Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Suitability: The Customer, Their Objectives and Firm Procedures
Wednesday, November 11
2:15 p.m. – 3:15 p.m.

Join industry panelists and FINRA staff as they discuss how small firms are complying with suitability requirements. They share small firm approaches to, among other things, obtaining and analyzing customers' investment profiles, performing reasonable diligence and training on securities products, and effective and deficient supervision of suitability practices. FINRA panelists also discuss possible compliance challenges that firms face.

Moderator:

James Wrona
Vice President and Associate General Counsel
FINRA Office of General Council

Panelists:

David Martin
Chief Executive Officer and Chief Compliance Officer
Keystone Capital Corporation

Han Nguyen
Examination Manager
FINRA Los Angeles District Office

Raymond Smith
President
Smith Brown & Groover, Inc.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Suitability: The Customer, Their Objectives and Firm Procedures Panelist Bios:

Moderator:

James S. Wrona is Vice President and Associate General Counsel for FINRA in Washington, DC. In this role, he is responsible for various policy initiatives, rule changes and litigation regarding the securities industry. Mr. Wrona formerly was associated with the law firm of K&L Gates LLP, where his practice focused on complex federal litigation. He also previously served as a federal law clerk for the Honorable A. Andrew Hauk of the United States District Court for the Central District of California (Los Angeles). Mr. Wrona is a frequent speaker at securities and litigation conferences and author of numerous law review articles, including *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 Bus. Law. 1 (Nov. 2012); *The Securities Industry and the Internet: A Suitable Match?*, 2001 Colum. Bus. L. Rev. 601 (2001).

Panelists:

David Martin is the CEO and Chief Compliance Officer of Keystone Capital, a FINRA member firm and SEC-registered Investment Adviser. Mr. Martin is responsible for the oversight of registered representatives; implementation of compliance policies, procedures and controls; and day-to-day operations of the firm. Mr. Martin maintains FINRA Series 7, 24, 66 and 99 licenses. In addition to his responsibilities at Keystone, Mr. Martin is a partner at Monahan-Roth, LLC, a securities consulting and expert witness firm. He obtained the FINRA/Wharton Certified Regulatory Compliance Professional designation in 2010.

Han T. Nguyen joined the NASD in October 1995. She was previously employed with T. Rowe Price Associates, a mutual fund company, in their Los Angeles satellite office. Ms. Nguyen has worked as a Cycle Exam Manager for 13 years and is currently a Cause Exam Manager since 2006. Ms. Nguyen received a B.S. in Public Administration from the University of Southern California.

Raymond H. Smith, Jr. is President of Smith Brown & Groover, Inc., a securities broker/dealer in Macon, Georgia. In 1997 he became a co-founder of Rivoli Bank and Trust, a commercial bank chartered in Georgia, and served on its board of directors until its sale in 2005. He also was a founding investor in Patriot Bank of Georgia in 2006. In 2010 Mr. Smith founded Cordia Bank Holding Co. and purchased a controlling interest in Bank of Virginia in Richmond. Mr. Smith previously served as chairman of a 5-state committee for the Financial Industry Regulatory Advisory Board (FINRA). He has also served on FINRA's Small Firm Advisory Board in Washington, DC. After completing his M.B.A. in 1982, Mr. Smith was appointed Vice President at Prudential Capital, where he was responsible for asset and liability management and new product development. Subsequently he developed interest rate hedging strategies as a Vice President at E.F. Hutton in New York, and co-founded Capital Risk Management Corp., where he specialized in asset securitization. Mr. Smith holds leadership positions in various civic and charitable groups in Macon, Georgia. He earned his B.B.A from the University of Georgia and M.B.A. from the University of Texas.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Suitability: The Customer, Their Objectives and Firm Procedures

FINRA

Panelists

Moderator:

- James Wrona, Vice President and Associate General Counsel, FINRA Office of General Council

Panelists:

- David Martin, Chief Executive Officer and Chief Compliance Officer, Keystone Capital Corporation
- Han Nguyen, Examination Manager, FINRA Los Angeles District Office
- Raymond Smith, President, Smith Brown & Groover, Inc.

© 2015 FINRA. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Suitability: The Customer, Their Objectives and Firm Procedures
Wednesday, November 11
2:15 p.m. – 3:15 p.m.

Citations to Publications Regarding Suitability and Related Topics

SEC Studies

- SEC Request for Data and Other Information Regarding the Duties of Investment Advisers and Broker-dealers, Release Nos. 34-69013; IA-3558 (March 1, 2013) (requesting data and other information regarding possible rulemaking for investment advisers and broker-dealers to, *inter alia*, create a uniform fiduciary duty)

  http://www.sec.gov/rules/other/2013/34-69013.pdf

- SEC Study on Investment Advisers and Broker-Dealers (Jan. 2011) (discussing the obligations of investment advisers and broker-dealers, including suitability obligations, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)

  http://www.sec.gov/news/studies/2011/913studyfinal.pdf

FINRA Rules

- FINRA Rule 2111 (Suitability)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859

- FINRA Rule 2330 (Member Responsibilities for Deferred Variable Annuities)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8824

- FINRA Rule 2353 (Trading in Index Warrants, Currency Index Warrants, and Currency Warrants – Suitability)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6295

- FINRA Rule 2360 (Options)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306

- FINRA Rule 2370 (Security Futures)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6309

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

FINRA Frequently Asked Questions

- Combined Suitability FAQs

  http://www.finra.org/Industry/Issues/Suitability/

FINRA Subject-Matter Webpages

- Senior Investors

  http://www.cb.finra.org/Industry/Issues/Seniors/

- Suitability

  http://www.cb.finra.org/Industry/Issues/Suitability/

- Variable Annuities

  http://www.cb.finra.org/Industry/Issues/VariableAnnuities/

FINRA Regulatory Notices

- *Regulatory Notice 13-45* (Dec. 2013) (reminding firms of their responsibilities concerning IRA rollovers)

  http://www.finra.org/Industry/Regulation/Notices/2013/P418694

- *Regulatory Notice 13-31* (Sept. 2013) (highlighting FINRA examination approaches, common findings and effective practices for complying with the suitability rule)

  http://www.finra.org/Industry/Regulation/Notices/2013/P351221

- *Regulatory Notice 12-55* (Dec. 2012) (addressing the scope of the terms "customer" and "investment strategy" for purposes of the suitability rule)

  http://www.cb.finra.org/Industry/Regulation/Notices/2012/P197436

- *Regulatory Notice 12-25* (May 2012) (providing guidance on the new suitability rule in Q&A format)

  http://www.finra.org/Industry/Regulation/Notices/2012/P126432

- *Regulatory Notice 12-03* (Jan. 2012) (providing guidance regarding heightened supervision of and explaining suitability obligations for complex products)

  http://www.finra.org/Industry/Regulation/Notices/2012/P125398

- *Regulatory Notice 11-25* (May 2011) (providing guidance on and a new effective date for FINRA's new "know your customer" and suitability rules)

  http://www.finra.org/Industry/Regulation/Notices/2011/P123702

- *Regulatory Notice 11-02* (Jan. 2011) (announcing SEC approval of FINRA's new "know your customer" and suitability rules)

  http://www.finra.org/Industry/Regulation/Notices/2011/P122779

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

- *Regulatory Notice 10-41* (Sept. 2010) (reminding firms of their sales practice and due diligence obligations when selling municipal securities in the secondary market

  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122112.pdf

- *Regulatory Notice 10-22* (April 2010) (discussing suitability obligations in context of private offerings)

  http://www.finra.org/Industry/Regulation/Notices/2010/P121299

- *Regulatory Notice 10-06* (Jan. 2010) (providing guidance on recommendations made on blogs and social networking websites)

  http://www.finra.org/Industry/Regulation/Notices/2010/P120760

- *Regulatory Notice 09-42* (July 2009) (reminding firms of their obligations with variable life settlement activities)

  http://www.finra.org/Industry/Regulation/Notices/2009/P119547

- *Regulatory Notice 09-35* (June 2009) (recommending review of municipal securities activities)

  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119067.pdf

- *Regulatory Notice 09-32* (June 2009) (announcing SEC approval of amendments to the variable annuity rule that limited the rule's application to recommended transactions, changed the triggering event that begins the principal review period, and clarified various other issues)

  http://www.finra.org/Industry/Regulation/Notices/2009/P118955

- *Regulatory Notice 09-31* (June 2009) (reminding firms of sales practice obligations relating to leveraged and inverse exchange-traded funds)

  http://www.finra.org/Industry/Regulation/Notices/2009/P118953

- *Regulatory Notice 09-25* (May 2009) (proposing consolidated FINRA rules governing suitability and know-your-customer obligations)

  http://www.finra.org/Industry/Regulation/Notices/2009/P118711

- *Regulatory Notice 08-81* (Dec. 2008) (reminding firms of their sales practice obligations with regard to the sale of securities in a high yield environment)

  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117558.pdf

- *Regulatory Notice 07-53*, *Deferred Variable Annuities* (November 2007) (announcing SEC approval of and the effective date for Rule 2821 covering sales practices for deferred variable annuities, including a suitability obligation tailored specifically to such transactions)

  http://www.finra.org/RulesRegulation/NoticestoMembers/2007NoticestoMembers/P037403

- *Regulatory Notice 07-43*, *Senior Investors* (September 2007) (reminding firms of the obligations, including suitability obligations, relating to senior investors and highlighting industry practices to serve such customers)

  http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p036816.pdf

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Notices to Members

- *Notice to Members 07-06*, Supervision of Recommendations after a Registered Representative Changes Firms (Feb. 2007) (explaining special considerations when supervising recommendations of newly associated registered representatives to replace funds and variable products)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_018630.pdf

- *Notice to Members 05-59*, NASD Reminds Members of Obligations When Selling Structured Products (Sept. 2005) (reminding members of their obligations, including suitability requirements, when selling structured products)

  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014997.pdf

- *Notice to Members 04-89*, NASD Alerts Members to Concerns When Recommending or Facilitating Investments of Liquefied Home Equity (Dec. 2004) (discussing, *inter alia*, suitability concerns when recommending the use of liquefied home equity to purchase securities)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_012714.pdf

- *NASD Notice to Members 04-30* (April 2004) (reminding firms of sales practice obligations in sale of bonds and bond funds)

  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003130.pdf

- *Notice to Members 03-71*, NASD Reminds Members of Obligations When Selling Non-Conventional Investments (Nov. 2003) (reminding members of their obligations, including suitability requirements, when selling non-conventional investments)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003070.pdf

- *Notice to Members 01-23*, Suitability Rule and Online Communications (April 2001) (discussing various suitability issues in the online context and also providing guidelines for determining whether a particular communication—whether electronic or otherwise—constitutes a "recommendation" triggering application of the suitability rule)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf

- *Notice to Members 99-35*, NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities (May 1999) (reminding members of their responsibilities, including suitability obligations, regarding the sales of variable annuities and providing guidelines)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004395.pdf

- *Notice to Members 96-60*, Clarification of Members' Suitability Responsibilities under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities (March 1997) (discussing members' suitability obligations when selling low-priced securities and clarifying the breadth of the suitability rule's coverage)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_016905.pdf

- *Notice to Members 96-86*, NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements (Dec. 1996) (emphasizing that sales of variable contracts are subject to suitability requirements)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004697.pdf

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

- *Notice to Members 95-80*, NASD Further Explains Members Obligations and Responsibilities Regarding Mutual Funds Sales Practices (Sept. 1995) (reminding members that, when determining suitability of a mutual fund, they should consider fund's expense ratio and sales charges as well as its investment objectives)

  http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159003811&element_id=1159003637&highlight=95-80#r1159003811

- *Notice to Members 94-16*, NASD Reminds Members Of Mutual Fund Sales Practice Obligations (March 1994) (providing guidance regarding mutual fund sales practices, including suitability)

  http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159003811&element_id=1159003637&highlight=95-80#r1159003811

FINRA Interpretive Letters

- FINRA Interpretive Letter to Brian Sweeney, Trustmont Financial Group, Inc., dated Aug. 26, 2013, from James S. Wrona, FINRA Vice President and Associate General Counsel (providing guidance on the applicability of FINRA Rule 2111 (Suitability) to FINRA members' recommendations of securities transactions in connection with the EB-5 Immigrant Investor Program)

  http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P332008

FINRA Regulatory & Compliance Alerts

- *Reminder—Suitability of Variable Annuity Sales*, Regulatory & Compliance Alert (2002) (emphasizing, in part, that an associated person must be knowledgeable about a variable annuity before he or she can determine whether a recommendation to purchase, sell or exchange the variable annuity is appropriate)

  http://www.nasd.com/RulesRegulation/PublicationsGuidance/MemberUpdates/RegulatoryandComplianceAlerts/NASDW_015299

- *Online Brokerage Services and the Suitability Rule*, Regulatory & Compliance Alert (Summer 2000) (providing guidance regarding electronic communications that could be considered "recommendations" triggering application of the suitability rule)

  http://www.nasd.com/web/groups/rules_regs/documents/rca/nasdw_002377.pdf

- *Suitability Issues for Multi-Class Mutual Funds*, Regulatory & Compliance Alert (Summer 2000) (discussing various suitability issues related to mutual funds)

  http://www.nasd.com/web/groups/rules_regs/documents/rca/nasdw_002377.pdf

FINRA Investor Materials

- Suitability: What Investors Need to Know

  http://www.finra.org/Investors/ProtectYourself/BeforeYouInvest/P197434

- FINRA Investor Alert: Duration – What an Interest Rate Hike Could Do to Your Bond Portfolio

  http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318

- FINRA Investors – Smart Bond Investing – Tips Before You Invest

  http://www.finra.org/Investors/InvestmentChoices/Bonds/SmartBondInvesting/tips/index.htm

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Books

- NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION (4th ed. 2013).

Law Review Articles

- James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1 (Nov. 2012).

  http://www.americanbar.org/publications/the_business_lawyer/volume_68/number_1.html

- Nancy C. Libin & James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?* 2001 COLUM. BUS. L. REV. 601 (2001).

  http://www.cblr.org/archives.html

Other FINRA Publications Discussing Suitability-Type Issues

- *Notice to Members 05-50*, Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities (Aug. 2005) (discussing members' responsibilities for supervising sales of equity-indexed annuities)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014821.pdf

- *Notice to Members 05-48*, Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers (July 2005) (outlining members' responsibilities when outsourcing activities to third-party service providers)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014735.pdf

- *Notice to Members 05-26*, NASD Recommends Best Practices for Reviewing New Products (April 2005) (recommending best practices for reviewing new products)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013755.pdf

- *Notice to Members 03-68*, NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate (Nov. 2003) (discussing factors to consider when determining the appropriateness of fee-based compensation programs)

  http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003079.pdf

Significant Suitability Cases

- *Costello v. Oppenheimer & Co.,* 711 F.2d 1361, 1369 (7th Cir. 1983) (discussing various factors that courts and regulators consider in determining whether the trading was excessive)

- *Richard G. Cody*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862, *30-32 (May 27, 2011) (explaining, among other things, that a broker can violate reasonable-basis suitability by failing to perform a reasonable investigation of a recommended product and to understand the risks of the recommendation notwithstanding that the recommendation could be suitable for *some* investors)

- *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'")

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

- *Michael Frederick Siegel*, Exchange Act Rel. No.58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008) (discussing various factors to consider in determining whether a communication is a recommendation and reviewing elements of reasonable-basis and customer-specific suitability), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. Jan. 12, 2010), *cert. denied*, 2010 U.S. LEXIS 4340 (May 24, 2010)

- *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21-33 (Nov. 8, 2006) (discussing suitability obligations in the context of different mutual fund share classes, as well as the use of margin)

- *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004) (stating that, under the suitability rule, a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]"); *id.* at *26 ("We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.")

- *Wendell D. Belden*, Exchange Act Rel. No. 47859, 2003 SEC LEXIS 1154, at *14 (May 14, 2003) (finding unsuitable recommendations where motivation for recommending Class B shares over Class A shares was the significantly greater commissions that the broker received from the former shares)

- *James B. Chase*, Exchange Act Rel. No. 47476, 2003 SEC LEXIS 566, at *12-21 (March 10, 2003) (upholding suitability violation and noting that high concentration in a speculative security was inappropriate and that the customer's college education does not mean that she was a sophisticated investor who fully understood the risky investment)

- *Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *8 (Feb. 10, 2003) ("Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."); *id.* at *11 (stating that it was improper for a broker to make recommendations "on the basis of guesswork" regarding a customer's net worth where a customer refused to provide broker with any information regarding other assets not listed on her new account form)

- *Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 & 342 (1999) (holding that "[t]ransactions 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" and "excessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading")

- *Clinton Hugh Holland, Jr.,* 52 S.E.C. 562, 565-66 (1995) (emphasizing, in the suitability context, the inappropriateness of the shift in the customer's portfolio from conservative to speculative securities), *aff'd*, 105 F.3d 665 (9th Cir. 1996)

- *David Joseph Dambro*, 51 S.E.C. 513, 517 & n.14 (1993) ("[The respondent] was obligated to make his recommendation only on the basis of concrete information about [his customer's] financial situation . . . [and] [w]ithout knowing [the customer's] other securities holdings and financial situation, [the respondent] could not make the requisite customer-specific evaluation necessary for a suitable recommendation.")

- *F.J. Kaufman and Co.*, 50 S.E.C. 164, 168 (1989) (explaining "reasonable basis" and "customer specific" suitability obligations)

- *Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7 (NAC July 30, 2009) (discussing various elements of churning and excessive trading)

- *Dep't of Enforcement v. Frankfort*, No. C02040032 (NAC May 24, 2007) (finding a violation of the suitability rule and noting that a broker can, under certain circumstances, violate the suitability rule by failing to disclose material information)

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

- *Dep't of Enforcement v. Siegel*, No. C05020055 (NAC May 11, 2007) (discussing the relevant factors for determining whether a broker has made a "recommendation" triggering application of the rule and finding that the broker violated the "reasonable basis" suitability obligation)

- *Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests and the test for whether a broker's recommendation is suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs.")

- *Dep't of Enforcement v. Howard*, No. C11970032, 2000 NASD Discip. LEXIS 16, at *19 (NAC Nov. 16, 2000) (holding that the broker's recommendations "also led to an undue concentration of these speculative securities, making the recommendations particularly unsuitable"), *aff'd*, Exchange Act Rel. No 46269, 2002 SEC LEXIS 1909 (July 26, 2002), *aff'd*, No. 02-1939, 2003 U.S. App. LEXIS 19454 (1st Cir. Sept. 19, 2003)

- *Dist. Bus. Conduct Comm. v. Kunz*, Complaint No. C3A960029, 1999 NASD Discip. LEXIS 20, *62-63 & n.29 (NAC July 7, 1999) (holding that respondent's distribution of an issuer's offering document did not, by itself, constitute a recommendation of the subject security for suitability purposes), *aff'd*, Exchange Act Rel. No. 45290, 2002 SEC LEXIS 104 (Jan. 16, 2002)

- *Dist. Bus. Conduct Comm. v. Nickles*, Complaint No. C8A910051, 1992 NASD Discip. LEXIS 28, *18 (NBCC Oct. 19, 1992) (holding that suitability rule "applies not only to transactions that registered persons effect for their clients, but also to any recommendations that a registered person makes to his or her client")

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection

*By James S. Wrona**

A crucial debate on financial regulatory reform, affecting virtually every investor in the United States, is now taking place. The debate centers on the standards of care required of financial professionals when they provide investment advice. Two separate and markedly different regulatory regimes apply to these financial professionals: one for investment advisers and one for broker-dealers. This article discusses recent congressional initiatives related to advisers and broker-dealers, reviews existing obligations when advisers and broker-dealers provide advice to customers, and identifies regulatory gaps that need to be bridged. The level of regulatory oversight that both models receive also is explored. Finally, the article offers a framework to ensure robust investor protection and, as part of that framework, recommends that policymakers impose additional obligations on both broker-dealers and advisers to achieve truly universal standards of conduct that are in investors' best interests.

I. Introduction

In the wake of the worst economic crisis since the Great Depression,[1] one of the most important debates on financial regulation in the past several decades is now taking place. The debate, which will affect virtually every investor in the United States, centers on how to reform and, to the extent possible, reconcile the diverse standards of care required of financial professionals when they provide investment advice to customers. Unbeknownst to many investors before the

* Mr. Wrona is Vice President and Associate General Counsel for the Financial Industry Regulatory Authority in Washington, D.C. In this role, he assists with policy initiatives, rule changes, and litigation regarding the securities industry. Mr. Wrona formerly was associated with the law firm of K&L Gates LLP, where his practice focused on complex federal litigation. He also previously served as a federal law clerk for the Honorable A. Andrew Hauk of the United States District Court for the Central District of California (Los Angeles). The views and analysis expressed herein are those of the author and do not necessarily reflect those of FINRA or of the author's colleagues. FINRA, as a matter of policy, disclaims responsibility for any private publication or statement by any employee.

1. *See* Joseph E. Stiglitz, Freefall: America, Free Markets, and the Sinking of the World Economy 1 (2010) (comparing the recent recession to the Great Depression); Ben Bernanke, Four Questions About the Financial Crisis: Speech to Morehouse College (Apr. 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm (stating that it is the worst economic crisis since the Great Depression).

economic crisis (and no doubt to some afterward), there are two separate regulatory regimes in the United States for financial professionals who offer investment advice: one for investment advisers ("advisers") and one for broker-dealers.[2]

Federally registered advisers are regulated by the U.S. Securities and Exchange Commission ("SEC" or "Commission") and are subject to the Investment Advisers Act of 1940 ("Advisers Act") and the regulations and rules promulgated thereunder.[3] In general, broker-dealers that sell securities to the public in the United States are regulated by the self-regulatory organization ("SRO") the Financial Industry Regulatory Authority ("FINRA"),[4] the SEC, and the

2. *See* U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 93–101 (Jan. 2011) [hereinafter IA/BD STUDY] *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (citing studies indicating that investors generally do not understand the differences between advisers and broker-dealers regarding the services they provide and the standards of conduct to which they are subject).

3. Section 202(a)(11) of the Advisers Act defines an "investment adviser" to include "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11) (2006 & Supp. IV 2010). Section 202(a)(11)(C) excludes from the definition broker-dealers whose advisory activities are solely incidental to their securities business and receive no "special compensation" for their advisory services. 15 U.S.C. § 80b-2(a)(11)(C) (2006). Registration with the SEC generally is required if an adviser (1) manages more than $100 million in client assets, (2) advises certain funds or business development companies, or (3) works in a state that does not register advisers. *See* Advisers Act § 203, 15 U.S.C. § 80b-3 (2006 & Supp. IV 2010); Advisers Act § 203A, 15 U.S.C. § 80b-3a (2006 & Supp. IV 2010). All other advisers are subject to state registration systems that have requirements similar to the Advisers Act. Advisers are regulated by either the SEC or the states, but not both. This article focuses on advisers registered with the SEC.

4. FINRA, the largest SRO in the United States, is a national securities association registered with the SEC under section 15A of the Maloney Act Amendments to the Exchange Act. *See* 15 U.S.C. § 78o-3(a) (2006); *see also About the Financial Industry Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Oct. 29, 2012) (explaining that FINRA "is the largest independent regulator for all securities firms doing business in the United States"). FINRA was created in 2007 through the consolidation of the National Association of Securities Dealers ("NASD") and the New York Stock Exchange Member Regulation ("NYSE"). *See* Press Release, FINRA, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA (July 30, 2007), *available at* http://www.finra.org/newsroom/newsreleases/2007/p036329; SEC Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., 72 Fed. Reg. 42169 (Aug. 1, 2007). "FINRA's mission is to protect America's investors by making sure the securities industry operates fairly and honestly." *About the Financial Industry Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Oct. 29, 2012). FINRA oversees approximately 4,345 broker-dealer firms, 163,410 branch offices, and 635,145 registered securities representatives. *Id.* FINRA has nearly 3,300 employees and operates dual headquarters in Washington, D.C., and New York, NY, with twenty regional offices across the country. *Id.* In general, "all registered broker-dealers that deal with the public must become members of FINRA . . . and may choose to become exchange members." IA/BD STUDY, *supra* note 2, at 47. FINRA regulates these broker-dealers with SEC oversight. *See* Exchange Act § 19(b), (d), (g), (h), 15 U.S.C. § 78s(b), (d), (g), (h) (2006 & Supp. IV 2010).

FINRA has its own rulebook, with which broker-dealers must comply, and is in the process of creating a consolidated FINRA set of rules following the NASD and NYSE merger, discussed above. The current FINRA rulebook consists of (1) FINRA rules; (2) NASD rules; and (3) NYSE rules. *See FINRA's Rulebook Consolidation Process*, FINRA, http://www.finra.org/Industry/Regulation/FINRARules/P038095 (last visited Oct. 16, 2012). FINRA examines broker-dealers for compliance with FINRA

states.[5] Broker-dealers are subject to the requirements of the Securities Exchange Act of 1934 ("Exchange Act"), the regulations and rules promulgated thereunder, certain state laws, and FINRA rules.[6] The standard-of-care debate has been characterized, or perhaps mischaracterized, as whether "fiduciary" or "suitability" obligations provide better investor protection.

The fiduciary duty, which derives from a judicial interpretation of section 206 of the Advisers Act, applies to advisers in their dealings with customers.[7] This *fiduciary* obligation is not easily defined, but, as discussed below, it includes duties of loyalty and care regarding an adviser's interactions with a customer.[8] For broker-dealers, FINRA Rule 2111 imposes *suitability* obligations.[9] The suitability rule, explained in depth below, generally requires that a broker-dealer have a reasonable basis for believing that a recommendation of a security or investment strategy is suitable for a customer, based on the customer's investment profile.[10]

Media reports have repeatedly described the differences between the two standards by stating that advisers are subject to a stringent fiduciary duty requiring them to act in their customers' best interests, while broker-dealers are subject to a weaker duty that merely requires their recommendations be suitable for their customers.[11] That interpretation of the fiduciary duty and of the suitability

rules and the federal securities laws, and FINRA brings enforcement actions against broker-dealers when violations occur. *See* FINRA, WE'RE HERE TO PROTECT, EDUCATE AND INFORM INVESTORS: GET TO KNOW US 2 (2012), *available at* http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf. For purposes of this article, NASD and NYSE rules, decisions, and guidance will be referred to as FINRA rules, decisions, and guidance, unless specifically noted for citation or other purposes.

5. *See* IA/BD STUDY, *supra* note 2, at 46–47.

6. Section 3(a)(4)(A) of the Exchange Act generally defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A) (2006 & Supp. IV 2010). A dealer is defined under section 3(a)(5)(A) of the Exchange Act as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." *Id.* § 78c(a)(5)(A). The general distinction is that a broker acts as an agent and a dealer acts as a principal. This article will refer to brokers and dealers, and their employees, collectively as "broker-dealers" or "firms" unless otherwise indicated. As noted above, in addition to effecting securities transactions for their customers, broker-dealers are permitted to offer investment advisory services that are solely incidental to their securities business if they do not receive any special compensation for such advisory services. *See supra* note 3; *see also* IA/BD STUDY, *supra* note 2, at 15–16.

7. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

8. *See* IA/BD STUDY, *supra* note 2, at 22–24, 27–29, 106, 110–23.

9. *See* FINRA R. 2111(a) (2011). FINRA rules are available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607. Citations are to the last amendment dates of the rules.

10. *See* FINRA R. 2111(a).

11. *See* Paul Sullivan, *In Investing, Disclosure Only Gets You So Far*, N.Y. TIMES, Feb. 9, 2012, at F6 ("[A]verage investors do not understand the difference between a broker (legally bound only to recommend 'suitable' investments) and someone who is working as a fiduciary (more strictly required to recommend what's best for you, not merely suitable, and disclose any conflicts)."); Sarah Morgan, *The Battle Over Brokers' Duty to Their Clients Reaches a Standstill*, WALL ST. J., Jan. 24, 2012, at C7 ("A major push by consumer advocates to hold stockbrokers to the same client-comes-first standard of care required of investment advisers—the so-called fiduciary standard—seemed close to success only a year ago. . . . Under current rules, brokers only need to ensure the products they sell their clients are 'suitable' . . . ."); Elizabeth Ody, *Investors Prefer Broker Commissions; Rather Than a Fee Based on Their Assets*, USA TODAY, June 10, 2011, at B5 ("Brokers currently must meet a standard to offer clients 'suitable investments,' whereas [advisers] have a fiduciary obligation to put clients'

rule has begun to shape, and to a great extent skew, the debate. If the goal of the debate ultimately is to lead to meaningful regulatory reform, this mischaracterization is unhelpful as a starting point. The almost exclusive focus on those obligations also ignores numerous important investor-protection obligations imposed on broker-dealers that are not imposed on advisers. In addition, and perhaps more significant, broker-dealers are subject to much greater regulatory oversight, in terms of both compliance examinations and enforcement efforts. Indeed, the infrequency with which advisers currently are examined and disciplined is cause for concern. As one SEC Commissioner recently stated, "[f]or far too long, in the investment advisory area, the Commission has been unable to perform its responsibilities adequately to fulfill its mission as the investor's advocate, and investment advisory clients have not been adequately protected. This must change."[12]

This article begins with a discussion of recent congressional initiatives related to advisers and broker-dealers. It then provides a detailed review of the obligations imposed on advisers and on broker-dealers (including fiduciary and suitability obligations) when they provide advice to customers and identifies regulatory gaps that need to be bridged. The level of regulatory oversight that both models receive also is explored. The article, moreover, offers a framework for a regulatory approach that will ensure the most robust investor protection, while maintaining investors' choices regarding how best to make investment decisions. As part of that framework, this article concludes that policymakers need to impose additional obligations on both broker-dealers *and* advisers to achieve truly universal standards of conduct that are in investors' best interests.

best interests first."); Aldo Svaldi, *Regulatory Limbo Contributes to Slow Recovery, Expert Says*, DENVER POST, June 3, 2011, at B8 ("Fiduciaries must place the interest of a client before their own versus the more lenient requirement that a product they sell be 'suitable.' "); Chuck Jaffe, *Funds Will React to "Best Interests" Rule; Debate Whether Brokers' Advice Serves Customers*, BOSTON HERALD, Jan. 30, 2011, at B22 (stating that investment advisers "have a fiduciary duty to serve their client's best interest" and that the "law only requires that [broker-dealers'] recommendations be 'suitable' for the client"); Michelle Singletary, *One Set of Standards for Financial Advisers, Brokers Makes Sense*, WASH. POST, Jan. 27, 2011, at A13 ("An investment adviser has a fiduciary duty to serve the best interest of clients. . . . Brokers don't have to act in a client's best interest. Instead, the law says they have to make sure their recommendations are suitable for the client."); Eileen Ambrose, *SEC Suggests Brokers Have Fiduciary Duty*, BALT. SUN, Jan. 25, 2011, at C1 (same); Cort Haber, *2 Standards Too Much; One is "Fiduciary," the Other is "Suitability"; Risky When Investment Advisers Aren't All Held to the Same Set of Rules*, ATLANTA JOURNAL-CONSTITUTION, June 27, 2010, at 2D (same); Rob Lieber, *Finding Financial Advice in the Age of Bad Behavior*, N.Y. TIMES, June 6, 2009, at B1 (discussing SEC fraud charges against former president of the National Association of Personal Financial Advisers, an adviser trade organization critical of broker-dealers that has "promoted [advisers'] adherence to a 'fiduciary' standard, where members act only in a client's best interests. Other financial professionals often only agree to do what is 'suitable.' ").

12. Elisse B. Walter, Statement on Study on Enhancing Investment Adviser Examinations 8 (Jan. 2011) [hereinafter Commissioner Statement on IA Examinations Study], *available at* http://www.sec.gov/news/speech/2011/spch011911ebw.pdf. Commissioner Walter is uniquely knowledgeable about advisers, broker-dealers, SROs, and federal financial regulators. She worked as an SEC staff attorney, general counsel of the Commodity Futures Trading Commission, and FINRA executive before serving as an SEC Commissioner. *See SEC Biography: Elisse B. Walter*, U.S. SEC. & EXCH. COMM'N (Jan. 29, 2009), http://www.sec.gov/about/commissioner/walter.htm.

II. Congressional Action

In 2010, Congress enacted and President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[13] Congress promulgated Dodd-Frank in reaction to the economic crisis and a number of misdeeds in the financial industry thought to have played a role in creating it.[14] As such, Dodd-Frank sought to promote "financial stability" and "protect consumers from abusive financial services practices."[15] Dodd-Frank includes two sections that are particularly relevant to the current debate.

