

## **Our Capital Market's New Frontier: Professionalism**

**By Norman B. Arnoff**

Enron, Madoff and the financial crisis of 2008 were brought about by a number of different causes including the marketing of synthetic products that lacked due diligence of sufficient depth; high frequency and high speed trading; complex financial transactions susceptible to flawed analysis and misleading reporting; and limitations of regulatory and self-regulatory coverage in the processes of investigation and inspection that could have been ameliorated or eliminated by a higher degree of and more pervasive professionalism. As a result the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”) was enacted with a comprehensive mandate for studies of the systemic flaws in the capital markets, the financial services industry, and the regulatory and self-regulatory framework to be followed by informed and pragmatic rulemaking that will strengthen investor protection. Central to Dodd-Frank reform, while not fully expressed and certainly not implemented; is the mandate for more pervasive professionalism by the service providers and their organizations. This is the case, especially where personalized investment advice is given to the non-institutional, and individual investor (who many refer to as “the main street investor” and), whose welfare and that of his or her family depends upon the quality and integrity of that advice.

Where are we now and are we going in the right direction with the new professionalism that hopefully will serve as the bedrock for the advice and the services provided to the main street investor? This article will address this seminal issue.

## **The Dodd-Frank Mandate**

Section 913 of Dodd Frank mandates a study and consequential rulemaking regarding the obligations of brokers, dealers and investment advisors. By definition the term “retail customer is a natural person or the legal representative of such 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.”

The study was to evaluate legal and regulatory standards of care for those providing personalized investment advice and recommendations about securities to the individual and non-institutional investor. Whether the standards are flawed and do not serve the prime legislative purpose of greater investor protection is the key focus. The study was to consider what were the standards of care and whether different standards for broker-dealers and investment advisers were and are a source of confusion for the main street investor; the substantive differences in the regulations and how effective are those regulations; and whether if the standards were harmonized would they and to what extent better protect investors. Most significantly is the issue whether the broker-dealer exclusion , Section 202(a) (ii) (c) of the Investment Advisers Act of 1940 (the “40 Act”); should be eliminated or constricted as it relates to the applicable standard of care and the beneficial or detrimental effect of any change in the law or rules.

After reviewing the findings and conclusions of the study, the Commission was to and is authorized to establish fiduciary duty standards for broker-dealers including on such subjects as compensation; a continuing duty of care; and notice and disclosure regarding the sale of proprietary products, especially where there are a limited range of investment products being offered by the broker-dealer. In respect to broker-dealers and investment advisers the

Commission is to give consideration to promulgate conflict of interest disclosure and consent rules.

However the investor in privately managed funds is not deemed to be a “customer.” The receipt of compensation whether fees or commissions are not deemed a violation of the law and/or the applicable standards. We need to consider what different and beneficial functions of different categories of financial service professionals have to be recognized and whether we are truly going in the direction of reform intended by the statute.<sup>i</sup>

**The January 2011 SEC Study on Investment Advisers And Broker-Dealers As Required by Dodd-Frank Section 913**

In January 2011 the Staff published a study that stated a uniform fiduciary duty standard was appropriate and that its application to broker-dealer should be “no less stringent for broker-dealers than investment advisers.”<sup>ii</sup> The study articulated the rationale as follows:

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

To avert the confusion referred to above and give the investor the ability to make a more informed choice as to the nature of the relationship he or she is to have with his or her service provider, the staff was to make findings and recommendations “intended to make consistent the standards of conduct applying when retail customers receive personalized investment advice about securities from broker-dealers or investment advisers.” The Staff therefore recommended “establishing a uniform fiduciary ... [duty] standard for investment advisors and broker-dealers when providing investment advice

about securities to retail customers that is consistent with the standard that currently applies to investment advisers.” Further the Staff recommended “harmonization of the broker-dealer and investment adviser regulatory regimes.”

The Staff realized, however, “[t]he description of the standard as ... [a] fiduciary... [one] is by itself only a general characterization.” (Emphasis added). Justice Benjamin Cardozo is quoted “to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.”<sup>iii</sup> (Emphasis added.) The fundamental reality is that meaningful standards must be given specific content and not remain mere aspirations. What we call those standards means significantly less than what they are and whether those standards achieve a greater standard of professionalism to achieve more effective investor protection, irrespective of the professional role being considered.

**The Retail Investor Protection Act House  
Report No. 113-228 (1), September 25, 2013**

The House Committee on Financial Services is requiring consistent with Dodd-Frank informed and pragmatic rule-making. The Commission will be required before any rules are promulgated to identify “if retail customers (and such other customers as the Commission may by rule provide) are being systemically harmed or disadvantaged due to brokers or dealers operating under different standards of conduct than those that apply to investment advisors....” Any rules promulgated and published in the Federal Register have to be accompanied by “formal findings that such rule would reduce the confusion of a retail customer... about standards of conduct applicable to brokers, dealers, and investment advisers.”

