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February 3, 2011

**VIA EMAIL ([e-ORI@dol.gov](mailto:e-ORI@dol.gov))**

Mr. Fred Wong  
Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Attn: Definition of Fiduciary Proposed Rule  
Room N-5655  
Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210

**Re: Definition of the Term "Fiduciary" (RIN 1210-AB32)**

Dear Mr. Wong:

This comment letter by the Association for Advanced Life Underwriting (AALU) is in response to your request for written comments on the proposed rule amending the definition of the term "fiduciary" issued on October 22, 2010 (Department of Labor RIN 1210-AB32).

AALU is a national trade association representing over 2,000 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement and deferred compensation and employment benefit services. AALU members facilitate responsible retirement saving through the use of life insurance products for thousands of Americans. Many AALU members specialize in supplementing a variety of qualified retirement plans, such as defined benefit and defined contribution plans, with life insurance benefits and other lifetime income producing products. AALU feels strongly about maintaining the ability of life insurance and annuity products to help provide a stable and sustainable retirement for millions of Americans.

**Overview**

On October 22, 2010, the Department of Labor ("DOL") issued proposed regulations that would significantly modify the definition of the term "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA"). The DOL cited a number of reasons for proposing a new definition at this time, including, but not limited to, that the current definition was promulgated in 1975 and since that time the retirement plan community and the financial marketplace have changed significantly, as well as concerns that there are persons providing advice, recommendations and other information who are currently outside of the

definition of a fiduciary, but who significantly influence the decisions of plan fiduciaries and may have conflicts of interest that the plan fiduciaries may not be aware of. For these reasons, the DOL indicated that it believes there is a need to re-examine the types of advisory relationships that should give rise to fiduciary status under ERISA.

### **Comments**

AALU understands and appreciates the DOL's objectives of updating the definition of fiduciary to reflect the current market and to better protect plan participants and beneficiaries from conflicts of interest and self-dealing. However, AALU has the following concerns regarding the rule as proposed:

### **Modification of the Current Five-Part Test**

Under the current regulation, in the case of an adviser who does not have discretionary management authority over plan assets, the adviser is considered a fiduciary only if, for a direct or indirect fee or other compensation, the adviser satisfies each of the conditions in the following "five-part test." The adviser -

- (1) renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property,
- (2) on a regular basis,
- (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary that,
- (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that
- (5) the advice will be individualized based on the particular needs of the plan.

The proposed regulations make three significant changes to this five-part test. First, the new test would no longer require the advice to be provided on a regular basis. Any advice that would otherwise satisfy the new test, even if provided with respect to a single transaction, would fall within the new definition. Second, the proposed regulations eliminate the reference to a "mutual" agreement, arrangement or understanding, suggesting that if only a plan fiduciary or participant had the requisite understanding, the advice would fall within the new definition. Third, the advice would no longer have to serve as a "primary basis" for an investment decision. Instead, under the new standard, there would only have to be an understanding that the advice "may be considered in connection with making" an investment decision.

These proposed changes to the five-part test would significantly expand the type of "advisers" who would be considered ERISA fiduciaries. AALU is particularly concerned with the second two changes - namely, the elimination of mutuality in the parties understanding of the arrangement and the lowering of the primary basis standard to a simple consideration standard.

A person should not be an ERISA fiduciary unless the applicable parties have the same understanding or the person providing the advice should reasonably have had such an understanding under the circumstances. At the very minimum, a reasonableness standard should be added with respect to both the adviser's and the plan fiduciary's understandings of the arrangement.

In addition, the lowering of the primary basis standard to a simple consideration standard establishes too low of a standard. The parties should have to reasonably understand that any advice would (as opposed to may) be taken into account in a material manner by the plan fiduciary in making investment decisions. A "may be considered" standard is too low and would have a chilling effect on advisers' willingness to provide general information to plan fiduciaries and participants.

### **Sellers' Exception**

The proposed regulations provide an exception for those who buy and sell securities and other property, provided the person providing the advice or recommendation can demonstrate that the recipient knows or, under the circumstances, reasonably should know that: (i) the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property (or as an agent of a purchaser or seller), (ii) the person's interests are adverse to the interests of the plan or its participants or beneficiaries, and (iii) the person is not undertaking to provide impartial investment advice (the "sellers' exception"). With respect to a particular transaction, this exception is available to any person, including any plan fiduciary, other than a person who has acknowledged or represented his fiduciary status with regard to the transaction. It is important to note that, under the proposed rule, the burden of proof is on the person making the recommendation or providing the advice to prove what the recipient knows or reasonably should know about the nature of the arrangement (e.g., the person is a seller whose interests are adverse).

The requirement that a seller demonstrate that its customer knows or reasonably should know that the seller's interests are "adverse" to the customer's interests and that the advice is not intended to be impartial is too harsh of a standard and it is not necessary to address the DOL's concerns about plan fiduciaries not understanding potential conflicts of interest. Rather, the DOL's concerns can be addressed by requiring the seller to demonstrate that the seller has disclosed the role in which he or she was acting, and that the buyer knows or reasonably should have known that the seller was not an ERISA fiduciary with respect to the transaction and that the seller was not acting solely in the interests of the participants or for the exclusive purpose of providing benefits to the participants.

### **Advice Regarding Plan Distributions**

In Advisory Opinion ("Adv. Op.") 2005-23A, the DOL took the position that a recommendation to a plan participant to take an otherwise permissible plan distribution does not constitute investment advice within the meaning of ERISA Reg. § 2510.3-21(c). Additionally, because distribution proceeds are no longer considered plan assets, any recommendations

regarding the investment of such proceeds is not considered investment advice for purposes of determining fiduciary status.

Although the DOL has not proposed a rule modifying its position in Adv. Op. 2005-23A, in the preamble to the proposed regulations, the DOL explained that it is considering whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution. The DOL indicated that it is considering this issue because of concerns that plan participants may not be adequately protected from advisers who provide distribution recommendations that subordinate participants' interests to the advisers' own interests. Specifically, the DOL is seeking information on other laws that apply to the provision of these types of recommendations, whether and how those laws safeguard the interests of plan participants, and the costs and benefits associated with extending the final regulation to these types of recommendations.

It is AALU's view that, at this time, the DOL should not modify its current position that advice regarding plan distributions is not investment advice within the meaning of ERISA Reg. § 2510.3-21(c). A key fact considered in Adv. Op. 2005-23A should continue to guide the DOL's approach to this issue—that distribution proceeds are no longer considered plan assets. Distribution is the natural termination of DOL oversight, where extensive oversight, requirements and consumer protections of other regulatory organizations take over. If there is any final responsibility of the DOL in this area it should be limited to disclosures that should be provided by plan fiduciaries about any potential risks or adverse consequences that should be considered by participants before proceeding with a plan distribution.

AALU members and many of the other professionals that are providing advice to plan participants regarding plan distributions are already subject to various layers of federal and state regulation designed to protect consumers. Imposing additional, costly, and overlapping regulations through ERISA would not necessarily lead to greater protection for plans and their participants.

To provide additional background on the nature of business conducted by AALU members, please note that AALU members are engaged primarily in sales of life insurance and annuities used as a part of estate, charitable, retirement, deferred compensation and employee benefit plans. Some members sell life insurance primarily to business clients to finance and secure employee benefits. However, many members work primarily with individuals who often retain attorneys, accountants and other professionals to assist in developing products and services for their long-term life insurance protection and retirement needs.

In addition, other than associate members who are non-sales professionals such as attorneys, accountants and actuaries, all AALU members are licensed insurance producers. Many are registered representatives of an SEC/FINRA-registered broker-dealer, and many also are associated persons of an SEC-registered investment adviser. Many AALU members own insurance agencies. Some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Thus, AALU members are subject to state insurance laws of each state in which they operate. Those who sell registered products are, in addition, subject to SEC,

FINRA and state securities regulation. Those who operate or are associated persons of registered investment advisers are subject to SEC regulation of investment advisers.

Many AALU members have served the same individual clients and their families for decades. Their customers are of primary importance to AALU members and, for that reason, they work closely with them to understand their needs and objectives in connection with the insurance investment products the members are authorized to sell, within the framework of their contracts with carriers and other obligations under all of the laws and regulations to which the members are subject.

AALU, in our August 30, 2010 comment letter<sup>1</sup> to the Securities and Exchange Commission regarding the Commission's request for information to inform their study regarding the obligations of brokers, dealers, and investment advisers, commented extensively on the existing legal and regulatory standards applied to life insurance agents who are engaged in the sale of variable life insurance products to retail customers and who provide personalized investment advice about securities to those customers. AALU's submission to the SEC rigorously detailed AALU members' obligations under state insurance laws and to carriers by whom they are appointed to transact with retail and other customers, as well as their requirements under a multitude of applicable federal and state securities laws and regulations enforced by FINRA, the SEC, and states securities regulators. A copy of AALU's August 30 submission to the SEC is enclosed as an attachment to this letter to the DOL.

AALU's commentary and analysis of the existing legal and regulatory requirements of AALU members demonstrates that brokers, dealers, registered investment advisers, life insurance agents and many of the other persons who advise plan participants with respect to plan distributions are already subject to comprehensive federal and state regulation and supervision, and therefore, additional federal regulatory requirements with respect to advice regarding plan distributions is not necessary to protect plan participants.

## **Summary**

In summary, AALU requests that the DOL consider the following comments before taking any further action on its proposed regulation expanding the definition of fiduciary.

### **(1) Modifications to Current Five-Part Test**

Two of the proposed changes to the current five-part test should be modified before the regulations are finalized.

First, the elimination of mutuality in the parties understanding of the arrangement should be modified to provide that a person would not be an ERISA fiduciary unless the applicable

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<sup>1</sup> See AALU Comment Letter from David J. Stertz, Chief Executive Officer of AALU, to Elizabeth Murphy, "Re: Request for Comment to Inform Study Regarding Obligations of Brokers, Dealers, and Investment Advisers (Release No. 34-62677; IA – 3058; File No. 4-606)," August 30, 2010 (AALU Letter), *available at* <http://www.sec.gov/comments/4-606/4606-2631.pdf>. The AALU Letter is included as an attachment in this submission to the Department.

parties have the same understanding or the person providing the advice should reasonably have had such an understanding under the circumstances. At the very minimum, a reasonableness standard should be added with respect to both the adviser's and the plan fiduciary's understandings of the arrangement.

Second, the lowering of the primary basis standard to a simple consideration standard should be modified to require the parties to have a reasonable understanding that any advice would (as opposed to may) be taken into account in a material manner by the plan fiduciary in making investment decisions.

(2) **Sellers' Exception**

The requirement that a seller demonstrate that its customer knows or reasonably should know that the seller's interests are "adverse" to the customer's interests and that the advice is not intended to be impartial is an overly harsh standard and should be replaced with a requirement that the seller demonstrate, through appropriate disclosure of his or her role and professional responsibilities, that the buyer knows or reasonably should know that the seller was not an ERISA fiduciary with respect to the transaction and that the seller was not acting solely in the interests of the participants or for the exclusive purpose of providing benefits to the participants.

(3) **Advice Regarding Plan Distributions**

At this time, the DOL should not modify its current position that advice regarding plan distributions is not investment advice because AALU members and many of the other professionals providing advice to plan participants regarding plan distributions are already subject to various layers of rigorous federal and state regulation designed to protect consumers<sup>2</sup>. Imposing additional, costly, and overlapping regulation through ERISA and the additional costs of complying would not necessarily lead to greater protection for plans and their participants.

AALU appreciates the opportunity to provide comments in response to the DOL's proposed regulations and would welcome an opportunity to provide additional comments in the future as the DOL further considers this important matter.

If you have any questions regarding our comments, please contact Anthony Raglani at 202-742-4589.

Sincerely,



**David J. Stertzer**  
Chief Executive Officer, AALU

Attachment: AALU Letter from David Stertzer, CEO to Elizabeth Murphy, August 30, 2010.

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<sup>2</sup> See *Id.*

2010-2011  
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August 30, 2010

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Donald G. Carlson

By Hand and Electronic Delivery

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street N.E.  
Washington, D.C. 20549-1090

Re: Request for Comment to Inform Study Regarding  
Obligations of Brokers, Dealers, and Investment Advisers  
(Release No. 34-62577; IA - 3058; File No. 4-606)

Dear Ms. Murphy:

The Association for Advanced Life Underwriting (AALU) appreciates the opportunity to provide these comments to the Securities and Exchange Commission (Commission or SEC) in response to the above-referenced release requesting public comment for a study (Study) to evaluate: the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and their associated persons when providing personalized investment advice about securities to their retail customers; and whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries.

AALU is a nation-wide organization of 2,000 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services.

The release poses a number of important issues for public comment. While our letter does not comment on all of them, and the Commission will need to address and develop specific data in each area specified in the Study, we have endeavored to provide detailed information in areas where we believe AALU, based upon our members' business and expertise, can be most helpful in furthering the Commission's understanding as it seeks to determine whether there are gaps, shortcomings, or overlaps in existing laws and rules.

Our letter begins with a brief discussion of the legislation mandating the Study (pages 3 - 5, *infra*), and then identifies what we believe are key areas and considerations for the Commission as it conducts the Study (pages 6 - 10, *infra*). We then discuss at length the business and current regulation of our members (pages 10 - 20, *infra*). The discussion of the regulations under which our members currently operate, together with the section that follows, in which we discuss the comparative strengths of the broker-dealer and investment advisor regulatory regimes (pages 20 - 30, *infra*), speak directly to the key issue before the Commission in the Study: whether there are gaps, shortcomings, or overlaps in current regulation of broker-dealers and investment advisers relating to their standard of care when providing personalized investment advice about securities to retail customers. We also address (pages 30 - 32, *infra*) what we believe will be the adverse impacts of imposing a broad “best interest” standard on broker-dealers and their associated persons.

As discussed in more detail in the pages that follow:

- **Our members and their businesses currently operate under many layers of regulation designed for the protection of retail customers when they sell products subject to the Commission’s jurisdiction, particularly variable life insurance products.**

Our letter provides extensive information about the fact that insurance producers who sell variable products, which are among the most highly-regulated financial products sold to retail customers, are subject to multiple layers of regulation and oversight – by the Commission, the Financial Industry Regulatory Authority (FINRA), state securities regulators (including in each state in which they operate, which often results in oversight by multiple state securities regulators), and state insurance regulators (also in each state in which they are licensed and operate, which again results in oversight by multiple state insurance regulators). Insurance producers are subject to detailed requirements by the carriers who appoint them; robust internal supervisory procedures by the broker-dealers with which they are affiliated, and frequent and comprehensive regulatory examinations by the regulators who exercise jurisdiction over them. There is nothing comparable on the investment adviser side, except, of course, for advisers who are also licensed insurance producers and also are dually registered.

- **The detailed rules and multiple layers of supervision and oversight applicable to the broker-dealer regulatory regime are far superior in protecting investors to the investment adviser regulatory regime.**

Our letter discusses in detail, as requested by the Commission (and as Congress has required the Commission to evaluate in its Study), the comparative strengths and weaknesses of the broker-dealer and investment adviser regulatory regimes. We identify some of the most significant disparities in the two regulatory regimes in terms of: the level of regulatory oversight and examinations; the legal requirements for internal supervision programs; the specific liability of supervisors, which is designed to assure that they vigorously supervise the activities of those



subject to their supervision; the qualification requirements for salespersons/advisers and supervisors; requirements for training and continuing education; and the nature and totality of the regulatory requirements in furthering effective programs of supervision and oversight to protect retail customers. In each of these, as well as other, areas, the regulatory and oversight regime applicable to broker-dealers is far superior in protecting investors to the investment adviser regime, which falls short.

- **Investors should be protected through appropriate rules of conduct that preserve investor choice and access to a range of financial services offered through a diversity of financial professionals.**

We also provide our views on the potential impact of changes in the standard of care applicable to brokers, dealers, and investment advisers. The imposition of a broad “best interest” or fiduciary standard on broker-dealers would not improve investor protection, but it certainly could result in adverse consequences for investors if it reduces investor choice and access to financial services. As the Commission is aware, studies reflecting investor confusion over the legal roles of different financial professionals also reflect a high degree of investor satisfaction with financial services providers. The liability-creating nature of a vague, amorphous standard could result in financial professionals, in particular insurance producers who sell variable insurance products, moving away from recommending variable or other securities products, reducing investor choice and access to these products.

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As the Commission is aware, the market meltdown of 2008 and the resulting collapse of investor wealth and confidence were caused by incidents of corporate malfeasance, a disingenuous debt rating system, predatory mortgage loan practices, and a failure to enforce existing law by federal agencies. It was in no way a result of the different legal standard of care applied to investment advisers versus brokers and dealers. AALU nonetheless appreciates the Commission’s long-standing commitment and mission to enhance the protection of retail investors – many of whom are our customers. We appreciate the Commission’s prompt action to seek public comment to inform the Study required by Congress. AALU hopes our views and experience will be useful to the Commission, and we hope to engage in a continuing dialogue with the Commission as it continues its study of these important issues.

#### **The Study Required by Section 913; Key Considerations for the Commission as it Conducts the Required Study.**

**The Legislation.** As the Commission is aware, Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),<sup>1</sup> which mandated the Study, was adopted as a compromise between provisions of Section 7103 of H.R. 4173, financial reform

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<sup>1</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

legislation passed by the House of Representatives (House bill),<sup>2</sup> and Section 913 of the Senate amendment to H.R. 4173 (Senate bill).<sup>3</sup> The House bill directed the Commission, by rule, to adopt a uniform “best interest” standard of conduct for brokers, dealers and investment advisers when providing personalized investment advice about securities to retail customers. The Senate bill mandated a study of various issues to determine whether changes in the standard of care should be adopted and directed the Commission to use its existing authority to address any gaps or overlaps by rule and to report to Congress on the need, if any, for new authority. Section 913, as enacted, directs the Commission to study and evaluate a number of identified issues and to consider the findings, conclusions, and recommendations of the study before deciding whether to issue new rules in this area.

