FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT BROKER-DEALERS
AND INDEPENDENT FINANCIAL ADVISORS

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VIA ELECTRONIC MAIL

August 30, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File Number 4-606 – Study Regarding Obligations of Brokers, Dealers, and Investment Advisers

Dear Ms. Murphy:

On July 27, the Securities and Exchange Commission (SEC) published a request for public comment related to its study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors (Study). The Study is required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[1] which President Obama signed into law on July 21, 2010. As required by the Dodd-Frank Act, the SEC is requesting public input, comment, and data on issues related to the effectiveness of existing standards of care for brokers, dealers, and investment advisers, and whether there are gaps, shortcomings, or overlaps in the current legal or regulatory standards.

The Financial Services Institute (FSI)[2] welcomes this opportunity to offer input into this very important Study. FSI strongly supported the inclusion of the Study in Section 913 of the Dodd-Frank Act because we believe it provides the SEC, the financial services industry, investor advocates, and others with great familiarity with the retail market for securities sales and investment advice the opportunity to provide meaningful input and shape important regulatory reforms. Expertise in these areas is essential to insure that the final regulatory reforms support investor access to competent investment advice, preserve investor choice in service providers, and insure effective regulatory supervision of all market participants. We commend the SEC for its efforts to encourage public input, comment, and the submission of data to inform this Study and their efforts to enhance investor protection. We hope to further these efforts through the submission of this letter.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors affiliated with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis;

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[1] Public Law No: 111-20, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 121 Broker-Dealer member firms that have more than 188,000 affiliated registered representatives serving more than 15 million American households. FSI also has more than 14,500 Financial Advisor members.

primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees of their affiliated broker-dealer firm.[3] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market for advisors affiliated with IBDs is clients who have tens and hundreds of thousands, as opposed to millions, of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Introduction to Comments

Financial products and services are complicated—they come in different shapes and sizes and offer unique features to the investing public. The plethora of available options is a wonderful byproduct of the highly competitive financial services marketplace, but the choices can be overwhelming to many investors. As a result, retail investors often find they need the help and guidance of a broker, dealer, investment adviser, affiliated registered representative, or investment adviser representative (collectively referred to as Financial Advisors) to help them make appropriate choices to achieve their financial goals and dreams.

Nearly all Financial Advisors realize that their livelihoods depend on sustaining their reputations in the community and among their clients. As a result, they obtain information on each client's investment objectives, risk tolerance, financial situation, and other needs. They educate their clients on the various product and service options available to them through in-person meetings, disclosure documents, and other communications. Once the client is familiar with the options

[3] Cerulli Associates at http://www.cerulli.com/.
[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

available, the Financial Advisor makes suitable recommendations based upon the information provided by the client and facilitates the implementation of the client's informed decision-making. After the initial investment, the Financial Advisor insures that their client understands the account statements and other information related to their investments. The Financial Advisor also keeps abreast of market developments, reviews the client's portfolio periodically, and recommends changes as appropriate. The Financial Advisor designs a system of supervision to insure compliance with state and federal statutory and regulatory requirements. In other words, these Financial Advisors dedicate themselves to act in the best interests of their clients, without regard to whether the legal standard of care they owe complies with "just and equitable principles of trade"[5] or that of a fiduciary. It is simply how they operate as Financial Advisors.

Unfortunately, a small number of Financial Advisors take advantage of their clients' trust by directing clients to high-priced options intended to generate more compensation for the Financial Advisor or, worse still, simply converting client funds to their own use. When one unscrupulous Financial Advisor abuses an investor's confidence in this fashion, the reputation of all Financial Advisors is sullied. When one investor is harmed, the trust and confidence in our markets and Financial Advisors is shaken in all investors. Thus, recent market events, [6] including the emergence of several high profile Ponzi schemes,[7] indicate that a careful reexamination of our current financial services regulatory framework is needed.

IBD firms and independent financial advisors recognize these facts, but still have significant concerns about the potential unintended consequences of sweeping reforms enacted without careful consideration of their impact on:

- Investor access to advice and service;
- Investor choice between available providers of advice and service; and
- Effective investor protection efforts.

As a result, FSI members welcome this opportunity to express their views on the future regulation of their industry.

In short, FSI supports the adoption of a clearly stated universal fiduciary standard of care, plainly articulated conduct rules, effective customer disclosures, and balanced regulatory supervision efforts. The fiduciary standard of care should be applicable to all Financial Advisors who offer personalized investment advice to retail customers. This universal fiduciary standard of care must be carefully designed to promote universal access to advice, preserve investor choice, and enhance investor protection. FSI supports a universal fiduciary standard of care that would require a Financial Advisor providing personalized investment advice concerning securities to a retail customer to:

1. Act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice;

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[5] FINRA Rule 2010 (2008), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

[6] Wikipedia: Financial Crisis of 2007–2010, http://en.wikipedia.org/wiki/Financial_crisis_of_2007–2010 (last visited August 30, 2010).

[7] *See* U.S. SEC. AND EXCH. COMM'N, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, REPORT NO. OIG-509 (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf; *see also* CHARLES A BOWSHER ET AL., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES (October 2, 2009), http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.

2. Disclose material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided; and
3. Provide the advice with skill, care, and diligence based upon information that is known, or should be known, about the customer's investment objectives, risk tolerance, financial situation, and other needs.

Financial Advisors can control costs, insure compliance, and preserve investor access to advice and service if they know what the regulators expect of them. Therefore, it is essential that Financial Advisors have clarity as to their specific obligations to customers under the new standard of care. Regulators should use the existing rulemaking processes to develop regulatory requirements that are consistent with the new standard of care and enforced prospectively. Retroactive regulation by enforcement must be avoided, as it will inhibit the creativity and innovation necessary to develop efficient solutions to investor needs. These solutions expand access to advice and service. We encourage the SEC to delegate responsibility for any broker-dealer rulemaking necessary to implement the standard of care to the primary regulator of broker-dealers, the Financial Industry Regulatory Authority (FINRA).

FSI also supports an effective Financial Advisor disclosure regime. Investors can make wise choices about the Financial Advisors they utilize when they are informed of the differences between the advice and services being offered. Investors should receive concise, consolidated disclosure documents written in plain English. Point-of-engagement disclosures should focus on information material to the typical investor's decision-making process and not on arcane details of interest to a select few or designed solely to avoid liability. While issues of cost must be covered in these disclosures, the importance of this information should not be overemphasized at the expense of other relevant considerations. More detailed disclosure information should be made available to customers through Financial Advisor websites or brochures offered free of charge to those without Internet access. The amount and frequency of mandated post-engagement disclosures should be balanced in an effort to reduce the likelihood of information overload. This layered and measured approach to disclosure will facilitate customer understanding, allowing investors to make wise choices about the Financial Advisors with whom they work.

Finally, in order to affect meaningful regulatory reform, the new standard of care must be supported by effective regulatory supervision efforts. The existing gaps in regulatory supervision must be closed in order to make meaningful enhancements to investor protection. As a result, FSI supports a balanced, effective, and efficient program of regulatory supervision, examination, and enforcement for all Financial Advisors offering personalized investment advice to retail investors. Specifically, FSI supports the creation of an industry-informed, self-funded regulatory authority for registered investment advisers dedicated to effective supervision, timely examination, and vigorous enforcement. Emphasizing examination and supervision of investment advisers will benefit investors by contributing to the transparency, effectiveness, and efficiency of the financial services regulatory structure. Therefore, it is an essential part of any serious effort to enhance investor protection.

The combination of a clearly stated universal fiduciary standard of care, plainly articulated conduct rules, effective customer disclosures, and balanced regulatory supervision will promote universal access to advice, preserve investor choice, and enhance investor protection. We urge the SEC to consider these important issues as it conducts this Study, reports its findings to Congress, and implements its recommendations. Below you will find FSI's more detailed responses to the SEC's specific requests for comment.

Request for Comment One – Effectiveness of Existing Standards of Care

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

Regulatory Structures - Regulation of Broker-Dealers and Investment Advisers

The Securities Exchange Act of 1934 (Exchange Act) defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others,"[8] and defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise."[9] Broker and dealer (collectively broker-dealer) conduct is governed under the laws and regulations of the Exchange Act,[10] NASD/FINRA Conduct Rules,[11] and the various state securities laws. Individuals who work for broker-dealers and who are licensed to sell securities products are considered registered representatives of the broker-dealer.[12] Any person engaged in the securities business of the broker-dealer who is directly or indirectly controlled by the broker-dealer, whether or not they are registered or exempt from registration to sell securities, is considered an associated person.[13] Broker-dealers and registered representatives that conduct business in any of the 50 United States and the District of Columbia must also register and comply with the state's specific securities laws. Most states, but not all, have adopted some form of the Uniform Securities Act.[14]

The Investment Advisers Act of 1940 (Advisers Act)[15] defines an investment adviser as any person who, for compensation, engages in the business of advising others about the value of securities or investing in, purchasing, or selling securities and who is compensated for such advice.[16] Prior to the enactment of the Dodd-Frank Act, the majority of Registered Investment Advisers (RIA) with more than $25 million under management were required to register with the SEC and subject to SEC jurisdiction under the Advisers Act.[17] RIAs managing less than $25 million were required to register at the state level and were subject to state jurisdiction.[18] However, the Dodd-Frank Act altered these jurisdictional boundaries. With certain exceptions, RIAs with more than $100 million under management must register with the SEC and are subject to SEC jurisdiction. RIAs managing less than $100 million are required to register at the state level and are subject to

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[8] Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(a) (1934*), available at* http://www.law.uc.edu/CCL/34Act/sec3.html.
[9] Securities Exchange Act of 1934, 15 U.S.C. § 78(c) (a)(5)(A) (1934), *available at* http://www.law.uc.edu/CCL/34Act/sec3.html.
[10] See generally Securities Exchange Act of 1934, 15 U.S.C. § 78 (2010), *available at* http://www.law.uc.edu/CCL/34Act/index.html.
[11] *See generally* FINRA Rules, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607.
[12] FINRA Rule 10 (amended 1988), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=8511&element_id=6474&highlight=registered+representative#r8511.
[13] FINRA Glossary of Arbitration Terms, http://www.finra.org/ArbitrationMediation/Glossary/.
[14] NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM SECURITIES ACT (amended 2002), *available at* http://www.abanet.org/buslaw/newsletter/0009/materials/uniformsecure.pdf.
[15] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21 (1940*)* http://www.law.uc.edu/CCL/InvAdvAct/index.html.
[16] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-2(a)(11) (2010), *available at* http://www.sec.gov/rules/extra/ia1940.htm.
[17] Investment Advisers Act of 1940, 15 U.S.C. 80b-3a(a) (2010), *available at* http://www.law.uc.edu/CCL/InvAdvAct/sec203a.html.
[18] *Id.*

state jurisdiction.[19]

Section 202 (a)(11) of the Advisers Act contains six exemptions from registration as an investment adviser. One of these exemptions is referred to as the "broker-dealer exemption." This exemption provides that "any broker or dealer whose performance of such services is *solely incidental* to the conduct of his business as a broker or dealer and who receives no *special compensation* therefore" (emphasis added) is not required to register with the SEC as an investment adviser.[20] To qualify for the exemption, a broker-dealer must satisfy this two-prong test:

1) the advice must be solely incidental to the broker-dealers' business; and
2) the broker-dealer cannot receive special compensation (e.g., a fee) for the services.[21]

The phrase "solely incidental," as used in Section 202(a)(11)(C), focuses on the nature and amount of the investment advice the broker-dealer provides to clients in its brokerage capacity. The phrase has not been expressly defined, but the SEC has indicated that a broker-dealer would not be giving advice "solely incidental" to its brokerage business in the following four situations:

1) The broker-dealer offers investment advice as part of an overall financial plan for the client or performs investment management services tailored for the specific long-term needs of individual client.[22]
2) The broker-dealer establishes a separate advisory business or advertises investment advisory or financial planning services.[23]
3) The broker-dealer makes wrap fee programs available to clients.[24]
4) The broker-dealer's business consists almost exclusively of managing client accounts on a discretionary basis.[25]

The phrase "special compensation," as used in Section 202(a)(11)(C), refers to any compensation a broker-dealer may receive for investment advice other than brokerage commissions.[26] For example, the SEC staff believes that special compensation includes the following:

(1) Compensation for investment advice in a form other than commissions;
(2) Brokerage commissions that include a clearly definable charge for investment advice;
(3) Receipt of a specified percentage of the total advisory fees charged to the broker-dealer's clients by a separate investment adviser; and
(4) A portion of a wrap fee.[27]

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[19] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.
[20] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-2(a)(11)(C) (2010),
[21] *Id. See also* Kristina A. Fausti, *A Fiduciary Duty For All?*, 12 DUQ. BUS. L.J. 183, 187, (2010) (citing Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. L.J. 395 (2010).
[22] John P Moriarty & Curtlan R. McNeily, FINANCIAL PLANNING REGULATION, 19 REG. FIN. PL. § 3:9 (2010) (citing Amendment and Extension of Temporary Exemption From the Investment Advisers Act for Certain Brokers and Dealers, Investment Advisers Act Release No. 471 (Aug. 20, 1975).
[23] Moriarty, *supra* note 22, at § 3:9.
[24] *Id.* (citing Investment Company Act Rel. No. 21260 n.7, 1995 WL 447507, (July 27, 1995).
[25] Moriarty, *supra* note 22, at § 3:9 (citing Investment Advisers Act Rel. No. 626, 1978 WL 196894 (Apr. 27, 1978).
[26] *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).
[27] Moriarty, *supra* note 22, at § 3:10 (citing Investment Advisers Act Rel. No. 2, 1940 WL 975 (Oct. 28, 1940); American Capital Financial Services, Inc., SEC No-Action Letter, 1985 WL 54220 (Apr. 29, 1985); Investment Company Act Rel. No. 21260 n.7, 1995 WL 447507 (July 27, 1995).

Broker-Dealer Standard of Care

Under the anti-fraud provisions of the Exchange Act, a broker-dealer is deemed to owe its customer a duty of fair dealing.[28] Additionally, FINRA Conduct Rule 2010 provides that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[29] FINRA Conduct Rule 2310 is titled, "Recommendations to Customers (Suitability)," and provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[30] More specifically, Rule 2310 provides that, "[p]rior to the execution of a transaction recommended to a non-institutional customer [i.e. retail customer]…a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[31] This suitability standard flows directly from the broker-dealer's duty of fair dealing contained in the Exchange Act.[32]

Broker-dealers have been held to a fiduciary standard of care under certain limited circumstances. For example, when a broker-dealer exercises discretion or control over client assets, they may owe their client a broad fiduciary duty similar to that imposed on investment advisers.[33] The exception provided by section 202(a)(11)(C) of the Advisers Act is unavailable for any account over which a broker-dealer exercises investment discretion.[34] The SEC has determined that the ability of a broker-dealer to make investment decisions on behalf of clients warrants the protection of the fiduciary standard because of the special trust and confidence inherent in such relationships.[35]

The fiduciary duty may also apply to broker-dealers in circumstances where discretionary authority has not been granted. For example, in *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,*[36] the Court of Appeals for the Eighth Circuit ruled "[w]hether an account is discretionary or nondiscretionary is only one factor we examine in determining whether a securities broker owes a fiduciary duty to his or her customers."[37] The *Davis* case involved claims of unauthorized trading as well as churning. The Court of Appeals found that "[w]hen analyzing fiduciary duty claims arising from unauthorized trading of securities, the crucial question is who exercised actual control

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[28] Securities Exchange Act of 1934 §§ 9(a), 10(b), 15(c)(1)-(2), 15 U.S.C. §§ 78i(a), 78j(b), 78o(c)(1)-(2) (2010).
[29] FINRA Rule 2010 (2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905&element_id=5504&highlight=2010#r6905.
[30] FINRA Rule 2310(a) (2009), *available at* *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469*.
[31] *Id.* at (b).
[32] Fausti, *supra* note 21, at 188. It should be noted that certain courts have ruled that some discretionary brokerage accounts have a fiduciary duty that runs to the customer. *See* ANGELA A. HUNG ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, INVESTER AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 10 (2008), *available at* *http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf*.
[33] *See, e.g., In re* Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd sub nom.* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); *see also* SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990); MidAmerica Fed. Sav. & Loan v. Shearson, 886 F.2d. 1249 (10th Cir. 1989); Webber v. Adams, 718 P.2d 508 (Colo. 1986); Leib v. Merrill Lynch., 461 F. Supp. 951 (E.D. Mich. 1978), aff'd, 647 F.2d 165 (6th Cir. 1981); C. Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 IOWA J. CORP. L. 65 (1997).
[34] Exchange Act Release No. 51523 (Apr.12, 2005), 2005 WL 849053 (the 2005 Adoption Release).
[35] See footnote 31.
[36] Davis v. Merrill Lynch, 906 F.2d 1206, Fed. Sec. L. Rep. (CCH) ¶95311 (8th Cir. 1990).
[37] *Id.* at 1216.

over the account."[38] Whether an account is discretionary or not is relevant only in that it "is one factor that indicates control."[39] The *Davis* court further explained, "if for all practical purposes the broker exercised de facto control over a nondiscretionary account and the client routinely followed the recommendations of the broker, then a finding of fiduciary duty may be warranted."[40]

Finally, broker-dealers are obligated to inform their clients of conflicts of interest that may affect the service they provide. For example, broker-dealers are required to inform investors of the details of revenue sharing arrangements with product sponsors that may represent a conflict of interest.[41] Broker-dealer firms do so by disclosing the details of these revenue sharing programs on their web sites.[42] Failure to do so can lead to significant regulatory sanctions and civil liability.[43]

Investment Adviser Standard of Care

As mentioned above, the Advisers Act governs the conduct of SEC registered investment advisers. There is no provision in the Advisers Act that expressly applies a fiduciary duty to investment advisers. However, Section 206 of the Advisers Act contains antifraud provisions, which the United States Supreme Court (USSC) has held impose fiduciary duties on investment advisers.[44] In *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.,* a decision that articulates an investment adviser fiduciary duty, the court held that the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[45] Because of this decision, investment advisers are held to a fiduciary duty.