In pertinent part the House Report states:

“Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to conduct a study of the different legal standards of care broker-dealers and investment advisers owe their retail customers and authorizes but does not mandate that the SEC, in its discretion, issue rules to harmonize these standards of care.” (Emphasis added).

The question then becomes can the operative standards be harmonized and should they be to further investor protection.

### **The November 22, 2013 Open Meeting of the Investment Advisory Committee**

The November 22, 2013 meeting of the Investment Advisory Committee in reference to the strengthening of investor protection discussed the broadening of regulatory and self-regulatory coverage by means of the enlargement and greater frequency for investment adviser examinations. The Committee cited the figure of forty percent (40%) for the number of investment advisors never examined. The obvious consensus was that the SEC needs more examiners. Should taxpayer funds be used to fund an enhanced inspection process or should there be a user fee, the cost of which ultimately will be paid by the investor?

Another issue discussed was the allocation of examiner responsibilities to the SEC, the States, and the SROs. The Committee’s consensus was that greater exam coverage was a necessity but funding had to be given more serious consideration and whether OCIE would in fact receive the benefits of the funding. The Committee recommended more frequent investment advisor examinations achieved by means of user fees.

In respect to the broker-dealer fiduciary duty standard, the consensus of the Committee was that the suitability standard was not a fiduciary duty standard and the regulatory loophole needed to be closed.

The Committee stated that brokers are regulated as sales persons and this regulatory scheme is not adequate. Further investors should be given opportunity to make an informed choice with respect to the type of service and service provider that they will engage and the extent of the responsibilities the investor is willing to take with respect to his investments and trading. According to some on the Committee the distinction between brokers and investment advisors should not be a problem if documented pre-engagement disclosures are provided to the individual and non-institutional investor.

The Committee did recognize the legitimate differences between brokers and advisers such as the investment advisor trading prohibition with their clients. In respect to the 40 Act, the broker-dealer exemption allows the broker to give “incidental advice” without being deemed an investment advisor and this exemption should be tightened but not eliminated. This is the case provided the advice is not separately compensated.

The Committee did agree that the broker-dealer exclusion is too broad and does not facilitate the professionalism that should be the operative and the governing principle for broker-dealer conduct. Also of concern to the Committee was that while brokers may be deemed to be fiduciaries in given circumstances they should not be going in and out of that status e.g. no fiduciary responsibility after a recommendation to buy or sell was made but reassigned when additional recommendations are made and/or the broker-dealer performs other functions such as trade execution and custodial services. Firms with limited numbers of products, including proprietary ones, also were of concern.

Written recommendations of the Investor Advisory Committee were prepared and published subsequent to the meeting and addressed the Broker-Dealer Fiduciary Duty Standard

issues. Essentially two (2) recommendations were made to the SEC. The first recommendation was that the Commission should conduct rulemaking to impose a fiduciary duty on a broker-dealer when providing personalized investment advice. The issues and factors to be considered in this pro-active rule-making are whether the broker-dealer exclusion under the 40 Act should be narrowed; the broker-dealer should be held to a standard of care “no weaker than the existing Advisors Act Standard”; and any rules adopted should incorporate a principle-based obligation to act in the best interests of the customer. For further consideration in connection with transaction based recommendations was whether there should be sales related conflict disclosure; and in respect to transaction-based payments a determination should be made whether such payments would be acceptable under the fiduciary duty standard and could such payments be reconciled with that standard.

The second recommendation of the Committee to “the Commission ... [was to] adopt a uniform, plain English disclosure document to be provided to customers and potential customers of broker-dealers and investment advisers at the start of the engagement, and periodically thereafter that covers basic information about the nature of the services offered, fees and compensation, conflicts of interest, and disciplinary record.” The Committee expressed that the current “pre-engagement disclosure” was not sufficient standing alone to establish and implement a fiduciary duty standard for broker dealers. More comprehensive pre-engagement disclosure would be comparable to the option disclosure document provided to the customer prior to the customer opening an option account and this makes eminent good sense.

In pushing for this new rule making the Committee expressed the following:

“The limited opposition that exists to rulemaking in this area is based first on the argument that broker-dealers are already extensively regulated under existing

state and federal laws and self-regulatory organization rules. While this is true, it is largely irrelevant to the question of what standard should apply when broker-dealers provide personalized advice to retail customers. Put another way, the question is not whether broker-dealers are adequately regulated when they act as sales people but whether they are adequately regulated as advisers.” (Emphasis added).

