

Arbitration that concern RIA-related matters face a new and special threat of claim fragmentation. That threat does not pertain to AAA Arbitration, but access to that forum's consumer rules can be problematical.

NASAA occupies a special position from which to persuade AAA and FINRA to overcome these barriers to entry and to expand the realistic choice of forums available to investors with claims against their RIA providers. But, to do so, NASAA needs to overcome its own inertial resistance and, by acknowledging the fairness of modern-day arbitration at AAA and FINRA, serve RIA clients even more fully. NASAA can, without rulemaking, serve as a strong catalyst toward encouraging AAA and FINRA to foster access for RIA client claims and can ensure a lead role for itself in influencing future changes to FINRA's arbitration procedures. Through rulemaking, it can regulate PDAA's and implement many of the measures as to RIA-related disputes that it has recommended for implementation in BD-related disputes with customers.

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

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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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

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

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

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-

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

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 out³¹ 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 Act³⁶ 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

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

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 management⁴⁵ 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. persons⁴⁹ must register with the SEC (and thus may avoid registration with state regulators), unless an exemption from registration is

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

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 through 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

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

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

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

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 persons⁸³ are qualifying private funds; and (b) any management at a U.S. place of business by the adviser is solely

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 Part 1A, 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 SEC⁸⁵ 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

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

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

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 Brasileiros, 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

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

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/lapdMain/iapd_SiteMap.aspx](http://www.adviserinfo.sec.gov/(S(hdqosw4svnoutoxsmgo4mizx))/IAPD/Content/lapdMain/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

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

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

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

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

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).

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

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 affiliate¹⁴⁹) 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

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), see, 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

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

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.

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

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:

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

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

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

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

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

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

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 Rhumblin 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;

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 persons²¹⁰ 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

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.) (June 30, 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

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

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.

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

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

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 policies, 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,

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

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 written²⁵⁵ 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

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

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 than 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

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

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 Counsel*, 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.

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

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

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.

SECURITIES AND EXCHANGE COMMISSION (SEC)

17 CFR Part 275

[Release No. IA-1406; File No. S7-8-94]

RIN 3235-AG06

SUITABILITY OF INVESTMENT ADVICE PROVIDED BY INVESTMENT ADVISERS; CUSTODIAL ACCOUNT STATEMENTS FOR CERTAIN ADVISORY CLIENTS

59 FR 13464

DATE: Tuesday, March 22, 1994

ACTION: Proposed rule.

SUMMARY: The Commission is proposing for comment new rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act") that would expressly prohibit investment advisers from making unsuitable recommendations to clients. Proposed rule 206(4)-5 would make explicit advisers' suitability obligations under the Advisers Act.

The Commission also is proposing new rule 206(4)-6 under the Advisers Act to prohibit registered investment advisers from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly. Proposed rule 206(4)-6 is designed to prevent certain fraudulent practices.

DATES: Comments on the proposals should be received on or before May 23, 1994.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. All comment letters should refer to File No. S7-8-94. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: W. Thomas Conner, Attorney, or Kenneth J. Berman, Deputy Office Chief, (202) 272-2107, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, 450 5th Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment:

(1) Rule 206(4)-5 under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) ("Advisers Act") to expressly prohibit investment advisers from making unsuitable recommendations to clients;

(2) Rule 206(4)-6 under the Advisers Act to prohibit investment advisers registered or required to be registered under the Advisers Act from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly; and

(3) Amendments to rule 204-2 (17 CFR 275.204-2) under the Advisers Act to require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain (i) information about clients obtained by the investment advisers to comply with proposed rule 206(4)-5, and (ii) copies of client custodial account statements received by the advisers.

I. Introduction

The Commission is proposing two rules under the antifraud provisions of the Advisers Act. n1 Rule 206(4)-5 would make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client, after a reasonable inquiry into the client's financial situation, investment experience, and investment objectives. Rule 206(4)-6 would prohibit registered investment advisers from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly.

n1 Section 206(4) (15 U.S.C. 80b-6(4)) makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Section 206(4) authorizes the Commission to adopt rules and regulations defining the acts, practices, and courses of business that will be deemed fraudulent, deceptive, or manipulative for purposes of section 206(4), and to prescribe means reasonably designed to prevent such conduct. The Commission has adopted four rules under section 206(4): rule 206(4)-1 (17 CFR 275.206(4)-1) (advertisements); rule 206(4)-2 (17 CFR 275.206(4)-2) (custody or possession of funds or securities of advisory clients); rule 206(4)-3 (17 CFR 275.206(4)-3) (cash payments for client solicitations); and rule 206(4)-4 (17 CFR 275.206(4)-4) (financial and disciplinary information that investment advisers must disclose to clients).

II. Suitability of Investment Advice

Investment advisers are fiduciaries n2 who owe their clients a series of duties, n3 one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provision of the Advisers Act, section 206, n4 and the Commission has sanctioned advisers for violating this duty. n5 The Commission now proposes to make explicit this duty in a new rule under section 206(4) of the Advisers Act. The scope of proposed rule 206(4)-5 reflects the Commission's interpretation of advisers' suitability obligations under the Advisers Act. n6

n2 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191, 194 (1963) ("Capital Gains").

n3 These duties include the duty of full disclosure of conflicts of interest, Capital Gains at 191-92; utmost and exclusive loyalty, In re Kidder, Peabody & Co., Inc., 43 SEC 911, 915 (1968) ("Kidder"), Investment Advisers Act Rel. No. 40 (Feb. 5, 1945) (staff position stating advisers' duty of loyalty requires full disclosure of adverse interests and client consent before purchase or sale of securities from clients); and the duty of best execution, Kidder at 915-16. See generally 2 Frankel, The Regulation of Money Managers 343-47 (discussing general duties of fiduciaries), ch. XIII (duty of loyalty), ch. XV (duty of care); Leavell, Investment Advice and the Fraud Rules, 65 Mich. L. Rev. 1569 (1967) (discussing legal controls on providing investment advice).

n4 Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (Advisers Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations).

n5 See, e.g., In re David A. King and King Capital Corp., Investment Advisers Act Rel. No. 1391 (Nov. 9, 1993) (investment adviser recommended investments in a risky pool of first, second and third mortgages to retirees and others of limited means); In re George Sein Lin, Investment Advisers Act Rel. No. 1174 (June 19, 1989) (investment adviser with discretionary investment authority invested funds of clients desiring low-risk investments in uncovered option contracts and utilized margin brokerage accounts); In re Westmark Financial Services, Corp., Investment Advisers Act Rel. No. 1117 (May 16, 1988) (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); In re Shearson, Hammill & Co., 42 SEC 811 (1965) (sections 206(1) and (2) violated when adviser recommended investments unsuitable to child and widow).

n6 In addition, in formulating the proposed rule, the Commission has looked to interpretations of the scope of broker-dealers' suitability obligations under the antifraud provisions of the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] ("Exchange Act"). The federal securities laws, as well as rules of

various self-regulatory organizations ("SROs"), impose suitability requirements on broker-dealers. Under the "shingle" theory, a broker-dealer makes an implied representation to its customers that it will deal with them fairly and in accordance with the standards of the profession. Duker & Duker, 6 S.E.C. 386, 388 (1939). A broker-dealer that breaches this representation may violate certain antifraud provisions of the federal securities laws, namely, section 17(a) of the Securities Act of 1933 [15 U.S.C. 77q(a)], sections 10(b) and 15(c)(1) of the Exchange Act [15 U.S.C. 78j(b) and 78o(c)(1)], and rules 10b-5 and 15c1-2 thereunder [17 CFR 240.10b-5 and 240.15c1-2]. See, e.g., Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943); In re Harold Grill, 41 SEC 321 (1963). A broker making unsuitable recommendations breaches this representation. See, e.g., Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978) (recommended purchase of a convertible debenture was unsuitable for the needs of a widowed, retired customer, when the broker-dealer failed, among other things, to disclose the risks of the investment). This doctrine is incorporated into the rules of the SROs. National Association of Securities Dealers, Inc. ("NASD") Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) (paragraph) 2152; New York Stock Exchange ("NYSE") rule 405, 2 N.Y. Stock Exch. Guide (CCH) (paragraph) 2405 (the "Know Your Customer Rule"). See also Municipal Securities Rulemaking Board ("MSRB") rule G-19, MSRB Manual (CCH) (paragraph) 3591; NYSE rule 472, 2 N.Y. Stock Exch. Guide (CCH) (paragraph) 2472.40(1) ("When recommending the purchase, sale or switch of specific securities, supporting information must be provided or offered."). Broker-dealers also are required under SRO rules to establish and enforce written supervisory procedures that are reasonably designed to achieve compliance with the applicable securities laws and regulations, including the obligation of fair dealing. See, e.g., NASD Rules of Fair Practice, art. III, § 27, NASD Manual (CCH) (paragraph) 2177. In addition, broker-dealers must comply with specialized suitability rules when recommending certain kinds of securities, such as penny stocks and options, or when offering to extend, or arrange for the extension of, credit in connection with inducing the purchase of a security. See, e.g., rules 15g-9 (17 CFR 240.15g-9) (penny stocks) and 15c2-5 (17 CFR 240.15c2-5) (extensions of credit) under the Exchange Act; NASD Rules of Fair Practice, Art. III, § 2, Policy of the Board of Governors, NASD Manual (CCH) (paragraph) 2152 (statement of policy concerning recommendations of speculative low-priced securities and recommendations of or accepting orders for options). Compliance with proposed rule 206(4)-5 would not override the obligation of an investment adviser that is also a broker-dealer to meet the requirements of these rules. Nor would a determination by a broker-dealer under these rules that a particular investment is suitable relieve an investment adviser that is acting as the purchaser's adviser in connection with the transaction from making a suitability determination under proposed rule 206(4)-5 with respect to the investment.

As discussed in more detail below, rule 206(4)-5 would prohibit an investment adviser from providing investment advice to a client unless the adviser makes a reasonable inquiry into the financial situation, investment experience, and investment objectives of the client and reasonably determines that the investment advice is suitable for the client. n7 An amendment to rule 204-2 under the Advisers Act would require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain records of the information obtained from clients in the required inquiry.

n7 A similar provision is contained in H.R. 578, the Investment Adviser Regulatory Enhancement and Disclosure Act of 1993, which is currently pending before Congress.

1. Duty To Inquire

Paragraph (a)(1) of rule 206(4)-5 would require an investment adviser, before providing any investment advice, and, as appropriate thereafter, to make a reasonable inquiry into the client's financial situation, investment experience, and investment objectives. n8 The extent of the inquiry would turn on what is reasonable under the circumstances. For example, to formulate a comprehensive financial plan for a client, an adviser may be required to obtain extensive personal and financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals. This information must be updated periodically so that the adviser can adjust its advice to reflect changed circumstances. The frequency with which the information must be updated would turn on what is appropriate under the circumstances. Among the factors to be considered in determining when to update client information would be the passage of time since the information was last updated and whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the information on which it currently bases its advice. For example, a change in the tax law

or knowledge that the client has retired or experienced a change in marital status might trigger an obligation to make a new inquiry. Comment is requested on whether the proposed rule should specify the minimum frequency for making inquiries to update information concerning the client. For example, should the rule require that client information be updated no less frequently than annually?

n8 Rule 206(4)-5 would not apply to impersonal advisory services, and references to investment advice in this Release do not include impersonal advisory services. Impersonal advisory services would be defined in paragraph (b) of proposed rule 206(4)-5 as investment advisory services provided solely (1) by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts; (2) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or (3) any combination of the foregoing services. This definition is derived from the definition of "contract for impersonal advisory services" in rule 204-3 under the Advisers Act [17 CFR 275.204-3]. Rule 204-3 requires an adviser to provide clients and prospective clients with a written disclosure statement or "brochure," except when advisory services are provided in connection with a contract for impersonal advisory services.

Most advisers conduct an inquiry at an initial client meeting that would generally satisfy the proposed requirement. n9 Clients are typically asked to complete questionnaires that request information about each client's current financial situation, financial goals, risk tolerance, and any other information that the adviser believes necessary to develop recommendations for a financial plan or specific investments. n10 Clients typically are requested periodically to review the information and notify the adviser of any changes.

n9 See State and Federal Regulation of Financial Planners: A Policy Overview and Model for Reform, Prepared for the American Association of Retired Persons Public Policy Institute by Barbara L.N. Roper 2-3 (1993) (describing generally accepted standards of financial planning that include, among other things, meeting with a client at the outset of the engagement to review the client's personal finances, risk tolerance, and investment objectives).

n10 Financial Planners, Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance 8 (February 1988).

2. Duty To Give Only Suitable Advice

Paragraph (a)(2) of rule 206(4)-5 would prohibit an adviser from giving advice to a client unless the adviser reasonably determined that the advice was suitable to the client's financial situation, investment experience, and investment objectives. A reasonable determination of an investment's suitability for a client would require, for example, that certain kinds of particularly risky investment products be recommended only to those clients who can and are willing to tolerate the risks and for whom the potential benefits justify the risks. n11

n11 The prohibition against providing unsuitable advice would apply to advice to institutional clients as well as to individual clients. Institutional investors have experienced significant losses as a result of recommendations to invest in complex financial products that they did not fully understand. See H.R. Rep. No. 255, 103d Cong., 1st Sess. 30-34 (1993) (municipal governments and savings and loan associations experienced widespread losses in U.S. Treasury instruments, derivative products, futures transactions, options hedging, and mortgage-backed securities recommended by dealers). The rationale underlying the duty to make suitable recommendations, although developed largely in the context of investors who are not deemed to be "sophisticated," applies also to those who are ordinarily considered to be "sophisticated." See Root, Suitability-The Sophisticated Investor-and Modern Portfolio Management, Colum. Bus. L. Rev. 287 (1991).