Section 913 required the SEC to conduct a study on adviser and broker-dealer obligations and identify regulatory gaps.[16] This section, moreover, authorized, but did not require, the SEC generally to propose rules for advisers and broker-dealers that address those regulatory gaps.[17] Section 913 also specifically stated that the SEC may consider establishing a fiduciary duty for broker-dealers that is no less stringent than the one imposed on advisers.[18] Congress, however, expressed its preference that any such undertakings preserve existing investor choices and differing business models.[19]

One notable difference between advisers and broker-dealers is their fee arrangements. As discussed in greater detail below, advisers often use an asset-based fee structure (whereby a customer pays an annual fee "based on the percentage of assets under management"), while broker-dealers ordinarily use a transaction-based fee structure (whereby a customer pays a commission or other fee for each purchase, sale, or exchange of a security).[20] In addition, some advisers, by agreement with their customers, have ongoing responsibilities to monitor customer accounts and, when appropriate, recommend changes to the investment holdings in the accounts.[21] Broker-dealers normally do not have such ongoing responsibilities. Finally, broker-dealers generally are permitted to act in a principal capacity when dealing with customers.[22] Thus, a broker-dealer can buy

13. Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].

14. *See* U.S. Gov't Accountability Office, Report to Congress on Dodd-Frank Act Regulations 1 (Nov. 2011) (GAO-12-151), *available at* http://gao.gov/assets/590/586210.pdf.

15. Dodd-Frank, *supra* note 13, 124 Stat. at 1376 pmbl.

16. *Id.* § 913(b)–(d), 124 Stat. at 1824–27.

17. *Id.* § 913(f), 124 Stat. at 1827–28.

18. *Id.* § 913(g), 15 U.S.C.A. §§ 78o, 80b-11 (West 2009 & Supp. 2012).

19. For instance, Congress, in section 913 of Dodd-Frank, indicated that various services and practices that are distinct to the broker-dealer model should not be viewed as inconsistent with the imposition of a fiduciary standard that is no less stringent than the one imposed on advisers. *See* Dodd-Frank § 913(g), 15 U.S.C.A. §§ 78o, 80b-11; *see also* Exchange Act § 15(k)(1), 15 U.S.C. § 78o(k)(1) (2006 & Supp. IV 2010). As the SEC explained, those provisions, among others, "make clear that the implementation of the uniform fiduciary standard should preserve investor choice among such services and products and how to pay for these services and products (*e.g.*, by preserving commission-based accounts, episodic advice, principal trading and the ability to offer only proprietary products to customers)." IA/BD Study, *supra* note 2, at 113.

20. *See* IA/BD Study, *supra* note 2, at 7, 10–11.

21. *Id.* at 13 (noting that some advisers offer arrangements whereby they agree to provide ongoing investment advice).

22. *Id.* at 119.

securities from and sell securities to customers for or from its own account. A broker-dealer, however, must disclose the capacity in which it is acting, whether as principal or agent, and may only charge fair and reasonable fees and prices related to any transaction.[23] Section 206(3) of the Advisers Act imposes different requirements on advisers in this context. That provision generally requires an adviser that acts in a principal capacity to provide written disclosure to and receive consent from the customer to act in such capacity on a trade-by-trade basis prior to the completion of each transaction.[24]

In recognition of these differences, section 913 of Dodd-Frank amended the Exchange Act by providing that a broker-dealer's charging of commissions "shall not, in and of itself, be considered a violation of [any such fiduciary duty] applied to a broker-dealer" and that a broker-dealer would not be required to have a "continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."[25] Although section 913 of Dodd-Frank does not use similar language regarding broker-dealers acting in a principal capacity, section 913 references specific sections of the Advisers Act, but not section 206(3), when discussing a possible uniform fiduciary duty.[26] Congress's omission in section 913 of Dodd-Frank of any reference to section 206(3) of the Advisers Act evidences a congressional intent to allow broker-dealers to continue to act in a principal capacity without having to provide written disclosure to and receive consent from customers *for each individual transaction*. As discussed below in Part VI.B., requiring written disclosure and

23. *See id.* at 56 n.252 (noting that a broker-dealer that acts as principal must disclose the cost of the security and the best price obtainable on the open market and must disclose all material facts when recommending a security to a customer that the broker-dealer intends to sell to the customer from its own account); *id.* at 57 (stating that SEC Exchange Act Rule 10b-19 "requires a broker-dealer effecting customer transactions in securities . . . to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will receive"); *id.* at 66–69 (discussing broker-dealers' obligation to charge only those fees related to transactions that are fair and reasonable).

24. *See* Advisers Act § 206(3), 15 U.S.C. § 80(b)-6(3) (2006 & Supp. IV 2010) (prohibiting an adviser from "[a]cting as principal for his own account" regarding the purchase or sale of a security for a client "without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client"). The disclosure must be in writing, but the client's consent does not have to be in writing. *See* IA/BD STUDY, *supra* note 2, at 26. The disclosure and consent, however, generally must be obtained separately for each transaction—"blanket consent" ordinarily will not suffice. *Id. But see* Temporary Advisers Act Rule 206(3)-3T, 17 C.F.R. § 275.206(3)-3T (2012) (providing an alternative means of compliance with section 206(3) of the Advisers Act for investment advisers that are dually registered as investment advisers and broker-dealers).

25. *See* Dodd-Frank § 913(g), 15 U.S.C.A. §§ 78o, 80b-11 (West 2009 & Supp. 2012); *see also* Exchange Act § 15(k)(1), 15 U.S.C. § 78o(k)(1) (2006 & Supp. IV 2010).

26. Section 913(g) of Dodd-Frank amended the Exchange Act by providing, *inter alia*, that the SEC may promulgate a uniform fiduciary duty for broker-dealers and advisers that creates a standard that "*shall be no less stringent than the standard applicable to investment advisers under sections 206(1) and (2)* of [the Advisers Act] when providing personalized investment advice about securities." 15 U.S.C.A. §§ 78o, 80b-11 (emphasis added); *see also* Exchange Act § 15(k)(1), 15 U.S.C. § 78o(k)(1). Neither Dodd-Frank nor the Exchange Act references section 206(3) of the Advisers Act when discussing a potential uniform fiduciary duty.

consent on a trade-by-trade basis would hinder the handling of customer orders, reduce market liquidity, and be unnecessary in light of other protections that are available to address potential conflicts that may arise when a broker-dealer acts in a principal capacity.

Section 914 of Dodd-Frank required the SEC to prepare a second study to address ways to enhance adviser examinations.[27] Congress directed the SEC, in preparing the study, to consider the number and frequency of examinations and the feasibility of using an existing, or establishing a new, SRO to enhance the adviser examination process.[28]

In enacting Dodd-Frank, Congress was attuned to the main issues regarding the different regulatory regimes. It sought input, however, from experts in the field before requiring the creation of new or different obligations that might adversely impact the economy, businesses, and important investor choices without providing meaningfully enhanced investor protection.[29] SEC staff recently completed the mandated studies. They are discussed in detail below, but a few points should be mentioned at the outset.

The SEC staff studies are comprehensive and thoughtfully drafted. It must be acknowledged, however, that they were not prepared in a vacuum. Political concerns and public perception—and, to a lesser extent, occasional competing perspectives between different regulatory agencies and even between different departments within those agencies—can sometimes influence how such documents approach issues under consideration. With that in mind, this article focuses mainly on the SEC staff's factual findings discussed in the studies.

III. Adviser Obligations

Advisers are subject to the standards set forth in the Advisers Act, which do not expressly impose a fiduciary obligation. The courts and the SEC, however, have held that the Advisers Act implicitly imposes a fiduciary duty on advisers.[30] In addition to this somewhat imprecise duty, advisers are subject to several obligations under the Advisers Act and SEC rules that prohibit or require more specific conduct. This Part discusses each obligation in turn.

27. Dodd-Frank, *supra* note 13, § 914, 124 Stat. at 1830.

28. *Id.*

29. *Id.* (requiring SEC to prepare a study addressing ways to enhance adviser examinations); *id.* § 913(b)–(d), 124 Stat. at 1824–27 (mandating that SEC prepare a study on adviser and broker-dealer obligations that, *inter alia*, identifies regulatory gaps, analyzes ways to bridge those gaps, and assesses the potential impact on investors, advisers and broker-dealers—including as to costs and range of products and services offered—regarding any potential rulemaking). In preparing the studies, moreover, the SEC sought and received public comments on the identified issues. *See* IA/BD Study, *supra* note 2, at 4–5. In regard to the IA/BD Study, for example, the SEC "received more than 3,000 individualized comments, including comments from investors, financial professionals, industry groups, academics, and other regulators." *Id.* at 5.

30. Subsequent to the judicial interpretation of the Advisers Act as including a fiduciary duty, the SEC recognized this duty in SEC Advisers Act Rule 204A-1, discussed in detail below, but it did not identify the duty's parameters or provide an expanded discussion of the topic. 17 C.F.R. § 275.204A-1 (2012).

A. Fiduciary Duty

Much has been made in the standard-of-care debate of an adviser's fiduciary duty and, judging solely from media reports, one may well conclude that its investor-protection powers are unparalleled.[31] Closer scrutiny, however, reveals something a little less remarkable. Nonetheless, one of the SEC staff studies recommends, without proposing a specific rule, imposing a fiduciary duty on broker-dealers that is no less stringent than the one for advisers.[32] In determining what such a universal fiduciary duty might actually encompass, it is important to review both the historical underpinnings and current application of the adviser's fiduciary duty.

1. Judicial Interpretation of the Advisers Act

In *SEC v. Capital Gains Research Bureau, Inc.*,[33] the United States Supreme Court noted that advisers are held to high ethical standards.[34] The Court stated that the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship."[35] The Court found that section 206 of the Advisers Act, which contains antifraud provisions, imposes a fiduciary duty on advisers to act in "good faith," provide "full and fair disclosure of all material facts," and "employ reasonable care to avoid misleading" customers.[36]

The Court's decision, however, left a number of questions unresolved. As an initial matter, it remained unclear whether a cause of action based on an adviser's violation of its fiduciary duty would, in some circumstances, require a showing of scienter (that the defendant acted with intent or extreme recklessness rather than mere negligence).[37] In *Capital Gains*, the Court held that the SEC was not required to prove scienter in an enforcement action brought under section 206 of the Advisers Act.[38] The Court stated that Congress, "in empowering the courts to enjoin any practice that operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure and actual injury to the client."[39] The Court found that the defendant had violated section 206 of the Advisers Act by failing to disclose a conflict of interest.[40] Section 206 of

31. *See supra* note 11.
32. *See* IA/BD Study, *supra* note 2, at 108–23.
33. 375 U.S. 180 (1963).
34. *Id.* at 188–89.
35. *Id.* at 191.
36. *Id.* at 194.
37. For discussions of scienter requirements generally, see the following: Aaron v. SEC, 446 U.S. 680, 686–87 n.5 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); *In re* Baesa Sec. Litig., 969 F. Supp. 238, 241 (S.D.N.Y. 1997); Dep't of Enforcement v. Reynolds, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44–47 (NAC June 25, 2001).
38. *Capital Gains*, 375 U.S. at 196.
39. *Id.*
40. The defendant advisers published a monthly advisory report to 5,000 subscribers who paid an annual fee for the service. *Id.* at 182–83. Defendants "purchased shares of a particular security shortly before recommending it in the report for long-term investment." *Id.* at 183. The price of the security increased within days of the defendants' distribution of the report. *Id.* Defendants then sold their shares for a profit. *Id.* Defendants did not disclose this information to their clients. *Id.*

the Advisers Act, however, has four separate provisions and the Court did not cite to a particular provision when it rendered its decision.

Section 206(1) prohibits an adviser from "employ[ing] any device, scheme, or artifice to defraud" a client.[41] Section 206(2) prohibits an advisor from "engag[ing] in any transaction, practice or course of business which operates as a fraud or deceit upon" a client.[42] As noted above, section 206(3) prohibits an adviser from "[a]cting as principal for his own account" regarding the purchase or sale of a security for a client "without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client."[43] Section 206(4) prohibits an adviser from "engag[ing] in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[44]

Although the *Capital Gains* decision did not cite a particular paragraph of section 206, the Court relied on the language in section 206(2) when it held that the SEC did not have to show scienter.[45] After *Capital Gains*, courts have reaffirmed that scienter need not be proven in section 206(2) cases,[46] and some courts have similarly held that scienter is not an element of a case based on section 206(4).[47] Several courts have held, however, that scienter is required in an action under section 206(1).

Courts holding that section 206(1) requires a showing of scienter have looked to the treatment of other antifraud provisions that use similar language. In *Carroll v. Bear, Stearns & Co.*,[48] the plaintiff alleged violations of both section 206(1) of the Advisers Act and SEC Exchange Act Rule 10b-5, the latter of which requires a showing of scienter.[49] The court quoted language from section 206(1) that is identical to language in Rule 10b-5 and held that the same scienter requirement applies to both.[50] The court found that the plaintiff's claim failed because it did not allege facts sufficient to plead a cause of action requiring proof of scienter.[51] The court opined that the plaintiff's "remedy, if any, lies in an action in state court for common law breach of contract and/or negligence."[52]

41. 15 U.S.C. § 80b-6(1) (2006).
42. *Id.* § 80b-6(2).
43. 15 U.S.C. § 80b-6(3) (2006 & Supp. IV 2010). Section 206(3) does "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." *Id.*
44. *Id.* § 80b-6(4).
45. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (using the "fraud and deceit" language of section 206(2) of the Advisers Act).
46. Aaron v. SEC, 446 U.S. 680, 694 (1980) (reaffirming that there is no intent requirement for actions based on section 206(2) of the Advisers Act); Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979) (same), *aff'd*, 450 U.S. 91 (1981).
47. SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992) (holding that section 206(4) of the Advisers Act does not require a showing of scienter).
48. 416 F. Supp. 998 (S.D.N.Y. 1976).
49. *Id.* at 1000.
50. *Id.* at 1001; *see also* SEC v. Mannion, 789 F. Supp. 2d 1321, 1339 (N.D. Ga. 2011).
51. *Carroll*, 416 F. Supp. at 1001.
52. *Id.* at 1002.

Similarly, in *SEC v. Moran*,[53] the SEC brought a securities fraud action against an adviser under sections 206(1) and (2) of the Advisers Act. The court noted that the language of section 206(1) is identical to that of section 17(a)(1) of the Securities Act of 1933, which requires a showing of scienter.[54] The *Moran* court concluded that the defendant had not violated section 206(1) of the Advisers Act because that section requires a showing of scienter, which had not been proven.[55] The court, however, found that the defendant had violated section 206(2) of the Advisers Act since that provision requires only a showing of negligence.[56] Thus, an adviser's level of responsibility under a fiduciary duty may differ depending on which paragraph of section 206 the action is based.

The more perplexing dilemma is identifying exactly what this fiduciary duty requires of advisers beyond the issue of mental culpability. Unlike a prescriptive, rules-based approach, there is no detailed list of actions that must be taken or avoided. Historically, moreover, fiduciary obligations have differed markedly depending on a variety of factors, including the common law or statutory basis for the duty and the relationship between the parties.[57] Simply announcing the existence of a fiduciary duty does not provide a roadmap of acceptable or prohibited conduct. As Justice Cardozo once remarked, "[b]ut to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."[58] The only duty clearly imposed by the *Capital Gains* decision is the duty to disclose material conflicts of interest.

2. SEC Report on Adviser and Broker-Dealer Obligations

In the years since *Capital Gains*, the SEC has provided some clarity on what the fiduciary obligation means in the adviser context. In 2011, pursuant to Congress's directive in section 913 of Dodd-Frank, the SEC published its comprehensive report on the obligations of advisers and broker-dealers, the IA/BD Study.[59] In its discussion of an adviser's fiduciary obligations, the IA/BD Study

53. 922 F. Supp. 867 (S.D.N.Y. 1996).

54. *Id.* at 896.

55. *Id.* at 897.

56. *Id.*; *see also* SEC v. Chiase, No. 10-CV-5110, 2011 U.S. Dist. LEXIS 142331, at *13 (D.N.J. Dec. 12, 2011) ("Scienter is necessary to violate Section 206(1) of the Advisers Act, but is not required to prove violations of Section 206(2)."); SEC v. Mannion, 789 F. Supp. 2d 1321, 1339 (N.D. Ga. 2011) (same); SEC v. Batterman, 00 Civ. 4835 (LAP), 2002 U.S. Dist. LEXIS 18556, at *23 (S.D.N.Y. Sept. 30, 2002) (same).

57. *See* Advocare Int'l LP v. Horizon Labs., Inc., 524 F.3d 679, 695–97 (5th Cir. 2008) (discussing differing fiduciary obligations depending on parties' relationship); United States v. Murphy, 323 F.3d 102, 113–18 (3d Cir. 2003) (noting various fiduciary obligations in different settings); Cohen v. Cohen, 773 F. Supp. 2d 373, 396 (S.D.N.Y. 2011) (discussing limitation periods that apply for different fiduciary duties); *see also* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation,* 1988 DUKE L.J. 879, 879 ("Fiduciary obligation is one of the most elusive concepts in Anglo-American law. . . . Although one can identify common core principles of fiduciary obligation, these principles apply with greater or lesser force in different contexts involving different types of parties and relationships.").

58. SEC v. Chenery Corp., 318 U.S. 80, 84–85 (1943).

59. *See* IA/BD STUDY, *supra* note 2, at 1.

essentially identified two overarching duties, each of which can be broken into two subparts.

The SEC explained that an adviser has a *duty of loyalty* that includes acting in a customer's best interests and eliminating or disclosing conflicts of interest.[60] The SEC also stated that an adviser has a *duty of care* that includes providing suitable investment advice and seeking best execution.[61]

a. Duty of Loyalty—Acting in the Customer's Best Interests

The SEC has stated that the "duty of loyalty requires an adviser to serve the best interests of its clients."[62] In explaining this principle in the IA/BD Study, the SEC indicated that it includes the "obligation not to subordinate the clients' interests to its own."[63] At one point, the SEC noted that it had received many letters raising issues and seeking guidance regarding the scope of the term "best interests."[64] The SEC responded that it "interprets the uniform fiduciary standard to include, at a minimum, the duties of loyalty and care as interpreted and developed under Advisers Act sections 206(1) and 206(2)."[65] The SEC then reiterated that the duty of loyalty "prohibits an adviser from putting its interests ahead of its clients" and requires the elimination or disclosure of material conflicts of interest.[66]

This duty to act in their clients' best interests, frequently highlighted in media reports as the reason advisers provide better investor protection than broker-dealers, is not easy to define. Moreover, as discussed below in Part IV.B. and apparently not widely known, case law, the IA/BD Study, and FINRA regulatory notices make clear that this often-praised duty currently applies to broker-dealers as well.

b. Duty of Loyalty—Disclosing Conflicts of Interest

As mentioned above, advisers' duty of loyalty also includes an obligation either to eliminate or disclose material conflicts of interest.[67] An adviser's disclosure of conflicts of interest is accomplished largely through a "disclosure

60. *See id.* at 22–24, 106, 110–20.
61. *Id.* at 27–29, 106, 120–23.
62. *Id.* at 22.
63. *Id.*
64. *Id.* at 110.
65. *Id.* at 110–11.
66. *Id.* at 112–13. As support for its statement, the SEC cited *Capital Gains* and two SEC settlement releases: *In re* Speaker, Investment Advisers Act Rel. No. 1605 (Jan. 13, 1997) (settled order); *In re* Mark Bailey & Co., Investment Advisers Act Rel. No. 1105 (Feb. 24, 1998) (settled order). *See* IA/BD STUDY, *supra* note 2, at 113 n.513. All of the cited decisions addressed advisers' failures to disclose conflicts of interests. None offered additional explanation of what it means to act in a customer's best interests. The SEC's almost exclusive reliance on decisions involving an adviser's duty of disclosure when discussing the adviser's duty to act in the "customer's best interests" leads to the question of whether, in the SEC's view, they are (or at one point were) actually one and the same. For purposes of this article, however, the duty of disclosure and the duty to act in the customer's best interests will be treated as separate obligations.
67. IA/BD STUDY, *supra* note 2, at 22.

'brochure' that advisers must provide to prospective clients initially and to existing clients annually."[68] This brochure is commonly referred to as a Form ADV disclosure.[69] The SEC has explained that much of the Form ADV disclosure "addresses an investment adviser's conflicts of interest with its clients, and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements."[70] Form ADV lists specific items that must be disclosed.[71] The SEC has stated, however, that an adviser's "fiduciary duty to disclose is a broad one, and the delivery of the adviser's brochure alone may not fully satisfy the adviser's disclosure obligation."[72] As discussed in Part VI.A., broker-dealers currently are not subject to such broad disclosure requirements, although FINRA rules and case law do impose numerous discreet disclosure obligations on them.

c. Duty of Care—Providing Suitable Advice

According to the IA/BD Study, "advisers owe their clients the duty to provide only suitable investment advice. . . . To fulfill this obligation, an adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives."[73] To support such a proposition, the SEC cited a pair of older releases.[74] The first, published in 1997, made an identical statement regarding advisers' suitability obligations under the Advisers Act, but the release otherwise focused on the Investment Company Act of 1940.[75] In the second release cited, the SEC, in 1994, proposed its own suitability rule.[76] The proposal would have created explicit suitability obligations similar to those that the FINRA suitability rule imposed at that time.[77] During the discussion of the proposal, however, the SEC stated that advisers already were subject to an implicit suitability obligation.[78] The SEC ultimately did not adopt the proposed rule.

The SEC's IA/BD Study did not cite case law in support of its contention that advisers have a suitability obligation for the advice they provide, but there is an older case that was decided on suitability principles. In 1965, the SEC issued a decision in *In re Shearson, Hammill & Co.*,[79] finding that the adviser defendants had committed, *inter alia*, willful violations of sections 206(1) and (2) of the

68. *Id.* at 18.
69. *See id.* at 114.
70. *Id.* at 19.
71. *Id.* at 19–20.
72. *Id.* at 23.
73. *Id.* at 27; *see also id.* at 106, 123.
74. *Id.* at 27.
75. Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15098, 15102 (Mar. 31, 1997) (to be codified at 17 C.F.R. pts. 270, 274).
76. Suitability of Investment Advice Provided by Advisers; Custodial Account Statements for Certain Advisory Clients, 59 Fed. Reg. 13464 (proposed Mar. 22, 1994) (to be codified at 17 C.F.R. pt. 275).
77. *Id.* at 13464–66.
78. *Id.*
79. Nos. 8-475, 801-348, 1965 SEC LEXIS 269 (Nov. 12, 1965).

Advisers Act.[80] The advisers had recommended speculative securities that were at odds with their clients' investment objectives and needs.[81]

The SEC's IA/BD Study also stated that an "adviser has 'a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.'"[82] The SEC's IA/BD Study again relied on a release, this time regarding proxy voting by advisers,[83] but noted that the SEC "has brought enforcement actions alleging omissions and misrepresentations regarding investment strategies" and cited two settlements involving fraud.[84]

In brief, advisers have a suitability obligation. That obligation, while part of an adviser's fiduciary duty, has not developed over time through case law or the promulgation of a rule with broader and more detailed requirements. FINRA's suitability rule, on the other hand, has developed in numerous important ways over time and imposes more significant obligations on broker-dealers than the implicit suitability obligation imposes on advisers, addressed below in Part IV.B.

d. Duty of Care—Seeking Best Execution

The SEC's IA/BD Study states that advisers have a duty of care to seek "best execution of clients' securities transactions where they have responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts)."[85] Pursuant to this duty, an adviser must seek execution of transactions that are "the most favorable under the circumstances."[86] An adviser should consider a number of factors when deciding which broker-dealer to select for execution services, including "execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided."[87] An adviser must evaluate execution services periodically.[88]

An adviser is permitted to use a broker-dealer with which it is affiliated and to direct brokerage to particular brokers, as long as the adviser discloses any potential conflict of interest to clients.[89] An adviser also may aggregate orders on behalf of multiple accounts to receive volume discounts regarding execution costs

80. *Id.* at *59.

81. *Id.* at *54. One customer, a teenager, had asked to purchase shares of one stock, but an adviser defendant instead recommended that he buy shares of another stock at a higher price. *Id.* The adviser had suggested that there would soon be favorable developments regarding the recommended stock. *Id.* In addition, the adviser, without inquiring into a seventy-year-old widow's finances or investment objectives, recommended that the widow invest in a speculative security. *Id.* The widow, however, had limited financial means and actually desired safety of principal and some dividend income. *Id.*

82. IA/BD Study, *supra* note 2, at 28 (citing Proxy Voting by Investment Advisers, Investment Advisers Act Rel. No. 3052 (July 14, 2010)).

83. *Id.*

84. *Id.* (citing *In re* Fahey, Investment Advisers Act Rel. No. 2196 (Nov. 24, 2003) (settled order); *In re* Hamby, Investment Advisers Act Rel. No. 1668 (Sept. 22, 1997) (settled order)).

85. IA/BD Study, *supra* note 2, at 28.

86. *Id.*

87. *Id.* at 28–29.

88. *Id.* at 29.

89. *Id.*

if the aggregation is for the purpose of seeking best execution and no particular account is advantaged or disadvantaged by the aggregation.[90]

Broker-dealers must comply with a number of order handling requirements, discussed below in Part IV.F. They include the duty of best execution and the prohibition generally on trading ahead of customer orders. FINRA and case law have stated that both of these requirements create fiduciary duties for broker-dealers.

B. Advisers Act Provisions and SEC Advisers Act Rules Imposing Specific Requirements

In addition to the fiduciary duty, with its four subparts, advisers are subject to several Advisers Act provisions and SEC Advisers Act rules that impose more specific obligations regarding certain types of activities. These obligations cover registration, advertising, supervision, and recordkeeping.

1. Registration

Advisers must register with the SEC using Form ADV, Part 1A, which is filed electronically through the Investment Adviser Public Disclosure website ("IAPD").[91] Advisers must "disclose information about their disciplinary history, type of services provided and other aspects of their business"[92] and must keep their information current.[93]

Broker-dealers similarly must register with the SEC, FINRA, and state regulators.[94] As discussed below in Part IV.A., however, broker-dealers also are subject to an important admission process, which requires that they meet numerous standards before they can conduct a securities business. Broker-dealers' registered persons, moreover, must adhere to qualification, licensing, and continuing education requirements. Advisers are not subject to these additional requirements.[95]

2. Advertising

Advisers must comply with specific restrictions and prohibitions regarding advertisements. SEC Advisers Act Rule 204(4)-1 states that an adviser is prohibited by the provisions of section 206(4) of the Advisers Act from using an advertisement that (1) refers to a testimonial concerning the adviser; (2) refers to the adviser's past specific recommendations "that were or would have been profitable

90. *Id.*
91. *See* SEC Advisers Act Rules 203-1, 204-1, 17 C.F.R. §§ 275.203-1, 275.204-1 (2012). FINRA operates IAPD by agreement with the SEC and state regulators. IA/BD Study, *supra* note 2, at 18 n.66.
92. IA/BD Study, *supra* note 2, at 18.
93. *Id.*
94. *Id.* at 46–47.
95. *Id.* at 137–38.

to any person" unless the adviser provides or offers to provide a list of all recommendations that the adviser made within the past year; (3) represents that a graph, chart, formula, or other device can be used to determine whether and/or when to purchase or sell securities unless the advertisement prominently discloses the limitations and the difficulties regarding the use of such devices; (4) contains a statement that inaccurately represents that a report, analysis, or other service is free; or (5) contains a statement of a material fact that is untrue or otherwise false or misleading.[96]

Advisers, however, are not required to have a supervisor review and approve any advertisements.[97] They also are not obligated to submit any advertisements to regulators for review and approval.[98] As discussed in Parts IV.E. and VI.B., broker-dealers do have such obligations regarding various communications with the public.

3. Supervision

The Advisers Act imposes general supervision obligations on advisers. Section 203(e)(6) of the Advisers Act states that an adviser will not be deemed to have failed reasonably to supervise any person if it "(A) establishe[s] procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect" violations of the Advisers Act and rules thereunder and (B) reasonably discharges the duties and obligations outlined in such procedures.[99] SEC Advisers Act Rule 206(4)-7, moreover, requires an adviser to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder, annually review their adequacy and effectiveness, and designate a chief compliance officer who is responsible for administering them.[100]

In addition, section 204A of the Advisers Act requires advisers to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse . . . of material, non-public information."[101] SEC Advisers Act Rule 204A-1, moreover, requires advisers to "establish, maintain, and enforce a written code of ethics."[102] This code of ethics must include standards of business conduct that "reflect [the adviser's] fiduciary obligations and those of [the adviser's] supervised persons."[103] It also must require that supervised persons comply with applicable federal securities laws, report violations of the code of ethics promptly to the chief compliance officer, and receive a copy of the code

96. SEC Advisers Act Rule 206(4)-1(a)(1) to (a)(5), 17 C.F.R. § 275.206(4)-1(a)(1) to (a)(5) (2012).
97. IA/BD Study, *supra* note 2, at 131.
98. *Id.*
99. Advisers Act § 203(e)(6), 15 U.S.C. § 80b-3(e)(6) (2006).
100. SEC Advisers Act Rule 206(4)-7, 17 C.F.R. § 275.206(4)-7 (2012).
101. Advisers Act § 204A, 15 U.S.C. § 80b-4a (2006).
102. SEC Advisers Act Rule 204A-1, 17 C.F.R. § 275.204A-1 (2012).
103. SEC Advisers Act Rule 204A-1(a)(1), 17 C.F.R. § 275.204A-1(a)(1).

of ethics and acknowledge such receipt in writing.[104] Furthermore, "access persons"[105] must periodically report personal securities holdings.[106]

FINRA's supervision rules (reviewed in Parts IV.H. and VI.B.) impose more detailed obligations on broker-dealers. Among other things, these rules require broker-dealers to establish a detailed "supervisory hierarchy," including the designation of "a direct supervisor for each registered representative[,]" conduct inspections of branch offices, and supervise registered persons' private securities transactions under certain circumstances.[107] Broker-dealers also must receive notification of registered representatives' outside business activities, consider whether such activities will compromise the registered representatives' responsibilities to the broker-dealers' customers, and evaluate the advisability of prohibiting or imposing conditions on the activities.[108]

4. Recordkeeping

SEC Advisers Act Rule 204-2 imposes limited recordkeeping obligations on advisers. The rule requires advisers to create and maintain accurate and current books and records regarding only specific types of information.[109] The rule enumerates the particular records that advisers generally must create and maintain[110] and lists some additional ones if the adviser has custody of client assets or exercises proxy voting rights regarding client securities.[111] Finally, the rule indicates the length of time and the manner in which advisers must keep such records.[112]

In contrast to the comprehensive recordkeeping requirements for broker-dealers (discussed in Parts IV.J. and VI.B.), advisers are not subject to a broad general requirement to maintain other records not specifically listed that relate to their advisory business.[113] The lack of such a requirement, the SEC has acknowledged, diminishes the effectiveness of the SEC's examinations of advisers and could weaken "the level of investor protection that results from regulatory examination programs."[114]

104. SEC Advisers Act Rule 204A-1(a)(2) to (a)(4), 17 C.F.R. § 275.204A-1(a)(2) to (a)(4).

105. "Access person" includes a supervised person who has access to certain nonpublic information, a person "[w]ho is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic," and all of the adviser's directors, officers, and partners if the adviser's primary business is providing investment advice. SEC Advisers Act Rule 204A-1(e)(1), 17 C.F.R. § 275.204A-1(e)(1).

106. SEC Advisers Act Rule 204A-1(b)(1), 17 C.F.R. § 275.204A-1(b)(1).

107. IA/BD Study, *supra* note 2, at 135.

108. *See* FINRA R. 3270, 3270.01 (2009).

109. SEC Advisers Act Rule 204-2(a), 17 C.F.R. § 275.204-2(a) (2012).

110. *Id.*

111. SEC Advisers Act Rule 204-2(b), (c)(2), 17 C.F.R. § 275.204-2(b), (c)(2) (2012).

112. SEC Advisers Act Rule 204-2(e) to 2(k), 17 C.F.R. § 275.204-2(e) to 2(k) (2012).

113. IA/BD Study, *supra* note 2, at 139.

114. *Id.*

IV. Broker-Dealer Obligations

The SEC has described FINRA's suitability rule as having "the most far-reaching potential for dealing with improper selling practices"[115] and as "critical to ensuring investor protection and fair dealing with customers."[116] FINRA's suitability rule is arguably one of the most important customer-protection standards in the securities industry.[117] It is therefore understandable that the debate over whether the adviser or broker-dealer model provides better customer protection has focused on the suitability rule when analyzing broker-dealer obligations. That focus also may derive, at least in part, from a desire to simplify the analysis regarding the differences between advisers and broker-dealers by merely comparing one standard to another—fiduciary versus suitability. Unfortunately, that focus minimizes the relevance of myriad other sales practice rules that FINRA has in its arsenal, all of which play critical roles in protecting customers. In fact, only broker-dealers are subject to exacting standards even before they first open their doors to the investing public. That trend continues once they begin their securities operations, because broker-dealers are subject to rigorous oversight and regulatory requirements (including broad suitability obligations) that are more detailed than those imposed on advisers.