Section 913 also grants rulemaking authority to the Commission. Although the statutory study and report to Congress are mandatory, the Commission’s rulemaking with respect to the standard of care is discretionary. For example, Subsection (f) of Section 913 provides:

The Commission may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide) to address the legal or regulatory standards of care for brokers, dealers, investment advisers [and their associated persons] for providing personalized investment advice about securities to such retail customers.<sup>4</sup>

Subsection (g) of Section 913 contains amendments to the Securities Exchange Act of 1934 (Exchange Act) and Investment Advisers Act of 1940 (Advisers Act) to provide, subject to specified requirements and limitations:

The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.<sup>5</sup>

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<sup>2</sup> See H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, which passed the House on December 11, 2009, *available at* [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173eh.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eh.txt.pdf).

<sup>3</sup> See Senate amendment to H.R. 4173, the Restoring American Financial Stability Act of 2010, which passed the Senate on May 20, 2010, *available at* [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173eas.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eas.txt.pdf).

<sup>4</sup> Dodd-Frank Act, *supra* note 1, at § 913(f).

<sup>5</sup> Dodd-Frank Act, *supra* note 1, at § 913(g) (adding new subsection 211(g) to the Advisers Act). New subsection 15(k) of the Exchange Act, 15 U.S.C. §78o(k), provides that the Commission by rule may provide that the relevant standard of conduct for a broker or dealer shall be the same as

In view of the discretion given to the Commission by Congress, the Commission may choose, after completing the Study and considering public comments, to propose rules to adopt the above standard, to take no action imposing such a standard, or to propose other rules to address the standards of care. Of course, the Commission may choose to promulgate rules of conduct for brokers, dealers, and investment advisers pursuant to other provisions of the federal securities laws, as it has done in the past.<sup>6</sup> In addition, for brokers, dealers, and their associated persons, the Commission may determine that any gaps, shortcomings, or overlaps found in the Study (or otherwise determined to exist) may best be addressed through Financial Industry Regulatory Authority (FINRA) rulemaking, subject to Commission approval.<sup>7</sup>

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Footnote continued from previous page

the standard of conduct applicable to an investment adviser under Section 211 of the Advisers Act. Compensation based upon commission or other standard compensation shall not in and of itself be a violation of the standard, and the standard shall not require a continuing duty of care or loyalty after the provision of personalized advice. The Commission may by rule require that a broker disclose and obtain consent from the customer with regard to the broker's sale of only proprietary or a limited range of products, and such limitation shall not in and of itself be a violation of the standard. New subsection 211(g) of the Advisers Act, 15 U.S.C. §80b-11(g), provides that the Commission by rule may provide that the relevant standard of conduct for all brokers, dealers, and investment advisers shall be to act in the best interests of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. If the Commission adopts rules under this subsection, the rules shall provide that such standard is no less stringent than the standard applicable to investment advisers under subsections 206(1) and (2) of the Advisers Act, 15 U.S.C. §80b-6(1) and (2) (antifraud provisions). In accordance with such rules, any material conflicts shall be disclosed and may be consented to by the customer.

<sup>6</sup> For example, the Commission has used its antifraud rulemaking authority under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), to promulgate rules such as Rule 10b-10, requiring that brokers and dealers provide specified written disclosures to customers at or before the completion of a transaction. The Commission also has used its broad antifraud rulemaking authority under Section 15(c)(2) of the Exchange Act, 15 U.S.C. § 78o(c)(2), in promulgating a range of disclosure and other requirements for brokers and dealers in dealing with their customers. In addition, the Commission has used its antifraud rulemaking authority under Section 206(4) of the Advisers Act, 15 U.S.C. § 80b-6(4), to promulgate rules specifying requirements for investment advisers in a range of areas, including advertisements (17 C.F.R. §§ 275.206(4)-1), custody of client funds (17 C.F.R. 275.206(4)-2), and disclosures of adviser disciplinary history (17 C.F.R. 275.206(4)-4).

<sup>7</sup> For example, Sections 6 and 15A of the Exchange Act, 15 U.S.C. § 78f and 15 U.S.C. § 78o-3, require the rules of national securities exchanges and associations to be designed to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade. Section 19(c) of the Exchange Act, 15 U.S.C. § 78s(c), gives the Commission authority to amend the rules of a self-regulatory organization to, among other things, conform its rules to the requirements of the Exchange Act or otherwise in furtherance of its purposes.

**Key Areas for the Commission's Consideration.** As the Commission conducts the Study, we offer the following preliminary views on what we believe, based upon our experience, an objective and thorough Study should consider and ultimately will find.

**Acknowledging the existing level of overlapping and robust regulation of insurance producers who sell SEC-regulated products.** While the adequacy of current regulation and standards broadly applicable to brokers and investment advisers is the focus of the Study, the current level of regulation and oversight of insurance professionals when selling SEC-registered insurance products is distinct and should be taken into consideration by the Commission as it considers whether there are gaps or overlaps in regulation.

For example, the design of variable life insurance products requires medical and often financial underwriting that goes beyond the requirements for traditional securities products. The complexity and breadth of applications relating to these products requires an assessment primarily of financial and protection needs. This necessitates an analysis related to death benefit, cash values, tax advantages and costs. In each situation, the issuing insurance company is involved in determining the appropriateness of the product for the customer as it relates to risk selection and general suitability. In addition to the Commission's and FINRA's roles in the registration and sales of these products, the products are also regulated by state insurance commissions. Insurance producers/registered representatives who sell these products are subject to supervision by an SEC/FINRA-regulated broker-dealer and also subject to the terms of their contract with the issuing insurance company, which is subject to regulation by multiple state insurance regulators. Indeed, the scope and level of regulation is significantly higher for variable life insurance products than for other securities under the existing standard of care.

We believe consideration of the multiple layers of regulation and oversight of these variable insurance products, together with their product-specific disclosure and due diligence requirements, should lead the Commission to conclude that no change in standards or further regulation is necessary. The implications of being subject to a more subjective standard, in addition to all of the existing regulatory requirements, could result in many insurance producers moving away from variable to fixed insurance products, and limiting customer choice. The cost of meeting all regulatory and compliance obligations is already significant for all brokers, but especially insurance producers, due to levels of oversight and requirements that already exist. An unwarranted change in standard that requires increased time and cost to comply could render the delivery of this service to middle market clients too costly for insurance producers and their customers, resulting in limited access to insurance protection for millions of Americans.

Life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe, helping relieve pressure on government entitlement programs. It is unique in guaranteeing the delivery of financial security at precisely the moment it is needed, while contributing significantly to the nation's storehouse of savings and investment capital. Seventy-five million American families rely upon the important financial security that life insurance products provide, but there are, according to

Congress, an additional 68 million citizens that “lack the adequate level of life insurance coverage needed to ensure a secure financial future for their loved ones.”<sup>8</sup>

**Protecting investors through appropriate rules of conduct and effective regulatory oversight.** We are well aware that the legislative debate leading to the enactment of Section 913 focused upon the issue of whether the standard of conduct for brokers and dealers should be “raised” to the fiduciary duty standard under the Advisers Act. We also understand that some members of the Commission already have expressed support for a uniform fiduciary duty for brokers, dealers, and investment advisers. However, we urge the Commission to conduct the Study as Congress intended: as an objective evaluation, with no prejudgment as to what, if any, changes in rules should be proposed.<sup>9</sup>

In the end, if the goal of imposing upon financial intermediaries any “duty” – fiduciary or otherwise – is anything other than to create liability for the intermediary, it should be to protect investors through assuring appropriate broker and adviser conduct. We believe an objective study will find that the goal of achieving investor protection through appropriate broker and adviser conduct is best served by regulations that are (1) clear and understandable to the financial professionals to whom they apply; (2) capable of being measured and monitored by supervisory personnel who are held accountable for compliance (and which are, in fact, monitored by supervisory personnel); and (3) capable of being audited and enforced by regulators (and, which are, in fact, regularly audited and enforced by regulators). Based upon the many years of experience of our members, we believe clear rules of conduct, such as those adopted by FINRA under the Exchange Act, subject to Commission approval, best meet this test. For brokers and dealers, we do not believe a broad, amorphous fiduciary standard, such as the standard developed by the courts and enforced by the Commission under the Advisers Act, does. We believe the analysis required by the Study to determine the comparative effectiveness of the broker-dealer and investment adviser regulatory regimes will lead the Commission to this conclusion as well.

We also believe the focus on a uniform standard of conduct is an unfortunate diversion from what should be a more important priority for the Commission, the need to address the gaping disparity in regulatory oversight and inspections of broker-dealers and investment advisers. As the Commission is aware, some of the most dramatic failures in recent years on the retail brokerage/adviser side were not a result of the lack of rules governing financial professionals or the lack of a “fiduciary duty” of malefactors, but a failure of regulatory

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<sup>8</sup> S. Res. 211, 111th Cong. 2009; H. Res. 16, 111th Cong. (as agreed to in House Sept. 29, 2009).

<sup>9</sup> See 156 Cong. Rec. S5928-9 (daily ed. July 15, 2010) (Statement of Sen. Dodd) and 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (Statement of Sen. Johnson). See also Hearing of House-Senate Conference Committee Markup to reconcile differences between the House and Senate versions of H.R. 4173, Wall Street Reform and Consumer Protection Act (June 24, 2010), transcript available from CQ Transcript (Statement of Rep. Frank). Archived hearing available at [http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=0a33afd-985b-4e7a-914f-ef58da8f3dda](http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=0a33afd-985b-4e7a-914f-ef58da8f3dda).

oversight.<sup>10</sup> We believe few investors understand the significant disparity between the oversight of broker-dealers (who are subject to regular and consistent oversight and inspection by the Commission, FINRA, and state securities regulators, as well as state insurance regulators in the case of sales of securities-related products by insurance producers) and oversight of investment advisers (who are subject to oversight either by the Commission or states – but not both, and inspected by the Commission perhaps once every 11 years).<sup>11</sup> As discussed in more detail later in this letter, broker-dealers also employ significantly more internal resources, programs and procedures to comply with their responsibilities under Commission and FINRA rules, compared to investment advisers – a difference in regulatory requirements we also believe is unknown to most investors, who arguably would express concern if surveyed on this point. The level of internal broker-dealer resources committed to compliance, together with the industry's financial support of FINRA for its oversight of broker-dealers, is a significant multiple of government and private sector resources devoted to compliance on the investment adviser side.

No standard of care is effective without a mechanism to monitor and enforce its application. The Commission and other regulators and self-regulatory organizations already devote the clear majority of their oversight and inspection resources to broker-dealers. An investment adviser who is compensated based on assets under management can be just as likely to make an inappropriate recommendation to garner more assets as any commission-based broker. Devoting limited Commission resources to imposing a uniform standard of conduct for brokers, dealers and investment advisers should be considered only if and when the oversight, inspection, and supervision gap between broker-dealers and investment advisers is sufficiently addressed.

**Preserving investor choice and access to services.** We also urge the Commission, as it conducts the Study, to remain open to the idea that investors can be protected through appropriate rules of conduct that allow for a diversity of financial professionals and a range of activities and relationships between those professionals and their customers – rules that preserve investor choice and, therefore, are not uniform in every respect. One of the compelling findings

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<sup>10</sup> See, e.g., *SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme*, SEC Press Release 2008-293, Dec. 11, 2008, available at <http://www.sec.gov/news/press/2008/2008-293.htm>, and the SEC Complaint and Orders referenced therein. See also *SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme*, SEC Press Release 2009-26, Feb. 17, 2009, available at <http://www.sec.gov/news/press/2009/2009-26.htm>; and the SEC complaint and Litigation Release No. 20901 referenced therein. See also David Stout, *Report Details How Madoff's Web Ensnared S.E.C.*, N.Y. TIMES, Sept. 2, 2009, available at <http://www.nytimes.com/2009/09/03/business/03madoff.htm>; Zachary A. Goldfarb, *SEC Suspected R. Allen Stanford of Ponzi Scheme 12 Years Earlier, Report Says*, WASH. POST, Apr. 17, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/16/AR2010041604891.html>.

<sup>11</sup> See note 39, *infra*, and accompanying text.

of the 2008 report by the RAND Institute for Civil Justice (RAND Report)<sup>12</sup> was that investors had high levels of satisfaction with their own financial service providers. RAND summarized its findings as follows:

Overall, we found that the industry is very heterogeneous, with firms taking many different forms and offering a multitude of services and products. Partly because of this diversity of business models and services, investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define. Despite their confusion about titles and duties, investors express high levels of satisfaction with the services they receive from their own financial service providers.<sup>13</sup>

We remind the Commission that this level of investor satisfaction occurred within a diverse financial marketplace – one in which brokers, investment advisers, and insurance producers operate under rules designed for their specific products, services, and customer relationships, and within which the obligations of financial professionals to customers may be further shaped by agreement and by their particular relationships. The investors surveyed by RAND had a wide variety of choices. For example, they could choose a financial planner registered as an investment adviser who works for a fee to provide advice in developing a financial plan. They could choose other registered advisers who manage accounts for an asset-based fee. They also could choose an SEC/State/FINRA-regulated broker-dealer, who is in the business of selling securities on commission and provides investment advice incidental to that business. They could purchase life insurance with a variable component from a licensed insurance producer who also holds a license as a registered representative. They could choose a financial professional who provides a variety of these and other services separately, or in combination.

Perhaps an element of the level of investor satisfaction found by RAND was the fact that investors of all levels of wealth and sophistication have enjoyed access to financial services, because of the diversity of financial professionals and variety of options available. A one-size-fits-all standard designed for the sake of uniformity inevitably will mean that some investors are left out, and those inevitably will be smaller and mid-sized investors. From the perspective of our members, there is deep concern that the general imposition on brokers of a vague fiduciary duty – what one legal expert has called “one of the most amorphous concepts in the law”<sup>14</sup> – will

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<sup>12</sup> Angela A. Hung *et al.*, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice, *available at* [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf). *See also* SEC Press Release 2008-1, SEC Publishes Text of RAND Report on Investment Adviser, Broker-Dealer Industries, Jan. 3, 2008, *available at* <http://www.sec.gov/news/press/2008/2008-1.htm>.

<sup>13</sup> Hung *et al.*, at xiv.

<sup>14</sup> *Wall Street and Fiduciary Duties: Can Jail Time Serve As An Adequate Deterrent for Willful Violations*, Hearing Before the Senate Subcommittee on Crime and Drugs, Committee on the Judiciary (2010) (statement of Larry E. Ribstein, Mildred Van Voorhis Jones Chair, University

increase compliance costs, expand liability, and result in the withdrawal of some professionals from the sale of SEC-regulated products, such as variable life and variable annuities, resulting in a further reduction of investor choice.

Advocates for a “uniform” standard of conduct for investment professionals have focused upon only one element of the RAND Report, that of some investor confusion about differences in legal standards, and have ignored the strong element of investor satisfaction and access to financial services. While it is premature at this stage of the Study to propose rulemaking solutions, we urge the Commission to remain open to the view that investor confusion may best be addressed through disclosure – an approach uniquely within the Commission’s traditional expertise. If the Commission, after study, finds that investors are harmed because they do not understand the different roles in which financial professionals may be acting, then an approach in which investors are provided with clear, concise and understandable disclosure about the specific role in which a particular financial professional is serving them would address investor confusion, while preserving the freedom of investors to choose from a range of options and relationships with financial professionals.

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In the discussion below, we discuss the business of our members and the regulations under which they operate. We then turn to a discussion of the comparative regulatory regimes for broker-dealers and investment advisers, followed by a discussion of the implications of any change in the standard of conduct for brokers, dealers, and investment advisers.

### Discussion

#### **AALU Members, Their Business, and the Regulations Under Which They Operate**

AALU members are engaged primarily in sales of life insurance used as part of estate, charitable, retirement, deferred compensation and employee benefit services. Some of our members sell life insurance primarily to business clients to finance and secure employee benefits. However, many of our members work primarily with individuals, who often retain attorneys, accountants, and other professionals to assist in developing products and services for their long-term life insurance protection and retirement needs. Many of our members offer variable life insurance and variable annuities. These bundled products offer investment choices with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees, which are important options for many of our customers seeking to address their life insurance protection and retirement needs.

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of Illinois College of Law), *available at* <http://judiciary.senate.gov/pdf/10-05-04RibsteinsTestimony.pdf>.



Other than “associate” members who are non-sales professionals such as attorneys, accountants and actuaries, all of our members are licensed insurance producers. Many are registered representatives of an SEC/FINRA-registered broker-dealer, and many also are associated persons of an SEC-registered investment adviser, and therefore are subject to both the broker-dealer and investment adviser regulatory regimes. Many of our members own their own insurance agencies. Some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Thus, our members are subject to the state insurance laws of each state in which they operate.<sup>15</sup> Those who sell registered products are, in addition, subject to SEC, FINRA, and state securities regulation.<sup>16</sup> Those who operate or are associated persons of registered investment advisers are subject to SEC regulation of investment advisers.

Many of our members have served the same individual clients and their families for decades. Our customers are of primary importance to us and, for that reason, we work closely with them to understand their needs and objectives in connection with the insurance and investment products we are authorized to sell, within the framework of our contracts with carriers and other obligations under all of the laws and regulations to which we are subject.

**Our obligations under state insurance laws.** AALU members typically represent at least one and often a number of life insurance companies (carriers) and have multiple state insurance practices and licenses. Carriers set the policy provisions and costs of life insurance products sold by AALU members and other producers, and these products are filed and approved by the respective state insurance commissioners.

Life insurance producers must meet applicable standards, requirements and safeguards in every state in which they sell life insurance.<sup>17</sup> While each state has its own set of laws in this area, the National Association of Insurance Commissioners (NAIC) has brought significant uniformity to the various state laws. The NAIC and the states continuously work to develop and enhance regulation to meet the needs of insurance consumers, in light of new developments in the marketplace for insurance products and other products sold by licensed insurance producers. States typically adopt all or key portions of model laws developed by the NAIC.