As a fiduciary, an adviser owes its clients an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's.[46] The investment adviser's duty to offer suitable investment advice flows from the fiduciary status.[47] The SEC has not provided significant guidance regarding the nature of an adviser's suitability obligation. However, the SEC staff has made clear that a 1994 rule proposal represents their current position relating to an adviser's obligation to provide suitable investment advice.[48] Accordingly, investment advisers are

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[38] *Id.*
[39] *Id.* at 1217.
[40] *Id.*
[41] *In re* Edward D. Jones, Admin. Proc. File No. 3-11780 (SEC, October 20, 2006).
[42] *Id.*
[43] *Id.*
[44] *See* ROBERT E. PLAZE, SEC DIVISION OF INVESTMENT MANAGEMENT, THE REGULATION OF INVESTMENT ADVISERS BY THE S.E.C. 14, (2006), *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf, and S.E.C. v Capital Gains Research Bureau, Inc., 375 US 180 (1963), and S.E.C. v Zandford, 535 US 823 (2002).
[45] S.E.C. v Capital Gains Research Bureau, Inc., 375 US 180 (1963)
[46] Thomas P. Lemke & Gerald T. Lins, INVESTMENT ADVISERS, SECREGINA. § 2:33. *See also* SEC DIVISION OF INVESTMENT MANAGEMENT, *supra* note 44, at 14.
[47] Lemke, *supra* note 46, at § 2:33. *See also* In re John G. Kinnard and Co., SEC No-Action Letter, 1973 WL 11848, Fed. Sec. L. Rep. (CCH) ¶79,662 (Nov. 30, 1973).
[48] This rule was proposed in Investment Advisers Act Release No. 1406 (March 16, 1994). Under the Act's anti-fraud provisions, the SEC proposal would require advisers to give clients only suitable advice. Although the rule was never adopted, the SEC staff takes the position that the rule codifies existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act. Suitability obligations do not apply to impersonal investment advice, and compliance with the obligation is evaluated in the context of a client's overall portfolio. "Thus, inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable." *Id.* The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. *See In re* Westmark Financial Services, Investment Advisers Act Release No. 1117 (May 16, 1968) (financial

required "to make a reasonable inquiry into the client's financial situation, investment experience, and investment objectives."[49] Investment advisers are prohibited "from giving advice to a client unless the adviser reasonably determine[s] that the advice [is] suitable to the client's financial situation, investment experience, and investment objectives.[50] The SEC has instituted enforcement actions against advisers that failed to live up to their obligation to provide suitable investment advice.[51]

Finally, several other obligations flow from the RIA's fiduciary duty. They include:

- a duty to have a reasonable, independent basis for the RIA's investment advice;[52]
- a duty for best executions;[53]
- a duty to refrain from effecting personal securities transactions inconsistent with client interests,[54] and
- a duty to be loyal to clients.[55]

Effectiveness of Existing Legal or Regulatory Standards of Care

Notwithstanding the differences in the current legal standards of care, FSI believes that the existing regulatory system in place for broker-dealers is far superior to that for RIAs in providing effective supervision. The existence of a well-funded, experienced, self-regulatory authority dedicated to the supervision of broker-dealers and their associated persons allows for more frequent examinations of these regulated entities. The SEC and FINRA examine more than half of the registered broker-dealer firms subject to their jurisdiction each year.[56] This active broker-dealer examination program is a stark contrast to the current state of affairs for registered investment advisers. The SEC projects that fewer than 10 percent of the registered investment adviser firms subject to their supervision will be examined during the fiscal years 2009 and 2010.[57] State examination program quality varies widely, but they appear to be overwhelmed by the volume of RIAs requiring their supervision.[58] As a result, it is clear to us that broker-dealer compliance with the existing legal and regulatory standards is more frequently tested than that of

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planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); *In re* George Sein Lin, Investment Advisers Act Release No. 1391(Nov. 9, 1993) (adviser with discretionary authority invested funds of clients desiring low risk investment in uncovered option contracts and used margin accounts).

[49] Investment Advisers Act Release No. 1406 at page 2 (March 16, 1994).

[50] *Id.* at 3.

[51] *See In re* Matter of Westmark Financial Services, Investment Advisers Act Release No. 1117 (May 16, 1968) (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); *In re* George Sein Lin, Investment Advisers Act Release No. 1391(Nov. 9, 1993) (adviser with discretionary authority invested funds of clients desiring low risk investment in uncovered option contracts and used margin accounts).

[52] Lemke, *supra* note 46, at § 2:33., citing In re Alfred C. Rizzo, Investment Advisers Act Release No. 897 (Jan. 11, 1984).

[53] Lemke, *supra* note 46, at § 2:33., citing In re Michael L. Smirlock, Investment Advisers Act Release No. 1393 (Nov. 29, 1993); Interfinancial Corp., SEC No-Action Letter, 1985 WL 53983 (Mar. 18, 1985).

[54] Lemke, *supra* note 46, at § 2:33., citing Investment Advisers Act Release No. 203 (Aug. 11, 1966).

[55] Lemke, *supra* note 46, at § 2:33., citing Investment Advisers Act Release No. 40, 1945 WL 5321 (Feb. 5, 1945) and Investment Advisers Act Release No. 232, 1968 WL 4015 (Oct. 16, 1968).

[56] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.

[57] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.

[58] Kara Scannell, *States will be Hedge-Fund* Police, Wall St. J., August 19, 2010, *available at* http://online.wsj.com/article/SB10001424052748704557704575437663904234590.html?KEYWORDS=denise+crawford+TX.

RIAs. While frequency of examination is not the equivalent of effectiveness, we believe it is an essential component of effective regulatory supervision.

Request for Comment Two – Investor Protections, Regulatory Gaps, and Overlaps

The Study requires the SEC to examine "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute."

Supervision Gap

The current regulatory framework for broker-dealers is multilayered. The nearly 4,700 brokerage firms,[59] 167,000 branch offices,[60] and approximately 635,000 registered securities representatives[61] are subject to supervision by:

- The professional broker-dealer compliance staff of their broker-dealer firm,
- FINRA,
- SEC, and
- State securities regulators.

As stated above, the SEC and FINRA examine more than half of these registered broker-dealer firms each year.[62] While improvements can certainly be made, and are being made, to the effectiveness of these examinations, it is hard to sustain an argument that they do not occur with sufficient frequency.[63]

This layered and frequent broker-dealer supervision and examination program is unparalleled in the investment adviser world. The 14,500 state registered investment advisers[64] and 11,300 federally registered investment advisers[65] are subject to supervision by:

- A compliance officer, who may be the investment adviser himself, and
- Either the SEC or a state securities regulator.

The SEC projects that fewer than 10 percent of the registered investment adviser firms subject to their supervision will be examined during the fiscal years 2009 and 2010.[66] State examination programs vary widely, but are also overwhelmed by the volume of registered investment advisers requiring supervision. Even a strong state registered investment adviser examination program

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[59] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[60] *Id.*
[61] *Id.*
[62] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.
[63] See generally Bowsher, *surpa* note 7.
[64] David G. Tittsworth et al., *Evolution Revolution – A Profile of the Investment Advisor Profession*, 2009 INVESTMENT ADVISOR ASSOCIATION 8, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB (follow "2009 Evolution Revolution Report").
[65] David G. Tittsworth et al., *Evolution Revolution – A Profile of the Investment Advisor Profession*, 2009 INVESTMENT ADVISOR ASSOCIATION 4 n.1, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB (follow "2009 Evolution Revolution Report").
[66] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.

cannot match the regularity of broker-dealer exams. For example, the State of Texas indicates that they "try to get to every adviser once every five years."[67] Simply put, registered investment adviser firms go unsupervised by their regulators for long periods.

Regulatory Overlap

As described above, broker-dealers and RIAs are subject to different regulatory schemes. However, these schemes often subject broker-dealers and RIAs to similar regulatory requirements. One example previously described herein is that broker-dealers and investment advisers are each required to make suitable recommendations to their clients. A detailed summary of other overlapping regulatory requirements for broker-dealers and RIAs is provided as Exhibit A to the comment letter.

Request for Comment Three – Investor Understanding of the Current Standards of Care

The Study requires the SEC to examine "whether retail customers understand that there are different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers in the provision of personalized investment advice about securities to retail customers."

On January 3, 2008, the SEC released the "RAND Corporation Study on Investor and Industry Perspectives on Investment Advisers and Broker-Dealers" (RAND Study).[68] The main purpose of the RAND Study was to provide the SEC with a factual description of the current state of the investment advisory and brokerage industries for use in its evaluation of the legal and regulatory environment for investment professionals.[69] The study did not evaluate the legal or regulatory environment itself and did not make policy recommendations. The study addressed two primary questions:

1) What are the current business practices of broker-dealers and investment advisers?; and
2) Do investors understand the differences between and relationships among broker-dealers and investment advisers?[70]

In response to this SEC request for comment, we summarize the RAND Study's conclusions related to investor understanding of the differences between broker-dealers and investment advisers.

In order to assess investor understanding of these issues, RAND administered a national household survey and engaged in focus-group discussions with both experienced and inexperienced investors.[71] RAND concluded that investors have a hard time distinguishing between registered representatives and investment adviser representatives, and their respective relationships with a broker-dealer and RIA.[72] There was confusion related to the roles played by a registered representative and investment adviser representative, the services offered by these individuals, and the legal obligations related to these titles.[73]

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[67] Scannell, *supra* note 58. It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.
[68] *See generally* RAND INSTITUTE FOR CIVIL JUSTICE, *supra* note 32.
[69] *Id.* at xiii.
[70] *Id.* at xiv.
[71] *Id.* at xviii.
[72] *Id.* at 19.
[73] *Id.* at xix.

RAND identified that the compensation structures, disclosure requirements, and legal duties make investment advisers appealing to investors.[74] However, account minimums, industry certification, and costs make broker-dealers appealing. Further, RAND found that even after attempts to explain the concepts of fiduciary duty and suitability in plain language, focus-group participants struggled to understand the differences in these standards of care.[75] Furthermore, focus-group participants expressed doubt that the standards truly differ in practice.[76]

We agree with the RAND Study focus-group participants – in practice, there is little difference between the standards to which RIAs and broker-dealers are held when offering advice and service to retail investors. As noted above, all Financial Advisors are obligated to make suitable recommendations to their retail clients and any Financial Advisor interested in long-term success in this business will make the best interest of their client their top priority.

Request for Comment Four – Investor Confusion Over Current Standards of Care

The Study requires the SEC to examine "whether the existence of different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive."

As mentioned above, the RAND Study examined the issues of investor confusion related to different standards of cares applicable to both of these groups. In the research phase of the RAND Study, RAND conducted in-depth interviews and obtained feedback from interested and disinterested parties. Close to 75% of those interviewed agreed that investors were not able to tell if a financial service professional was acting as a registered representative of a broker-dealer or an investment advisor representative of a registered investment adviser.[77] The study found that many investors believe that broker-dealers and investment advisers offer the same products and services, noted that most investors do not know the differences between a broker-dealer and an investment adviser, and do not realize that the regulatory burdens between a broker-dealer and an investment adviser are in-fact different.[78] RAND also identified that most investors believe that the financial intermediary is acting in the investor's best interest, regardless of the capacity they are working in.[79]

Further, the RAND Study found that many participants reported that they thought that the offering of a variety of financial products caused investor confusion and made it more difficult to distinguish between a broker-dealer and investment adviser.[80] Moreover, they claimed that bundling of advice and sales by broker-dealers also added to investor confusion.[81] Participants noted that the line between investment adviser and broker-dealers has become further blurred because of recent marketing by broker-dealers focuses on the ongoing relationship between the broker and the investor and the adoption of titles such as "financial advisor" and "financial manager."[82] In sum, it appears from the RAND Study that there is investor confusion related to the distinctions between a broker-dealer and an investment adviser. However, investors are happy with their own financial service provider and believe the advisor is acting in their best interests.

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[74] RAND INSTITUTE FOR CIVIL JUSTICE, *supra* note 32, at xix.
[75] *Id.*
[76] *Id.*
[77] *Id.* at 18.
[78] *Id.*
[79] *Id.*
[80] RAND INSTITUTE FOR CIVIL JUSTICE, *supra* note 32, at 19.
[81] *Id.*
[82] *Id.*

Clearly, investors expect Financial Advisors to work in their client's best interests no matter what the legal standard. The high degree of investor satisfaction noted in the RAND Study is an indication that the vast majority of Financial Advisors are in fact focused on their client's best interests. As a result, we urge the SEC to take care in harmonizing the regulation of all Financial Advisors to avoid unintended consequences to investor access, choice, and protection.

Request for Comment Five – Regulatory Exam and Enforcement Resources

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

(A) the effectiveness of the examinations of brokers, dealers, and investment advisers in determining compliance with regulations;
(B) the frequency of the examinations; and
(C) the length of time of the examinations."

SEC Inspection, Examination, and Enforcement

As of January 2009, the SEC had 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 315 staff dedicated to examinations of registered broker-dealers.[83] These examiners are located in Washington, DC and the SEC's eleven regional offices located in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.[84]

The SEC has large and diverse examination responsibilities. The registered population consists of approximately: 11,300 investment advisers (a population that has grown rapidly in recent years, as discussed further below); 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers; and 600 transfer agents.[85] The SEC also examines eleven exchanges, five clearing agencies, ten nationally recognized statistical rating organizations, self-regulatory organizations (SROs) such as FINRA and the Municipal Securities Rulemaking Board (MSRB), and the Public Company Accounting Oversight Board (PCAOB).[86]

Broker-dealers are subject to primary oversight by FINRA, an SRO that conducts periodic routine examinations of its broker-dealer members. These examination efforts supplement the SEC's own examinations of broker-dealer firms. FINRA has approximately 3,000 employees.[87] It operates from Washington, DC, and New York, NY, with 20 regional offices around the country.[88] Investment advisers, and the other registrants mentioned above, are not subject to examination or oversight by any SRO.

From 1998 through 2002, the SEC staff examined every RIA subject to their jurisdiction using a periodic exam frequency of once every five years, and sought to examine newly-registered

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[83] Lori A. Richards, Testimony Concerning Examinations by the SEC and Issues Raised by the Bernard L. Madoff Investment Securities Matter (January 27, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts112709lar.htm.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[88] *Id.*

advisers early in their operations.[89] The staff was able to do this because the population of RIAs was much smaller at that time.[90] However, the SEC reports that the number of RIAs has increased dramatically in recent years. After 2002, the number of RIAs increased by 50% (in 2002, there were 7,547 advisers, and as of January 2009 there were nearly 11,300).[91] This growth has negatively affected the SEC's examination program. The SEC is now only able to examine a small fraction of RIAs each year. For example, in 2008 the SEC's staff conducted 1,521 investment adviser examinations (approximately 14% of the registered community).[92] These examinations included: routine examinations of certain investment advisers, examinations "for cause" based on an indication of a compliance problem, and "sweep" examinations focused on a particular risk area.

The SEC staff also conducted 720 cause, oversight and sweep examinations of broker dealer firms (together with the routine and other examinations conducted by FINRA, approximately 57% of broker-dealers were examined.)[93] Because only a small portion of RIAs can be examined each year, the process of selecting firms and business areas is of crucial importance to investor protection. Given the number of firms subject to examination oversight and the breadth of their operations, examinations are no longer comprehensive audits of a firm's activities, but are instead more limited in scope.[94]

Prior to 2010, the SEC's Office of Compliance Inspection and Examination (OCIE) developed and implemented a risk-based program for selecting RIAs and activities for examination. During these inspections and examinations, examiners interviewed firm personnel, reviewed the books and records of regulated entities, and analyzed the entity's operations.[95] The goal of the examinations was to test the registrant's compliance with the federal securities laws and regulations. OCIE used risk-based methodologies to focus resources on RIAs and activities that could pose the greatest risk to investors and the integrity of the markets.[96] Higher-risk RIAs were those that appeared to engage in activities associated with emerging or resurgent risks or that simply managed or handled such large amounts of investor assets that if something were to go wrong there could be significant harm to both investors and investor confidence.[97] As a result of these examinations, RIAs often corrected the deficiencies identified, and improved compliance controls to prevent them from reoccurring.[98]

However, in early 2010, due to lack of resources and investor confidence in the markets, the SEC changed its risk-based methodology for selecting RIAs for examination. The SEC unofficially announced that it had indefinitely suspended its goal of inspecting some 11,000 RIAs on a regular schedule, and instead was focusing its examination resources on investment advisers who were the subject of tips and complaints.[99]

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[89] Lori A. Richards, Testimony Concerning Examinations by the SEC and Issues Raised by the Bernard L. Madoff Investment Securities Matter (January 27, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts112709lar.htm.
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] Office of Compliance Inspections and Examinations: Highlights, http://www.sec.gov/about/offices/ocie/ocie_highlights.shtml.
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] Jed Horowitz, *SEC's new adviser exam schedule: 'We simply show up*, 'INVESTMENT NEWS, April 9, 2010, *available at* http://www.investmentnews.com/article/20100409/FREE/100409833.