While rule 206(4)-5 would require an investment adviser to have reasonably determined that each piece of its investment advice would be suitable for the client, n12 suitability of the advice would be evaluated in the context of the client's portfolio. n13 For example, an investment adviser may hedge a portfolio of U.S. government bonds for a client having very conservative investment objectives, in which case the

suitability of the hedging instruments would be evaluated in light of their hedging function. Thus, inclusion of some risky investments in the portfolio of a risk-averse client may not necessarily be unsuitable. n14

n12 For an account under discretionary management, each trade initiated by the adviser would constitute "advice." For a discussion of when an account is under discretionary management, see *infra* note 29.

n13 A similar standard is applied in determining the prudence of an investment made for a retirement plan under the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.) (see 29 C.F.R. 2550.404a-1(a)), and generally in determining the suitability of a trustee's investment decision under trust law (see Restatement (Second) of Trusts, § 227 commentary (1959)).

n14 Conversely, while advice to invest in a particular security may be suitable to the needs of a client, advice to make the same investment on margin may not be.

Proposed rule 206(4)-5's suitability obligation includes the requirement that an adviser "know his client," as well as the requirement that an adviser "know his product." Lack of actual knowledge about the client or the investment products recommended would not provide a defense for an adviser unless it would be reasonable for the adviser not to have known the information. n15 It generally would, for example, be reasonable for an adviser to rely on information provided by a client (or the client's agent) regarding the client's financial circumstances in response to the inquiry required by paragraph (a)(1) of proposed rule 206(4)-5, and an adviser should not be held to have given unsuitable advice if it is later shown that the client had misled the adviser. n16 If a client refused to provide requested information, however, the adviser could not make assumptions about the client that were not reasonable. n17 When no other information is available, the adviser may have to assume the client has no assets or source of income other than the assets the adviser manages. If the client refused to provide information upon which an adviser could base recommendations, the adviser would be permitted to rely upon trustworthy information about the client that it obtains from other reliable sources, such as a consultant to the client or other intermediary.

n15 See *In re Baskin Planning Consultants, Ltd.*, Investment Advisers Act Rel. No. 1297 (Dec. 19, 1991) (adviser failed adequately to investigate investment recommendations to clients); *In re Alfred C. Rizzo*, Investment Advisers Act Rel. No. 897 (Jan. 12, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer of security); *In re Winfield & Co., Inc.*, 44 SEC 810, 817-18 (1972) (investment adviser to investment company failed to make reasonable investigation before causing the company to purchase securities); *In re Shearson, Hammill & Co.*, *supra* note 5.

n16 An adviser could not disregard information concerning the client's affairs that the adviser knows or should have known.

n17 In one case involving a client that turned over approximately \$ 100,000 to a broker but refused to provide financial information, the Commission explained that the broker had a "duty to proceed with caution; to make recommendations only on the basis of the concrete information that [the client] did supply and not on the basis of guesswork as to the value of other possible assets." *In re Eugene J. Erdos*, 47 SEC 985, 988 (1983), *aff'd sub nom. Erdos v. Securities and Exchange Commission*, 742 F.2d 507 (9th Cir. 1984). See also *In re Gerald M. Greenberg*, 40 SEC 133, 137-38 (1960), petition for review dismissed on motion of petitioner *sub nom. Greenberg v. SEC*, 287 F.2d 571 (10th Cir. 1960) ("clear purpose" of NASD suitability rule would be defeated if it were construed as permitting a broker-dealer to recommend low price speculative securities to "unknown" customers "without any knowledge of or attempt to obtain information concerning the customer's other security holdings, his financial situation, and his needs so as to be in a position to judge the suitability of the recommendation" (citation omitted)).

Proposed rule 206(4)-5 would not require that knowledge of an affiliate of the adviser be imputed to the adviser if it would be unreasonable to expect the adviser to know the information. For example, section 204A of the Advisers Act (15 U.S.C. 80b-4a) requires that advisers establish, maintain, and enforce

written procedures designed to prevent insider trading, in which case the adviser may not, and should not, have access to certain information about a recommended security that an affiliated adviser might have. Comment is requested on whether the proposed rule should specify standards that would establish a presumption that the knowledge of an affiliate would not be imputed to the adviser.

3. Recordkeeping

The Commission is proposing an amendment to rule 204-2 under the Advisers Act to require any investment adviser subject to the recordkeeping requirements of the Advisers Act n18 to maintain records of the information obtained about clients from the inquiries the adviser has made in complying with paragraph (a)(1) of proposed rule 206(4)-5. n19 The proposed recordkeeping requirement would not require advisers to memorialize the suitability considerations underlying each recommendation to clients. The amendment would require advisers to maintain, as part of their records, completed client questionnaires, or any other records or documents that the advisers have obtained from their client inquiries. These records would assist the Commission in determining whether investment advisers have complied with rule 206(4)-5. Comment is requested on whether advisers should be required to document the bases upon which suitability determinations have been made, either in connection with each piece of investment advice or in the form of a list of generic investments that the adviser has determined are suitable for the client.

n18 Rule 204-2, the general recordkeeping rule under the Advisers Act, applies to every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser, other than one specifically exempted from registration pursuant to section 203(b) of the Advisers Act.

n19 Proposed paragraph (a)(17) of rule 204-2.

III. Custodian Account Statements

Under typical discretionary advisory arrangements, a third-party custodian holds client assets and sends account statements to the client and copies of the account statements to the client's investment adviser. n20 These account statements provide clients with independent reports of account activity and are designed to permit clients to protect themselves against illegal or questionable conduct, including inappropriately high levels of trading in their accounts, unauthorized transactions, and unsuitable investments. n21

n20 Custodial arrangements are typically made with broker-dealers and banks. Broker-dealers are required to provide account statements to customers. For example, the rules of the NASD, the NYSE, and the American Stock Exchange ("AMEX") require member broker-dealers to provide account statements to customers at least quarterly. NASD Rules of Fair Practice, § 45, art. III, NASD Manual (CCH) (paragraph) 9440; NYSE rule 409, 2 New York Stock Exchange Guide (CCH) (paragraph) 2409; AMEX rule 419, 2 American Stock Exchange Guide (CCH) (paragraph) 9439. These rules, however, permit customers to direct delivery of statements to investment advisers holding powers of attorney over customer accounts. See, e.g., NYSE rule 409(b), 2 New York Stock Exchange Guide (CCH) (paragraph) 2409; AMEX rule 420(a), 2 American Stock Exchange Guide (CCH) (paragraph) 9440. Commission rules under the Exchange Act require a broker-dealer to send account statements to its customers under certain circumstances. See, e.g., rule 15g-6 [17 CFR 240.15g-6] (monthly account statements for penny stock customers); rule 15c3-2 [17 CFR 240.15c3-2] (quarterly statement concerning use by broker-dealer of funds arising out of free credit balance in customer's account). See also *infra* note 21. Commission rules under the Advisers Act require an investment adviser that has custody or possession of client funds or securities to send to clients account statements at least every three months. Rule 206(4)-2 under the Advisers Act [17 CFR 275.206(4)-2].

n21 Another means of permitting clients to monitor their accounts would be to require advisers to have a reasonable belief that brokers send confirmations to clients. The Commission is not proposing such a requirement. A broker-dealer, however, has an obligation under rule 10b-10 under the Exchange Act [17 CFR 240.10b-10] to send its customers an immediate confirmation with respect to each transaction the

broker-dealer effects. In the case of an account managed by a fiduciary, the customer, rather than the fiduciary, is considered to be the customer of the broker-dealer. Accordingly, under rule 10b-10, the broker-dealer must send an immediate confirmation to the account holder, in addition to any confirmation it may send to the account fiduciary; however, an account that has given discretionary authority in writing to its fiduciary may agree in writing with the broker-dealer effecting its trades to waive the receipt of the immediate confirmation required by rule 10b-10 if, among other things, the broker-dealer sends the discretionary account a statement no less frequently than quarterly containing all the information required to be disclosed on the immediate confirmation. The customer may not waive this quarterly statement. See Securities Exchange Act Rel. No. 33743 (March 9, 1994) [59 FR 12767 (March 17, 1994)] at note 3.

Failure of a custodian to provide account information directly to clients may facilitate fraudulent transactions in client accounts, as illustrated in the case of Institutional Treasury Management, Inc. ("ITM"), a registered investment adviser, and its controlling person, Steven Wymer. ITM attracted clients by promising above-market returns through the use of sophisticated trading strategies in U.S. Government securities. When the strategies not only failed to produce the promised returns, but also began to cause substantial losses, Wymer began to trade client accounts aggressively, often without the clients' knowledge, in an attempt to recover losses. To cover additional losses, Wymer began to divert funds from one client account to another. n22 Total client losses as a result of the fraud amounted to approximately \$ 104 million. n23

n22 On September 29, 1992, the Commission and the U.S. Attorney's Office for the Central District of California jointly announced a settlement of civil and criminal actions against Wymer. Wymer pleaded guilty to nine felony counts, including securities fraud, and was ordered to pay \$ 209 million in restitution and prejudgment interest to his defrauded clients. Litigation Rel. No. 13389 (Sept. 29, 1992) (concerning Securities and Exchange Commission v. Institutional Treasury Management, Inc., Civil Action No. 91-6715 MRR (C.D. Cal. Sept. 25, 1992) and United States v. Steven D. Wymer, No. CR 92-2-RG.) In entering his guilty plea before the court, Wymer described how he traded in options and other speculative investments for accounts with conservative investment objectives, and then sent false account statements to clients to conceal losses and misappropriation of funds. Transcript of Proceedings before the Honorable Richard A. Gadbois, Jr., United States v. Steven D. Wymer, No. CR 92-02-(A)-RG (C.D. Cal. Sept. 29, 1992), at 25.

n23 See SEC v. Institutional Treasury Management, Inc., Denman & Company and Steven D. Wymer (Civil Action No. 91-6715 RJK) (C.D. Cal.) (Commission's Motion for an Order Distributing the Steven D. Wymer Qualified Settlement Fund, filed on Dec. 22, 1993).

Crucial to Wymer's fraudulent scheme was his ability to persuade the custodians of client accounts not to send confirmations and monthly statements to his clients. n24 Because clients received no independent reports of account activities, Wymer was able to successfully fabricate false account statements to hide the losses, unauthorized transactions, and the misappropriation of client funds and securities. n25 Other investment advisers have engaged in similar fraudulent schemes resulting in substantial client losses. n26

n24 Wymer testified before a Congressional subcommittee that he selected for his clients only those custodians that agreed to make ITM the exclusive recipient of account information. Investment Adviser Industry Reform, Hearing before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 1st Sess. 88-89 (1993).

n25 Id.

n26 See, e.g., In re Thomas Walter McKibbin and Equitrust, Inc., Investment Advisers Act Rel. No. 1165 (May 1, 1989) (adviser invested clients' funds in mutual funds, which sent account statements directly to adviser, which, in turn, sent false account statements to clients concealing misappropriation of funds); In re Robert Schwarz, Inc. and Robert G. Schwarz, Investment Advisers Act Rel. No. 1248 (Aug. 31, 1990) (adviser sent false account statements to clients concealing markups on municipal bonds purchased from broker-dealer, which sent confirmations of the transactions only to the adviser).

The Commission is proposing for comment new rule 206(4)-6 under the Advisers Act as a means reasonably necessary to prevent the type of fraudulent conduct in which Wymer and other advisers have engaged. n27 Rule 206(4)-6 would prohibit an investment adviser registered or required to be registered under the Advisers Act from exercising investment discretion with respect to a client account n28 unless it reasonably believed that the custodian of the account is providing account statements to the client no less frequently than quarterly. n29 An adviser would be deemed to have a reasonable belief that the custodian is providing account statements if the adviser has received copies of client account statements indicating that they were sent to clients. n30 Comment is requested on whether the "reasonable belief" standard in the proposed rule is appropriate and consistent with the duties of a fiduciary.

n27 In addition, the Commission is proposing an amendment to rule 204-2 to require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain in their records copies of custodian account statements that are received by the adviser. Proposed paragraph (a)(18) of rule 204-2.

n28 Proposed rule 206(4)-6 would not apply to an adviser's exercise of investment discretion with respect to the assets of investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) ("1940 Act") or business development companies. The 1940 Act regulates custodial arrangements with respect to these assets. Section 17(f) of the 1940 Act (15 U.S.C. 80a-17(f)) and rules 17f-1, 17f-2, 17f-4, and 17f-5 thereunder (17 CFR 270.17f-1, 17f-2, 17f-4, and 17f-5) and Section 59 of the 1940 Act (15 U.S.C. 80a-58).

n29 For purposes of rule 206(4)-6, an investment adviser would be deemed to exercise investment discretion with respect to an account if, directly or indirectly, the investment adviser is authorized to determine what securities or other property are purchased or sold for the account, or makes decisions as to what securities or other property are purchased or sold by or for the account, even though some other person may have responsibility for those investment decisions. Paragraph (c)(2) of proposed rule 206(4)-6. This definition is the same as in section 3(a)(35) of the Exchange Act [15 U.S.C. 78c(a)(35)].

n30 Paragraph (c)(4) of proposed rule 206(4)-6. The adviser could not rely on the copy of the account statement as a basis for its reasonable belief if the adviser had reason to believe that the account statements had not been delivered. Under the proposed rule, receipt of a copy of the account statement would not be the exclusive means by which an adviser could form a reasonable belief that the custodian is providing account statements to the client.

In some cases, a client may appoint another person to monitor his account and receive communications regarding the account. In such cases, proposed rule 206(4)-6 would permit the account statement to be sent to the client's designee. In order to prevent the rule from being circumvented, the rule would not permit the designee to be the custodian, the investment adviser, a person associated with the investment adviser, or a person under common control with the investment adviser. n31 Investment advisers often act as general partners of limited partnerships that invest in various types of financial instruments. In these cases, the account statement could be sent to a designee of the partnership—another general partner, an accountant or an attorney—that is not associated with the adviser. n32 Comment is requested, however, on whether the rule should contain specific provisions to address the delivery of account statements to limited partnerships. For example, should the rule specify that the account statement may, or should, be sent to each limited partner? Comment also is requested on how the proposed rule should address shares of open-end management investment companies, which might not be held by third-party custodians.

n31 Paragraph (c)(1) of proposed rule 206(4)-6. The term "person associated with an investment adviser" is defined in section 202(a)(17) of the Advisers Act [15 U.S.C. 80b-2(a)(17)] to mean any partner, officer, or director of the investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the adviser, including any employee of the adviser.

n32 See, e.g., GBU, Inc. (pub. avail. Apr. 22, 1993); PIMS, Inc. (pub. avail. Oct. 21, 1991); Bennett Management Company, Inc. (pub. avail. Feb. 26, 1991) (general partner not deemed to have custody of client assets when it is authorized to make certain draws on partnership funds if, before making draws, the general partner provides certain information concerning the draws to an independent representative of the partnership for review and authorization).