State insurance laws typically regulate the activities of both insurance companies and producers. They protect the interests of life insurance consumers in a number of critical ways. Every state law requires minimum levels of competency for producers by requiring that they pass a test, answer background check questions as part of the application process, and obtain a license prior to selling, soliciting, or negotiating life insurance and annuity products. Many states require producers to complete pre-licensing education. All states require insurance producers to

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<sup>15</sup> Many of our members are licensed in more than half of the 50 states.

<sup>16</sup> Many of our members also are subject to regulation by multiple state securities regulators.

<sup>17</sup> See Comment Letter of NAIC on *Indexed Annuities and Certain Other Insurance Contracts*, File No. S7-14-08, Sept. 10, 2008, available at <http://www.sec.gov/comments/s7-14-08/s71408-1712.pdf>.

complete ongoing continuing education to maintain their licenses.<sup>18</sup> Some states mandate training in specific products that have particular risks associated with them. As part of licensing, state insurance commissioners must determine that the producer is competent, trustworthy, financially responsible and of good personal and business reputation. Commissioners have broad discretion to revoke licenses based upon violations of insurance law or financial dishonesty.

States also have widely adopted a version of the NAIC Model Unfair Trade Practices Act,<sup>19</sup> which gives insurance commissioners authority to revoke a producer's insurance license and issue cease and desist orders for estimates, illustrations, circulars or statements, sales misrepresentations, omissions or comparisons which misrepresent the benefits, advantages, terms or conditions of a life insurance or annuity contract. Another model law, the NAIC Insurance and Annuities Replacement Model Regulation,<sup>20</sup> establishes protections for consumers through required systems of supervision, control, monitoring, and recordkeeping for insurers and producers. Most states have adopted a version of the NAIC Suitability in Annuity Transaction Model Regulation,<sup>21</sup> which is designed to ensure that annuity transactions address insurance and financial objectives of consumers by imposing suitability standards and duties for life insurance companies supervising and detecting unsuitable sales. Many states have adopted a version of the NAIC Annuity Disclosure Model Regulation<sup>22</sup> to provide standards for the disclosure of certain minimum information about annuity contracts to protect consumers and foster consumer education. In addition, states have widely adopted a version of the NAIC Model Law on Examinations,<sup>23</sup> which sets forth clear guidelines for state insurance commissioners to schedule and conduct effective and efficient market conduct examinations of the activities, operations, and financial conditions of those who sell life insurance products.

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<sup>18</sup> The NAIC Uniform Licensing Standards, as revised through December 2008, requires 24 hours of continuing education for all major lines of authority on a biannual basis, and many states' requirements are based upon this model. *Available at* [http://www.naic.org/documents/committees\\_ex\\_pltf\\_plwg\\_uniformity\\_stds\\_wclar.pdf](http://www.naic.org/documents/committees_ex_pltf_plwg_uniformity_stds_wclar.pdf).

<sup>19</sup> Unfair Trade Practices Act, NAIC Model Regulation Service-January 2004, at 880-1. This model act and other model acts cited in this letter are proprietary NAIC materials, which may be obtained through the following website link:  
[http://www.naic.org/store\\_pub\\_legal.htm#model\\_laws](http://www.naic.org/store_pub_legal.htm#model_laws).

<sup>20</sup> Insurance and Annuities Replacement Model Regulation, NAIC Model Regulation Service-October 2007, at IV-613-1.

<sup>21</sup> Suitability in Annuity Transactions Model Regulation, NAIC Model Regulation Service-April 2010, at II-275-1.

<sup>22</sup> Annuity Disclosure Model Regulation, NAIC Model Regulation Service-April 1999, at II-245-1.

<sup>23</sup> Model Law on Examinations, NAIC Model Regulation Service-1991, at III-390-1.

We understand that other submissions to the Commission in response to its request for comments will address these various state laws in detail. It is important that the Commission recognize the breadth and effectiveness of these state laws, many of which address the same issues of customer protection (e.g., requirements for full disclosure about the risks of the products being sold; regulation of sales practices by the financial professionals who sell them; training, supervision, and auditing of those financial professionals) addressed under Exchange Act and FINRA regulation.

As the NAIC testified before the Senate Banking Committee in early 2009, consumer protection is a critical focus for State insurance regulators, who have a keen understanding of the unique nature of insurance products:

Consumer protection has been, is, and will remain priority one for State insurance regulators. State insurance supervision has a long history of aggressive consumer protection, and is well-suited to the local nature of risk and the unique services offered by the insurance industry. State regulators live and work in the communities they serve, and respond accordingly....Insurance is a uniquely personal and complex product that differs fundamentally from other financial services, such as banking and securities....State officials have responded quickly and fashioned effective remedies to respond to local conditions in the areas of claims handling, underwriting, pricing, and market practices.<sup>24</sup>

**Our contractual obligations to the carriers who appoint us.** In the sale of insurance products, our members are appointed by carriers pursuant to producer contracts that specify, in detail, the producer's duties and obligations to the carrier.<sup>25</sup> These contracts vary among carriers, but typically may include, among other things, the producer's responsibilities to (1) treat money and applications as property held in trust; (2) comply with the carrier's underwriting and issue requirements and all applicable insurance laws and regulations of the jurisdictions in which the producer operates, including laws and regulations pertaining to client funds, confidentiality, licensing, rebating, replacements, illustrations, solicitation, and advertising; (3) comply with the carrier's rules and procedures regarding the sale of products and delivery and servicing of policies; (4) inform the carrier of all material facts of which a producer is aware relating to the insured or proposed insured prior to issuance and delivery of policies; (5) train and supervise a

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<sup>24</sup> *Perspectives on Modernizing Insurance Regulation*: Hearing before the Senate Committee on Banking, Housing, and Urban Affairs (2009) (testimony of Mr. Michael McRaith, Director of Insurance, Illinois Department of Financial and Professional Regulation, on behalf of the NAIC, at 11), available at [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=9d32d178-0b51-415d-989d-8bd87d6477e0](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9d32d178-0b51-415d-989d-8bd87d6477e0).

<sup>25</sup> In general, the carrier must file a notice with the state insurance department regarding the appointment of the producer to sell its products and any termination of the producer.

producer's employees, agents, and representatives; (6) solicit and submit only authorized products; and (7) immediately notify the carrier of any customer complaint.

These contracts generally require further representations and warranties by the producer, including that the producer will comply with licensing and other requirements of the jurisdictions in which the producer operates, as well as with the carrier's own rules and processes relating to market conduct and other activity. Failure to comply with any of these requirements may result in the termination of a producer's appointment by the carrier. Producer contractual obligations to carriers are designed to help ensure compliance with laws and rules which are designed to protect life insurance product purchasers and policyholders.

The carrier is regulated and audited by state insurance regulators in each of the states in which it operates. While information concerning the scope and detail of these audits may be best obtained from the carriers, they often involve examinations of market conduct, focusing on the carrier's records and files concerning producers who are appointed to sell the carrier's products.

To further ensure proper practices, approximately 60 carriers and the agents who sell their products adhere to the Insurance Market Standards Association (IMSA) Code of Ethical Conduct. Participating companies must set up processes and procedures and undergo an assessment by an outside examiner to help ensure honesty, fairness, and compliance with IMSA's standards in customer contacts involving the sale, servicing, or replacement of life insurance products, as well as responding to customer concerns or complaints.

With respect to the sale of variable life insurance and variable annuities, the carrier's contract may involve multiple parties (e.g., the distributor, a broker/dealer registered with the Commission and a member of FINRA, and the insurance agency) and the carrier typically enters an agreement with the broker/dealer and those persons associated with the agency who are FINRA registered representatives of the broker/dealer and state insurance licensed agents of the carrier to solicit and procure applications. Pursuant to the contract, the broker/dealer makes numerous representations, including, among others, (1) that it is registered with the Commission and a member of FINRA; (2) that the broker/dealer will ensure that no registered representative will sell or recommend for sale any contract without reasonable grounds for believing, after appropriate inquiry, that the purchase of a contract is suitable for that person [and other requirements under FINRA rules]; (3) that the broker/dealer agrees to provide the carrier with annual certification as to compliance with applicable state laws; and (4) that the broker/dealer has implemented a training program for its affiliated registered representatives in specified areas.

**The unique nature and regulation of variable products sold by insurance producers; our obligations under state insurance laws and SEC/FINRA regulation.** AALU members often offer clients a choice of life insurance products, including fixed and variable life. In evaluating and planning for death benefits, many clients also seek to obtain certain guaranteed retirement benefits, and, therefore, fixed and variable annuities are an important adjunct to the other life insurance products offered by producers. In addition to regulation at the producer/registered representative level, variable products are subject to a very high level of

disclosure through the prospectus that each client receives, which contains a detailed disclosure of how the product works and all charges to the contract. The disclosure includes not only explicit sales charges but also all other related costs of the policy. Every penny of investor money must be accounted for in confirmation statements itemizing all charges associated with the policy premium. Producers selling these products are subject to regulation by state insurance regulators, the SEC, FINRA, and state securities regulators.

**Sales of variable life.** Although treated as a security under the securities laws, a variable life insurance policy is, like a fixed life insurance product, first and foremost a contract that pays a death benefit to the insured's beneficiaries in the event of an untimely death. From an insurance law perspective, the primary interest of the client must be to purchase a policy that is suited to his or her individual insurance needs. That in turn requires careful and thorough medical and/or financial underwriting of the particular individual, after gathering detailed information from the client. This is a lengthy process, ranging from 30 to up to 180 days, during which there are multiple points at which the client and the client's other advisors have the opportunity to consider various aspects of the transaction.

Underwriting of medical/non-medical risk factors is almost always required when obtaining bids from one or more carriers for a life insurance policy. Medical underwriting evaluates the current and prospective health of the insured, and assesses the probability of when the insurance company may be required to pay death benefit proceeds to the insured's beneficiaries, based upon the collected medical information and any non-medical risk factors. This assessment sustains the initial carrier decision whether to deny coverage, offer coverage at various defined risk classifications, or offer coverage subject to certain restrictions.

As part of this process, the producer helps the client determine the appropriate death benefit based upon a detailed and thorough "needs analysis" which, for a person seeking to replace his or her income for surviving family members, would generally include analysis of information for the individual and spouse, including: annual gross income from all sources; mortgage debt and all outstanding loan and revolving credit balances and other outstanding debt; estimated routine household expenses; a calculation of final expenses (including medical costs, probate and funeral expenses); calculation of an estimated annual inflation rate; estimated liquid assets; estimated retirement assets, such as amounts in pension plans, IRAs, 401(k)s; amount of any existing life insurance coverage in place; the number of dependent children and the estimated cost of education through college for each child; and the number of years of salary the client wishes to set aside for lifestyle maintenance. The subsequent analysis would then calculate an insurance amount that is needed to cover debts, providing for children, and lifestyle maintenance. This would result in the total protection needed, from which total assets would be subtracted to determine the additional life insurance needed.

Once the appropriate death benefit has been set, and medical underwriting has judged whether coverage is available and under what conditions, the insurance agent (a registered representative) then examines potential policies from one or more carriers. The cover letter to the carrier is often used by the representative to describe in detail the background of the

transaction, show how the amount of proposed insurance was calculated, and disclose and clarify unusual factors that may not be obvious in the application. Some carriers may treat certain pre-existing conditions or other factors less onerously than others and offer better pricing for the same type of policy.

Financial underwriting is often required to address the state insurance law requirement of “insurable interest”; that is, to ensure that the owner of a variable life insurance policy has a greater interest in the continued life of the insured than they would have in the insured’s death. The existence of insurable interest is a legal prerequisite under state insurance law to the issuance of an insurance policy. Financial underwriting is also designed to address the issue of “loss” – whether the amount of insurance applied for is reasonable in relationship to the potential loss. Here, the underwriter looks to the purpose of the insurance, such as income replacement, estate planning, or charitable giving.

To assess both “insurable interest” and “loss,” the underwriter of a life insurance policy is provided with extensive and accurate information that provides the financial justification for the amount of coverage requested. Such details would include, for instance, in the case of income replacement insurance, information regarding age of the insured, current gross annual income and current insurance in force. Insurance for purposes of estate planning would require an estate analysis, and insurance for charitable giving would require such things as documented history of giving to the named charity, such as past copies of tax returns as well as details of any volunteer work with the charity to demonstrate strength of the relationship.

A key component of financial underwriting is assessing the policy owner’s sources of funding for the life insurance premium payments. In connection with this assessment, the underwriter would attempt to determine, among other things, whether a particular type of investment is being depleted to fund life insurance, whether those funds are needed (or are more likely to be needed) more for living expenses, whether the client is retired, and whether the need for liquidity is greater than the need for insurance.

Layered on top of this analysis, much of which is designed to meet the requirements of state insurance laws, as well as the carrier’s underwriting requirements, is a set of comprehensive SEC/FINRA requirements for the recommendation/sale of the investment product. Among other requirements under applicable FINRA rules, a broker-dealer must have a reasonable basis to believe that each securities transaction recommended by a broker-dealer is “suitable” for the client based upon very specific information that the broker-dealer is required to gather from the client and maintain, regarding the client’s financial status, tax status, investment objectives and such other information used or considered to be reasonable in making recommendations to the client (typically including the client’s age, other investments, and risk tolerance).<sup>26</sup> Broker-

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<sup>26</sup> NASD Conduct Rule 2310, *Recommendations to Customers (Suitability)*, available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=3638](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638). See also *Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111*

dealers are required to use diligence to learn the essential facts regarding the opening and maintenance of customer accounts. In addition, broker-dealers are required to perform product due diligence before an investment product can be recommended to the broker-dealer's clients.<sup>27</sup> After the initial diligence and approval, the broker-dealer is further required to monitor the approved products for continued appropriateness for the broker-dealer's clients.<sup>28</sup> Recommended transactions effected by a broker-dealer must be reviewed for suitability under these rules on a daily basis by a registered, qualified principal of the broker-dealer. Our members who sell these products also are covered by requirements that broker-dealers have in place systems of supervisory control designed to assure the suitability of recommended transactions and to spot unsuitable recommendations, which include both daily real-time monitoring of transactions and review of every brokerage client account not less frequently than annually.

In considering the appropriate standard of care for sales of these products, it is noteworthy that the context and motivations of the purchaser of a variable life insurance contract are very different from those of a normal retail investor. The insurance purchaser is seeking to address insurable risks of loss, often to benefit persons other than the purchaser, rather than generate a return for the purchaser. The loss being covered usually is the lost income resulting from the death of the purchaser. Variable life insurance products commonly are used in connection with tax and estate planning. The purchaser is seeking to provide a life insurance death benefit for a third party beneficiary – usually family members. The insurance element adds the expense of the mortality risk expenses, which decreases the net investment return on the securities element of the investment.

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Footnote continued from previous page

*(Suitability) in the Consolidated FINRA Rulebook, SR-FINRA-2010-039, available at* <http://www.finra.org/Industry/Regulation/RuleFilings/2010/P121836>.

<sup>27</sup> As restated earlier this year in a FINRA notice to members, a broker-dealer “that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer’s representations about it. This duty emanates from the [broker-dealer’s] ‘special relationship’ to the customer, and from the fact that in recommending the security, the [broker-dealer] represents to the customer ‘that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.’” FINRA Regulatory Notice 10-22 (April 2010), *available at* <http://www2.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf>. (citations omitted) FINRA further stated in that notice that a broker-dealer’s failure to fulfill this obligation can be viewed as a violation of the anti-fraud provisions of the federal securities laws as well as of FINRA Rule 2010, which requires adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices, in addition to Rule 2310, the basic suitability rule.

<sup>28</sup> See *New Products - NASD Recommends Best Practices for Reviewing New Products*, NASD Notice to Members 05-26 (April 2005), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf>.

There is an element of investment management to these variable insurance products, but it is embedded within the funding vehicle for the insurance contract. The investment management of the funding vehicle is regulated under the Advisers Act, and in many cases the Investment Company Act as well (in addition to regulation under state insurance laws). The appropriateness of the recommendation of the variable insurance contract by the broker/insurance agent is regulated and supervised under suitability rules. It is a one-time time of sale review for which the FINRA rules were designed. The appropriateness of the investment activity conducted over time within the funding vehicles is regulated under the Advisers Act, the Investment Company Act and state insurance laws (as well as federal tax laws).

**Sales of variable annuities.** As noted above, variable annuities are a useful product in the portfolio of an insurance producer/registered representative. They are attractive to many clients as a means of securing sufficient retirement savings, because they can offer the opportunities provided by equity investments while providing guarantees by an insurance company that hedge against the risk of loss. FINRA's due diligence, disclosure, suitability assessment, and supervisory requirements governing the sale of variable annuities is even more expansive than its general suitability rule. FINRA Rule 2330 sets forth extensive and detailed sales practice requirements for recommended purchases or exchanges of variable annuities, including: (1) detailed information that must be provided by the registered representative to the customer regarding the investment; (2) the registered representative's thorough assessment that the particular variable annuity is suitable for the customer, based upon specified factors; (3) detailed due diligence that must be performed by the registered representative regarding the customer, including age, income, financial situation and needs, investment experience, investment objectives, intended use of the annuity, investment time horizon, liquidity needs, liquid net worth, risk tolerance, tax status, and other relevant information; (4) the requirement that the registered representative who recommends the variable annuity must promptly send a complete application package to supervisory personnel; (5) the requirement that a registered principal review and determine whether to approve the recommendation (only after making and documenting his/her own suitability analysis); (6) the requirement for enhanced supervisory procedures for variable annuity sales and exchanges; (7) specific training policies; and (8) other requirements regarding the depositing of funds prior to approval and other requirements.<sup>29</sup>

Of course, all recommendations by our members regarding securities products are reviewed by a securities principal. The broker-dealers with which they are affiliated are subject to regular and detailed inspections by the Commission, FINRA, and state securities regulators. The producer's activities in the sale of a variable product may be subject to scrutiny by all three securities regulators, as well as state insurance regulators in any market conduct examination of the carrier.