FINRA Inspection, Examination, and Enforcement

Broker-dealers are subject to primary oversight by a FINRA. FINRA is the largest non-governmental regulator for securities brokerage firms doing business in the United States.[100] Congress mandated the creation of FINRA's predecessor, the National Association of Securities Dealers (NASD), in 1938.[101] In 2007, FINRA was created through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. FINRA has approximately 3,000 employees and operates from Washington, DC, and New York, NY, with 20 additional District Offices around the country.[102] FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives.[103] Federal law charges FINRA with the responsibility to examine each broker-dealer for compliance with the Exchange Act, MSRB rules, and NASD/FINRA Conduct Rules.[104]

FINRA has a comprehensive examination program with dedicated resources of more than 1,000 employees.[105] Routine examinations are conducted on a regular schedule that is established based on a risk-profile model.[106] This risk-profile model permits FINRA to focus resources on the items most likely harm to investors.[107] FINRA applies the risk-profile model to each broker-dealer firm, and its exams are tailored accordingly. [108] In performing its risk assessment, FINRA considers a broker-dealer's business activities, methods of operation, types of products offered, compliance profile, and financial condition, among other things.[109] In addition, FINRA conducts more narrow examinations based on information received, including investor complaints, referrals generated by FINRA market surveillance systems, terminations of brokerage employees for cause, arbitrations, and referrals from other regulators.[110] In 2009, FINRA conducted approximately 2,500 routine examinations and approximately 7,900 cause examinations in response to events such as customer complaints, terminations for cause, and regulatory tips.[111]

FINRA's Enforcement Department is dedicated to vigorous enforcement of the Exchange Act, MSRB rules, and NASD/FINRA Conduct Rules.[112] FINRA brings disciplinary actions against broker-dealer firms and their associated persons that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry.[113] In 2009, FINRA took 993 disciplinary actions, barring 383

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[100] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[101] *Id.*
[102] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited August 30, 2010).
[103] *Id.*
[104] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[111] *Id.*
[112] *Id.*
[113] *Id.*

individuals, suspending 363 others, and expelling 20 broker-dealer firms[114]. FINRA levied fines against firms and individuals totaling nearly $50 million, and ordered broker-dealers and individuals to return more than $8.2 million in restitution to investors.[115] Over the past decade, FINRA issued 12,158 decisions in formal disciplinary cases, expelled or suspended 208 firms, and barred or suspended 7,496 individuals.[116]

State Inspection, Examination, and Enforcement

The inspection, examination, and enforcement capabilities of state securities regulators vary significantly from state-to-state. Approximately 15 state securities regulators do not currently conduct routine examinations of the brokers-dealers or investment advisers under their jurisdiction.[117] The remaining 35 states that do conduct routine examinations have significant resource constraints that prevent them from completing robust and comprehensive examinations. For the purposes of this comment letter, we will not review each state's examination program, however, we will provide a few examples.[118]

The state of New York does not routinely examine broker-dealers or investment advisers registered in the state. The Investor Protection Bureau of the state of New York is charged with enforcing the Martin Act, which is the New York State blue-sky law. Article 23-A,[119] sections 352 and 353 of the Martin Act give the Attorney General broad law-enforcement powers to conduct public and private investigations of suspected fraud in the offer, sale, or purchase of securities. Where appropriate, the Attorney General may commence civil and/or criminal prosecutions under the Martin Act to protect investors. The Bureau also protects the public from fraud by requiring broker-dealers and investment advisers to register with the Attorney General's Office. However, the Bureau does not have the authority to conduct routine examinations of the broker-dealers or investment advisers registered in the state.

The lack of a routine examination program in New York has had consequences for investors. Bernard Madoff operated his massive Ponzi scheme from his firm's office on Third Avenue in New York City.[120] In addition, Cohmad Securities Corporation brought investors into the Ponzi scheme from offices located within the Madoff firm.[121] There is no indication that the New York Investor Protection Bureau ever conducted an examination of the offices or activities of Bernard L Madoff Investment Securities or Cohmad Securities Corp. As a result, valuable opportunities to uncover the ongoing frauds were lost.[122]

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[114] FINRA: 2009 A Year In Review 2, http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p121646.pdf (last visited August 30, 2010).

[115] *Id.*

[116] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 26, 2009), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P118298.

[117] Carol e. Curtis, *Could Dodd Bill Pave the way for Another Madoff?*, SECURITIES TECHNOLOGY MONITOR, May 3, 2010, *available at* http://www.securitiestechnologymonitor.com/issues/22_9/-25249-1.html?zkPrintable=true.

[118] *See* NATL. CONF. ST. LEGISLATORS, STATE BUDGET UPDATE: JULY 2009 14 (2009), *available at* http://www.ncsl.org/documents/fiscal/statebudgetupdatejulyfinal.pdf. *See also* SUNSHINE REVIEW, STATE BUDGET ISSUES, 2009 – 2010, http://sunshinereview.org/index.php/State_budget_issues,_2009-2010#cite_note-NCSL_July-1.

[119] N.Y. Gen. Bus. § 23-A (McKinney 2009), *available at* http://law.justia.com/newyork/codes/general-business/idx_gbs0a23-a.html.

[120] *See* BrokerCheck report of Bernard L. Madoff Investment Securities LLC at http://brokercheck.finra.org/.

[121] *See* Bowsher, *supra* note 7, at 5 n.6.

[122] The SEC and FINRA also failed to uncover the Madoff Ponzi scheme and Cohmad's involvement in it despite examining each firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs. The New York Investor Protection Bureau has not.

In contrast to the state of New York, the Texas State Securities Board does conduct examinations of broker-dealers and investment advisers. According to the Texas State Securities Board Strategic Plan for Fiscal Years 2009 – 2013,[123] Texas has 19 full time employees who conduct examinations for the Agency.[124] As of August 31, 2009, Texas had approximately 2,700 registered broker-dealers (both FINRA and non-FINRA member firms), 1,200 state registered investment advisers, and 3,500 SEC-registered Notice filers subject to their jurisdiction.[125] As previously mentioned, the number of RIAs regulated by the states, including Texas, will likely rise given that investment advisers who manage $100 million or less will soon be regulated by the states.[126] Texas appears to be a well-funded state,[127] however, they cannot match the frequency of broker-dealer examinations conducted by FINRA. In fact, Texas states that their current examination program amounts to trying "to get to every adviser once every five years."[128] It remains to be seen what impact the jurisdictional change will have on Texas' examination program.

Based on the lack of routine examination programs in every state and the budget problems being experienced by most state governments,[129] we believe that the states are not adequately prepared to take on the inspection, examination, and enforcement role assigned to them under the Dodd-Frank Act.[130] Ultimately, investor protection will be diminished if regulators are unable to increase substantially the quality and frequency of RIA examinations.

Request for Comment Six and Seven – Substantive Differences in the Regulation of Broker-Dealers and Investment Advisers

The Study requires the SEC to examine" the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers" and "the specific instances related to the provision of personalized investment advice about securities in which—

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

As described in more detail above, broker-dealer conduct is governed under the laws and regulations of the Exchange Act,[131] NASD/FINRA Conduct rules,[132] and the various state

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[123] TEXAS SECURITIES BOARD, AGENCY STRATEGIC PLAN FOR THE FISCAL YEARS 2009 – 2013 PERIOD, (2008), *available at* http://www.ssb.state.tx.us/About_Us/StratPlan2008.pdf.

[124] *Id.* It should be noted that in 2007, the Texas State Securities Board experienced an employee turnover rate of approximately 20%. The Texas Securities Commissioner has indicated that they plan to add 10 additional staff positions in the near future to accommodate the investment advisers that will now fall under state jurisdiction as a result of the Dodd-Frank Act. Also, it should be noted that the headquarters of Stanford Financial Group was located in Houston, TX. On February 17, 2009, the SEC put the company under management of a receiver alleging it operated a massive Ponzi scheme. There has been no public indication that Stanford Financial Group was ever the subject to a Texas State Securities Board examination. The SEC and FINRA also failed to uncover Stanford's Ponzi scheme despite examining the firm's activities. However, each of these regulators engaged in a thorough public review of the failures of their exam programs. The Texas State Securities Board has not.

[125] *Id.*

[126] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

[127] Texas State Securities Board was appropriated funding of $5,712,676 for Fiscal Year 2008 and again for Fiscal Year 2009. *See* TEXAS SECURITIES BOARD, *supra* note 124, at 7.

[128] Scannell, *supra* note 58.It is important to note that Section 410 of the Dodd-Frank Act will further stress state securities regulators by shifting oversight responsibility for some 4,000 registered investment advisers to the states.

[129] *See* NATL. CONF. ST. LEGISLATORS, *supra* note 119; *see also* SUNSHINE REVIEW, *supra* note 119.

[130] Public Law No: 111-20 § 410, *available at* http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

[131] Securities Exchange Act of 1934, 15 U.S.C. § 78 (2010), *available at* http://www.law.uc.edu/CCL/34Act/index.html.

securities laws. Investment adviser conduct is governed under the Adviser Act and the various state securities laws. Compliance with these laws and regulations is enforced by the SEC, SROs, states, and/or the respective Financial Advisor's compliance personnel.

It is estimated that approximately 4,500 firms are dually registered as broker-dealers and investment advisers or have affiliated broker-dealers and investment advisers.[133] Moreover, approximately 88 percent of all investment advisor representatives are also registered representatives of a broker-dealer.[134] Most of these representatives are employed by a firm that is dually registered, and is subject to both the broker-dealer and investment advisor regulatory regime.

Generally speaking, the rules imposed on broker-dealers are direct and prescriptive in nature. The rules imposed on investment advisers are principles based and do not provide specific direction for compliance. In an effort to highlight the substantive differences in regulation over broker-dealers and investment advisers, it is easiest to compare and contrast the different legal and regulatory requirements as they apply to certain aspects of the businesses operated by these entities. Attached as Exhibit A is a document entitled, "Chart of Overlapping Compliance Requirements for Dually Register Broker-Dealers and Registered Investment Advisers." This document summarizes areas where broker-dealers, who are dually registered with the SEC as broker-dealers and registered investment advisers, find themselves applying overlapping compliance requirements to their activities. It speaks to and highlights the competing compliance burdens related to the application of these principles, rules, and regulations. The chart covers the following issues:

1. Supervision,
2. Advertising,
3. Record retention,
4. Annual testing requirements,
5. Outside business activities disclosures,
6. Anti-money laundering programs,
7. Business continuity plans,
8. Standards of care,
9. Compensation,
10. Customer disputes,
11. Privacy,
12. Account records,
13. Trade monitoring,
14. Insider trading,
15. Personal trading,
16. Best execution,
17. Principal trading,
18. Referral fees/solicitors fees,
19. Custody,
20. Examination,
21. Continuing education, and
22. Licensing.

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[132] *See generally* FINRA Rules, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607.
[133] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[134] *Id.*

Request for Comment Eight – Existing State Regulatory Standards

The Study requires the SEC to examine "the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail customers."

As discussed in more detail in FSI's response to Request for Comment One, as a general rule, broker-dealers are held to a suitability standard of care and investment advisers are held to a fiduciary duty of care. However, most states elaborate on these established standards of care via case law. Attached as Exhibit B to this comment letter, you will find a detailed chart that summarizing the various interpretations the states have developed related to a fiduciary duty of care.

Request for Comment Nine – Impact of Imposing the Advisers Act's Fiduciary Duty on Broker-Dealers

The Study requires the SEC to examine "the potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers, and persons associated with brokers or dealers—

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

FSI supports a universal fiduciary standard of care applicable to all Financial Advisors who provide personalized investment advice to retail clients. We do not support applying the standard of care derived from the Advisers Act, or other Advisers Act requirements, to broker-dealers and their registered representatives. As described above, there is no provision in the Advisers Act that expressly applies a fiduciary duty to investment advisers. Instead, Section 206 of the Advisers Act contains antifraud provisions, which the USSC has held impose fiduciary duties on investment advisers.[135] The *Capital Gains* decision articulated the fiduciary standard of care, but its specific application to investment adviser activities has been developed through other fact specific case law.[136] The courts in these cases did not contemplate the application of their decisions to the activities and services offered by broker-dealers.

FSI recognizes that a single fiduciary standard of care will promote and enhance investor protection. However, attempting to solve the inconsistencies in the competing standards of care by transferring the standards and requirements developed over decades for investment advisers to the broker-dealer world - a world that has its own history, business practices, and clientele - is fraught with difficulty. It is a mistake to assume the existing investment adviser case law can be easily translated into clear conduct rules for broker-dealers and registered representatives. Simply imposing the amorphous standard of care and other Adviser Act requirements on broker-dealers and registered representatives would subject these firms to tremendous uncertainty as to their compliance obligations. Firms cannot control costs if they do not know what is expected of them. As a result, we would expect firms to react to the imposition of the Adviser's Act standard by limiting their services to investors who offer significant profit potential thereby reducing investor access to products and services.

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[135] *See* SEC DIVISION OF INVESTMENT MANAGEMENT, *supra* note 44, at 10; SEC v Capital Gains Research Bureau, Inc., 375 US 180 (1963); and SEC v Zandford, 535 US 823 (2002). *See also* Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 34-62577 (July 27, 2010).
[136] *See* Exhibit B.

Instead of importing the existing investment adviser standard of care and other requirements into the broker-dealer regulatory framework, FSI supports the adoption of a clearly stated new universal fiduciary standard of care. The universal fiduciary standard of care must be carefully designed to promote access to advice and preserve investor choice while enhancing investor protection. For these reasons, FSI supports a standard of care that would require a Financial Advisor providing personalized investment advice concerning securities to a retail customer to:

1. Act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice;
2. Disclose material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided; and
3. Provide advice with skill, care, and diligence based upon information that is known, or should be know, about the customer's investment objectives, risk tolerance, financial situation, and other needs.

This standard of care could be applied to broker-dealer firms and registered representatives by amending existing FINRA Rule 2010 as follows:

> **2010. Standards of Commercial Honor and Principles of Trade**
> A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade. <u>When providing personalized investment advice to retail customers, members shall:</u>
>
> (a) <u>Act in the best interest of the customer without regard to the financial or other interest of the member providing the advice;</u>
> (b) <u>Disclose material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided; and</u>
> (c) <u>Provide advice and service with skill, care, and diligence based upon information that is known, or should be know, about the customer's investment objectives, risk tolerance, financial situation, and needs.</u>

Investor access will be preserved through the development of clear conduct rules that allow firms to understand what is expected of them and plan accordingly. FINRA should use its existing rulemaking processes to amend its current rules and adopt additional ones that are consistent with the universal standard of care and enforced prospectively. IBD and other broker-dealer firms should have an opportunity to comment on the rule proposals because these comments are often helpful in alerting FINRA to unintended consequences of their proposed rulemaking. While this process moves forward, broker-dealer firms and registered representatives would have clear guidance as to their obligations through reference to the current FINRA rules. They would also have the opportunity to plan for future changes due to their knowledge of FINRA's rulemaking efforts. In this way, FINRA and the SEC will avoid inhibiting the creativity and innovation that is essential to the development of efficient solutions to investor needs that expand access to advice.

Request for Comment Ten – Impact of Eliminating the Broker-Dealer Exclusion Under the Advisers Act

The Study also requires the SEC to examine "the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" under section 202(a)(11)(C) of the Investment Advisers Act of 1940, in terms of—

> (A) the impact and potential benefits and harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;
> (B) the number of additional entities and individuals that would be required to register under, or become subject to, the Investment Advisers Act of 1940, and the additional requirements to which brokers, dealers, and persons associated with brokers and dealers would become subject, including—
>
> > (i) any potential additional associated person licensing, registration, and examination requirements; and
> > (ii) the additional costs, if any, to the additional entities and individuals; and
>
> (C) the impact on Commission and State resources to—
>
> > (i) conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and
> > (ii) enforce the standard of care and other applicable requirements imposed under the Investment Advisers Act of 1940;"

As indicated by this request for comment, some have suggested that harmonization can be achieved through the elimination of the "broker-dealer exemption" from the definition of "investment adviser" contained the Section 202(a)(11)(C) of the Advisers Act. As described more fully above, the existing broker-dealer exemption allows broker-dealers, and their registered representatives, to offer "solely incidental" advice to investors without registration as an investment adviser so long as they do not receive "special compensation."[137] The repeal of this exemption would require all broker-dealers and registered representatives who wish to provide personalized investment advice about securities to retail clients to become registered investment advisers or investment adviser representatives. In other words, this one change would subject all Financial Advisors to a common body of regulatory requirements, supervision, and a fiduciary duty.[138] While this is a seemingly simple solution to a complex problem, FSI has significant concerns that this approach to harmonization would have unintended consequences for investor access, choice, and protection.