The account statement specified in proposed rule 206(4)-6 would be required to show all transactions occurring in the account during the period covered by the account statement, and the funds, securities, and other property in the account at the end of the period. n33 The Commission requests comment on whether the rule should require other information to be provided (e.g., the value of securities positions in the account) to assure that clients receive sufficient information to monitor account activity. n34

n33 Paragraph (b) of proposed rule 206(4)-6.

n34 See, e.g., rule 15g-6(d)(2) (17 CFR 240.15g-6(d)(2)) under the Exchange Act (requiring market value of penny stocks, if determinable, to appear on account statement sent to customer that purchases penny stocks).

The Commission believes that the proposed rule reflects the business practices of most investment advisers and custodians under which an account statement showing all account transactions is generated by the custodian and delivered directly to the client. Copies of account statements are typically provided to the investment adviser, and the data is used by the adviser to verify the accuracy of the adviser's own records.

If proposed rule 206(4)-6 is adopted, the Commission anticipates delaying the effective date of the rule for a sufficient period to permit advisers to confirm that their clients' custodians are providing account statements to the clients and, if they are not, to permit clients to direct custodians to provide them with account statements. An adviser that exercises investment discretion with respect to client accounts that cannot form a reasonable belief that the custodians of those accounts are sending account statements to clients could not continue to provide investment advice to the clients on a discretionary basis. Comment is requested on whether a sixty-day delay would be sufficient.

IV. General Request for Comments

Any interested persons wishing to submit written comments on the rule proposals that are the subject of this release, suggest additional changes, or submit comments on other matters that might have an effect on the proposals described in this release, are requested to do so.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding the proposed rules and rule amendments. The analysis notes that proposed rule 206(4)-5 makes explicit an adviser's current obligation under the Advisers Act to make a reasonable inquiry into a client's financial situation, investment experience, and investment objectives, and, thereafter, to reasonably determine that investment advice is suitable for the client. Proposed paragraph (a)(17) of rule 204-2 would require investment advisers to retain for Commission inspection the client questionnaire or other records or documents received by the adviser in response to the inquiry that would be required by proposed rule 206(4)-5. The Commission does not have information on how many investment advisers that are "small entities" under the Advisers Act ("small advisers") do not currently record this information. The Commission believes, however, that the costs involved in doing so would not be significant and would be outweighed by the benefits to clients.

The analysis also notes that proposed rule 206(4)-6 would prohibit a registered investment adviser from exercising investment discretion with respect to client accounts unless it has a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly. The analysis notes that most custodians already provide account statements to clients, and in many cases also send copies of account statements to the clients' investment advisers. The Commission

believes that the costs involved with sending these statements to clients and to advisers would not be significant, and would be outweighed by the benefits to clients. Proposed paragraph (a)(18) of rule 204-2 would require investment advisers to maintain copies of client custodial account statements received by the adviser. The Commission believes that the costs associated with retaining these copies would not be significant and, in any event, would be outweighed by the benefits to the Commission's adviser examination program.

The analysis notes that alternatives to the proposals were considered, including establishing different compliance or reporting requirements or timetables that would take into account the resources available to small advisers, and the simplification of compliance and reporting requirements for small advisers. The Commission also considered the use of performance rather than design standards, and the exemption of small advisers from coverage of part or all of the proposed amendments. The Commission concluded that the alternatives would not be as effective as the proposals in assuring that the suitability standard is understood and adhered to by all advisers and that all discretionary clients are provided with independent reports to monitor account activity. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting W. Thomas Conner, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549.

VI. Statutory Authority

The Commission is proposing rules 206(4)-5 and 206(4)-6 under the authority set forth in sections 206(4) and 211(a) of the Advisers Act (15 U.S.C. 80b-6(4) and 80b-11(a)).

The Commission is proposing amendments to rule 204-2 under its authority in sections 204 and 211(a) of the Advisers Act (15 U.S.C. 80b-4 and 80b-11(a)).

Text of Proposed Rules and Rule Amendments

List of Subjects in 17 CFR Part 275

Investment advisers, Fraud, Reporting and recordkeeping requirements.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows.

PART 275-RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The general authority for part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b-3, 80b-4, 80b-6(4), 80b-6A, 80b-11, unless otherwise noted.

* * * * *

2. By adding paragraphs (a)(17) and (a)(18) to § 275.204-2 to read as follows:

§ 275.204-2 -- Books and records to be maintained by investment advisers.

(a) * * *

(17) With respect to each client (other than a client to which the adviser provides only impersonal advisory services), completed client questionnaires, or other records or documents received by the investment adviser in response to the inquiry made by the investment adviser into the client's financial situation, investment experience, and investment objectives required by § 275.206(4)-5.

(18) With respect to each client (other than an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or a business development company), copies of account statements sent to such client by the custodian of such client's account that were also received by the adviser.

* * * * *

3. By adding § 275.206(4)-5 to read as follows:

§ 275.206(4)-5 -- Suitability of investment advice.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to provide investment advice to any client, other than in connection with impersonal advisory services, unless the adviser:

(1) Before providing any investment advice, and as appropriate thereafter, makes a reasonable inquiry into the client's financial situation, investment experience, and investment objectives; and

(2) Reasonably determines that the investment advice is suitable for the client.

(b) For purposes of this section, the term impersonal advisory services shall mean investment advisory services provided solely:

(1) By means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;

(2) Through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

(3) Any combination of the foregoing services.

4. By adding § 275.206(4)-6 to read as follows:

§ 275.206(4)-6 -- Custodial account statements.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser registered or required to be registered pursuant to section 203 of the Act (15 U.S.C. 80b-3) to exercise investment discretion with respect to a client account (other than the account of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or a business development company), unless the investment adviser reasonably believes that the custodian of the client account is providing to the client or its designee an account statement described in paragraph (b) of this section not less frequently than once every three months.

(b) The account statement required by paragraph (a) of this section shall show, for the period of the account statement:

(1) All transactions occurring in the account during the period; and

(2) The funds, securities, and other property in the account at the end of the period.

(c) For purposes of this section:

(1) The client's designee shall not be the custodian, the investment adviser, a person associated with the investment adviser, or a person under common control with the investment adviser;

(2) An investment adviser exercises investment discretion with respect to an account if, directly or indirectly, the investment adviser:

(i) Is authorized to determine what securities or other property shall be purchased or sold by or for the account; or

(ii) Makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for those investment decisions;

(3) A person (other than the client) is a custodian of a client account if it has custody or possession of any securities or other property in which the client has any beneficial interest; and

(4) An adviser shall be deemed to have a reasonable belief that the custodian has provided a particular account statement to the client or its designee if the adviser has received a copy of such statement indicating that it has been sent to the client, provided that the adviser has no reason to believe that the account statement has not been delivered to the client.

By the Commission.

Dated: March 16, 1994.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94-6658 Filed 3-21-94; 8:45 am]

BILLING CODE 8010-01-P

RIA and Hybrid RIA/BD Regulation
2019 Securities Law Seminar
October 22, 2019
Barton Creek Resort, Austin, Texas

Materials, Cases, Regulations
Additional Resource List

Darlene Pasieczny

Suggested Reading:

James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisors and Broker-Dealers And A Framework For Enhanced Investor Protection*, 68 Bus. Law. 1 (November, 2012) (including detailed explanation of SEC and FINRA regulatory frameworks, and highlighting differences between RIA / BD obligations and duties).

RN 18-08 (February 26, 2018) – FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

PIABA Comment Letter re: RN 18-08 (April 27, 2018) (including citations to numerous case examples of BD firms being sanctioned for failing to supervise third-party RIA activities)

SEC Staff *Study on Investment Advisers and Broker-Dealers* (January, 2011) re: investor confusion regarding duties of investment professionals, available at: <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>

FINRA Rules and Guidance:

Rule 2010 (Standards of Commercial Honor and Principles of Trade)

Rule 2111 (Suitability)

Rule 3110 (Supervision)

Rule 3270 (Outside Business Activities of Registered Persons)

Rule 3280 (Private Securities Transactions of an Associated Person)

NTM 85-84

NTM 91-32

NTM 94-44

(Specifically clarifying the applicability of the "private securities transaction" rule to dual registered RRs/RIAs)

NTM 96-33

(Discussing NTM 94-44 and its analysis that members must follow to determine whether the full recordkeeping & supervision requirements of the "private securities transaction"

rule applies. "Fundamental to this analysis is whether the RR/IA participates in the execution of a securities transaction . . . beyond a mere recommendation".

NTM 01-79

(NASD Reminds Members of Their Responsibilities Regarding Private Securities Transactions Involving Notes . . . Discussion how "given the significant number of fraudulent promissory note schemes that have been uncovered, members should review their supervisory and compliance procedures to make sure that their reporting requirements are clear and complete and that each associated person receives appropriate education and training regarding the sale of notes."

FINRA DR Submission Agreement for Investment Adviser Disputes, available at <http://www.finra.org/arbitration-and-mediation/forms-tools>

Securities and Exchange Act of 1934

15 U.S.C. § 78o(b)(4)(E) (SEC may sanction or revoke registration of any member for numerous reasons, including, if a broker or dealer has "willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, **or 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.**" (emphasis added).

***Dep't of Enforcement v. Fox Fin. Mgmt. Corp.*, Complaint No. 2012030724101 at *17-18 (FINRA NAC Jan. 6, 2017) (emphasis added):**

A member must implement and enforce its supervisory system and written procedures reasonably in light of the circumstances presented. *See Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec.19, 2008). **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. *Id.***)

Disclosure Documents:

Registered Representatives: Form U4 / CRD / BrokerCheck Report; Outside business activities

Registered Investment Advisors: Form ADV, Item 6 (Outside Business Activities); Also, Schedule D (Other business activities performed at office locations)

Record keeping:

Securities and Exchange Act of 1934

SEA Rule 17a-4(e)(1) and SEA Rule 17a-3

17 CFR 140.17a-4 (Records to be preserved by certain exchange members, brokers and dealers)

(e) Every member, broker and dealer subject to § 240.17a-3 shall maintain and preserve in an easily accessible place:

(1) All records required under paragraph (a)(12) of § 240.17a-3 until at least three years after the associated person's employment and any other connection with the member, broker or dealer has terminated.

Investment Advisors Act of 1940

SEC Rule 206(4)-7(a)

17 CFR 275.206(4)-7(a) (Compliance procedures and practices)

If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 ([15 U.S.C. 80b-3](#)), it shall be unlawful within the meaning of section 206 of the Act ([15 U.S.C. 80b-6](#)) for you to provide investment advice to clients unless you:

(a)Policies and procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;

Recent Cases of Note:

(Arbitration under AAA, over several years, and upwards of \$100,000 forum costs for investor's ½ share of forum fees...)

***Weiler v. Marcus & Millichap Real Estate Inv. Servs., Inc.*, 22 Cal App 5th 970, 981, 232 Cal Rptr 3d 155, 164 (Ct App 2018), rev filed (June 8, 2018) (emphasis added):**

In sum, we hold, as we did in *Roldan*, **when a party who has engaged in arbitration in good faith is unable to afford to continue in such a forum, that party may seek relief from the superior court.** If sufficient evidence is presented on these issues, and the court concludes the party's financial status is not a result of the party's intentional attempt to avoid arbitration, the court may issue an order specifying: (1) the arbitration shall continue so long as the other party to the arbitration agrees to pay, or the arbitrator orders it to pay, all fees and costs of the arbitration; and (2) if neither of those occur, the arbitration shall be deemed “had” and the case may proceed in the superior court.³

As our Supreme Court has explained, “[b]oth California and federal law treat the substitution of arbitration for litigation as the mere replacement of one dispute resolution forum for another, resulting in no inherent disadvantage.” (*Sonic-Calabasas A, Inc. v. Moreno* (2013) 57 Cal.4th 1109, 1152, 163 Cal.Rptr.3d 269, 311 P.3d 184.) With the rising costs of arbitration (see *Toyo Tire Holdings Of Americas Inc. v. Continental Tire North America, Inc.* (9th Cir. 2010) 609 F.3d 975, 980-981), our decision today ensures those compelled to arbitrate will not, as a result, be inherently disadvantaged.

...

FN3: At oral argument, defendants claimed that allowing parties to seek relief from arbitration in the courts based on their current financial condition creates an open invitation for abuse by those seeking to escape their arbitration obligations. We seriously doubt parties will purposefully make themselves impecunious to have their cases returned to the courts. Regardless, we are more concerned with deep-pocketed parties leveraging their wealth to deprive their opponents of the right to resolve their disputes than we are with parties choosing to bankrupt themselves as a way out of arbitration and into court. And, under our holding today, a court may not grant relief if the evidence demonstrates a party's financial status is a result of the party's intentional attempt to avoid arbitration.

(FINRA Rule 3280 and related NTMs establish BD duty to supervise outside IA activities...)

***Milliner v. Mut. Sec., Inc.*, 15-CV-03354-TEH, 2017 WL 1064978, at *2–4 (ND Cal Mar 18, 2017), opinion vac'd in part on recons, 15-CV-03354-TEH, 2017 WL 3453340 (ND Cal Aug 11, 2017) (emphasis added):**

Prior to determining whether [Broker-Dealer] MSI breached its duty to supervise [RIA] Bock and Evans by failing to determine suitability, the Court finds it necessary to discuss what MSI's duty entailed. As previously established by the Court, MSI was required to supervise the activities of Bock and Evans under FINRA regulations:

This Court holds that the NTMs accompanying FINRA Rule 3280 undoubtedly establish that MSI had a duty to supervise Bock and Evans' outside advisory investment activities.