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<sup>29</sup> As discussed later in this comment letter, nothing even approaching this level of due diligence, supervision, and standard of care exists in Commission rules governing investment advisers.



**Regulation of our members as registered investment advisers.** Since most investment advisers with which our members are affiliated have assets under management above the minimum Federal/state threshold, they are subject to Commission, but not state, regulation on the investment adviser side. Our members who are RIAs or their associated persons therefore must abide by Commission rules under the Advisers Act. Our members take seriously these requirements, as well as our fiduciary duties to those customers for whom we act as investment advisers.

As the Commission is aware, in general, the management of client accounts by an investment adviser is subject to less specific regulatory requirements and processes than those applicable to broker-dealers. As the Commission also is aware, the frequency of examinations of investment advisers is much lower than for brokers and dealers.

Under Commission rules, each registered adviser must deliver to clients a written disclosure statement or “brochure” containing information about the adviser’s business, including certain relationships and activities that may present conflicts with clients. While disclosures specified by Commission rules may not have been particularly detailed or helpful to clients in the past, the Commission recently adopted rules, which must be implemented by investment advisers in 2011, to provide more detailed disclosures, including with regard to conflicts. (These forthcoming requirements are discussed in more detail below.<sup>30</sup>) Investment advisers generally are required by the Commission to manage client accounts in a manner consistent with the governing advisory agreement in place between the client and the investment adviser, which may or may not specify permitted or forbidden investment classes, whether leverage is permitted, position limits or diversification requirements. Our members review the content and performance of their advisory accounts for consistency with specific portfolio requirements or prohibitions dictated by the client agreement or client instructions on an on-going basis, and periodically for consistency with general investment goals and strategies and the advisers’ outlook for particular segments, investment weightings, or issuers. Investment advisers commonly centralize the portfolio selection process to some degree, in terms of segment weightings and approved investments, either through an approved list or a model portfolio, which is subject to variation to meet the particular client’s account agreement terms, including investment objectives and needs.

While it is well understood that investment advisers owe a fiduciary duty to their clients, there is no specific process or set of concrete standards that must be followed by an investment adviser in managing client accounts or in reviewing the management of client accounts under the Advisers Act. In 1994, the Commission proposed codifying the implied fiduciary obligation of investment advisers in recommending and managing client advisory accounts under a “suitability” rule modeled on the NASD and MSRB suitability rules that apply to broker-dealers, but never finalized that rulemaking.<sup>31</sup>

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<sup>30</sup> See text accompanying notes 62 - 63, *infra*.

<sup>31</sup> See text accompany notes 51- 53, *infra*.

Bundled products like variable annuities and variable life products do not lend themselves to an advisory process, because of the self-contained nature of these products. Unlike individual stocks and bonds that need to be separately assembled in portfolios, variable life and annuities come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees.

### **Comparative Strengths and Weaknesses of the Broker-Dealer and Investment Adviser Regulatory Regimes.**

The Release, consistent with the requirements of the Study, asks that commenters compare and contrast the broker-dealer and investment adviser regulatory regimes and identify the comparative strengths and weaknesses of each in the regulation of financial intermediaries when providing personalized investment advice about securities to retail customers. Objectively evaluating these comparative strengths and weaknesses is critical to determining whether new rules should be adopted for either, or both, broker-dealers and investment advisers, and determining the substance of any new rules. As discussed above, for life insurance producers in particular, there are significant overlaps in regulation, such as in the underwriting of a variable life product for death benefit purposes and suitability analysis required by FINRA. Overlapping regulators (the SEC, FINRA, state securities regulators, and state insurance regulators) each review issues such as market conduct and customer protection. There is no identified need for further regulation in this area.

**General distinctions between broker-dealers and investment advisers.** As a general matter, the main difference between the typical broker-dealer and the typical SEC-registered investment adviser is that a broker-dealer makes non-discretionary recommendations to the client and the client chooses whether to buy or sell the securities on a transaction-by-transaction basis.<sup>32</sup> The broker-dealer is paid for effecting the transactions. In contrast, an SEC-registered investment adviser may exercise discretionary investment management over the customer's account and generally will be paid an asset-based fee over time for the management of the client's account.<sup>33</sup>

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<sup>32</sup> Broker-dealers with investment discretion generally are required by Commission rules to register as investment advisers. See Rule 202(a)(11)-1 of the Advisers Act, 17 C.F.R. § 275.202(a)(11)-1. Although other aspects of this rule were the subject of a successful legal challenge, the SEC has re-proposed the provision of the interpretive rule requiring broker-dealers that exercise investment discretion over client accounts to register as investment advisers, which remains the SEC's interpretive position. See *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Release No. IA-2652 (Sept. 24, 2007), [72 Fed. Reg. 55126 (Sept. 28, 2007)].

<sup>33</sup> Most investment advisers, to be registered with the SEC, must have discretionary investment management or continuous supervision over client accounts totaling at least \$25 million under management. Advisers Act § 203A, 15 U.S.C. § 80b-3a(a)(1)(A). (This threshold for federal registration will increase to \$100 million in assets under management in July 2011).

Investment advisers are subject to implied fiduciary duties in their management of client accounts. These fiduciary duties for the most part are not specifically mentioned in the Advisers Act or Commission rules, but have been developed through case law and by reference to state fiduciary duty law.<sup>34</sup> Because they are not set out in a rule or statute, and there are no private rights of action under the Advisers Act other than for return of fees, the content and details of these fiduciary duties are not entirely clear. As discussed below, many of the general fiduciary principles that have been alluded to in SEC releases for investment advisers are the subject of analogous, but much more specific and detailed, rules applicable to broker-dealers.

Securities “brokers” and “dealers” are regulated by the SEC, FINRA and state securities commissioners under a unified system for supervision of “broker-dealers.” The old common law distinctions between a “broker” (an agent, and at common law a fiduciary to its customers) and a “dealer” (a firm buying and selling securities from its own inventory when dealing with customers, generally not a fiduciary at common law) were largely abandoned by the SEC, the NYSE and NASD decades ago and replaced with an extremely detailed rules-based approach governing all aspects of business of broker-dealers, including their duties and responsibilities to customers.<sup>35</sup> These broker-dealer rules, however, address the same basic customer issues and obligations that were covered by older common law “fiduciary” principles, but in a far more concrete and specific fashion.

**Broker-dealer regulation and oversight provides greater protection to retail customers than does the regulation and oversight of investment advisers in the following ways:**

**Number of regulators, frequency of examinations, size of regulatory oversight staff involved in oversight.** Broker-dealers are examined and regulated by the SEC, FINRA and state securities regulators. On average, FINRA conducts an in-depth on-site examination of every broker-dealer firm every 18 to 24 months. In contrast, registered investment advisers have a single regulator (either the SEC or a state securities regulator, generally not both)<sup>36</sup> and are examined on average about once every 11 years. In addition, FINRA audits are not only more frequent but more intense and lengthy, often with a team of compliance professionals who make extensive document requests both preceding and following the audit. The frequency of examination of broker-dealers means that issues will be detected and corrected through the examination process much more quickly than at an investment adviser. The anticipation of a near-term examination also has a deterrent effect on adverse behavior and creates a greater incentive for broker-dealers to continuously monitor and adhere to regulatory requirements.

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<sup>34</sup> See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

<sup>35</sup> See, generally, Randall W. Quinn, *Déjà vu All Over Again: the SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61; *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir. 1998).

<sup>36</sup> Advisers Act § 203A, 15 U.S.C. § 80b-3a(a)(1)(A).

As discussed above, broker-dealers that sell variable life insurance products are subject to a fourth group of regulators, the state insurance commissioners. Variable insurance products are subject to detailed merit review of both the terms of the product and the disclosure documents by state insurance commissioners, who also exercise oversight of both the issuer/insurance companies and their licensed insurance producers at the broker-dealer firms who sell insurance products. In this oversight capacity, state insurance commissioners address sales practice issues and customer complaints in sales of insurance products, including variable insurance products that are regulated as securities.

According to the Commission's most recent budget justification, the Commission oversees approximately 11,500 investment advisers and 5,400 broker-dealers.<sup>37</sup> The Commission's budget justification states that 54% of all broker-dealers were examined by the Commission or an SRO in 2009, and the Commission expects that 55% of all broker-dealers will be examined by the Commission or an SRO in FY 2010 and FY 2011.<sup>38</sup>

Investment advisers are examined far less frequently. In 2009, only 10% of investment advisers were examined. The Commission has projected that in FY 2010 and FY 2011, only 9% of investment advisers will be examined.<sup>39</sup>

**Program of internal supervision and compliance.** For many decades, the NASD, the New York Stock Exchange, and now their successor on most firm regulation matters, FINRA, have required all broker-dealer firms to create and maintain a comprehensive supervisory program that includes a written supervisory manual, qualified principals who are assigned to supervise each specific area of a firm's operations, and each of its personnel and offices in the conduct of the broker-dealer firm's business. These requirements have been updated and enhanced many times over the years, including with the adoption in 2004 of what are now NASD Conduct Rules 3010, 3012, 3030, 3040 and 3050 (to be recodified in FINRA Rules 3110, 3120, and 3150), which further codified the requirements for supervisory control programs at broker-dealer firms.

FINRA rules dictate that the supervisory programs and controls must be designed and tailored by the firm to take into account its size, activities and product mix, organization structure, volume of business and other factors. The broker-dealer's supervisory program must include processes to assure they are adhered to, annual compliance interviews with all personnel and inspections of offices, annual reviews of all accounts, and daily, real-time review by a principal of all correspondence and all recommended customer transactions. Written documentation is required of the conduct of this supervision, the program must be annually

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<sup>37</sup> U.S. Securities and Exchange Commission: FY 2011 CONGRESSIONAL JUSTIFICATION - IN BRIEF, at 2 (2010), available at <http://www.sec.gov/about/secfy11congbudjust.pdf>.

<sup>38</sup> *Id.* at 20.

<sup>39</sup> *Id.*

reviewed and refined and a report made to the CEO, and annual certification is required by the broker-dealer's CEO of the supervisory system and controls. As a result of all of these requirements, broker-dealers typically have large compliance staff and spend substantial resources on this activity.

In contrast, registered investment advisers had no formal regulatory requirement to have supervisory assignments, a compliance officer, or written compliance programs until December 2003, 63 years after the enactment of the Advisers Act. Compliance with this requirement did not become mandatory until October 2004. The Advisers Act compliance rule is far less detailed and specific than the supervisory and control rule requirements that apply to regulated broker-dealers.

**Liability of Broker-Dealer and its Principals for Failure to Supervise.** The Exchange Act authorizes the SEC to impose administrative sanctions, including fines, corrective action, restrictions on future activities, or a ban on firms or individuals temporarily or permanently from the securities industry, for failure to appropriately supervise the business or personnel of a broker-dealer firm.<sup>40</sup> Failure to supervise or implement an appropriate system of supervision, even in the absence of an underlying violation or problem, can result in SEC or FINRA enforcement action against a broker-dealer and its principals.<sup>41</sup>

There are not similarly robust supervisory control rules for investment advisers. The system for holding supervisors of a broker-dealer responsible for failing to reasonably supervise persons subject to their supervision is far more developed than that applicable to investment adviser personnel.

**Qualification requirements for broker-dealer staff and supervisors.** The basic qualification test for broker-dealer personnel (Series 7 examination) is widely viewed as the most difficult examination in the industry, and requires extensive study preparation for those planning to take the test if they hope to pass it. Other broker-dealer examinations are required for broker-dealer personnel who will serve as supervisors or perform tasks in specialized products or areas of a broker-dealer's operations. In contrast there is only one investment adviser examination (Series 65/66), and it is generally viewed as relatively simple to pass.

Principals (supervisory personnel) of broker-dealers must take and pass additional specialized examinations (for example the Series 24 general principal examination) before

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<sup>40</sup> Exchange Act Sections 15(b)(4)(E), 15(b)(6); *In re Shearson, Hammill & Co.*, SEC Release No. 34-7743 (Nov. 12, 1965); *In re Reynolds & Co.*, SEC Release No. 34-6273 (Mar. 25, 1960); John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 Colum. Bus. L. Rev. 165. See also Exchange Act Sections 15(f), 20, 21A(b) (supervisory programs to prevent misuse of material inside information, and to controlling person liability).

<sup>41</sup> See, e.g., *In re Bates*, SEC Admin Proc. File 3-11346 (June 2, 2004).

assuming a supervisory role at a broker-dealer. There also are specialized requirements, such as separate supervisory exams and procedures for options and municipal securities. Moreover, a broker-dealer generally is required by FINRA to have at least two registered principals (and for all but the smallest firms, many more) who have at least five years work experience in the securities industry.

In contrast, there is no supervisory examination or work experience requirement for registered investment adviser supervisory personnel, other than the basic Series 65/66 examination.

**Continuing education requirements.** Broker-dealer firms and their registered personnel are subject to continuing education requirements that must track the nature of the business conducted by the firm and engaged in by the registered individuals.<sup>42</sup> Among the required elements of broker-dealer continuing education programs under FINRA/NASD Continuing Education Rule 1120, each firm is required to hold mandatory in-house training sessions, with proctors, to be attended not less frequently than annually in person, by all registered personnel with client contact (and certain other registered personnel). The session must cover compliance issues tailored to the business and activities of the firm. Attendance is kept and must be certified and tracked for each covered employee.

The Commission does not require that investment advisers comply with continuing education requirements.

**Ability to translate requirements into a supervisory program.** Commission and FINRA rules applicable to customer transactions recommended and effected by broker-dealers impose specific rule-based suitability and disclosure requirements that lend themselves to control processes, particularly in the context of individual transactions. A general “fiduciary” standard without more specificity is difficult to build a real-time supervision and compliance program around.

The word “fiduciary” appears in only two places in the Advisers Act, and neither is in reference to a registered or unregistered investment adviser. The first reference is in the definition of a “bank” that is excluded from the definition of “investment adviser.”<sup>43</sup> The second is in a list of the types of legal violations in an entity’s past that may disqualify it from becoming registered as an investment adviser.<sup>44</sup> In contrast, other federal statutes that impose fiduciary duties on regulated investment businesses, such as the Investment Company Act,<sup>45</sup> ERISA,<sup>46</sup> and

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<sup>42</sup> NASD Conduct Rule 1120.

<sup>43</sup> Advisers Act § 202(a)(2), 15 U.S.C. § 80b-2(a)(2)(11).

<sup>44</sup> Advisers Act § 203(e)(2)(B), 15 U.S.C. § 80b-3(e)(2)(B).

<sup>45</sup> See Investment Company Act § 36, 15 U.S.C. § 80a-35.

<sup>46</sup> 29 U.S.C. §§ 1001, 1102, 1104 *et seq.*

the National Bank Act,<sup>47</sup> are very specific in stating that the regulated entity is subject to fiduciary duties in respect of its client and either defining what those duties are or incorporating by reference state law fiduciary obligations. There is no provision in the Advisers Act that states that an investment adviser is a fiduciary or is subject to fiduciary duties, or that specifies what those fiduciary duties might be.

Similarly, the Commission rules under the Advisers Act contain the word “fiduciary” in only three places. The first place the word occurs is in the Commission’s rule requiring an investment adviser to have a “code of ethics” which specifies that the code of ethics must include, among other things, “[a] standard (or standards) of business conduct that you require of your supervised persons, which standard must reflect your fiduciary obligations and those of your supervised persons,” but does not purport to create or define what those fiduciary duties might be or whether they arise under the Advisers Act or some other federal or state law. The second location, in the “cash payment for client solicitation” rule, merely states that “[n]othing in this section shall be deemed to relieve any person of any fiduciary or other obligation to which such person may be subject under any law” and does not purport to impose a fiduciary duty or define what fiduciary duties might apply.<sup>48</sup> The final location requires an investment adviser to disclose disciplinary information related to investment related businesses, where the word “fiduciary” appears (along with commodities, securities, banking, insurance and real estate) in a list of what constitutes an “investment related business.”<sup>49</sup> None of these references in the Commission’s Advisers Act rules purport to impose a fiduciary obligation on a registered investment adviser or to define those obligations.

Fiduciary law generally has been a matter primarily of state law that varies state by state (much of which has been developed by state courts through decisional law or “common law.” and not by statute) and differs for different types of fiduciary relationship even within a state. Except where Congress provides otherwise, there is no federal common law.<sup>50</sup> In contrast, broker-dealers operate under very specific and detailed rules of the Commission and FINRA that specify the duties and obligations of broker-dealers in minute detail, which are then worked into very detailed day-to-day supervisory control and compliance programs at broker-dealers. Broker-dealer regulation is analogous to civil law, while fiduciary principles are creatures of common law and courts of equity.

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<sup>47</sup> 12 U.S.C. § 92a.

<sup>48</sup> 17 C.F.R. § 275.206(4)-3(c).

<sup>49</sup> 17 C.F.R. § 275.206(4)-4(d)(3).

<sup>50</sup> *Erie R.R. v. Tompkins*, 304 U.S. 64, 78 (1938); *Ruhlin v. N.Y. Life Ins. Co.*, 304 U.S. 202, 205 (1938); *Texas Indus. v. Radcliff Materials, Inc.*, 451 U.S. 630, 640-47 (1981); *Burks v. Lasker*, 441 U.S. 471, 478, 486 (1979). Cf. 12 U.S.C. § 92a (duties of national banks to their fiduciary customers are defined by reference to state law).

As a result of the absence of a statute or rule that establishes and defines the fiduciary duties of investment advisers and of a federal common law of fiduciaries, there is no place a firm can look to for a clear definition of when fiduciary duties apply to an investment adviser or what the contours and requirements of those fiduciary duties might be. The lack of clarity makes it difficult to train staff or to create and operate a supervisory system, compliance program or audit routine to monitor and assure compliance with undefined fiduciary obligations. Quality means conformance to specifications. If one cannot specify what fiduciary standards and obligations must be met, it is difficult to conform to them on a real-time basis. Instead, it becomes simply a “gotcha” test for regulators, where the violation can only be recognized after the fact. In general, regulation by enforcement does not permit the development of the best controls in advance of problems and seems inconsistent with the role of regulators to provide clear guidance and a regulatory framework designed to head off problems before they occur.