The elimination of the broker-dealer exemption would have the unfortunate consequence of significantly increasing the cost of providing financial services to investors. These costs, which include the recreation and retooling of written supervisory procedures, additional documentation requirements, increased registration expenses, and enhanced liability exposure for broker-dealers and registered representatives that are inherent in the fiduciary duty that arises from the Advisers

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[137] Investment Advisers Act of 1940, 15 U.S.C. 80b-2a(11)(c) (2010), *available at* http://www.law.uc.edu/CCL/InvAdvAct/sec202.html.
[138] Sara Hansard, *Dodd's financial reform bill would eliminate the 'broker-dealer exemption,'* INVESTMENT NEWS, November 10, 2009, *available at* http://www.investmentnews.com/article/20091110/FREE/911109975.

Act case law, will be passed on to investors. If such an approach to regulatory harmonization were to be adopted, we would anticipate broker-dealers and registered representatives imposing minimum investable asset requirements for all clients who seek their professional financial advice to insure they can cover these and other costs. This practice is already common among independent retail registered investment advisers.[139] The regrettable result of this shift would be the pricing of professional financial advice and service beyond the reach of the small investors who need it most.

Eliminating the broker-dealer exemption would also have the unintended consequence of limiting investor choice. Insurance companies, wire houses, discount firms, clearing firms, independent broker-dealers, and others make up the broker-dealer marketplace. The great diversity of business models utilized by financial firms to deliver products and services to investors is more than an accident of history. These existing broker-dealer business models were developed to address the various needs of members of the investing public. Some investors make their own investment decisions and want to place orders in the cheapest manner possible. Other investors want to put their faith and trust in a Financial Advisor they pay to make these decisions for them. Still others want to receive personalized investment advice for some assets and be free to trade other assets with minimal input from the Financial Advisor. In other words, different investors require different levels of advice and service, and the market has responded to address these needs. The continuation of these different business models provides investors with meaningful choices. Elimination of the broker-dealer exclusion would move the business of providing retail investment advice from these specialized firms to a single model – that of RIAs. This would harm investors by reducing the available choices in service providers.

Finally, requiring broker-dealers and registered representatives who offer personalized investment advice to clients to become RIAs under the Advisers Act would also have the unfortunate consequence of reducing investor protection. For example, it would deprive investors of several important protections currently available to them under the existing broker-dealer regulatory structure by causing many registered representatives who wish to provide advice to their clients to drop their broker-dealer affiliation and become affiliated with a RIA firms. These protections include:

- Qualifying Examinations – Registered representatives affiliated with broker-dealers must pass examinations to demonstrate their knowledge of securities products, sales practice obligations, and other legal requirements.[140] SEC registered investment advisers are not required to demonstrate this knowledge through the successful completion of qualifying examinations.
- Continuing Education – Registered representatives affiliated with broker-dealers must participate in an annual continuing education program designed to insure they are aware of relevant industry developments, new product features, and changes in regulatory

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[139] ADVISOR BENCHMARKING, ANNUAL SURVEY RESULTS – SUMMER 2009 3, (2009), available at http://www.advisorbenchmarking.com/practice_value/Benchmarking_Survey_Highlights_Summer_09.pdf. Also, see examples of account minimums at Trusskey Investment Advisors, Frequently Asked Questions, http://www.ourmoneyfirm.com/FAQ.html, Evanson Asset Management , http://www.evansonasset.com/index.cfm/Page/1.htm (last visited August 30, 2010); and McCracken & Company, Asset Management, http://www.investorsadv.com/asset-management (last visited August 30, 2010).

[140] *See generally* FINRA Registration and Examination Requirements, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Qualifications/p011051 (last visited August 30, 2010).

requirements.[141] SEC registered investment advisers are not required to participate in continuing education programs.

- Advertising Review – Registered representatives affiliated with broker-dealers must have their advertising reviewed and approved by their broker-dealer.[142] In addition, certain advertising is required to be submitted to the regulators for review.[143] SEC registered investment advisers approve their own advertising materials and are not required to submit it to regulators for review.
- Minimum Net Capital – Broker-dealers are required to maintain a minimum amount of net capital in order to operate their business.[144] This minimum net capital is designed to ensure that a firm that falls below its minimum capital requirement can be liquidated in an orderly fashion. SEC registered investment advisers are not subject to a minimum net capital requirement.
- Fidelity Bond – Broker-dealers are required to maintain fidelity bond coverage in order to operate their business.[145] Fidelity bond requirements protect investors against losses incurred because of fraudulent acts by the broker-dealer or financial advisor. SEC registered investment advisers are not subject to fidelity bond requirements.[146]

Eliminating the broker-dealer exemption would also reduce investor protection by placing a tremendous strain on regulatory resources. As discussed herein previously, the current regulatory framework for broker-dealers is multilayered and allows the SEC and FINRA examine more than half of these registered broker-dealer firms each year.[147] However, regulatory examinations of investment adviser are far less frequent. Striking the broker-dealer exemption from the Advisers Act would shift the burden of supervision, examination, and enforcement over a large numbers of Financial Advisors from the broker-dealer system that offers layered regulation and frequent exams to the investment adviser framework that is already struggling under its current responsibilities. As a result, the proposal does not enhance investor protection; rather, it exacerbates the current problem by exposing all investors to the dangers of the most significant existing regulatory gap.

In summary, eliminating the broker-dealer exemption from the Advisers Act would harm investors by reducing access to advice, limiting investor choice among service providers, and hampering investor protection efforts. As a result, this approach should be rejected in favor of a clearly stated new universal standard of care, plainly articulated conduct rules for Financial Advisors, effective customer disclosures, and balanced regulatory supervision.

<u>Request for Comment Eleven – Varying Levels of Service Provided to Retail Customers</u>

The Study requires the SEC to examine "the varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer

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[141] NASD Conduct Rule 1120(a), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3597.

[142] NASD Conduct Rule 2210, IM-2210-1 through IM-2210-8, Rule 2110, Rule 3110, Rule 2330, MSRB Rule G-21, NTM 92-38, 93-73, 93-85, 95-74, 96-50, 98-3, 98-107, 99-16, 00-15, 00-21, 02-39, 03-17, 03-38, 04-36, 06-48, and 09-10.

[143] NASD Conduct Rule 2210, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10467&element_id=3617&highlight=2210#r10467.

[144] Net Capital Requirements for Brokers or Dealers, 17 C.F.R. §240.15c3-1.

[145] NASD Conduct Rule 3020.

[146] *See* Exhibit A.

[147] Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/speeches/Ketchum/P118889.

relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers."

IBDs support and provide business services to independent financial advisors who typically are small business owners. These services include clearing, business processing, licensing, practice management, product due diligence, marketing assistance, education, and training. The IBD channel is known as the "financial planning channel" because of the independent advisor's focus on comprehensive advice, guidance, and financial counseling, in addition to plan and product implementation. As previously mentioned, it is estimated that approximately 4,500 firms are dually registered as broker-dealers and investment advisers or have affiliated broker-dealers and investment advisers.[148] Moreover, approximately 88 percent of all investment advisor representatives are also registered representatives of a broker-dealer.[149] The majority of these dual registered broker-dealers and registered representatives operate in the IBD channel.

As described previously herein, financial advisors affiliated with IBDs are entrepreneurial business owners who typically have strong ties within their communities and among their client base. They help middle-class families prepare for retirement and send children to college, advise small business owners on estate planning, prepare basic family protection plans such as disability income insurance and life insurance, work with all multi-generation needs such as elder care and special needs children, set up employee benefit plans for businesses, and help younger generations establish lifelong savings habits by advising them on Individual Retirement Accounts and company sponsored 401(k)s—among dozens of other services to meet individual financial goals. Financial advisors affiliated with IBDs have the ability to scale their advice and services to meet the needs of clients with low incomes and who have very little assets to invest, to the largest clients who require complex wealth management services.

IBDs are distinct from other financial services channels such as wire house firms, discount broker-dealers, and insurance- or bank-owned broker-dealers for several reasons: they are not market makers of securities underwriters, they do not create research, they do not engage in investment banking, and they were not involved in the recent scandals that have tainted Wall Street.[150] Financial advisors affiliated with IBDs generally offer "packaged products" such as mutual funds and variable insurance products from a wide variety of companies, provide investment advisory services, and are compensated by fees, commissions, or both.

According to Cerulli Associates, a Boston-based strategic research and consulting firm specializing in the financial services industries, the financial services industry offers approximately sixteen different services to the public which include the following: asset allocation, retirement income planning, retirement accumulation planning, insurance (life, health, disability, etc.), estate planning, education funding, employer benefits retirement planning, investment manager due diligence, cash management/budgeting, tax planning, elder care planning, charitable giving, business planning (continuance, financing, transition planning, etc.), trust services, private banking, and concierge and lifestyle services.[151] In the IBD channel, the percentages of Financial Advisers who offer these services break down as follows:

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[148] Richard G. Ketchum, Chairman and CEO of FINRA, Testimony before the U.S. House of Representatives Committee on Financial Services (October 6, 2009), *available at* http://financialservices.house.gov/media/file/hearings/111/ketchum_testimony.pdf.
[149] *Id.*
[150] *Lehman Brothers Holdings Inc.*, N.Y. TIMES, May 28, 2010, *available at* http://topics.nytimes.com/top/news/business/companies/lehman_brothers_holdings_inc/index.html.
[151] Cerulli Associates at http://www.cerulli.com/.

- Asset allocation – 97%,
- Retirement income planning– 94.9%,
- Retirement accumulation planning – 94.7%,
- Insurance (life, health, disability, etc.) – 89.4%,
- Estate planning – 85.4%,
- Education funding – 82.3%,
- Employer benefits retirement planning – 71.5%,
- Investment manager due diligence – 65.9%,
- Cash management/budgeting, tax planning – 62.4%,
- Elder care planning – 59.6%,
- Charitable giving – 53%,
- Business planning (continuance, financing, transition planning, etc.) – 51%,
- Trust services – 30%,
- Private banking – 7.1%, and
- Concierge and lifestyle services 13.1%.[152]

Request for Comment Twelve – Impact of Changes to Standard of Care to Retail Customers

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

(A) protection from fraud;
(B) access to personalized investment advice, and recommendations about securities to retail customers; or
(C) the availability of such advice and recommendations;"

As stated above, FSI supports the adoption of a clearly stated universal standard of care applicable to all Financial Advisors who offer personalized investment advice to retail customers. This universal standard of care must be carefully designed to promote access to advice, preserve investor choice and enhance investor protection. Careful implementation of the standard of care will protect investors from fraud, promote access to personalized investment advice, and insure investors are informed about their choices among Financial Advisors.

Investor protection from fraud will be enhanced most effectively by pairing the universal standard of care with effective regulatory supervision. While we recognize the value of a heightened standard of care, a universal standard is not a guarantee against misconduct. The standard of care must be accompanied by a comprehensive examination program. This is especially important today when so many Financial Advisors are dually registered as both broker-dealers and investment advisers, or have affiliated businesses that perform these functions. Both sides of those businesses must be examined on a regular basis to insure that regulators see the full picture and can better protect investors. Financial Advisors cannot be allowed to engage in "regulatory arbitrage" by structuring their businesses to avoid the scrutiny of broker-dealer regulation and examination. The existing regulatory supervision gaps must be closed in order to make meaningful enhancements to investor protection from fraud.

[152] *Id.*

FSI supports a balanced, effective, and efficient program of regulatory supervision, examination, and enforcement for all Financial Advisors serving retail investors. Specifically, FSI supports the creation of an industry-informed and industry-funded SRO dedicated to effective supervision, timely examination, and vigorous enforcement over registered investment advisers. The creation of such an entity would result in a layering of effective specialized regulatory entities that mirrors the structure utilized to supervise broker-dealer firms. Under the supervision of the SEC, the new regulatory authority would focus on the routine examination and supervision of all investment advisers. The SEC would thus be free to focus on capital markets concerns, the development of appropriate regulations for all regulated entities, the supervision of the new investment adviser regulatory authority, and the fulfillment of other appropriate regulatory goals. Placing the same emphasis on investment adviser examination and supervision as that of broker-dealers will benefit investors by contributing to the transparency of the financial services regulatory structure. Investors will not only be told that their Financial Advisor is working in their best interests, but will be comforted by the fact that a knowledgeable and specialized regulatory authority is working to insure compliance with this standard of care. The layered regulatory framework will allow the SEC to double-check the quality of the supervisory work of the SRO resulting in a more effective system of supervision. Industry input into the SRO's rulemaking process will encourage efficiency by helping the regulators avoid the unintended consequences of their rulemaking. Therefore, an SRO for registered investment advisers is an essential part of any serious effort to enhance investor protection.

Access to personalized investment advice can be preserved by giving Financial Advisors clear conduct rules outlining their specific obligations under the new standard of care. Clarity will allow Financial Advisors the ability to plan effectively to meet the regulators expectations of them. As stated previously, FINRA and the SEC should use their rulemaking processes to amend its existing rules and adopt additional ones that are consistent with the standard of care and enforced prospectively. While this process moves forward, broker-dealer firms and registered representatives would have clear guidance as to their obligations through reference to the current FINRA rules. As a result, we encourage the SEC to delegate responsibility for any broker-dealer rulemaking necessary to implement the new standard of care to their primary regulator, FINRA.

Investors will make wise choices about the Financial Advisors they utilize if they are informed. Investor choice among the available Financial Advisors will be facilitated through the creation of clear, concise, plain English point-of-engagement disclosure documents. Point-of-engagement disclosures should focus on information material to the typical investor's decision-making process and not on arcane details of interest to a select few. While issues of cost must be covered in these disclosures, the importance of this information should not be overemphasized at the expense of other relevant considerations. Such a disclosure document should consist of:

- A summary of the standard of care owed by the Financial Advisor to each of his clients;
- A brief statement of the nature and scope of the business relationship between the parties, the services to be provided, and the length of the engagement;
- A brief disclosure of the nature and form of compensation to be received by the Financial Advisor;
- A brief disclosure of any material conflicts of interest that exist;
- A brief explanation of the client's obligation to provide the Financial Advisor with information on their investment objectives, risk tolerance, financial situation, and needs;
- A brief explanation of the client's need to inform their Financial Advisor if their investment objectives, risk tolerance, financial information, or needs change;

- A phone number and/or e-mail address the client can use to contact the Financial Advisor should they have concerns about the advice or service they have received; and
- A description of the means by which a customer can obtain more detailed information on these issues free of charge.

In order to be effective, the point-of-engagement disclosure document must be brief. In this regard, research into investor preferences conducted during the profile prospectus rulemaking serve as a helpful guide. To this end, the Investment Company Institute asked mutual fund shareholders whether prospectuses and shareholder reports contained too much information.[153] The results of the research indicated that:

- 59% of investors described prospectuses as "very difficult to understand" or "somewhat difficult to understand";[154]
- 66% of investors said that prospectuses contained too much information, while only 31% said they contained the right amount of information.[155] The numbers for shareholder reports were 54% and 43%, respectively;[156]
- On average, investors only deemed five of 19 disclosure items contained in mutual fund prospectus as "very important" in their decision-making.[157]
- 94% percent of investors generally supported the concept of receiving a short-form prospectus, so long as additional information was available upon request.[158]

These sentiments clearly influenced the SEC's introducing release for the final rule allowing a profile prospectus for open-end investment companies: "The profile, by providing investors with a concise, standardized information option, also may enable investors to use information efficiently by making it easier to compare funds before investing. This result will promote competition among funds and better enable investor to select an investment that is appropriate and consistent with their investment goals."[159]

Based on this research, it is clear investors do not want or derive benefit from comprehensive disclosure documents. Rather, they seek concise disclosures that present the information most relevant to their decision-making in a manner that facilitates easy comparison of available choices. Some investors may want additional information. This information should be made available to customers through Financial Advisor websites or brochures offered free of charge to those without Internet access. The amount and frequency of subsequent mandated disclosures should be limited to reduce the likelihood of information overload. This layered and measured approach to disclosure will facilitate customer understanding, allowing them to make wise choices about the Financial Advisors they work with. For these reasons, FSI urges the SEC to develop a

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[153] SANDRA WEST & VICTORIA LEONARD-CHAMBERS, INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION (2006), *available at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.
[154] *Id.* at 23.
[155] *Id.* at 6.
[156] *Id.*
[157] *Id.*
[158] Karrie McMillan & Brian Reid, Comment Letter, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, File No. S7-28*-07 (August 29, 2008), *available at* http://www.ici.org/pdf/22836.pdf.
[159] Final Rule: New Disclosure Option for Open-End Management Investment Companies, Exchange Act Release No. 33-7513 (March 13, 1998).

simple and concise point-of-engagement disclosure document for Financial Advisors that that has been focus-group tested with investors for effectiveness.[160]

Request for Comment Thirteen – Potential Costs and Expenses

The Study requires the SEC to examine "the potential additional costs and expenses to—

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

Under any circumstances, subjecting Financial Advisors to a new standard of care will have significant costs. These increased compliance costs will inevitably be passed on to customers. Existing broker-dealer written supervisory procedures, compliance and supervision systems, continuing education programs, contracts, marketing materials, signage, and other documents, functions, and systems will have to be reviewed carefully to insure their compliance with the new standard of care. New disclosure documents, policies and procedures, supervisory systems, education programs, contracts, and marketing materials will need to be created so that compliance officers, supervisors, and registered representatives will have the tools they need to function appropriately under the new standard. This review of existing and the creation of new materials, functions, and systems will be disruptive to the service of existing clients and efforts to obtain new ones.