Ergo, the Committee recommended that both the mind set for viewing broker-dealers and the rules governing their conduct should be rooted in professionalism as opposed to their being sales persons that are in the business of aggressively marketing a variety of products and activities, including proprietary ones.

### **The Fiduciary Duty Standard And Audited Professionalism**

The Study On Investment Advisors and Broker-Dealers (January 2011) with a prime purpose to lead to rule making to establish a fiduciary duty standard for brokers and broker-dealers “no less stringent than for investment advisers” should trigger a reexamination of not only the operative standards of professionalism for brokers but for all categories of positions in the financial services industry and capital markets. To say that different classes of professionals are fiduciaries is only helpful, if appropriate, specific, and textually clear standards are promulgated and applied.

Where there is an expectation that a position brings with it professional responsibilities, it is the author’s view that to accord professional status to categories of key participants in the capital markets that not only includes brokers and investment advisors, but credit and investment analysts, firm supervisory personnel, and compliance professionals; is sound public policy and will have most beneficial effects.

On the other hand, there needs to be clarity in setting the standards of competency and ethics. Rigidity or mere use of terms of aspiration without filling in the content will not produce



the objectives intended and overlook what has already been established in the industry in the applicable rules, customs, and practices. There has been for brokers a clear distinction that when they have formal and de facto discretion and have care, custody, and control of a customer's funds and securities they do in fact have fiduciary responsibilities. However, the standards applicable to the broker do not always equate with those applicable to the investment advisor representative. This is the case, where the customer is fully capable of and makes his or her own investment decisions; the trades are unsolicited; and the customer has responsibilities to read and protest confirmations and account statements that are not accurate and that reflect trades the customer never authorized or approved. Moreover the current standards are not either/or, but adapted to the specific context. The broker has fiduciary obligations in making suitable recommendations and getting best execution but they do not equate to the investment advisor representative's duties. The investment advisor representative has management responsibilities for the client's account and the client is completely dependent on the adviser. There is a sound rationale for this in that the broker and dealer creates the access to the markets for the investor, whereas the investment advisor serves primarily in the role of a professional asset manager.

By way of example the suitability concept and the broker's role in the context of a non-discretionary account requires the broker to have a written information base before making a recommendation consistent with the investment objectives of a non-vulnerable customer but does not abrogate the customer's responsibility to check his or her confirmations and account statements and make a timely and documented objection to unauthorized transactions or charges deemed excessive. In that context where the customer has the choice, the full fiduciary obligation is only triggered again when the broker has the duty of best execution, and when the broker has custody of the customer's funds and securities in specific relation to custody.

Rather than a uniform standard that will run the risk of being too mechanically applied the better approach in this author's opinion will be to allow each professional group to set their own standards of competency and ethics with the SEC's oversight to assure whatever the context, the public customer is accorded appropriate protection. Changing labels will not give meaningful content to the rules, customs, and practices that should give informed and beneficial guidance on an ongoing basis to those assuming responsibility for other people's money and securities.

Key to the articulation and lasting internalization of professional standards by the broker, investment advisor, or investment and credit analyst will be textual clarity in the rules that give educative notice as well as rules that make sense in a practical context. Continuous and pragmatic review to reasonably assure that the rules will work for the protection of investors will also be essential and this requires pro-activity on the part of the regulators, self-regulators and the financial services industry.

While the SEC and other regulators now strive to be everywhere they cannot be everywhere. In part the gaps will be covered by cultures of compliance created and sustained by sound financial service organizations and the professionals they engage or employ and especially with respect to rules that assign supervisory responsibility within the organization. No doubt the SEC seeks to give OCIE's examination process greater breadth and depth but that too will extend coverage but not reasonably assure its presence in all contexts. To assure even greater investor protection it is this author's recommendation that the SEC, the industry, and the professions that serve in and for the industry and the investors expand our notions for more comprehensive compliance audits to audit the professionalism of both the individuals serving in professional roles as well as the organizations.<sup>iv</sup> These audits should be performed by independent and

private sector auditors and will add a new dimension of self-regulation to supplement OCIE and SRO examinations.

These audits should have auditor opinions and/or certifications and representations by the organization and the professionals within them that will state that after the application of sound audit procedures, the organization and its professionals have complied with the applicable law and professional standards of competency and ethics and there is a solid basis to make such a representation. While firms and professional organizations will have collective responsibilities to comply those who sign off on the independent private sector compliance audits should and will have non-delegable duties. This will assure in every context someone will have to take responsibility for the firm's compliance and its audits. This is not to say there will be insurer liability should errors or omissions occur as the defenses pursuant to Section 20(a) of the '34 Act will apply, i.e. respondents will be allowed to show good faith and observance of the standards of due care by demonstrating that sound supervisory and compliance systems are in place in their organizations.