The Commission has, on occasion in rulemaking releases and no action letters, stated that investment advisers have fiduciary duties and listed certain of those duties in the text of the release, rather than in the text of the rule. For example, in the release adopting the Advisers Act compliance rule (17 C.F.R. § 275.206(4)-7), the Commission stated that an investment adviser has a fiduciary duty to have a means to address natural disasters and other business interruptions in order to continue servicing client accounts,<sup>51</sup> and in a 1994 release proposing a suitability rule for investment advisers (the “Adviser Suitability Rulemaking Proposal,” which was never adopted) the Commission stated that an investment adviser has fiduciary duties that include (1) duty to disclose conflicts of interest; (2) duty of loyalty; (3) duty to obtain best execution; (4) duty of care; and (5) duty to make only suitable investment recommendations to clients.<sup>52</sup> The Commission’s Adviser Suitability Rulemaking Proposal listed the fiduciary duties of care and making suitable recommendations separately, but more commonly they are described in the trust context as the fiduciary duty to exercise care and skill in the management of the account, sometimes referred to as the “prudent investor rule.”<sup>53</sup>

By contrast, broker-dealers are subject to very specific rules governing these duties. A broker-dealer is required to have a business continuity plan.<sup>54</sup> A broker-dealer is required to disclose a variety of specific conflicts of interest,<sup>55</sup> an area in which the Commission several

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<sup>51</sup> 68 Fed. Reg. 74714, 74716 n.22 (Dec. 24, 2003).

<sup>52</sup> Proposed Rules: Suitability of Investment Advice Provided by Investment Advisers, Re. IA-1406, 59 Fed. Reg. 13464, 13465 (Mar. 22, 1994).

<sup>53</sup> For a discussion of this fiduciary duty, see 3 *Scott & Ascher on Trusts* § 17.6, at 1205-1212 (5th ed. 2007).

<sup>54</sup> FINRA Rule 4370.

<sup>55</sup> See, e.g., NASD Conduct Rule 2230; 17 C.F.R. § 240.10b-10 (confirmation requirements including whether the broker-dealer is acting in the capacity of agent or principal and disclosure of compensation charged by broker to client or paid by third party to broker-dealer in securities transactions); Exchange Act Rules 10b-16 and 15c2-5, 17 C.F.R. §§ 240.10b-16 and 240.15c2-5 (credit disclosures); § 240.15g-2 *et seq.* (penny stock disclosures by broker-dealers); Regulation



years ago considered but failed to adopt additional disclosure rules.<sup>56</sup> More generally, material conflicts involved in the purchase or sale of a security for a customer's account may need to be disclosed by a broker-dealer to avoid potential liability to the customer under Rule 10b-5. The "duty of loyalty" is the duty not to engage in transactions with the fiduciary account that involve a conflict of interest, unless the beneficiary or a person authorized to consent on behalf of the account has given informed consent to the conflict or the conflict transaction is authorized by applicable law, the governing instrument, or court order.<sup>57</sup> Thus, existing SEC and FINRA rules that require a broker-dealer to either disclose a variety of conflicts of interest to customers or abstain from engaging in transactions with customers involving those conflicts are the essence of the common law fiduciary duty of loyalty. A broker-dealer also has an obligation to deal fairly with its customers,<sup>58</sup> which includes an obligation to exercise care in handling a customer's account.<sup>59</sup> A broker-dealer has a duty of best execution.<sup>60</sup> As discussed earlier in this letter, a broker-dealer has a duty to only recommend suitable transactions to a client.<sup>61</sup>

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Footnote continued from previous page

AC, 17 C.F.R. §§ 242.500 *et seq.*, NASD Conduct Rules 2210 *et seq.* (communications with customers and public, including disclosures), 2711 (research analyst conflicts and disclosures), 2720 (public offering conflicts disclosures), 2750 (transactions with related persons); 2800 *et seq.* (special product disclosures); SR-FINRA-2010-029 (Proposed Rule Change to Adopt FINRA Rule 5141). *See also* 17 C.F.R. § 240.10b-5. Other disclosure obligations in respect of broker-dealer conflicts of interest and compensation are required in the offering documents provided to investors in connection with public offerings of securities.

<sup>56</sup> *See e.g.*, Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, 69 Fed. Reg. 6438 (Feb. 10, 2004) (proposing new point of sale disclosure requirements for mutual funds and other securities); 70 Fed. Reg. 10521 (Mar. 4, 2005).

<sup>57</sup> *See, e.g.*, 3 *Scott & Ascher on Trusts* § 17.2, at 1084-5 (5th ed. 2007); 12 U.S.C. § 371c-1(b) (prohibiting certain conflict of interest transactions by a bank acting as a fiduciary except where permitted by the terms of the governing instrument, court order or applicable fiduciary law); *accord* 17 C.F.R. § 275.206(3)-2 (Advisers Act rule allowing certain conflict of interest transactions with disclosure and client consent).

<sup>58</sup> FINRA Rule 2010.

<sup>59</sup> FINRA Rule 2150; NASD Conduct Rule 2330, NASD IM-2330; NASD Conduct Rule 3230; 17 C.F.R. § 240.15c3-3 (possession, control and handling of brokerage customer accounts and securities).

<sup>60</sup> FINRA Rule 2010; NASD Conduct Rule 2320(a); NASD IM-2320; NASD Notice to Members 01-22 (2001). *See generally*, M. MacHarg and G. Raine, *Best Execution and Customer Order Handling*, Ch. 13 in *PLI, Broker-Dealer Regulation* (C. Kirsch ed).

<sup>61</sup> *See* NASD Conduct Rule 2310 (suitability requirement); NASD Conduct Rules 2300 *et seq.*, NASD Conduct Rule 2510 (members must not effect transactions in a discretionary account which are excessive in size or frequency in view of the financial resources and character of such account); FINRA Rule 2114; MSRB Rule G-19.

The Commission has revised and specified adviser rules in a number of areas in recent years, although for the most part, they continue to lack the scope and detail of rules governing broker-dealer conduct. In one important area related to an adviser's fiduciary duty to clients, conflicts disclosure, the Commission recently adopted rules to improve conflicts disclosure by advisers to their clients in the client "brochure," which an adviser must furnish a client at the beginning of an advisory relationship. Currently, Rule 204-3 under the Advisers Act requires registered investment advisers to deliver a disclosure statement in the form of Part 2 of Form ADV (or a document containing information required to be disclosed in Part 2) to advisory clients at the time or before they enter into advisory contracts with such clients.<sup>62</sup> Part 2 describes, among other things, an investment adviser's background, advisory services offered, advisory fees, business practices, educational background of senior executives, financial industry affiliations, arrangements with service providers, and disciplinary history. Part 2 does not mandate many specific conflicts disclosures (other than those related to an investment adviser's participation or interest in client transactions), which has resulted in substantial uncertainty about what types of conflicts disclosures should be included in Part 2 and a wide disparity in the types of conflicts disclosures actually provided by advisers.

Recent Commission amendments to these requirements, which generally will be implemented by advisers in 2011, will require registered investment advisers to provide enhanced, detailed disclosures of certain conflicts of interest in Part 2 of Form ADV to their advisory clients.<sup>63</sup> What is interesting about the view, held by some, of the benefits of a fiduciary duty in protecting the clients of registered investment advisers is that the very essence of a fiduciary duty is the duty of loyalty – to either avoid conflicts with a client or to disclose them (and in some cases obtain consent). The fact that the Commission believed it necessary to adopt the recent very detailed amendments to the brochure rule – which since 1979 has been the primary vehicle for investment advisers' disclosures to clients – underscores the problem of reliance upon vague and amorphous "fiduciary duties" to guide and enforce advisers' loyalty to clients; it demonstrates the benefit of more specific and clear rules of conduct as the best means to assure customer protection.

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<sup>62</sup> 17 C.F.R. § 275.204-3.

<sup>63</sup> *Amendments to Form ADV*, Advisers Act Release No. IA-3060 (July 28, 2010), available at <http://www.sec.gov/rules/final/2010/ia-3060.pdf>. Among other things, amended Part 2 of Form ADV will require registered investment advisers to specifically describe conflicts of interest related to their other business activities, other financial industry affiliations, and arrangements with service providers that provide additional economic benefits to an adviser or its affiliates and how those conflicts are addressed—which are disclosures that are not specifically required by the current Part 2. In addition, in contrast to the current Part 2, in certain areas, the amended Form ADV will require very specific conflicts disclosures, including disclosures of conflicts related to an investment adviser's receipt of soft dollar benefits, its use of client brokerage to compensate broker-dealers for client referrals, and its side-by-side management of client accounts where only certain clients are charged performance-based fees.

**FINRA and MSRB suitability rules clearly define the investment recommendation process and are the model for investment advisers.** When the Commission proposed to adopt a suitability rule applicable to investment advisers, it modeled the proposal upon the suitability obligations of broker-dealers.<sup>64</sup> Although the Adviser Suitability Rulemaking Proposal was never adopted, its proposal documents that the only clearly established model for regulating under the securities laws the process by which advice and recommendations are made are the suitability rules applicable to broker-dealers. In other words, in order to clarify what it means in an operational sense for an investment adviser to exercise its fiduciary duties of care and loyalty in managing an advisory client's account, the Commission looked to rules applicable to broker-dealers.

**Custody of client assets.** One of the common law fiduciary duties is to exercise care in the control of client assets.<sup>65</sup> Broker-dealers are required to maintain custody of client assets directly or through another broker-dealer approved for this purpose that must operate under detailed Commission rules.<sup>66</sup> Investment advisers are required generally to maintain client assets with a qualified custodian (i.e., a broker-dealer or bank).<sup>67</sup>

**Rendering account statements.** Another common law fiduciary duty is the duty to keep and render statements of account to the client.<sup>68</sup> Both broker-dealers,<sup>69</sup> and investment advisers<sup>70</sup> are subject to analogous regulatory obligations to keep records, provide customer account statements (or cause the custodian to send statements to the adviser's client that meet Advisers Act requirements), and respond to customer requests for information.

Thus, in sum, broker-dealer regulation provides far greater customer protection than does investment adviser regulation, because broker-dealers are subject to far more detailed rules governing dealings with clients—which cover essentially the same topics as common law fiduciary principals of agency but in more detail, and which detailed rules lend themselves to comprehensive supervision and control processes. Broker-dealers are required to have in place more detailed systems of supervision and control, and are subject to more detailed and far more frequent regulatory inspections, by more regulators, than are investment advisers. The detailed

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<sup>64</sup> *Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements For Certain Advisory Clients*, Advisers Act Release No. IA-1406 (Mar. 16, 1994), [59 Fed. Reg. 13464, 13465 n.6 (Mar. 22, 1994)].

<sup>65</sup> Scott and Ascher on Trusts, *supra* note 53, at §§ 17.7, 17.8.

<sup>66</sup> FINRA Rule 2150; NASD Conduct Rule 2330; 17 C.F.R. § 240.15c3-3.

<sup>67</sup> 17 C.F.R. § 275.206(4)-2.

<sup>68</sup> Scott and Ascher on Trusts, *supra* note 53, at §§ 17.4, 17.5.

<sup>69</sup> 17 C.F.R. §§ 240.10b-10 (customer confirmations); 240.17a *et seq.* (records, including customer account records); NASD Conduct Rule 2230, 2340 (customer confirmations, statements).

<sup>70</sup> 17 C.F.R. § 275.204-2 (records); § 275.206(4)-2(a)(3)(customer statements).

rules-based approach under which broker-dealers are regulated, supervised, controlled and examined is more protective of clients than is the system of regulation of investment advisers, which is why the SEC has used the broker-dealer model as a template for suitability, and as the cornerstone for the custody (and through the custody rule, the customer account statement) requirements that apply to investment advisers.

We believe the comparative strength of broker-dealer versus adviser regulation is further reflected in the attached Commission staff memorandum recently provided to its Investor Advisory Committee, which spends five pages describing the federal standards of conduct applicable to investment advisers and 15 pages describing the federal standards of conduct applicable to broker-dealers.<sup>71</sup>

### **Potential Impact of Changes in the Standard of Care Applicable to Brokers, Dealers, and Investment Advisers**

A number of considerations in the Study relate to the potential impact of Advisers Act type requirements for brokers and dealers and Exchange Act type requirements for advisers. For example, one of the issues on which the Commission has requested comments as part of the Study relates to the impact of removing the exclusion for broker-dealers from the definition of "investment adviser" in the Advisers Act. This proposal was included in early drafts of Senate financial reform legislation, but was abandoned in favor of the comprehensive Study the Commission is now undertaking and the grant of discretionary rulemaking authority to the Commission to address the standard of conduct for brokers, dealers, and investment advisers but not to eliminate the broker-dealer exclusion from the definition of an investment adviser. Since the Commission does not have statutory authority to adopt such a proposal by rule, and since we do not believe Congress is seriously considering a proposal of this nature, we will focus primarily on what we believe a "fiduciary duty" or a "best interest/without regard to" standard on retail brokers would mean.

**Imposing a broad, vague fiduciary duty on broker-dealers would provide no increase in investor protection.** While under certain circumstances (such as when a broker has discretionary authority over a customer's account) a broker may be held to the legal standard of a "fiduciary," we believe Advisers Act regulation or a broad fiduciary duty standard would provide no measurable increase in investor protection for retail customers of broker-dealers, while a regime for advisers that more closely resembles that for brokers and dealers probably would benefit retail customers, in view of the specificity of the rules and the strong examination program resulting from FINRA oversight.

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<sup>71</sup> See Standards of Conduct Applicable to Investment Advisers and Broker-Dealers, Memorandum prepared by SEC staff to Investor Advisory Committee, May 17, 2010, attached as Attachment "A" to this letter. While this memorandum was prepared for members of the Investor Advisory Committee, it was not posted with the publically available material on the Commission's website, perhaps through an oversight.

For variable life insurance products sold by licensed insurance agents in particular, which are among the most highly-regulated products sold by the most highly-regulated financial services professionals, we believe nothing under the Advisers Act regulatory scheme compares to the comprehensive and robust customer protections already in place that we identified earlier in this letter: comprehensive due diligence with respect to the customer's needs and financial capacity; suitability assessment relating to both annuity and investment products; disclosures to customers about the investment product; transaction-by-transaction review and approval by the carrier/issuer; immediate and transaction-by-transaction review of each transaction by a securities principal; and meaningful and effective oversight by as many as four different levels of regulators (and often involving multiple regulators at the state level). While we do not believe AALU members' clients are confused about the insurance producer's role and any potential conflicts, we believe the Commission, if it finds after the required Study that there is a need to address some clearly identified investor confusion, does not need to look to the Advisers Act or to the newly-created "best interest" standard available to the Commission in the new law to address it. The Commission and FINRA have ample other authority (authority existing both prior to and after enactment of the new law) to require additional disclosures by brokers to their customers. Specifically, if the Study finds that investors would benefit from further clarification of the role in which a particular financial professional operates or the potential conflicts that may affect that professional's service, we would be pleased to work with the Commission in discussing the types of appropriate disclosures that would clarify financial professionals' roles and potential conflicts.

Even beyond highly regulated variable products, as discussed above, the Commission/FINRA regulatory and oversight regime for brokers and dealers – which is highly specific, proactive, capable of being monitored by supervisors (and is, in fact, monitored) and capable of being audited by regulators (and is, in fact, regularly audited by regulators) is superior to current regulation of investment advisers. In fact, we believe investors, if fairly surveyed, would choose a regime which provides specific rules of conduct to guide financial professionals, imposes liability upon supervisors for failing to meet robust supervisory requirements, and provides for periodic and robust regulatory oversight, over a regime in which a financial professional may have a legal "fiduciary" obligation but operates under the assumption that a regulator may audit its activities only once every 11 years. We believe any shift in regulation should be toward moving advisers to the more specific regulatory regime of broker-dealers and providing for FINRA oversight to supplement the Commission's current inadequate oversight regime for investment advisers. We believe the comparative benefits of the broker-dealer regulatory and oversight regime over the current regime for investment advisers are amply demonstrated in the discussion above.

**Imposing an Advisers Act fiduciary duty standard or "best interest" standard could harm investors by reducing customer choice and access to financial services, particularly in the area of life insurance products.** As the Commission is well aware, the concept of "fiduciary duty" addresses the agent monitoring problem (the lack of a principal's control over, and inability to continuously monitor, its agent) by imposing various duties and obligations enforced

through the courts. The elements of the duty are principles-based, not rules based, and the duty is, by its very nature, after-the-fact liability creating.

As noted earlier, many of our members operate under the Adviser's Act implied fiduciary duty and under certain specific rules adopted by the Commission under the Advisers Act. But a general fiduciary standard is inappropriate as applied broadly to sales of securities products where the broker does not hold himself/herself out as an investment adviser and does not exercise discretionary authority. It is particularly inappropriate for bundled, self-contained products like variable life and variable annuities, which come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees. The complexity of these products makes it difficult to determine which product is "best" and, under a "best interest" standard, almost certainly would lead to increased litigation. Our members have a long history of being able to determine suitability – and we operate under FINRA and state insurance regulators' enhanced suitability standards for these products. However, as some of our members separately write, determining what is "best" would be a highly subjective determination, opening a producer to second-guessing and liability, often years after the sale of a product. For example, is the best product in a rising market the one that is most aggressively allocated to equities? The best product for the client that dies three years into the contract would be the one with the highest death benefit. In a prolonged depressed equity market, the product with the best income guarantee would clearly be the most favorable to the client. One product may have fewer investment choices and lower costs; another may come with higher charges but a wider range of investment choices.