These costs can be minimized by following the approach to harmonization that we have outlined in this letter. This approach is summarized below:

- Adopt a clearly stated universal standard of care;
- Amend FINRA Rule 2010 to incorporate the new standard of care;
- Use the existing SEC and FINRA rulemaking processes to obtain industry and investor feedback on other rule changes necessitated by the new standard of care;
- Develop a simple and concise point-of-engagement disclosure document that is focus-group tested with investors for effectiveness;
- Create an industry informed and self-funded SRO dedicated to effective supervision, timely examination, and vigorous enforcement over RIAs.

This approach will promote universal access to advice by allowing firms to the opportunity to develop innovative and efficient solutions to future regulatory requirements. It will promote investor choice by providing investors the information they need in a format they can understand. Finally, it will enhance investor protection by closing the most significant existing regulatory gap.

Request for Comment Fourteen – Other Considerations

Finally the Study requires the SEC to examine "any other considerations commenters would like to comment on to assist the Commission in determining whether to conduct a rulemaking, following the study, to address the legal or regulatory standards of care for brokers, dealers,

[160] Please note that FSI will submit to the SEC an additional paper entitled "On the Brink of a New Disclosure Regime: Effective Disclosure as Opposed to Comprehensive Disclosure" summarizing important considerations in the creation of Financial Advisor disclosure documents.

investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers."

Once again, FSI wishes to commend the SEC for its efforts to encourage public input, comment, and the submission of data to inform this Study and their efforts to enhance investor protection. It is our contention that the combination of a clearly stated standard of care, plainly articulated conduct rules, effective customer disclosures, and balanced regulatory supervision will promote universal access to advice, preserve investor choice, and enhance investor protection. We hope this letter makes a meaningful contribution to the Study. We urge the SEC to consider these important issues as it reports its findings and implements its recommendations.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to harmonize the regulation of brokers, dealers and investment advisers.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 379-0943.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO

EXHIBIT A

CHART OF OVERLAPPING COMPLIANCE REQUIREMENTS FOR DUALLY REGISTERED BROKER-DEALERS AND REGISTERED INVESTMENT ADVISERS

The chart below summarizes areas where independent broker-dealers, who are dually registered with the SEC as broker-dealers and registered investment advisers, find themselves applying overlapping compliance requirements to their activities. These requirements arise from the broker-dealer regulatory scheme, contained in the Securities Exchange Act of 1934 (the "1934 Act") and NASD/FINRA Rules; and the investment adviser regulatory scheme, set forth in the Investment Advisers Act of 1940 (the "1940 Act"). This list is broken down by: 1) the topic/area of interest; 2) the broker-dealer (BD) requirement; 3) the registered investment advisers (RIA) requirement; and 4) a comparison of the compliance burden created by the competing requirements. The areas of interest are not listed in any particular order.

Area of Interest	BD Requirement	RIA Requirement	Compliance Burden
1. Supervision	Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.[1]	Registered investment advisers must adopt and implement written policies and procedures reasonably designed to prevent violation, by its supervised persons, of the Act and the rules that the Commission has adopted under the Act.[2]	In general, there are similar burdens for BDs and RIAs. However, BDs are subject to more detailed technical requirements that complicate the job of demonstrating compliance, while RIA supervision is principles based and the nature and complexity of supervisory programs differs significantly depending on the RIA's business model.
2. Advertising	Depending on the type of communication with the public (Advertisement, Sales Literature, Correspondence,	It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning the Act, for any registered investment adviser to distribute any	BDs have more detailed, rules based requirements that complicate the job of demonstrating compliance, while RIA

	Institutional Sales Material, Public Appearance, and Independently Prepared Reprint), there are different review, approval, and retention periods prescribed by NASD Conduct Rules, Notice to Members (NTM), and interpretive releases.[3]	advertisement: which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser; or which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person; or which represents, directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which contains any statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation, directly or indirectly; or which contains any untrue statement of a material fact, or which is otherwise false or misleading.[4]	supervision is more principles based. RIA regulations prohibit the use of testimonials; past specific recommendations; charts, graphs, and formulas; free services unless they are entirely free; and misleading pieces. Additionally, most of the guidance that is available is based upon interpretative guidance, no action letters, and enforcement cases, rather than rules and regulations. In general, BDs can use a wider array of advertising materials. However, such materials must comply with Rule 2210, undergo the review and approval process at the broker-dealer, and possibly an additional review by FINRA.
3. Record Retention Periods	Broker-dealers are required to make, maintain and disseminate records and reports prescribed by the SEC as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the 1934 Act.[5] Rules 17a-3 and 17a-4 under the 1934 Act specify	Section 204 under the 1940 Act requires investment advisers to make and keep records for prescribed periods, furnish copies thereof, and make and disseminate reports as the SEC may prescribe as necessary. Rule 204-2 under the 1940 Act identifies the books and records that are required to be made and kept. Most records are required to be maintained for a period of not less than five years from the end of the fiscal year during	Record retention periods vary between BDs and RIAs. BDs are required to keep the following records for the stated periods: **Six year**: records of original entry (blotters), customer account records, financial records, and cash records; **Three years:**

	minimum requirements with respect to the records that must be generated or kept by broker-dealers and the periods for which such records and other documents must be preserved. Most of the records must be retained in an easily accessible place for the first 2 years after their creation. Certain of these records must be retained permanently; others may be discarded after a period of time. For purposes of the 1934 Act, records include accounts, correspondence, memoranda, tapes, disks, papers, books, and other documents or transcribed information of any type, whether recorded in ordinary or machine language.[6]	which the last entry was made on the records, the first two years in an appropriate office of the investment adviser (unless otherwise noted).[7] All records must be kept on a "current" basis and must contain true and accurate representations of the facts. The SEC staff takes the position that the term "current" is not a fixed concept, but may vary with the circumstances of an advisory business and the nature of the records being kept.[8] Although Rule 204-2 covers a variety of records, maintenance of these records fall into three categories based on the functions of the investment adviser. The categories are (i) records relating to all investment advisers, (ii) additional records that must be kept by an adviser with custody of client funds or securities, and (iii) records an investment adviser rendering investment supervisory or management services must maintain for the portfolios it supervises or manages. Furthermore, Rule 204-2 permits an adviser that is also a registered broker-dealer to substitute or rely on records maintained under the 1934 Act for substantially similar records required to be kept by Rule 204-2.	order tickets, guarantees and power of attorney, communications, net capital computations and related records, written agreements, advertising records, bills, and training, supervision and continuing education files; and **Permanent:** corporate records and fingerprint cards. RIAs are required to keep the following records for the stated period: **Five years:** records of original entry (journals), customer account records, financial records, communications, net capital computations and related records, bills, written agreements, advertising, and powers of attorney; and **Three years:** corporate records. BDs must comply with the strict WORM technology, indexing and regulatory notice requirements of SEC Rule 17a-4(f), while RIAs are permitted to maintain electronic records if they establish and maintain certain procedures described under 204-2 and Release IA-1945 without specific

			requirements for WORM technology or notice filing.
4. Annual Testing Requirement	Broker-dealers shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify, on an annual basis, that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons.[9] The designated principal must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.[10]	At least annually, registered investment advisers must review the adequacy of the policies and procedures established and supervise the effectiveness of their supervisory system.[11]	Generally, there are similar burdens for BDs and RIAs. However, BDs have more detailed technical requirements that complicate the job of demonstrating compliance, while RIA testing is principles based. For example, there are no formal requirements for the means by which testing for RIAs is to be completed, who must see the results of the testing, and what, if any, corrective action must be taken. BDs must prepare a written report while no such requirement exists for R IAs, and CEOs of BDs must certify annually to the adequacy of the procedures. No such certification is required for RIAs.
5. Outside Business Activity (OBA) – Disclosure	No person associated with a broker-dealer in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive	Registered investment advisors have a fiduciary duty to disclose all real and potential conflicts of interests to clients as well as all material arrangements. At times, this broad requirement encompasses outside business activities the registered investment advisor considers	Registered representatives are required to provide prompt written notice to the BD when they engage in an OBA. Investment advisor representatives are required to disclose all

	investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. [12]	non-advisory. The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients.	real and potential conflicts of interests to clients. The RIA firm itself must disclose OBAs on its Form ADV Part II, Schedule F and it must disclose its affiliations that are material to the RIA's business.
6. Anti-Money Laundering Program	Each BD shall develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act (BSA)[13] and the implementing regulations promulgated thereunder by the Department of the Treasury. Each member's anti-money laundering program shall, at a minimum, establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the Bank Secrecy Act, provide an annual (on a calendar-year basis) independent testing, and designate and identify to NASD the individual or	There is no requirement for RIAs to have an AML program at this time. A rule was proposed in 2003, but it has since been withdrawn. An investment adviser that is "willfully blind" to money laundering that is occurring within accounts that it manages may be subject to criminal liability.[15]	BDs have to create, design, and implement an AML program to comply with NASD Rule 3011 and the BSA. RIAs do not have to create an AML program.

	individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program; and provide ongoing training for appropriate personnel.[14]		
7. Business Continuity Plans (BCP)	Each member must create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption. Such procedures must be reasonably designed to enable the member to meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties. The business continuity plan must be made available promptly upon request to NASD staff. The BCP plan must be reviewed annual to determine if any modifications are necessary.[16]	No formal rule on point for RIA BCP. However, the SEC stated in the rule release of 206(4)-7 that "an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations."[17]	There are similar burdens for BDs and RIAs, except BDs have detailed technical requirements that complicate the job of demonstrating compliance, while RIAs BCP requirements are principles based and rely upon case law establishing the fiduciary duty to its client.
8. Standard of Care	In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such	Registered investment advisors have a fiduciary duty to their clients. [19]	The fiduciary duty owed by RIAs and Investment Advisor Representatives (IARs) to their clients would appear, on its face, to be a higher compliance burden than the suitability obligation

	customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[18] There are also additional product specific suitability considerations that carry a greater compliance burden (i.e. variable annuity sales, direct participate programs, penny stock transactions).		owed by Registered Representative (RRs) of a BD. However, FINRA 2821 (Variable Annuities) and other product specific requirements may approach or even surpass the obligations owed by an RIA to his client.
9. Compensation	In securities transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking	"Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…[23] Generally speaking, advisory fees above 2% require an IAR to make a disclosure to clients and advisory fees of 3% or not allowed.[24]	RRs of BDs are generally compensated on a transaction-by-transaction basis, while IARs of an RIA are compensated with a fee, which is usually a percentage of a client's total assets under management. RRs are generally held to a 5% commission / mark up, while IARs are held to a 2.9% or lower advisory fee based on assets under management.

	into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefore. [20] RRs of a BD are prohibited from accepting fee-based compensation from customers on brokerage accounts.[21] Generally, RRs cannot earn a commission in excess of 5% of the transaction.[22]		
10. Customer Disputes	Parties may arbitrate a dispute under the FINRA Code of Arbitration Procedures if: the parties agree in writing to submit the dispute to arbitration under the Code after the dispute arises; and the dispute is between a customer and a member, associated person of a member, or other related party; and the dispute arises in connection with the business activities of a member or an associated person, except disputes	There is no rule in the 1940 Act that addresses resolution of customer and internal claims.	BDs can resolve disputes with customers and employees of the BD in binding arbitration through the auspices of FINRA's Dispute Resolution Department if they are contracted to do so. BDs are required to arbitrate disputes with any associated person or another member firm. RIAs can resolve disputes in the following forums: arbitration (Not FINRA DR), county court, state court, and/or federal

	involving the insurance business activities of a member that is also an insurance company. [25] Except as otherwise provided in the Code, a dispute must be arbitrated under the Code if the dispute arises out of the business activities of a member or an associated person and is between or among: Members; Members and Associated Persons; or Associated Persons.[26]		court. FINRA arbitration offers a low cost alternative to court with relaxed rules of evidence and fewer barriers to entry.
11. Privacy	Regulation S-P applies to BDs.	Regulation S-P applies to RIAs.	Both BDs and RIAs are held to the same standard with respect to privacy issues. Noteworthy, is the fact that RIA contracts generally cannot be assigned to another IAR… However, transfer of securities accounts, especially those of RRs of Independent BDs, has become very complicated and burdensome due to Regulation S-P.
12. Account Records	Blotters (or other records of original entry) containing an itemized daily record with information as to all orders taken for securities purchases and sales, including redemption requests, transfers and exchanges, premium payments, policy loan	Rule 204-2 requires an RIA to maintain records separately for each client reflecting purchases and sales (client "posting pages").[29]	BDs are required to enter each transaction into a blotter, while RIAs have to create posting pages. While there is no formal requirement for an adviser to maintain a trade blotter, however there seems to be an expectation by

	requests, policy loan repayments, withdrawal requests, surrender requests, and death benefit payments; all receipts and disbursements of cash; and other debits and credits.[27] With some exceptions, BDs must obtain an account record containing specific client information, and the information contained in the account record must be provided to new clients within 30 days of opening the account, to all clients within 30 days of an update to the client's investment objectives, and to all clients at least every three years thereafter.[28]		the SEC that the adviser will maintain the said record. This is evidenced in the review of a recent SEC exam request letter where transactional data (such as those on a blotter) are requested. RIA's do not have a requirement to obtain an account record containing specific information, nor provide copies to RIA clients on any predetermined basis or timeline exists.
13. Trade Monitoring	All firms are required to establish, maintain, and enforce supervisory systems and procedures that are designed to address all areas of a member's business.[30] A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities. In a fully disclosed clearing	The SEC staff has indicated that, to comply with Rule 206(4)-7, "[e]ach adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred."[32] Specifically, the SEC proposed that advisers should complete "an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation	RIAs are held to a higher standard of care given their fiduciary duty. However, BDs have more detailed technical requirements that complicate the job of demonstrating compliance, while RIAs regulation is primarily principals based pursuant to Rule 206(4)-7 of the 1940 Act. BDS are concerned with churning (excessive trading of customer accounts in an effort to earn

	arrangement, the clearing member generally provides exception reports that are available to assist the introducing member in carrying out its supervisory obligations.[31]	of investment opportunities, or other breaches of fiduciary responsibilities)."[33]	commissions),[34] while RIAs are concerned with reverse churning (where the firm places buy and hold clients in managed accounts).[35]
14. Insider Trading	It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange: to employ any device, scheme, or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.[36]	Every investment adviser shall 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 in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.[37]	There are similar burdens for BDs and RIAs with respect to insider trading, except BDs have detailed technical requirements that complicate the job of demonstrating compliance, while the RIAs rule is principles and based upon case law establishing a fiduciary duty to its client.
15. Personal Trading	A person associated with a member who opens a securities account or places an order for the purchase or sale of securities	All "Access Persons" of an investment advisor registered with the SEC shall report, and the investment advisor shall review, their personal securities transactions and holdings	There are similar burdens for BDs and RIAs with respect to personal trading by RRs and RIA access persons. However,

	with a broker/dealer, a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements or other information concerning the account or order.[38]	periodically. SEC Rule 204A-1 defines "Access Person" to mean any supervised persons of an investment advisor who (1) has access to nonpublic information regarding any advisory clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or (2) is involved in making securities recommendations to advisory clients, or who has access to such recommendations that are nonpublic.[39]	BDs have detailed technical requirements that complicate the job of demonstrating compliance which requires duplicative statements be sent to the BD for its associated persons. The purpose of the member's request for duplicate statements of its registered persons would be to comply with NASD Rule 3010, which obligates a member firm to supervise its registered persons. An RIA is required to have all access persons self report their securities holdings. Again, the RIA rules are more principles based and based on the fiduciary duty to a client.
16. Best Execution	In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing	As a fiduciary, an adviser has an obligation to obtain "best execution" of clients' transactions. In meeting this obligation, an adviser must execute securities transactions for clients in such a manner as to insure the clients' total cost or proceeds in each transaction is the most favorable under the circumstances.[41] In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial	There are similar compliance burdens for BDs and RIAs with respect to best execution for a customer transaction. However, the RIA rules are principles based and proceed from case law establishing a fiduciary duty to the client. Given the existence of the fiduciary duty, IARs are able to avoid or limit their best execution obligation if they

	market conditions. Among the factors that will be considered in determining whether a member has used "reasonable diligence" are: (A) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; (B) the size and type of transaction; (C) the number of markets checked; (D) accessability of the quotation; and (E) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member. [40]	responsibility, responsiveness to the adviser, and the value of any research services provided.[42] However, IARs can disclose to their clients that they may not achieve best execution for their clients and avoid liability if they obtain informed client consent.	disclose this to their clients.
17. Principal Trading	A principal trade occurs when a brokerage house buys securities on the secondary market with the strategy to hold long enough for a price appreciation. There is no prohibition in place that prohibits this type of transaction by a BD.	In light of a recent court decision vacating Rule 202(a)(11)-1 under the 1940 Act, the SEC has adopted temporary Rule 206(3)-3T to establish an alternative method for investment advisers who are dually registered with the SEC as both advisers and broker-dealers to meet the requirements of the 1940 Act when they act in a principal capacity in transactions with certain of their advisory clients. The Temporary Rule was effective September 30, 2007 and will expire on December 31, 2009. Prior to this temporary rule, investment advisers were prohibited from acting "as [a] principal for his own account, knowingly to sell any security to	Prior to the enactment of the temporary rule, set to expire on December 31, 2009, all RIAs were prohibited from engaging in principal trading. Principal trading is, however, core to the business of many broker-dealers. This is appropriate in light of broker-dealer's traditional role as liquidity providers.

		or purchase any security from 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 to such transaction.". [43]	
18. Referral Fees / Solicitors Fees	FINRA prohibits members from paying persons not registered with a member firm a commission or fee derived from a securities transaction, including a referral fee or solicitation fee. Payments that are transaction-based made by members who are registered broker/dealers to non-registered persons are prohibited. [44]	A "solicitor" is "any person who directly or indirectly, solicits any client for, or refers any client to, an investment adviser."[45] As such, activity which seeks to steer a prospective client to an adviser will be deemed solicitation activity. In addition, a person could be engaged in solicitation activity by supplying the names of prospective clients to an adviser, even if he or she does not specifically recommend to the client that he retain that adviser. It is unlawful for any investment adviser to pay a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities unless: the investment adviser is registered under the Act; the solicitor is not a person (A) subject to a Commission order issued under section 203(f) of the 1940 Act, or (B) convicted within the previous ten years of any felony or misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the Act, or (C) who has been found by the Commission to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5) or (6) of section 203(e) of the Act, or (D) is subject to an order, judgment or decree described in section 203(e)(4) of the Act; and such cash fee is paid pursuant to a written agreement to which the adviser is a party;...[46]	BDs are prohibited from paying a referral fee to a person who is not licensed with a FINRA member firm, but RIAs can pay solicitor fees to individuals if they meet the requirements set forth in the 1940 Act.

