Chapter 52

Private Banking and Wealth Management

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§ 52:1 Broker-Dealer Regulation of Private Banking and Wealth Management

§ 52:1.1 Overview: "Standard of Care" for Securities Recommendations to Non-Institutional Investors

The broker-dealer "standard of care" is a suitability standard. This means that recommended transactions must be suitable for the customer, taking into account the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other information the customer may disclose to the member or associated person in connection with such recommendation. This "suitability" standard is

sometimes viewed as, or purported to be, a lower standard than a fiduciary standard (which applies to recommendations of investment advisers, banks acting in a fiduciary capacity, and which under the Employee Retirement Income Security Act of 1974 (ERISA), may apply to certain accounts). Under the suitability standard, the recommended transaction does not necessarily have to be the best one possible for the client, or free from conflicts of interest, but the specific transaction does nonetheless need to be suitable for the specific customer. (Differences between a suitability standard and a fiduciary standard are described below.)

The Financial Industry Regulatory Authority, Inc. (FINRA) pays close attention to sales of certain asset classes to retail investors, including structured notes, funds of hedge funds, securitized products, and leveraged exchange traded funds (ETFs). These tend to be securities and asset classes that are perceived to be more complex. Suitability determinations for each sale do not generally need to be documented, but firms sometimes do so where there is elevated risk. The relevant rule is FINRA Rule 2111 (Suitability).

The SEC has recently proposed major changes to the broker-dealer standard of care in dealing with retail customers.

FINRA has noted that financial compensation of registered representatives can be a major source of conflicts of interest that may influence registered representatives of broker-dealers to behave in ways that affect customer interests negatively. FINRA has noted in its 2013 Report on Conflicts of Interest (the "FINRA Conflicts Report"[1]) that it is a best practice to:

- Use neutral compensation grids that do not favor particular products; and
- Monitor activity of registered representatives approaching compensation thresholds.

FINRA also noted that conflicts may arise in recommending the type of account that a customer should open with a firm. For example, a firm that is dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer. The relevant rules are FINRA Rule 2010 (Just and Honorable Principles of Trade) and FINRA Rule 3110 (Supervision).

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1. FINRA, Report on Conflicts of Interest (Oct. 2013) [hereinafter FINRA Conflicts Report], https://www.finra.org/sites/default/files/Industry/p359971.pdf.

§ 52:1.2 *Standards of Care*

[A] FINRA Rule 2111 Imposes a Suitability Requirement on All Recommendations Made by Broker-Dealers

Broker-dealers have historically been subject to a "suitability" standard with respect to recommendations, including those made to institutional accounts. FINRA, the principal regulator for the broker-dealer community, has not established a fiduciary standard applicable to broker-dealers, but has rather continued the historical practice of evaluating the suitability of broker-dealer recommendations. FINRA Rule 2111 ("Rule 2111"), otherwise known as the "Suitability Rule," imposes the basic requirement that a broker-dealer must have a ***reasonable basis*** to believe that a ***recommended transaction***[2] or investment strategy is suitable for a customer.[3] In particular, Rule 2111 imposes three distinct suitability obligations on broker-dealers:

(i) *Reasonable-Basis Suitability* means that a broker must perform reasonable diligence to understand the investment products and strategies that are recommended to customers, and must determine that a product or strategy is appropriate for sale in a general sense.[4] The level of necessary due diligence will vary with the complexity of the product and the registered representative's familiarity with the security or investment strategy. One test colloquially used by broker-dealers to evaluate reasonable-basis suitability is this: is the investment suitable for *any* customer?

(ii) *Customer-Specific Suitability* means that a broker must have a reasonable basis to believe that a recommendation is suitable for the specific customer to whom it is made, based on the customer's investment profile.[5] Customer-specific suitability does take into account the customer's sophistication, both generally and specifically, with respect to the applicable investment.