Thus, we believe the imposition of a broad new "best interest" or fiduciary duty standard inevitably will lead to uncertainty and litigation. In our view, this will influence many life insurance producers to withdraw from the sale of these products and reduce investor access to them. Moreover, while we have not had an opportunity to fully explore this area, our preliminary discussions with a major insurance broker suggest that the problem of uncertainty and potential liability that would be created by a new fiduciary standard for brokers could be compounded by the potential lack of, or increased cost of, errors and omissions insurance – a further reason for producers to shift their focus away from products for which a broad, amorphous, liability-creating new "duty" applies.

### **Conclusion**

AAU believes the current legal and regulatory standards of care for brokers and advisers are fundamentally sound. These standards of care recognize a range of customer relationships and are aligned with the options to deliver financial services to customers in terms of needs and cost. Well publicized abuses and failures that led to the recent financial reform effort have not been related to the standards of care for brokers, dealers and advisers. Indeed, where there have been abuses and scandals, they in large part have been due to the failure of vigorous regulatory oversight and enforcement of existing standards, and not any identifiable weaknesses in the standards themselves. This problem will remain regardless of any changes to

the standard. As a result, the focus should be on the process of ensuring that the standard appropriate to a defined customer relationship is met.

We believe there are no gaps or shortcomings in legal or regulatory standards protecting the customers served by licensed life insurance producers who are separately licensed as registered representatives of a broker-dealer, or who are dually registered. An individual may be subject to SEC, FINRA, state securities regulation, and state insurance regulation depending upon their role. There is little evidence that the “fiduciary standard” would offer superior customer protection to the current standards applicable to brokers and dealers. Indeed, we would argue that the specificity of broker-dealers standards, the superior supervisory structure within firms and regular and consistent audits by the SEC/FINRA of brokers and dealers provides superior investor protection.

We also believe the issue of investor confusion is somewhat misdirected. There exist many choices and options in accessing financial services that may be “confusing” to customers without their becoming educated beyond their desire. Yet, these differences in product choices, costs and services are fundamental to a delivery system that allows people across all wealth and income levels to access the benefits of financial services in some form. The solution is not to eliminate potential confusion through homogenization, but to ensure understanding of the standard selected to meet their needs and the role in which a financial professional is serving them.

Variable products sold by licensed life insurance producers regulated by the Commission, FINRA, state securities regulators and state insurance regulators are among the most highly-regulated and supervised financial products sold to retail investors. These products serve important roles in the financial security and retirement needs of millions of Americans. Access to these products could be significantly curtailed as a result of changes to the standard of care. The cost of meeting all regulatory and compliance obligations is already significant for all brokers, and especially life insurance producers, due to levels of oversight and requirements that already exist. A change to a vague standard that requires increased time and costs to comply, as well as creating uncertain and potentially uninsurable liability, could significantly increase the costs associated with the delivery of these products to middle market clients. This could result in limited access to insurance protection for millions of Americans. As stated earlier, 75 million American families rely upon the important financial security that life insurance products provide, but there are, according to Congress, an additional 68 million citizens that “lack the adequate level of life insurance coverage needed to ensure a secure financial future for their loved ones.”<sup>72</sup>

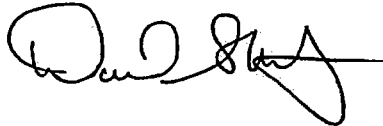
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<sup>72</sup> S. Res. 211, 111<sup>th</sup> Cong. 2009; H. Res. 16, 111<sup>th</sup> Cong. (as agreed to in House, Sept. 29, 2009).

Ms. Elizabeth M. Murphy  
August 30, 2010  
Page 34

AALU appreciates the opportunity to submit these comments to help inform the Commission's important Study. We hope to engage in a continuing dialogue with the Commission and its staff as you evaluate the public comments and conduct further study of these issues.

Sincerely,

A handwritten signature in black ink, appearing to read "David J. Stertz". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

David J. Stertz  
Chief Executive Officer

cc: The Honorable Mary L. Schapiro, Chairman  
The Honorable Luis A. Aguilar, Commissioner  
The Honorable Kathleen L. Casey, Commissioner  
The Honorable Troy A. Paredes, Commissioner  
The Honorable Elisse B. Walter, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets  
Andrew J. Donohue, Esq., Director, Division of Investment Management



# ATTACHMENT A

## MEMORANDUM

**To:** Investor Advisory Committee

**From:** Holly Hunter-Ceci, Office of Chief Counsel, Division of Investment Management  
Emily Westerberg Russell, Office of Chief Counsel, Division of Trading and Markets

**Date:** May 17, 2010

**Re:** Standards of Conduct Applicable to Investment Advisers and Broker-Dealers

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We prepared this memorandum at the request of the Investor Advisory Committee (“Committee”).<sup>1</sup> This memorandum is intended to provide the Committee with a general overview of certain of the federal standards of conduct<sup>2</sup> applicable to investment advisers and broker-dealers, and to serve as background to help facilitate the Committee’s work. Therefore, please note that this memorandum is not intended to serve as a comprehensive treatise on the regulation (business conduct or otherwise) of investment advisers and broker-dealers.

### **I. Executive Summary**

Investment advisers and broker-dealers must adhere to high standards of conduct in their interactions with investors. These standards are imposed by the federal securities laws and, in the case of broker-dealers, also by self-regulatory organization (“SRO”) rules.

Under the Investment Advisers Act of 1940 (“Advisers Act”), investment advisers are fiduciaries. As fiduciaries, investment advisers are required to act in the best interest of clients and to avoid conflicts with clients or, if conflicts cannot be avoided, to provide appropriate disclosure of the conflicts and to obtain client consent before acting on the conflict. For example, advisers are prohibited from knowingly selling any security to or purchasing any security from a client when acting as principal for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting

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<sup>1</sup> This memorandum was prepared by members of the staff of the Division of Investment Management and the Division of Trading and Markets upon the request of the Committee. The Securities and Exchange Commission (“Commission”), as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views herein are those of the authors, and do not necessarily reflect those of the Commission or of the authors’ colleagues upon the staff of the Commission.

<sup>2</sup> Please note that state laws governing standards of conduct for investment advisers and broker-dealers are generally beyond the scope of this memorandum.

and obtaining the client's consent before the completion of the transaction. Investment advisers are also required to make suitable recommendations, have a reasonable basis for its investment advice, and seek best execution of client transactions. Much of the Advisers Act is designed to enforce the investment adviser's fiduciary duty, as discussed below.

Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. This fundamental obligation implies certain duties and prescribes certain conduct, which has been articulated by the Commission, the SROs, and the courts, over time through rules, interpretive statements and enforcement actions. These duties include, among other things, investigating and having adequate information regarding the security that the broker-dealer is recommending and ensuring that its recommendations are suitable based on the customer's financial situation and needs (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, disclosing conflicts of interest, and receiving fair compensation both in agency and principal transactions. A customer cannot waive or contract away these obligations. While the statutes and regulations do not uniformly impose fiduciary obligations on a broker-dealer, brokers may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state. Generally, broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty similar to that of investment advisers. Broker-dealers are also subject to a variety of requirements under the federal securities laws and SRO rules that enhance their business conduct obligations, as discussed below.

## **II. Investment Adviser Standard of Conduct**

Most money managers, investment consultants, and financial planners are regulated as "investment advisers" under the Investment Advisers Act of 1940 (the "Advisers Act") or similar state statutes. Section 202(a)(11) of the Advisers Act defines an investment adviser as any person or firm that: a) for compensation; b) is engaged in the business of; c) providing advice to others or issuing reports of analyses regarding securities. A person must satisfy all of the three elements to fall within the definition of "investment adviser." A person that falls within the definition of "investment adviser" (but is not eligible for one of the exclusions, *e.g.*, it is not a bank or a broker-dealer) must register under the Advisers Act, unless it (i) qualifies for an exemption from the Advisers Act registration requirement (*e.g.*, it has fewer than 15 clients and does not hold itself out publicly as an investment adviser)<sup>3</sup> or (ii) is prohibited from registering under the

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<sup>3</sup> Section 203(b) of the Advisers Act provides several exemptions from registration, such as: advisers whose only clients are insurance companies; advisers that do not hold themselves out publicly as an investment adviser and who do not act as an investment adviser to any registered investment companies or any business development companies and have fewer than 15 clients; advisers all of whose clients are residents of the state in which the adviser maintains its principal office and place of business and that does not give advice about exchange-listed securities; advisers that are charitable organizations (or are trustees, directors, officers, employees or volunteers thereof acting within the scope of their employment or duties with such organizations)

Advisers Act because it is a smaller firm regulated by one or more states. An unregistered investment adviser is not subject to the Advisers Act's recordkeeping rules or Commission examination, but is subject to the Advisers Act's antifraud provisions.

### Fiduciary Duty

The Advisers Act broadly prohibits investment advisers from defrauding their clients. Specifically, Section 206(1) of the Advisers Act prohibits an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client." Section 206(2) prohibits advisers from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client." The Supreme Court has construed Section 206 as establishing a federal fiduciary standard governing the conduct of advisers, stating: "[t]he Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."<sup>4</sup>

That fiduciary duty, which is a central proposition of the Advisers Act, imposes upon investment advisers the "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading'" their clients.<sup>5</sup> Several obligations flow from an investment adviser's fiduciary duty, as discussed below.

### *Conflicts of Interest*

An investment adviser must act solely for the benefit of its client and must not place itself in a position of conflict with its client. Therefore, an investment adviser that has a material conflict of interest must either refrain from acting upon that conflict, or it must fully disclose to its clients all material facts relating to that conflict, and obtain the informed consent of its clients, before acting upon that conflict.<sup>6</sup> An investment adviser

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and that provide advice to charitable organizations and plans; and commodity trading advisors registered with the Commodity Futures Trading Commission ("CFTC") whose business does not consist primarily of acting as an investment adviser and who does not act as an investment adviser to any registered investment companies or any business development companies. These exemptions are voluntary; advisers eligible for them can nonetheless register with the Commission.

<sup>4</sup> See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963). See also Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

<sup>5</sup> See Capital Gains, *id.* at 194.

<sup>6</sup> See e.g., In the Matter of Kidder Peabody & Co., Inc., Advisers Act Release No. 232 (Oct. 16, 1968) (adviser's failure to disclose that it purchased securities for its family at prices that were generally more favorable than when it purchased the same securities shortly thereafter for its clients) ("Kidder") and In the Matter of Mark Bailey & Co., Advisers Act Release No. 1105 (Feb. 24, 1988) (adviser's failure to disclose its potential conflict of interest between its clients' interest

must not only refrain from effecting, on its own behalf, securities transactions that are inconsistent with its fiduciary obligations; it should also be reasonably certain that persons associated with it are not improperly utilizing the information that they obtain in the conduct of the investment advisory business in a manner likely to adversely affect the interest of clients or limit the adviser's ability to fulfill its fiduciary obligations.<sup>7</sup>

### *Suitability and Reasonable Basis*

Investment advisers owe their clients a duty to provide only suitable investment advice. To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.<sup>8</sup> An adviser must also have a reasonable, independent basis for its recommendations.<sup>9</sup>

### *Best Execution*

Where an investment adviser has the responsibility to direct client brokerage, it has an obligation to seek to obtain best execution of its client's securities transactions.<sup>10</sup> To comply with this duty, an investment adviser must select a broker-dealer to execute securities transactions for each of its clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.<sup>11</sup>

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in obtaining best execution and the adviser's interest in receiving future referrals from the brokerage firm) ("Bailey").

<sup>7</sup> See Adoption of Amendment to Rule 204-2 under the Investment Advisers Act of 1940, Advisers Act Release No. 203 (Aug. 11, 1966).

<sup>8</sup> See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) (in the context of adopting a final rule providing for a nonexclusive safe harbor from the definition of investment company for certain investment advisory programs). See also Suitability of Investment Advice Provided by Investment Advisers, Advisers Act Release No. 1406 (Mar. 16, 1994) (proposing a rule under the Advisers Act's antifraud provisions requiring that advisers give only suitable advice). Although the rule was never adopted, the Commission staff takes the position that the rule would have codified existing suitability obligations of investment advisers and, as a result, the proposed rule reflects the current obligation of investment advisers under the Advisers Act. See also In the Matter of John R. Brick, Advisers Act Release No. 483 (Oct. 24, 1975).

<sup>9</sup> See also In the Matter of Alfred C. Rizzo, Advisers Act Release No. 897 (Jan. 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on the "incredible claims" of the issuer) and In the Matter of Baskin Planning Consultants, Ltd., Advisers Act Release 1297 (Dec. 19, 1991) (investment adviser failed to investigate adequately its recommendations to clients).

<sup>10</sup> See, e.g., Kidder and Bailey, *supra* note 6. See also In the Matter of Delaware Management Company, Inc., Advisers Act Release No. 8128 (July 19, 1968).

<sup>11</sup> See Commission Guidance Regarding the Duties of Investment Company Boards with Respect to Investment Adviser Portfolio Trading Practices, Advisers Act Release No. 2763 (July 30, 2008) at text accompanying footnote 36, citing to Interpretative Release Concerning the Scope of Section

## Additional Related Obligations

The Advisers Act contains other, more specific prohibitions and requirements designed to enforce the investment adviser's fiduciary duty, as discussed below.

### *Client Transactions*

Section 206(3) of the Advisers Act prohibits an adviser, acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client's consent before the completion of the transaction.<sup>12</sup> It also prohibits an investment adviser from knowingly acting as broker for both its advisory client and the party on the other side of the transaction without obtaining its client's consent before each transaction. The Commission has adopted Rule 206(3)-2 under the Advisers Act that permits these agency-cross transactions if the client has given blanket consent in writing and certain other conditions are met.<sup>13</sup>

### *Compliance Program*

Rule 206(4)-7 under the Advisers Act requires each Commission-registered investment adviser to establish a written compliance program that addresses the adviser's performance of its fiduciary and substantive obligations under the Advisers Act, and review the effectiveness of the program at least annually. The adviser must also designate a chief compliance officer to oversee the program. The chief compliance officer must have the authority to develop and enforce appropriate compliance policies and procedures for the adviser.

### *Code of Ethics and Protection of Material Nonpublic Information*

Rule 204(A)-1 requires each Commission-registered investment adviser to adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients. The code of ethics must, among other things, (i) set forth a minimum standard of conduct for the adviser's employees, directors/partners, officers and other supervised persons, (ii) require each of the adviser's access persons (*i.e.*, supervised persons who have access to nonpublic information regarding clients' securities transactions) to report his or her

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28(e) of the Securities Exchange Act and Related Matters, Securities Exchange Act Release No. 23170 (Apr. 23, 1986).

<sup>12</sup> See Interpretation of Section 206(3) of the Advisers Act, Advisers Act Release No. 1732 (July 17, 1998) (identifies a) the points at which an adviser may obtain its client's consent to a principal or agency transaction, and b) certain transactions for which an adviser would not be acting as broker within the meaning of Section 206(3) of the Advisers Act).

<sup>13</sup> Rule 206(3)-2 does not apply to a transaction when the adviser has discretionary authority to act for the purchaser and seller. Paragraph (c) of the Rule admonishes advisers that the Rule does not relieve them of the duty to act in the best interests of their clients, including fulfilling the duty to seek best execution for the transaction.

personal securities transactions and in some cases, seek their preapproval for transactions in IPOs and limited offerings, and (iii) require all supervised persons to promptly report any violations of the code to the adviser's chief compliance officer or other designated person. In addition, each Commission-registered investment adviser is required by Section 204A of the Advisers Act to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information about the adviser's securities recommendations and client securities holdings and transactions.

### *Custody*

Rule 206(4)-2 under the Advisers Act requires Commission-registered investment advisers with custody of client funds or securities to take a number of steps designed to safeguard client assets. For example, the adviser must maintain client funds and securities with "qualified custodians," such as a bank or a broker, and make due inquiry to ensure that the qualified custodian sends account statements directly to the clients. If the qualified custodian is not independent of the investment adviser (*i.e.*, it is a related person), the adviser must obtain, or receive from its related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Accounting Oversight Board.

### *Advertisements*

The antifraud provisions of the Advisers Act apply with respect to both clients and prospective clients. The Commission has adopted Rule 206(4)-1 under the Advisers Act that prohibits any Commission-registered adviser from publishing, circulating, or distributing any advertisement that contains any untrue statement of material fact or is otherwise misleading. The Rule specifically prohibits, among other things, past specific recommendations unless the advertisement also provides a list of all recommendations made by the adviser during the preceding year, and testimonials.

### *Proxy Voting*

An investment adviser that exercises voting authority over client securities is required to vote them in the best interest of the client and not in its own interest. Under Rule 206(4)-7 under the Advisers Act, each Commission-registered investment adviser is also required to: (i) adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes in the clients' best interests; and which must specifically address conflicts of interest that may arise between the adviser and its clients; (ii) describe its policies and procedures to clients and inform them how to obtain a copy, as well as information about the adviser's voting record; and (iii) keep certain records relating to the adviser's voting of client proxies.

### *Disclosure of Financial and Disciplinary Information*

Rule 206(4)-4 under the Advisers Act expressly requires each Commission-registered investment adviser to disclose to clients and prospective clients all legal or disciplinary events that are material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients. The Rule also requires that an investment adviser that has discretionary authority (express or implied), or custody over a client's assets, or that requires prepayment of more than \$500 in fees per client (six months or more in advance) to disclose material facts that may impair the ability of the investment adviser to meet its contractual commitments to its clients. A Commission-registered investment adviser that has custody of a client's assets, or requires prepayment 6 or more months in advance of more than \$500 in fees from its clients, also must provide a balance sheet as an exhibit to its Form ADV.

### *Use of Solicitors*

Each Commission-registered investment adviser generally is prohibited from paying a cash fee, directly or indirectly, to a "solicitor" (any person who solicits any client or prospective client for, or refers any client or prospective client to, the adviser) unless the arrangement complies with a number of conditions imposed by Rule 206(4)-3 under the Advisers Act, including the delivery by the solicitor of a statement describing its solicitation activities and the compensation it will receive. The adviser has an obligation to supervise the activities of solicitors.