MSJ Order II 12:1–7. FINRA 3280(c)(2) explains that pursuant to this duty, MSI shall record such transactions “on the books and records of [MSI]” and that MSI “shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.” This duty to supervise includes a duty to determine suitability as well. Notice to Member (“NTM”) 96-33² explains that when a broker approves an RR/IA's participation in private securities transactions for which he or she receives selling compensation, the firm must create a recordkeeping system and supervisory procedures that “enable the member to properly supervise the RR/IA by aiding the [broker-dealer's] understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the *suitability of the transactions.*” *Id.* (emphasis added).

See also NTM 16-12 (explaining that when a broker-dealer approves an associated person to engage in private securities activities for selling compensation, the supervising broker-dealer must ensure “compliance with suitability standards for recommended securities.”).

FINRA Rule 2111(a)³ defines what determining suitability means: “a member or an associated person must have a reasonable basis to believe that a recommendation transaction ... 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 factors such as the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, and risk tolerance, among other things. *Id.* The duty to determine suitability cannot be disclaimed. FINRA Rule 2111, Supplementary Material .02.

While the parties do not dispute that FINRA rules require a party who has approved the outside investment activities of a registered representative to determine the suitability of those outside activities, the crux of the parties' dispute lies in whether the agency relationship created by the parties' agreements excuses MSI from the duty to determine suitability. *See* ECF No. 65 at 15–16. MSI's theory is that because the Plaintiffs entered into a Trading Authorization which designated “[BEFC] as his/her agent and attorney-in-fact with full discretion, power and authority” to trade securities on their accounts, all trades conducted by Bock and Evans were essentially unsolicited, thus releasing MSI from any duty to

determine suitability. *Id.* at 15–17. Similarly, MSI also argues it was not required to determine the suitability of Bock and Evans' transactions because FINRA Rule 2111 only applies to transactions that are “recommended” by the member, and here MSI never recommended any transactions. *Id.* at 18:2–19:1. But these arguments are foreclosed by prior opinions from the SEC.⁴ “FINRA and the SEC have held that registered representatives who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule.” *FINRA Rule 2111 (Suitability) FAQ*, n. 37, <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq> (last visited Mar. 9, 2017).⁵ *See also Pinchas v. Sec. Exch. Comm'n*, 54 S.E.C. 331, 341 n. 22 (1999) (“Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules.”); *Kettler v. Sec. Exch. Comm'n*, 51 S.E.C. 30, 32 n. 11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended). Additionally, FINRA Rule 2111 does not mention an exception to the duty to determine suitability based on whether an account is discretionary or not. And, if MSI were to provide Plaintiffs with direct investment advisory services, it would clearly be subject to FINRA Rule 2111; therefore, it logically follows that the duty under FINRA Rule 3280 to supervise a person's participation in an outside transaction “as if the transaction were executed on behalf of the member” also includes a duty to comply with the suitability requirements of FINRA Rule 2111.

In short, pursuant to FINRA regulations, MSI had a duty to determine the suitability of Bock and Evans' recommended transactions.

Outside Business Activities

FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Comment Period Expires: April 27, 2018

Summary

FINRA seeks comment on a proposed new rule to address the outside business activities of registered persons. The proposal is the result of FINRA's recent retrospective review of FINRA's rules governing outside business activities and private securities transactions, FINRA Rule 3270 (Outside Business Activities of Registered Persons) and FINRA Rule 3280 (Private Securities Transactions of an Associated Person), respectively. The proposed rule would replace FINRA Rules 3270 and 3280 and is intended to reduce unnecessary burdens while strengthening investor protections relating to outside activities.

The proposed rule text is available in *Attachment A*.

Questions regarding this *Notice* should be directed to:

- ▶ James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270; or
- ▶ Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 27, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

February 26, 2018

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Systems

Key Topics

- ▶ Outside Business Activities
- ▶ Private Securities Transactions
- ▶ Recordkeeping
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 3210
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 3280
- ▶ FINRA Rule 5130
- ▶ Notice to Members 85-21
- ▶ Notice to Members 94-44
- ▶ Notice to Members 96-33
- ▶ Regulatory Notice 17-20



To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC or Commission) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).²

Background & Discussion

In May 2017, FINRA launched a retrospective review of its outside business activities and private securities transactions rules to assess their effectiveness and efficiency.³ These rules serve important goals – they seek to protect the investing public when a member’s registered or associated persons engage in potentially problematic activities that are unknown to the member but could be perceived by the investing public as part of the member’s business. An ancillary benefit is that the rules protect the member from resulting reputational and litigation risks.

The retrospective rule review confirmed the continuing importance of rules relating to outside activities, but also indicated that the current rules, as well as related guidance,⁴ could benefit from changes to better align the investor protection goals with the current regulatory landscape and business practices.⁵ In particular, FINRA received significant feedback on members’ obligations with respect to the investment advisory (IA) activities of their registered persons, which is addressed in detail below.

Consistent with a number of recommendations by stakeholders⁶ during the retrospective review, FINRA is proposing a single streamlined rule to address the outside business activities of registered persons.⁷ The proposed rule would clarify the obligations in this area and reduce unnecessary burdens while strengthening protections relating to activities that may pose a greater risk to the investing public. The proposed rule would require registered persons to provide their members with prior written notice of a broad range of outside activities, while imposing on members a responsibility to perform a reasonable risk assessment of a narrower set of activities that are investment related, allowing members to focus on outside activities that are most likely to raise investor protection concerns. The proposed rule also would generally exclude from the rule a registered person’s personal investments (sometimes referred to as “buying away”) and work performed on behalf of a member’s affiliates. Moreover, the proposed rule would not impose supervisory and recordkeeping obligations for most other outside activities, including IA activities at an unaffiliated third-party IA. At the same time, the proposal would hold a member responsible for approved activities that could not take place but for the registered person’s association with a member.

The following illustration summarizes core concepts of the proposed rule, which are discussed in greater detail in this *Notice*.



Registered Persons' Obligation to Provide Notice of Outside Activities

A majority of stakeholders that provided feedback during the retrospective review believed that the scope of activities subject to the outside business activities rule, Rule 3270, should be narrowed.⁸ On the other hand, a significant minority of stakeholders favored the rule's current notice requirement to ensure that registered persons report a broad range of outside activities to their employing firms. Moreover, a number of stakeholders believed that notice of private securities transactions under Rule 3280 should not be narrowed.⁹ The proposed rule takes a balanced approach that would ensure that members are apprised of their registered persons' outside activities, while tailoring members' responsibilities to those activities that are most likely to raise investor protection concerns.

To that end, FINRA is proposing a single rule that would require registered persons to provide their firms with prior written notice for all investment-related or other business activities outside the scope of their relationship with the member. The proposed rule would require that a registered person include in the notice a description of the proposed activity and the registered person's proposed role therein, and that the registered person update the notice in the event of a material change to the activity.¹⁰ With respect to investment-related activities only, a registered person would be required to receive prior written approval from the member before participating in the activity.

The rule would define "investment-related" as "pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association)." This definition is also used for purposes of the Uniform Application for Securities Industry Registration or Transfer (Form U4) and would better harmonize the Form U4 reporting requirements and the notice obligations under FINRA rules, an issue frequently raised during the retrospective review.¹¹ The concept of "business activity" would be similar to current Rule 3270, with minor clarifying changes, and would be defined in the rule as (1) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (2) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.¹²

Similar to current Rule 3270, the proposed rule would apply only to the outside activities of registered persons. It would not apply to the activities of members' non-registered associated persons because the risk of potential conflicts is more prevalent with regard to registered persons.¹³ However, the proposed rule would not preclude members from instituting policies and procedures relating to the outside activities of associated persons more broadly.

Members' Responsibilities Upon Receiving Notice

Although the proposed rule would require registered persons to provide prior written notice of a broad range of outside activities, the focus of a member's responsibilities is on investment-related activities.¹⁴ If an activity is not investment related, the member has no obligation under the rule. If the activity is investment related, then the member would be required to perform a reasonable risk assessment, as described below.

Assessment

Upon receiving written notice of an outside *investment-related* activity, the proposed rule would require that a member perform an upfront reasonable assessment of the risks created by the engagement of the registered person in the proposed activity. Specifically, the member would be required to evaluate whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (2) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. These considerations are similar to those required by current Rule 3270 and are aimed at assessing possible conflicts that could negatively impact the member's customers or the investing public. Although the risk assessment must be reasonable and will vary depending on the facts and circumstances, the rule's focus is on the registered person's participation in the activity and ordinarily would not require the member to perform an analysis of the underlying outside business activity.¹⁵ In addition to this risk assessment, the member would be required to consider whether the person is relying on a member's registration as a broker or dealer to conduct the activity, in which case the activity would be deemed to be that of the member, if approved.¹⁶

Then, based on the foregoing, the member would determine whether to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. The member would be required to advise the registered person in writing of its determination.

By focusing the member's assessment on investment-related activities, the proposed rule would allow members to concentrate their compliance resources on those activities that may pose a greater chance of harm to investors. Members would no longer be required to conduct a risk assessment on a non-investment-related activity, such as a registered person driving for a car service or holding seasonal retail employment, regardless of whether the registered person receives compensation.¹⁷

Supervision

The proposed rule would impose a supervisory obligation in two situations. First, if a member imposes conditions or limitations on a registered person's participation in an investment-related activity, the member would be required to reasonably supervise the registered person's compliance with those conditions or limitations. The proposed rule would not require members to supervise the underlying activities. For example, after conducting the required risk assessment of an investment-related activity, a member may approve a registered person to act as a registered investment adviser through an unaffiliated, third-party IA; however, the member also may condition that approval on the IA's custody of its clients' advisory assets with the member. In this example, the proposed rule would require the member to reasonably supervise the registered person's adherence to that condition, but the member would not be required by the rule to otherwise supervise the IA activity.¹⁸

Second, to the extent that a member approves a registered person's participation in a proposed investment-related activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity would be deemed to be the member's business. In other words, if the person can only legally engage in the outside business activity because the person is associated with a member, the member approving that activity must treat it as its own. Accordingly, all applicable securities laws and regulations and FINRA rules, including supervision and recordkeeping, would apply to the member with respect to that activity. This provision serves a critical investor protection interest and requires the member's supervision over the types of activities that the private securities transactions rule was originally adopted to address.¹⁹ It would ensure that a registered person's outside broker-dealer activity – for example, selling private placements away from the member in a manner that would require broker-dealer registration – would be reported to the member and that such activity, if approved, would be under the supervision and control of a broker-dealer and subject to the same supervisory safeguards as any of the member's other broker-dealer business.

Under this second scenario, if the registered person is associated with more than one member, the proposed rule would allow members to develop a formal allocation arrangement whereby at least one member agrees in writing with specificity to comply with all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those covering supervision and recordkeeping.²⁰

Recordkeeping

The proposed rule would require a member to maintain and preserve records demonstrating compliance with the obligations of the rule for at least three years after the registered person's employment or association with the member has terminated.²¹ Records required to demonstrate compliance with the rule would depend upon the facts and circumstances, but would include, for example, the registered person's written notice of the proposed activity, a record of the member's risk assessment, the member's written determination and whether any conditions or limitations are imposed. The proposed rule would not impose a general obligation to record transactions resulting from a registered person's outside activities on the member's books and records, except in the circumstance discussed above where a member approves an activity for which the registered person is relying on a member's broker-dealer registration.

Proposed Exclusions from the Rule

The proposed rule has several exclusions that would reduce unnecessary burdens without lessening investor protection. First, the proposal would exclude from the rule's coverage registered persons' personal investments (*e.g.*, buying away), which commenters and stakeholders consistently noted do not raise the same investor protection concerns as selling away activities. Second, the proposed rule would exclude activities conducted on behalf of a member's affiliate, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Therefore, a registered person generally would not be required to provide prior written notice, and a member would not be required to conduct the assessment required by the proposed rule, of any non-broker-dealer activity conducted for a member's affiliate, such as an affiliated IA, insurance entity or bank. In addition, any non-broker-dealer activity conducted on behalf of the member (*e.g.*, any IA activities for a dually registered broker-dealer/investment adviser (BD/IA)) would not be subject to the rule. These exclusions recognize members' ability to implement meaningful controls across business lines and are consistent with functional regulation – that such activities are subject to other regulatory regimes and oversight.²² They also ensure that dually registered BD/IAs or members that share employees with affiliates are not faced with unnecessary additional burdens. The rule would define an "affiliate" as "any entity that controls, is controlled by or is under common control with a member," which is consistent with other FINRA rules.²³ For these purposes, a member would not be deemed to control an IA firm merely because it is owned by the member's registered person.

Finally, similar to the current private securities transactions rule, the proposed rule would not apply to transactions in accounts that are subject to FINRA Rule 3210 or to transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation.²⁴

Application to Registered Persons' Investment Advisory Activities

The proposed rule would change the current approach with respect to IA activities of registered persons. Under Rule 3280 and related guidance, members must supervise and record on the members' books and records the transactions resulting from most outside IA activities of their associated persons.²⁵ This approach has caused significant confusion and practical challenges, including, for example, privacy challenges with a member obtaining account information for customers of an unaffiliated IA through which a member's registered person may be acting in an IA capacity. Given these challenges, and in light of the fact that these activities are subject to another regulatory regime, some stakeholders argued that the current approach imposes unnecessary burdens without providing meaningful investor protections over the activities.

Based on FINRA's review of the rules, public comment and other stakeholder feedback, and the evolving environment in which members operate, modifications to the current approach appear appropriate. Under the proposed rule, as discussed above, any IA activity conducted on behalf of a dually registered BD/IA or for an IA affiliate of a member would be excluded from the rule. Any IA activity conducted for a third-party, non-affiliated IA would constitute an "investment-related" activity under the rule. As such, the rule would require that the registered person provide prior written notice of such activity, and the member would be required to conduct the upfront risk assessment described above and, based on its assessment, to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. However, the proposed rule would not impose a general supervisory obligation over the IA activities and would not require the member to record on its books and records transactions resulting from such IA activities. Although this proposed approach streamlines members' obligations over IA activities, these IA activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme.²⁶

Economic Impact of the Proposal

Regulatory Need

FINRA's recent review of the current rules on outside business activities and private securities transactions and industry and stakeholder input indicate that the current rules may benefit from substantive changes that clarify the obligations and tailor them to better achieve investor protection.