(iii) *Quantitative Suitability* means that a broker who has control over a customer's account (such as a discretionary trading

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2. For more information as to what constitutes a "recommendation" for purposes of the suitability rule, see *infra* section 52:1.2[D].
3. FINRA Rule 2111.
4. FINRA Rule 2111, Supplementary Material .05; FINRA, Regulatory Notice 12-25, Additional Guidance on FINRA's New Suitability Rule (July 9, 2012), http://www.finra.org/industry/notices/12-25.
5. *Id.*

> account), or *de facto* control must have a reasonable basis to believe that a series of recommended securities transactions is not excessive.[6]

Note that FINRA also imposes heightened suitability requirements in connection with the recommendation of certain complex products, such as asset-backed securities, certain structured products, and products with embedded leverage or derivative components.[7] Because the suitability rule covers "investment strategies" in addition to securities, this would include a recommendation to hold a security as well. In addition, Rule 2111 would cover a recommendation to purchase securities using margin or liquefied home equity, or to engage in day trading, regardless of whether the recommendation results in a transaction or references particular securities.

Although Rule 2111 focuses on the suitability of a recommendation by a broker-dealer, rather than a fiduciary duty of care or loyalty, the policy behind the rule is intended to achieve comparable results. Rule 2111 states that the basis for the rule lays in the "responsibility for fair dealing" that is "implicit in all member and associated person relationships with customers . . . " and that the suitability rule "is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."[8]

[B] What Constitutes a "Customer" for Purposes of the FINRA Suitability Rule?

The suitability rule only applies to a broker's recommendation to a "customer." FINRA defines "customer" broadly as including anyone who is not a "broker or dealer." As a result, a "customer" can include individuals or entities with whom a broker-dealer has an *informal* business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer. There can be a circularity to the manner by which FINRA analyzes who is a broker's customer: the suitability obligation applies to any recommendation made to a customer, but FINRA is more likely to find a customer relationship exists where a recommendation has been made or where a detailed discussion of a product transaction, or investment strategy has taken place.

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6. *Id.*
7. FINRA, Regulatory Notice 12-03, Heightened Supervision of Complex Products (Jan. 2012), http://www.finra.org/industry/notices/12-03.
8. FINRA Rule 2111, Supplementary Material .01.

[C] What Constitutes a "Recommendation" for Purposes of the FINRA Suitability Rule?

Rule 2111 does not specify what constitutes a "recommendation" for purposes of the FINRA suitability rule. As a general matter, whether a particular communication qualifies as a "recommendation" requires a case-by-case analysis. However, FINRA has set forth certain guiding principles that are relevant to determining whether a particular customer communication could be viewed as a recommendation under the suitability rule.[9] First, a communication's content, context, and presentation are important in the determination of whether a particular communication is a "recommendation." FINRA's view is that a broker-dealer cannot avoid suitability obligations through a disclaimer where, given its content, context and presentation, the particular communication reasonably would be viewed as a recommendation. One factor in this regard is whether a particular communication to a customer reasonably would be viewed as a suggestion that the customer take action, or refrain from taking action, regarding a security or investment strategy given the communication's content, context and manner of presentation (that is, whether the communication contains a "call to action" for the customer). Second, the more individually tailored the communication, the more likely it is to be viewed by FINRA as a recommendation. Finally, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate.

FINRA has also stated that there is no difference whether a communication was initiated by a person or through a computer software program.

Note that both FINRA and SEC, and in the past NYSE Regulation, have at times taken a very broad view of what constitutes a recommendation. FINRA and SEC staff members have even, from time to time, expressed the view that *the mere bringing of a security or investment opportunity to the attention of* a customer or potential customer would constitute a "recommendation" that would trigger suitability obligations for a broker-dealer.

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9. FINRA, FINRA RULE 2111 (SUITABILITY) FAQ [hereinafter FINRA RULE 2111 FAQ], http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq, Q 1.1; FINRA, Regulatory Notice 11-02, SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (eff. Oct. 7, 2011; eff. date delayed to July 9, 2012), http://www.finra.org/industry/notices/11-02.

[D] Exception for Institutional Accounts

For institutional accounts,[10] the suitability obligation is fulfilled if (i) there is a reasonable basis for believing that the institutional customer can evaluate investment risks independently (both generally and for specific transactions and strategies) and (ii) the institutional customer affirmatively indicates that it is using independent judgment in evaluating recommendations. Where an institutional customer has delegated decision-making authority to an agent, such as an investment adviser, the preceding factors will be applied to the agent.[11]

An institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.[12]

FINRA member firms generally obtain a written affirmation from the institutional customer for risk management purposes.[13]

[E] Documentation of Suitability Determinations

Other than a general obligation to evidence compliance with applicable FINRA rules, Rule 2111 does not include any specific documentation requirements.[14] FINRA has stated that member firms must take a risk-based approach regarding documentation of its compliance with Rule 2111.