### **III. Broker-Dealer Standard of Conduct**

Section 15(a) of the Securities Exchange Act of 1934 ("Securities Exchange Act") generally requires brokers or dealers<sup>14</sup> that effect securities transactions, or that induce or attempt to induce the purchase or sale of securities, to register with the SEC, absent an exception or exemption. In addition, broker-dealers are required to become members of at least one SRO,<sup>15</sup> and (with few exceptions) the Securities Investor Protection Corporation ("SIPC"). Generally, all registered broker-dealers that deal with the public must become members of the Financial Industry Regulatory Authority, Inc. ("FINRA"), a registered national securities association, and may also choose to become exchange members.<sup>16</sup> Broker-dealers must also comply with applicable state registration and qualification requirements.

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<sup>14</sup> The Securities Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," and a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." Securities Exchange Act Section (3)(a)(4)(A) and Section (3)(a)(5)(A).

<sup>15</sup> Securities Exchange Act Section 15(b)(8) and Securities Exchange Act Rule 15b9-1.

<sup>16</sup> Securities Exchange Act Section 15(b)(8) and Securities Exchange Act Rule 15b9-1. FINRA was created in 2007 as a result of a merger between the National Association of Securities Dealers ("NASD"), a national securities association established to regulate broker-dealers in the over-the-

In addition, a broker-dealer generally must register each natural person who is an associated person,<sup>17</sup> other than those persons whose functions are solely clerical or ministerial, with one or more SROs.<sup>18</sup> An associated person who effects or participates in effecting securities transactions also must meet qualification requirements, which may include passing a securities qualification exam.<sup>19</sup>

### Business Conduct Obligations

Broker-dealers are subject to a comprehensive set of statutory, Commission and SRO requirements that are designed to promote business conduct that, among other things, protects investors from abusive practices. These business conduct obligations cannot be waived or contracted away by customers. The following is an overview of certain of these business conduct requirements.

#### *Duty of Fair Dealing*

The antifraud provisions of the Securities Exchange Act broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.<sup>20</sup> One provision,

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counter market, and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (“NYSE”).

Generally, FINRA’s authority is limited to enforcing the Securities Exchange Act and rules thereunder, Municipal Securities Rulemaking Board (“MSRB”) rules, and FINRA rules. FINRA does not generally exercise regulatory oversight with respect to the advisory side of a broker-dealer that is also registered as an investment adviser (with either the Commission or the states).

<sup>17</sup> The Securities Exchange Act defines an “associated person” of a broker-dealer as any partner, officer, director, or branch manager or employee of a broker-dealer, any person performing similar functions, or any person controlling, or controlled by, or under common control with, the broker-dealer. See Section 3(a)(18). However, an “associated person” does not include any such person whose functions are solely clerical or ministerial. Id.

<sup>18</sup> See Securities Exchange Act Section 15(b)(1) and (b)(2), and Securities Exchange Act Rule 15b-7-1. See also NASD IM-1000-3 Failure to Register Personnel; NASD Rule 1013 (“New Member Application and Interview”), NASD Rule 1021 (“Registration Requirements”); NASD Rule 1031 (“Registration Requirements”); NASD Rule 1041 (“Registration Requirements for Assistant Representatives”).

<sup>19</sup> See NASD Rule 1021 (“Registration Requirements”); NASD Rule 1031 (“Registration Requirements”); NASD Rule 1041 (“Registration Requirements for Assistant Representatives”).

<sup>20</sup> Securities Exchange Act Sections 10(b) and 15(c). See also Exchange Act Section 9(a). Broker-dealers may also be held liable under Section 17(a) of the Securities Act of 1933 if “in the offer or sale” of any securities, the broker-dealer (1) employs any device, scheme, or artifice to defraud, (2) obtains money or property by means of any untrue statement of a material fact or any omission to state a material fact, or (3) engages in any practice which operates as a fraud or deceit upon the purchaser.



Section 15(c) of the Securities Exchange Act, prohibits any broker or dealer from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under this prohibition, broker-dealers are precluded from making material omissions or misrepresentations and from any act, practice, or course of business that constitutes a manipulative, deceptive, or other fraudulent device or contrivance.<sup>21</sup>

The antifraud provisions of the federal securities laws also require broker-dealers to deal fairly with their customers.<sup>22</sup> Under the so-called “shingle” theory, by virtue of engaging in the brokerage profession (*e.g.*, hanging out the broker-dealer’s business sign, or “shingle”), a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.<sup>23</sup> This essential representation implies certain duties and proscribes certain conduct, which has been articulated by the Commission and courts over time through interpretive statements and enforcement actions.<sup>24</sup>

Broker-dealers are also required under SRO rules to deal fairly with customers and to “observe high standards of commercial honor and just and equitable principles of trade.”<sup>25</sup> This includes having a reasonable basis for recommendations in light of customer financial situation to the extent known to the broker (suitability),<sup>26</sup> engaging in fair and balanced communications with the public,<sup>27</sup> providing timely and adequate

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<sup>21</sup> See Securities Exchange Act Rules 10b-3, 15c1-2, and 15c1-3. These rules and Securities Exchange Act Section 15(c) mirror Section 10(b) and Rule 10b-5 thereunder, but expressly apply to broker-dealers.

<sup>22</sup> See SEC, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, at 238 (1st Sess. 1963); Richard N. Cea, 44 S.E.C. 8, 18 (1969) (involving excessive trading and recommendations of speculative securities without a reasonable basis); Mac Robbins & Co., 41 S.E.C. 116 (1962) (involving “boiler-room” sales tactics of speculative securities).

<sup>23</sup> Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944) (although not expressly referencing the “shingle theory,” held that broker-dealer was under a “special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers’ ignorance of market conditions”; failure to disclose substantial mark-ups on OTC securities sold to unsophisticated customers thus constituted fraud).

<sup>24</sup> See supra note 22.

<sup>25</sup> See FINRA Rule 2010 (“Standards of Commercial Honor and Principles of Trade”); NASD Interpretive Material (“IM”) 2310-2 (“Fair Dealing with Customers”) (“Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association’s Rules, with particular emphasis on the requirement to deal fairly with the public.”).

<sup>26</sup> See, *e.g.*, NASD Rule 2310 (“Recommendations to Customers (Suitability)”).

<sup>27</sup> See NASD Rule 2210(d) (“Communications with the Public”).

confirmation of transactions,<sup>28</sup> providing account statements,<sup>29</sup> disclosing conflicts of interest,<sup>30</sup> and receiving fair compensation both in agency and principal transactions.<sup>31</sup> Some of these duties are discussed in more detail below.

Further, the Commission has held that FINRA's authority to enforce "just and equitable principles of trade" permits FINRA to sanction member firms and associated persons for a broad range of unlawful or unethical activities, including those that do not implicate "securities." For example, the Commission has approved FINRA disciplinary actions involving conduct related to insurance applications<sup>32</sup> and premiums,<sup>33</sup> tax shelters,<sup>34</sup> the general entrepreneurial activity of member firms,<sup>35</sup> a registered representative's forgery of an executive's signature,<sup>36</sup> a member firm employee's improper use of a co-worker's credit card,<sup>37</sup> a registered representative and associated person's request and receipt of reimbursement for expenses not incurred,<sup>38</sup> and a registered representative's misuse of a member firm's charitable donation matching gifts program.<sup>39</sup>

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<sup>28</sup> See, e.g., Securities Exchange Act Rule 10b-10 (confirmation of transactions); MSRB Rule G-15 (confirmation of transactions); NASD Rule 2230 ("Confirmations").

<sup>29</sup> See, e.g., Securities Exchange Act Rule 15c3-2 (account statements); NASD Rules 2340 ("Customer Account Statements"). See also Securities Exchange Act Rule 10b-16 (disclosure of credit terms in margin transactions); Rule 606 of Regulation NMS (disclosure of order routing information). These disclosure requirements, together with the trade confirmation, allow a customer to keep track of his or her assets held at the broker-dealer as well as provide customers with information regarding best execution, order-handling, and the broker-dealer's own financial condition, so that the customer has the necessary information to determine whether he or she should continue to do business with the broker-dealer.

<sup>30</sup> See, e.g., NASD Rule 2720 ("Public Offerings of Securities With Conflicts of Interest"); NASD Rule 3040 ("Private Securities Transactions of an Associated Person").

<sup>31</sup> See, e.g., NASD Rule 2440 ("Fair Prices and Commissions"); FINRA Rule 5110(c). Similarly, a broker-dealer's charges and fees for services performed must be "reasonable" and "not unfairly discriminatory between customers." See NASD Rule 2430.

<sup>32</sup> In the Matter of Thomas E. Jackson, 45 S.E.C. 771 (1975).

<sup>33</sup> In the Matter of Ernest A. Cipriani, Jr., 51 S.E.C. 1004 (1994).

<sup>34</sup> In the Matter of Daniel C. Adams, 47 S.E.C. 919 (1983).

<sup>35</sup> In the Matter of DWS Securities, 51 S.E.C. 814 (1993).

<sup>36</sup> In the Matter of Mark F. Mizenko, Securities Exchange Act Release No. 52600 (Oct. 15, 2005); In the Matter of Eliezer Gurfel, Securities Exchange Act Release No. 41229 (Mar. 30, 1999).

<sup>37</sup> In the Matter of Daniel D. Manoff, Securities Exchange Act Release No. 46708 (Oct. 23, 2002).

<sup>38</sup> In the Matter of Leonard John Ialeggio, Securities Exchange Act Release No. 37910 (Oct. 31, 1996).

<sup>39</sup> In the Matter of James A. Goetz, Securities Exchange Act Release No. 39796.

### *Fiduciary Duty*

A broker-dealer may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state.<sup>40</sup> This has led courts to reach different conclusions with respect to the facts that create a fiduciary relationship between a broker-dealer and its customer. Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a broad fiduciary duty, similar to that of investment advisers.<sup>41</sup> Thus, even for nondiscretionary accounts, broker-dealers may have fiduciary duties with respect to the limited matters entrusted to their discretion.<sup>42</sup>

In those instances where a broker-dealer is not subject to a fiduciary duty, it remains subject to the business conduct requirements discussed herein.

### *Suitability*

As noted above, a central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are in the best interests of his customer.<sup>43</sup> The concept of suitability appears in

<sup>40</sup> See Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215 (8<sup>th</sup> Cir. 1990).

<sup>41</sup> See, e.g., U.S. v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account"); United States v. Szur, 289 F.3d 200, 211 (2d Cir. 2002) ("Although it is true that there 'is no general fiduciary duty inherent in an ordinary broker/customer relationship,' a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.") (citations omitted); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), aff'd, 647 F.2d 165 (6<sup>th</sup> Cir. 1981) (recognizing that a broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature); Assoc. Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7<sup>th</sup> Cir. 1993) (broker is not fiduciary "with respect to accounts over which the customer has the final say"); MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc., 886 F.2d 1249, 1257 (10<sup>th</sup> Cir. 1989) (fiduciary relationship exists under Oklahoma law "where trust and confidence are placed by one person in the integrity and fidelity of another"); Arleen W. Hughes, Securities Exchange Act Release No. 4048, 27 S.E.C. 629 (Feb. 18, 1948) (Commission Opinion), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (broker-dealer is fiduciary where she created relationship of trust and confidence with her customers); Paine Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986); Cheryl Goss Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 J. Corp. L. 65 (1997). Restatement (Second) of Torts § 874 cmt. a (1979) ("A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.").

<sup>42</sup> See Press v. Chemical Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999) ("the fiduciary relationship that arises between a broker and a customer as a matter of New York common law is limited to matters relevant to the affairs entrusted to the broker.").

<sup>43</sup> See, e.g., Raghavan Sathianathan, Securities Exchange Act Release No. 54722, 2006 SEC LEXIS 2572, at \*21 (Nov. 8, 2006) ("As we have frequently stated, a broker's recommendations must be consistent with his customers' best interests."); see also Dane S. Faber, Securities Exchange Act

specific SRO rules<sup>44</sup> and has also been interpreted as an obligation under the antifraud provisions of the federal securities laws.<sup>45</sup>

The antifraud provisions of the federal securities laws and the implied obligation of fair dealing thereunder prohibit broker-dealers from, among other things, making unsuitable recommendations and require broker-dealers to investigate an issuer before recommending the issuer's securities to a customer.<sup>46</sup> The fair dealing obligation also requires the broker-dealer to reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances (customer-specific suitability).<sup>47</sup> Obtaining a customer's consent to an unsuitable transaction does not relieve a broker-dealer of his obligation to make only suitable recommendations.<sup>48</sup>

In general, there are two approaches to suitability that have developed under both U.S. case law and FINRA and Commission enforcement actions – “reasonable basis” suitability and “customer-specific” suitability. Under reasonable basis suitability, a broker-dealer has an affirmative duty to have an “adequate and reasonable basis” for any

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Release No. 49216, 2004 SEC LEXIS 277, at \*23-24 (2004) (stating that a broker's recommendations “must be consistent with his customer's best interests, and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation”); Powell & McGowan, Inc., 41 S.E.C. 933, 935 (1964) (a broker has “an obligation not to recommend a course of action clearly contrary to the best interests of the customer”).

<sup>44</sup> FINRA members' suitability obligations are set out in NASD Rule 2310, “Recommendations to Customers (Suitability),” and NASD IMs, specifically, IM 2310-1 (“Possible Application of SEC Rules 15g-1 through 15g-9”), 2310-2 (“Fair Dealing with Customers”), and 2310-3 (“Suitability Obligations to Institutional Customers”), as applicable.

<sup>45</sup> See Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); see also Securities Exchange Act Release No. 26100, at n. 75 (Sept. 22, 1988), 53 Fed. Reg. 37778 (Sept. 28, 1988).

<sup>46</sup> See Hanly, 415 F.2d 589; see also Securities Exchange Act Release No. 26100, supra note 45.

<sup>47</sup> See Richard N. Cea, Securities Exchange Act Release No. 8662 (Aug. 6, 1969); F.J. Kaufman and Co., Securities Exchange Act Release No. 27535 (Dec. 13, 1989).

<sup>48</sup> See, e.g., Clinton Hugh Holland, Jr., 52 S.E.C. 562, 566 (1995) (“Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations.”), aff'd, 105 F.3d 665 (9th Cir. 1997) (table format); John M. Reynolds, 50 S.E.C. 805, 809 (1992) (regardless of whether customer wanted to engage in aggressive and speculative trading, representative was obligated to abstain from making recommendations that were inconsistent with the customer's financial condition); Eugene J. Erdos, 47 S.E.C. 985, 989 (1983) (citing Philips & Company, 37 S.E.C. 66, 70 (1956)) (“[W]hether or not [the customer] considered the transactions in her account suitable is not the test for determining the propriety of [the registered representative's] conduct. The proper test is whether [the representative] ‘fulfilled the obligation he assumed when he undertook to counsel [the customer], of making only such recommendations as would be consistent with [the customer's] financial situation and needs.’”).

recommendation that it makes.<sup>49</sup> A broker-dealer, therefore, has the obligation to investigate and have adequate information about the security it is recommending. Under customer-specific suitability, a broker-dealer must make recommendations based on a customer's financial situation and needs as well as other security holdings, to the extent known.<sup>50</sup> This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations<sup>51</sup> and to keep such information current.<sup>52</sup>

Specific suitability, disclosure, and due diligence requirements apply to certain securities products, including penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, variable insurance products, and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds. Activities such as excessive trading, churning, and switching by themselves also can violate obligations under the SRO suitability rules and federal

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<sup>49</sup> See F.J. Kaufman and Co., 50 S.E.C. 164, 1989 WL 259961 (1989) (finding that the broker's recommendations violated suitability requirements because the broker did not have a reasonable basis for the strategy he recommended, wholly apart from any considerations relating to the particular customer's portfolio). See also, Hanly, 415 F.2d at 597; In re Walston & Co., Securities Exchange Act Rel. No. 8165, 43 S.E.C. 508, 1967 WL 87755 (1967); Michael F. Siegel, 2007 NASD Discip. LEXIS 20 (2007).

<sup>50</sup> See Richard N. Cea, Securities Exchange Act Release No. 8662 (Aug. 6, 1969); F.J. Kaufman and Co., Securities Exchange Act Release No. 27535 (Dec. 13, 1989); NASD Rule 2310 (requiring that members "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"). See also, In re Luis Miguel Cespedes, Securities Exchange Act Release No. 59404 (Feb. 13, 2009); In re Maughan, NYSE Disc. Dec., 2004 WL 1801597 (2004); Dep't of Enforcement v. Stein, NASD Disc. Dec., 2001 WL 156957 (2001); In re Glenzer, NYSE Disc. Dec., 1994 WL 721660 (1994).

<sup>51</sup> See NASD Rule 2310.

Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, 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.

Id. See also Gerald M. Greenberg, 40 S.E.C. 133 (1960) (holding that a broker cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer's financial situation entirely).

A broker-dealer's suitability obligations are different for institutional customers than for non-institutional customers. NASD IM-2310-3 sets out factors that are relevant to the scope of a broker-dealer's suitability obligations in making recommendations to an institutional customer.

<sup>52</sup> Securities Exchange Act Rule 17a-3(a)(17)(i) requires, subject to certain exceptions, broker-dealers to update customer records, including investment objectives, at least every 36 months.

antifraud provisions. Moreover, considerations related to suitability may be raised with regard to specific types of accounts such as discretionary accounts and day trading accounts.