A. Registration, Admission, Qualification, Licensing, and Continuing Education

Broker-dealers are subject to FINRA registration, admission, qualification, licensing, and continuing education requirements.[118] These serve an important

115. SEC Special Study of Securities Markets, H.R. Doc. No. 88-95, pt. 1, at 311 (1st Sess. 1963).

116. SEC Order Granting Accelerated Approval of Proposal to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, 75 Fed. Reg. 71479, 71479 (Nov. 23, 2010) [hereinafter Order Approving Suitability and KYC Rules].

117. The IA/BD Study recognized the importance of suitability obligations on numerous occasions. The SEC emphasized that an adviser's fiduciary duty includes an implicit suitability obligation and that "a central aspect of a broker-dealer's duty of fair dealing is the suitability obligation." IA/BD Study, *supra* note 2, at 27–28, 59, 106, 123. The study also explained that FINRA's suitability rule is "grounded in concepts of ethics, professionalism, fair dealing, and just and equitable principles of trade, which gives [FINRA] more authority in dealing with suitability issues" than federal regulators have when enforcing suitability obligations based on the legal requirements of certain antifraud provisions of the federal securities laws. *Id.* at 60. Not surprisingly, therefore, the IA/BD Study emphasized that "the uniform fiduciary standard would be an overlay on top of the existing investment adviser and broker-dealer regimes and would supplement them, and not supplant them." *Id.* at 109. Of course, the fact that the SEC recently approved FINRA's new suitability rule in the face of substantial lobbying efforts to delay such action until after the SEC proposes a universal fiduciary duty also signals the SEC's belief that suitability obligations will continue to play a significant investor-protection role if it adopts a universal fiduciary duty. *See* SEC Notice of FINRA Proposal to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, 75 Fed. Reg. 51310, 51314–15 (Aug. 19, 2010) [hereinafter Notice of Proposed Suitability and KYC Rules]; *see also* Order Approving Suitability and KYC Rules, *supra* note 116. The SEC also recently proposed a rule on security-based swap activities pursuant to Dodd-Frank that would impose SEC suitability obligations modeled after FINRA's suitability rule. *See* Business Conduct Standards for Security-Based Swap Dealers and Major Participants, 76 Fed. Reg. 42396 (proposed July 18, 2011) (to be codified at 17 C.F.R. pt. 240).

118. *See* IA/BD Study, *supra* note 2, at 136–38.

role in allowing FINRA to know and assess the business activities of broker-dealers and to ensure that their registered persons are qualified to handle their assigned responsibilities. Advisers also are subject to a registration requirement,[119] but have no admission, qualification, licensing, or continuing education obligations.[120]

Broker-dealers first must register with FINRA, the SEC, and applicable states by completing and filing a Uniform Application for Broker-Dealer Registration form ("Form BD") with the Central Registration Depository system ("CRD"), which FINRA administers and the SEC, the states, and SROs use.[121] In general, broker-dealers also must register their associated persons with FINRA using a Uniform Application for Securities Industry Registration form ("Form U4") via CRD.[122] Broker-dealers, their control persons, and their associated persons must disclose, among other things, whether they have been subject to certain criminal, regulatory, or civil actions, and they must keep their information current.[123] FINRA BrokerCheck®, moreover, allows investors to review the professional and disciplinary backgrounds of firms and brokers online.[124]

In addition to these registration and disclosure requirements, a broker-dealer may not engage in a securities business unless it satisfies FINRA's standards for admission to membership.[125] As part of this admission process, FINRA evaluates, *inter alia*, whether the applicant is capable of complying with all applicable laws, regulations, and rules.[126] FINRA may deny an application, approve an application in full, or approve an application with "one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern based on the standards for admission."[127] FINRA approvals of new membership applications often include various business restrictions that address FINRA concerns.[128] Broker-dealers cannot remove or modify any such business restrictions or materially change their business operations without FINRA approval.[129]

Furthermore, broker-dealers' associated persons "who effect or participate in effecting securities transactions must satisfy certain qualification requirements . . . , which include passing one or more examinations administered by FINRA to

119. *Id.* at 136.
120. *Id.* at 137.
121. *Id.* at 47.
122. *Id.* at 49 & n.213.
123. *Id.* at 47–49 & n.213; *see also In re* Neaton, Admin. Proc. File No. 3-14252, 2011 SEC LEXIS 3719, at *17–18 (Oct. 20, 2011); Dep't of Enforcement v. Knight, No. C10020060, 2004 NASD Discip. LEXIS 5, at *13 (NAC Apr. 27, 2004).
124. BrokerCheck® is available on FINRA's website at www.finra.org/brokercheck.
125. *See* IA/BD Study, *supra* note 2, at 48.
126. NASD R. 1014(a) (2008). NASD rules are available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=605. All citations are to the last amendment dates of the rules.
127. *Id.* R. 1014(b).
128. IA/BD Study, *supra* note 2, at 49.
129. *Id.*

demonstrate competence in the areas in which they will work."[130] These persons also must comply with continuing education requirements.[131] The continuing education topics, which FINRA periodically updates and the SEC approves, generally "focus on current compliance, regulatory, ethical and sales-practice standards."[132] Individuals subject to the requirements ordinarily must complete the training in their second year of registration and every three years thereafter.[133]

In addition, broker-dealers must institute an ongoing, in-house education program to keep employees current on "securities products, services, and strategies offered by the [broker-dealer]."[134] The program must include, at a minimum, specific training on "investment features and associated risk factors[,] [s]uitability and sales practice considerations[,]" and "regulatory requirements" related to the types of products, services, and strategies that the broker-dealer offers.[135] Advisers are not subject to any such requirements.

B. Suitability

FINRA imposes numerous suitability obligations on broker-dealers through its general suitability rule—applicable to all recommendations to customers involving all types of securities and investment strategies involving securities—and various other rules with heightened suitability components that apply to specific types of complex or risky investment products and strategies. As previously noted, the explanation frequently used to describe the differences between fiduciary and suitability obligations is that the former requires that an adviser act in the customer's best interests while the latter merely requires that a broker-dealer recommend a security or strategy that is suitable. That facile description is incomplete and incorrect on many levels.

FINRA's general suitability rule is based on the fundamental principle of fair dealing with customers and is intended to promote ethical practices and high standards of professional conduct.[136] Numerous cases, the IA/BD Study, and FINRA regulatory notices explicitly state that, under FINRA's suitability rule, "a broker's recommendations must be consistent with his customers' best interests."[137] The very premise of what has become the starting point in the debate

130. *Id.* at 77.

131. FINRA R. 1250 (2011); *see also* Exchange Act § 15A(g)(3)(B)(i), 15 U.S.C. § 78o-3(g)(3)(B)(i) (2006).

132. IA/BD Study, *supra* note 2, at 77.

133. FINRA R. 1250(a)(1). In addition, individuals subject to certain types of disqualification or disciplinary sanctions are required to retake the training. *Id.*

134. *Id.* R. 1250(b)(2)(B).

135. *Id.*

136. FINRA R. 2111.01 (2011).

137. *In re* Sathianathan, Admin. Proc. File No. 3-12245, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *see also In re* Epstein, Admin. Proc. File No. 3-12933, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'"); *In re* Faber, Admin. Proc. File No. 3-11156, 2004 SEC LEXIS 277, at *23–24 (Feb. 10, 2004); *In re* Belden, Admin. Proc. File No. 3-10888, 2003 SEC LEXIS 1154, at *11 (May 14, 2003); *In re* Howard, Admin. Proc. File No. 3-10392, 2002 SEC LEXIS 1909, at *5–6 (July 26, 2002), *aff'd*, 77 F. App'x 2 (1st Cir. 2003); *In re* Powell &

over which regulatory model provides better investor protection with regard to investment advice is thus faulty. The same principle that some opine makes the advisers' model more protective of investors' interests actually also applies to broker-dealers when they recommend securities or investment strategies involving securities to customers.

The misperception, moreover, does not end there. The suitability obligation imposed on advisers as part of their fiduciary duty is not nearly as detailed as the obligations that FINRA's suitability rule imposes on broker-dealers. Indeed, the SEC has acknowledged that it has not provided specific guidance on an adviser's suitability obligation.[138] The relatively few SEC cases and releases that discuss an adviser's suitability obligation merely repeat that the advice must be suitable based on the customer's financial situation and investment objectives.[139] That obligation is but a small piece of the broader suitability obligations that FINRA's rules explicitly impose on broker-dealers.

1. FINRA's General Suitability Rule

FINRA has imposed explicit, rule-based suitability obligations on broker-dealers for more than seventy years.[140] Over that period, case law also has used the rule as a basis to establish numerous additional suitability requirements for broker-dealers.[141] Recently, FINRA adopted a new general suitability rule (FINRA Rule 2111) that replaced its old one (NASD Rule 2310). FINRA Rule 2111 provides, in part, that a broker-dealer "must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [broker-dealer] to ascertain the customer's investment profile."[142] The general suitability rule originally was developed

McGowan, Inc., Nos. 8-2212, 8-11453, 1964 SEC LEXIS 497, at *3–4 (Apr. 24, 1964); Dep't of Enforcement v. Evans, No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (Oct. 3, 2011); Dep't of Enforcement v. Cody, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *19 (May 10, 2010), *aff'd*, Admin. Proc. File No. 3-13932, 2011 SEC LEXIS 1862 (May 27, 2011); Dep't of Enforcement v. Bendetsen, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004); IA/BD Study, *supra* note 2, at 59; FINRA Regulatory Notice 12-25, 2012 FINRA LEXIS 32, at *10 (May 2012) [hereinafter Notice 12-25]; FINRA Notice to Members 01-23, 2001 NASD LEXIS 28, at *20 (Apr. 2001) [hereinafter NTM 01-23].

138. IA/BD Study, *supra* note 2, at 123.

139. *See supra* Part III.A.2.c.

140. Nancy C. Libin & James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?*, 2001 Colum. Bus. L. Rev. 601, 610 & n.28.

141. *See generally* IA/BD Study, *supra* note 2, at 63–65, 106 (noting that case law interpretations have imposed a number of important suitability obligations on broker-dealers); Notice 12-25, *supra* note 137, at *2–3, *10–13, *50–52 (explaining that, over the years, case law has imposed various key suitability obligations on broker-dealers).

142. FINRA R. 2111(a) (2011). The suitability rule is only triggered when a broker-dealer makes a "recommendation." *See* FINRA Regulatory Notice 11-02, 2011 FINRA LEXIS 11, at *5 (Jan. 2011) [hereinafter Notice 11-02]. FINRA does not define the term, but it has offered several guiding principles that should be considered when determining whether a particular communication is a recommendation. *See id.* at *6; *see also* Notice 12-25, *supra* note 137, at *15–17 & nn.24–26 (discussing guiding principles and various interpretations of the term "recommendation"); FINRA Regulatory Notice 10-06, 2010 FINRA LEXIS 6, at *6–9 (Jan. 2010) (providing guidance on recommendations

"to neutralize the inherent conflict of interest in the broker-customer relationship, in which the broker's interest in generating commissions may be at odds with the customer's interest."[143] The rule also "implicitly recognizes that customers may rely on broker-dealers' special investment skills and knowledge, and it is thus appropriate to make broker-dealers responsible for the investment advice that they give to customers."[144]

FINRA's new rule retains the core features of its predecessor, codifies in one place many of the significant interpretations of the old rule, and otherwise makes the general suitability rule an even more powerful investor-protection tool.[145] This subpart highlights some of the differences between the old and new FINRA general suitability rules and explores the numerous obligations that the general suitability rule imposes on broker-dealers.

a. Differences Between Old and New Suitability Rules

In November 2010, the SEC approved FINRA's new suitability rule.[146] A review of some of the differences between the old and new general suitability rules provides several examples of how broker-dealers' suitability obligations have been expanded and strengthened over time. Other examples are discussed in Part IV.B.1.b.

(i) New Rule Explicitly Covers Investment Strategies

The new rule covers not only recommended purchases, sales, and exchanges of securities, but, unlike the old rule, also *explicitly* covers recommended investment *strategies* involving securities, including recommendations to *hold* securities.[147] Although previous interpretations stated that the predecessor rule

made on blogs and social networking websites); NTM 01-23, *supra* note 137, at *10–15 (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *In re* Siegel, Admin. Proc. File No. 3-12659, 2008 SEC LEXIS 2459, at *21–27 (Oct. 6, 2008) (applying these principles to the facts of the case to find a recommendation), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir.), *cert. denied*, 130 S. Ct. 333 (2010); *In re* Kunz, No. G3A960029, 1999 NASD Discip. LEXIS 20, at *63 (NAC July 7, 1999) (stating that the distribution of offering material ordinarily would not, by itself, constitute a recommendation triggering application of the suitability rule).

143. Libin & Wrona, *supra* note 140, at 605.

144. *Id.* It must be emphasized, however, that FINRA need not prove actual customer reliance on broker-dealer communications to find a violation of its rules. *See In re* Glodek, Admin. Proc. File No. 3-13414, 2009 SEC LEXIS 3936, at *14 (Nov. 4, 2009).

145. Notice 11-02, *supra* note 142, at *2. FINRA emphasized that, "[t]o the extent that past Notices to Members, Regulatory Notices, case law, etc., do not conflict with the new rule requirements or interpretations thereof, they remain potentially applicable, depending on the facts and circumstances of the particular case." *Id.* at *2 n.3; *see also* FINRA Regulatory Notice 11-25, 2011 FINRA LEXIS 45, at *4 (May 2011) [hereinafter Notice 11-25] (same). Although FINRA did not codify case law requiring a broker to act in a customer's best interests, it went to great lengths to ensure that the obligation was highlighted during and after the rulemaking process for the new suitability rule. *See* Notice of Proposed Suitability and KYC Rules, *supra* note 117, at 51314–15; Notice 12-25, *supra* note 137, at *10–15; Notice 11-02, *supra* note 142, at *7 n.11. The obligation clearly applies under the new rule.

146. *See* Order Approving Suitability and KYC Rules, *supra* note 116.

147. Notice 12-25, *supra* note 137, at *6–7.

implicitly applied to recommended investment strategies,[148] the case law suggests that the old rule's coverage of investment strategies was somewhat narrow in practice.[149] The new rule states that the term "investment strategy" is to be interpreted "broadly."[150] As a result, the rule creates some new or modified obligations regarding recommendations of investment strategies.[151]

One area where this is particularly evident is the new rule's application to an *explicit* recommendation to *hold* securities.[152] This aspect is completely new—it does *not* codify or build on an interpretation of the predecessor rule.[153]

148. For instance, when it published NASD's Online Suitability Policy Statement in the *Federal Register* in April 2001, the SEC included the following broad statement in the release: "The Commission notes that although NASD Notice to Members 01-23 does not expressly discuss electronic communications that recommend investment strategies, the NASD suitability rule continues to apply to the recommendation of investment strategies, whether that recommendation is made via electronic communication or otherwise." SEC Announcement of NASD's Online Suitability Policy Statement, 66 Fed. Reg. 20697, 20702 (Apr. 24, 2001). FINRA interpretive materials ("IMs") addressing FINRA's old suitability rule also referenced the rule's application to recommended strategies. *See* NASD IM-2310-3 (1996) ("Members' responsibilities include having a reasonable basis for recommending a particular security *or strategy*, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made." (emphasis added)). NASD IM-2310-3 has been superseded by FINRA Rule 2111. NASD rules that have been superseded by FINRA rules are available at http://finra.complinet.com/. All citations to such NASD rules are to the last amendment dates of the rules prior to being superseded by FINRA rules.

149. In *In re F.J. Kaufman & Co.*, Admin. Proc. File No. 3-6710, 1989 SEC LEXIS 2376 (Dec. 13, 1989), the SEC held that a "margined buy-write strategy was unsuitable for the" customers, "given their 'financial situation and needs.' " *Id.* at *15 (internal citation omitted). A number of SEC decisions issued after *Kaufman* also lent support for applying the old suitability rule to recommended strategies in certain situations. As with *Kaufman*, many involved recommendations to purchase securities on margin. *See*, *e.g.*, *In re* Stein, Admin. Proc. File No. 3-10675, 2003 SEC LEXIS 338, at *15 (Feb. 10, 2003); *In re* Rangen, Admin. Proc. File No. 3-8994, 1997 SEC LEXIS 762, at *8–11 (Apr. 8, 1997); *In re* Lewis, Admin. Proc. File No. 3-7317, 1991 SEC LEXIS 2245, at *2–8 (Oct. 8, 1991). In these cases, the SEC did not appear to find liability based solely on the volatility of the particular stocks purchased on margin but rather considered the risk involved in leveraging the customers' portfolios to purchase additional stock. In other words, the focus was not solely on the recommendation of "the purchase, sale or exchange of any security" but also on the recommendation to use a risky technique (a margin account) to enable the purchase of more stock.

Similarly, the old rule applied to recommendations to use liquefied home equity to purchase securities. FINRA stated under the old suitability rule, for instance, that "recommending liquefying home equity to purchase securities may not be suitable for all investors. [Broker-dealers] should consider not only whether the recommended investments are suitable, but also whether the strategy of investing liquefied home equity in securities is suitable." FINRA Notice to Members 04-89, 2004 NASD LEXIS 76, at *7 (Dec. 2004). Finally, the old rule applied to recommended strategies to liquidate securities for the express purpose of purchasing a non-security investment, such as an equity-indexed annuity. *See In re* Barto, Settlement No. 20060043524 (Oct. 27, 2008), *available at* http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=11360 (barring a broker for recommending that customers sell securities to purchase equity-indexed annuities where the customers were at or near retirement and needed access to their funds and the equity-indexed annuities were long-term, illiquid investments with high surrender penalties).

150. *See* FINRA R. 2111.03 (2011).

151. *See* Notice 12-25, *supra* note 137, at *21–33 (discussing the breadth of the new rule's "investment strategy" language); Notice 11-25, *supra* note 145, at *22 (same); Notice 11-02, *supra* note 142, at *8 (same).

152. FINRA R. 2111.03 (stating that the strategy language would apply to an explicit recommendation to hold a security or securities).

153. NASD Rule 2310(a) explicitly referred to "the purchase, sale, or exchange of any security," thereby precluding its application to recommendations to hold securities. NASD R. 2310(a) (1996) (superseded by FINRA R. 2111 (2011)).

A broker's statements to a customer during an annual account review that the customer should maintain the securities positions in the account or continue to use an investment strategy are examples of explicit hold recommendations covered by the rule.[154] The rule's focus, however,

> is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities, or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations.[155]

Notwithstanding the potentially broad scope of the new rule's "investment strategy" language, FINRA provided a safe-harbor provision for certain types of educational information and tools that the rule otherwise might cover, including certain asset allocation models.[156] FINRA wanted "to encourage [broker-dealers] to freely provide educational material and services to customers."[157] Nonetheless, FINRA warned that the safe-harbor provision would be strictly construed[158] and would not apply if the educational information was accompanied by a recommendation of a specific security.[159]

(ii) New Rule Codifies the Three Main Obligations

The new rule codifies the three primary suitability obligations: reasonable-basis, customer-specific, and quantitative suitability.[160] Previously, these obligations largely were discussed in case law, rather than in the rule itself.[161]

154. Notice 12-25, *supra* note 137, at *23; Notice 11-25, *supra* note 145, at *14.

155. Notice 12-25, *supra* note 137, at *23.

156. FINRA R. 2111.03. Under this safe-harbor provision, broker-dealers may use, *inter alia*, "[a]sset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools), if the asset allocation model is an 'investment analysis tool' covered by Rule 2214." *Id.* Such "models often take into account the historic returns of different asset classes over defined periods of time." Notice 12-25, *supra* note 137, at *25 n.39. FINRA stated that "the suitability rule would not apply, for example, to a general recommendation that a customer's portfolio have certain percentages of investments in equity securities, fixed-income securities, and cash equivalents, if the recommendation is based on an asset allocation model that meets the above criteria and the firm does not recommend a particular security or securities in connection with the allocation." *Id.* at *25. In addition, the rule "would not apply to a firm's allocation recommendation regarding broad-based market sectors," as long as it meets the above criteria and does not include recommendations of particular securities. *Id.* at *25–26. FINRA warned, however, that "broker-dealers should assess whether allocation recommendations involving certain types of sub-categories of broader market sectors or even more limited groupings are so specific or narrow that they constitute recommendations of particular securities" and thus fall outside the safe-harbor provision. *Id.* at *26–27.

157. Notice 11-02, *supra* note 142, at *9.

158. Notice 12-25, *supra* note 137, at *24 n.38; Notice 11-25, *supra* note 145, at *17.

159. FINRA R. 2111.03 (2011); *see also supra* note 156.

160. FINRA R. 2111.05 (2011); *see also* Notice 11-02, *supra* note 142, at *11–12.

161. There were some passing references to these obligations in the IMs following NASD Rule 2310 (*see* NASD IM-2310-2; IM-2310-3), but the IMs did not explain the obligations. That was left to the case law. *See, e.g.*, *In re* Cody, Admin. Proc. File No. 3-13932, 2011 SEC LEXIS 1862, at *30–32 (May 27, 2011) (discussing reasonable-basis suitability); *In re* Siegel, Admin. Proc. File No. 3-12659, 2008 SEC LEXIS 2459, at *28–30 (Oct. 6, 2008) (explaining reasonable-basis and customer-specific suitability); *In re* Pinchas, Admin. Proc. File No. 3-9639, 1999 SEC LEXIS

The codification of the three main obligations provides greater clarity regarding what is expected of broker-dealers.[162]

The *reasonable-basis* obligation has two components: a broker-dealer must (1) perform reasonable diligence to understand the nature of the security or strategy, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least *some* investors based on that understanding.[163] A broker-dealer must adhere to both components of reasonable-basis suitability. A broker-dealer, for example, could violate the obligation if it did not understand the recommended security or strategy, even if the security or strategy is suitable for at least *some* investors.[164] The new rule also explains that,

> [i]n general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the [broker-dealer's] familiarity with the security or investment strategy. A [broker-dealer's] reasonable diligence must provide [it] with an understanding of the potential risks and rewards associated with the recommended security or strategy.[165]

The reasonable-basis obligation is critically important because some products and strategies that are offered to investors, including retail investors,[166] have become increasingly complex or risky.[167]

Customer-specific suitability requires that a broker-dealer have a reasonable basis to believe that a recommendation is suitable for a particular customer based on that customer's investment profile.[168] Under customer-specific suitability, broker-dealers have affirmative due-diligence obligations to seek to obtain a considerable amount of information from customers to understand their "invest-

1754, at *22 (Sept. 1, 1999) ("[E]xcessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading."); *In re* F.J. Kaufman & Co., Admin. Proc. File No. 3-6710, 1989 SEC LEXIS 2376, at *8–13 (Dec. 13, 1989) (discussing reasonable-basis and customer-specific suitability).

162. FINRA R. 2111.05 (2011).

163. *Id.* R. 2111.05(a).

164. *See Cody*, 2011 SEC LEXIS 1862, at *30–32 (stating that broker can violate reasonable-basis suitability by failing to perform reasonable investigation of recommended product and to understand risks even though recommendation is otherwise suitable); *Siegel*, 2008 SEC LEXIS 2459, at *28–30 (finding violation for failing to perform reasonable diligence to understand the security).

165. FINRA R. 2111.05(a) (2011).

166. Dodd-Frank defines "retail customer" as a natural person "who (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes." Dodd-Frank § 913(a), 124 Stat. at 1824.

167. Notice 12-25, *supra* note 137, at *49.

168. FINRA R. 2111.05(b); *see also Siegel*, 2008 SEC LEXIS 2459, at *28 (noting customer-specific obligation); Dep't of Enforcement v. Evans, No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22–24 (Oct. 3, 2011) ("A [broker-dealer] violates FINRA suitability standards when [it], among other things, inadequately assesses whether a recommended trade is suitable for the specific customer to whom the representative directs the recommendation."); Dep't of Enforcement v. Cody, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *18 (NAC May 10, 2010) (same), *aff'd*, Admin. Proc. File No. 3-13932, 2011 SEC LEXIS 1862 (May 27, 2011).

ment profiles."[169] Indeed, the new rule broadens the information-gathering obligations by, for instance, requiring broker-dealers to seek more information than was *explicitly* required by the predecessor rule.[170] The new rule adds a customer's age, investment experience, time horizon, liquidity needs, and risk tolerance to the explicit list of customer-specific factors from the predecessor rule (i.e., other investments, financial situation and needs, tax status, and investment objectives).[171] The added language codifies interpretations of the predecessor rule.[172] Together, these factors generally make up a customer's "investment profile."[173] There is, however, some flexibility—a broker-dealer would not have to seek to obtain a factor if the broker-dealer documents that there is a reasonable basis to believe that the factor is irrelevant under the circumstances.[174] This list of customer-specific factors that a broker-dealer must seek to obtain and analyze is much broader and more detailed than the information required by advisers' implicit obligation, which, as noted above, generally requires only that an adviser consider a client's "financial situation and investment objectives."[175]

Quantitative suitability requires a broker-dealer that has actual or *de facto* control over a customer account to have a reasonable basis for believing that, in light of the customer's investment profile, a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer.[176] Factors such as turnover rate, cost-to-equity ratio, and use of

169. FINRA R. 2111(a) (2011) (listing customer-specific factors that broker-dealers must seek to obtain and analyze to determine a customer's "investment profile").

170. Notice 11-02, *supra* note 142, at *9.

171. *Compare* FINRA R. 2111(a), *with* NASD R. 2310 (1996) (superseded by FINRA R. 2111 (2011)). For explanations of these factors, see Notice 12-25, *supra* note 137, at *3–6 & nn.4–11.

172. *See* Notice 12-25, *supra* note 137, at *3 n.3 (explaining that the newly added factors derived from case law interpretations under the predecessor suitability rule).

173. FINRA R. 2111(a).

174. *See* FINRA R. 2111.04 (2011). The "essential requirement of [the information-gathering] provision is that the [broker-dealer] exercise 'reasonable diligence' to ascertain the customer's investment profile." Notice 11-25, *supra* note 145, at *8. FINRA emphasized that "a broker-dealer cannot make assumptions about customer-specific factors for which the customer declines to provide information. Furthermore, when customer information is unavailable despite a broker-dealer's reasonable diligence, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of a recommendation." Notice 12-25, *supra* note 137, at *41. Nonetheless, the suitability rule "would not prohibit a broker-dealer from making a recommendation in the absence of certain customer-specific factors as long as the firm has enough information about the customer to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information will depend on the facts and circumstances of the particular case." *Id.* FINRA also stated that, "[w]hile the rule lists some of the aspects of a typical investment profile, not every factor may be relevant to all situations. Indeed, Supplementary Material .04 states that a [broker-dealer] need not seek to obtain and analyze all of the factors if it 'has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile.'" Notice 11-25, *supra* note 145, at *8.

175. *See* IA/BD Study, *supra* note 2, at 27.

176. FINRA R. 2111.05(c) (2011). For an explanation of actual and *de facto* control, see Notice 12-25, *supra* note 137, at *50 n.64.

in-and-out trading in a customer's account may provide a basis for finding that the activity at issue was excessive.[177]

The new rule thus explicitly requires a broker-dealer to understand both the product/strategy and the customer's investment profile.[178] It also makes clear that the lack of such an understanding may itself violate the suitability rule, irrespective of whether the recommendation otherwise may be appropriate.[179] Once the broker-dealer fully understands the product/strategy and customer's investment profile, it then must ensure that the recommended product/strategy is a suitable fit for that particular customer and, if there are a series of recommendations for an account that the broker-dealer controls, that the recommendations are not excessive.

(iii) New Rule Prohibits Disclaiming Suitability Obligations

FINRA's new suitability rule explicitly prohibits a broker-dealer from "disclaim[ing] any responsibilities under the suitability rule."[180] It is unclear whether, or to what extent, an adviser may disclose away its suitability or other responsibilities.[181]

(iv) New Rule Alters Institutional-Customer Exemption

The new rule modifies the institutional-customer exemption that existed under the old rule (IM-2310-3). FINRA Rule 2111 replaces the old rule's definition of "institutional customer" with the more common definition of "institutional account" in FINRA's "books and records" rule, FINRA Rule 4512(c).[182] In addition to the definitional change, the new institutional-customer exemption

177. FINRA R. 2111.05(c). For an explanation of the factors used to determine whether the activity in a customer's account was excessive, see Notice 12-25, *supra* note 137, at *50–52 & nn.66–68.

178. Notice 11-02, *supra* note 142, at *12.

179. *Id.*

180. FINRA R. 2111.02 (2011).

181. To the extent that an adviser's disclaimer of suitability obligations is viewed as an attempted waiver of an Advisers Act provision or a "rule, regulation, or order thereunder," the disclaimer arguably would be void under section 215 of the Advisers Act. *See* Advisers Act § 215, 15 U.S.C. § 80b-15(a) (2006) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void."); *see also* Use of Electronic Media, Securities Act Release No. 33-7856, 2000 SEC LEXIS 847, at *40 n.61 (Apr. 28, 2000) (reminding "issuers that specific disclaimers of anti-fraud liability are contrary to the policies underpinning the federal securities laws" and citing, *inter alia*, section 215(a) of the Advisers Act). Because an adviser's suitability obligation is *implicit*, however, section 215 may not apply to such a disclaimer. In addition, the theme running through the regulation of advisers is that disclosure (often at account opening) is of paramount importance. As a result, an adviser's disclosure that it may not perform suitability reviews or may not provide advice that meets suitability standards conceivably could be viewed as an adequate substitute for adherence to suitability standards under the adviser regulatory model.

182. *See* FINRA R. 2111(b) (2011). "Institutional account" means the account of a bank, savings and loan, insurance company, registered investment company, registered investment adviser, or any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. *See id.* R. 4512(c) (2011). In regard to the "other person" category, the monetary threshold generally changed from $10 million invested in securities and/or under management used in the predecessor rule to at least $50 million in total assets in the new rule. *Compare* NASD IM-2310-3 (1996) (superseded by FINRA R. 2111 (2011)), *with* FINRA R. 2111(b), 4512(c).

focuses on two factors: (1) whether a broker "has a reasonable basis to believe the institutional customer is capable of analyzing investment risks independently" (a factor used in the predecessor rule), and (2) whether "the institutional customer affirmatively indicates that it is exercising independent judgment" (a new requirement).[183] A broker-dealer fulfills its customer-specific suitability obligation (discussed above) if these conditions are satisfied.[184]

(v) Releases Clarify Documentation Obligations

FINRA also explained in two releases accompanying the new rule that broker-dealers may use a risk-based approach to evidencing compliance.[185] FINRA stated that, "although a firm has a general obligation to evidence compliance with applicable FINRA rules, the suitability rule does not include explicit documentation requirements, except in a situation where a firm determines not to seek certain information in the first place."[186] The suitability rule applies to *all* recommendations, "but the extent to which a firm needs to document its suitability analysis depends on an assessment of the customer's investment profile and the complexity of the recommended security or investment strategy involving a security or securities (in terms of both its structure and potential performance) and/or the risks involved."[187] For example, "the recommendation of a large-cap, value-oriented equity security usually would not require documentation."[188] Conversely, the recommendation of a complex or particularly risky security or investment strategy usually would require documentation.[189]

b. Other Obligations Imposed by the General Suitability Rule

Over the course of more than seventy years, FINRA examinations of and enforcement actions against broker-dealers have resulted in a substantial body of case law that provides significant additional interpretations of the suitability rule. Case law makes clear, for example, that there is no scienter requirement under the suitability rule.[190] Case law also emphasizes that, even when a customer initiates a discussion about or enthusiastically expresses an interest in a security or strategy, a broker-dealer has a duty to refrain from recommending

183. FINRA R. 2111(b). The facts and circumstances of the particular situation will dictate the type of information that a broker-dealer will need to obtain to comply with the exemption.

184. *Id.* R. 2111(b). The institutional-customer exemption does not apply to reasonable-basis and quantitative suitability. *See* Notice 12-25, *supra* note 137, at *54 n.73; Notice 11-02, *supra* note 142, at *14.

185. Notice 11-25, *supra* note 145, at *6.

186. *Id.*

187. *See* Notice 12-25, *supra* note 137, at *34. The fact that a broker-dealer has documented its suitability analysis, however, does not mean that it has complied with its suitability obligations. Notice 11-25, *supra* note 145, at *6.

188. *See* Notice 12-25, *supra* note 137, at *35.

189. *See id.* FINRA provided numerous examples of complex or particularly risky securities or strategies. *Id.* at *35–36 & nn.50–51. FINRA also gave examples of specific types of hold recommendations that broker-dealers should consider documenting. *See id.* at *37–38.