The extent to which a firm needs to evidence suitability generally depends on an assessment of the customer's investment profile and the complexity of the recommended security or investment strategy involving a security or securities (in terms of both its structure and potential performance) and/or the risks involved. For example, FINRA has stated that a recommendation of a "large-cap," value-oriented, equity security would not usually require documentation; but a recommendation of a complex and/or particularly risky security or

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10. "Institutional account" for these purposes means the account of a bank, savings and loan association, insurance company, registered investment company, registered investment adviser, or any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. *See* Rule 2111(b). For the complete definition, see *infra* note 61.
11. FINRA Rule 2111(b).
12. FINRA Rule 2111, Supplementary Material .01; FINRA, Regulatory Notice 13-31, FINRA Highlights Examination Approaches, Common Findings and Effective Practices for Complying with Its Suitability Rule (Sept. 2013), http://www.finra.org/sites/default/files/NoticeDocument/p351220.pdf; FINRA RULE 2111 FAQ, *supra* note 9, Q 8.1, Q 8.3.
13. *Id*.
14. Note, however, that various aspects of a customer account profile are required records under SEC Rules 17a-3 and 17a-4.

investment strategy involving a security or securities may well require documentation.[15]

Note that compliance with the suitability obligation does not necessarily turn on whether the basis for the determination was properly documented. In particular, documentation itself does not cure an otherwise unsuitable recommendation.

[F] Comparison of Broker-Dealer and Investment Adviser Standards of Care

The Investment Advisers Act of 1940 (the "Investment Advisers Act") fiduciary duty is sometimes regarded as a higher standard of care than the suitability duty applicable to broker-dealers.[16] A key difference is that investment advisers are fiduciaries under the federal securities laws, while broker-dealers generally are not.

A fundamental aspect of the fiduciary standard under the Investment Advisers Act is the duty of loyalty, which prohibits an adviser from putting its interests ahead of its clients. However, in a broker-dealer suitability framework, a broker-dealer has discretion to pursue its own self-interest provided that all recommended securities are nonetheless suitable for the customer.[17] Specific differences include:

(1) Disclosure Requirements

- Investment advisers must provide clients and prospective clients with a current firm brochure before or at the time an adviser enters into an advisory contract with the client and annually thereafter. Investment advisers must also provide a brochure supplement (Part 2B of Form ADV) setting forth information about each advising employee who provides investment advice to its clients, including such employee's educational background, business experience, other business activities, and disciplinary history. The firm brochure (Part 2A of Form ADV) is required to contain information about the investment adviser's services, certain conflicts of interest, and other information including its range of fees, methods of analysis, investment

15. FINRA RULE 2111 FAQ, *supra* note 9, Q 9.1.
16. *See* SEC, Study on Investment Advisers and Broker-Dealers (Jan. 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf.
17. The absence of a duty of loyalty *per se* often stems from the fact that a broker-dealer acting as a broker will have clients on both sides of any transaction; in acting as a broker, the broker-dealer puts those clients together. Similarly, when acting as market maker, a broker-dealer faces customers as principal, and traditionally not as fiduciary.

strategies and their risk of loss, brokerage (including trade aggregation policies and directed brokerage practices, as well as the use of soft dollars), review of accounts, client referrals and other compensation, and the adviser's disciplinary and financial information.

- Broker-dealers also must make a variety of disclosures, but the extent, form, and timing of the disclosures are different. They are not subject to a comparable requirement for a general disclosure of conflicts at the time the relationship is established, as well as other information contained in the investment adviser brochure.

(2) Principal Trading

- Investment advisers are prohibited from engaging in a principal trade with an advisory client, unless it discloses to the client in writing before completion of the transaction the capacity in which the adviser is acting and obtains the consent of the client to the transaction.
- By contrast, broker-dealers may engage in principal transactions with customers, subject to a number of requirements, including that they disclose their capacity in the transactions (typically on the applicable transaction confirmation), seek to obtain best execution for the customer, make only suitable recommendations, and charge customers fair and reasonable prices and commissions. There is no specific requirement for written disclosure or explicit consent for each principal transaction.