The existing gaps resulting from the reality of an absence of regulatory omnipresence will have a greater assurance of being filled. These private sector investor protection audits should now be mandatory for investor protection including in areas beyond the scope of the traditional financial statement audit and encompass inter alia, an organization's claims handling procedures and practices.

By way of example to the above in Securities Act of 1933 Release 33-9415 the Commission promulgated a rule "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A" that on its face eliminates the restriction of the

private offering exemption to a limited group and allow such an offering in essence to become mass marketed.

In a talk on September 12, 2013 at the PLI Hedge Fund Management Conference Norm Champ, Director of the Division of Investor Management, stated in respect to the Rule 506 amendment eliminating the prohibition on general solicitation and general advertising for certain offerings, the following:

“The final rule permits issuers to use general solicitation and general advertising to offer their securities if, among other things, issuers take reasonable steps to verify ‘accredited investor’ status and all purchasers of the securities are accredited investors. Determination of the reasonableness of the steps taken to verify that an investor is accredited is by an objective assessment {of the} issuer, and in response to comments the final rule provides a non-exclusive list of methods that issuers may use to satisfy the verification requirement for individual investors.” (Emphasis added).

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Advisers should carefully review their policies and procedures to determine whether they are reasonably designed to prevent the use of fraudulent or misleading advertisements and update those policies, where necessary, particularly if the hedge funds intend to engage in general solicitation activity. Hedge fund sponsors intending to rely on the new rule should also consider whether their current practices for verifying accredited investor status meet the requirements of the new rule.” (Emphasis added).

Private sector and independent auditing of the verification of accredited investor status will be essential and prevent to the greatest extent possible participation by non-accredited and unsuitable investors. Investor literacy should also be tested by questionnaires sent by the auditors in relation to the product(s) or trading activity of the investor. Financial wealth alone cannot qualify an investor to engage in complex trading and/or investing in newly created, high risk, and hybrid products.

There must be a heightened consciousness of the risks of general solicitation and auditing to avert those risks. The accounting profession has developed what is termed as a “special procedures engagement” that can serve as a model in this context. Another area that should be subject to an independent private sector audit of compliance procedures and practices on an ongoing basis is investment adviser performance compensation.<sup>v</sup>

The above contexts are precisely where an independent compliance auditor applying review and verification procedures would greatly enhance investor protection and supplement the SEC’s and the SROs’ inspection and investigation processes.

In respect to the public investor-client relationship with the high risk brokers or dealers independent and private sector compliance audits should focus in a fact specific way on the nature of the business being done by the broker or dealer with the public customer (directly or indirectly) and audit such procedures and practices as the new account qualification process and whether the customer by signature or otherwise essentially has made an informed choice with respect to investment strategies and choices; whether the compensation is fair taking into consideration the transaction costs, risks, and attendant disclosure; whether there is reliable and verifiable trading authority and confirmation. IPO due diligence, disclosure, after-market trading activities, and irregularities that come with the context; best execution; and meaningful up-front and on-going disclosure and transparency for the investor whatever the nature of the relationship of the investor with the financial service professional should also be within the scope of the audit.

Moreover in view of the fundamental remedial purpose of the federal and state securities laws, private sector and independent compliance auditing should also focus on the fairness and

effectiveness of the claims processes before as well as during and after arbitration and litigation. Rather than increasing the costs of litigation and arbitration it is likely by allowing for earlier, monitored and fair resolution of disputes; costs to the industry and public customer will be significantly reduced. Catastrophic losses triggering SIPIC liquidations and minimal investor indemnification are also likely to be minimized or eliminated. An organization that does not in good faith have meaningful claims processes and litigation loss reserves in place should also be made to incur reasonable litigation and arbitration costs as an exception to the American Rule against attorney fee and other cost shifting when there are adverse awards and judgments against a firm. All of the foregoing should be subject to independent and private sector compliance auditing.

In developing and continuing to develop SEC and SRO Rules, Section 29(a) of the Securities Exchange Act of 1934 (“34 Act”){ 15 U.S.C. Section 78cc} is critical in that it provides in pertinent part, “ any condition, stipulation, or provision binding any person to waive compliance with any rule of an exchange required thereby shall be void.” The legislative history to this statutory section makes it clear that any claim of waiver of the SRO Rules is not proper. The legislative history to this provision provides as follows: “This subsection declares void any condition or stipulation requiring any person to waive compliance with any rule or regulation there- under or any rule of...{an} exchange.” Not only will this provision prohibit advance and uninformed waivers without consideration by the public customer but prevent contractual reassignments of responsibilities by firms among themselves such as when clearing broker-dealers try to absolve themselves of any legal obligation to the customer of the introducing broker. Firms should not be allowed to delegate away their fundamental duties for investor protection even if another firm has principal responsibility.. Professional responsibility to adhere

to the rules promulgated by the SROs pursuant to statute and SEC oversight is a keystone of the capital market regulatory and self regulatory framework and this cannot be given enough emphasis.