Economic Baseline

The current rules governing member employees' business and securities activities outside the regular course or scope of their employment with their firms, Rules 3270 and 3280, and related guidance, serve as the economic baseline for the analysis. These rules impact a broad spectrum of members, irrespective of business model, client base and product type.

A survey on the rules sent to all FINRA members provided insights into the extent to which registered and associated persons are conducting, or proposing to engage in, activities subject to the rules.

Rule 3270 requires registered persons to provide prior written notice before engaging in an outside business activity. Approximately 80 percent of the members responding to the survey stated that they have received at least one written notice in the last five years pursuant to Rule 3270. Approximately 40 percent of the registered persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit outside business activities, and 42 percent stated that they have limited or prohibited a registered person's participation in an outside business activity before, mostly due to potential conflicts of interest and potential confusion by the customer as to whether the activity falls within the firm's business.

Rule 3280 requires associated persons to provide prior written notice before participating in any manner in private securities transactions. In the survey, approximately 40 percent of the responding members stated that they have received at least one written notice in the last five years pursuant to Rule 3280. Approximately 19 percent of the associated persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit private securities transactions for compensation to address the potential conflicts of interest between associated persons and the firm or its customers and to mitigate the litigation risk.

Economic Impacts

The proposed rule would directly impact registered persons that seek to engage in outside investment-related or other business activities and the members that employ them, and may potentially provide benefits for customers through better investor protection.

Streamlining the rules into a single combined rule will benefit both members and registered persons by reducing the likelihood of regulatory confusion, as raised by stakeholders and identified in the survey, and should make it easier for both members and registered persons to determine the activities that are within the proposed rule's scope. Stakeholders noted that the potential overlap between the two rules may lead to inconsistent interpretation and application of the rules. Moreover, some outside business activities may evolve into private securities transactions, resulting in confusion over which rule applies. The simplified approach may encourage registered persons who have previously avoided these activities because of the perceived regulatory uncertainty to pursue outside activities.

The proposal's requirement that registered persons provide their firms with prior written notice for all investment-related or other business activities will benefit members by ensuring they receive notice of a broad range of registered persons' outside activities. At the same time, there could be marginal costs for registered persons who would be required

to report a broad range of activities. It may also increase compliance costs for members to the extent that members must determine which of the reported activities are subject to a risk assessment under the rule.

With respect to a narrower set of activities – investment-related activities – the rule requires the member to conduct a reasonable assessment of the risks created by the registered person’s engagement in the proposed activity and to approve or disapprove the registered person’s participation. Imposing these requirements on the narrower set of activities will reduce unnecessary burdens to members of having to conduct a risk assessment of non-investment-related activities that may pose little harm to the member or the investing public. Specifically, members may benefit from employing compliance resources on those outside activities that are more likely to raise investor protection concerns.

Unlike current Rule 3270, the proposed rule imposes a requirement, with respect to investment-related activities only, to determine whether to approve or disapprove the activity, and to provide the registered person with written notice of this determination. Although FINRA understands that many members already do so, members may incur compliance costs associated with the proposal in providing written responses to registered persons regarding approval or disapproval decisions. On the other hand, this requirement will provide clarity for registered persons, as they will have a clear understanding of the member’s determination. However, it may delay registered persons’ participation in the activity until the member’s written approval decision, if provided, which could result in additional costs to registered persons up to and including the possibility of lost business opportunities. At the same time, where the member disapproves of the investment-related activity, ex post costs of such prohibition would be relatively lower under the proposal as the registered person receives the information before engaging in the activity. In addition, requiring registered persons to receive an approval determination before engaging in an investment-related activity may also benefit the investing public as registered persons will not have the opportunity to engage in activities that the member ultimately disapproves.²⁷

The current rules apply to different populations, with Rule 3270 applying to registered persons and Rule 3280 applying to associated persons. The proposed rule would eliminate this disparate treatment and apply uniformly to registered persons. In doing so, the proposal relieves associated persons from some obligations, which could potentially impact behaviors. Because non-registered associated persons would not be subject to the rule, they would have lower costs to engage in the covered activities under the proposal. This may create an incentive for associated persons to remain unregistered, to the extent that costs associated with the notification and, with respect to investment-related activities, assessment and approval requirements outweigh the benefits of being a registered person. The possible negative impact of this hypothetical may be tempered, however, by the fact that many activities require a person to be registered in one capacity or another before the person may engage in them.

Under current Rule 3280, if a member approves an associated person's participation in a private securities transaction for compensation, the member must record the transaction on the member's books and records and supervise the associated person's participation as if the transaction were executed on behalf of the member. The proposed rule, which imposes supervision only in the two limited situations described above, would eliminate those current requirements with respect to the majority of activities that fall within the current rule and, accordingly, should simplify the supervisory efforts and lower the direct compliance costs.

In addition, the proposed rule excludes non-broker-dealer activities conducted on behalf of a dually registered firm, such as IA or banking activities, and activities conducted for an affiliate of the member (unless those activities would require registration as a broker or dealer if not for the person's association with a member). These exclusions should potentially alleviate some of the burdens that are associated with reporting and assessing outside activities that may pose relatively little risk to the member and investing public.

FINRA also considered the potential impacts of the proposed amendments on investors. Limiting the risk assessment and approval requirements of the proposed rule to investment-related activities, as defined in the Form U4, mitigates the confusion and misalignment between the Form U4 and Rule 3270, and should enhance the investor protection purpose of the rule.

Alternatives Considered

FINRA staff also considered a principles-based approach, as suggested by some stakeholders, which potentially would provide members with more flexibility in developing the systems and the protocols to assess and approve or disapprove outside business activities and private securities transactions. However, the approach presented here was deemed to better balance the costs and benefits of governing registered persons' outside business and private securities activities. It also takes into account the views of numerous other stakeholders that favored a rules-based approach with specific requirements.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. What are the alternative approaches, other than the proposal, that FINRA should consider?
2. How would consolidation of the rules governing outside business activities and private securities transactions in this proposal simplify compliance? What impact would it have on the cost of compliance?

3. Unlike Rule 3280, the proposed rule would apply to registered persons, rather than to associated persons. Should the proposed rule be expanded to apply to all associated persons? If so, why?
4. Is the proposed scope of the notice requirement appropriately tailored to balance the interest of members to receive information regarding their registered persons' outside activities and any investor protection concerns?
 - a. Should the proposal be modified to require registered persons to provide notice with respect to a narrower set of activities? If so, should notice be required only with respect to investment-related or some other categorization of activities?
 - b. Would narrowing the scope of the proposal impose any additional risks to investors?
5. A member's obligation to conduct a risk assessment is only triggered under the proposal with respect to investment-related activities.
 - a. Does limiting the required risk assessment to activities that are "investment-related" properly balance the interest of allowing members to focus compliance efforts on activities that pose the greatest concerns and any potential harm to investors?
 - b. Is the definition of "investment-related," which is based on the definition used by the Form U4, appropriate given the regulatory objectives of the proposal, or should other activities be included in or excluded from the definition? If so, why?
 - c. The proposed rule's focus is on assessing the risks created by the registered person's engagement in the outside investment-related activity, rather than the underlying activity itself. Is this an appropriate focus? Should the risk assessment include a requirement for the member to perform due diligence of the underlying outside activity?
 - d. The member would be required in the risk assessment to evaluate whether the proposed activity will: (i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Are these appropriate criteria to evaluate conflicts of interests and other potential areas of harm to investors?
6. The proposal has several exclusions, including for registered persons' personal investments and activities conducted on behalf of an affiliate of a member, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Are the proposed exclusions appropriate?
 - a. Should any other activities be excluded from the rule? If so, why?

- b. Should the proposed exclusions, including the exclusion for activities on behalf of affiliates, be limited in any manner? For example, should the exclusion be limited to activities on behalf of affiliates that are subject to federal or state financial registration or licensing requirements, such as registered investment advisers, banks and insurance companies?
- 7. Unlike current Rule 3280 and related guidance, the proposed rule would not impose a general supervisory obligation over IA activities and would not require the member to record on its books and records transactions resulting from such IA activities. Does the treatment of IA activities under the proposed rule appropriately address investor protection concerns while recognizing that separate obligations exist under the IA regulatory regime?
- 8. Under paragraph (b)(4), if a member approves a person's participation in a proposed activity that would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act, the activity is deemed to be the member's business and the member must supervise accordingly.
 - a. Is registration under the Exchange Act the appropriate trigger for this provision?
 - b. Should paragraph (b)(4) be expanded to require a member to supervise a registered person's sale of securities through an entity that is not required to register under the Exchange Act?
 - c. When the registered person is associated with more than one member, the proposed rule allows members to develop a formal allocation arrangement whereby at least one member has the regulatory responsibility, including the supervision and recordkeeping of the proposed outside business activity. Are there any competitive effects of such allocation arrangements? Does this flexibility potentially create a disadvantage for some firms regarding how the costs are allocated? Should FINRA consider any other approaches?
- 9. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
 - a. What are these economic impacts and what are their primary sources?
 - b. To what extent would these economic impacts differ by business attributes, such as size of firm or differences in business models?
 - c. What would be the magnitude of these impacts, including costs and benefits?
- 10. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73 (Online Availability of Comments) (November 2003)* for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See Regulatory Notice 17-20 (May 2017)*.
4. *See, e.g., Notice to Members 94-44 (May 1994); Notice to Members 96-33 (May 1996)*.
5. FINRA Rule 3270 is incorporated by reference into the Capital Acquisition Broker (CAB) Rules. *See* CAB Rule 327. Persons associated with a capital acquisition broker may not participate in any manner in a private securities transaction as defined in Rule 3280(e). *See* CAB Rule 328. FINRA will consider whether conforming changes to the CAB rules are appropriate as a result of any changes to FINRA Rules 3270 and 3280.
6. The term “stakeholder” is used to describe those entities, organizations and persons who may be impacted by or otherwise have an interest in FINRA Rules 3270 and 3280 and this proposed rule.
7. A number of stakeholders commented on the similar notice requirements of Rules 3270 and 3280 and noted confusion over the often overlapping concepts. A combined rule would eliminate this confusion and streamline the requirements.
8. Subject to specified exemptions, Rule 3270 prohibits a registered person from being an employee, independent contractor, sole proprietor, officer, director or partner of another person, or being compensated, or having the reasonable expectation of compensation, from another person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member. In a survey sent to all FINRA members as part of the retrospective review, approximately 60 percent of the respondents believed that there are outside business activities that should not be included within the scope of Rule 3270.
9. Rule 3280 provides that, prior to participating in any private securities transaction, an associated person must provide written notice to the member with which he or she is associated, describing the transaction and the associated person’s role, and disclosing whether the associated person has received or may receive selling compensation in connection with the transaction. The rule defines “private securities transaction” as any securities transaction outside the regular course or scope of an associated person’s employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, but excludes transactions subject to the notification requirements of FINRA Rule 3210 (Accounts At Other Broker-Dealers and Financial Institutions), transactions among immediate family members (as defined in FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings)), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities.

10. For example, some stakeholders noted that an outside business activity that appears on its face to pose little risk to the investing public may evolve into a private securities transaction if the registered person seeks to sell interests in an outside business. Such a material change in the activity would require the registered person to provide updated written notice and, in this example, would trigger the member to conduct a risk assessment and, depending on the activity and whether the member approves the registered person's participation, may require the member's supervision.
11. See Form U4 Explanation of Terms, available at <https://www.finra.org/file/explanation-terms-crd-forms>.
12. FINRA notes that, irrespective of whether an outside activity is investment related, other rules may apply, depending on the facts and circumstances, to business-related conduct, including FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).
13. FINRA Rule 3270 applies to registered persons, while FINRA Rule 3280 applies to associated persons. The proposed rule would harmonize this distinction, which was an issue raised by stakeholders during the retrospective review.
14. Because a member's obligations under the rule apply with respect to investment-related activities, a member necessarily must have a process for reasonably determining which activities are investment related.
15. As part of the risk assessment, FINRA would expect a member, for example, to consider the registered person's proposed role in the activity, whether the registered person intends to use separate or shared facilities or electronic presence, whether the registered person intends to solicit the member's customers and the general nature of the underlying activity. A member also must consider any "red flags" indicating problematic activities that raise the risks of the engagement of the registered person in the proposed activity. See, e.g., *Dep't of Enforcement 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" and finding that the firm failed to investigate and act upon red flags indicating that an outside business activity in fact involved private securities transactions); *Dep't of Enforcement v. Merrimac Corp. Securities, Inc.*, Complaint No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at *9 (FINRA NAC Apr. 29, 2015) (affirming the imposition of sanctions for the firm's failure to adequately consider red flags of outside business activities and private securities transactions, for example, by neglecting "to investigate after it learned of allegations on a website that one of the outside businesses was a Ponzi scheme and was suffering serious financial difficulties").
16. As discussed more fully *infra*, in this circumstance, a firm would be responsible for complying with all applicable securities laws and FINRA rules, including supervision and recordkeeping.
17. The rule would not prohibit a member from deciding for its own business reasons to create additional obligations and procedures for its registered or associated persons regarding outside business activities.
18. In this example, the member would have other obligations related to its custodial role, but those are separate and apart from the proposed rule's treatment of *outside* business activities.