190. Erdos v. SEC, 742 F.2d 507, 508 (9th Cir. 1984); *In re* Stein, Admin. Proc. File No. 3-10675, 2003 SEC LEXIS 338, at *18 n.31 (Feb. 10, 2003).

the security or strategy if it is inconsistent with the customer's investment profile.[191] In addition, some cases involving different classes of mutual fund shares indicate that the suitability rule includes a requirement that a broker-dealer minimize costs of securities transactions when possible and consistent with the customer's investment objectives.[192] In certain circumstances, there can be a suitability obligation to disclose material information about a recommended security or strategy[193] and to ensure that the customer understands the risks associated with the recommendation.[194] Finally, a broker-dealer cannot recommend a transaction or strategy that would result in or exacerbate an undue concentration of a particular security or limited number of securities in a customer's account.[195]

These important requirements have largely been left out of the public standard-of-care debate, perhaps because they are not easily summarized in a brief news article or a sound bite. A discussion of the suitability rule without them, however, is obviously incomplete. Even a thoughtful explanation of the general suitability rule must be the beginning and not the end of the discussion, since broker-dealers are subject to numerous other investor-protection obligations.

2. Product/Strategy-Specific FINRA Rules that Include Suitability Components

FINRA has created a number of rules with heightened suitability and other obligations focusing on specific securities or strategies that are particularly complex

191. *Stein*, 2003 SEC LEXIS 338, at *8 ("Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."); *In re* Pinchas, Admin. Proc. File No. 3-9639, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999) (stating that a customer's desire "to double her money . . . would not have relieved [the defendant] from his duty to recommend only those trades suitable to her situation"); *In re* Reynolds, Admin. Proc. File No. 3-7203, 1991 SEC LEXIS 2725, at *8 (Dec. 4, 1991) (explaining that broker must abstain from making unsuitable recommendations even when customer desires to engage in aggressive trading); Dep't of Enforcement v. Cody, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *19 (May 10, 2010), *aff'd*, Admin. Proc. File No. 3-13932, 2011 SEC LEXIS 1862 (May 27, 2011).

192. *See* Dep't of Enforcement v. Sathianathan, No. C9B030076, 2006 NASD Discip. LEXIS 3, at *30–32 (NAC Feb. 21, 2006) (finding suitability violation where broker recommended that customer purchase mutual fund class B shares even though, with the size of the investment, he could have saved thousands of dollars in costs by availing the customer of breakpoint discounts available with class A shares), *aff'd*, Admin. Proc. File No. 3-12245, 2006 SEC LEXIS 2572 (Nov. 8, 2006); Dep't of Enforcement v. Belden, No. C05010012, 2002 NASD Discip. LEXIS 12, at *13 (NAC Aug. 13, 2002) (same), *aff'd*, Admin. Proc. File No. 3-10888, 2003 SEC LEXIS 1154 (May 14, 2003).

193. *See* Dep't of Enforcement v. Frankfort, No. C02040032, 2007 NASD Discip. LEXIS 16, at *31–32 (NAC May 24, 2007) (noting that a broker can, under certain circumstances, violate the suitability rule by failing to disclose material information).

194. *See In re* Chase, Admin. Proc. File No. 3-10586, 2003 SEC LEXIS 566, at *18 (Mar. 10, 2003) (stating that a broker-dealer "must be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks"); *In re* Keel, Admin. Proc. File No. 3-7449, 1993 SEC LEXIS 41, at *5 (Jan. 11, 1993) (same).

195. *See In re* Faber, Admin. Proc. File No. 3-11156, 2004 SEC LEXIS 277, at *26 (Feb. 10, 2004) ("We have repeatedly found that a high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk."); *Chase*, 2003 SEC LEXIS 566, at *13 (same).

or risky, such as the rules covering variable annuities,[196] day trading,[197] direct participation programs,[198] index warrants,[199] options,[200] and securities futures.[201] Broker-dealers, moreover, are subject to SEC rules containing heightened suitability and other obligations regarding the sale of penny stocks.[202] FINRA also has issued regulatory notices suggesting that broker-dealers implement heightened suitability and supervisory standards when they recommend certain other types of complex or particularly risky securities or strategies.[203]

FINRA's Rule 2330, which covers recommendations of variable annuities, offers a good example of FINRA's approach to supplementing its general suitability rule to address particularly complex securities that have been the subject of sales abuses.[204] Before the adoption of Rule 2330, FINRA had grown increasingly concerned over inappropriate sales and exchanges of variable annuities, which are complex, illiquid, and often expensive investments containing both securities and insurance features.[205] Brokers sold "variable annuities to elderly customers for whom such long-term, illiquid products were not suitable."[206] They sold "variable annuities without explaining (and, in some cases, without knowing) the characteristics of the products."[207] Brokers recommended that customers exchange one variable annuity for another "without ensuring that such exchanges were beneficial for their customers or properly disclosing costs."[208] Moreover,

196. FINRA R. 2330 (2012).

197. FINRA R. 2130 (2011) (requiring special account opening procedures for day trading); *id.* R. 2270 (requiring delivery of a day trading risk disclosure statement).

198. FINRA R. 2310 (2009) (requiring heightened suitability and disclosure for direct participation programs).

199. FINRA R. 2350 Series (2009) (requiring special account opening procedures and heightened suitability and supervision for certain index and currency warrants).

200. FINRA R. 2360 (2011) (requiring special account opening procedures, disclosure, and heightened suitability regarding options).

201. *Id.* R. 2370 (requiring special account opening procedures, disclosure, and heightened suitability regarding securities futures).

202. SEC Exchange Act Rules 15g-1 to 15g-7, 15g-9, 17 C.F.R. §§ 240.15g-1 to -7, -9 (2012). See *supra* note 4 for an explanation of FINRA's enforcement of the Exchange Act and rules thereunder.

203. *See* FINRA Regulatory Notice 12-03, 2012 FINRA LEXIS 3, at *1–6 (Jan. 2012) (providing guidance to broker-dealers on heightened supervision and suitability for various complex or risky products and citing numerous other regulatory notices that FINRA has issued on the topic).

204. At the outset, it is important to recognize that variable annuities can be appropriate and, indeed, beneficial investments for certain investors. The ability to annuitize for lifetime income payments may become increasingly important, for instance, as people have to plan for their own retirement rather than being able to rely on pension plans. Tax-deferred growth also is a significant component of a variable annuity. Investing with multiple money managers through one vehicle can be important to some investors. Furthermore, some investors may benefit from guaranteed living benefits upon reaching retirement age when market values have declined. In spite of those positive features, however, variable annuity sales have raised investor-protection concerns.

205. *See* SEC Notice of Amendment 1 to FINRA Proposed Variable Annuity Rule, 70 Fed. Reg. 42126, 42126 (July 21, 2005) [hereinafter Notice of Amendment 1 to FINRA VA Rule]; FINRA Notice to Members 04-45, 2004 NASD LEXIS 85, at *1 (June 2004) [hereinafter NTM 04-45]; FINRA Regulatory Notice 07-53, 2007 FINRA LEXIS 52, at *2, *8 & n.10 (Nov. 2007) [hereinafter Notice 07-53].

206. Notice of Amendment 1 to FINRA VA Rule, *supra* note 205, at 42126.

207. *Id.*

208. *Id.*; *see also* NTM 04-45, *supra* note 205, at *1 & n.1.

firms "failed to adequately train and supervise" brokers regarding variable annuity transactions.[209] After first attempting to address these problems by issuing numerous warnings, publishing "best practice" guidelines for broker-dealers and educational material for investors, "strengthen[ing] its examination program, and [bringing] a number of significant enforcement actions,"[210] FINRA "determined that it needed to create a rule specifically covering" variable annuities.[211]

Rule 2330, which became effective in February 2010,[212] covers recommended purchases and exchanges of variable annuities and initial subaccount allocations.[213] Brokers must make reasonable efforts to learn the numerous customer-specific factors listed as part of a customer's investment profile under the new general suitability rule, discussed above, as well as the customer's intended use of the variable annuity, liquid net worth, and other life insurance holdings.[214] Brokers must have reasonable grounds for believing that the customer has been informed, in general, of the material features of annuities[215] and would benefit from "tax-deferred growth, annuitization, or a death or living benefit."[216] They also must have reasonable grounds for believing that the contract as a whole, subaccount allocations, and riders and other enhancements are suitable based on the customer's investment profile.[217] In the case of an "exchange," moreover, the broker must consider whether the customer would incur a surrender charge, would lose existing benefits, or has had another

209. Notice of Amendment 1 to FINRA VA Rule, *supra* note 205, at 42126.

210. *Id.* at 42126–27 & nn.6–7.

211. *Id.* at 42127; SEC Notice of FINRA's Amendment 2 to Proposed Rule Relating to Transactions in Variable Annuities, 71 Fed. Reg. 36840, 36842 (June 28, 2006) [hereinafter Notice of Amendment 2 to FINRA VA Rule].

212. *See* FINRA Regulatory Notice 10-05, 2010 FINRA LEXIS 5, at *1 (Jan. 2010).

213. FINRA R. 2330(a)(1) (2012). The rule does not cover recommendations regarding customers' sales of variable annuities; qualified retirement plans (unless there is an individualized recommendation to a plan participant); subaccount reallocations; and payments made after the initial purchase. *Id.* However, FINRA's general suitability rule, FINRA Rule 2111, discussed above, does apply in those situations. *See* Notice of Amendment 2 to FINRA VA Rule, *supra* note 211, at 36842.

214. FINRA R. 2330(b)(2) (2012). FINRA emphasized that, "in general, variable annuities are appropriate only for customers with long-term investment objectives who intend to take advantage of tax-deferred accumulation and annuitization." Notice of Amendment 2 to FINRA VA Rule, *supra* note 211, at 36844.

215. FINRA R. 2330(b)(1)(A)(i) (2012). Examples include the existence of a surrender period and charges, potential tax penalty, and unique fees. *Id.* The rule's requirement that a broker-dealer disclose, only "in general" terms, the material features of variable annuities does not mean that a broker-dealer "may ignore product-specific features. [FINRA] noted that the [broker-dealer] must be capable of discussing the specific features of the variable annuity under consideration, and must know these features in order to adequately perform a suitability analysis." Notice of Amendment 2 to FINRA VA Rule, *supra* note 211, at 36843; *see also* Notice 07-53, *supra* note 205, at *6. Significantly, FINRA also explained that a broker-dealer that "merely delivers a prospectus to an investor ordinarily would not have a reasonable basis to believe that the customer has been instructed or educated—'informed'—about the material features of a variable annuity for purposes of the rule." Notice 07-53, *supra* note 205, at *7 n.8.

216. FINRA R. 2330(b)(1)(A)(ii) (2012).

217. *Id.* R. 2330(b)(1)(A)(iii).

exchange in the preceding thirty-six months.[218] The broker must document and sign these determinations.[219]

The rule also imposes supervisory and training obligations. The rule, for example, requires a supervisor to review and approve or reject each variable annuity transaction.[220] The supervisor can approve a transaction only if it is suitable based on the same factors that the broker must consider.[221] The supervisor must document and sign such determinations.[222] In addition, firms must establish and maintain written supervisory procedures reasonably designed to achieve compliance with the rule and implement surveillance procedures to determine whether brokers are engaging in inappropriate rates of exchanges.[223] Furthermore, firms must develop specific training so that brokers and supervisors understand and comply with the rule's requirements and understand the material features of annuities.[224]

FINRA's experience with variable annuities demonstrated that its general suitability rule, a crucial component of FINRA's program, is not a panacea for every ill in the securities industry. The general suitability rule was an important tool in combating abuses in relation to variable annuities, but it was not enough standing alone.

C. Know Your Customer

A "know your customer" rule, FINRA Rule 2090, requires broker-dealers to seek to obtain and document a wide range of customer information at account opening, irrespective of whether the broker-dealer makes or intends to make recommendations to the customer. The rule states that a broker-dealer must "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[225] The rule defines "essential facts" as "those [facts] required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[226]

218. FINRA R. 2330(b)(1)(B) (2012). The Supplementary Material to Rule 2330 places an obligation on a broker-dealer to have actual knowledge of exchanges that previously occurred at that broker-dealer and to make "reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months." *Id.* R. 2330.05. The better approach is to view the obligation to seek to obtain information about a customer's "existing assets" under FINRA Rule 2330(b)(2) as similarly requiring a broker-dealer actually to know what assets are held at that broker-dealer and then to use reasonable efforts to obtain information about assets that the customer holds at other financial or insurance institutions.

219. *Id.* R. 2330(b)(1).

220. *Id.* R. 2330(c).

221. *Id.*

222. *Id.*

223. *Id.* R. 2330(d).

224. *Id*. R. 2330(e).

225. FINRA R. 2090 (2011).

226. *Id.* R. 2090.01.

The exact type of information that must be obtained often will vary depending on a number of factors, including the customer's needs, the broker-dealer's business model, and the products and services that the broker-dealer offers. With regard to the requirement that a broker-dealer "understand the authority of each person acting on behalf of the customer[,]" however, FINRA has stated that a broker-dealer generally would need "to know the names of any persons authorized to act on behalf of a customer and any limits on their authority that the customer establishes and communicates to the [broker-dealer]."[227]

The rule does not provide definite periods within which broker-dealers must update customer information. FINRA has stated that, "[a]s with a customer's investment profile under the suitability rule, a [broker-dealer] should verify the 'essential facts' about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances."[228] The reasonableness of such efforts would "depend on the facts and circumstances of the particular case."[229]

D. Just and Equitable Principles

FINRA's rulebook includes a broad, generalized ethical provision. The rule serves a crucial role in FINRA's regulation of broker-dealers because it covers all aspects of a broker-dealer's business conduct, including conduct that is not covered by more specific rules.[230] FINRA Rule 2010 states that a broker-dealer, "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[231] FINRA Rule 2010 does not require a showing of scienter.[232]

FINRA, the SEC, and the courts have interpreted the Rule 2010 requirement that the misconduct occur "in the conduct of [a broker-dealer's] business" as broadly applying to all unethical business conduct, regardless of whether the conduct involves securities.[233] The breadth of FINRA Rule 2010 is particularly important because, at times, broker-dealers engage in conduct that is not directly

227. Notice 11-25, *supra* note 145, at *4–5.

228. Notice 11-02, *supra* note 142, at *3 n.5.

229. *Id.* FINRA noted, however, that SEC Exchange Act Rule 17a-3 "requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations." *Id.*

230. FINRA often considers a violation of another FINRA rule or the federal securities laws to constitute a violation of FINRA Rule 2010. *See In re* FCS Sec., Admin. Proc. File No. 3-14015, 2011 SEC LEXIS 2366, at *3 n.2 (July 11, 2011); *In re* Fox & Co. Invs., Inc., Admin. Proc. File No. 3-11873, 2005 SEC LEXIS 2822, at *18 n.19 (Oct. 28, 2005). The significance of FINRA Rule 2010, however, is that it broadly captures myriad types of business conduct not covered by more specific rules, including conduct unrelated to securities activity.

231. FINRA R. 2010 (2008).

232. *In re* DiFrancesco, Admin. Proc. File No. 3-14195, 2012 SEC LEXIS 54, at *9 (Jan. 6, 2012).

233. Iallegio v. SEC, No. 98-70854, 1999 U.S. App. LEXIS 10362, at *4–5 (9th Cir. May 20, 1999); Vail v. SEC, 101 F.3d 37, 39 (5th Cir. 1996); Jefferson Pilot Sec. Corp. v. Blankenship, 257 F. Supp. 2d 962, 967–68 (N.D. Ohio 2003); *In re* Kobey, Admin. Proc. File No. 3-7548, 1992 SEC LEXIS 3313, at *7–8 (Dec. 22, 1992).

related to securities activity. With many of FINRA's rules explicitly applying only to securities activity, a gaping hole in the regulatory fabric would exist in the absence of a broad application of FINRA Rule 2010. The public trust in the financial industry is damaged when broker-dealers engage in any misconduct, whether or not it occurs in relation to securities activity.

FINRA Rule 2010 has been found to cover various types of misconduct that do not involve securities. Violations of the rule have been found, for example, when brokers have forged customer signatures on insurance applications or misappropriated funds from customers' insurance premiums.[234] A broker who was treasurer of a political organization was found to have violated the rule when he misappropriated the organization's funds.[235] Similarly, a broker who was an officer of a charitable foundation violated the rule when he "used gift certificates and wine, purchased with the [charitable organization's] funds, for his own personal benefit and not in connection with the [organization's] business."[236] Another broker was expelled from the securities industry for altering customer documents that his firm was required to produce to FINRA.[237] Moreover, the president and owner of a firm was disciplined under the rule for failing to comply with a court judgment requiring him to pay attorney's fees and costs in a lawsuit he initiated against his former customers challenging an arbitration award.[238]

Adjudicators also have found violations of the rule when, for instance, brokers have made various misrepresentations to their firms, such as misrepresenting purchases of annuities in order to increase commissions,[239] submitting false expense reports to obtain reimbursement for country club fees,[240] persuading a

234. *In re* Cipriani, Admin. Proc. File No. 3-8152, 1994 SEC LEXIS 506, at *4–10 (Feb. 24, 1994); *In re* Jackson, Admin. Proc. File No. 3-4079, 1975 SEC LEXIS 1404, at *2–4 (June 16, 1975); *In re* Lablow, Admin. Proc. File No. 3-6343, 1985 SEC LEXIS 1913, at *3 (Mar. 20, 1985); DBCC v. Shegon, No. C9A960030, 1997 NASD Discip. LEXIS 66, at *4 (NAC Nov. 20, 1997).

235. *In re* Vail, Admin. Proc. File No. 3-8532, 1995 SEC LEXIS 1514, at *7–9 (June 20, 1995), *aff'd*, 101 F.3d 37 (5th Cir. 1996).

236. *In re* Mullins, Admin. Proc. File No. 3-14302, 2012 SEC LEXIS 464, at *33–42 (Feb. 10, 2012).

237. *In re* Rooms, Admin. Proc. File No. 3-11621, 2005 SEC LEXIS 728 (Apr. 1, 2005), *aff'd*, 444 F.3d 1208 (10th Cir. 2006). FINRA's document request, issued pursuant to Rule 8210 (which requires firms' compliance with such requests), was addressed to the firm's president, not to the defendant. *Id.* at *5, *10–11. The firm's president had instructed the defendant to assist with the document production. *Id.* at *7. The defendant then altered some of the documents. *Id.* at *7–9. The SEC held that a person could not be found liable under Rule 8210 if the person was unaware of the Rule 8210 request, but could be found liable under Rule 2010 in such circumstances. *Id.* at *11–14. The *Rooms* decision is important because broker-dealers often must use numerous employees to comply with large FINRA document requests. It is virtually impossible for FINRA or any regulator to know in advance all of the firm employees who might play a role in gathering and producing documents pursuant to a Rule 8210 request for information. Without just and equitable principles, the defendant in *Rooms* likely would have gone unpunished and document productions, which serve a vital role in FINRA's enforcement efforts, potentially would have been rendered less reliable.

238. Dep't of Enforcement v. Shvarts, CAF980029, 2000 NASD Discip. LEXIS 6 (June 2, 2000).

239. *In re* Rembert, Admin. Proc. File No. 3-8074, 1993 SEC LEXIS 3146, at *2–3 (Nov. 16, 1993).

240. Iallegio v. SEC, Admin. Proc. File No. 3-8925, 1996 SEC LEXIS 3057, at *5–7 (Oct. 31, 1996), *aff'd*, No. 98-70854, 1999 U.S. App. LEXIS 10362 (9th Cir. May 20, 1999).

back-office employee to wrongly credit commissions,[241] or improperly obtaining donations as part of a gift matching program.[242] Another broker was disciplined under the rule when he made unauthorized use of a coworker's credit card.[243]

In addition to covering broker-dealer activities that do not involve securities, Rule 2010 has been interpreted as imposing important due diligence and disclosure obligations on broker-dealers regarding their participation in private securities offerings. In *In re Kunz*,[244] for instance, FINRA held that the defendants violated Rule 2010 when they distributed offering material for a private placement that (1) included a misleading financial statement for the issuer, which a certified public accountant had audited, and (2) failed to disclose their close relationship with the issuer. As to the issuer's misleading financial statement, FINRA stated, "[w]hile it may be reasonable for a broker/dealer to rely on financial statements audited by a certified public accountant in some situations, we do not believe that to be the case here."[245] FINRA pointed to numerous "red flags" indicating irregularities that required the defendants to look behind the audited financials.[246] FINRA held that these red flags, which could be gleaned from the offering material, required the defendants to investigate "whether [the issuer] actually owned [a large asset on its books], notwithstanding that the financials were audited by an accountant."[247]

With regard to the omission claim, FINRA found that the defendants had a duty to refrain from distributing the offering material without disclosing to their customers a consulting relationship they had with the issuer.[248] FINRA stated that "it strains credibility to suggest that a reasonable investor would not have viewed a potential conflict of interest like that present here as having altered the total mix of information."[249]

FINRA's holdings in *Kunz* regarding a broker-dealer's due diligence and disclosure obligations have become important components of FINRA's regulation of broker-dealer participation in private placements.[250] Because of the unique facts of that case, however, FINRA likely would not have been successful in

241. *In re* Burkes, Admin. Proc. File No. 3-7756, 1993 SEC LEXIS 949, at *8 n.16 (Apr. 14, 1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994).

242. *In re* Goetz, Admin. Proc. File No. 3-9206, 1998 SEC LEXIS 499, at *4–12 (Mar. 25, 1998).

243. *In re* Manoff, Admin. Proc. File No. 3-10499, 2002 SEC LEXIS 2684, at *11–16 (Oct. 23, 2002).

244. No. G3A960029, 1999 NASD Discip. LEXIS 20 (NAC July 7, 1999), *aff'd*, Admin. Proc. File No. 3-9960, 2002 SEC LEXIS 104 (Jan. 16, 2002).

245. *Id.* at *33.

246. FINRA noted, among other things, that the asset "was by far the largest asset [the issuer] listed in the financial statement, it caused [the issuer] to have a positive net worth, it [supposedly] was purchased a mere four days prior to the accountant's certification of the financial statement[,]" and the valuation of the issuer's stock that was used to purchase it was suspect. *Id.* at *33–34.

247. *Id.* at *34.

248. *Id.* at *35.

249. *Id.* at *35–36.

250. *See* FINRA Regulatory Notice 10-22, 2010 FINRA LEXIS 43, at *17–18 (Apr. 2010) (highlighting *Kunz* decision in discussion on broker-dealer obligations when participating in private offerings).

prosecuting the action in the absence of Rule 2010.[251] In sum, the requirement that a broker act in accordance with just and equitable principles appropriately applies to a wide variety of conduct.

E. Communications with the Public

FINRA's "communications with the public" rule provides standards for various types of broker-dealer communications, such as advertisements, correspondence, and public appearances.[252] The rule generally requires broker-dealer communications with the public to be fair and balanced; include material information; be free from exaggerated, false, or misleading statements or claims; and be consistent with applicable securities laws, regulations, and rules.[253] Perhaps most important, the rule requires various broker-dealer communications with the public to be submitted to a firm supervisor and/or FINRA for content review and approval.[254]

It also is important to note that, as with just and equitable principles, FINRA's standards for communications with the public apply irrespective of whether the activity involves a security. In *In re Wallace*,[255] the SEC emphasized that Rule 2210 is "not limited to advertisements for securities, but provide[s] standards applicable to all [broker-dealer] communications with the public."[256]

F. Order Handling

Broker-dealers are subject to a number of obligations when they execute orders for customers. In fact, two of those obligations have been found to create fiduciary duties. FINRA Rule 5310, known as the best execution rule, requires broker-dealers to "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."[257] FINRA has emphasized that "a broker/dealer's duty of best execution derives from common law agency principles and fiduciary obligations."[258] Similarly, the requirement in FINRA Rule 5320 that a broker-dealer generally not trade ahead of customer orders is rooted in a broker-dealer's "basic fiduciary obligations under agency law."[259]

---

251. The record in *Kunz*, for instance, lacked the type of evidence needed to prove a suitability or fraud violation. 1999 NASD Discip. LEXIS 20, at *62–63.

252. FINRA R. 2210(a) (2011).

253. *Id.* R. 2210(d).

254. *Id.* R. 2210(c).

255. Admin. Proc. File No. 3-9549, 1998 SEC LEXIS 2437 (Nov. 10, 1998).

256. *Id.* at *13.

257. FINRA R. 5310 (2011).

258. FINRA Notice to Members 01-22, 2001 NASD LEXIS 27, at *4 (Apr. 2001); *see also* Newton v. Merrill, Lynch, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998) (discussing obligation's roots in agency and fiduciary law).

259. FINRA Regulatory Notice 09-15, 2009 FINRA LEXIS 235, at *4 (Mar. 2009); *see also* FINRA Notice to Members 85-12, 1985 NASD LEXIS 430, at *1 (Feb. 1985).

Broker-dealers also are subject to restrictions on how much they charge a customer for executing an order. FINRA's "mark-up policy" states that it shall be a violation for a broker-dealer "to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."[260]

SEC Exchange Act Rule 10b-10, moreover, requires that a broker-dealer provide a customer with written confirmation of a securities transaction.[261] The confirmation generally must disclose, *inter alia*, the "date and time of the transaction"; the "identity, price, and number of shares . . . of such security purchased or sold by such customer"; whether the broker-dealer is acting in an agent or principal capacity; whether the broker-dealer received payment for order flow regarding certain securities; and the "source and amount of any other remuneration received or to be received by the broker in connection with the transaction."[262]

G. Financial Responsibility

Broker-dealers (but not advisers) are subject to stringent financial responsibility requirements pursuant to the SEC's net capital rule, Exchange Act Rule 15c3-1. The rule's main purposes "are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation ["SIPC"]."[263] In general, a firm that fails to meet its minimum net capital requirement must immediately cease operating its securities business.[264]

In addition, broker-dealers must file with FINRA monthly and quarterly reports concerning their financial and operational status ("FOCUS Reports"),[265] as well as annual audited financial statements.[266] These provide FINRA with valuable information regarding a broker-dealer's business and financial stability. Advisers have no equivalent requirements.

260. NASD IM-2440-1 (2008) (Mark-Up Policy). See *supra* note 4 for an explanation of FINRA's enforcement of NASD rules.

261. SEC Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10 (2012); *see also* FINRA R. 2232 (2011). See *supra* note 4 for an explanation of FINRA's enforcement of the Exchange Act and rules thereunder.

262. SEC Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10.

263. *In re* Fox & Co. Invs., Inc., Admin. Proc. File No. 3-11873, 2005 SEC LEXIS 2822, at *18 (Oct. 28, 2005). As the IA/BD Study explained, broker-dealers generally are "required to be members of SIPC[,] which protects their customers from loss of their cash and securities up to specified limits if the broker-dealer becomes insolvent." IA/BD Study, *supra* note 2, at 73.

264. IA/BD Study, *supra* note 2, at 73. However, a broker-dealer that fails to meet its net capital requirement may be permitted to engage in very limited securities activities, such as effecting liquidating or closing transactions at customers' requests, depending on the facts and circumstances and likely only with SEC and/or FINRA approval.

265. SEC Exchange Act Rule 17a-5, 17 C.F.R. § 240.17a-5 (2012). See *supra* note 4 for an explanation of FINRA's enforcement of the Exchange Act and rules thereunder.

266. SEC Exchange Act Rule 17a-5(d), 17 C.F.R. § 240.17a-5(d); NASD R. 3170 (2006); FINRA Regulatory Notice 11-46, 2011 FINRA LEXIS 81 (Oct. 2011).

H. Supervision

The SEC has described supervision as "the touchstone to ensuring that broker-dealer operations comply with the securities laws and [FINRA] rules. It is also a critical component to assuring investor protection."[267] Consistent with that view, FINRA imposes numerous important supervisory obligations on broker-dealers. FINRA's supervision rules cover all aspects of a broker-dealer's business activities, mandate participation by all levels of firm personnel, and require review and analysis of the effectiveness of firm systems and procedures, as well as appropriate modifications thereto when deficiencies are identified.

Rule 3010, for instance, requires a broker-dealer to establish a supervisory system for the firm's business activities, including the adoption of written supervisory policies and procedures reasonably designed to achieve compliance with applicable securities laws and FINRA rules.[268] A broker-dealer's supervisory system must provide for, among other things, (1) the designation of a registered principal or principals to execute the supervisory responsibilities for each type of the firm's activities,[269] (2) the assignment of each registered person to a supervisor,[270] (3) written procedures for conducting office inspections,[271] and (4) a commitment to meet at least annually with each registered representative and registered principal to discuss compliance matters relevant to the individual.[272] Broker-dealers also are required to inspect branch offices.[273]

Furthermore, Rule 3012 requires broker-dealers to designate one or more principals responsible for a system of supervisory control policies and procedures that "test and verify" that the supervisory procedures are reasonably designed to achieve compliance with relevant laws, regulations, and rules and "create additional or amend supervisory procedures where the need is identified by such testing and verification."[274] A broker-dealer's *senior management* must receive a report that details the firm's system of supervisory controls, summarizes test results, and discusses additional supervisory procedures, if any, created in response to the test results.[275] In addition, Rule 3130 requires a broker-dealer's chief executive officer (or equivalent officer) to certify annually that the firm has a process to adopt compliance policies and supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and rules.[276]

267. *In re* Kaminski, Admin. Proc. File No. 3-14054, 2011 SEC LEXIS 3225, at *35 (Sept. 16, 2011).

268. NASD R. 3010(a), (b) (2007). "The standard of 'reasonable' supervision is determined based on the particular circumstances of each case." *In re* Pellegrino, Admin. Proc. File No. 3-12941, 2008 SEC LEXIS 2843, at *32–33 (Dec. 19, 2008). See *supra* note 4 for an explanation of FINRA's enforcement of NASD rules.

269. NASD R. 3010(a)(2) (2007).

270. *Id.* R. 3010(a)(5).

271. *Id.* R. 3010(a)(1), (c).

272. *Id.* R. 3010(a)(7). For all minimum requirements that a broker-dealer's supervisory system must contain, see *id.* R. 3010(a)(1)–(7).

273. *Id.* R. 3010(c).

274. NASD R. 3012(a)(1) (2005).

275. *Id.*

276. FINRA R. 3130 (2008).

FINRA also has stated that broker-dealers should consider implementing formal written procedures for vetting new products.[277] A broker-dealer's product committee, which ordinarily includes representatives from all relevant parts of the broker-dealer (e.g., compliance, legal, finance, marketing, sales, and operations), should perform a detailed review of new products.[278] The product committee then should make a formal decision regarding whether to allow a product to be sold to customers.[279] If the committee approves the product, the broker-dealer's procedures also should include some level of post-approval review to determine whether the product has performed as anticipated.[280] Broker-dealers, moreover, should assess whether to employ a similar approach to the introduction of new technologies.[281]

Although supervisory systems and procedures are important, they are not sufficient in and of themselves to ensure reasonable supervision. The duty of supervision requires broker-dealers to investigate "red flags" that indicate irregularities.[282] This responsibility requires a broker-dealer to conduct adequate follow-up and review to make sure the identified problem has been meaningfully addressed.[283] In addition, broker-dealers must "determine that supervisors understand and can effectively conduct their requisite responsibilities."[284]

277. *See* FINRA Notice to Members 05-26, 2005 NASD LEXIS 7 (Apr. 2005).

278. *Id.* at *12.

279. *Id.*

280. *Id.* FINRA has stated, however, that a broker-dealer's "approval of a product for sale does not necessarily mean that an *associated person* has complied with the reasonable-basis obligation" under the suitability rule. Notice 11-25, *supra* note 145, at *20 (emphasis added). FINRA explained that, "even if a firm's product committee has approved a product for sale, an individual broker's lack of understanding of a recommended product or strategy still could violate the obligation[.]" *Id.* at *21. A firm needs to educate its brokers on the risks and rewards of products and strategies. *Id.* at *22. A broker can "rely on a firm's fair and balanced explanation of the" risks of a product or strategy, but "if the [broker] remains uncertain about the potential risks . . . or has reason to believe that the firm failed to address a particular issue or has done so in an incomplete or inaccurate manner, then the [broker] would need to engage in further inquiry before recommending the product [or strategy]." *Id.*

281. *See* FINRA Regulatory Notice 07-59, 2007 FINRA LEXIS 58, at *4–5 (Dec. 2007) (emphasizing that broker-dealers "should consider, *prior* to implementing new or different methods of communication, the impact on the firm's supervisory system. . . . In this way, firms can identify and timely address any issues that may accompany the adoption of new electronic communications technologies." (emphasis added)); FINRA Notice to Members 05-49 (July 2005), *available at* http://www.finra.org/Industry/Regulation/Notices/2005/P014773 (stating that broker-dealers must ensure that reasonable supervisory measures have been or will be implemented "before [they] actually use[] or allow[] [their] associated persons to use such technology").