Professional responsibility in the financial services industry and capital markets can be enhanced by establishing for those groups with recognized professional status, self-regulatory organizations that by virtue of their special expertise will set professional standards of competency and ethics under SEC oversight. Merging all self-regulatory functions and responsibility into FINRA will not enhance investor protection. A better option will be to establish an SRO for investment advisers comparable to FINRA and the PCAOB that would also in addition to regulatory oversight provide a dispute resolution forum. Where industry expertise combines with the participation of public arbitrators it is likely such a forum will maintain the highest level of fairness in perception and reality.

### **The Wolves of Wall Street**

“Boiler-rooms”, “bucket shops” and “chop-shops”, more frequently found in youth cultures where high pressure selling practices are found; where there is broad telemarketing off vendor compiled lists; board room campaign rallies that sound more like football team rallies than informed presentations of the products and activities to be offered to the investor; and sales contests and overall production bonuses that incentivize high pressure selling irrespective of the customer’s needs and objectives; are a complete antithesis to the professionalism we now seek to develop in our financial services industry. What do we do to not merely stop the “Wolves of Wall Street” but to prevent this phenomenon from occurring? Standards of professionalism have

to be more effectively developed and applied so that even if the public customer is disposed to market-risk taking, he or she can do it with the reasonable assurance of professionally delivered services. The reality is that regulatory enforcement alone will not do it but an industry working with its SROs ,the states, and the SEC will be the primary way to accomplish the objective. The area that in the first and most significant instance that needs to be focused upon is the elimination of excessive compensation incentives unrelated to the broker or dealer's risk and the nature and extent of the work and services performed.<sup>vi</sup>

### **Mediation, Arbitration, and Pre-Dispute Claims Resolution**

In an address to the North American Securities Administrators Association, Annual/SEC/9(d) Conference April 16, 2013 Commissioner Luis A. Aguilar addressed among other subjects "Efforts to Weaken Investor Protection" and expressed his "main concern ... [that] pre-dispute mandatory arbitration is the denial of investor choice;... and investors should not have their option of choosing between arbitration and the traditional judicial process taken away from them at the very beginning of their relationship with their brokers and advisers."

Experienced securities lawyers have seen cases where arbitration has been fair to both the public customer and the industry; situations where arbitration has been grossly unfair and almost as costly as litigation in court; and cases in court where customers with smaller claims were overwhelmed by prohibitive costs. If the customers are put in a position at the outset of or at any point in their professional relationship to make an informed choice of forum and that is confirmed in writing *separate* from their selection of an adviser, or the type of account they are opening i.e., cash, margin, or option account; and the mediation-arbitration processes is reformed; mediation-arbitration will be the better alternative for most individual and non-institutional customers.



Two critical reforms should be put in place. In securities arbitration any one of the parties should have the option of having the arbitrators issue a reasoned award. This will not only enhance the customer's perception of fair process but also allow the arbitration forum to contribute to and maintain the principled development of the Federal and State Securities Laws. To re-enforce the foregoing, I would also recommend that SROs with arbitration forums have an internal appeals process that will also enhance the perceptions of fairness. In today's securities arbitration process non-reasoned awards and judicial deference to arbitrators, unless there is a manifest disregard of law or corruption; does in fact on occasion prevent the truth from coming to light with respect to serious wrongdoing and achieving a fair and equitable result for the public customer.

With reasoned awards and an internal appellate process matters having disciplinary implications will be more readily referred to the SEC and other appropriate regulators and the SRO arbitration forum will be more informative and effective in facilitating regulatory oversight. Regulatory enforcement and rule-making processes will also be greatly enhanced. The complaint and disciplinary history of individual brokers and their firms will also be more informative to prospective customers. The arbitration process should be a significant and open window to see how industry practices and the law are impacting the main street investor.