19. Custody	Rule 15c3-3 of the 1934 Act governs a broker-dealer's acceptance, custody and use of a customer's securities. Rule 15c3-3 is intended to ensure that a broker-dealer in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to prevent commingling of customer and firm funds. Rule 15c3-3 seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes. The Rule also aims to protect customers involved in a broker-dealer liquidation. If a broker-dealer holding customer property fails, Rule 15c3-3 seeks to ensure that the firm has sufficient reserves and possesses sufficient securities so that customers promptly receive their property and there is no need to use the SIPC fund. NASD Conduct Rule 3020 requires members to maintain fidelity bonds to insure	Under 206(4)-2, an RIA is generally deemed to have custody of client assets when the RIA holds or has possession of those assets or has the authority to obtain possession of the assets. An RIA has custody of a client's account where the RIA or one of its supervised persons has the authority to transfer assets in the account to itself. If an RIA has custody of client assets, the RIA is required to implement controls designed to protect client assets from being lost, misused, misappropriated or subject to the RIA's financial reserves. The rule contains two primary protections. First, the RIA is required, subject to certain limited exceptions, to place the assets with a "qualified custodian," which includes, among others, banks and registered broker-dealers. Second, an RIA with custody of client assets that maintains the assets with a qualified custodian is generally required to have a reasonable belief that the qualified custodian delivers account statements directly to each client at least quarterly.	Both BDs and RIAs have rules and regulations that direct their actions with respect to custody of client funds. BDs have to place the customer funds in a safe area related to the servicing of the customer or in a reserve bank account. RIAs with custody have to implement controls designed to protect client assets from being lost, misused, misappropriated, or subject to the RIA's financial reserves. Again, BDs have detailed technical requirements that complicate the job of demonstrating compliance, while RIAs have more principles based rules.

	against certain losses and the potential effect of such losses on firm capital. The Rule applies to all members with employees who are required to join SIPC and who are not covered by the fidelity bond requirements of a national securities exchange.		
20. Examination	The SEC and industry-funded regulators examine more than half of the approximately 4,900 registered broker-dealer firms each year.	The Securities and Exchange Commission (SEC) projects that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010.[47]	BDs will have one or more regulatory visit in a two-year period, while RIAs may have only one regulatory visit in a ten-year period.[48]
21. Continuing Education	Each registered person shall complete the Regulatory Element on the occurrence of their second registration anniversary date and every three years thereafter, or as otherwise prescribed by NASD.[49] Each member must maintain a continuing and current education program [Firm Element] for its covered registered persons to enhance their securities knowledge, skill, and professionalism.[50]	There is no rule related to continuing education under the 1940 Act.	RRs of a BD have regulatory element and firm element continuing educations requirements. IARs of an RIA have no requirement for continuing education under the 1940 Act.
22. Licensing	RRs of a BD are required to take, pass, and obtain a Series 7 (or Series 6 to sell only investment company or variable annuity products) in order to sell securities	IARs and RIAs do not have a standardized licensing examination under the 1940 Act. Although, in order to offer advice concerning securities products in a majority of states, IARs must obtain a Series 65 or 66 (Uniform Investment Adviser Law	RRs are required to take and pass a liciensing exmainaiton in order to sell securities products, while IARs are not required to take a standardized licensing

	products.[51]	Examination), which is a combination of the Series 63 and 65. Series 65 or 66 exams are often waived by the majority of states if the IAR holds one of several acceptable professional designations such as CFP, CFA, ChFC, PFS or CIC.	examination.

[1] NASD Conduct Rule 3010.

[2] Rule 206(4)-7 of the Rules and Regulations promulgated under the 1940 Act.

[3] NASD Conduct Rule 2210, IM-2210-1 through IM-2210-8, Rule 2110, Rule 3110, Rule 2330, MSRB Rule G-21, NTM 92-38, 93-73, 93-85, 95-74, 96-50, 98-3, 98-107, 99-16, 00-15, 00-21, 02-39, 03-17, 03-38, 04-36, 06-48, and 09-10.

[4] Rule 206(4)-1 of the Rules and Regulations promulgated under the 1940 Act

[5] Section l7(a)(i) under the 1934 Act.

[6] Section 3(a)(37) under the 1934 Act.

[7] Rule 204-2(e) of the Rules and Regulations promulgated under the 1940 Act.

[8] See, e.g., American Asset Management Company, SEC No-Action Letter (July 23, 1987 and William P. Frankenhoff, Inc., SEC No-Action Letter (August 24, 1987).

[9] NASD Conduct Rule 3012.

[10] FINRA Rule 3130.

[11] Rule 206(4)-7 of the Rules and Regulations promulgated under the 1940 Act.

[12] NASD Conduct Rule 3030

[13] 31 U.S.C. 5311, *et seq*.

[14] NASD Conduct Rule 3011.

[15] 18 U.S.C. §§ 1956 and 1957.

[16] NASD Conduct Rule 3510.

[17] SEC Release Nos. IA 2044; IC-26299 Final Rule: Compliance Programs of Investment Companies and Investment Advisers

[18] NASD Conduct Rule 2310

[19] S.E.C. v Capital Gains Research Bureau, 375 U.S. 180 (1963). *See generally,* the Anti-Fraud provisions of the 1940 Act

[20] NASD Conduct Rule 2440

[21] *Financial Planning Ass'n* v. S.E.C., 2007 WL 935733, C.A.D.C. (March 30, 2007)

[22] *See generally,* IM-2440-1 (In 1943, the Association's Board adopted what has become known as the "5% Policy" to be applied to transactions executed for customers. It was based upon studies demonstrating that the large majority of customer transactions were affected at a mark-up of 5% or less. The Policy has been reviewed by the Board of Governors on numerous occasions and each time the Board has reaffirmed the philosophy expressed in 1943. Pursuant thereto, and in accordance with Article VII, Section 1(a)(ii) of the By-Laws, the Board has adopted the following interpretation under 2440).

[23] Rule 202 of the 1940 Act

[24] *See*, Berkman Ruslander et. al., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 68 (Jan. 6, 1977); Shareholder Services Corp., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 159 (Feb. 2, 1989); BISYS Fund Services, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 720 (Sept. 2, 1999).

[25] Code of Arbitration Procedure for Customer Disputes, Rule 12200.

[26] Code of Arbitration Procedure for Industry Disputes Rule 13200

[27] Rule 17a-3(a)(1) under the 1934 Act.

[28] Rule 17a-3(a)(17)(i)(A) under the 1934 Act.

[29] Rule 204-2 under the 1940 Act.

[30] NASD Conduct Rule 3010.

[31] Notice to Members 99-54, pursuant to NASD Conduct Rule 3010.

[32] Securities and Exchange Commission; "Compliance Programs of Investment Companies and Investment Advisers"; Final Rule. 68 Fed. Reg. 74714 - 74730 (December 24, 2003).
[33] *Id.*

[34] IM-2310-2

[35] *See* FINRA Fines Robert W. Baird & Co. $500,000 for Fee-Based Account, available at http://www.finra.org/Newsroom/NewsReleases/2009/P117860. (

[36] Rule 10b-5 of the Rules and Regulations promulgated under the 1934 Act, NASD Conduct Rule 3010 and 2110.

[37] Rule 204A under the 1940 Act.

[38] NASD Conduct Rule 3050(d).

[39] Rule 204A under the 1940 Act.

[40] NASD Conduct Rule 2320(a)(1).

[41] *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, SEC Rel. No. 34-23170 (Apr. 23, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) at Section V. S*ee also Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Rel. No. IC-26313 (Dec. 18, 2003) at 16.

[42] *Id.*

[43] Rule 206(3) of the 1940 Act.

[44] NASD Conduct Rule 2420.

[45] Rule 206(4)-3 of the 1940 Act.

[46] *Id.*

[47] *See* Richard Ketchum Speech at The Exchequer Club, June 17, 2009, available at http://www.finra.org/Newsroom/Speeches/Ketchum/P119009

[48] *Id.*

[49] NASD Conduct Rule 1120(a).

[50] NASD Conduct Rule 1120(b)(2)(A).

[51] *See generally, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Qualifications/p011051*

EXHIBIT B

SUMMARY OF STATE APPLICATION OF FIDUCIARY DUTY TO BROKER-DEALER ACTIVITIES

State	Fiduciary Duty?	Scope/Support
Alabama	Maybe	On appeal, the *Chipser* court stated, "a broker's duty to his customer can be modified in important respects by contract." *Chipser v. Kohlmeyer & Co.*, 600 F.2d 1061, 1066 (5th Cir. 1979) (not specifically applying or referencing Alabama law, although customer was from Alabama). Without clarification from the contract terms on the record before it, the Court finds "the scope of [the brokerage firm's] fiduciary duty is undefined." *Id.* at 1067.
Alaska	*Maybe*	A fiduciary duty arises "'when one imposes a special confidence in another, so that the latter, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one imposing the confidence.'" *Enders v. Parker*, 66 P.3d 11, 16 (Ak. 2003) (citation omitted) (describing duty with respect to estate representative).
Arizona	No	Arizona imposes a fiduciary duty only where there is a "'great intimacy, disclosure of secrets, entrusting of power, and superiority of position in the case of the representative . . . .'" *SEC v. Raucher Pierce Refsnes, Inc.*, 98 Fed. Sec. L. Rep. (CCH) ¶90,284 (D Ariz. Aug. 10, 1998) (quoting *Rhoads v. Harvey Publications, Inc.*, 700 P.2d 840, 847 (Ariz. Ct. App. 1984)). This is not present between a broker and the nondiscretionary accountholder.
Arkansas	No	*Greenwood v. Dittmer*, 776 F.2d 785, 788 (8th Cir. 1985) (relying in District Court's determination that under Arkansas law, no fiduciary duty is owed by a commodities broker to a nondiscretionary accountholder) (citations omitted).

California	Yes	A broker's fiduciary duty requires that he/she act "in the highest good faith" toward the customer. *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 165 Cal. App. 3d 174, 201, 210 Cal. Rptr. 387 (Cal. Ct. App. 1985).
Colorado	No	Although a client agreement is not definitive, Colorado employs a "practical control test" to determine whether a broker owes his/her customer a fiduciary duty. Where there is no practical control, the broker does not owe a fiduciary duty. *Hudson v. Wilhelm*, 651 F. Supp. 1062 (D. Col. Jan 12, 1987).
Connecticut	Probably Not	In analyzing the relationship between an insurance broker and the insured, a Connecticut state court found that the broker owed its insured a duty to exercise reasonable skill, care and diligence in procuring the policy, but once procured, the agency relationship ends and there is no ongoing duty or authority to act for the insured absent explicit authorization. *Precision Mechanical v. T.J. PFund*, CA 90-0416692, 2003 Ct. Sup. 14518, 14521 (Conn. Sup. Ct. Dec. 22, 2003) -- This case was overturned on appeal in 2008, but it appears that the rule concerning a potential fiduciary duty still stands: "We recognize that as a general rule, the agency relationship between a broker and the insured terminates *566 upon procurement of the requested insurance policy. See *Lewis v. Michigan Millers Mutual Ins. Co.*, supra, 154 Conn. at 664, 228 A.2d 803. However, "[i]nherent in the obligation to seek continuation of an insurance policy is the duty to notify the applicant if the insurer declines to continue [to insure] the risk, so the applicant may not be lulled into a feeling of security or put to prejudicial delay in seeking protections elsewhere." (Internal quotation marks omitted.) *Lazzara v. Howard A. Esser, Inc.*, 802 F.2d 260, 266 (7th Cir.1986); see also 12 E. Holmes, supra, § 86.6, at p. 497 ("[a]n agent or broker cannot sit idly with a cancellation notice or information, but must seasonably inform the insured client thereby giving the client sufficient time to obtain protect[ion] with another insurer")." *Precision Mechanical Services, Inc. v. T.J. Pfund Associates, Inc.*, 109 Conn.App. 560, 952 A.2d 818 (Conn.App.,2008).

Delaware	Limited	*O'Malley v. Boris*, No. 15735-NC, n. 16 (Del. Chanc. Ct. Mar. 18, 2002) ("Because the plaintiffs had nondiscretionary accounts, this [fiduciary] duty was limited in nature;" going on to cite *Leib* favorably).
Florida	Limited	*First Union Brokerage v. Milos,* 717 F.Supp. 1519, 1526 (S.D.Fla.,1989): "Fiduciary duties associated with a nondiscretionary account, such as the one presently at issue, include the following: (1) the duty to recommend [investments] only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to perform the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing ...; (5) the duty not to misrepresent any material fact to the transaction; and (6) the duty to transact business only after receiving approval from the customer." (citing *Gochnauer v. A.G. Edwards & Sons, Inc.*, C.A. 86-3169, CCH ¶ 72,483 (11th Cir. Feb. 20, 1987)).
Georgia	Limited	*Holmes v. Grubman*, 691 S.E.2d 196, 201–02 (Ga.,2010.) (February 08, 2010): "Looking to federal precedent, the Court of Appeals has also determined that a stockbroker has limited fiduciary duties towards a customer who holds a non-discretionary account [. . .] We further conclude that the fiduciary duties owed by a broker to a customer with a non-discretionary account are not restricted to the actual execution of transactions. The broker will generally have a heightened duty, even to the holder of a non-discretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest. See *Leib v. Merrill Lynch, Pierce, Fenner & Smith,* 461 F.Supp. 951, 953(Il) (E.D.Mich.1978) (cited in *Glisson*); 5 Law Sec. Reg. § 14.15[2] (6th ed.).
Hawaii	No	The court determines Washington law governs, but that, alternatively, Hawaii courts would adopt the reasoning of other courts in holding a broker does not owe fiduciary duties to nondiscretionary accountholders. *Unity House, Inc. v. North Pacific Inv., Inc.*, 918 F. Supp. 1384, 1393 (D. Ha. 1996).