282. *In re* Midas Sec. LLC, Admin. Proc. File No. 3-14308, 2012 SEC LEXIS 199, at *46 (Jan. 20, 2012) ("[R]ed flags and suggestions of irregularities demand inquiry."); *In re* World Trade Fin. Corp., Admin. Proc. File No. 3-14307, 2012 SEC LEXIS 56, at *42–43 (Jan. 6, 2012); *In re* Pellegrino, Admin. Proc. File No. 3-12941, 2008 SEC LEXIS 2843, at *32–33 (Dec. 19, 2008); *In re* Studer, Admin. Proc. File No. 3-11426, 2004 SEC LEXIS 2347, at *22 (Oct. 14, 2004). A broker-dealer, however, can violate its supervisory obligations even in the absence of red flags. *See* Seco Sec., Inc., Admin. Proc. File No. 3-6754, 1988 SEC LEXIS 1776, at *6 (Sept. 1, 1988).

283. *See Midas Sec.*, 2012 SEC LEXIS 199, at *49–50 (stating that red flags "demand inquiry as well as adequate follow-up and review"); *World Trade Fin. Corp.*, 2012 SEC LEXIS 56, at *42–43; *Pellegrino*, 2008 SEC LEXIS 2843, at *32–33.

284. *In re* Kresge, Admin. Proc. File No. 3-12402, 2007 SEC LEXIS 1407, at *35 (June 29, 2007). It is not enough, however, "to delegate supervisory responsibility to a subordinate, *even a capable one*,

Red flags could exist, for instance, not only with regard to a particular broker or customer account, but also as to the ineffectiveness of a supervisor, compliance department, or supervisory system.[285]

Advisers' supervision obligations are much more generalized. They do not require the type of top-to-bottom supervision and formal checks and balances that FINRA's rules mandate.

I. Securities and Business Activities Conducted Away from the Broker-Dealer

FINRA imposes obligations on a broker-dealer to understand and, when appropriate, preclude or impose reasonable conditions on associated persons' securities *and* non-securities activities that occur away from the firm. Misconduct that occurs away from a broker-dealer nonetheless can raise investor-protection, reputational, and other concerns. Indeed, investors who are aware that an individual is employed by a broker-dealer may not understand that the activity in question is occurring away from and without the full oversight of the broker-dealer.[286]

Rule 3040 requires an associated person to provide written notice to the broker-dealer of a proposed *securities* transaction away from the firm ("private securities transaction").[287] The associated person's written notice must describe in detail the proposed transaction and the person's intended role in it.[288] The notice also must state whether the person "has received or may receive selling compensation in connection with the transaction."[289] If the associated person has received or expects to receive compensation, the firm must provide written notice to the person that it approves or disapproves the person's participation in the proposed transaction.[290] If the firm disapproves, the associated person may

and then simply wash his hands of the matter until a problem is brought to his attention. . . . Implicit is the additional duty to follow up and review that delegated authority to ensure that it is being properly exercised." *In re* Patrick, Admin. Proc. File No. 3-7715, 1993 SEC LEXIS 1213, at *7–8 (May 17, 1993) (emphasis added), *aff'd*, 19 F.3d 66 (2d Cir.), *cert. denied*, 115 S. Ct. 54 (1994); *see also In re* Goddard, Admin. Proc. File No. 3-7859, 1993 SEC LEXIS 2214, at *13 (Sept. 2, 1993) (finding inadequate a compliance director's reliance on a subordinate supervisor to monitor problematic activity without follow up).

285. *See* Dep't of Enforcement v. Cohen, No. EAF0400630001, 2010 FINRA Discip. LEXIS 12, at *27–35 (NAC Aug. 18, 2010) (finding supervision violation where broker-dealer's chief administrative officer, who was responsible for the compliance department, did not take appropriate action in the face of numerous red flags that a particular supervisor and the compliance department as a whole were not functioning properly).

286. *See In re* McNabb, Admin. Proc. File No. 3-9886, 2000 SEC LEXIS 2120, at *23 (Oct. 4, 2000) (noting that the rule on private securities transactions "protects investors from the hazards of unmonitored sales and protects the firm from loss and litigation"); FINRA R. 3270.01 (2009) (requiring broker-dealers to consider whether a registered person's outside business activity will incorrectly be viewed by customers as related to the broker-dealer's business and to, among other things, assess risks to the customers and the firm).

287. NASD R. 3040(b) (1999). See *supra* note 4 for an explanation of FINRA's enforcement of NASD rules.

288. NASD R. 3040(b).

289. *Id.*

290. *Id.* R. 3040(c)(1).

not participate in the transaction.[291] If it approves, the firm must record the securities transaction on its books and records and supervise the associated person's participation in the transaction as if the transaction were executed at the firm.[292]

Rule 3270 requires registered persons to notify their broker-dealer in writing prior to engaging in *non-securities* activities away from the firm ("outside business activities").[293] Although the rule does not aim to regulate the day-to-day outside business activities of a registered person, it does require a broker-dealer to assess whether such activities will compromise the registered person's responsibilities to the broker-dealer's customers or cause customers to believe mistakenly that the activities are part of the broker-dealer's business.[294] Based on its assessment of a proposed outside business activity, a broker-dealer must determine whether to prohibit or impose conditions on the activities.[295] In its order approving Rule 3270, the SEC explained that the rule requires a broker-dealer "to implement a system to assess the risk that these outside business activities may cause potential harm to investors and to manage these risks by taking appropriate actions."[296]

J. Recordkeeping

Broker-dealers are subject to comprehensive recordkeeping obligations. SEC Exchange Act rules provide minimum requirements regarding the records that broker-dealers are required to create and the length of time they must maintain such records.[297] SEC Exchange Act Rule 17a-3 lists numerous specific types of records that broker-dealers must create and maintain, including, among other things, operational records (e.g., trade blotters, ledgers, order tickets, trade confirmations), employee records, computerized or automated systems records,

291. *Id.* R. 3040(c)(3).

292. *Id.* R. 3040(c)(2). Where the associated person has not and will not receive selling compensation, the broker-dealer must provide the associated person "prompt written acknowledgement of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction." *Id.* R. 3040(d).

293. FINRA R. 3270 (2009).

294. *Id.* R. 3270.01; *see also* SEC Approval of FINRA Proposed Rule Relating to Outside Business Activity of Registered Persons, 75 Fed. Reg. 53362, 53365 (Aug. 31, 2010) [hereinafter Approval Order for Outside Business Activity Rule].

295. FINRA R. 3270.01. The rule does not require broker-dealers to provide approval, written or otherwise, of a registered person's outside business activities. *See* Approval Order for Outside Business Activity Rule, *supra* note 294, at 53364. FINRA has stated, however, that the rule "does not preclude any [broker-dealer] from including a prior member consent requirement as part of its procedures to manage the outside business activities of its registered persons." *Id.*

296. Approval Order for Outside Business Activity Rule, *supra* note 294, at 53365. A broker-dealer should require registered persons to notify the firm in the event of a material change to their outside business activities. FINRA stated "that the requirement for a registered person to amend or supplement the nature of the prior written notice is implicit in [Rule 3270]." *Id.* Nonetheless, FINRA noted that a broker-dealer's "supervisory system should demand that each registered person notify the member in the event of a material change to his or her outside business activities." *Id.* A broker-dealer also must maintain a record of compliance with the rule for each written notice received. FINRA R. 3270.01.

297. *See* SEC Exchange Act Rule 17a-3, 17a-4, 17 C.F.R. §§ 240.17a-3, 17a-4 (2012).

customer account records, customer complaint records, and communications with the public.[298]

SEC Exchange Act Rule 17a-4 generally indicates both the length of time that broker-dealers must hold such records and the manner in which they must be held.[299] That rule also requires a broker-dealer to retain all communications that it receives and sends (including inter-office memoranda and communications), as well as all written agreements (including with respect to any account) "relating to [its] business as such."[300] The SEC has stated that the "content, rather than the format, of a message determines whether it is covered" under the rule.[301] The provision thus covers external *and* internal electronic communications—such as e-mails, instant messaging, and internet communications—as long as they relate to the broker-dealer's "business as such."[302]

Advisers have more limited recordkeeping obligations.[303] They must retain a narrower list of specifically enumerated documents and do not have the equivalent of the broker-dealer "business as such" obligations.[304] The SEC has stated that this limits the effectiveness of examinations of advisers and could compromise the protection afforded to adviser clients.[305]

K. Self-Reporting to FINRA

In addition to the reporting and disclosure obligations discussed above, broker-dealers are required to report to FINRA written customer complaints, various types of civil and criminal actions filed against them, and certain internal conclusions of wrongdoing. The information obtained through this requirement plays a crucial role in helping FINRA identify misconduct and operational difficulties.

Broker-dealers, for example, must report to FINRA various specified events and quarterly statistical and summary information regarding written customer complaints and file with FINRA copies of certain criminal actions, civil complaints, and arbitration claims.[306] In addition, broker-dealers must report internal conclusions of violations. Pursuant to this requirement, a broker-dealer must submit a report to FINRA within thirty calendar days after the firm has concluded *or reasonably should have concluded* that an associated person or the firm violated certain securities, insurance, commodities, financial- or investment-related laws,

298. SEC Exchange Act Rule 17a-3, 17 C.F.R. § 240.17a-3.
299. SEC Exchange Act Rule 17a-4, 17 C.F.R. § 240.17a-4.
300. SEC Exchange Act Rule 17a-4(b)(4), (7), 17 C.F.R. § 240.17a-4(b)(4), (7).
301. vFinance Invs., Inc., Admin. Proc. File No. 3-12918, 2010 SEC LEXIS 2216, at *22 (July 2, 2010).
302. *Id.*; *see also* Centreinvest, Inc., Admin. Proc. File No. 3-13304, 2009 SEC LEXIS 2611, at *17–18 (July 31, 2009).
303. *See* IA/BD Study, *supra* note 2, at 139.
304. *Id.*
305. *Id.*
306. FINRA R. 4530 (2011).

rules, regulations, or standards of conduct of any domestic or foreign regulatory body or SRO.[307] Advisers have no such self-reporting obligations.

V. Examinations and Disciplinary Actions

The imposition of investor-protection obligations on advisers and broker-dealers, no matter how stringent, largely will be ineffective unless there are frequent and searching examinations for compliance with and meaningful enforcement regarding such obligations. This Part reviews the relevant statistics for both advisers and broker-dealers.

A. Examinations

Pursuant to section 914 of Dodd-Frank, SEC staff prepared its Study on Enhancing Investment Adviser Examinations.[308] The study provided statistics that raise concerns regarding adviser examinations. The number of adviser examinations conducted each year "decreased 29.8%, from 1,543 examinations in 2004 to 1,083 examinations in 2010."[309] The study further noted that "only 9% of advisers were examined in 2010."[310] SEC staff reported that "the average adviser can expect to be examined only once every 11 years."[311]

Conversely, the SEC explained that, on average, FINRA conducts examinations of 55 percent of all broker-dealers every year.[312] All broker-dealers are examined at least once every four years, and oftentimes more frequently.[313] Those broker-dealers that present the greatest risk (e.g., those that have had serious disciplinary or financial problems) are examined at least annually.[314] FINRA examinations often lead to "informal and formal disciplinary actions, which range from deficiency letters to enforcement actions and can result in censure and fines as well as suspension or expulsion from FINRA membership or association."[315]

307. *Id.* R. 4530(b). Only violations that meet the reporting threshold under the rule must be reported. These generally include misconduct that has a "widespread impact or potential widespread impact" on a firm, its customers, or the markets, or that results from a "material failure" of the firm's "systems, policies, or practices involving numerous customers, multiple errors, or significant dollar amounts." *Id.* R. 4530.01.

308. *See* U.S. Sec. & Exch. Comm'n, Staff Study on Enhancing Investment Adviser Examinations as Required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011) [hereinafter IA Examinations Study], *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

309. *Id.* at 14.

310. *Id.*

311. *Id.*

312. *Id.* at 30–31; *see also* Commissioner Statement on IA Examinations Study, *supra* note 12, at 2–3.

313. IA/BD Study, *supra* note 2, at A-9. FINRA conducts " 'cycle' or 'routine' examinations on cycles ranging from every one, two, three, or four years, depending on FINRA's annual risk assessment of the member firm." *Id.* FINRA also initiates " 'cause' or 'targeted' examinations based on customer complaints, anonymous tips, and referrals from the Commission, market surveillance staff, and arbitrations." *Id.* at A-11.

314. *Id.* at A-9.

315. *Id.* at A-11; *see also id.* at A-12.

Broker-dealers also are examined by the SEC and the states.[316] Although the SEC does not routinely examine broker-dealers, it initiates "cause" examinations based on tips and customer complaints.[317] In 2008, 2009, and 2010, for example, the SEC conducted 772, 662, and 490 examinations, respectively, of broker-dealers.[318] In 2008, 2009, and 2010, the states collectively conducted 1,651, 1,774, and 1,525 examinations, respectively, of broker-dealers.[319] These SEC and state examinations are in addition to FINRA's, providing multiple extra layers of oversight to an already heavily regulated industry. In the case of the adviser industry, only the SEC examines and otherwise regulates advisers registered with it.[320]

The SEC staff study on adviser examinations also discussed three main options for enhancing adviser examinations, as section 914 of Dodd-Frank required. The approaches were (1) imposition of "user fees" on advisers that would help fund the SEC's adviser program; (2) authorization of one or more SROs to examine advisers, with SEC oversight; and (3) authorization of FINRA to examine advisers that are dually registered as broker-dealers.[321] The SEC staff study heavily favored the first option and discounted the effectiveness of using SROs.[322]

In a highly unusual step, one SEC Commissioner provided a very public, very strong rebuke of the SEC staff's study.[323] The SEC Commissioner expressed her disappointment in the study and, "for the first time in [her] tenure as a Commissioner," felt it necessary "to write separately in order to clarify and emphasize certain facts, and ensure that Congress knows that the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now."[324] The Commissioner stated that the SEC "is not, and, unless significant changes are made, cannot fulfill its examination mandate with respect to investment advisers."[325] That would be the case, she added, "even if the Commission had the resources to double its examination frequency percentage, returning to the 2004 frequency level of 18%. Eighteen percent coverage annually is better than 9%, but still insufficient."[326]

The brunt of the Commissioner's criticism, however, focused on the study's promotion of "user fees" to fund increased SEC examinations and disregard of

316. *See id.* at 89, 91 (explaining that broker-dealers are regulated by the SEC, SROs, and the states and that states conduct examinations of broker-dealers).

317. *See id.* at A-13 to A-14.

318. *Id.* at A-15.

319. *Id.* at A-26.

320. Similarly, those advisers registered with states are only examined by the states—not by the states and the SEC. *See id.* at 84. Some states, however, do impose certain registration requirements on *employees* of advisers registered with the SEC. *See id.* at 86.

321. IA Examinations Study, *supra* note 308, at 25. Approximately five percent of advisers are dually registered as broker-dealers. *Id.* at 37. FINRA has jurisdiction to regulate the broker-dealer part of such businesses, but it does not have jurisdiction to regulate the adviser part. *Id.*; *see also* IA/BD Study, *supra* note 2, at A-8.

322. *See* IA Examinations Study, *supra* note 308, at 25–39.

323. *See* Commissioner Statement on IA Examinations Study, *supra* note 12.

324. *Id.* at 1–2.

325. *Id.* at 2.

326. *Id.*

the benefits of the SRO model. The Commissioner stated that the answer to the second inquiry under section 914 of Dodd-Frank—that the SEC evaluate and recommend ways to enhance examinations—"is that one or more SROs would dramatically improve the frequency of adviser examinations."[327] The Commissioner pointed, in part, to the fact that the SEC's "current examination rate for advisers (9%)—which [the SEC's Office of Compliance Inspections and Examinations ("OCIE")] estimates could drop as low as 7% in 2011 if additional examiners are not added—would have to increase by . . . more than six times to reach the average rate at FINRA (55.5%)."[328] The SEC's OCIE also estimated that "it would need to double the current number of its adviser examiners (460) to increase the frequency of examinations to even 20%."[329] To get to the level of frequency with which FINRA examines broker-dealers annually, "OCIE would need to add more than 2,000 examiners to its advisory program, bringing the total to about 2,500."[330] The Commissioner noted that the "frequency of [SEC] examinations [of advisers from 2004–2010] continued to drop despite increases in the number of [SEC adviser] examiners in 2009–10."[331]

Perhaps most significant was the Commissioner's view that the study's discussion and weighing of the three options to improve examinations was "far from balanced or objective."[332] The study, for instance, did "not make clear that many of the benefits of the user fee option are shared by the SRO options."[333] The Commissioner stated that the study also failed to discuss disadvantages to the user fee option, exaggerated the disadvantages of using SROs, lacked an objective discussion of the benefits of using SROs, and gave too much weight to adviser industry concerns about using SROs.[334] As noted in this article's introduction, the Commissioner concluded that the lack of adequate examinations of advisers raised serious investor-protection concerns regarding adviser clients.[335]

B. Disciplinary Actions

The SEC has authority to bring enforcement actions against both advisers and broker-dealers. The IA/BD Study provided data on such actions, stating that, "[i]n recent years, [the SEC's Division of] Enforcement has brought approximately 600 enforcement actions each year against individuals and entities accused of

327. *Id.*
328. *Id.* at 3.
329. *Id.*
330. *Id.*
331. *Id.*
332. *Id.* at 6.
333. *Id.*
334. *Id.* at 7. With regard to the advantages of using SROs, the Commissioner explained that it would free-up SEC resources, add significant resources outside the SEC, increase "speed and efficiency through SRO processes that are more expedited than those used by the government," and add to the SEC's "set of tools an ability to promulgate ethical and business conduct standards that would further protect investors." *Id.* The Commissioner noted that "the user fee option does not necessarily provide any of these benefits." *Id.*
335. *Id.* at 8.

violating the federal securities laws."[336] The IA/BD Study then stated, "Typically, actions primarily involving broker-dealers represent 9% to 22% of total [SEC] Enforcement actions brought each year [or 54 to 132 actions per year], and actions primarily involving advisers represent 11% to 16% of total Enforcement actions brought each year [or 66 to 96 actions per year]."[337]

Of course, broker-dealers, unlike advisers, also are subject to FINRA disciplinary actions. The IA/BD Study stated that, "[i]n 2009, FINRA brought over 993 disciplinary actions[,]" levied significant fines, and "expelled 20 firms, barred 383 individuals from the industry, and suspended 363 others."[338] The SEC noted, moreover, that the statistics for 2009 are "consistent with disciplinary actions taken by FINRA . . . between 2004 and 2008."[339] In addition to SEC and FINRA disciplinary actions, the states can take enforcement action against broker-dealers.[340] Statistical information for state disciplinary actions is not available, however.

Using the SEC's 2009 data, a total of seventy-six disciplinary actions were brought against advisers[341] and a total of 1,102 disciplinary actions were brought against broker-dealers (109 SEC enforcement actions[342] and 993 FINRA enforcement actions[343]). These disparate figures are even more significant in light of the larger number of advisers at the time. In 2009, there were 11,452 advisers registered with the SEC[344] compared with 5,100 broker-dealers.[345] It is fair to assume that this odd juxtaposition reflects the significantly fewer detailed and actionable obligations that are imposed on—and the dearth of examinations of—advisers. Whatever the exact causes, however, this lack of enforcement of adviser obligations should raise serious concerns for policymakers as they consider how best to protect investors going forward.

VI. Framework for Strengthening Investor Protection

Section 913 of Dodd-Frank specifically requires the SEC to consider imposing a universal fiduciary duty on advisers and broker-dealers that is no less stringent than the one currently imposed on advisers. It also directs the SEC to consider closing the regulatory gaps in other areas. This article proposes steps for doing both. Customers deserve these reforms in light of the abuses that played at least a partial role in creating the worst economic crisis since the Great Depression. The marketplace needs them to restore the public trust. *Financial professionals*—the term this article will use to refer to both advisers and broker-dealers—ultimately

336. IA/BD Study, *supra* note 2, at A-18.
337. *Id.* at A-19.
338. *Id.* at A-21.
339. *Id.*
340. *Id.* at A-22 (noting generally that states have examination and enforcement programs for broker-dealer activities).
341. *Id.* at A-19.
342. *Id.*
343. *Id.* at A-21.
344. IA Examinations Study, *supra* note 308, at 8.
345. IA/BD Study, *supra* note 2, at 8.

will benefit from them in the form of greater investor reliance on and confidence in their services. Financial professionals also should benefit from lower litigation costs as they create improved supervisory systems and procedures to comply with the new obligations, leading to the discovery and correction of problems at an earlier stage. Enhanced disclosure of conflicts and of material features related to investment advice, moreover, should lead to fewer investor misunderstandings regarding the risks associated with that advice.

A. Universal Fiduciary Duty

As discussed above, an adviser's current fiduciary duty includes obligations to disclose conflicts of interest, act in the customer's best interests, provide suitable investment advice, and seek best execution.[346] Broker-dealers are subject to all of those obligations but the broad disclosure requirement[347] and, as demonstrated above, some broker-dealer obligations are more demanding than those of advisers.[348] Although FINRA rules and case law currently impose myriad discreet disclosure requirements,[349] broker-dealers do not have a broad disclosure obligation comparable to the one imposed on advisers. That should change.

346. *Id.* at 22–29.

347. Although an adviser's broad disclosure requirement is the only adviser fiduciary duty to which broker-dealers currently are not subject, an adviser's obligation to act in a customer's best interests could be viewed as somewhat broader than that of a broker-dealer. Unlike that of an adviser, a broker-dealer's obligation to act in a customer's best interests generally is tied to a recommendation through interpretation of the suitability rule. *See supra* Part IV.B. Therefore, an adviser's obligation may apply in a wider range of circumstances. Nonetheless, the protection the obligation provides is most needed when a recommendation is made. Indeed, there may be only rare circumstances when the protection of the obligation would be necessary in the absence of a recommendation. One such situation when the obligation may be necessary irrespective of whether a broker-dealer makes a recommendation is when a broker-dealer executes a customer's order. In that situation, however, broker-dealers also must act in the customer's best interests via the best execution rule, which has been interpreted as imposing fiduciary obligations on broker-dealers. *See supra* Part IV.F. Accordingly, in practice, a broker-dealer's duty to act in a customer's best interests is substantially similar to that of an adviser and it is only the broad disclosure part of the advisers' fiduciary duty that differs in material respect from the obligations of broker-dealers. Furthermore, as discussed above, broker-dealers are subject to numerous other important requirements that do not apply to advisers.

348. Broker-dealer suitability obligations, for instance, are far more detailed and actionable than those imposed on advisers. *See supra* Parts III.A.2.c. & IV.B.

349. *See, e.g.*, FINRA R. 2210 (2011) (requiring various disclosures of material facts regarding communications with the public); *id.* R. 2214 (requiring various disclosures regarding the use of investment analysis tools); FINRA R. 2232 (2009) (requiring a broker-dealer to provide a customer with a written confirmation of any security transaction with numerous disclosures about the transaction); *id.* R. 2262 (requiring written disclosure that a broker-dealer is controlled by, controlling, or under common control with the issuer of any security before entering into a contract with or for a customer for the purchase or sale of such security); FINRA R. 2264 (2011) (requiring a broker-dealer, before opening a margin account for a customer, to furnish to the customer a margin disclosure statement explaining, *inter alia*, margin and the risks associated with it); FINRA R. 2267 (2008) (requiring broker-dealers to provide in writing to customers, at least once every calendar year, FINRA's BrokerCheck® hotline number and FINRA's website address); FINRA R. 2269 (2009) (requiring disclosure of participation or interest in a primary or secondary distribution of a security); FINRA R. 2270 (2011) (requiring a broker-dealer that promotes a day-trading strategy to provide a day-trading risk disclosure statement to a customer before opening an account for the customer and to post such disclosure statement on the firm's website in a clear and conspicuous manner); FINRA R. 2310 (2009) (requiring a broker-dealer to inform a prospective participant in a direct

Imposing on broker-dealers the adviser broad duty to disclose conflicts of interest would provide needed transparency and allow customers to make more informed decisions about the ways in which they receive investment advice and make investment decisions. Customers should have access to clear, plain English information about any potential conflict that may arise during their relationship with the broker-dealer. At present, advisers generally make such disclosures at the beginning of the adviser-customer relationship using Form ADV. Policymakers should use a similar approach with broker-dealers. Fortunately, a model for such an approach already exists.

In 2010, FINRA issued a concept release proposing a Form ADV-type disclosure regime for broker-dealers.[350] FINRA's proposal would require broker-dealers at account opening "to provide a written statement to [retail] customer[s] describing the types of accounts and services it provides, as well as conflicts associated with such services and any limitations on the duties the firm otherwise owes to retail customers."[351] FINRA explained that it "conceived of a document similar in purpose to Form ADV."[352] The proposed disclosure document would cover four broad areas.

First, a broker-dealer would need to disclose "[t]he types of brokerage accounts and services the firm provides to retail customers, such as research, underwriting and recommendations of securities, products and strategies."[353] Second, a broker-dealer would need to disclose "financial or other incentives that a firm or its registered representatives have to recommend certain products, investment strategies or services over similar ones."[354] Third, a broker-dealer would need to disclose "conflicts that may arise between a firm and its customers, as well as those that may arise in meeting the competing needs of multiple customers, and how the firm manages such conflicts."[355] Fourth, a broker-dealer would need to disclose the "limitations on the duties a firm owes to its customers."[356] The concept release also provides detailed examples of the types of dis-

participation program (DPP) or a real estate investment trust (REIT), prior to executing a purchase transaction, all pertinent facts relating to the liquidity and marketability of the DPP or REIT during the term of the investment); FINRA R. 2330 (2011) (requiring broker-dealers to make various disclosures about the features and fees related to variable annuities); *id.* R. 2360 (requiring delivery of an options risk disclosure statement); *id.* R. 2370 (requiring delivery of a security futures risk disclosure statement); NASD R. 2711 (2012) (requiring various disclosures regarding research reports); *see also In re* Chase, Admin. Proc. File No. 3-10586, 2003 SEC LEXIS 566, at *18 (Mar. 10, 2003) (requiring explanation to customers of risks associated with recommendations); Dep't of Enforcement v. Frankfort, No. C02040032, 2007 NASD Discip. LEXIS 16, at *31–32 (NAC May 24, 2007) (requiring disclosure to customers of information material to a recommendation in certain circumstances); *In re* Kunz, No. G3A960029, 1999 NASD Discip. LEXIS 20, at *35–36 (NAC July 7, 1999) (requiring disclosure of conflicts of interest to customers regarding private offerings), *aff'd*, Admin. Proc. File No. 3-9960, 2002 SEC LEXIS 104, at *35–36 (Jan. 16, 2002).

350. FINRA Regulatory Notice 10-54, 2010 FINRA LEXIS 102 (Oct. 2010).

351. *Id.* at *1.

352. *Id.* at *3–4.

353. *Id.* at *5–6.

354. *Id.* at *7.

355. *Id.* at *8.

356. *Id.*

closures that would be required under each broad category.[357] Policymakers should adopt FINRA's disclosure approach, or a similar one, to close the regulatory gap on the broker-dealer side and provide enhanced investor protection.

As part of that account-opening disclosure obligation, policymakers should explicitly require a broker-dealer that intends to act in a principal capacity to provide such information in writing to the customer and to receive the customer's consent before it may act in a principal capacity. Unlike the requirement for advisers, however, broker-dealers should be permitted to make the disclosure and obtain the customer's consent prospectively at account opening for all orders. This approach recognizes the important liquidity function that broker-dealers serve when they buy and sell securities for or from their own account. In addition, because broker-dealers (unlike advisers) are in the business of *effecting* customer orders, allowing disclosure and consent to apply prospectively for all orders (rather than requiring it on a trade-by-trade basis) promotes the efficient handling of customer orders, in terms of timing, pricing, and overall costs. A number of existing FINRA rules, moreover, provide significant added protections against potential conflicts that could arise when a broker-dealer acts in a principal capacity.

Under FINRA rules, for example, a broker-dealer, "[i]n any transaction for or with a customer[,]" must "ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions" and may only charge a reasonable fee for the transaction.[358] These obligations protect against a customer paying a higher price or higher fees when a broker-dealer acts in a principal capacity. In fact, customers may receive price improvement when a broker-dealer internalizes a customer order. Furthermore, the suitability rule requires a broker-dealer to have a reasonable basis to believe that a securities recommendation is suitable for and consistent with the best interests of the customer.[359] These obligations provide important safeguards against an unscrupulous broker-dealer attempting to dump underperforming stock held in its inventory on an unsuspecting customer.

In addition to these account-opening disclosure requirements, broker-dealers, consistent with advisers' current obligations, should be required to disclose certain information when making recommendations of securities or investment strategies involving securities. In general, this *recommendation*-disclosure obligation should require a financial professional, when making a recommendation, to disclose conflicts of interest that are not adequately addressed by the account-opening written disclosure. In addition to addressing such conflicts, this obligation should require a financial professional to disclose material information about the recommended security or strategy, such as particular risks associated with or unusual features of the recommended security or strategy. The obligation,

357. *Id.* at *5–8.
358. FINRA R. 5310 (2011); NASD IM-2440-1 (2008).
359. *See* FINRA R. 2111(a) (2012); *see also supra* note 137 and cases cited therein.

however, should be flexible. The obligation should depend on the facts and circumstances of the particular recommendation; it should not require written disclosure, and it should not require a broker-dealer to duplicate disclosures made pursuant to other federal laws or FINRA rules.[360]

A few more points about the recommendation-disclosure obligation deserve additional consideration. As an initial matter, financial professionals should make every effort to educate customers about recommended securities and strategies, especially when those securities and strategies are complex or particularly risky. They should do so, moreover, in a manner calculated to provide customers with a full understanding of the securities and strategies.[361] While this goal is important (and perhaps necessary regarding certain types of securities and strategies), a *requirement* that customers *fully* understand recommendations not only would be nearly impossible to demonstrate, but might not always be in customers' best interests.

Financial professionals generally are expected to have a more thorough understanding of securities and strategies than their customers and to apply that expertise when assisting customers with investment decisions. That is a financial professional's job. Moreover, some segments of the investing public, for a variety of reasons (including time constraints), are not particularly interested in gaining an in-depth education about specific securities and strategies. These individuals should not be denied access to sound investment advice simply because of financial professionals' concerns over potential liability—a result that might occur if a rule *required* such a *full* understanding. Obviously, however, when recommended securities or strategies are particularly complex or risky, there is a greater need to ensure that customers understand the potential risks and benefits involved.

Imposing these disclosure obligations on broker-dealers will enhance investor protection. Such action also will create more uniformity between advisers and broker-dealers.

Both advisers and broker-dealers already are required to act in a customer's best interests when making recommendations; however, some uncertainty remains regarding the parameters of such a duty. Some have suggested that it means that a financial professional can only recommend the "best" or "cheapest" product,[362] although this is not the current standard for either advisers or

360. As noted previously, a number of FINRA rules and case law already impose various discreet disclosure obligations on broker-dealers, including some that relate to recommendations or transactions. *See supra* note 349.

361. It must be emphasized, however, that a customer's comprehension of and willingness to follow a recommendation does not (and should not) relieve a broker-dealer from only recommending a security or strategy that is suitable based on that customer's investment profile. *In re* Stein, Admin. Proc. File No. 3-10675, 2003 SEC LEXIS 338, at *14 (Feb. 10, 2003).

362. *See, e.g.*, Sarah Morgan, *The Battle Over Brokers' Duty to Their Clients Reaches a Standstill*, WALL ST. J., Jan. 24, 2012, at C7 ("Under current rules, brokers only need to ensure the products they sell their clients are 'suitable,' and not necessarily the best possible or least expensive option. . . . Advisers, on the other hand, are held to a fiduciary standard that requires them to recommend the *less-pricey option* . . . ."); Elizabeth Ody, *In Whose Best Interest? Brokers, Advisers and You*, WASH. POST, Nov. 28, 2010, at G3 ("Some advocates say that if brokers were required to meet the fiduciary standard,

broker-dealers. All financial professionals should strive to provide the best possible advice to their customers. It is unclear, however, exactly how a financial professional would quantify what is the best or cheapest product. As one securities lawyer emphasized, " 'I have never seen any case law defining the difference between suitable and best'. . . . [I]f an investor sued his or her adviser, arguing that the adviser recommended a product that was suitable but not the best, 'it would be considered frivolous.' "[363]

The SEC's IA/BD Study makes numerous references to the duty of advisers and broker-dealers to act in customers' best interests,[364] but the report does not offer any guidance beyond explaining that it includes the "obligation not to subordinate the client's interest to its own."[365] Nowhere in its comprehensive report does the SEC state, or even suggest, that advisers or broker-dealers can recommend only the best or cheapest product pursuant to this standard. It is hard to imagine the SEC failing to mention such a proposition if case law supported it or the SEC believed it to be true. Indeed, the closest support for such a proposition comes from FINRA's regulation of broker-dealers.