Further a more comprehensive claims process conducted by firms that will also be subject to independent and private sector auditing along with professional liability insurance for investment professionals will also confer significant benefits in a number of ways. Professional liability insurance will provide greater investor protection for investor loss caused by wrongful conduct and supplement and possibly prevent SIPIC liquidations. Further the underwriting process will provide additional self-regulation and compliance in order to satisfy the

requirements for insurability. Recently FINRA announced that it was considering mandatory professional liability insurance.<sup>vii</sup>

More pervasive professional liability insurance along, with the other reforms discussed, will add to the greater development of professionalism in the financial service industry and shift the prime focus of broker-customer disputes to professional malpractice instead of fraud. Not complying with objective professional standards of financial service competency and ethics developed initially by the industry is more susceptible to reliable and easier proof than fraud or constructive fraud with its scienter and/or reckless disregard standard. In fact under Dodd-Frank there is already a diminishment of the standard of reckless disregard to recklessly failing to comply or in essence, professional malpractice.<sup>viii</sup>

On December 23, 2013 the Commission published Release No. 34-7119, File No Sr.-FINRA-2013-025, approving Rules Regarding Supervision in the Consolidated FINRA Rulebook. In this author's view the Consolidated Supervision Rules issued by FINRA that declined to accept the two (2) recommendations of this author regarding independent private sector compliance audits and making explicit cost shifting when the firm does not have in place a sound supervisory and compliance framework are materially flawed as a result . I believe both of the foregoing are essential to elevating the standards of professionalism for both brokers and dealers as well investment advisors and reconsideration is required

Independent private sector compliance audits provide a greater assurance of transparency and individual and firm compliance with applicable laws and regulations and will not subject the industry or the public investors to undue expense and certainly not if the benefits of such an approach are duly considered.

The gaps in regulatory examination coverage will never be filled because of manpower and budget constraints, and we will never have the comfort that the gaps will be covered unless new and better alternatives are devised. Nor will internal compliance audits and reporting out be sufficient because they do not have the badge of credibility and reliability of an independent audit. Nor will the expense to the industry be extraordinary because the scope and extent of the audit will be working off and from prior regulatory exams as well as preceding internal processes of review and verification.

Supervisory responsibility is the key to capital market integrity and investor protection and should be subject to independent private sector auditing. By reason of the defenses allowed by Section 20(a) of the 34 Act the responsibility imposed is reasonable. The party asserting the 20 (a) defenses must show both good faith and reasonableness to be relieved from secondary liability and this is not an undue burden.

The recommendation to make explicit fee and cost shifting to the firm that does not have a sound supervisory and compliance system in place was also declined. Arbitrators like Courts have inherent authority to impose fees and costs on a party that has not acted in good faith or indirectly or directly caused the other party unnecessary litigation expense. This authority should be made explicit as well as the rationales for the imposition of monetary sanctions, especially when the triggering conditions are systemic flaws in the compliance and supervisory system of the firm.<sup>ix</sup> Neither of the above two (2) proposals *i.e.*, independent private sector compliance auditing and cost shifting in securities arbitrations are as FINRA claimed in their response to the comments beyond the scope of the Consolidated Supervision Rules. Measures to make rules work and work more effectively should never be considered beyond the scope or content of the rules.

As a result of Dodd-Frank, the Department of Labor is prohibited from prescribing any regulation under the Employee Retirement Income Security Act of 1974 (“ERISA”) defining the circumstances under which an individual is considered a fiduciary until sixty (60) days after the SEC promulgates a final rule governing the standard of conduct for brokers and dealers under specified law. Ultimately there should be no question that broker-dealers, their associated persons, and registered representatives when they are the primary service providers for retirement accounts, whatever other relationships they have with the client should be deemed fiduciaries.

### **Criticism, Clarification, And Conclusion**

Section 913 (Study and Rule Making Regarding Obligations of Brokers, Dealers, and Investment Advisors) needs clarification and remedial measures to be taken. In pertinent part the statute defines the term “retail investor” as follows:

“...[T]he term ‘retail customer’ means 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.

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Further Section 913 goes on to ... [provide:]

(g) Standard of Conduct

(l) General

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

However “the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser where such private fund has entered into an advisory contract with such advisor.” (Emphasis added).

The main theme of Section 913 is to elevate the standards for broker dealers to standards no less stringent than investment advisers. The above language is incongruous with the purpose of Title IX to strengthen rather than weaken investor protection. Arguably the language quoted resurrects the “strict privity” rule that will preclude the individual and non-institutional investor in the hedge or private equity fund from suing the third party investment adviser and contractor with the fund for professional negligence.

The private adviser exemption has been eliminated and a significant regulatory loop hole closed. However, there is no implied right of action under the Investment Advisors Act of 1940 so in consequence Section 913 of Dodd-Frank constricts the individual and non-institutional investor’s available remedies even further than what they were pre-Dodd-Frank. State tort and contract law is superseded by the federal statute so it will be doubtful whether the non-customer public investor will have standing to sue the fund’s advisor for professional negligence.