As stated above, FINRA rules permit accounts that meet the definition of "institutional account" to affirmatively release the broker-dealer from suitability-related obligations arising from the customer-specific suitability obligation. Although application of the Investment Advisers Act fiduciary duty will take into account the institutional status of customers, there is no similar waiver from fiduciary obligations under the Investment Advisers Act.

§ 52:1.3 SEC 2018 Proposal for Harmonized Standard

[A] Standards of Conduct for Broker-Dealers Under Proposed Regulation Best Interest

In April 2018, the SEC issued proposed rules, interpretations, and guidance that seek to enhance and clarify the standards of care applicable to broker-dealers and to investment advisers when dealing

with retail clients (the "2018 Proposed Rules").[18] With respect to broker-dealer standard of care, the SEC has proposed Regulation Best Interest, which is to be implemented under the Securities Exchange Act of 1934 ("Exchange Act"). Regulation Best Interest would create a principles-based standard, which will apply solely to broker-dealers. The SEC notes that the standards of conduct for broker-dealers and investment advisers retain differences on account of "different relationship types and models for providing advice."[19]

Under proposed Regulation Best Interest, brokers, dealers, or associated persons of a broker-dealer will be required to act in the best interest of a retail-investor customer,[20] without placing their financial or other interests ahead of the customer, when recommending a securities transaction or investment strategy involving securities.[21] This best interest obligation is satisfied if the broker, dealer, or associated person complies with separate disclosure, care, and conflicts of interest obligations. It remains undetermined (and in fact, a matter that the SEC has called for comment) whether compliance with these obligations provides a safe harbor under Regulation Best Interest, or if these three obligations are intended to be the sole means of compliance.

[A][1] Disclosure Obligation

This prong of the best interest obligation requires broker-dealers or associated persons, prior to providing a recommendation to a retail investor, to reasonably disclose in writing, the material facts relating to the relationship with the retail investor, including all material conflicts of interest.[22]

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18. Regulation Best Interest, Exchange Act Release No. 34-83062 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/34-83062.pdf [hereinafter Regulation Best Interest Release].
19. *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 5 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.
20. Regulation Best Interest defines "retail investor" as "a person, or the legal representative of such person, who: (A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) Uses the recommendation primarily for personal, family, or household purposes."
21. *See* Regulation Best Interest Release, *supra* note 18, sec. II.A, at 44. For the purposes of Regulation Best Interest, the definition of "recommendation" incorporates FINRA's definition of recommendation and also includes recommendations to roll over a retail investor's IRA. *See id.* sec. II.C.2.a, at 72–78, sec. II.C.3, at 82–83.
22. *See id.* sec. II.A, at 44.

[A][2] Care Obligation

This obligation, which tracks the language of FINRA Rule 2111, requires a broker-dealer or associated person to exercise reasonable diligence, care, skill and prudence to:

- Understand the potential risks and rewards of the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least *some* retail investors;[23]
- Have a reasonable basis to believe that the recommendation is in the best interest of the particular retail investor;[24] and
- Have a reasonable basis to conclude that a series of recommendations, when viewed together, is not excessive and in the retail investor's best interest.[25]

[A][3] Conflict of Interest Obligations

This obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to (i) identify and, at minimum, disclose, or (ii) eliminate, all material conflicts of interest associated with a recommendation; and, to (i) identify, disclose, and mitigate; or (ii) eliminate, material conflicts of interest that arise from any financial incentives associated with a recommendation.[26]

[B] Form CRS Relationship Summary

The 2018 Proposed Rules would require broker-dealers and investment advisers to provide a relationship summary (limited to a maximum of four pages) to investors at the onset of the investor's

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23. This language is similar to that of FINRA Rule 2111 Supplementary Material .05(a) (the "reasonable-basis" component of suitability). *See* Regulation Best Interest Release, *supra* note 18, sec. II.A, at 44–45.
24. This language is similar to that of FINRA Rule 2111 Supplementary Material .05(b) (the "customer-specific" component of suitability). *See* Regulation Best Interest Release, *supra* note 18, sec. II.A, at 44–45.
25. This language is similar to that of FINRA Rule 2111 Supplementary Material .05(c) ("quantitative suitability"). Note, however, that under FINRA Rule 2111, this quantitative suitability obligation applies only to accounts where the broker-dealer or associated person has *de facto* control over the customer's account. *See* Regulation Best Interest Release, *supra* note 18, sec. II.A, at 44–45. *But see* FINRA Regulatory Notice 18-13, Quantitative Suitability (Apr. 20, 2018), http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf (noting that FINRA has proposed amendments to FINRA Rule 2111 that would harmonize the language in Supplementary Material .05(c) with the quantitative suitability obligation language in Regulation Best Interest.
26. *See* Regulation Best Interest Release, *supra* note 18, sec. II.A, at 45.

relationship with the firm that captures certain specific information, including generally describing the nature of the firm and the standard of care applied by the firm.