FINRA has brought several disciplinary actions against brokers who recommended mutual fund shares that were unsuitable for their customers because they were more costly for the customers than mutual fund shares of a different class. In one case, *Department of Enforcement v. Belden*,[366] FINRA stated that "a registered representative's suitability obligation encompasses the requirement to minimize the sales loads that a customer pays for mutual fund shares, when consistent with the customer's investment objectives."[367] Those interpretations, however, have not been read to require broker-dealers to recommend only the best or cheapest investment products. Nor should they be.[368]

As inviting as it may be to suggest that financial professionals should always limit their recommendations to the best or cheapest products, imposing a legal obligation to do so may be unrealistic. The questions that such an obligation would raise are almost limitless. How would best or cheapest be defined or

they would have to recommend the *best investments for clients*, rather than merely suitable investments, because they would be required to take their clients' best interests to heart." (emphasis added)).

363. Ody, *supra* note 362, at G3 (quoting Nelson Ebaugh, a Houston-based securities lawyer).

364. *See* IA/BD STUDY, *supra* note 2, at 22, 59, 101, 105–07, 109–10, 112.

365. *Id.* at 22.

366. No. C05010012, 2002 NASD Discip. LEXIS 12, at *13 (NAC Aug. 13, 2002), *aff'd*, Admin. Proc. File No. 3-10888, 2003 SEC LEXIS 1154 (May 14, 2003).

367. *Id.* at *13; *see also* Dep't of Enforcement v. Sathianathan, No. C9B030076, 2006 NASD Discip. LEXIS 3, at *30–32 (NAC Feb. 21, 2006) (same), *aff'd*, Admin. Proc. File No. 3-12245, 2006 SEC LEXIS 2572 (Nov. 8, 2006).

368. The better approach is to view these interpretations consistent with previous ones suggesting that the suitability rule requires consideration not only of the suitability of a recommended mutual fund, but also of the particular share class within that fund. In that regard, factors such as the cost of the share class and the customer's expected holding period would be important considerations, particularly since share classes are investments in the same funds. *See* FINRA Notice to Members 95-80, 1995 NASD LEXIS 109, at *8 (Sept. 26, 1995) ("An added concern relative to funds having multiple fee structures is not only matching the type of fund to the investor's objective, but also recommending the appropriate fee structure.").

quantified? Would financial professionals essentially be prohibited from recommending actively managed mutual funds[369] in light of historical data suggesting that less expensive index funds[370] often, although not always, outperform the former?[371] Are policymakers better equipped than market forces to make such decisions?[372] Assuming no outright legal prohibition on particular types of securities, would a financial professional need to compare *all* securities to determine the best or cheapest securities or a more limited universe of securities? If the former, can regulators realistically expect financial professionals to have the kind of knowledge of all securities that would suffice to meet the reasonable-basis suitability obligation? Would firms' product committees, which perform searching reviews of products and serve as the first line of quality control, be prohibited from limiting the universe of products that can be offered to customers? If the obligation allowed financial professionals to compare a more limited universe of securities, how would that more limited universe be defined?

As these questions suggest, there is a practical side to the analysis that policymakers must consider. Imposing a requirement that financial professionals recommend only the best or least expensive securities or investment strategies may be unworkable from an implementation standpoint, may discount the importance of numerous factors that financial professionals should consider when making recommendations,[373] and may limit customers' investment choices. Policymakers should clarify that the obligation prohibits financial professionals from placing their interests ahead of customers' interests but does not impose a legal requirement that financial professionals recommend only the best or least expensive securities or investment strategies.

369. FINRA has noted that the "particular investments a fund makes are determined by its objectives and, in the case of an actively managed fund, by the investment style and skill of the fund's professional manager or managers." *Mutual Funds*, FINRA, http://www.finra.org/Investors/SmartInvesting/ChoosingInvestments/MutualFunds/ (last visited Oct. 18, 2012).

370. Passively managed "[i]ndex funds aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all—or perhaps a representative sample—of the companies included in an index." *SEC's Invest Wisely: An Introduction to Mutual Funds*, U.S. Sec. & Exch. Comm'n (July 2, 2008), http://www.sec.gov/investor/pubs/inwsmf.htm.

371. FINRA explained, "In any given year, most actively managed funds do not beat the market. In fact, studies show that very few actively managed funds provide stronger-than-benchmark returns over long periods of time, including those with impressive short term performance records. That's why many individuals invest in funds that don't try to beat the market at all. These are passively managed funds, otherwise known as index funds." *Mutual Funds*, FINRA, http://www.finra.org/Investors/SmartInvesting/ChoosingInvestments/MutualFunds/ (last visited Oct. 18, 2012); *see also* Mark Hulbert, *Index Funds Win Again*, N.Y. Times, Feb. 21, 2009, at B5 (discussing a recent study and stating that "after fees and taxes, it is the extremely rare actively managed fund or hedge fund that does better than a simple index fund").

372. There are varying views on the appropriateness of investing in actively managed funds, a small percentage of which do outperform lower cost index funds. *See The 6% Factor: Which Fund Managers Will Outperform Index Funds?*, Knowledge@Wharton (Mar. 21, 2000), http://knowledge.wharton.upenn.edu/article.cfm?articleid=149.

373. Notice 12-25, *supra* note 137, at *13 (emphasizing, for example, that the "customer's investment profile . . . is critical to [a suitability] assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions").

To reconcile the suitability obligations of advisers and broker-dealers under a new *universal* fiduciary duty, policymakers also should consider imposing an explicit suitability rule, modeled after FINRA's rule, on advisers.[374] At present, the suitability obligations of broker-dealers and advisers simply are not coterminous. FINRA's suitability rule places much more detailed and actionable obligations on broker-dealers than does the vaguely stated, rarely enforced, implicit suitability obligation that the SEC imposes on advisers under the rubric of "fiduciary."

A universal fiduciary duty also should continue to require that advisers seek and broker-dealers provide best execution for customer orders. The SEC's guidance and FINRA rules, however, appear to provide necessary protection at present. Beyond a passing reference to their importance under the universal fiduciary duty, the best execution requirements thus would not need to be the subject of proposed rulemaking.

The suggested changes described above would create a strong universal fiduciary duty providing enhanced investor protection. The changes also would provide clearer guidance to the regulated community on the scope of their obligations. Policymakers are encouraged to give these proposed changes meaningful consideration as they review options for creating a universal fiduciary duty.

B. Other Initiatives to Enhance Investor Protection

The creation of a *universal* fiduciary standard will assist in ensuring equal protection of investors under both regimes, but, even more important, additional reform may be needed to reconcile those areas where regulation of advisers is deficient. Beyond imposing a universal fiduciary duty, with its four subparts, policymakers should consider requiring advisers to adhere to the more rigorous standards applicable to broker-dealers in a number of areas (in addition to this article's proposal to subject advisers to the broader and more detailed FINRA suitability requirements, addressed above). Policymakers, for instance, should impose on advisers the same type of admission, qualification, licensing, and continuing education requirements that currently apply to broker-dealers, with obvious tailoring for the adviser business model. At present, advisers are not subject to any such requirements.[375] As the IA/BD Study emphasized, "FINRA's process for evaluating membership applications aims to fully evaluate relevant aspects of applicants and to identify potential weaknesses in their internal systems, thereby helping to ensure that successful applicants would be capable of conducting their business in compliance with applicable regulations."[376] Furthermore, broker-dealer qualification, licensing, and continuing education requirements for registered persons create an important "barrier to entering and

374. Minor additional modifications would need to be made to the adviser version in recognition of the differences between advisers and broker-dealers, for example, where an adviser agrees to monitor a customer's portfolio and recommend changes thereto on an ongoing basis.

375. IA/BD Study, *supra* note 2, at 137–38.

376. *Id.* at 136–37.

remaining in the profession."[377] There are no such barriers for an adviser to enter and remain in the adviser industry.

Policymakers also should consider requiring advisers to submit certain types of communications with the public to supervisors and/or regulators for content review and approval, as broker-dealers currently must do. In one year alone, "FINRA reviewed more than 99,000 communications" and "completed 476 investigations involving 2,378 separate communications."[378] Although statistics are not available, the FINRA requirements for broker-dealer supervisor review of various communications presumably result in keeping myriad problematic communications from being disseminated each year. These measures help eliminate misleading communications before they can harm substantial numbers of investors. Advisers are subject to important advertising standards, but overall they are not as stringent as those imposed on broker-dealers and do not require any review and approval by adviser supervisors or regulators.[379]

Both advisers and broker-dealers are subject to supervisory obligations. The adviser model, however, might benefit from some of the detailed structure imposed on broker-dealers.[380] Broker-dealer supervisory obligations explicitly require accountability from the top of a firm's leadership on down. From mandating a significant level of commitment on the part of a firm's leadership through to requiring a direct supervisor for each registered person, FINRA's supervisory obligations send the message that such systems and procedures are not merely a formality to appease regulators.

Furthermore, policymakers should assess whether advisers should be subject to the broader broker-dealer recordkeeping requirements. Broker-dealers must create and maintain a long laundry list of specific types of documents.[381] In addition, a broker-dealer must retain all communications sent and received (external and internal), as well as all written agreements, "relating to [its] business as such."[382] At present, advisers are merely required to retain materials that fall "in specific enumerated categories, meaning that many important records relating to an adviser's business may not be available for internal supervision and compliance oversight or for inspection by Commission staff."[383]

Advisers should be required to adhere to certain financial responsibility requirements as well. Because advisers, unlike many broker-dealers, generally do not maintain custody of customer funds or securities, they should not be required to maintain high levels of net capital. Advisers, however, should be held to at least minimal standards, similar to those applied to broker-dealers that do not maintain custody of customer funds and securities. Such requirements would provide a measure of assurance that customers seeking financial guidance

377. *Id.* at 138.
378. *Id.* at 72.
379. *Id.* at 131.
380. *Id.* at 135.
381. *See* Exchange Act Rule 17a-3, 17 C.F.R. § 240.17a-3 (2012).
382. Exchange Act Rule 17a-4(b)(4), (7), 17 C.F.R. § 240.17a-4(b)(4), (7) (2012).
383. IA/BD Study, *supra* note 2, at 139.

(and often paying fees on an annual basis for services to be rendered throughout the year) are dealing with an entity that is itself financially responsible and not operating at or near a loss.

Advisers also should be subject to the type of self-reporting obligations to which broker-dealers must adhere. Broker-dealer self-reporting to FINRA of customer complaints, various types of civil and criminal actions, and certain internal conclusions of wrongdoing provide critical information to FINRA and can stop misconduct before greater harm to customers or the integrity of the markets occurs.

Perhaps the most significant reform that could occur would be to subject advisers to meaningful examinations and enforcement actions. The examination of advisers every eleven years and the almost complete lack of enforcement actions brought against them are disconcerting. As one SEC commissioner recently explained, the SRO model offers many benefits and certainly would enhance adviser examination efforts.[384] Policymakers, however, must take action to provide stricter oversight of advisers, irrespective of whether they choose to adopt the SRO model, increase the SEC's funding, or enable the SEC examination program to be self-funded through user fees. Imposing more stringent obligations will mean very little without appropriate oversight.

Finally, it must be acknowledged that advisers and broker-dealers generally use distinct fee structures and offer some differing services. As noted earlier, advisers primarily charge an asset-based fee, while broker-dealers primarily charge a commission or other fee for each transaction. The advisers' fee structure has the benefit of reducing incentives to recommend securities simply to procure commissions. In theory, such a fee structure may be more justifiable in the adviser context because many advisers, by agreement with their customers, have ongoing responsibilities to monitor customer accounts and, when appropriate, recommend changes to the investment holdings in the accounts.[385] An asset-based fee arrangement essentially allows advisers to receive remuneration for such ongoing monitoring, among other services. Broker-dealers normally do not have such ongoing responsibilities. As discussed below, moreover, charging an asset-based fee does not always benefit customers.

In Dodd-Frank, Congress considered but rejected a prohibition on charging commissions.[386] Congress also stated in Dodd-Frank that a broker-dealer

384. Commissioner Statement on IA Examinations Study, *supra* note 12, at 2.

385. IA/BD Study, *supra* note 2, at 13 (noting that some advisers offer arrangements whereby they agree to provide ongoing investment advice). It is important to emphasize, however, that an asset-based fee arrangement can be extremely beneficial to advisers because it provides them with a regular (and, depending on the circumstances, higher) income stream. That is, an adviser that charges annual or quarterly fees based on a percentage of the value of assets under management has a more regular (and potentially higher) income stream from each customer than does an adviser or other entity that charges transaction-based or hourly fees. After all, many customers trade or seek advice infrequently or sporadically. An adviser charging an asset-based fee would still get paid during those periods of inactivity. An adviser charging transaction-based or hourly fees would not.

386. *See* Dodd-Frank § 913(g), 15 U.S.C.A. §§ 78o, 80b-11 (West 2009 & Supp. 2012); *see also* Exchange Act § 15(k)(1), 15 U.S.C. § 78o(k)(1) (2006 & Supp. IV 2010).

would not be required to have a "continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."[387] Those decisions were prudent, not simply because the alternative would have required thousands of businesses to alter radically their business models and incur massive costs in the process, but the decisions preserve investors' choices regarding financial services and fee structures.

Some broker-dealers have moved toward the adviser model of charging asset-based fees.[388] What broker-dealers, their customers, and regulators have discovered, however, is that asset-based fee arrangements can result in higher fees for customers than if they paid commissions on a per-transaction basis.[389] Broker-dealer customers who use "buy and hold" strategies (or otherwise trade infrequently) and who seek investment advice only sporadically inevitably pay much higher fees under an asset-based model without any concomitant benefits.[390] Indeed, regulators brought a number of disciplinary actions against broker-dealers that had placed customers in fee-based accounts for whom such accounts were inappropriate.[391]

This article does not take a position on which fee structures and business models are more appropriate. All fee structures and business models have benefits and drawbacks. The appropriateness of a fee structure or type of financial service for a particular investor will depend on a variety of factors, including the investor's objectives, investment experience, preferred investment strategy, and need or desire for ongoing or frequent investment advice. Providing customers with a choice of fee structures and financial services, however, is undoubtedly a desirable approach.

VII. Conclusion

In recently discussing the need for greater investor protection, the SEC's Chairperson stressed that all financial professionals providing similar services "should be subject to the same standard of conduct."[392] Unquestionably, that would be the best outcome. On the broker-dealer side, that would mean imposing a new, broad disclosure obligation. Broker-dealers already are subject to the

387. *See supra* note 386.

388. *See* FINRA Notice to Members 03-68, 2003 NASD LEXIS 78, at *1 (Nov. 2003).

389. *Id.* at *4.

390. *Id.*; *see also supra* note 385 and discussion therein.

391. *See In re* A.G. Edwards & Sons, Inc., NYSE Hearing Panel Decision 06-133, 2006 NYSE Disc. Action LEXIS 143, at *11–14 (July 10, 2006) (finding firms inappropriately maintained customers in fee-based accounts that were more expensive in light of the trading activity); *In re* Oppenheimer & Co., NYSE Hearing Panel Decision 05-190, 2005 NYSE Disc. Action LEXIS 112, at *40–41 (Dec. 29, 2005) (finding violations where firm allowed customers to be charged significantly more for fee-based accounts than if the customers had paid commissions); Press Release, FINRA, NASD Orders Morgan Stanley to Pay Over $6.1 Million for Fee-Based Account Violations (Aug. 2, 2005), *available at* http://www.finra.org/Newsroom/News Releases/2005/P014804; Press Release, FINRA, NASD Fines Raymond James $750,000 for Fee-Based Account Violations (Apr. 27, 2005), *available at* http://www.finra.org/Newsroom/NewsReleases/2005/P013876.

392. Alexis Leondis & Elizabeth Hester, *Proposed Rules for Brokers May Remake Industry*, Wash. Post, June 21, 2009, at G3 (quoting SEC Chairperson Mary L. Schapiro).

other aspects of the adviser fiduciary duty, although clarifying the adviser and broker-dealer obligation to act in the customer's best interests would be helpful.

What may surprise many unfamiliar with the current obligations of advisers and broker-dealers is that Congress or the SEC will need to impose new obligations on advisers and subject them to regular examinations and enforcement actions before the two models provide similar levels of investor protection. True regulatory reform of financial professionals cannot focus solely on the need to improve the broker-dealer model. Broker-dealers are subject to many more explicit investor-protection obligations than are advisers. Policymakers should consider imposing several of these obligations on advisers, such as broker-dealer requirements regarding admission, qualification, licensing, continuing education, communications with the public, supervision, recordkeeping, financial responsibility, and self-reporting of violations. In addition, advisers' fiduciary duties include the obligation to provide suitable advice, but this obligation is ill-defined and, in practice, far less actionable than that imposed on broker-dealers. That must be remedied. Imposing on advisers some of the more prescriptive and actionable broker-dealer obligations mentioned above would be a significant start toward real harmonization.

Perhaps most important is closing the huge gaps that exist in the oversight examination and enforcement of adviser obligations. The infrequency with which advisers are examined and disciplined in comparison with broker-dealers is troubling. The obligations that are imposed on advisers, whether they remain the same or are enhanced to make them comparable with those of broker-dealers, are of little consequence without meaningful examinations and enforcement actions.

Differences in regulatory oversight may result in financial professionals deciding to act in a capacity that subjects them to the least oversight. Advisers and broker-dealers both provide investment advice to customers (and often offer other similar services). At present, however, advisers are subject to vastly different levels of regulatory oversight than are broker-dealers. Policymakers must consider the possibility that financial professionals offering similar services may choose a form of registration (adviser or broker-dealer) that will subject them to the least regulatory oversight and reduce the risk of discipline for misconduct. Imposing uniform levels of regulatory oversight on both advisers and broker-dealers would eliminate such considerations, which in turn would promote competition and maintain investor choices. More important, it would ensure that all investors receive the same level of protection.

Regardless of the outcome, the debate on the appropriate standards of care and level of regulatory oversight should be well informed and clear. Both models have something to offer to regulatory reform. However, the widely held belief that broker-dealers are subject to substantially lower standards of conduct is illusory.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Outside Business Activities Reviews, Approval and Monitoring
Wednesday, November 11
3:30 p.m. – 4:30 p.m.

Join industry practitioners and FINRA staff as they cover the key requirements of the outside business activities (OBA) rules. FINRA panelists discuss common OBA deficiencies found during examinations. Panelists share effective practices regarding policies and procedures for identifying, documenting and disclosing OBAs.

Moderator:

Christopher LeVasseur
Associate Director
FINRA Los Angeles District Office

Panelists:

Donald Runkle
Regulatory Compliance Director
Coordinated Capital Securities, Inc.

Tammy Tam
Principal Consultant
ACA Compliance Group

Elizabeth Wilson
Executive Vice President and Chief Compliance Officer
O'Neil Securities, Inc.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Outside Business Activities Reviews, Approval and Monitoring Panelist Bios:

Moderator:

Chris LeVasseur is the Associate Director of the FINRA Los Angeles District Office where he is responsible for managing the District Office's regulatory programs. Mr. LeVasseur has been with FINRA/NASD since 1996 and was previously an Examination Manager in the Los Angeles and San Francisco District Offices. Mr. LeVasseur is designated as a Certified Regulatory and Compliance Professional by the FINRA Institute. Mr. LeVasseur graduated with a Bachelor of Arts degree in Economics and Psychology from Lafayette College and a Masters of Business Administration degree from National University.

Panelists:

Don Runkle is the Regulatory Compliance Director for Coordinated Capital Securities, Inc. In his role with CCS, Mr. Runkle helps to ensure that the firm has appropriate processes and procedures to exceed all regulatory requirements and manage risks in an efficient and effective fashion. He also assists with the execution of all procedures as necessary, including support functions in examinations, regulatory inquiries, customer complaints, options activities, municipal bond activities, new and ongoing product reviews, suitability analyses, and general operational and compliance functions. Mr. Runkle also serves as the Director of Consulting Services at Edgerton and Weaver, LLC. Mr. Runkle works with the firm's staff to help broker-dealers, investment advisers, and registered representatives develop, implement, and execute strategies to mitigate or eliminate their litigation and regulatory risks. The combination of the firm's legal expertise, strong regulatory relationships, and extensive business experience makes the firm a unique "one stop shop" for clients. Prior to joining the Edgerton and Weaver, he was the Chief Compliance Officer for Raymond James Financial Services, Inc., in St. Petersburg, Florida. He has over 23 years of experience in the financial services industry, having worked as a financial advisor and in several compliance-related roles. Mr. Runkle has been an active leader in numerous industry associations and regulatory committees. He currently serves on the FINRA Membership Committee, and he was previously elected to two terms on the FINRA District 7 Committee. He has also served on the FINRA Regulatory Advisory Committee, the SIFMA Compliance and Regulatory Policy Committee, the FSI Compliance Council, and the SIFMA Compliance and Legal Society's Regional Firms Committee. Previous industry involvement also includes the FINRA Compliance Resources and Education Committee, the FINRA Books and Records Task Force, the NASD Licensing and Registrations Council, the SIFMA Self-Regulations and Supervisory Practices Committee, the SIFMA State Regulation and Legislation Committee, and the IAFP Compliance Advisory Council. He holds numerous industry licenses, including the Series 7, 24, 53, 4, 63, 65, and previously obtained the Florida Life and Health insurance license. He also completed the Securities Industry Institute at the University of Pennsylvania Wharton School in 2004, and he has been a FINRA arbitrator since 1998.

Tammy Tam joined ACA in July 2014 as a Principal Consultant in the New York City office. Prior to joining ACA, Ms. Tam spent nine years at the FINRA Boston Office. She worked as a Senior Compliance Examiner until 2006, when she became a Regulatory Principal and then a Principal Examiner. During her time at FINRA, Ms. Tam led or managed examinations that included investment banking, investment management, research and trading firms. Ms. Tam is experienced with FINRA, MSRB and SEC rules that apply to broker-dealer activities. Ms. Tam earned a B.A. in Economics and a B.A. in International Relations from Boston University. She is also a Certified Financial Services Auditor, IIA ("CFSA") and holds a Graduate Certificate in Forensic Accounting from Northeastern University. She currently is an active Certified Anti-Money Laundering Specialist (CAMS).

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Elizabeth Wilson, is the EVP, Chief Compliance Officer for O'Neil Securities, Inc. Servicing the investment community since 1963, O'Neil Securities provides trading services to institutional clients, including pension and mutual funds, hedge funds, banks, insurance companies, and corporations. In her role as CCO since 1998, Ms. Wilson's responsibilities include overarching elements like WSPs and facilitating all regulatory examinations and responses, reports, filings and record keeping; business function elements such as registrations and licensing, regular oversight as well as trend analysis, and; associate interaction elements such as procedural review for policy updates, annual training, and critical initial orientation meetings with each new hire to ensure proper understanding of the compliance perspective of the firm as well as coverage and acknowledgment of compliance policies. Prior to joining O'Neil Securities, Ms. Wilson was a Senior Compliance Examiner for Prudential Securities, traveling throughout the US conducting branch office inspections and often providing annual compliance meetings for the branch during the review. Training of new examiners was a significant part of her role over her tenure starting in 1994. Ms. Wilson entered the financial services industry in 1992 as a New Accounts/Compliance Supervisor at Kidder Peabody. She received both her master's and bachelor's degrees in Business Economics from University of California at Santa Barbara.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Outside Business Activities: Reviews, Approval and Monitoring

Panelists

Moderator:

- Christopher LeVasseur, Associate Director, FINRA Los Angeles District Office

Panelists:

- Donald Runkle, Regulatory Compliance Director, Coordinated Capital Securities, Inc.
- Tammy Tam, Principal Consultant, ACA Compliance Group
- Elizabeth Wilson, Executive Vice President and Chief Compliance Officer, O'Neil Securities, Inc.

What is an Outside Business Activity (OBA)?

- **FINRA Rule 3270**
  - **Business activity outside the scope of the relationship with his or her member firm**
- **Details on rule requirements**
  - **Employee, independent contractor, sole proprietor, officer, director or partner of another person**
  - **Receive compensation, or**
  - **Reasonable expectation of compensation**

© 2015 FINRA. All rights reserved.

What is an Outside Business Activity (OBA)? (Cont.)

- **Considerations**
  - Activity does not interfere with registered person's responsibilities to the member
  - Activity should not be viewed by customers or the public as part of the member's business
- **Complications**
  - Sports coach – compensation vs. voluntary
  - Owner of a company – the company offers financial-like services (e.g. accounting, retirement planning)
  - Member of a Board – company was non-public, now decides to do an IPO
  - What happens when the scope of the OBA changes?

© 2015 FINRA. All rights reserved.

Basic Procedures for OBA

- Representatives must provide prior written notice to the firm
- The firm should review the activities of the OBA and either provide approval or rejection
- Records must be kept evidencing the firm's consideration of conflicts and approval/rejection of activity

© 2015 FINRA. All rights reserved.

Additional considerations involving OBAs

- Firm's risk tolerance for OBAs
- New employees
- Client disclosure
  - Representatives soliciting firm clients for outside business
  - Independent contractor model vs. affiliated entities model
- Ongoing monitoring
- Branch inspections
- Form filings

© 2015 FINRA. All rights reserved.

Mitigating Conflicts

- **Reject the OBA**
  - How is that documented
  - Do we request acknowledgment in writing?
- **Placing limitations on the activity**
  - How do you determine the limitations?
  - How much monitoring is needed?

© 2015 FINRA. All rights reserved.

OBA vs. Private Securities Transactions (PST)

- **What is a PST**
  - **FINRA Rule 3280 – 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**
  - **PST can be grouped into two categories**
    - Transactions in which an associated person is selling securities to public investors on behalf of another party
    - Transactions in securities owned by the associated person
- **A review of OBA can involve a review of PST**
  - **How to determine if a reported OBA is a PST**
  - **What to do if the activity is a PST**

© 2015 FINRA. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Supervision: From Procedures to Implementation
Thursday, November 12
9:00 a.m. – 10:00 a.m.

This session provides an overview of the key requirements of the supervision rules. Join industry panelists as they share their firms' practices for keeping up to-date written supervisory procedures. Panelists also discuss their procedures for hiring, retaining and supervising personnel.

Moderator:

Kosha Dalal
Associate Vice President and Associate General Counsel
FINRA Office of General Council

Panelists:

Linde Murphy
Chief Compliance Officer
M.E. Allison & Co., Inc.

Fernando Paiz
Examination Manager
FINRA Los Angeles District Office

Sandy Pappalardo
Vice President, Branch Supervision
Sorrento Pacific Financial, LLC

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Supervision: From Procedures to Implementation Panelist Bios:

Moderator:

Kosha Dalal is Associate Vice President and Associate General Counsel with FINRA's Office of General Counsel. In this role, she provides legal guidance on various policy initiatives and rule changes/interpretations including, supervision, non-cash compensation, branch office, customer account statements, payments to unregistered persons and corporate actions. She has been with FINRA's Office of General Counsel since 2000. Prior to coming to FINRA, she was an associate with the law firm of Venable in Baltimore, MD, Kalkines Zall in New York, NY and Skaden Arps in New York, NY. Ms. Dalal attended Columbia University in New York, NY where she received a bachelor's degree in political science and economics. She received her law degree from Brooklyn Law School.

Panelists:

Linde Murphy is Chief Compliance Officer for M.E. Allison & Co., Inc., a full service broker/dealer and Texas registered investment adviser. Founded in 1946, the firm also provides municipalities with advisory and underwriting services. In 2012, Ms. Murphy joined Presidio Financial Services as they began the CMA process to join M.E. Allison & Co., Inc. Ms. Murphy started her career in investments on a trading desk in Chicago in 1999 and has held positions in compliance, sales, business development and management. Ms. Murphy graduated with honors from American University in Washington, D.C. with a Bachelor's of Science in Business Administration focusing on international finance. In addition to the pertinent industry licenses, Ms. Murphy obtained the CRCP™ designation in 2014 after attending the FINRA Institute at Wharton on the FINRA Small Firm scholarship.

Fernando Paiz is an Examination Manager with FINRA's Member Regulation Department in Los Angeles. He has been with FINRA since 2005. Prior to joining FINRA (formerly NASD), Mr. Paiz worked as a retail Registered Representative for AXA Advisors. Prior to becoming a Registered Representative, he worked 13 years as a Peace Officer for the Los Angeles County Sheriff's Department, which included expertise in a variety of criminal matters, including but not limited to, Forgery Fraud. Mr. Paiz has a Bachelor of Arts Degree in Business Administration – Finance from California State University Fullerton.

Sandy Pappalardo is Vice President of Branch Supervision for Sorrento Pacific Financial, LLC and has been in the financial services industry for more than 20 years. She has held various compliance and operations positions for both broker-dealers and investment advisers. She also spent several years working for compliance consulting firms and now serves as a FINRA District Committee Member representing District 2. Ms. Pappalardo graduated from the University of New Hampshire with a bachelor's degree in economics. Her professional designations include general securities representative (Series 7), general securities principal (Series 24), financial and operations principal (Series 27), municipal fund securities principal (Series 51), operations professional (Series 99) and investment adviser representative (Series 66).

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Supervision – From Procedures to Implementation

Panelists

Moderator:

- Kosha Dalal, Associate Vice President and Associate General Counsel, FINRA Office of General Counsel, Regulatory Policy and Oversight

Panelists:

- Linde Murphy, Chief Compliance Officer, M.E. Allison & Co., Inc.
- Fernando Paiz, Examination Manager, FINRA Los Angeles District Office
- Sandy Pappalardo, Vice President, Branch Supervision, Sorrento Pacific Financial, LLC

© 2015 FINRA. All rights reserved.

Overview of Topics

- New Supervision Rule
- Supervision and Inspection of Offices
- Keeping Written Supervisory Procedures Current
- Conducting Risk-based Reviews of Correspondence, Internal Communications and Transactions
- Updating Form U-4 Information/Background Checks

© 2015 FINRA. All rights reserved.

Overview of FINRA's New Consolidated Supervision Rules (3110 and 3120)

- **SEC Approved SR-FINRA-2013-25 on December 23, 2013.**
- **FINRA published Regulatory Notice 14-10 to announce December 1, 2014 as the effective date for the new rules, except for deletion of Incorporated NYSE Rules 343, 343.10 and NYSE Rule Interpretation 343(a)/01 relating to space sharing arrangements which became effective on April 7, 2014.**
- **Adopted the following new FINRA Rules:**
  - **3110 (Supervision), replaced NASD Rule 3010;**
  - **3120 (Supervisory Control Systems), replaced NASD Rule 3012;**
  - **3150 (Holding Customer Mail), replaced NASD Rule 3010(i); and**
  - **3170 (Tape Recording of Registered Person by Certain Firms), replaced NASD Rule 3010(b)(2).**

Highlights of Consolidated FINRA Rules 3110 and 3120

- **Rules restate and continue to apply core supervision concepts.**
  - **FINRA Rule 3110 requires a firm to have a supervisory system for the activities of its associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.**
- **Rules codify a number of existing FINRA interpretations.**

© 2015 FINRA. All rights reserved.

Highlights of Consolidated FINRA Rules 3110 and 3120

- **Rules add new provisions or guidance, including, among others, in the following areas:**
  - Presence of on-site principal for OSJ
  - Risk-based review principles
  - Avoiding conflicts of interest in supervision
  - Frequency of office inspections
  - Annual compliance meetings
  - Insider trading policies
  - Holding mail for customers
- **Clarification Regarding Supplementary Material. Supplementary Material at the end of a rule is part of the rule, and a provision's location as supplementary material is intended to improve the readability of the rule without affecting the weight, significance, or enforceability of the provision.**

© 2015 FINRA. All rights reserved.

Polling Question #1

- **How many offices (both registered and unregistered) does your firm have?**

  a) 1-5 offices
  b) 6-10 offices
  c) 11-25 offices
  d) 26-50 offices
  e) 51+ offices

© 2015 FINRA. All rights reserved.

Supervision and Inspection of Offices

- Branch Office and OSJs
- Designating Branch Principals
- Supervision of Remote Locations Offices
- Managing Conflicts of Interest in Supervision – New Rule 3110(b)(6)
- Inspection Cycles/Red Flags
- Different Supervisory Models
- Challenges

© 2015 FINRA. All rights reserved.