19. *See, e.g., Notice to Members 85-21* (March 1985) (requesting comment on private securities transactions rule, which was aimed at addressing transactions that had long been a regulatory concern, namely “transactions in which an associated person is selling securities to public investors on behalf of another party, *e.g.*, as part of a private offering of limited partnership interests, without the participation of the person’s employer firm”).
20. This provision is consistent with current guidance regarding the application of the private securities transactions rule to the activities of registered persons employed by more than one member. *See Notice to Members 96-33* (May 1996), Question 5 (allowing members to develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide required supervision and recordkeeping under the private securities transactions rule with respect to outside investment advisory activities of a registered person employed with more than one member).
21. This retention period is consistent with the retention period in the current rule on outside business activities and with the retention period of other records relating to associated persons required to be made and preserved under the Exchange Act. *See* SEA Rule 17a-4(e)(1) (setting forth the retention period for specified records relating to associated persons).
22. For example, investment advisers registered with the SEC are overseen by the SEC and subject to the obligations of the Investment Advisers Act of 1940 (Advisers Act) and the regulations and rules promulgated thereunder. Other investment advisers are subject to state registration systems, many of which have requirements similar to the Advisers Act.
23. *See, e.g.,* FINRA Rule 5121(f)(1) (defining “affiliate” for purposes of the rule governing public offerings of securities when a participating firm has a conflict of interest); FINRA Rule 6710(ee) (defining “Non-member Affiliate” for purposes of the rules relating to the Trade Reporting and Compliance Engine (TRACE)).
24. The proposal would not alter the obligations under FINRA Rule 3210.
25. *See* Rule 3280(c)(2) (requiring a member that approves an associated person’s participation in a private securities transaction for compensation to record the transaction on the member’s books and records and supervise the associated person’s participation as if the transaction were executed on behalf of the member); *see also Notice to Members 94-44* (May 1994) (providing that an associated person is considered to be participating in the execution of the transaction, and, therefore, triggering the application of Rule 3280, if the person’s investment advisory activities exceed the mere recommendation of securities).
26. *See supra* note 22. To the extent that FINRA becomes aware of potentially problematic IA or other non-broker-dealer activities during the course of its oversight of broker-dealers, FINRA would take appropriate action within the scope of its authority, including, but not limited to, referring the matter to the SEC or states.
27. Under Rule 3270, a registered person must provide prior written notice to the firm of outside business activity, but there is no requirement in the rule that the member approve the activity before the registered person may engage in it.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

3290. Outside Business Activities

(a) Obligations of a Registered Person

No registered person may participate in any manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to any investment-related activity, receives prior written approval from, the member. In the case of a material change to the activity, a registered person must provide the member with updated prior written notice and, with respect to any investment-related activity, receive updated prior approval. The notification shall be provided in such form as specified by the member, describing the proposed activity and the person's proposed role therein. If the member disapproves the proposed activity or places conditions or limitations on it, the registered person shall not participate in the activity or shall comply with such conditions or limitations.

(b) Obligations of a Member Receiving Notice of an Investment-Related Activity

(1) Upon receipt of a written notice of any investment-related activity, a member shall:

(A) perform a reasonable assessment of the risks created by the engagement of the registered person in the proposed activity, including an evaluation of whether the proposed activity will:

(i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or

(ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered;

(B) consider whether the activity would require the person's registration as a broker or dealer under the Exchange Act if not for the person's association with a member; and

(C) make a reasonable determination of whether to approve the registered person's participation in the proposed activity, to approve it subject to specific conditions or limitations, or to disapprove it.

(2) Upon completion of the member's assessment, a member shall advise the registered person in writing whether the member:

(A) approves the person's participation in the proposed activity and imposes any conditions or limitations on that participation; or

(B) disapproves the person's participation in the proposed activity.

(3) If the member imposes conditions or limitations on its approval of the person's participation in the proposed activity, the member shall reasonably supervise the registered person's compliance with such conditions or limitations.

(4) If the member approves the person's participation in the proposed activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity shall be deemed to be that of the member and the member shall be subject to all applicable securities laws and regulations and FINRA rules, including those requiring supervision and recordkeeping, with respect to that activity. If the person is associated with more than one member, the members may develop a detailed, formal allocation arrangement, which must be in writing, whereby at least one member agrees to be responsible for compliance with respect to all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those requiring supervision and recordkeeping.

(5) A member must keep a record demonstrating its compliance with the obligations pursuant to this Rule and must preserve this record at least three years after the registered person's employment or association with the member has terminated.

••• **Supplementary Material:** -----

.01 This Rule shall not apply to:

(a) a registered person's personal investments (including transactions in accounts that are subject to FINRA Rule 3210);

(b) transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation;

(c) activities conducted on behalf of a member's affiliate, unless those activities would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered; or

(d) a member's non-broker-dealer activities.

.02 For purposes of this Rule:

(a) "Affiliate" means any entity that controls, is controlled by or is under common control with a member.

(b) "Business activity" means: (i) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (ii) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.

(c) "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, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).



PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

2415 A Wilcox Drive | Norman, OK 73069
Toll Free (888) 621-7484 | Fax (405) 360-2063
www.piaba.org

April 27, 2018

pubcom@finra.org

Ms. Jennifer Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-08 – Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority (hereinafter “FINRA”) related to investor protection.

FINRA Regulatory Notice 18-08 seeks comments concerning reforms to FINRA Rules 3270 and 3280. FINRA has proposed eliminating supervision requirements, including record keeping, for all registered representatives’ outside business activities, with two exceptions. First, if a member imposes conditions or limitations on participation in an investment-related activity, the member would be required to reasonably supervise compliance with those limitations, but the member would not have to actually supervise the underlying activities. Second, an approved private securities transaction would have to be supervised only where the person would otherwise need to register as a broker or dealer under the Exchange Act if not for the member’s registration.

FINRA proposes to exempt member firms from supervising:

- Investment related activities at third-party investment advisor firms (“IA”);
- Investment related activities at member affiliates including IAs, banks, and insurance companies;
- Non-investment related work and outside business activities; and,
- Personal investments.

PIABA strongly disfavors the proposed modifications to FINRA Rules 3270 and 3280.

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Ms. Jennifer Mitchell

April 27, 2018

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PIABA's position is that FINRA's proposed rule changes would: result in member firms implementing supervisory procedures that would be deemed unreasonable under the Exchange Act; subject members to substantial reputational and litigation risks; and, increase investor exposure to harm through those who would exploit the rules. FINRA's supervisory rules that deal with selling away and private securities transactions have serious consequences for investors and members alike. Despite the existing rules, each year FINRA members and their representatives engage in dozens of fraudulent schemes that cost investors millions of dollars.¹ For over 30 years, the NASD and now FINRA have emphasized that private securities transactions present "serious, regulatory concerns." See Notice to Members ("NTM") 85-84. The SEC has stated that:

[FINRA] Conduct Rule 3040 [prohibiting "selling away"] is designed not only to protect investors from unsupervised sales, but also to protect securities firms from liability and loss resulting from such sales. Such misconduct deprives investors of a firm's oversight, due diligence, and supervision, protections investors have a right to expect.

In re Siegel, 2008 SEC LEXIS 2459 at *36 (Oct. 2, 2008), *aff'd Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (citation omitted).

FINRA's current efforts to limit supervisory requirements for registered representatives' outside IA activities is a significant deviation from the NASD's and FINRA's former stated positions on the subject. Previously, NASD stated that its National Business Conduct Committee found Rule 3040 "should apply to all investment advisory activities" and "to conclude otherwise would permit registered persons to participate in securities transactions outside the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers."² Accordingly, FINRA Rules 3270 and 3280 and NTMs 91-32, 94-44, and 96-33 are designed to assist members in reasonably achieving compliance with their supervisory obligations under the Exchange Act. Repealing existing guidance and rules will endanger member firms and remove guidance that is an essential foundation for firms to use in understanding their supervisory obligations under federal law.

Exchange Act Section 15(b)(4)(E) provides that the SEC can sanction or revoke the registration of any member firm "if it finds... that such broker or dealer... has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, **or 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.**" 15 U.S.C. § 78o(b)(4)(E) (emphasis added).

The Exchange Act was written with the understanding that those who commit securities fraud might use various entity affiliations, whether registered or not, to perpetrate their frauds. The Exchange Act requires broker-dealers to supervise a representative's investment activities, no matter how the activity is executed, providing a prophylactic approach to supervision designed to prevent violations of the securities laws. Registration by a representative under

¹<http://www.investmentnews.com/article/20111002/REG/310029969/selling-away-again-a-concern-for-regulators> (The North American Securities Administrators Association reported that in 2011 there were 54 enforcement actions involving selling away.)

² NASD NTM 91-32.

the Investment Advisor Act or any other securities act in no way lessens a broker-dealer's responsibility to reasonably supervise the activity of the representative, in order to prevent violations of securities laws.

FINRA's proposed rule does not address how it reasonably complies with the Exchange Act's explicit supervisory requirements. In addition, FINRA's proposed rule contains confusing and inconsistent supervisory loopholes that create an avenue for wrongdoing. Ultimately, FINRA's proposed rule leaves member firms defenseless to a charge of failure to supervise under the Exchange Act and unable to claim available statutory defenses.³

FINRA's proposed rule states that it "would not impose a general supervisory obligation over the IA activities..." Regulatory Notice 18-08, pg. 8. It is unlikely that a rule limiting supervision of an activity that could lead to a violation of the securities laws could be deemed reasonable under the Exchange Act. Consequently, a member firm citing FINRA's guidance under the proposed rule when charged by the SEC with failing to supervise would be unable to show that following FINRA's guidance would lead to reasonable supervision of its registered representatives.

For example, a member that failed to supervise a registered representative that committed a violation of the Investment Advisers Act of 1940, through a third-party IA, would likely be unable to demonstrate reasonable supervision under FINRA's proposed rule. The SEC has sanctioned brokerage firms in the past for these types of failures. In the matter of *In re Commonwealth Equity Services, LLP*, Bleidt, a registered representative, misappropriated over \$31 million from more than 100 victims. SEC Rel. No. 56362, 2007 WL 3071391 (Sept. 6, 2007). Bleidt misappropriated client funds to fund his own radio station and to run other ventures. He was dually registered with Commonwealth and was the owner of an IA firm, which was "an independent investment adviser registered under the Advisers Act and not affiliated with or controlled by Commonwealth." *Id.* at *2. The SEC was clear in describing the applicable supervisory requirement: "[u]nder Section 15(b)(4)(E) of the Exchange Act, broker-dealers are responsible for reasonably supervising, with a view to preventing violations of the federal securities laws, persons subject to their supervision." *Id.* at *3. The SEC continued, finding that Commonwealth had "failed to establish reasonable policies and procedures for responding to red flags related to Bleidt's outside business activities." *Id.* There are other similar examples of firms being sanctioned for failing to supervise third-party IA activities.⁴

FINRA's only stated justification for the proposed rule is that "IA activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme." Regulatory Notice 18-08, pg. 8. However, FINRA's reasoning does not address the Section 15(b)(4)(E) of the Exchange Act, which imposes obligations on broker-dealers to supervise their representatives with a view of preventing violations of the securities laws. There

³ "[N]o person shall be deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with." 15 U.S.C.A. § 78o(b)(4)(E).

⁴ *In re Signator Investors, Inc., et al*, SEC Rel. No. 75690 (Aug. 13, 2015) (finding that Signator failed to reasonably supervise both brokerage and advisory client activity of its representative leading to 125 clients being defrauded of \$13.5 million); *FINRA v. MidAmerica Financial Services, Inc.*, AWC No. 2012034475001 (FINRA, Jun. 2, 2014) (failing to supervise two brokers' IA activities); *FINRA v. VFG Securities, Inc.*, 2014038997601 (Jan. 26, 2017) (same); *NFP Advisor Services, LLC*, AWC No. 2011025618702 (Jul. 16, 2015) (same).

are no exemptions to the supervisory obligations contained in the Exchange Act. As such, FINRA's reliance on other statutory schemes as support for its proposed rule is misplaced.

In addition, FINRA's proposed rule creates loophole issues that make it difficult, if not impossible to implement the rule. As proposed, "a member also must consider any 'red flags' indicating problematic activities" associated with its registered representatives' activities. Regulatory Notice 18-08, fn. 15. If a registered representative ran his promissory note Ponzi scheme through an outside business that was not an investment advisory firm, his broker/dealer would be required to supervise the activity (and presumably prevent the Ponzi scheme from succeeding). If the same person registered himself as an IA, and ran his scheme through that IA operation, his broker/dealer would not be under the same obligation to monitor the conduct. When called to task, the member firm would surely claim it conducted FINRA's nebulous and meaningless "risk assessment,"⁵ but was otherwise not required to supervise the activity. Registered representatives seeking to engage in violations of the securities laws will be incentivized to establish advisory practices in order to shield their activities from the supervision of their member firms.

To further illustrate the unworkable nature of the proposal, we will change the above fact pattern so that some Ponzi scheme victims never sign opening account forms with the IA and no accounts are established at the IA firm. The member firm would be unable to show that the Ponzi scheme, with respect to at least certain victims, was conducted through the IA. Accordingly, the registered representative would be engaging in promissory note sales outside the context of the IA firm, and that activity would accordingly have to be registered under the Exchange Act and subject to the supervision of the registered representative's broker-dealer.

FINRA should not propose a private securities transaction rule whereby a Ponzi schemer's ability or inability to complete paperwork has the effect of altering a member's supervisory responsibilities. A member's supervisory responsibilities stem from the Exchange Act - not from the ability of the firm's representatives to claim supervisory loopholes.

Beyond Ponzi schemes, FINRA's proposed rule would contradict multiple Notice to Members (hereinafter "NTMs") regarding topics as far reaching as suitability, record keeping, and branch audits. If the proposed rule were implemented, FINRA would have to spend years clarifying whether or not dozens of previously issued NTMs were intended to be modified by the proposed rule or how firms would be expected to comply with prior guidance.

For example, a recommendation to a registered representative's client to sell all of their assets held at a member firm to invest entirely in private placements through the registered representative's IA would be a recommendation or investment strategy that the registered representative's member would have to supervise under NTM 12-25. See pg. 6. Under the proposed rule, registered representatives would be incentivized to move assets from brokerage accounts to their IA in order to make recommendations in products and services that their member firm would not approve.