Form CRS will consist of concise, plain-language Relationship Summaries that will be provided to customers, posted online by the SEC in a compiled database, and available on a firm's website.

The Proposed Rules will also require disclosure of whether a firm or financial professional is registered as a broker-dealer or associated person, an investment adviser or supervised person, or both, in communications with retail investors.

As part of the series of SEC releases issued at the same time as the Regulation Best Interest Release, the SEC published certain sample Forms CRS.

[C] Standards of Conduct for Investment Advisers and Enhancing Investment Adviser Regulation

The 2018 Proposed Rules contain a series of interpretations to address aspects of the investment adviser's fiduciary duty.[27] In addition, this Release requested comment on possible significant rulemaking with respect to regulation of investment advisers, including: (i) requiring federal licensing and continuing education requirements for personnel of registered investment advisers; (ii) requiring registered investment advisers to provide client account statements disclosing fees paid by the customer to the investment adviser; and (iii) regulations regarding financial responsibility requirements applicable to investment advisers to ensure that investment advisers are adequately capitalized in the event of fraud or financial distress.

§ 52:1.4 Broker-Dealer "Networking Rules"

[A] Requirements for Dual-Hatted Broker-Dealer/Bank Representatives and for In-Bank Brokerage "Kiosks"

"Networking arrangements" between broker-dealers and banks typically refer to either contractual or other arrangements between a broker-dealer and a bank pursuant to which the broker-dealer conducts broker-dealer business on the premises of such bank where retail deposits are taken. As a general matter, regulators are concerned with broker-dealer activities occurring on bank premises or through dual-hatted broker-dealer/bank representatives, and especially with the possibility of confusion when sales persons are not clear about the

27. For a discussion of the various aspects of the investment adviser's fiduciary duty, including those discussed by the SEC in connection with the 2018 Proposed Rules, see *supra* section 52:1.3, *infra* section 52:2.1.

risks of the securities products and services, or that a customer may view broker-dealer products sold within a bank to be safe, guaranteed by the bank, or insured by the Federal Deposit Insurance Corporation (FDIC).

Regulators have issued guidance and various rules to address these concerns, including FINRA Rule 3160 and Regulation R of the SEC and the Board of Governors of the Federal Reserve System (FRB).[28] These rules and principles are sometimes referred to by industry personnel as the "kiosk" or "kiosking" rules.

Prior to these rules, networking arrangements between banks and broker-dealers were generally conducted pursuant to interpretive "no-action" letters issued by the SEC.[29] As banks became increasingly involved in selling uninsured nondeposit investment products to retail customers on their premises, the four main federal bank regulators responded by issuing an Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency RNDIP Statement") in 1994.[30] The Interagency RNDIP Statement incorporates numerous Chubb Letter provisions, and applies to broker-dealers when the sales occur on the premises of the bank and to sales activity of a bank-affiliated broker-dealer if the activity results from a referral from the bank, and to other broker-dealers if the activity results from a referral from the bank and the bank receives a benefit for the referral.[31]

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28. 17 C.F.R. pt. 247 (SEC); 12 C.F.R. pt. 218 (FRB). The SEC and the FRB jointly issued Regulation R, which implements the so-called "push-out" provisions of the Gramm-Leach-Bliley Act (GLBA), Pub. L. No. 106-102, which was enacted in 1999. Prior to GLBA, banks enjoyed a blanket exemption from broker-dealer registration under the Exchange Act (as defined below). GLBA removed the blanket exemption and generally required banks to "push out" securities-related activities to a registered broker-dealer, subject to a limited number of exceptions for certain traditional securities-related banking activities. Rules 700 and 701 under Regulation R pertain to the networking exception in GLBA. For ease of reference, citations in this section are to the SEC's Regulation R.