Polling Question #2

- **What is your firm's most significant challenge relating to the supervision and inspection of offices?**

  a) **Managing conflicts of interest**
  b) **Remote supervision and inspection of offices**
  c) **Communicating with, and training of, representatives**
  d) **Having access to appropriate technology**

Joint FINRA and SEC Branch Inspection Alert

- **In November 2011, FINRA and the SEC issued a joint report on broker-dealer branch inspections.**
  - ***http://www.finra.org/sites/default/files/NoticeDocument/p125204.pdf***
- **OCIE and FINRA examination staff observed that firms that execute the branch inspection process well typically:**
  - tailor the focus of branch exams to the business conducted in that branch and assess the risks specific to that business;
  - schedule the frequency and intensity of exams based on underlying risk, rather than on an arbitrary cycle, but examine branch offices at least annually;
  - engage in a significant percentage of unannounced exams, selected through a combination of risk based analysis and random selection;
  - deploy sufficiently senior branch office examiners who understand the business and have the gravitas to challenge assumptions; and
  - design procedures to avoid conflicts of interest by examiners that may serve to undermine complete and effective inspection.

Keeping Written Supervisory Procedures Current

- **Establish WSPs**
- **Maintain WSPs**
- **Implement WSPs**
- **FINRA Rule 3110(a)(1) requires a firm's supervisory system to provide for the establishment and maintenance of written supervisory procedures.**
- **FINRA Rule 3110(b) (Written Procedures) requires a firm to establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.**

© 2015 FINRA. All rights reserved.

Polling Question #3

- **What resource does your firm primarily rely on to keep its WSPs current?**

  a) **CCO review of rule filings and Regulatory Notices on a periodic basis**
  b) **FINRA email alerts**
  c) **Outside vendors or consultants**
  d) **Conferences or seminars for compliance professionals**
  e) **Trade publications**

Conducting Risk-based Reviews of Correspondence, Internal Communications and Transactions

- Internal Communications (emails, written complaints, communications between research and non-research, communications that require principal pre-approval)
- Correspondence
- Evidence of Review and Delegation
- Review of Securities Transactions
- Use of Risk-based systems, principal responsibility and delegation
- Challenges

© 2015 FINRA. All rights reserved.

Updating Form U-4 Information/Background Checks

- A critical part of the registration process in the securities industry is the background investigation of applicants for registration and the timely and accurate reporting of information to the Central Registration Depository (CRD®) system via the Form U4.
- FINRA Rule 3110(e) requires that each member firm ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the firm applies to register that applicant with FINRA and before making a representation to that effect on the application for registration.
- See FINRA Regulatory Notice 15-05 (March 2015).

Polling Question #4

- **How many registered representatives does your firm have?**

  a) 1-10
  b) 11-50
  c) 51-100
  d) 100+

Updating Form U-4 Information/Background Checks

- **Verification Process**
  - A firm must adopt written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant's Form U4 by no later than 30 calendar days after an initial or a transfer Form U4 is filed with FINRA.
- **What steps should your firm take?**
  - Verify identity and name by checking valid state-issued driver's license.
  - Verify pervious employers.
  - National search of reasonably available public records conducted by the firm or a third-party service provider to verify the accuracy and completeness of the information contained in an applicant's Form U4.
  - Public records include, but are not limited to general information, such as name and address of individuals, criminal records, bankruptcy records, civil litigations and judgments, liens, and business records.

© 2015 FINRA. All rights reserved.

Questions and Wrap-up

- Final Thoughts from Panelists
- Questions from Audience

TELEPHONE
AREA CODE 210
930-4000

TELECOPIER
AREA CODE 210
930-4001

M. E. Allison & Co., Inc.
INVESTMENT BANKERS
950 East Basse Road, Second Floor
San Antonio, Texas 78209-1831

List of Resources

Many companies provide white pages and articles discussing industry hotspots:

- ACA Compliance Group
- Regulatory Compliance, LLC (Regline)
- McCormick/O'Brien, LLP.
- Quest CE
- Broker/Dealer Law Corner – Alan Wolper Articles
- Investment News
- Bill Winterberg

Networking Groups:

- NSCP
- Local Compliance Groups

Other resources:

- FINRA Webinars
- FINRA podcasts

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Lessons Learned by Experienced CEOs of Broker-Dealers
Thursday, November 12
10:15 a.m. – 11:15 a.m.

During this session, FINRA moderates a discussion with seasoned small firm business owners about the common pitfalls of new firms, and share helpful hints and effective practices that have made their business models successful.

Moderator:
John Veator
Senior Director
FINRA Member Relation and Education

Panelists:
Mark Cresap
President
Cresap, Inc.

Robert Muh
Chief Executive Officer and Chief Compliance Officer
Sutter Securities

Paige Pierce
Chief Executive Officer
RW Smith & Associates, LLC

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Lessons Learned by Experienced CEOs of Broker-Dealers Panelist Bios:

Moderator:

John Veator is a Senior Director in FINRA's Office of Member Relations and Education. His duties include advising firms on FINRA initiatives, rules and resources. He also collects feedback from the industry and advocates for changes to FINRA's programs where appropriate. Previously, he was a senior counsel in FINRA's Regulatory Policy Office, where he advised FINRA exam staff on rule interpretations and prosecuted administrative actions. He was also a senior staff member of FINRA's Registration and Disclosure Department, where he advised on state securities laws and processes. Prior to joining FINRA, Mr. Veator served as the North American Securities Administrators Association's (NASAA) Deputy General Counsel and was NASAA's Acting General Counsel when he left the association to join NASD. Mr. Veator received his bachelor's degree from Colgate University and his JD from Vanderbilt Law School.

Panelists:

Mark W. Cresap III is the President and owner of Cresap, Inc., a position he has held since 1990. Cresap, Inc. is a fully disclosed broker-dealer and Pennsylvania-registered investment adviser with 40 registered representatives. Previously, from 1980 to 1989, Mr. Cresap was the President of PML Securities (aka 1717 Capital Management), a broker-dealer subsidiary of Provident Mutual Insurance. He was responsible for more than 1,800 registered representatives. Before that, Mr. Cresap worked as regional sales director for CIGNA Securities and as a registered representative for W. H. Newbolds & Sons. Mr. Cresap is a current member of the FINRA Board of Governors. He previously served as Chair of the FINRA Small Firm Advisory Board, Chair of a FINRA District Committee, FINRA Nominating Committee Chair, and as a member of the FINRA Membership Committee. He received his bachelor's degree from Williams College.

Robert A. Muh co-founded Sutter Securities Incorporated in 1992 where he is the Chief Executive Officer and the Chief Compliance officer. Sutter is a San Francisco based full service broker-dealer specializing in fixed income products including municipal bonds, institutional private placements primarily for small and medium sized public companies and providing expert testimony in securities related litigation or arbitration. Sutter has also been approved to operate an Alternative Trading System to provide financing for major infrastructure projects. Mr. Muh has served on FINRA's Small Firm Advisory Board and the National Arbitration and Mediation Committee. He currently serves as a member of District Committee No.1. From 1978 to June 1987, Mr. Muh was a senior managing director with Bear Stearns & Co. Mr. Muh was head of the Bear Stearns Los Angeles corporate finance department until 1984 when he relocated to San Francisco to manage all of the firm's business activities in the Pacific Northwest. Mr. Muh has supervised numerous public offerings and merger assignments. Prior to joining Bear Stearns, Mr. Muh was chairman of Newburger, Loeb & Co., Inc. a New York Stock Exchange member firm and a management consultant with McKinsey & Co. in New York. Mr. Muh has a bachelor's degree from the Massachusetts Institute of Technology and both an MBA and a Master of Philosophy degree from Columbia University. While at Columbia, Mr. Muh was an Adjunct Assistant Professor of Finance. Mr. Muh is currently an Adjunct Professor at the University of San Francisco Law School where he is on the Advisory Board to the University's Investor Justice Project.

Paige W. Pierce is the President and Chief Executive Officer of RW Smith & Associates, LLC. Ms. Pierce brings over 30 years of senior level investment industry experience with small firms and major corporate entities in the North American capital markets to RW Smith. Ms. Pierce has extensive trading and sales, compliance, operational, business and product development, as well as strategic partner development experience both domestically and internationally. In her current position she oversees the growth and

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

strategy of the firm, works closely with industry regulators, and continues to focus on ensuring small firms and their customers have access to information flow, extended distribution networks, price transparency and the wholesale market. She was elected to represent the Small Firm sector of the investment industry, currently over 3700 firms, on the Financial Industry Regulatory Authority's National Adjudicatory Council, which is the appellate court for regulatory actions brought by FINRA against members and member firms within the investment industry, as well as membership application reviews. Ms. Pierce actively serves as a member of the Securities Industry and Financial Markets Association Small Firms Advisory Committee, Municipal Executive Committee, Municipal Broker's Broker Committee (Chair 2008-11 and 2015), and the Emergency Markets & Calendar Committee. In 2008, she was elected to serve a 3-year term on the FINRA District 3 Committee (Chair 2010-11) and currently serves on the FINRA Fixed Income Committee. She serves as hearing panelist for cases brought by or through FINRA and is a frequent speaker at industry events. Ms. Pierce co-founded the Women in the Investment Industry PSA group, is a member of the Utah Chapter of the World Presidents' Organization and previously held both the Network Chair position of the Utah Chapter of the Young Presidents' Organization (2011-13) and the position of Chair of the YPO Pacific Region Women's International Network (2007-09). She is currently on the YPO Advisory Board with Stanford University and has represented the Small Firm sector of the municipal bond market in Municipal and Credit Markets meetings with the Federal Reserve Chairman. In 2008, she was appointed by the United States Air Force 388th Fighter Wing as Honorary Commander at Hill Air Force Base in Utah and serves to this day with pride. She is also currently on the Board of Directors for RW Smith, the Municipal Bond Information Services (MBIS) and the National Association of Broker Dealers (NABD).

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Lessons Learned By Experienced CEOs of Broker-Dealers

FINRA

Panelists

Moderator:

- John Veator, Senior Director, FINRA Member Relations and Education

Panelists:

- Mark Cresap, President, Cresap, Inc.
- Bob Muh, Chief Executive Officer and Chief Compliance Officer, Sutter Securities
- Paige Pierce, Chief Executive Officer, RW Smith & Associates, LLC

© 2015 FINRA. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Operational Best Practices: Day to Day Responsibilities
Thursday, November 12
11:30 a.m. – 12:30 p.m.

During this session, industry panelists and FINRA staff discuss operational best practices for small firms. Panelists provide strategies to help take the guesswork out of assembling an effective back office. Learn how practitioners manage the challenges they encounter and the effective practices they have implemented to simplify their day-to-day responsibilities.

Moderator:
David Greene
District Director
FINRA Los Angeles District Office

Panelists:
Whitney Bullock
Chief Compliance Office
Wescom Financial Services, LLC

Allan Goldstein
Chief Operating Officer, Chief Compliance Officer and Chief Financial Officer
Trade Informatics LLC

James H. Williams
President
Gogan & Williams

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Operational Best Practices: Day to Day Responsibilities Panelist Bios:

Moderator:

David Greene is director of FINRA Los Angeles - District 2 - Member Regulation Sales Practice. He served in the same role at NASD before its 2007 consolidation with NYSE Member Regulation, which resulted in the formation of FINRA. In his capacity as District Director, Mr. Greene oversees the Sales Practice oversight process of FINRA-regulated securities firms based in District 2, as well their employees, with responsibility for ongoing surveillance, examinations and investigations. In January 2000, Mr. Greene joined FINRA (then NASD) as a Regional Counsel for FINRA's Enforcement Department, and was based in the Los Angeles District Office. For two and a half years preceding his appointment as Director, Mr. Greene served as the Deputy Regional Chief Counsel, FINRA Enforcement Western Region, where his responsibilities included managing Enforcement attorneys in FINRA district offices of Los Angeles, San Francisco, Denver and Seattle, developing and overseeing FINRA's national non-summary proceedings programs, as well as his own Enforcement docket. Among the significant cases Mr. Greene handled were those involving mutual fund share classes, gifts and gratuities, market timing, brokered certificates of deposit, sales practice violations, and operational compliance issues. Prior to joining FINRA, Mr. Greene was associated with a law firm in Los Angeles for 10 years. Mr. Greene received his undergraduate degree from Pepperdine University and his Juris Doctorate from Southwestern University School of Law. Mr. Greene is licensed to practice law in California, and is admitted to practice before various federal courts. He is an Executive Committee Liaison of the Los Angeles County Bar Association Business & Corporations Law Section and is frequently a speaker at securities industry events. Mr. Greene is also designated as a Certified Regulatory and Compliance Professional through the FINRA Institute at Wharton.

Panelists:

Whitney Bullock is the Chief Compliance Officer for Wescom Financial Services (WFS), a full-service broker-dealer and investment advisory firm with $963 million in assets under management. With 14 years of experience in the securities industry, Ms. Bullock is primarily responsible for all Compliance/Legal matters at WFS including the development, implementation, and assessment of the firm's compliance program as well as the compliance training and supervision of its 15 Financial Advisors and 21 Platform Representatives. Since joining WFS in 2002, Ms. Bullock has played a crucial role in the development and implementation of compliance procedures and was instrumental in WFS's 2005 transition to become its own broker-dealer. Prior to being appointed Chief Compliance Officer in 2012, WFS faced the common small-firm challenge of balancing FINRA regulatory and compliance standards with production. In just two years, Ms. Bullock successfully identified procedural weaknesses within the firm and developed and implemented Supervisory Controls and Suitability guidelines that led to WFS completing its 2014 FINRA Examination without exceptions. Ms. Bullock graduated from University of North Carolina at Wilmington where she majored in Political Science. She maintains her series 7, 24, 53, 66 and 63 licenses.

Allan Goldstein is CFO, COO and CCO of Trade Informatics, and is responsible for all compliance and regulatory matters as well as day-to-day operational and financial management of the firm. Mr. Goldstein has worked in the securities industry since 1985, when he began as a Specialist Trading Assistant on the NYSE trading floor. He later operated as an independent floor broker at the NYSE serving as CCO, CFO and FINOP with the floor based "Direct Access" institutional brokerage Safir Securities. Mr. Goldstein has additional experience as an Institutional Sales Trader in global equities and fixed income with Friemark Blair & Co., Chief Compliance Officer at Bear Hunter Structured Products, and Compliance Officer at Bear Wagner Specialists, as part of a team designing its electronic market making business on the Archipelago Exchange. Mr. Goldstein earned his bachelor degree and MBA in Finance and Statistics from the Stern School of Business at New York University.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

James H. Williams is the President of Gogan & Williams, an accommodation broker dealer, located in northern California. Mr. Williams has over 30 years' experience in the securities' industry as a CFO, CCO, FINOP, President and owner. Mr. Williams began his securities career in 1985 as the CFO, CCO and FINOP for Planned Investments Inc., a general securities' firm located in San Francisco, CA. In 1988, he became the Senior V.P., CFO and CCO for Grigsby Brandford, a municipal bond underwriting firm in San Francisco with branch offices in many major cities across the country. In 1992, he founded Financial Telesis Inc. (FTI), a California based broker dealer and RIA, specializing in providing services and support for retirement plan and wealth management representatives and advisors. At the time of its sale in July, 2014, FTI had over 480 reps/advisors, and produced in excess of $81M of annual commissions and fees. He has extensive regulatory experience, including a three year term for the NASD District 1 Committee (2008-2010), and was elected Chairman of that committee in 2010. He is a currently serving a three year term as a member of the FINRA District 1 Committee (2015-2017). He was also a member of the 2010 FINRA Advisory Council. He was elected to the mid-size firm seat on FINRA's National Adjudicatory Council (NAC) for the 2011-2013 term. He is a past President of the Board of Directors, San Francisco Chapter IAFP, and also served as Treasurer for the National Association of Independent Broker Dealers (NAIBD), a nonprofit broker dealer industry association. Mr. Williams has an undergraduate degree from the University of Maryland and an MBA from Golden Gate University.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Operational Best Practices: Day to Day Responsibilities

FINRA

Panelists

Moderator:

- David Greene, District Director, FINRA Los Angeles District Office

Panelists:

- Whitney Bullock, Chief Compliance Officer, Wescom Financial Services, LLC
- Allan Goldstein, Chief Operating Officer, Chief Compliance Officer, Chief Financial Officer, Trade Informatics LLC
- James H. Williams, President, Gogan & Williams

© 2015 FINRA. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Operations Best Practices: Day to Day Responsibilities
Thursday, November 12
11:30 a.m. – 12:30 p.m.

Resources

FINRA Notices

- *Regulatory Notice 11-33 – SEC Approves Operations Professional Registration Category and Consolidated FINRA Continuing Education Rule* (July 2011)

  http://www.finra.org/sites/default/files/NoticeDocument/p123960.pdf

- *Regulatory Notice 11-14 – FINRA Requests Comment on Proposed New FINRA Rule 3190 to Clarify the Scope of a Firm's Obligations and Supervisory Responsibilities for Functions or Activities Outsourced to a Third-Party Service Provider* (May 2011)

  http://www.finra.org/sites/default/files/NoticeDocument/p123398.pdf

- *Notice to Members 05-48 – Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers* (July 2005)

  http://www.finra.org/sites/default/files/NoticeDocument/p014735.pdf

FINRA Resources

- Ketchum's top priorities for 2016 (October 2015)

  http://www.thinkadvisor.com/2015/10/15/finras-ketchum-3-top-exam-priorities-for-2016

- FINRA Vendor Partners

  http://www.finra.org/industry/compliance-resource-providers

- Small Firm Resources - Templates

  http://www.finra.org/industry/tools

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Decode Cyber Risks and Security
Thursday, November 12
1:45 p.m. – 2:45 p.m.

This session provides an overview of the latest cybersecurity threats that small firms face, and provides preventative measures firms can take to protect their practice. Join industry panelists and FINRA staff as they share effective practices to protect your firm's data. Panelists discuss real-life examples of cyber breaches and lessons learned.

Moderator:
David Kelley
Surveillance Director
FINRA Kansas City District Office

Panelists:
Joe Romano
President
Romano Brothers & Co.

Lisa Roth
President
Monahan & Roth, LLC

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Decode Cyber Risks and Security Panelist Bios:

Moderator:

David Kelley is the Surveillance Director based out of their Kansas City District office, and has been with FINRA for more than five years. Mr. Kelley also leads FINRA's Regulatory Specialist team for Cyber Security, IT Controls and Privacy. Prior to joining FINRA, he worked for more than 19 years at American Century Investments in various positions, including Chief Privacy Officer, Director of IT Audit and Director of Electronic Commerce Controls. He led the development of website controls, including customer application security, ethical hacking programs and application controls. Mr. Kelley is a CPA and Certified Internal Auditor, and previously held the Series 7 and 24 licenses.

Panelists:

Joe Romano is President of Romano Brothers & Co., a dually registered RIA/BD founded by his father Richard Romano in 1962, which now manages $1 billion in client assets. In addition to administering the firm, Mr. Romano heads its Investment Committee and acts as a portfolio manager, creating customized portfolios for private clients using individual stocks and bonds. He began his career in 1995 earning his Series 7 General Securities and Series 55 Equity Trading licenses. He later obtained the Series 24 General Securities Principal and Series 4 Registered Options Principal licenses. He served for several years until 2007 as the firm's Chief Compliance Officer (CCO). Mr. Romano is a past President of the Illinois Securities Industry Association and a former member of the FINRA District 8 (Midwest) Committee from 2009-2012. He then became a member of the FINRA Small Firm Advisory Board and served as its Chair in 2015. Most recently in August of 2015 he was elected by his constituency to serve a three year term as a Small Firm representative on the FINRA Board of Governors. Mr. Romano graduated with honors in economics from Wesleyan University, Middletown, CT, in 1992.

Lisa Roth is a registered principal with Keystone Capital Corporation; a FINRA member firm headquartered in San Diego, CA. Ms. Roth holds FINRA Series 4, 7, 24, 53 and 65 licenses. Ms. Roth is also the President of Monahan & Roth, LLC, a professional consulting firm offering regulatory compliance consulting, expert witness and litigation support services. Previously, Ms. Roth was the founder and CEO of ComplianceMAX Financial Corp., a regulatory compliance company offering technology and consulting services to more than 1,000 broker-dealers and investment advisers. Ms. Roth's leadership at CMAX led to the development of audit and compliance workflow technologies now in use by some of the United States largest (and smallest) broker-dealers and investment advisers. Ms. Roth has also served in various executive capacities with Royal Alliance Associates, First Affiliated Securities, and other brokerage and advisory firms. Ms. Roth has served on the FINRA Small Firm Advisory Board, including one year as its chair. She is the past chairman of the National Association of Independent Broker-Dealer (NAIBD), and has served on the Board of the Third Party Marketers' Association. Ms. Roth has recently completed a two-year term as a member of the PCAOB Standing Advisory Group. She is an active participant in industry forums, including FINRA committees and trade associations. Ms. Roth is a frequent speaker at industry and regulatory conferences, and serves on ad hoc committees as necessary to promote a culture of continuous improvement for compliance and operations among investment services firms. Ms. Roth resides in CA, but is a native of Pennsylvania, where she attained a bachelor's degree and was awarded the History Prize from Moravian College.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Decode Cyber Risks and Security

FINRA

Panelists

Moderator:

- Dave Kelley, Surveillance Director, FINRA Kansas City District Office

Panelists:

- Joe Romano, President, Romano Brothers and Company
- Lisa Roth, President, Monahan & Roth, LLC

© 2015 FINRA. All rights reserved.

Outline

I. FINRA's Definition of Cybersecurity
II. Governance
III. Risk Assessment
IV. Access Control
V. Vendor Management
VI. Incident Response Plan
VII. Training
VIII. Branch Controls
IX. Technical Measures

© 2015 FINRA. All rights reserved.

What do we mean by “Cybersecurity”?

- **In broad terms we mean the protection of investor and firm information from compromise through the use – in whole or in part – of electronic media (e.g., computers, cell phones, IP-based telephony systems).**
  - **“Compromise” refers to a loss of data confidentiality, integrity or availability**
  - **Protection of customer information and PII (Personal Identifiable Information)**
  - **Protection of firm confidential information**

Governance

Principle: Firms should establish Information Security governance frameworks that support informed decision-making and escalation at appropriate levels within the organization. This would include:

- **Active senior management and, as appropriate, board level oversight of cybersecurity**
- **Articulated risk appetite that guides firm decision-making with respect to the acceptance, mitigation, avoidance or transfer of risks**
- **Defined accountabilities, structures, policies and procedures to support decision-making based on risk appetite and industry effective practices**
- **Use of appropriate metrics and thresholds**

Risk Assessment

Principle: Firms should conduct regular risk assessments to identify vulnerabilities and prioritize risk remediation activities.

- **What is a risk assessment?**
  - As defined by the International Organization for Standardization (ISO), risk assessment is a systematic approach to estimating the magnitude of risks (risk analysis) and comparing risk to risk criteria (risk evaluation). It is an ongoing process, not a single point-in-time review
- **Scope of a risk assessment**
  - Critical asset inventory
  - Threat evaluation – both external and internal
  - Vulnerability assessment of assets
  - Risk evaluation and prioritization – governance
  - Technical Controls
  - Vendors and their Affiliates

© 2015 FINRA. All rights reserved.

Access Control

Principle: Physical and logical - Access to assets and associated facilities is limited to authorized users, processes, or devices, and to authorized activities and transactions.

- **Access permissions are managed, incorporating the principles of least privilege and separation of duties**
- **Identities and credentials are managed for authorized devices and users**
- **Physical access to assets is managed and protected**
- **Remote access is managed**
- **Password rules are appropriate**

© 2015 FINRA. All rights reserved.

Vendor Management

Principle: Firms should address cybersecurity risks that arise from vendor relationships.

- **Vendor management should cover the lifecycle of the relationship, from initiation through termination, and should be risk-based, i.e., there is greater due diligence and oversight on vendors who have access to sensitive data or processes.**
- **Appropriate initial and ongoing due diligence**
- **Incorporation of appropriate contractual requirements**
- **Include vendors and vendor systems as part of the overall risk assessment process**
- **Cloud Computing applications – understanding segregation of data and controls around access**
- **Firms should conduct ongoing vendor re-assessments**

Incident / Breach Response Planning

Principle: Firms should develop plans to respond to cybersecurity incidents. Key elements include:

- **Event / Alert Management**
  - Established policies and procedures – as well as roles and responsibilities – for escalating cybersecurity incidents
- **Media**
  - Prepared communications plan for outreach to relevant stakeholders, e.g., customers, regulators, industry information-sharing bodies, law enforcement, and intelligence agencies, as appropriate
- **External Sources**
  - Involvement in industry-wide exercises as appropriate to the role and scale of a firm's business in the securities markets, e.g. BCP/DR
- **Testing of the Plan**

Training

Principle: Firms should provide cybersecurity training to their staff and provide additional training based on staff's role.

- **Appropriate types of training are driven by:**
  - Staffs' functional responsibilities:
    - Training on fraudulent money transfer schemes for account reps
    - Training on secure coding practices for developers
  - Firm's experience with cybersecurity incidents, such as loss incidents
  - Risk assessment
  - Awareness and intelligence about threats firm may face
- **In addition, firms should also consider providing resources to customers that will help them enhance their own cybersecurity practices**

© 2015 FINRA. All rights reserved.

Branch Office Controls

Firms with an Independent Contractor branch model may have more risk due to the nature of the branch technology infrastructure.

- **Control Areas would include:**
  - The use of passwords
  - Physical security of assets and data
  - Encryption of computers
  - Use and storage of email
  - Transmission of data
  - Incident reporting of lost or stolen data and hardware
  - Patch and virus protection processes
  - Firm branch exams
  - RR training and certification

© 2015 FINRA. All rights reserved.

Technical Measures

There are a number of technical measures firms take to enhance their cybersecurity controls.

Anti-virus software	Anti-malware software
Application firewalls	Identity, access and privilege management
Data encryption	DDOS tools
Patch and software updates	Email content filtering
Web/URL filtering	Use of removable media
Penetration (PIN) testing	WiFi protection
BYOD	Online Access Management

Handouts

- Outsourcing Due Diligence Form
- Electronic Devices and Communications Inspection Form
- Cyber Security Incident Report
- Bring Your Own Device Policy Development and Implementation Outline
- Cybersecurity Terminology

© 2015 FINRA. All rights reserved.

Supplemental Guidance

- FINRA Report on Cybersecurity - *http://finranet.finra.org/news-events/employee-news/announcements/FINRA-Releases-Report-on-Cybersecurity-Practices*
- NIST - *www.nist.gov/cyberframework/index.cfm*.
- COBIT 5 - *www.isaca.org/COBIT/Pages/COBIT-5-Framework-product-page.aspx*
- ISO 27001/27002 - *www.iso.org/iso/home/standards/management-standards/iso27001.htm*
- SIFMA Cybersecurity Resource Center: *www.sifma.org/issues/operations-and-technology/cybersecurity/overview/*
- FFIEC cybersecurity resources for banking organizations: *http://www.ffiec.gov/cybersecurity.htm* AND *http://www.ffiec.gov/cybersecurity.htm*
- *www.sec.gov/rules/final/34-42974.htm*
- *www.sec.gov/rules/final/2013/34-69359.pdf*
- *www.ncsl.org/research/telecommunications-and-information-technology/state-laws-related-to-internet-privacy.aspx*
- *www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx*
- *www.sec.gov/rules/final/34-44992.htm*
- *www.fsisac.com/*
- *www.ncfta.net/*

OUTSOURCING DUE DILIGENCE FORM

SERVICE TO BE OUTSOURCED

1. **Type of service to be outsourced:**
   - ☐ Accounting/Finance: _____ ☐ Compliance Consulting: _____
   - ☐ Legal Services: _____ ☐ Administrative Functions: _____
   - ☐ Information Technology: _____ ☐ Operations/Support Functions: _____
   - ☐ Other: _____

2. Is this service essential to the operation of the Firm (i.e. transaction order entry; custody and prime brokerage; service designed to promote rapid recovery of operations etc.)? ☐ Yes ☐ No

APPROPRIATENESS OF OUTSOURCING

1. **Potential impact on Firm if service provider fails to perform:**

Financial Impact:	☐ High	☐ Medium	☐ Low	☐ N/A
Reputational Impact:	☐ High	☐ Medium	☐ Low	☐ N/A
Operational Impact:	☐ High	☐ Medium	☐ Low	☐ N/A
Customer Service Impact:	☐ High	☐ Medium	☐ Low	☐ N/A
Potential Losses to Customers:	☐ High	☐ Medium	☐ Low	☐ N/A
Comply with Regulatory Requirements:	☐ High	☐ Medium	☐ Low	☐ N/A
Costs to Firm:	☐ High	☐ Medium	☐ Low	☐ N/A
Degree of Difficulty Replacing Service Provider:	☐ High	☐ Medium	☐ Low	☐ N/A

Comments:

2. Is there an affiliation or other relationship between the Firm and the service provider? ☐ Yes ☐ No
   If yes, please describe the relationship and any potential conflicts of interest:

3. Is the service provider a regulated entity subject to independent supervision or jurisdiction? ☐ Yes ☐ No
   If yes, name of regulator: _____

SERVICE PROVIDER INFORMATION

1. **General Information**
   Vendor Name:
   _____

   Vendor Address:
   _____

   _____

   Contact Name(s): _____ CRD # (if applicable): _____
   Phone: _____ Fax: _____ Website: _____

2. Is the service provider owned/controlled by a Parent Co.? ☐ Yes ☐ No Name: _____

3. **Personnel:**
   Approximate # of employees:_____
   Does the service provider hire independent contractors? ☐ Yes ☐ No

4. **Background Information:**
   How many years has the service provider been in business? _____
   How many years has the service provider provided the outsourced function? _____

   Is the service provider known to the Firm or employees of the Firm? ☐ Yes ☐ No
   If yes, please name the individual(s) and describe any prior experience each had with the service provider:
   _____
   _____

DUE DILIGENCE

1. What methods did the Firm use to verify the service provider's information? (Choose all that apply.)

☐ FINRA Public Disclosure	☐ Internet Research	☐ Entity Formation Documents
☐ SEC Public Disclosure	☐ Credit/Background Check	☐ Independent Research
☐ Form BD/ADV	☐ Media/News Reports	☐ Personal Referral
☐ Business Plan	☐ 10K	☐ RFP
☐ Policies Manual(s)	☐ Personal Interviews	☐ Marketing Materials
☐ Financials	☐ Onsite Inspection	☐ Sales Materials
☐ Other:		

_____

Identify where this evidence is maintained of the above methods used to verify the service provider's information (i.e. copies of documents reviewed; notes from personal interviews and onsite inspections; printouts from public disclosure sites etc.)?

2. Please list one or more qualified references; firms that use this service (if contacted personally, identify the name of the contact and the result of the contact):

1.
2.
3.

3. Please describe the background and experience of individuals who will be performing the services:

4. Based on your review of reference and background information, has/have the service provider and/or its principals been subject to any regulatory, criminal or civil disciplinary issues? ☐ Yes ☐ No
   If yes, please describe:

5. Based on your review of reference and background information, please describe the service provider's ability and capacity to perform the outsourced activities effectively, reliably, and to a high standard (include in your description relevant technical, financial, human resources, and/or other assets of the service provider):

6. Confirm that the service provider has an adequate information security plan in effect. ☐ Yes ☐ No

   If yes, review a copy of the plan and comment on its adequacy including at minimum standards for compliance (NIST or other) and method(s) for breach reporting and mitigation:

7. Will the service provider have access to non-public information? ☐ Yes ☐ No

If yes, comment on the adequacy of the service provider's for safeguarding non-public information:

8. After reviewing the information, are there any questionable issues or potential conflicts of interest?
   ☐ Yes ☐ No
   If yes, please describe:

CONTRACTS AND AGREEMENTS

1. Has (or will) the Firm entered into a written agreement with the service provider? ☐ Yes ☐ No
   If yes, please identify the relevant provisions and disclosures in the contract (choose all that apply).