Yet, FINRA's rule proposal does not provide guidance on the supervision of a registered representatives liquidation and transfer of assets to institutions under the registered representative's control or how to comply with NTM 12-

⁵ FINRA's stated "risk assessment" test is meaningless as a supervisory device because it merely requires a brokerage firm to approve an activity based upon unverified assertions of its registered representative and without any due diligence or subsequent supervision of the activity. Regulatory Notice 18-08, pg. 5 (the risk assessment would "ordinarily would not require the member to perform an analysis of the underlying outside business activity."); *Id.* pg. 6 (no supervision required if no conditions are placed on the activity).

25's suitability requirements. *See also* NTM 12-25, pg. 8 (Similarly NTM 12-25 states that "[s]uitability obligations apply...to a broker's recommendation...to liquidate securities to purchase an investment-related product that is not a security" but it is unclear whether the proposed rule would require members to supervise these transactions occurring in part at other financial institutions).

Likewise, member firms are obligated under Rule 17a-4 to record and supervise communications of their registered representatives related to firm business. *See* SEC Rel. No. 34-38245 (Jan. 31, 1997). FINRA's proposed rule does not clarify FINRA's past guidance on member firms' requirements to record correspondence when "red flags" of misconduct are present through outside business activities, through affiliated firms, or third-party IAs that share joint clients with members. It is unlikely that FINRA would be able to devise a supervisory protocol that would achieve compliance with Rule 17a-4 without requiring firms to monitor and record all investment-related emails.

Finally, the proposed rule contradicts prior SEC guidance and fails to clarify whether or not FINRA is proposing to limit the scope of branch audits and its joint guidance with the SEC under NTM 11-54. FINRA's proposed rule states that "[i]f an activity is not investment related, the member has no [supervisory] obligation under the rule." Regulatory Notice 18-08, pg. 5. Yet the SEC has stated that "a firm should be alert to and investigate 'red flags' indicating possible undisclosed outside business activities and **assess all outside business activities by a representative, whether or not related to the securities business.**" Staff Legal Bulletin No. 17: Remote Office Supervision, SEC Rel. No. SLB-3A(CF), 2004 WL 5698359 (Mar. 19, 2004) (emphasis added). "The Commission has recognized that there is a risk that representatives will use outside business activities to carry out or conceal securities law violation[s]." *Id.*

The SEC's position is completely in line with NASD's. The NASD stated long ago that off-site employees who engage in other non-securities businesses "have a greater opportunity than on-site personnel to engage in undetected selling away. Consequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonably intended to detect violations." NTM 86-65. FINRA has also recommended that branch office inspections "identify the nature and extent of outside business activities of registered branch office personnel. Outside business activities conducted by registered persons may carry added risk because these activities may be perceived by customers as part of the member's business." NTM 11-54, pg. 2.

Regulatory Notice 18-08 has not provided evidence that outside businesses no longer pose a risk that registered representatives would use those businesses to conceal securities laws violations. Failing to supervise disclosed businesses or those discovered by "red flags" would subject member firms to charges of failing to supervise and increase the likelihood of investor harm.

PIABA members have seen, all too often, registered representatives establishing solo or small IA firms and using outside business activities in order to avoid member supervision, in order to engage in activities that harm of investors. Below are just some examples of investors losing hundreds of millions in investment frauds perpetrated by registered representatives through third-party IAs established by a registered representative:

Registered Representative	Securities Violation Details
Patrick Churchville (CRD#: 2245842)	Victims alleged that Churchville's member firm failed to supervise Churchville's private equity fraud conducted through his IA. Churchville's

	fraud caused \$27 million in losses to more than 220 victims and was subject to an SEC action and criminal charges.
Dean Mustaphalli (CRD#: 2792038)	Victims alleged that Mustaphalli's member firm failed to supervise a hedge fund operated through his IA. Mustaphalli's fraud caused \$10 million in losses to 58 victims and was subject of an action by the New York Attorney General's office.
Cory Burnell (CRD#: 3260340)	Victims alleged that Burnell's member firm failed to supervise extraordinarily risky leveraged ETF trades conducted through Burnell's IA. Burnell's fraud caused about 30 investors more than \$2 million.
Tamara Steele (CRD#: 3227494)	Victims alleged that Steele's member firm failed to supervise private placement sales conducted through Steele's IA. Steele's sales caused approximately 100 investors more than \$7.5 million in losses.

Despite FINRA's stated intention to propose a single streamlined rule that addresses the outside business activities of registered persons, the proposal contained in Regulatory Notice 18-08 is unworkable. The proposal, if implemented, would clearly increase member firm's reputational and litigation risk as reduced levels of supervision would be unreasonable.

The current rules were issued in order to protect member firms from litigation risk and investors from unsupervised investment activity. FINRA's proposed rule only ensures that members will be exposed to increased litigation and increases the likelihood of investor harm. Moreover, FINRA's Regulatory Notice provides no justification for the rule proposal other than perceived confusion by members. Further, it creates an undue burden on other regulators, who would suffer increased supervisory obligations that are currently assumed by FINRA members.

In sum, PIABA is gravely concerned that FINRA's proposed rule will lead to industry non-compliance with the supervisory requirements of the Exchange Act and provide unscrupulous advisors with a clear road map to commit securities laws violations away from member supervision. PIABA thanks you for the opportunity to comment on this important topic.

Respectfully submitted,



Andrew Stoltmann
PIABA President

Speech

Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors



Chairman Jay Clayton

Boston, Massachusetts

July 8, 2019

Good evening and thank you for being here.^[1]

As many of you know, in June, the Securities and Exchange Commission adopted a package of rules and interpretations that will enhance the quality and transparency of retail investors' relationships with broker-dealers and investment advisers. Importantly, they bring the legal requirements and mandated disclosures for broker-dealers and investment advisers in line with reasonable investor expectations. These actions do not attempt to favor one type of service or relationship. Rather, they are designed to increase investor protection while preserving access for Main Street investors—both in terms of choice and cost—to a variety of investment services and products.

Our rules and interpretations benefit from and build upon the Commission's extended history of broker-dealer and investment adviser regulation, the substantial experience and expertise of our staff, our analysis over many years of prior efforts to modernize and improve regulation in this area, and the many thoughtful comments and other feedback we received on our proposals.^[2] Without question, these actions, individually and collectively, will significantly benefit Main Street investors.

Since we adopted our rulemaking package, there has been no shortage

of views expressed, both from those in support of our efforts and from those who would have preferred a different approach. Some of this commentary has, in my view, shown a lack of understanding of the law and legal obligations of financial professionals, both before and after adoption of our rulemaking package. This has only further solidified my view that our actions were timely and appropriate, and will ultimately benefit retail investors and our markets.

Today, I will begin with a brief overview of our rulemaking package. I will then respond to some of the commentary you may have heard. Finally, building on our investor roundtable earlier this afternoon, I will provide a few words of advice to retail investors who are considering whether to work with a financial professional.

1. Summary Overview of Rules and Interpretations

Broadly speaking, our rules and interpretations address the obligations of broker-dealers and investment advisers when they provide recommendations and investment advice to Main Street investors. The rules and interpretations address an area of law and practice that has become more important and more complex.

a. Regulation Best Interest – Enhancing the Standards of Conduct for Broker-Dealers

Regulation Best Interest—or “Reg. BI”—imposes a new standard of conduct specifically for broker-dealers that substantially enhances their obligations beyond the current “suitability” requirements. The standard can be viewed as having two components. First, it establishes a general obligation that draws from key fiduciary principles, requiring broker-dealers to act in the best interest of their retail customers and not place their own interest ahead of the retail customer’s interest. Second, it includes specific requirements to address aspects of the broker-dealer relationship where our experience indicated that focused attention was appropriate. More specifically, Reg. BI is satisfied only if the broker-dealer complies with four specified component obligations: Disclosure, Care, Conflict of Interest, and Compliance. Each of these obligations includes a number of prescriptive requirements, all of which must be satisfied to comply with the rule.

b. Fiduciary Interpretation – Affirming and Clarifying the Investment Adviser Fiduciary Duty

Our Fiduciary Interpretation reaffirms, and in some cases clarifies, certain aspects of the federal fiduciary duty that an investment adviser owes to its clients. This duty—comprised of both a duty of care and a duty of loyalty—is principles-based and applies to the entire relationship between the investment adviser and the client.

The Fiduciary Interpretation confirms the Commission’s longstanding view

that an investment adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own.

c. Form CRS Relationship Summary – Enhancing Transparency and Comparability

Investment advisers and broker-dealers will be required to deliver a short, plain language relationship summary to retail investors at the beginning of their relationship. The relationship summary is designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing in one place—on two pages—specific information about the broker or adviser.

Firms will be required to provide information about their relationship and services, fees and costs, conflicts of interest, standard of conduct, and whether or not the firm and its financial professionals have legal or disciplinary history. This disclosure will have a standardized question-and-answer format to promote comparability across firms.

d. Solely Incidental Interpretation – Clarifying Broker-Dealer and Investment Adviser Activities

Finally, the rulemaking package includes an interpretation of the solely incidental prong of the broker-dealer exclusion under the Investment Advisers Act of 1940 (“Advisers Act”). This interpretation confirms and clarifies the Commission's position, and illustrates the application in practice in connection with exercising investment discretion over customer accounts and account monitoring.

2. Commentary on Reg. BI, the Fiduciary Interpretation and other Commission Actions

Let me now address some of the commentary, or, more specifically, the criticism and misinformation, I alluded to at the outset. I believe that much of this criticism—which is focused broadly on the extent of the investor protections under Reg. BI and our Fiduciary Interpretation—is false, misleading, misguided, and unfortunately, in some cases, is simply policy preferences disguised as legal critiques.

Before discussing specific points, I want to address a general issue—whether it is appropriate to maintain a regulatory distinction between broker-dealers and investment advisers. A number of commenters expressly or impliedly advocated for regulation that would collapse the distinction, with a substantial majority of those commentators favoring the generally applicable investment adviser model where clients pay an asset-based fee or a flat fee for generally broad-based financial advice from a fiduciary. To be clear, I believe this is a good model, and for many investors, this type of investment adviser relationship may better match their needs than the typical broker-dealer relationship. However, for many other investors, the broker-dealer model, particularly after the implementation of Reg. BI—either alone or in combination with an

investment adviser relationship—provides the better match. For example, a retail customer that intends to buy and hold a long-term investment may find that paying a one-time commission to a broker-dealer is more cost effective than paying an ongoing advisory fee to an investment adviser to hold the same investment. That same investor might want to use a brokerage account to hold those long-term investments, and an advisory account for other investments.

This is a key reason why one of our goals in this rulemaking was to preserve access and choice for Main Street investors. I firmly believe that as a result retail investors will be better off—choice and competition will ultimately inure to the benefit of retail investors in terms of lower fees, better services and transparency, and more offerings.

Under our approach, Main Street investors will be able to choose the type and level of services they want—from occasional recommendations about particular investments to comprehensive account management—and how they want to pay for those services. I do not believe that a “one size fits all” approach would best serve the diverse interests of our Main Street investors. Further, I believe in this area, a one-size fits all approach could reduce the availability and increase the cost of advice and services, particularly for those with relatively smaller accounts.

Claim #1: The Regulation Best Interest standard of conduct will not do enough to protect retail investors

Let me be clear: Reg. BI substantially enhances the standard of conduct for broker-dealers. Importantly, it does so in a manner that (1) establishes a standard of care for transaction-based advice that draws upon principles underlying the investment adviser fiduciary duty, and (2) is workable for broker-dealers.^[3] As a result, (1) whether a retail investor chooses a broker-dealer or an investment adviser (or both), the recommendation or advice is required to be in the best interest of the retail investor and cannot place the interests of the firm or the financial professional ahead of the interests of the retail investor, and (2) the ability to choose between a broker-dealer transaction-based model and an investment adviser portfolio-based model—and choose among the various iterations and combinations of each—will be preserved.

But let me be more specific, and highlight just a few (of the many) key features of Reg. BI that enhance the standard of conduct:

1. Reg. BI applies to account recommendations, including recommendations to roll over or transfer assets in a workplace retirement plan account to an IRA, as well as recommendations to take a plan distribution. These recommendations are often provided at critical moments (such as at retirement), may be irrevocable (or very costly to reverse), can involve a substantial portion of a retail investor’s net worth, and can have significant long-term impacts on the retail investor. Accordingly, this is a critical enhancement over both existing broker-dealer

obligations and our proposal.

2. Reg. BI affirmatively requires broker-dealers to act in the best interest of their retail customers and not place their own interests ahead of the customer's interests. The broker-dealer must comply with the four component obligations I mentioned:

- The Disclosure Obligation, which requires full and fair disclosure of all material facts about the scope and terms of its relationship with the customer, including material facts relating to conflicts of interest associated with its recommendations.
- The Care Obligation, which requires brokers to exercise reasonable diligence, care, and skill, to understand the potential risks, rewards, and costs associated with the recommendation, and to consider those risks, rewards, and costs in light of the customer's investment profile in order to make a recommendation that is in the best interest of the retail customer and does not place the broker-dealer's interests ahead of the retail customer's interest.
- The Conflict of Interest Obligation, which requires firms to implement policies and procedures to mitigate (and in some cases, eliminate) certain identified conflicts of interest that create incentives to make recommendations that are not in the retail customer's best interest.
- The Compliance Obligation, which requires firms to implement policies and procedures reasonably designed to achieve compliance with Reg. BI as a whole.

3. The Care Obligation will apply to a series of recommended transactions (currently referred to as "quantitative suitability") *irrespective* of whether a broker-dealer exercises actual or de facto control over a customer's account. This enhancement will allow us to bring enforcement actions against broker-dealers engaging in misconduct over the course of a relationship more efficiently and thereby return money to harmed retail investors more quickly.

Some critics have gone so far as to fault Reg. BI for failing to require elimination of all conflicts of interest. This criticism is misguided—there are conflicts of interest inherent in all principal-agent relationships, and the broker-customer relationship and the investment adviser-client relationship are no exception. Reg. BI recognizes that these conflicts exist, and requires that firms address those conflicts and provide recommendations that are in the best interest of their retail customers.