Idaho	Maybe Limited	No fiduciary relationship between lender and creditor, even where bank has longstanding relationship with its client. *Black Canyon Racquetball v. First Nat'l*, 119 Idaho 171, 176, 804 P.2d 900 (1991). *See also Madrid v. Roth*, 134 Idaho 802, 805, 10 P.3d 751 (Idaho Ct. App. 2000) (citing rule that lender may owe fiduciary duty where there is an agreement creating a duty, or the lender exercises complete control over disbursement of funds, and finding no fiduciary duty was owed). A fiduciary relationship is a relationship of trust and confidence and is generally applicable to relations between family members, attorney and client, insurer and insured, principal and agent. *Baker Farms v. LDS Corp.*, 136 Idaho 922 (Idaho Ct. App. 1992) (internal citation omitted).
Illinois	Limited	"In the case of a nondiscretionary account, a broker's fiduciary duty is 'generally limited to the completion of a transaction.'" *Refco, Inc. v. Troika Inv. Ltd.*, 702 F. Supp. 684, 686 (N.D. Ill. 1988) (addressing commodities broker). *See also CFTC v. Heritage Capital Advisory Servs.*, 923 F.2d 171, 173 (7th Cir. 1987) (favorably citing *Leib*); *Martin v. Heinold Commodities, Inc.*, 139 Ill App. 3d 1049, 1054-55 (1985) (citing *Leib*, stating, "[g]enerally, the scope of affairs entrusted to a broker is limited to the completion of the transaction," and finding assessment of foreign service fee in connection with transaction within the scope of the limited fiduciary duties owed the nondiscretionary account customer).
Indiana	Probably Not	"Indiana Courts have never held that such a special [fiduciary trust] relationship exists [between a broker and client]." *Dolatowski v. Lynch*, 808 N.E.2d 676 (Ind. App. Ct. 2004) (citing favorably *Shearson Hayden Stone, Inc. v. Leach*, 583 F.2d 367, 372 (7th Cir. 1978), which the *Dolatowski* court describes as holding that a broker ordinarily has no fiduciary relationship with an investor) *Shearson*, 583 F.2d at 372 (broker owes no fiduciary duty where account is nondiscretionary and customer does not rely on broker for advice).

Iowa	Maybe	In *McCracken v. Edward D. Jones & Co.*, the Court found the plaintiff was owed a fiduciary duty by her broker. 445 N.W.2d 375 (Iowa App. Ct. 1989). The Court noted that no prior Iowa case had imposed a fiduciary relationship between a broker a client, *id.* at 381, but described the factors that lead it to uphold a jury finding the relationship in this case: (1) plaintiff's lack of prior investment experience; (2) broker advised plaintiff; (3) broker knew plaintiff relied on him and trusted his judgment; (4) broker was likely aware plaintiff had not read literature concerning investment at issue. *Id.* There is no discussion of the scope. The broker was held liable for providing false information to the plaintiff. *See also Greatbatch v. Metropolitan Federal Bank*, 534 N.W.2d 115, 117 (Iowa App.,1995) (stating that "No clear guideline exists to define whether a party is in the business of supplying information. [. . .] the duty has been readily applied to accountants and investment brokers. *Ryan,* 170 N.W.2d at 403; *McCracken v. Edward D. Jones & Co.,* 445 N.W.2d 375, 382 (Iowa App.1989). These professions directly involve the supply of information).
Kansas	Limited	In non-discretionary accounts, brokers' duties are limited to carrying out orders with due care and loyalty, entering into only authorized transactions, and avoiding self-dealing. *Arst v. Stifel, Nicolaus & Co., Inc.*, CCH ¶ 74,100 (10th Cir. June 11, 1996) (applying Kansas law, finding broker had duty to disclose to customer purchases made for broker's own account, but did not have obligation to advise customer concerning customer's unsolicited transaction).
Kentucky	Maybe Limited	One Kentucky state court has cited with favor authority providing that an insurance broker's duties may be either specific to procuring one policy, in which case they terminate when the policy is procured, or more general, in which case they may include ongoing duties. *Stuyvesant Ins. Co. v. Barkett*, 226 Ky. 424, 428, 11 S.W.2d 87 (Ky. Ct. App. 1928). A fiduciary relationship "is one founded on trust or confidence reposed by one person in the integrity and fidelity of another and which also necessarily involves an undertaking in which a duty is created in one person to act primarily for another's benefit in matters connected with such undertaking." *Morton v. Bank of the Bluegrass/Trust*, 18 S.W.3d 353, 359 (Ky. Ct. App. 2000)

Louisiana	Limited	"[T]he nature of the fiduciary duty owed will vary, depending on the relationship between the broker and the investor. Such determination is necessarily particularly fact-based. And although courts draw no bright-line distinction between the fiduciary duty owed customers regarding discretionary as opposed to non-discretionary accounts, the nature of the account is a factor to be considered . . . ." *Beckstrom v. Parnell*, 730 So.2d 932, 948 (La. App. Ct. 1998) (citing *Romano v. Merrill Lynch*, 835 F.2d 533, 528 (5th Cir. 1987)). *Beckstrom* cites *Leib* (*see* Mich.) with approval. *Id.* at 948-49. The Court notes that depending on the customer-broker relationship, the nature of the transaction, and the sophistication of the customer, the duty can change. *Id.* at 948 (citing *Leib*). "In a non-discretionary account each transaction is viewed singly. In such cases the broker is bound to act in the customer's interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed. Duties associated with a non-discretionary account include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer's orders *949 promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer." *Beckstrom v. Parnell*, 714 So.2d 188, 195 (La. App. Ct. 1998)
Maine	Probably Not	Maine law requires real estate brokers to disclose only material information known or that should be known with exercise of reasonable care. *Binette v. Dyer Library Ass'n*, 888 A.2d 898, 905 (Me. 1996).

Maryland	Limited	A Maryland state court has noted the distinction between discretionary and nondiscretionary accounts for fiduciary purposes made in other courts, but then applied agency law. *Huppman v. Tighe*, 642 A.2d 309, 315 (Md. App. Ct. 1994) (noting trial court's analysis). Citing *Huppman*, the court in *E. David Gable & Assoc. v. Dean Witter Reynolds, Inc.*, 1998 U.S. App. LEXIS 29831, *16-17 (4th Cir. 1998), noting District Court's refusal to determine whether the broker-customer relationship was a fiduciary one, instead applied Maryland agency law "concluding that Dean Witter in its capacity as agent had a duty to act in appellant's best interests and to communicate truthfully all relevant information to appellant."
Massachusetts	No	"[U]nder Massachusetts law, a "simple" broker-customer relationship is not fiduciary in nature . . . ." *Pastos v. First Albany*, 433 Mass. 323, 330, 741 F.2d 841 (2001) (citing *Vogelaar v. H.L. Robbins & Co.*, 348 Mass. 787, 204 N.E.2d 461 (1965)).
Michigan	Limited	*Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978). Per *Leib*, the brokers owe the following duties to nondiscretionary accountholders: (1) make recommendations only when sufficiently informed; (2) promptly execute orders consistent with customer's interests; (3) inform customer of risks involved in buying/selling a particular security; (4) refrain from self-dealing; (5) not misrepresent facts material to the transaction; and (6) transact business only after receiving customer approval.
Minnesota	No	"Absent a special agreement or a special relationship, a securities broker does not owe a customer a fiduciary duty." *MERF v. Allison-Williams Co.*, 508 N.W.2d 805, 806 (Minn. Ct. App. 1993) (finding no evidence that MERF, a pension fund, was owed a fiduciary duty by its broker). *See also Rude v. Larson*, 296 Minn. 518, 519, 207 N.W.2d 709 (1973) (same).
Missouri	Yes	"In Missouri, stockbrokers owe customers a fiduciary duty. [citation omitted] This fiduciary duty includes at least these obligations: to manage the account as dictated by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies." *State ex rel PaineWebber v.*

		Voorhees, 891 S.W.2d 126, 130 (Mo. 1995) (en banc). *See also Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 396 S.W.2d 570, 575 (Mo. 1965) (en banc); *Mercantile Trust Co. v. Harper*, 622 S.W.2d 345, 349 (Mo. App. 1981); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo. App. 1978). "A stockbroker's duty to disclose material facts does not, however, include an obligation to discuss orally with a competent party conspicuous written provisions . . . ." *Voorhees*, 891 S.W.2d at 130 (finding no obligation to discuss arbitration and loan clauses in customer agreement).
Mississippi	No	*Puckett v. Rufenacht, Bromagen & Hertz*, 587 So.2d 273, 279 (Miss. 1991) (citing *Leib* favorably, and finding no duty was breached, stating "a broker in a non-discretionary account . . . has a duty to properly carry out his customer's principal instructions, ordinarily his duty ends there").
Montana	No	"[I]n the absence of discretionary authority by a broker to buy and sell in a customer's account, no fiduciary relationship is created between the broker and the customer." *Willems v. U.S. Bancorp Piper Jaffray, Inc.*, 326 Mont. 103, 107, 107 P.3d 465 (2005) (citation omitted) (finding fiduciary duty was created where agreement granted broker discretionary trading authority for its own protection, but did not describe limited circumstances in which such discretion would be exercised). *See also Chor v. Piper, Jaffray & Hopwood*, 261 Mont. 143, 152-53, 862 P.2d 26 (1993) (finding no fiduciary duty in nondiscretionary account).
Nebraska	Maybe	*Nord v. AmFirst Invest. Servs.*, 14 Neb. App. 97, 107-8, 704 N.W.2d 796 (2005) (bank sold notes to customer; court found ongoing duty to disclose material facts to plaintiffs in part because sellers had promised to assist plaintiffs in recovering their money).
New Hampshire	Probably Not	A customer complaining of losses and urging that Merrill should be held responsible for "failure to properly liquidate his [margin] account." *Merrill Lynch Futures v. Sands*, 143 N.H. 507, 511, 727 A.2d 1009 (1999). The court refused to hold Merrill liable to the customer for failure to follow its own policies, and further went on to say, "[t]he defendant's account was non-discretionary; that is, Merrill Lynch did not have authority to make investment decisions in the defendant's interest…

		Merrill Lynch was not obligated to liquidate the account to protect the defendant from further imprudent investment activity." *Id.*, 143 N.H. at 512.
New Jersey	Probably Not	The Third Circuit, finding no New Jersey on point, assumed the NJ Supreme Court would find a broker owed a fiduciary duty to his customer in a discretionary account. *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 767 (3rd Cir. 1990) (citing *Leib* favorably, and relying on *White v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 218 A.2d 655 (N.J. Sup. Ct. 1966)).
New Mexico	Maybe	In the context of a negligence claim, a New Mexico state court has described the relationship between a customer and stockbroker as "fiduciary" in nature, relying on agency principles and finding the broker the maker of a contract between the seller-customer and third-party buyer of securities. *Reinhart v. Rauscher Pierce Sec. Corp.*, 490 P.2d 240, 245 (N.M. 1971). The broker "must execute his duties with the utmost good faith and loyalty." *Id.* The court goes on to say the broker "had a duty to use reasonable care to obtain terms which best satisfy the manifested purposes" of his customer. *Id.* The firm "had a duty to exercise reasonable skill and ordinary diligence and not to act negligently." *Id.* The court reversed summary judgment in favor of the customer, finding an issue of fact was created based on evidence that broker did not sell when stock fell below customer's stated price point because he had not observed the fall. *Id.*
New York	No	*Fesseha v. TD Waterhouse Investor Servs.*, 305 A.D.2d 268, 268-69 (N.Y. App. Ct. 2003) (nondiscretionary account holder not owed fiduciary duty by broker).
Nevada	Maybe	A fiduciary relationship arises where one imposes special confidence in another so that the latter is bound to act in good faith and with due regard to the other's interests. *Executive Mgmt. v. Ticor Title Ins. Co.*, 114 Nev. 823, 841, 963 P.2d 465 (1998).

North Carolina	No	Acknowledging that broker/dealers may be liable to customers for negligence, *Sterner v. Penn*, 159 N.C. App. 626, 629 (2003), the court found broker/dealers have no legal duty to monitor a customer's investments on an ongoing basis. *Id.* at 631 (noting that broker was not alleged to have acted as investment adviser to plaintiffs, suggesting that in a discretionary account, such a duty to monitor may arise). The *Sterner* court found that absent this legal duty, plaintiffs had not stated a claim for negligence. *Id.*
North Dakota	No	*Ray E. Friedman & Co. v. Jenkins*, 738 F.2d 251, 254 (8th Cir. 1984) (finding refusal to give jury instruction on fiduciary duty was proper because account was nondiscretionary). Although *Friedman* did not specifically reference North Dakota law for this proposition, it does apply North Dakota law generally to other claims.
Ohio	Limited	*Burns v. Prudential Sec., Inc.*, 167 Ohio App.3d 809, 828–29 (Ohio App. Ct. July 11, 2006) (citing *Leib* favorably). Stating duties for nondiscretionary account include: (1) duty to recommend stock only after studying it sufficiently; (2) duty to inform customer of risks involved in buying or selling a particular security; (3) duty not to misrepresent any material facts; and (4) duty to engage in transactions only after obtaining customer approval. *Id.* (citing *Leib*). "[I]f a nondiscretionary broker assumes control of his clients' accounts and performs transactions *at his own discretion* without the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients." *Id.* (citing Leib).
Oklahoma	Maybe	A fiduciary relationship is one where trust is placed by one person in the fidelity and integrity of another. Although the court notes that in some cases this is a question of law, in some a question of fact, it states that equitable courts will not define the bounds of these relationships, suggesting this is a fact-intensive inquiry. *Clark, Jr. v. Clark*, 2002 Ok Civ. App. 96, 98, 57 P.3d 95 (2002).

Oregon	No	In *Berki v. Reynolds Securities, Inc.*, the Court relied on the customer agreement, which provided that the broker would buy and sell at the customer's direction without discretion, and lack of facts to the contrary, in finding the broker did not have a fiduciary relationship with his customer. C.A. 415-354, CCH ¶ 71,365 (Or. Feb. 10, 1977). "A stockbroker is a fiduciary if his client trusts him to manage and control the client's account and he accepts that responsibility." *Wallace v. Hinkle Northwest*, 79 Or. App. 177, 181 (Or. App. 1986).
Pennsylvania	Limited	"The relationship between a broker and his customer is one of principal and agent by virtue of which the broker is subject to certain fiduciary obligations to his client." *Merrill Lynch v. Perelle*, 356 Pa. Super. 165, 183-84, 514 A.2d 552 (Pa. Su. Ct. 1986) (citing *Leib* favorably).
Rhode Island	Probably Not	In the context of an insurance broker and the customer-insured, there is ordinarily no fiduciary relationship; rather the broker's duties depend on the request of the insured. *Kenny Mfg. Co. v. Starkweather & Shepley, Inc.*, 693 A.2d 203, 208 (R.I. 1994). *See also United Nat'l Bank v. Tappan*, 79 A. 946, 958-59 (R.I. 1911) (addressing sale of stock in bankruptcy context and stating generally, "the relation between a broker and customer is not a fiduciary one").
South Carolina	Yes	Duties include accounting for customer's funds; refraining from acting contrary to customer's interest; avoiding fraud; and communicating information that would be to the customer's advantage. *Cowburn v. Leventis*, CCH ¶ 75,542 (S. Ca. Ct. App. May 16, 2005). This does not require the broker to research unknown risks. *Id.*
South Dakota	Yes	*Dismore v. Piper Jaffray, Inc.*, 593 N.W.2d 41, 46 (S.D. 1999) (holding securities brokers owe same fiduciary duties to customers as those owed by real estate brokers, specifically "a duty of utmost good faith, integrity and loyalty") (citation omitted). When a fiduciary relationship exists, "the fiduciary has a 'duty to act primarily for the benefit' of another." *Id.* (citation omitted). While the precise scope of these duties is not addressed, in *Dinsmore* Piper Jaffray was not in violation of these duties by providing plaintiff a form customer agreement and not going over it with him, because in entering into the agreement Piper acts on its own behalf and not for the customer. *Id.* In other cases, this case

		has been described as requiring an analysis of the facts, rather than reliance on the nondiscretionary-discretionary dichotomy. *See*, *e.g.*, *Marchese v. Nelson*, 809 F. Supp. 880, 894 (D. Utah 1993).
Tennessee	Limited	*Johnson v. John Hancock Funds*, 217 S.W.3d 414, 428 n. 24 (Tenn. Ct. App. June 30, 2006) ("The duties associated with a non-discretionary account are discussed in *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978).").
Texas	Limited	*In re Rea*, 245 B.R. 77 (N.D. Tex. 2000) (noting no Texas authority addressing applicability of fiduciary relationship between broker and customer, the Court cites *Leib* favorably, noting no reason to depart from this precedent).
Utah	Maybe	Noting no Utah courts had addressed the issue, the *Marchese* court determined Utah courts would likely first look to discretionary or nondiscretionary nature of the account, imposing fiduciary duties in cases of discretionary accounts. *Marchese v. Nelson*, 809 F. Supp. 880, 894 (D. Utah 1993). For nondiscretionary accounts, the Court suggested looking at whether the broker has agreed to manage the account or merely offered advice. *Id.* If the former, a fiduciary relationship exists. *Id.* Applying the rule, the Court determined there was no fiduciary relationship because the account was nondiscretionary and the broker had merely offered advice. *Id.* at 894-95.
Vermont	Probably Limited	A fiduciary relationship is one where one person is under a duty to "act for or to give advice for the benefit of another upon matters within the scope of the relation." *Cooper v. Cooper*, 173 Vt. 1, 7, 783 A.2d 430 (Vt. 2001). It is a relationship of trust and confidence. *Id.*
Virginia	Maybe	The nondiscretionary nature of an account tends to suggest a reduced fiduciary duty, but that all facts involved must be assessed. Where the broker and customer are not on "equal footing," that is, where one side there is significant influence or on the other there is justified dependency or trust, there is a fiduciary duty. *Roberson v. PaineWebber, Inc.*, 998 P.2d 193, 198-99 (Ok. App. Ct. 1999) (finding fiduciary relationship existed, but remanding for determination of extent of relationship) (applying Virginia law).