   ☐ Provides for Firm and regulator access to records
   ☐ Limitations on service provider's ability to sub-contract
   ☐ Defines responsibilities of all parties subject to contract
   ☐ Defines how responsibilities will be monitored
   ☐ Liability for unsatisfactory performance or other breach
   ☐ Requirement to maintain a disaster recovery plan
   ☐ Time Commitment (Termination Date):
   _____
   ☐ Other relevant provision(s):
   _____
   ☐ Firm and client confidentiality
   ☐ Payment arrangements
   ☐ Provide quality services measures
   ☐ Guarantees and indemnities
   ☐ Information security provisions
   ☐ Disclosure of breaches in security

2. Was the written agreement reviewed by the Firm's legal counsel? ☐ Yes ☐ No ☐ N/A
   If yes, name of legal counsel: _____
   Date of Review: _____

3. Was the written agreement reviewed by the principal responsible for outsourcing functions?
   ☐ Yes ☐ No
   If yes, name of principal: _____ Date of Review: _____

OVERSIGHT AND PERIODIC REVIEW

1. List the name and title of the Firm Principal who is responsible for the periodic oversight and review of the outsourced service? _____

2. Please identify the individual(s) who will monitor the outsourced service if different from above.
_____

3. Please identify the tools that will be used to monitor the outsourced service:

☐ Service delivery reports prepared internally
☐ Publicly available resources
☐ Internal auditor
☐ External auditor
☐ Other
☐ Service delivery reports supplied by the service provider
☐ Performance levels established in written agreement
☐ Onsite inspection
☐ Attestations by service provider

_____

4. Frequency of monitoring: ☐ Daily ☐ Weekly ☐ Monthly ☐ Quarterly ☐ Annually
☐ Other
_____

5. If deficiencies are found, are there procedures in place to respond to such deficiencies (i.e. communicate with the service provider; terminate the contract)? ☐ Yes ☐ No

DOCUMENTATION REVIEW AND APPROVAL

1. Individual(s) responsible for completing this due diligence review:
   a. _____
   b. _____
   c. _____

Firm Principal: I have reviewed the information contained in this Outsourcing Due Diligence Form and:

☐ The Firm has elected to use the service provider above.

☐ The Firm will not use the service provider above.

_____ _____ _____
Principal Signature Date Printed Name of Principal

Electronic Devices and Communications Inspection Form

Electronic Device Review:

Device Name	Description	% Business Use	% Personal Use

□ Yes □ No Anti-malware software is installed on this device.

□ Yes □ No Anti-virus software is installed on this device.

□ Yes □ No Software auto-update is set to "ON" on this device.

□ Yes □ No Log in privileges to this device are password protected.

□ Yes □ No This device 'times out' after 15 minutes or less time of non-use.

□ Yes □ No ONLY approved (company) email is received on this device.

□ Yes □ No This device 'times out' after 15 minutes or less time of non-use.

□ Yes □ No ONLY associated personnel have access to this device.

Please explain any "NO" answer in the space provided below:

Exceptions, Notes:

Electronic Device Review:

Device Name	Description	% Business Use	% Personal Use

□ Yes □ No Anti-malware software is installed on this device.

□ Yes □ No Anti-virus software is installed on this device.

□ Yes □ No Software auto-update is set to "ON" on this device.

□ Yes □ No Log in privileges to this device are password protected.

□ Yes □ No This device 'times out' after 15 minutes or less time of non-use.

□ Yes □ No ONLY approved (company) email is received on this device.

□ Yes □ No This device 'times out' after 15 minutes or less time of non-use.

□ Yes □ No ONLY associated personnel have access to this device.

Please explain any "NO" answer in the space provided below:

Exceptions, Notes:

2015 Courtesy of Monahan & Roth, LLC

Cyber Security Incident Report

Complete the following form when any of the following events has occurred. Include incidents resulting from an accident or negligence, as well as those resulting from deliberate wrongdoing.

1. *Malware was detected on one or more Firm devices.*
2. *Access to a web site or network resource was blocked or impaired by a denial of service attack.*
3. *The availability of a critical web or network resource was impaired by a software or hardware malfunction.*
4. *An unauthorized user breached the network.*
5. *The compromise of a customer's or vendor's computer was used to remotely access the Firm's network resulted in fraudulent activity, such as efforts to fraudulently transfer funds from a customer account or the submission of fraudulent payment requests purportedly on behalf of a vendor.*
6. *The Firm received fraudulent emails, purportedly from customers, seeking to direct transfers of customer funds of securities.*
7. *The Firm was the subject of an extortion attempt by an individual or group threatening to impair access to or damage the Firm's data, devices, network, or web services.*
8. *An employee or other authorized user of the Firm's network engaged in misconduct resulting in the misappropriation of funds, securities, sensitive customer or Firm information or damage to the Firm's network or data.*
9. *The Firm, either directly or as a result of an incident involving a vendor, experienced the theft, loss, unauthorized exposure, or unauthorized use of or access to customer information.*
10. *Any other security breach event.*

Which of the above best describes the incident: (No.#): __

If (other) please describe:

Date detected: _____ Date Remediated: _____

How was the incident detected? ☐ Internally ☐ Externally ☐Not Known
What was the source of the incident? ☐ Internal ☐ External ☐Not Known
Please identify the cause of the incident. ☐ Deliberate wrongdoing ☐ Error, accident

Was client non-public data compromised? ☐ Yes ☐ No

Please describe the nature, duration, and consequences of the breach, how it was detected and how it was remediated:

Please provide any additional notes and/or details regarding this event, including the name(s) of any regulatory authorities to which the incident was reported.

Report Submitted by: _____ Date: _____

Report Reviewed by: _____ Date: _____

2015 Courtesy of Monahan & Roth, LLC

Bring Your Own Device ("BYOD")

Policy Development and Implementation Outline

- **Secure Mobile Devices**
  - **Authentication (passcode/PIN) requirements**
  - **Storage/transmission encryption requirements**
  - **Requirements to automatically wipe devices after a number of failed login attempts**
  - **Usage restrictions for mobile devices**
  - **Company rights to monitor, manage and wipe**
    Invest in a mobile device management (MDM) solution to enforce policies and monitor usage and access.
  - **Enforce industry standard security policies as a minimum: whole-device encryption, PIN code, failed login attempt actions, remotely wiping, etc.**
  - **Set a security baseline: certify hardware/operating systems for enterprise use using this baseline.**
  - **Differentiate trusted and untrusted devise access: layer infrastructure accordingly.**
  - **Introduce more stringent authentication and access controls for critical business apps.**
  - **Add mobile device risk to the organization's awareness program.**

- **Address App Risk**
  - **Use mobile anti-virus programs to protect company- issued and BYOD malware-prone mobile operating systems with mobile anti-virus.**
  - **Ensure security processes cover mobile app development and leverage tools, and vendors to bridge assessment skill gaps.**
  - **Manage apps through a mobile app management product.**
  - **Introduce services that enable data sharing between BYOD devices.**
  - **To increase productivity and security, continually assess the need for new apps.**

- **Manage the Mobile Environment**
  - **Create and enforce an appropriate BYOD support and usage policy.**
  - **Revamp support provisioning and de-provisioning (wipe) of devices, and an increased level of self-help.**
  - **Create a patch education process to encourage users to update their mobile devices.**
  - **Introduce a social support mechanism to augment the existing IT support team.**
  - **Implement a wiki/knowledge base employee self-service support solution.**

- **Test and Verify the Security of the Implementation**
  - **Perform security testing and review of the implemented solution**
  - **Use an integrated testing approach combining automated tools**
  - **Perform manual penetration testing**

- **Test Infrastructural Changes Affecting Mobile Connections to the Enterprise Network**
  - **Wi-Fi deployments**
  - **VPN endpoints**

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Cybersecurity Terminology Defined

- Access controls (including employees): controls to certain assets based on least privilege, and is limited to authorized users, processes, or devices, and to authorized activities and transactions.
- Application Software Security: measures taken throughout the code's life-cycle to prevent gaps in the security policy of an application or the underlying system through flaws in the design, development, deployment, upgrade, or maintenance of the application.
- Assets, including inventory process: Identify PII of employees, customers, or other individuals that may be impacted by or connected to cybersecurity procedures, including systems, applications; e.g. define the firms "Crown Jewels"
- Authorized v. Unauthorized Devices: authorized devices can be laptops, mobile phones, tablets which are configured within firm policy. Unauthorized devices might be USB, removable storage devices.
- Availability of the website: Websites can go down due to website defacement attacks.
- Boundary Defense: protection of configuration and architectural frameworks; the perimeter systems, network devices, and Internet-facing client machines.
- Breach: system has been compromised; loss of data, confidential firm and/or client information
- Change Management: – is the management of technical security solutions to ensure the security and resilience of systems and assets are consistent with related policies and procedures and agreements.
- Cybersecurity architectures and industry models include NIST, COBIT 5, OSO/IEC 27001/2. Refer to the references section for hyperlinks to additional resources.
- Cybersecurity Governance: The policies, procedures, and processes to manage and monitor the organization's regulatory, legal, risk, environmental and operational requirements are understood and inform the management of cybersecurity risk.
- Data recovery capability: defined backup and restore services
- Data security programs: policies and procedures that outline protection of PII and other confidential firm data.
- Distributed denial of services attacks/incidents
- Hack of wireless network: This is usually caused by poor configuration and those caused by weak encryption.
- Incident response planning and recovery: This is the process of capturing, classifying, and remediating events. Depending on the nature and severity, might be updated in a firm's BCP/DR plans.

- Information Sharing: sharing known threats/attacks with various organizations; e.g. FS-ISAC, NCFTA, local Law Enforcement Authorities
- Limitation and Control of network ports, protocols and services: secure socket layers (SSL) are cryptographic protocols designed to provide communications security over a computer network.
- Malware defined and defenses: malicious software that may be blocked with tools such as McAfee, Kaspersky, Norton, TrendMicro, etc.
- Password sniffing: software application that scans and records passwords that are used or broadcasted on a computer.
- Patch Management: the process to deploy updates from vendor applications, and systems addressing known deficiencies in code, networks, devices.
- Penetration Tests: is an attack on a computer system with the intention of finding security weaknesses, potentially gaining access to it, its functionality and data. The process involves identifying the target systems and the goal, then reviewing the information available and undertaking available means to attain the goal. A penetration test target may be a white box or black box. A penetration test can help determine whether a system is vulnerable to attack, if the defenses were sufficient and which defenses were defeated in the penetration test.
- Personally Identifiable Information ("PII") – any information about an individual maintained by an agency, including any information that can be used to distinguish or trace an individual's identity, such as name, social security number, date and place of birth, etc.
- Phishing: is the attempt to acquire sensitive information such as usernames, passwords, and other PII details by masquerading as a trustworthy entity in an electronic communication.
- Red team exercises: finding network threats before hackers do.
- Secure Configurations for hardware and software: appropriate safeguards are in place at all stages of PII's lifecycle within the organization
- Secure Network Engineering: Threats and vulnerabilities are assessed and monitoring and control processes in place to ensure protection of PII.
- Social engineering or social hacking: manipulation of people into performing actions or divulging confidential information.
- SSAE 15: certification that controls are in place and are designed and operating effectively.
- System Development Lifecycle: the process workflow of a change to the technology environment; Scope through Implementation.
- System Penetration: attack on a computer system with the intention of finding security weaknesses, potentially gaining access to it.
- Table-top exercise: A discussion-based exercise where personnel meet in a room or breakout groups and are presented with a scenario to validate the content of plans, procedures, policies, cooperative agreements or other information for managing an incident.
- Technology Framework: depending on the business model, the platform in which technology monitors and controls the firm's assets; e.g. applications, systems, data, servers, network, workstations, other devices
- Vendor management process, including controls, audit and termination clauses: process for selecting, monitoring, and terminating relationships with vendors who have access to customer PII or company confidential information.

- Vulnerability Assessment and Remediation: regularly evaluate the effectiveness of procedures detecting vulnerabilities in applications and systems, and remediate known deficiencies
- Website defacement: an attack on a website that changes the visual appearance of the site or a webpage. These are typically the work of system crackers, who break into a web server and replace the hosted website with one of their own.
- Wireless access controls: access controls that might require a fob – such as an RSA fob.

[Firm Name]
Cyber Security Policies and Procedures
September 2015

CONTENTS

OVERVIEW 2

ACCESS MANAGEMENT 3

END-USER: MOBILE DEVICE AND APPLICATION SECURITY 5

COLLABORATION SITES AND END-USER DATA STORAGE 6

SECURITY RISK ASSESSMENT 7

EMPLOYEE SECURITY AWARENESS TRAINING 8

VENDOR SELECTION AND MANAGEMENT 9

TECHNOLOGY ASSET INVENTORY, CLASSIFICATION AND TRACKING 9

TECHNOLOGY END-OF-LIFE PROCESS 10

EMPLOYEE TERMINATION 10

DISASTER RECOVERY AND BACKUP TESTING 11

CYBERSECURITY INSURANCE 11

CYBERSECURITY BREACH FRAMEWORK 11

Overview

[Firm Name] has a holistic, systematic and risk-based approach to technology and information security. At a high level, the goal of this program is to:

- Provide that the business takes action relevant to the firm's technology assets and related events
- Provide for the safety and protection of information
- Prevent inappropriate use or access to data that can lead to an information security incident, where any firm computer, device or data is lost, stolen, misused or left unsecured
- Minimize the impact of adverse information security events to the portfolio, and therefore the investors of the fund

[Name] has been designated as the Chief Information Security Officer ("CISO") and has primary oversight, maintenance, and execution of this Technology and Information Security Program (the "Program"). The CISO is authorized to delegate physical, technical, and administrative components of this program to qualified third parties as and whenever appropriate.

The [Firm Name] CCO bears overall responsibility for Business Continuity Plan ("BCP") / Disaster Recovery ("DR") planning, information protection, and creating agile security processes and procedures. The CCO has identified the following core functions to guide the Program. These functions will be evaluated and updated by the CISO as indicated below to adjust to technological, business and/or operational changes at the firm that may have a material impact on the Program. The CISO will also be reporting any exceptions to the COO, CEO or other management as appropriate.

Functions	Designated Person	Frequency of Document Review	Frequency of Execution
Access management: password and technology access	CISO	Quarterly	As needed
Access management: physical access	CISO	Quarterly	As needed
End-user: desktop, web, network and server security	CISO	Quarterly	As needed
End-user: mobile devices and application security	CISO	Quarterly	As needed

Collaboration sites and storage networks	CISO	Quarterly	Quarterly with 3rd Party
Security risk assessment	CISO	Annually	Annually with RSI Technologies
Cybersecurity testing and audit	CISO	Annually or as needed	Annually or as needed with RSI Technologies
Network intrusion scan	CISO	Annually	Ongoing with 3rd Party
Employee security awareness training	CISO	Annually	Annually (CCO during ACM)
Vendor selection and maintenance	COO	As needed	Ongoing with 3rd Party
Technology asset inventory	CISO	Annually	Annually
Technology end-of-life process	CISO	Annually	As needed with 3rd Party
Employee termination	COO	Annually	As needed with CCO
Disaster recovery and backup testing	COO	See BCP/DR Manual	See BCP/DR Manual
Cybersecurity insurance	CISO	Upon renewal	N/A as of 9.2015

Access Management

We have a rigorous approach to entitlement management that helps establish controls around access activities. The goal of this program is focused on the following:

- Protect remote, mobile, cloud and social access
- Provide transparency and up-to-date information on entitlements
- Provide centralized administration for permissions
- Ensure that employees have access only relevant to their job functions
- Protect against insider threats and unauthorized escalation of user privileges

Each employee's profile will be managed in a central directory that will be used to create, delete and modify employee access data. The CCO is the primary owner of the central directory.

Authorization: We will manage authorization information that defines what functions an employee can perform in the context of a specific application. Please consult the CCO for the complete directory of employees and associated applications.

Passwords: For accessing any firm desktop or device, employees will use unique passwords, requiring the following characteristics:

- Contains at least 8 characters
- Uses a combination of lower and uppercase letters
- Uses at least one number and one symbol
- Expires every 180 days (the reuse of any previous password is disallowed)
- After 10 failed login attempts within 15 minutes, the user account will be locked until released by the CISO or 3rd Party.

Each administrator will have a unique login account and password

3rd Party's employees, on an as needed basis, will each have a unique login and password to access the firm's password management list.

Physical access: We will secure the firm's physical premises with locks and inventory keys issued to authorized persons on an ongoing basis.

End-user: desktop, web, network and server security
We have developed practices in our firm to protect the sensitivity of all information by implementing the following processes:

• Implement the use of password protection for all sensitive data, applications, and collaboration tools

• Reconcile the inventory of hardware, software and devices with 3rd Party

• Educate end-users on appropriate use of desktops and web browsing for business purposes

• Track and log USB portable flash drive uses that access the firm's desktop to detect any unauthorized use

• Maintain white-list of desktop approved applications and blacklist policy for websites (i.e. adult content, social media, gambling, etc.)

Working closely with the CISO, 3rd Party will proactively manage the following items:

• Maintain inventory of hardware, software and devices

• Closely monitor application and systems log activity (i.e. control the execution of code with an application white-listing policy)

• Deploy critical operating system security patches within 48 hours of release

• Non-critical patches are delivered monthly

• Implement appropriate protections for electronic systems, including anti-virus software and firewalls

• Anti-virus software is set to auto-update and firewalls are updated at least quarterly by 3rd Party

• To combat social engineering, the 3rd Party will do the following:

– Employ up-to-date anti-malware systems (continuously updated by auto-update plus quarterly reviews)

– Employ spam filters and other email gateways (continuously updated by auto-update and periodically reviewed by 3rd Party)

End-user: mobile device and application security

Firm-owned devices include, but are not limited to, laptops, tablets, cellular phones, and smartphones. Personal devices may utilize mobile access as long as they are password-encrypted and firm-approved. At the time of hiring, and annually thereafter, we request disclosure of all electronic devices, including the % business and personal use for purposes of maintaining an up-to-date inventory.

Employees are advised to report any lost, stolen, or compromised electronic device to the CISO or CCO immediately. The CISO or CCO will update the firm inventory and shut off inbound and outbound access to the device as necessary. Firm personnel will receive training on the secure use of mobile devices and removable media on an as-needed basis including during the annual compliance meeting.

Collaboration sites and end-user data storage

The CISO will be primarily responsible for vetting any collaboration site and data storage along with the CCO. Each site must have identified "data owners," who manage, control, and review access. Only firm approved collaboration sites listed below will be utilized:
[NO APPROVED SITES CURRENTLY IN USE]

Protecting firm data includes the proper use of collaboration sites and data storage sites. The following are requirements for collaboration sites and storing data:

Desktop, laptop, remote desktop and tablets

• Ensure storage only in an approved, sandboxed or otherwise encrypted location instead of the desktop

• Save information to be shared to an access-controlled network location such as a network shared drive

• Store data and information with retention requirements in a records management repository

• Only use applications obtained through firm-approved channels

Mobile devices (smart phones and tablets)

• Only store data within firm-approved applications

• [Firm Name] intends to have remote-wipe capability for all employee devices

Records retention

- • Certain types of data have retention periods
- • All records including digital should be stored in an approved records repository
- • Collaboration sites are not approved repositories
- Employees are responsible for preventing inappropriate use of or access to data by
- • Only accessing information needed for your job function
- • Preparing, handling, using and releasing data

- • Using correct storage locations
- • Following appropriate use or restrictions of electronic communications, including but not limited to email, instant messaging, text, chat, audio/video conferencing and social media

Security risk assessment

The firm will use an independent 3rd party to perform a comprehensive enterprise risk assessment. The 3rd party will assess any potential or existing cyber-security threats to identify potential risks and business impacts. The following items under review include, but are not limited to:

Category	Subcategory
Network Security	Network Infrastructure Firewalls Network Diagram Frequency of Documentation Wireless
Data Security	Data Classification Backup and Restoration Encryption Mobile Security Disposal Protection of Transmission
Access Control	Active Directory Authentication Network Access Control Account/Password Management Application Access
System Development	Systems Installation Software Development Maintenance and Patching Decommissioning Change Control Management
Protection	Antivirus software Updates and patches Web Filter and traffic
Testing and Monitoring	Server Monitoring Network Monitoring Penetration Testing Vulnerability Testing Alerting

Vendors	Vendor Assessment Client Data
Employees	Termination / Role Transfer
Physical Premise Security	Data Center Building Security and Staff Building and Office Access Server Room
Information Security Program	Info Security Policy
Cybersecurity Insurance	Coverage Review

Employee security awareness training

To assist firm employees in understanding their obligations regarding sensitive firm information, the CISO will provide each employee with a copy of this Program upon commencement of employment and whenever changes are made. In addition, the CISO and/or CCO will implement programs to perform training functions on an as-needed basis.

Employee security awareness training will include, but is not limited to:

• Instruct employees to take basic steps to maintain the security, confidentiality and integrity of client and investor information, including:

– Secure all files, notes, and correspondence

– Change passwords periodically and do not post passwords near computers

– Avoid the use of speaker phones and discourage discussions in public areas

– Recognize any fraudulent attempts to obtain client or investor information and report to appropriate management personnel

– Access firm, client, or investor information on removable and mobile devices with care and on an as-needed basis using firm protocols (passwords, etc.)

• Instruct employees to close out of files that hold protected client and investor information, investments, investment strategies, and other confidential information when they are not at their desks

• Educate employees about the types of cybersecurity attacks and appropriate responses

Vendor selection and management

For vendors interacting with our systems, network and data, the firm will perform the following activities to protect sensitive information:

• Assess vendors before working with them including a cyber-security risk assessment

• Review third-party vendor contract language to establish each party's responsibility with respect to cyber-security procedures

• Segregate sensitive firm systems from third-party vendor access and monitor remote maintenance performed by third-party contractors

Technology asset inventory, classification and tracking

[Firm Name] has a process in place to identify, classify, and track all technology assets ("assets"):

• To ensure accurate classification and tracking, we will procure/vet all assets through 3rd Party

• We will maintain an inventory of all assets as well as an identified owner

• We will cross-reference the list of internal assets with 3rd Party

• Asset identification and classification process will be scalable to accommodate growth and acquisition

• We will track assets and their attributes throughout their lifecycle

• Automated processes will be used periodically to perform discovery of unknown assets

• We will create a map of network resources, including data flows, internal connections and external connections

We will establish and enforce a process of assessing and classifying assets based on their sensitivity to attack and business value.

3rd Party will auto-alert [Firm Name] if a new device is discovered on the network

Technology end-of-life process

We have developed and will follow processes for securely disposing of assets once they are no longer being used by the firm or have reached the end of their usable life (the "end-of-life process").
Working closely with the CISO, 3rd Party will closely monitor the firm hardware and recommend a refresh every 3-5 years per individual hardware equipment. A certified end-of-life management vendor ("EMV") will properly recycle any old hardware.

Notification: The end-of-life process will notify all necessary and relevant parties to initiate a coordinated execution:

- CISO
- Asset owner
- End user(s)
- Relevant vendor(s)

Hard Drives: Any decommissioned hard drive will be securely stored for a minimum of 6 years since decommission date. When disposing the hard drive, the EMV will do the following:

- Erase all data on the drive
- Physically destroy the hard drive
- Produce documentation of proper disposal

Employee termination

The firm is highly focused on protecting the network and proprietary data at risk upon termination of employees. To prevent any issues of former employees leaking information, we have a strict approach towards access controls and entitlement management.
Please refer to the 3rd Party checklist for employee on/off-boarding. We will continuously maintain this list as new applications, drives, systems, and vendors are incorporated. The following items will be monitored:

- Network access
- Desktop access
- Mobile device access

• Internal and external applications

• Vendors, such as prime brokers, executing brokers, etc.

Disaster recovery and backup testing

Please see the original Business Continuity Procedures / Disaster Recovery Plan ("BCP") for detailed documentation. Any changes can be represented in that BCP / DR plan.

The CCO in connection with the CISO will update the firm's BCP on an as-needed basis to ensure that it is consistent with the Program.

Cybersecurity insurance

On an annual basis the CISO will review the firm's insurance coverage related to cybersecurity threats and make a determination as to its adequacy in conjunction with the CCO and COO. It is anticipated that cybersecurity insurance will not be attained unless or until the firm's risk profile substantially increases, because currently the majority of client sensitive data are retained by competent third party vendors primarily including its clearing firm.

Cybersecurity breach framework

The firm has implemented a framework to identify, prepare, prevent, detect, respond, and recover from cybersecurity incidents.

In the event of a cybersecurity incident, the firm's information technology personnel (or anyone detecting the incident) will immediately notify the CISO (or 3rd Party Fishell) who will work with appropriate personnel to:

• Assess the nature and scope of any such incident and maintain a written record of the systems and information involved

• Take appropriate steps to contain and control the incident to prevent further unauthorized access, disclosure or use, and maintain a written record of steps taken

• Promptly conduct a reasonable investigation, determine the likelihood that personal information has or will be misused, and maintain a written record of such determination

• Discuss the issue with outside counsel and make a determination regarding disclosing the issue to regulatory authorities, law enforcement and/or individuals whose information may have been affected

• Evaluate the need for changes to the firm's policies and procedures in light of the breach

• The firm will work with 3rd Party and outside counsel as necessary to determine appropriate next steps

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Decoded Cyber Risks and Security
Thursday, November 12
11:30 a.m. – 12:30 p.m.

Resources

FINRA Resources

- *FINRA Report on Cybersecurity*

  http://finranet.finra.org/news-events/employee-news/announcements/FINRA-Releases-Report-on-Cybersecurity-Practices

SEC Resources

- *Identity Theft Red Flags Rules* (April 2013)

  http://www.sec.gov/rules/final/2013/34-69359.pdf

- *Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934* (May 2003)

  http://www.sec.gov/rules/final/34-44992.htm

- *Privacy of Consumer Financial Information (Regulation S-P)* (November 2000)

  http://www.sec.gov/rules/final/34-42974.htm

Other Resources

Federal Financial Institutions Examination Council (FFIEC) Cybersecurity Resources

- Cybersecurity Awareness

  http://www.ffiec.gov/cybersecurity.htm

NIST Resources

- Cybersecurity Framework

  http://www.nist.gov/cyberframework/index.cfm

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

National Conference of State Legislatures Resources

- State Laws Related to Internet Privacy

  http://www.ncsl.org/research/telecommunications-and-information-technology/state-laws-related-to-internet-privacy.aspx

- Security Breach Notification Laws

  http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx

SIFMA Resources

- Cybersecurity Resource Center

  http://www.sifma.org/issues/operations-and-technology/cybersecurity/overview/

Information Systems Audit and Control Association

- COBIT 5 Framework

  http://www.isaca.org/COBIT/Pages/COBIT-5-Framework-product-page.aspx

International Organization for Standardization

- ISO/IEC 27001 - Information Security Management

  http://www.iso.org/iso/home/standards/management-standards/iso27001.htm

Financial Services Information Sharing and Analysis Center

- FSISAC main webpage

  http://www.fsisac.com/

National Cyber-Forensics & Training Alliance

- Cracking Down on Cyber Crime

  http://www.ncfta.net/

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Financial Industry Regulatory Authority

Small Firm Conference

Santa Monica, CA | November 11 – 12, 2015

Examination Priorities: Suggestions for Small Firms
Thursday, November 12
3:00 p.m. – 4:00 p.m.

This session includes a discussion of FINRA's risk-based examination program, examination priorities, common findings, and practices small firms can implement to prepare for a FINRA examination. Industry practitioners share, among other things, their practices and recommendations for what to do before, during and after an examination.

Moderator:
Donald Lopezi
Senior Vice President and Regional Director
FINRA West Region

Panelists:
Nicholas Cochran
Vice President
American Investor Company

Connie Kuhl
Chief Compliance Officer & Senior Vice President of Customer Service and Operations
Motif Investing, Inc.

Allison Petchenick
Chief Compliance Officer and Chief Operating Officer
B. Riley & Co., LLC

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Examination Priorities: Suggestions for Small Firms Panelist Bios:

Moderator:

Don Lopezi, Senior Vice President and Regional Director of FINRA's West Region. The West Region consists of the District Offices located in Denver, Los Angeles, San Francisco and Seattle. The West Region is responsible for conducting examinations, investigations and ongoing surveillance of broker-dealers and registered persons located in the western half of the United States. Previously, Don was the District Director of the FINRA San Francisco District Office. Prior to joining the San Francisco Office, Don was a Director of FINRA's Examination Programs Group (EPG), located in Washington, DC. EPG, among other things, authored and maintained examination policies and procedures used by FINRA's examination staff, coordinated national special projects and initiatives, and oversaw the national examination program—the regulated firm-focused examination and surveillance activities conducted by FINRA's Member Regulation Department. Don began his career as an Examiner in NASD's Denver District Office in 1992 and, after serving as a Supervisor in the Denver District Office, joined the Washington, DC, office in September 2003. He graduated from the University of Colorado at Boulder with a B.S. degree in Accounting, and received his MBA from the University of Colorado at Denver.

Panelists:

Nicholas C. Cochran is Vice President of American Investors Company, a FINRA member firm and registered investment adviser. Mr. Cochran served as President of the Alliance of Independent Broker-Dealers, a non-profit, mutual benefit corporation dedicated to the review and research of investment offerings, from 1998 through 2012; and also served as an elected Director of the National Association of Independent Broker-Dealers (NAIBD), an organization dedicated to small firm advocacy, from 2003 through 2010. Additionally, Mr. Cochran was elected to a four-year term on the Securities Industry/Regulatory Council on Continuing Education in 2009 and was elected Chair in 2012. Mr. Cochran had previously served on FINRA's Continuing Education Content Committee from 2004 through 2009. He served on the NASD's National Nominating Committee from 2001 through 2007, and was a member of NASD's Board of Governors in 1999 and 2000. Additionally, he was elected to the NASD's National Adjudicatory Council in 1998 and served as Chair in 1999 and 2000. Mr. Cochran also served as an elected member of NASD District 1 Committee from 1994 through 1996, was elected Chair in 1996 and was appointed to an additional one-year term in 2002. He has previously served three separate elected terms on the District 1 Nominating Committee, serving one term as Chair. Before joining American Investors Company in 1992, Mr. Cochran was President of the NASD member firm Equity Engineering, Inc., and in 1990 founded Nicholas C. Cochran & Associates, an investment planning and asset supervisory firm. In addition to his experience in the securities industry, Mr. Cochran has served as the Board Vice Chair and Finance Committee Chair at the Pacific Graduate School of Psychology, Vice President of Finance at the University of Phoenix, Corporate Accounting Manager for Raychem Corporation, Controller for Behavioral Research Laboratories and Senior Accountant for Price Waterhouse & Co. Mr. Cochran holds a CPA certificate and earned a bachelor's degree from San Jose State University.

Connie Kuhl – Chief Compliance Officer and Senior Vice President of Customer Service and Operation at Motif Investing, Inc. As one of the early executives at E*TRADE, Ms. Kuhl brings to Motif Investing a wealth of experience in the online brokerage space and an impeccable track record for success. Her career at E*TRADE spanned over 13 years, during which time she held roles such as Chief Communications Officer and Senior VP of Global Service Quality & Brokerage Operations. Ms. Kuhl was instrumental in building and growing the franchise from $23M to $2B in annual revenue and taking the company public in 1996. She has served on the Boards at Archipelago Holdings, E*TRADE Securities, Web Street, and as an advisor to the Chicago Board of Options Exchange. Ms. Kuhl holds the Series 7, 63, 24, and 55 licenses.

Allison Petchenick has served as the Chief Compliance Officer and Chief Operating Officer at B. Riley & Co., LLC ("B. Riley"), a FINRA member broker-dealer, since 2007. She also serves as the Chief Compliance Officer

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

at B. Riley Capital Management, LLC (“BRCM”), a SEC registered investment adviser. B. Riley & BRCM are wholly owned subsidiaries of B. Riley Financial, Inc. (NasdaqCM: RILY). Ms. Petchenick joined B. Riley in July 2005 as Director of Operations. Prior, Ms. Petchenick worked at Bel Air Investment Advisors (a former affiliate of State Street Global Markets, LLC) as Operations Manager. Earlier, she worked for four years at JB Oxford & Co. (aka National Clearing Corp. & Stocks 4 Less, Inc./Mr. Stock, Inc.) holding several positions, including Assistant Branch Manager and Operations Manager. Ms. Petchenick holds a Bachelor of Science and Economics in Business Administration from St. Mary’s College of California.

© 2015 Financial Industry Regulatory Authority, Inc. All rights reserved.

Small Firm Conference

November 11-12, 2015 | Santa Monica, CA

Examination Priorities: Suggestions for Small Firms

FINRA

Panelists

Moderator:

- **Donald Lopezi, Senior Vice President and Regional Director, FINRA West Region**

Panelists:

- **Nicholas Cochran, Vice President, American Investor Company**
- **Connie Kuhl, Chief Compliance Officer and Senior Vice President Customer Service and Operations, Motif Investing, Inc.**
- **Allison Petchenick, Chief Compliance Officer and Chief Operating Officer, B. Riley & Co., LLC**

Examination Priorities: Suggestions for Small Firms

Agenda

- **Introductions/Opening Remarks**
- **FINRA's Risk Based Examination Program**
- **Examination Priorities**
  - Complex and New Products (New Product Features/Terms)
    - Vetting, Approvals, Education, Systems and Controls
    - Point of Sale Risks
  - Conflicts of Interest
    - Compensation Structure
    - Outside Business Activities/Private Securities Transactions
- **Common and Material Findings**
- **Closing Remarks**

© 2015 FINRA. All rights reserved.