The fiduciary duty standard for broker-dealers no less stringent than that for investment advisers is confusing and requires clarification so that Section 913 of Dodd-Frank will keep the

statute and the rules moving in the right direction to strengthen the law in protecting the individual and non-institutional investor. To bring further clarity it must be understood that while the overwhelming number of brokers virtually always provide personalized investment advice, the prime role of the broker and dealer is to create effective access to the capital markets for the investor; whereas investment advisors provide portfolio management and advisory services. In such latter contexts there is significant if not total dependency of the investor upon the investment advisor. When there is such dependency to the extent described, not just mere advice that can be disregarded; there is a fiduciary relationship between the investor-client and the financial services professional, whether he or she is a broker or investment adviser representative.

The fundamental differences were clearly described in the Second Circuit's opinion in De Kwiatkowski v. Bear Stearns & Co. Inc.<sup>x</sup> The Court's explanation makes it clear that while professional standards should apply to both the broker and the investment adviser representative they are not identical and can never be in terms of the nature of the services provided.

While the investment adviser must comply and faithfully serve because of his or her fiduciary duty to the investor, the broker engaging in more of an arms-length transaction not only has to comply inter alia with the know your customer, suitability and best execution requirements of the federal securities laws and the SRO rules but also to the standards of "just and equitable principles of trade" and Ezra Weiss' "Shingle Theory" i.e., the broker-dealer's registration and licensing always implies good faith and fair dealing. In either professional context the highest standards of competency and ethics have to be observed.

The Second Circuit held in De Kwiatkowski on the subject of the inherent differences and assigned responsibilities of the two rule sets, held:

It is uncontested that a broker ordinarily has no duty to monitor a non discretionary account, or to give the advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice or warnings concerning the customer's investments. A non discretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction-by transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obligated to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but ...[has] no legal claim on the broker's ongoing attention.

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The giving of advice triggers no ongoing duty to do so....

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No doubt, a duty of reasonable care applies to the broker's performance of its obligations to customers with non discretionary accounts.

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But in establishing a non discretionary account, the parties ordinarily agree and understand that the broker has narrowly defined duties that begin and end with each transaction. We are aware of no authority for the view that, in the ordinary case, a broker may be held to an open-ended duty of reasonable care, to a nondiscretionary client, that would encompass anything more than limited transaction-by-transaction duties. Thus, in the ordinary nondiscretionary account, the broker's failure to offer information and advice between transactions cannot constitute negligence.

All of the cases relied on by De Kwiatkowski in which brokers have been found liable for their non discretionary customers' trading losses involve one or more of the following: unauthorized measures concerning the customer's account (i.e., the account became discretionary-in-fact because as the broker effectively assumed control of it); failure to give information material to a particular transaction; violation of a federal or industry rule concerning risk disclosure upon

the opening of the account; or advice that was unsound, reckless, ill-formed, or otherwise defective was given.

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But the giving of advice is an unexceptional feature of the broker-client relationship. What little case law there is on the subject makes clear that giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to advise in the future (or between transactions) or to monitor all data potentially relevant to a customer's investment....

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A broker may be liable in tort for breach of a duty owed in respect of advice given. But if a broker had a broad duty to furnish a non discretionary customer with all advice and information relevant to an investment, then, the customer could recover damages "merely by proving non-transmission of some fact which, he could testify with the wisdom of hindsight, would have affected his judgment had he learned of it." (Emphasis added).

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The Investment Advisor Act of 1940, Section 206 has a principal trade prohibition of the investment adviser to not engage in such transactions with the client. This does not mean where a broker-dealer that takes an inventory risk and engages in a principal transaction the law leaves the "retail customer" unprotected. The rules and the practices relating to fair mark-ups and mark downs; and limiting the broker's discretion to authorize a trade where there is a signed writing by the customer and to one (1) day time and price discretion, clearly protects the customer; even when the broker's obligations are not equivalent to the investment advisor representative's obligations.

The same doctrine of informed consent, confirmed in writing that applies to lawyers pursuant to the Model Code of Professional Conduct applies by means of having the customer sign the new account form acknowledging his or her investment objectives; trade confirmations,



account statements, and activity letters.<sup>xi</sup> Where the public customer elects ultimately their own decision-making of what to buy, sell, trade, and hold; it comes with responsibility and the nature of that relationship is different from the one the investor has with the investment advisor which is one to the greatest degree of complete dependency. Where the customer elects his or her own means of market access, even facilitated by the broker's advice; that does not equate with the broker or dealer accepting that degree of legal and investment responsibility that the 40 Act investment advisor-manager has for the investor's accounts that he or she services.

### **Conclusion**

It is clear the consistencies as well as the differences in the operative standards should be developed by the SRO for the particular professional group under SEC oversight and that is why an Investment Advisor SRO is now an essential necessity. Changing labels by itself will have no significance. This is not to say the term, "fiduciary" which has a special meaning for those who serve in professional roles does not have utility. It is a term of aspiration that motivates all professionals to act in accordance with the highest standards of care, ethics, and honor when the facts present the interstices of law and regulation.