Washington	No	"A broker whose client maintains a nondiscretionary account has no common law duty to ascertain the suitability of a customer to make investments." *Sherry v. Dierks*, 29 Wn. App. 433, 442, 628 P.2d 1336 (1981) (citing *Leib*).
West Virginia	Maybe	In *Baker v. Wheat First Securities*, a federal district court in West Virginia analyzed a claim of fiduciary duty on the firm's motion for summary judgment. 643 F. Supp. 1420, 1428–29 (S.D. W. Va. 1986). Finding no West Virginia cases precisely on point, the Court expressed disfavor for relying solely on the distinction between discretionary and non-discretionary account status, referring to cases where a fiduciary relationship was found where the broker effectively controlled the account or, as in churning cases, where the customer routinely follows the broker's suggestions. Noting an agent owes a fiduciary duty to his principal, and a broker is an agent of his customer, the Court suggests the determination is a fact-intensive one. There is no discussion of the scope of the fiduciary duties owed.
Wisconsin	No	*Merrill Lynch v. Boeck*, 127 Wisc.2d 127, 135-36 (1985). The *Boeck* customer had a nondiscretionary account and was an experienced investor, and there was no agreement to provide investment advice other than that incidental to brokerage activities. The Court found without an agreement placing greater obligation on the broker, there was no fiduciary duty.

Wyoming	Probably Not	Under Wyoming law, a home mortgage lender does not owe the borrower fiduciary duties, but this can be altered based on the circumstances of the relationship and transactions involved. *Burt v. Wells Fargo Home Mort.*, Inc. 75 P.3d 640, 661 (Wyo. 2003). In the borrower-lender context, factors that tend to demonstrate a fiduciary relationship include the borrower's offering of advice and consultation, lender's involvement in the borrower's business, and borrower's lack of sophistication. Id. Moreover, an insurance agent/broker has been held to have no ongoing duty to its insured under facts where the broker did not notify insured of the underlying insurer's insolvency after underlying policy had expired, noting plaintiff had failed to show that a special relationship existed between him and the broker. *Gordon v. Spectrum, Inc.*, 981 P.2d 488, 492 (Wyo. 1999).

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On the Brink of a New Disclosure Regime: Effective Disclosure as Opposed to Comprehensive

I. Introduction

Recently, the U.S. Securities and Exchange Commission (SEC) issued a release requesting public comment to inform the SEC's study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors. The SEC's study regarding these issues is required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which was signed into law on July 21, 2010.

More specifically, section 913 of the Dodd-Frank Act directs the SEC to study, among other things:

- the standards of care applicable to broker-dealers and investment advisers giving investment advice to retail customers;
- the effectiveness of existing legal or regulatory standards; and
- whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards.

The Study presents a unique opportunity for the SEC, as directed by Congress, to focus on complex and important issues with respect to the provision of personalized investment advice about securities to retail customers by brokers, dealers and investment advisers and also the overall effectiveness of the regulatory structure applying to broker-dealers and investment advisers.

Many believe that the Study will lead to rules that require broker-dealers to provide certain disclosures at the point of engagement. At the same time, some anticipate that the Study will provide an avenue to allow the SEC to focus upon its disclosure regime with respect to advisers and broker-dealers with a view to providing shorter and more targeted disclosures with those investors who want more detailed information being able to access additional disclosure via a firm's website (or by hard copy if so requested).

In this paper, we first provide an overview of recent studies which would suggest that retail customers would embrace a disclosure regime calling for delivery via electronic means. We then review the current regulatory scheme applying to electronic delivery and the regulatory changes that would be necessary in order to usher in a modernized disclosure regime allowing for greater flexibility with respect to the use of electronic delivery.

II. Retail Customers Would Embrace and Benefit from an Effective Disclosure Regime with Electronic Delivery as a Centerpiece

The Investment Company Institute (ICI) found in a recent study that 95% of investors surveyed use the Internet and that 90% of those surveyed "agree or strongly agree with the statement

that 'getting investment information online is the wave of the future.'"[1] The ICI survey also found that almost 90% of investors overall and more than 80% of mutual fund investors who access the Internet use it to gather financial information.[2] Moreover, in another survey the ICI found that 79% of mutual-fund owning households with Internet access went online at least once a day.[3] The same survey also found that mutual fund owners were 10% more likely than non-fund owners to engage in common online activities, such as accessing email, obtaining information about nonfinancial products and services, or purchasing products and services other than investments.[4]

Furthermore, as noted below,[5] while expressing his support for electronic delivery of adviser disclosure documents, SEC Commissioner Troy A. Paredes referred to conclusions substantially similar to the conclusions in the ICI surveys described above. For example, Commissioner Paredes stated, "investors have widespread access to the Internet, with the ability to connect using an expanding array of devices, not just traditional computers."[6] Commissioner Paredes further noted that "many diverse commercial interactions occur online as a routine matter," and that "[t]hese and similar developments argue in favor of updating the 1996 guidelines,"[7] which are discussed in further detail below.

III. The Existing Regulatory Framework

The current regulatory framework allows for electronic delivery of required disclosure documents, but only if certain notice and consent procedures are followed.

A. SEC Guidance on Electronic Delivery

The SEC has not adopted any specific rules regarding the electronic delivery of broker-dealer and adviser disclosure documents, but has identified in several interpretative releases some general requirements for the use of electronic media by issuers, investment companies, and market intermediaries, such as broker-dealers (collectively, "SEC Guidance").[8] The SEC has identified three basic requirements that must be met to deliver a prospectus electronically: notice, access, and evidence of delivery.[9] "Notice" essentially means informing an investor that a new document will be delivered electronically. "Access" refers to the ability of the investor to locate easily and read the document. "Evidence of delivery" is evidence that a given investor actually receives the electronic document.

[1] "Investor Views on U.S. Securities and Exchange Commission's Proposed Summary Prospectus" at 19 (March 14, 2008), *available at* http://www.ici.org/stats/res/ppr_08_summary_prospectus.pdf.
[2] *Id.*
[3] "Ownership of Mutual Funds, Shareholder Sentiment, and Use of Internet, 2009" at 13 (Dec. 3, 2009), *available at* http://www.ici.org/pdf/fm-v18n7.pdf.
[4] *Id.*
[5] *See infra* note 21 and accompanying text.
[6] *Id.*
[7] *Id.*
[8] Use of Electronic Media, Rel. Nos. 33-7856, 34-42728, and IC-24426 (Apr. 28, 2000) [hereinafter 2000 Release]; Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Rel. Nos. 33-7288, 34-37182, and IC-21945 (May 15, 1996) [hereinafter 1996 Release]; Use of Electronic Media for Delivery Purposes, Rel. Nos. 33-7233, 34-36345, and IC-21399 (Oct. 6, 1995) [hereinafter 1995 Release].
[9] For simplicity and because SEC Guidance focuses primarily on electronic prospectus delivery, we have tailored this discussion to the electronic delivery of prospectuses. This analysis, however, would also apply equally to the electronic delivery of prospectus supplements and other types of documents, including semi-annual and annual reports.

1. Notice

In the case of delivery by mail, notice is essentially automatic: the investor opens an envelope, sees the document, and understands that it should be read. Similarly, if an issuer directly provides an investor with an electronic copy of a required disclosure document – by e-mail or CD ROM, for example – the delivery itself generally is sufficient notice. Notice does not have to include providing a copy of the document; it can be a simple notification to an investor that there is a new document available, along with instructions on where and how to read it. Notice cannot be a one-time event covering all documents to be delivered electronically; it must be given each time a document is delivered electronically.

2. Access

The SEC stated in the 1995 Release that accessing an electronic document should be as easy as reading a paper document. Electronic formatting cannot be burdensome, and investors cannot be required to "proceed through a confusing series of ever-changing menus to access a required document so that it is not reasonable to expect that access would generally occur."[10] The 1995 Release requires that investors also be able to download or otherwise retain documents provided in electronic format. Moreover, if a document is delivered by posting on a website, the document must be available for as long as the delivery requirement applies.

3. Evidence of Delivery

A company relying on electronic delivery must be able to reasonably establish that delivery actually occurs. Evidence of delivery should be comparable to the assurance of delivery one receives from putting a paper prospectus or other required disclosure document in the mail. In the 1995 Release, the SEC presented the following examples of reasonable evidence of delivery:

- obtaining informed consent from an investor to receive a document through a particular electronic medium, coupled with assuring notice and access;
- obtaining evidence of actual receipt of a document, by e-mail return receipt or confirmation of accessing, downloading, or printing;
- sending documents by fax;
- an investor's accessing a document with a hyperlink to a required document; or
- an investor's use of forms or other material (such as application forms) available only by accessing the document that is to be delivered.

The first of these examples, informed consent, is discussed below.

i. Informed Consent

Informed consent means that an investor agrees, given specified notice and access, to accept delivery of a document electronically, instead of by paper. For informed consent to occur under SEC Guidance, contract owners should be advised of the following:

[10] 1995 Release.

- that the document is available through a specific electronic medium or source, such as a website;
- that contract owners may incur costs with electronic delivery, such as on-line time required to access information electronically; and
- the period and the documents to be covered by the consent. For instance, an investor should be aware of whether the consent extends to more than one type of document.[11]

Additionally, it is strongly recommended that as a part of obtaining informed consent under SEC Guidance, investors be told that they have the right to revoke their consent to electronic delivery at any time.

Under SEC Guidance, investors can give informed consent directly to the company, or to market intermediaries,[12] such as registered representatives.[13] The SEC Guidance provides that informed consent can be given by telephone or in writing, such as checking a box on an application or by signing a separate consent form. In the 2000 Release, the SEC provided the following example of obtaining informed consent by telephone:

- An investor gives informed consent over the phone using automated touch tone instructions, after accessing the service using a personal identification number;
- The automated instructions inform the investor of the manner, costs, and risks of electronic delivery;
- The consent is to the electronic delivery of documents; and
- Before electronic delivery, the issuer sends the investor a letter in the mail confirming consent.

According to the 1995 Release, informed consent can be inferred if an investor affirmatively requests electronic delivery in a particular medium and format. Informed consent cannot, however, be inferred from investor silence.[14]

Finally, consent to electronic delivery must be revocable; contract owners should always be able to request delivery of hard copy documents.

B. E-SIGN

Section 101(c)(1) of the Electronic Signatures in Global and National Commerce Act ("E-SIGN") provides that a consumer must either consent electronically to electronic delivery, or confirm his or her consent electronically, "in a manner that reasonably demonstrates that the consumer can access [the] information in the electronic form that will be used to provide the information." In contrast to the SEC's approach to consent which is more permissive and allows consent to be obtained written or electronically, under E-SIGN a client may consent to electronic delivery only through an electronic consent method.

[11] 1995 Release.
[12] 2000 Release.
[13] 1995 Release, Example 6.
[14] *But see* B. Recent Developments below for a discussion of the new proxy rules governing electronic distribution of proxy materials where the rules do allow informed consent to be inferred from investor silence.

Under E-SIGN, an agency like the SEC could exercise exemptive authority from the consent provisions. Section 104(d) of E-SIGN provides federal regulatory agencies the authority to exempt a specified "category or type of record" from section 101(c)'s affirmative consent requirements "without condition" if the exemption (i) is necessary to eliminate a substantial burden on electronic commerce and (ii) does not increase the material risk of harm to consumers.

To date, the SEC has not sought to specifically exempt E-SIGN's provisions with respect to broker-dealer and adviser disclosure documents. This has been a major barrier to more widespread use of electronic delivery of adviser and broker-dealer disclosure documents.

IV. Modernizing the SEC Regulatory Framework to Embrace Electronic Delivery.

If the SEC were to adopt one or more of the following three approaches it would help serve to modernize the regulatory framework regarding delivery of broker-dealer and adviser disclosure documents:

- Allow "access equals delivery" for required disclosure documents—e.g., firms could deliver documents by posting them on their website without the need to obtain client consent;
- Usher in a layered approach (where targeted disclosure is provided by hardcopy at point of sale and investors wanting additional information can access such via an adviser's or broker-dealer's website (unless he or she specifically requests a hard copy); and/or
- Expressly exempt broker-dealer and adviser point of engagement disclosure documents from E-SIGN's electronic consent requirements—e.g., permitting firms to obtain consent to e-delivery through a client's written or verbal consent.

Recent actions of the SEC reflect movement in the direction of modernizing its framework for the delivery of disclosure documents.

A. Securities Offering Reform Rules

The SEC embraced the access equals delivery concept in the securities offering reform rules and amendments adopted in 2005.[15] These rules serve to modernize and liberalize the registration and offering of securities under the Securities Act of 1933, as amended ("Securities Act"). Among other things, the offering reforms include relief from the requirement under Section 5 of the Securities Act to deliver a final or statutory prospectus at or prior to the earlier of the delivery of a confirmation of sale or delivery of the security.[16] The rules embrace the "access equals delivery" model for delivery of prospectuses based on the assumption that

[15] Securities Offering Reform, Rel. No. 33-8591 (July 19, 2005).

[16] New Rule 172 under the Securities Act provides that a prospectus would be deemed to precede or accompany a security for sale for purposes of Section 5(b)(2) of the Securities Act as long as a prospectus meeting the requirements of Section 10(a) of the Securities Act is filed with the Commission. This allows for the delivery to investors of only the confirmation and no prior or accompanying delivery of a written prospectus. Notwithstanding the relief provided under new Rule 172, issuers relying on the Rule still need to retain some paper copies of the prospectus. Specifically, new Rule 173 under the Securities Act requires the principal underwriter or selling broker-dealer to provide a paper copy of the prospectus upon request by an investor.

investors have access to the Internet, and thereby permit issuers to satisfy the Section 5 delivery requirement if the prospectus is posted via EDGAR on the SEC's website.

B. Proxy Rules

The SEC took an approach similar to the securities offering reform rules in its adoption of amendments to the proxy rules relating to the electronic delivery of proxy material.[17] Rule 14a-16(d) under the Exchange Act governs the contents of the notice that an issuer must send to its security holders in connection with the availability on the Internet of proxy material for that issuer. The rule requires the notice to state that if the security holder wants a paper copy of the proxy material, the security holder must request one. It also requires that the notice provide the security holder with a toll-free phone number, email address and Internet website where current and future proxy material in paper form can be requested.

C. Mutual Fund Summary Prospectus

The SEC recently adopted rules that would permit mutual funds to use a new summary section of the prospectus as an optional "summary prospectus" to satisfy the fund's prospectus delivery requirements under Section 5(b) of the Securities Act.[18] Funds are permitted to use short-form summary prospectuses only on the condition that they make their full statutory prospectus and other specified fund documents available on the Internet, with paper copies available upon request. The fund's full statutory prospectus on the Internet is in turn required to contain hyperlinks to assist investors in being able to navigate quickly from the headings in the table of contents in the full statutory prospectus to the corresponding sections in that prospectus and from the full statutory prospectus to the summary prospectus and the statement of additional information. The SEC stated that this approach is "intended to provide investors with better ability to choose the amount and type of information to review, as well as the format in which to review it (online or paper)."[19]

D. The Recent ADV Amendments

Earlier this year, the SEC adopted amendments to Part 2 of Form ADV, and related rules under the Investment Advisers Act of 1940, as amended ("Advisers Act"), to require investment advisers registered with the SEC to provide new and prospective clients with a brochure and brochure supplements written in plain English.[20] The SEC acknowledged that many comments relating to this proposal recommended that advisers be permitted to deliver disclosure documents via the Internet.[21] Although the SEC did not implement this recommendation into the amendments, it did note that it "will continue to consider different approaches to delivering financial information to investors."[22] Furthermore, at the SEC open meeting relating to the

[17] Shareholder Choice Regarding Proxy Materials, Rel. No. 34-56135 (July 26, 2007).
[18] Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Rel. No. 33-8861 (Nov. 21, 2007).
[19] *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Rel. No. 33-8998 (Jan. 13, 2009).
[20] *See* Amendments to Form ADV, Rel. No. IA-3060 (July 28, 2010).
[21] *Id.*
[22] *Id.*

adoption of these amendments to Part 2 of Form ADV, an SEC Commissioner expressed support for electronic delivery of disclosure documents.[23]

Conclusion. The SEC's Study presents an opportunity to review the current disclosure regime with a critical eye, and with a view to overhauling and modernizing the manner in which disclosures are delivered to advisory and broker-dealer clients.

[23] Troy A. Paredes, Commissioner, Securities and Exchange Commission, Speech by SEC Commissioner: Statement at Open Meeting to Adopt Amendments Regarding Part 2 of Form ADV (July 21, 2010), *available at* http://sec.gov/news/speech/2010/spch072110tap-adv.htm ("Commenters recommended that the Commission afford advisers more leeway in satisfying the annual brochure delivery requirement. Consistent with the tenor of these comments, I encourage the staff to continue considering different means for the delivery of information to investors. Much has changed over the 14 years since the 1996 electronic delivery guidelines were adopted. Today, for example, investors have widespread access to the Internet, with the ability to connect using an expanding array of devices, not just traditional computers. Methods for sending and receiving email have become much more standardized, and important information is routinely accessed from websites, as parties look to capture the efficiencies that technology permits. Indeed, many diverse commercial interactions occur online as a routine matter. These and similar developments argue in favor of updating the 1996 guidelines.").