Claim #2: Regulation Best Interest is deficient because it does not define "best interest" and does not require a

broker to recommend the “best” security

I disagree with this criticism.

In the comment letters and in meetings with various parties, differing views were expressed regarding whether the standard should be more principles-based or more prescriptive—and in particular, whether to provide a detailed, specific, situation-by-situation definition of “best interest” in the rule text.

We considered this issue very carefully. Our view was that the best approach would be to apply the specific component obligations of Reg. BI, including the “best interest” requirement in the Care Obligation, in a principles-based manner. Under Reg. BI, whether a broker-dealer has acted in the retail customer’s best interest will turn on an objective assessment of the facts and circumstances of how the specific components of the rule are satisfied.

This principles-based approach is a common and effective approach to addressing issues of duty under law, particularly where the facts and circumstances of individual relationships can vary widely and change over time, including as a result of innovation. This approach to determining what is in the “best interest” of a retail customer is similar to an investment adviser’s fiduciary duty, which has worked well for advisers’ retail clients and our markets. Indeed, there is no definition of “best interest” under the Advisers Act.

Neither investment advisers nor broker-dealers are required to recommend the single “best” product. Many different options may in fact be in the retail investor’s best interest, and what is the “best” product is likely only to be known in hindsight. In short, it is appropriate and symmetrical for both standards to use a principles-based approach to determining “best interest.”

Claim #3: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to “put clients first”

This claim is flatly wrong. Our Fiduciary Interpretation in no way weakens the existing fiduciary duty; rather, it reflects how the Commission and its staff have inspected for compliance, applied and enforced the law in this area for decades. The interpretation reaffirms the important protections that the fiduciary duty under the Advisers Act has long provided and will continue to provide.

The Fiduciary Interpretation makes clear that an investment adviser’s fiduciary duty is the duty that was articulated by the Supreme Court in *SEC v. Capital Gains*^[4] and further explained by courts and the Commission over the years since the decision was issued.

Although courts and the Commission have used a variety of formulations to describe an adviser’s fiduciary duty, the core principle has always been that the adviser must at all times serve the best interest of its client and

not subordinate its client's interest to its own. This is the standard reaffirmed in the Fiduciary Interpretation.

Some have taken issue with the words we used in describing the investment adviser's fiduciary duty, that an adviser "not subordinate its clients' interests to its own" or "not place its own interest ahead of its client's interests." They would prefer the formulation that an adviser must "put its client's interest first." I have no qualms with an adviser saying that they "put their client's interest first"—as our Fiduciary Interpretation recognizes, that is a plain English formulation of the legal standard that may be more understandable to retail clients.

But in setting forth the Commission's interpretation of an investment adviser's fiduciary duty, we have stated what the law requires. In our decades of administering this standard consistent with the *Capital Gains* decision, we have never heard that the fiduciary standard is a weak legal standard, and our interpretation is firmly grounded in longstanding law in this area. Given this, it is not surprising that critics have been unable to cite to existing case law that supports the view that the "client first" formulation would provide greater legal protections to investors, nor have they been able to articulate how their preferred formulation would lead to a different result in practical application to the firms we regulate under the Advisers Act. Nothing in the law has changed, but for reasons that I cannot grasp, a few critics want to say it has.

Claim #4: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to avoid all conflicts

There is no legal or regulatory basis for this claim.

A few commentators have erroneously pointed to an instruction in SEC Form ADV for support for this claim. The cited instruction was added without comment or commentary by the Commission in 2010. Yet a few have cited this instruction as evidence of a significant, newfound, independent legal requirement for an adviser to *seek to avoid* all conflicts, which would reflect a fundamental change in the fiduciary duty articulated in *SEC v. Capital Gains*.^[5]

These critics are simply wrong. Worse, the unfounded grounds on which they place their arguments include the implication that a prior Commission effected such a significant change in regulation without public notice or comment. I am confident that the 2010 Commission did not act that way.

Let's look at the facts. First, it would be strange regulatory policy to re-interpret a foundational legal standard for the investment adviser industry through an instruction to a disclosure form; much less to do so without any indication that the standard had changed. Second, for anyone who looks carefully at the development of this instruction, it is obvious that it did not change the longstanding fiduciary duty.^[6]

It is implausible that the Commission would have taken such an important action by: (1) not proposing the new language in the 2008 proposing release; (2) not requesting comment on or otherwise discussing the modification; (3) not identifying any change in law at the time of adoption; (4) creating a new “avoidance” obligation in a Form ADV instruction about disclosure obligations; and (5) not taking any post-adoption regulatory action premised on this alleged “new” standard. It is, in a word, nonsense.

Claim #5: The standards of conduct under Regulation Best Interest and our Fiduciary Interpretation can be satisfied by disclosure alone

This claim reflects a fundamental misunderstanding of how the independent component obligations of Reg. BI operate and a misconception of the investment adviser’s fiduciary duty.

When making a recommendation, a broker-dealer has a general obligation to act in the retail customer’s best interest and cannot place its own interests ahead of the customer’s interests. The general obligation is satisfied only if the broker-dealer complies with the four specified component obligations that I discussed—again, the Disclosure, Care, Conflict of Interest and Compliance Obligations.

Let me focus on the Conflict of Interest Obligation first. In many cases, conflicts of interests will effectively have to be mitigated by broker-dealers, such as conflicts that apply at the representative level. In other cases, conflicts will effectively have to be eliminated.

However, *irrespective* of whether a conflict can be addressed through disclosure or has to be mitigated or eliminated, compliance with Reg. BI does not end with broker-dealers addressing conflicts of interest. The Conflict of Interest Obligation is just one of four specific components of the rule. In all cases, the broker-dealer will *also* need to comply with each of the other component obligations, including, in particular, the Care Obligation.^[7] The Care Obligation applies to every single recommendation, regardless of whether a broker-dealer has disclosed, mitigated, or eliminated its conflicts of interest.

In sum, Reg. BI cannot be satisfied by disclosure alone.

Similarly, an investment adviser has an obligation to act in the best interest of its client—which is an overarching principle that encompasses both the adviser’s duty of care and duty of loyalty. While an adviser may be able to satisfy the duty of loyalty by providing full and fair disclosure *and* obtaining informed consent, the adviser could not satisfy its duty of care solely through disclosure. Thus, the fiduciary duty cannot be satisfied by disclosure alone.

Claim #6: Regulation Best Interest is a weak standard because it does not require broker-dealers to monitor a customer’s account or impose an ongoing duty

This argument is fundamentally flawed. Not only does it reflect a misunderstanding of how federal law applies, it disregards a fundamental goal of our rulemaking which I've discussed—to preserve access to different types and levels of services and related cost structures. I believe investors should be able to choose whether they want ongoing monitoring services and whether to incur the cost of those services.

In addition to preserving access and choice for retail customers, there is a legal reason for not imposing an ongoing monitoring requirement on broker-dealers. As we discussed in our Solely Incidental Interpretation, we do not believe that it would be consistent with the solely incidental prong of the broker-dealer exclusion under the Advisers Act for a broker-dealer to agree to provide continuous monitoring of a customer account. That activity would subject the broker-dealer to regulation as an investment adviser. Therefore, and let me be clear about what such a requirement would mean: imposing an ongoing monitoring obligation would effectively prohibit brokers from providing retail customers with advice without registering as investment advisers. Again, that would mean less access and choice, and higher costs, for retail customers.

While Reg. BI would apply to any periodic monitoring a broker agrees to provide with respect to a customer account, it does not require a broker to provide such service. Why? Because—while key elements of Reg. BI and the investment adviser fiduciary duty are substantially similar—Reg. BI adopts a specific and tailored approach that recognizes that it would be inappropriate to apply certain generally applicable obligations of investment advisers (e.g., duty to monitor) in the context of a transaction-based relationship.

Claim #7: The relationship summary will not accomplish its original goals of addressing investor confusion regarding the differences between brokers and advisers

We have engaged in extensive and rigorous investor testing relating to the issues addressed by the relationship summary, not just for purposes of this rulemaking, but in connection with our long history in this space.^[8] The amount of feedback, investor testing and other information our staff considered in developing the final requirements for the relationship summary, leveraging their considerable experience and expertise with investor disclosures, was extensive—perhaps even unprecedented.^[9]

It is clear that retail investors are confused about the differences between brokers and investment advisers. The new Form CRS relationship summary is a substantial improvement over existing retail disclosures, which are often lengthy, framed in legal terminology and dispersed among many documents. No existing retail disclosure provides this level of transparency and comparability across SEC-registered investment advisers, broker-dealers, and dual registrants.

Our final relationship summary, which benefited from investor testing and commentary,^[10] is consistent with the original goals of the proposal—it

will highlight key information in one place for retail investors. This will help them select or decide whether to continue to use a particular firm or financial professional. It will encourage them—and empower them—to have meaningful and individualized conversations with their financial professionals. It will also help them to easily find additional information because of the layered disclosure approach we adopted.

Let me be clear about two enhancements to Form CRS from our proposal. First, while the final form permits more flexibility in language to enable firms to describe their services more accurately, each firm is required to provide disclosure on the same topics, in the same order and with mandated headings and specific disclosure requirements—on two pages (or four pages for dual registrants). Second, I believe that the design of the final form will result in more meaningful comparisons among firms that will be more relevant to retail investors—because they will be considering the *actual* services, fees and conflicts of firms in a format that allows comparability between and among firms.

To address general investor education, we added a requirement in the very first item of the relationship summary for firms to link to a dedicated, retail investor-oriented landing page on the SEC website Investor.gov. We are committed to undertaking a comprehensive investor education campaign in this space, and to making significant updates to Investor.gov to provide additional plain language content relating to this topic.

I believe the combination of the relationship summary with the educational resources on Investor.gov will be more helpful to retail investors than the proposed prescribed comparisons that may not accurately reflect the services, fees and conflicts of the particular firm or its financial professionals.

3. Conclusion: Some Tips for Retail Investors

Let me wrap up with a few thoughts for retail investors—and let me address my comments directly to the retail investors who have joined us here tonight.

I have covered a lot of ground here, on some very complex rules and interpretations, which are the culmination of decades of debate over what should be done to better protect your interests while preserving access to investment services and products. Interested parties on all sides of the debate have developed strident and divergent views on these issues. For me, it has always been about doing what is best for you.

I recognize that some interest groups would have preferred a different approach. But, after careful consideration, our approach addresses multiple, interrelated issues in a way that best achieves our goals of enhancing investor protection and decision making, while—again—preserving your access and choice.

Today's events are one part of an ongoing SEC investor outreach and education campaign designed to help you understand key differences

between brokers and advisers, and to help you decide whether working with one of these types of financial professionals is right for you.

This is an important decision, and I urge you to do your homework and consider it carefully. For example: What types of services do you want? Do you want someone managing your account on an ongoing basis or do you want recommendations on a few stocks, bonds, mutual funds and ETFs? How do you want to pay for those services? Is the financial professional registered and do they have any prior disciplinary history? How is the financial professional compensated and what conflicts of interest do they have?

These are important questions to consider and ask. Our website [Investor.gov](#) has more information to help you no matter your level of financial sophistication, including a free and simple search tool that allows you to research financial professionals. It also has examples of questions that can get you started in a conversation with the broker or adviser you are considering—and as I mentioned we're in the process of adding additional specific content, including a series of short educational videos with my tips for Main Street investors.^[11]

And if you're not sure what to ask, try my favorite question: how much of my money is going to fees and costs, and how much is going to work for me?

[1] My words are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.

[2] See Chairman Jay Clayton, Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019), available at: <https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd>.

[3] I believe a standard that is not properly calibrated will result in broker-dealers exiting the market, resulting in less choice and higher costs for retail investors. See Regulation Best Interest, Exchange Act Release No. 86031 (June 5, 2019) (discussing ramifications for investor access, choice, and cost in connection with adoption of the Department of Labor's now vacated fiduciary rule and related prohibited transaction exemptions), available at: <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

[4] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (“*SEC v. Capital Gains*”).

[5] *SEC v. Capital Gains* states that advisers are required “to eliminate, or at least to expose, all conflicts of interest.”

[6] The relevant language in the instruction to Form ADV was not proposed or discussed in the 2008 proposing release, and the 2010 adopting release in which that language appeared did not describe it as changing an adviser's fiduciary duty. To the contrary, the relevant portion

of the adopting release cites to the same precedents cited in our interpretation, demonstrating that the explanation in the instruction of an adviser's duty was *consistent* with settled precedent, not a change in interpretation. Critics have not identified any enforcement action, rule, guidance, or other statement by the Commission since the 2010 amendment that expressly or impliedly embraced this supposed enhancement; and we are not aware of any.

[7] As outlined above, the Care Obligation requires broker-dealers to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer, taking into account the potential risks, rewards, and costs associated with the recommendation, and the customer's investment profile in order to make a recommendation that is in the best interest of the retail customer and does not place the broker-dealer's interests ahead of the retail customer's interest.

[8] See e.g., Angela A. Hung, *et al.*, RAND Corporation, *Investor Testing of Form CRS Relationship Summary* (2018), available at <https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf>; Brian Scholl, *et al.*, SEC Office of the Investor Advocate and RAND Corporation, *The Retail Market for Investment Advice* (2018), available at <https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf>; Angela A. Hung, *et al.*, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice Technical Report (2008), available at https://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf ("2008 RAND Study").

[9] See *supra* note 2 (providing overview of information and feedback our staff considered in developing the final requirements for the relationship summary).

[10] We know, based on extensive testing that we conducted and that other parties submitted, investors found the prescribed wording in our proposed relationship summary to be confusing in many instances. Firms also noted that in many cases that the proposed prescribed wording did not accurately reflect their services. See Form CRS Relationship Summary; Amendments to Form ADV Exchange Act Release No. 86032, Advisers Act Release No. 5247 (June 5, 2019).

[11] Tips for Main Street Investors from Chairman Jay Clayton, available at: <https://www.sec.gov/page/investment-tips-chairman-jay-clayton>