*Conflicts of Interest: Disclosure*

Under the antifraud provisions, when recommending a security, broker-dealers and registered representatives have a duty to disclose any material adverse facts or material conflicts of interest, including any economic self-interest, so that customers may evaluate their overlapping motivations.<sup>53</sup> For example, in making recommendations, broker-dealers have been required to disclose the following: acting as a market maker for the recommended security;<sup>54</sup> trading as principal with respect to the recommended security;<sup>55</sup> revenue sharing with respect to a recommended mutual fund;<sup>56</sup> and “scalping” a recommended security.<sup>57</sup> In addition, if a broker-dealer recommends mutual funds with different classes, it must disclose the various class expenses and fees and how they will impact the expected return on investment.<sup>58</sup>

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<sup>53</sup> See Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970); SEC v. Hasho, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992).

<sup>54</sup> See Chasins, 438 F.2d at 1172 (applying shingle theory, court found broker-dealer impliedly represents that it will disclose market making capacity).

<sup>55</sup> If a broker-dealer recommends a security to a customer, and proposes to sell such security from the broker-dealer’s own account, then the broker-dealer must disclose all material facts. See Arleen W. Hughes, Securities Exchange Act Release No. 4048, 27 S.E.C. 629 (Feb. 18, 1948) (Commission opinion), aff’d sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (where broker-dealer acts as principal, it must disclose cost of securities and the best price obtainable on the open market);

<sup>56</sup> Revenue sharing occurs where a broker-dealer is paid by a mutual fund in exchange for promoting the funds to the broker-dealer’s customers. When a broker-dealer makes a recommendation of a mutual fund with which it has a revenue sharing arrangement, it must disclose this to the customer because it is information about the bias of the investment advice. See In re AIG Advisor Group, 2007 WL 1213395, at \*7-9 (E.D.N.Y. Apr. 25, 2007), aff’d, 390 Fed. Appx. 495 (2d Cir. 2009) (where broker-dealer received payments in form of revenue sharing and directed brokerage from mutual funds in exchange for recommending the funds to customers, omissions concerning such conflicts of interest are not immaterial as a matter of law).

<sup>57</sup> Scalping is the practice “whereby the owner of a security recommends that security for investment and then immediately sells it at a profit upon the rise in the market price which follows the recommendation.” SEC v. Huttoe, 1998 WL 34078092, at \*7 (D.D.C. Sept. 14, 1998). Failure to disclose such activity is a violation of Securities Exchange Act Rule 10b-5. See SEC v. Park a/k/a Tokyo Joe, 99 F. Supp. 2d 889, 899-900 (N.D. Ill. 2000) (holding that a scalper must “disclose his interest in the targeted stock”).

<sup>58</sup> See, e.g., Michael Flanagan, Securities Exchange Act Release No. 49979, 83 S.E.C. 734 (2004) (legal theory that respondents committed fraud by failing to disclose fully the difference between Class A and Class B shares of mutual funds has substantial justification); J. Michael Scarborough, Securities Exchange Act Release No. 49982, 2004 SEC LEXIS 1450 (2004) (settled order) (respondent failed to disclose that Class A shares generally produce higher returns than Class B shares when purchased in amounts of \$100,000 or more).

Moreover, Securities Exchange Act Rule 10b-10 requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities<sup>59</sup>) to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third party remuneration it has received or will receive.<sup>60</sup> Among other things, such information allows customers to verify the terms of their transactions, alerts customers to potential conflicts of interest, and serves as a safeguard against fraudulent conduct by the broker-dealer.<sup>61</sup>

Securities Exchange Act Rules 15c1-5 and 15c1-6 also require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or the issuer of such security.<sup>62</sup>

The Commission and the SROs have also adopted rules designed to address conflicts of interest that can arise when security analysts recommend equity securities in research reports and public appearances.<sup>63</sup> By requiring certain certifications and disclosures, these rules are intended to promote the integrity of research reports and investor confidence in those reports and analyst public appearances.

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Merely providing the customer with a prospectus may not discharge this duty. See, e.g., IFG Network Securities, Inc., Securities Exchange Act Release No. 54127, 88 S.E.C. 1195 (2006) (failure to make full disclosure as to the differences in cost structures between the two classes of stock made his recommendations to invest in Class B shares misleading). But see Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 606-9 (6<sup>th</sup> Cir. 2005) (given that all information necessary to compare different class shares was in prospectus, alleged omissions—e.g., that over certain levels, investments in Class B shares would always result in lower returns than Class A—were not material).

<sup>59</sup> MSRB rule G-15 requires similar disclosures from municipal securities brokers and dealers.

<sup>60</sup> See Securities Exchange Act Rule 10b-10. Rule 10b-10 is not a safe harbor from the antifraud provisions. Rule 10b-10, Preliminary Note; see, e.g., Edward D. Jones & Co., L.P., Securities Exchange Act Release No. 50910 (Dec. 22, 2004) (failure to disclose nature and extent of conflict of interest violates Section 17(a)(2) of the Securities Act of 1933; Morgan Stanley DW, Inc., Securities Exchange Act Release No. 48789 (Nov. 17, 2003) (same).

<sup>61</sup> In addition, prior to effecting a penny stock transaction, a broker-dealer generally is required to provide certain disclosures, including the aggregate amount of any compensation received by the broker-dealer in connection with such transaction; and the aggregate amount of cash compensation that any associated person of the broker-dealer has received or will receive from any source in connection with the transaction. See Securities Exchange Act Rules 15g-4 and 15g-5.

<sup>62</sup> SROs require similar disclosures. See, e.g., NASD Rules 2240 and 2250; MSRB Rule G-22; NYSE Rule 312(f).

<sup>63</sup> See Regulation Analyst Certification, or Regulation AC; see also NASD Rule 2711 and NYSE Rule 472.

### *Conflicts of Interest: Prohibited or Restricted Conduct*

The federal securities laws and FINRA rules restrict members from participating in certain transactions that may present particularly acute potential conflicts of interest. For example, FINRA rules generally limit how a member may participate in the public offering of its own or its affiliates' public debt or equity securities.<sup>64</sup>

Moreover, the Commission's Regulation M generally precludes persons having an interest in an offering (such as an underwriter or broker-dealer and other distribution participants) from engaging in specified market activities during a securities distribution.<sup>65</sup> These rules are intended to prevent such persons from artificially influencing or manipulating the market price for the offered security in order to facilitate a distribution.<sup>66</sup>

Pursuant to Section 11(a) of the Securities Exchange Act, broker-dealers generally cannot effect transactions on exchanges for their own accounts, the accounts of their associated persons, or accounts that they or their associated persons manage, except under certain conditions.<sup>67</sup>

Under Securities Exchange Act Section 11(d)(1), any person that is both a broker and a dealer is also prohibited from extending credit on "new issue" securities if the broker-dealer participated in the distribution of the new issue securities within the preceding 30 days. This prohibition addresses sales practice abuses deriving from conflicts of interests by preventing broker-dealers from disposing of undesirable "sticky issues" by extending easy credit terms to customers, or using easy credit terms to create the appearance of high demand for an offering to facilitate distribution.

Furthermore, Section 15(f) of the Securities Exchange Act requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the firm or its associated persons from misusing material non-public information (i.e., insider trading).

### *Duty of Best Execution*

Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers also have a legal duty to seek to obtain best execution of customer

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<sup>64</sup> See NASD Rule 2720.

<sup>65</sup> See Regulation M, Securities Exchange Act Release 38067 (Apr. 1, 1997).

<sup>66</sup> Id.

<sup>67</sup> Exceptions from this general prohibition include transactions by market makers, bona fide hedge transactions, bona fide arbitrage transactions, transactions made to offset transactions made in error, transactions routed through other members, and transactions that yield to other orders.



orders.<sup>68</sup> The duty of best execution requires broker-dealers to seek to execute customers' trades at the most favorable terms reasonably available under the circumstances.<sup>69</sup> When engaging in transactions directly with customers on a principal basis, a broker-dealer violates Securities Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups, without disclosing the fact to the customer.<sup>70</sup>

### *Communications with the Public*

Broker-dealers must ensure that their communications with the public are not misleading under the federal securities laws. In addition, FINRA has detailed rules that address broker-dealers' communications with the public and specifically require broker-dealer communications to be based on principles of fair dealing and good faith and to be fair and balanced.<sup>71</sup> For example, communications with the public must include material facts and qualifications, must not exaggerate or include misleading statements, and must not predict or project performance. FINRA rules also establish disclosure requirements for advertisements and sales literature.

In certain circumstances, communications with the public must be approved by a registered principal of the broker-dealer before distribution to the public. Generally, a registered principal must approve each advertisement, item of sales literature and independently prepared reprint prior to the earlier of its use or filing with FINRA. Moreover, certain broker-dealer communications with the public must be filed with FINRA for approval.<sup>72</sup> All communications with the public must be maintained in the broker-dealer's records.

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<sup>68</sup> See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-270 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); In re Arleen Hughes, 27 S.E.C 629, 636 (1948), aff'd sub nom., Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). See also Regulation NMS, Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("Regulation NMS Release"); NASD Rule 2320 ("Best Execution and Interpositioning").

<sup>69</sup> See Regulation NMS Release.

<sup>70</sup> See, e.g., Grandon v. Merrill Lynch & Co., 147 F.3d 184, 189-90 (2d Cir. 1998).

<sup>71</sup> See NASD Rule 2210(d).

<sup>72</sup> NASD Rule 2210(c)(8) exempts from the rule's filing requirements institutional sales material (i.e., any communication that is distributed or made available only to institutional investors).

## Additional Related Obligations

Broker-dealers are also subject to a variety of requirements under the federal securities laws and SRO rules that enhance the business conduct obligations discussed above. The following is a brief overview of some of these requirements.

### *Books and Records*

Commission and SRO books and records rules help to ensure that regulators can access information regarding broker-dealer trading activity, to examine for compliance with sales practice and other obligations. Section 17(a)(1) of the Securities Exchange Act requires registered broker-dealers to make and keep for prescribed periods reports the Commission deems “necessary or appropriate in the public interest, for the protection of investors.” Securities Exchange Act Rules 17a-3 and 17a-4 specify minimum requirements with respect to the records that broker-dealers must make (e.g., order tickets, purchase and sale blotters, account ledgers, and customer confirmations), and how long those records and other documents must be kept.

### *Financial Responsibility*

Broker-dealers must meet certain financial responsibility requirements, including maintaining minimum amounts of liquid assets (“net capital”); safeguarding customer funds and securities held by the broker as required by the “customer protection rule”; complying with margin requirements; filing periodic reports, including quarterly and annual financial statements; notifying the Commission and the appropriate SRO of operational or financial difficulties, and in some cases filing reports regarding those problems; and maintaining certain books and records.<sup>73</sup> As noted above, broker-dealers (with few exceptions) are also required to be members of SIPC which protects their customers from loss of their cash and securities up to specified limits if the broker-dealer becomes insolvent.

### *Supervision*

The Securities Exchange Act authorizes the Commission to sanction a firm or any associated person that fails to reasonably supervise another person subject to the firm’s or the person’s supervision that commits a violation of the federal securities laws.<sup>74</sup>

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<sup>73</sup> See, e.g., Securities Exchange Act Rules 15c3-1 (the “net capital rule”) and 15c3-3 (the “customer protection rule”); Securities Exchange Act Section 7(a) (prohibiting broker-dealers from, directly or indirectly, extending or maintaining credit or arranging for the extension or maintenance to or for any customer in contravention of the rules and regulations prescribed by the Board of Governors of the Federal Reserve System (“FRB”) and without collateral or on any collateral other than in accordance with the rules promulgated by the FRB); 12 CFR 220.1–220.12 (FRB’s Regulation T); Incorporated Rule NYSE Rule 431 (Margin Requirements); NASD Rule 2520 (“Margin Requirements”); Securities Exchange Act Rules 17a-3, 17a-4, 17a-5, 17a-11, and 17a-13.

<sup>74</sup> Securities Exchange Act Sections 15(b)(4)(E) and (b)(6)(A).

Generally, broker-dealers must establish policies and procedures (and systems for implementing and monitoring compliance with such procedures), that are reasonably designed to prevent and detect violations of the federal securities laws and regulations, as well as applicable SRO rules.<sup>75</sup>

Specifically, NASD Rule 3010 requires firms to establish and maintain systems to supervise the activities of their registered representatives, principals and other associated persons for purposes of achieving compliance with applicable securities laws and NASD rules. In addition, NASD Rule 3012 requires each member firm to have a system of supervisory control policies and procedures to test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and NASD rules.<sup>76</sup> FINRA rules also generally require supervision of outside business activities and private securities transactions by associated persons of members.<sup>77</sup>

In addition FINRA rules require broker-dealers to designate one or more principals to serve as CCO.<sup>78</sup> At least annually, the CCO must meet with the broker-dealer's chief executive officer ("CEO") to discuss the compliance program, and the CEO must certify that, among other things, the firm has in place processes to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.<sup>79</sup>

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<sup>75</sup> See, e.g., Securities Exchange Act Sections 15(b)(4)(E) and (b)(6)(A); In re Kirkpatrick, Pettis, Smith, Polican Inc., et al, Securities Exchange Act Release No. 48748 (Nov. 5, 2003); NASD Rule 3010 and 3012; NASD Notice to Members 99-45, NASD Provides Guidance on Supervisory Responsibilities (June 1999); NASD Notice to Members 98-38, NASD Reminds Members of Supervisory and Inspection Obligations (May 1998); NASD Notice to Members 86-65, Compliance with the NASD Rules of Fair Practice (Sept. 1986). See also, Incorporated NYSE Rule 342.

<sup>76</sup> NASD Rule 3012 also requires the designation and identification of one or more principals who shall establish, maintain, and enforce a system of such supervisory control policies and procedures. At least annually, the designated principal(s) must submit to senior management a report detailing the 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.

<sup>77</sup> See NASD Rule 3040; NASD Rule 3030; and NYSE Rule 346(b). In addition, private securities transactions of an associated person may be subject to an analysis under Securities Exchange Act Section 10(b) and Rule 10b-5, as well as the broker-dealer supervisory provisions of Section 15(f) and Section 15(b)(4)(E), and other relevant statutory or regulatory provisions.

<sup>78</sup> FINRA Rule 3130(a).

<sup>79</sup> See FINRA Rule 3130(b) and (c).

### *Employee Competency and Character Standards*

As part of the registration process, associated persons of broker-dealers who effect or participate in effecting securities transactions must satisfy certain qualification requirements set forth in FINRA rules, which may include passing one or more examinations administered by FINRA to demonstrate competence in the areas in which they will work.<sup>80</sup> Registered persons are also required to comply with continuing education requirements.<sup>81</sup>

Individuals who have engaged in specified “bad acts” are subject to a “statutory disqualification” and must undergo a regulatory review before being permitted to become associated with a broker-dealer or being granted membership in an SRO.<sup>82</sup> This process, which encompasses reviews first by the appropriate SRO and subsequently by the Commission,<sup>83</sup> is designed to prevent individuals who present a higher risk of doing harm to investors from entering the business and to ensure that such individuals are subject to appropriate safeguards (*e.g.*, enhanced supervision or limitations on the scope of their activities) if they are permitted to enter the business.

### *Customer Complaints and Disclosure of Disciplinary Information*

Broker-dealers must (1) maintain a record for each written customer complaint received regarding an associated person, including the disposition of the complaint, and (2) maintain a record indicating that each customer has been provided with a notice with the address and telephone number to which complaints may be directed.<sup>84</sup> SRO rules require broker-dealers to document and respond to all customer complaints.<sup>85</sup>

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<sup>80</sup> See generally NASD Rule 1000 Series.

<sup>81</sup> NASD 1120.

<sup>82</sup> See Section 3(a)(39) of the Securities Exchange Act. A wide range of disciplinary events subjects a person to statutory disqualification, including convictions for any felony or certain enumerated misdemeanors within the last ten years; temporary or permanent injunctions from violating the securities laws issued by a court of competent jurisdiction; or bars from association with a broker-dealer by the Commission, the CFTC, or an SRO.

<sup>83</sup> Those persons who are subject to statutory disqualification, but wish to enter or re-enter the industry, must apply to the SRO under procedures adopted pursuant to the Securities Exchange Act. If the SRO determines that it would be in the public interest to permit the individual to work as proposed with one of its members, it formally notifies the Commission. See Sections 6(c)(2) and 15A(g)(2) of the Securities Exchange Act and Rule 19h-1 under the Securities Exchange Act. The Commission then has the opportunity to review the SRO’s determination, and if necessary, to direct that the SRO not permit the proposed association.

<sup>84</sup> Securities Exchange Act Rule 17a-3(a)(18).

<sup>85</sup> See *e.g.*, Incorporated NYSE Rule 401A. Broker-dealers also must report to the SROs certain specified events related to customer complaints, as well as statistical and summary information on customer complaints. See NASD Rule 3070; Incorporated NYSE Rule 351(d).

In addition, Forms BD and U4, which are used to register broker-dealers and the natural persons who are associated persons of a broker-dealer, respectively, are also used to disclose certain information regarding the applicant.<sup>86</sup> For example, Form BD requires the applicant to disclose whether it or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity. Form U4 requires disclosure of disciplinary actions, other sanctions that are deemed “statutory disqualifications,” as well as certain customer complaints. This information is made publicly available through FINRA’s BrokerCheck system.

### *Use of Solicitors*

Receipt of placement or finder fees by an individual in connection with the purchase and sale of securities typically requires association with a registered broker-dealer.<sup>87</sup> Registration helps to ensure that persons who have a “salesman’s stake” in a securities transaction operate in a manner that is consistent with customer protection standards governing broker-dealers and their associated persons.<sup>88</sup>

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<sup>86</sup> Broker-dealers and registered representatives must keep their respective Form BD or Form U4 current by amending it promptly when changes occur.

<sup>87</sup> Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 From Broker-Dealer Registration, Securities Exchange Act Release No. 61884 (Apr. 9, 2010) (hereinafter “Maiden Lane Exemptive Order”) (citations omitted) (“[T]he receipt of transaction based compensation often indicates that [] a person is engaged in the business of effecting transaction in securities.”).

<sup>88</sup> See Maiden Lane Exemptive Order, *quoting* Rule 3a4-1 Adopting Release (“Compensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation under the Act.”).