However, textually clear and informative rules that are a product of industry, regulatory, arbitration and litigation experiences are the most essential building blocks for the financial markets. Such rules can only be written, promulgated and ultimately established and complied with by the strongly rooted professionalism of lawyers, accountants and financial service professionals (whether brokers or advisors).

For brokers and dealers, practices such as aggressive cold calling, over inflated mass advertising to a mass audience, and sales bonuses subsequent to and supplementary to the receipt

of fair transaction compensation set by the industry standards have to be rooted out if cultures of compliance can be established for brokers and dealers. High pressure and fraudulent sales activity is a product of (more often than not) extraordinary compensation incentives. Extraordinary sign-on bonuses coupled with forgivable loans also pressure the salesman to engage high pressure sales tactics and while these types of loans and bonuses as a matter of practical reality cannot be prohibited altogether they should be made more transparent and strictly regulated. Only when we constrain the extremes of sales activity and substitute the basic concepts of professionalism will we have reasonable comfort that “personalized investment advice “in whatever context will be in accordance with the highest professional standards of competency and ethics.

Judge Cardozo in Meinhard v. Salmon<sup>xii</sup> best expressed both the spirit and force of the term “fiduciary”. Judge Cardozo wrote:

Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions.... Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

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Little profit will come from a dissection of the precedents. None precisely similar is cited in the briefs of counsel. What is similar in many, or so it seems to us, is the animating principle. (Emphasis added).

Obviously, the term standing alone without specific content cannot build and maintain an effective regulatory and self-regulatory framework that maximizes investor protection through

heightened professionalism. If we want a market place that is always in the process of improving its collective morality, we need occupations that move to and accept professional status with their attendant responsibilities. In the financial service context this will mean SROs where the constituent community under the auspices of the SEC promulgate intelligible standards of ethics and competency taking into consideration the nature of the services provided by the particular professional group in comparison with the other groups; whether there are effective forums fair to both the investor and the financial service professional to resolve professional malpractice claims justly as well as be informative for the further principled development of the securities law including SEC and SRO rule-making; and professional liability insurance that will provide an additional dimension of self-regulation and compensation for losses resulting from serious professional error.

As Chief Judge Cardozo wrote the term “fiduciary” only expresses an “animating principle” that should set us in the right direction but not ultimately get us where we want to be. This can only be done in the capital market context by establishing the solid and true foundations of professionalism for the critical roles that are intended to and must serve the public investor and maintain capital market integrity.

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<sup>i</sup> SEC Study Investment Advisors and Broker Dealers, (January 2011), Executive Summary.

<sup>ii</sup> SEC Study Investment Advisors and Broker Dealers, (January 2011), Executive Summary, Pages V and VI.

<sup>iii</sup> SEC Study on Investment Advisors and Broker-Dealers, (January 2011) Page 110.

<sup>iv</sup> Financial statement audits do audit “internal controls” but this is not sufficient to give reasonable assurance of a more comprehensive coverage that even with the maximum number of inspections and investigations of regulators can only be achieved if there are independent private sector compliance audits.

<sup>v</sup> See 17 CFR Part 275, Release No. 1A 3372, File no 57-17-11.

<sup>vi</sup> See Securities Brokers Malpractice and Its Avoidance ; Franklen D. Ormsten, Norman B. Arnoff, and Gregg R. Evangelist, Seton Hall Law Review, Book One, Vol. 25, 1994, that addresses the development of professional

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standards for broker-dealers that have traditionally exhibited compliance risks by reason of their youth cultures or the franchise nature of their operation.

<sup>vii</sup> See Wall Street Journal, October 5, 2013. See also: Norman B. Arnoff, Esq., Steven B. Wexler, Esq. and Ronald Shindler, Esq., A Guide to Professional Liability Insurance for the Investment Professional, Securities Arbitration Commentator.

<sup>viii</sup> Section 933 of Dodd-Frank Wall Street Consumer and Investment Protection Statute, Senate Report No. 111-176, April 30, 2010 pg. 85.

<sup>ix</sup> FINRA Dispute Resolution Arbitrator's Guide, Issuing Sanctions, page 55.

<sup>x</sup> 306 Fd 3d 1293 (2d Cir. 2002)

<sup>xi</sup> New York Law Journal, December 8, 2009, Informed Consent Confirmed in Writing, Norman B. Arnoff, Esq.

<sup>xii</sup> 249 NY 458, 164 NE 545, 62 A.L.R. 1 (NY Court of Appeals 1928).

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