29. For example, in November 1993, the SEC issued the "Chubb Letter," which details SEC policy relating to certain broker-dealer operational activities occurring on bank premises. *See* Chubb Securities Corp., SEC No-Action Letter, 1993 WL 565540 (Nov. 24, 1993).

30. The Interagency RNDIP Statement, issued by the Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS) on February 15, 1994, can be found in OCC Bulletin 1994-13, Nondeposit Investment Sales Examination Procedures: Interagency Statement (Feb. 24, 1994), and in the FRB's SR Letter No. 94-11 (Feb. 17, 1994). The OTS was eliminated and its functions transferred to the other bank regulatory agencies under Dodd-Frank.

31. The Interagency RNDIP Statement is discussed in detail in *infra* section 52:4.2[F][1].

Following the Interagency RNDIP Statement, the National Association of Securities Dealers (NASD) proposed new Conduct Rule 2350 (now FINRA Rule 3160 ("Rule 3160"), discussed below in section 52:1.4[C]) based on the Chubb Letter and Interagency RNDIP Statement, setting forth standards related to broker-dealer services taking place on depository institution premises.[32] The SEC approved Rule 2350 in 1997.[33] This was followed by the passage of the Gramm-Leach-Bliley Act (GLBA) in 1999 and the subsequent adoption by the SEC and the FRB of Regulation R, which includes an exception that permits banks to enter into networking arrangements with securities broker-dealers to offer securities on or off bank premises.[34]

[B] Requirements for Broker-Dealer/Bank Networking Arrangements: Rules 700–701 of Regulation R

[B][1] Overview

Regulation R allows banks to perform certain securities-related activities without registering as a broker-dealer with the SEC, but limits those activities to certain broker exceptions as set forth in section 3(a)(4)(B) of the Exchange Act. Among other things, Regulation R implements the GLBA statutory exceptions that allow a bank, subject to certain conditions, to refer customers to a securities broker-dealer pursuant to a networking arrangement with a broker-dealer.[35]

The networking exception sets forth the permissible conditions under which banks and bank employees (who are not registered and qualified under self-regulatory organization (SRO) rules, referred to as, "unregistered employees") may participate in securities referral activities with a registered broker-dealer absent the bank itself registering with the SEC as a broker-dealer and unregistered employees registering and qualifying as registered representatives under SRO rules. Regulation R defines "referral" as "an action taken by one or more bank

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32. *See* 94-94 NASD Requests Comment on Proposed Rule Governing Members Operating on Bank Premises (1994), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1439 (last visited Aug. 22, 2018).
33. *See* Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 to Proposed Rule Change Governing Broker-Dealers Operating on the Premises of Financial Institutions, Release No. 34-39294, 65 SEC Docket 1799, 1997 WL 685310 (Nov. 4, 1997).
34. *See* 17 C.F.R. §§ 247.700–.701.
35. *Id.*

employees to direct a customer of the bank to a broker-dealer for the purchase or sale of securities for the customer's account."[36] By its terms, the networking exception applies solely to referrals of securities transactions that otherwise could cause a bank or its unregistered employees to be subject to the broker-dealer registration requirements of Exchange Act section 15(a)(1). This exception does not restrict referral or other activities relevant to non-securities activities of a bank, such as loans, transactions in currency, commodities, and nonsecurities futures contracts; or government securities for which a bank may be regulated as a government securities dealer under Exchange Act section 15C(a)(1).

The statutory exception requires, in relevant part, that:

(i) a bank enter into a written agreement with a registered broker-dealer;[37]

(ii) securities brokerage services be kept clearly separate from the bank and its depository services;

(iii) brokerage marketing materials clearly identify the broker-dealer as the securities service provider and comply with advertising regulations under the Exchange Act and SRO rules;

(iv) unregistered employees solely perform clerical and ministerial functions with respect to brokerage transactions (that is, no investment advice or securities recommendations); and

(v) for referrals, unregistered bank employees not receive incentive compensation tied to securities transactions, although they are eligible to receive referral compensation of a "nominal one time cash fee of a fixed dollar amount" not contingent on any successful referral or transaction. In addition to limiting referral fees to a nominal amount, Regulation R also addresses bank bonus plans and the circumstances under which such plans can include securities-related activities without being considered incentive compensation for purposes of the Exchange Act.[38]

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36. 17 C.F.R. § 247.700(e).

37. The written agreement is important, not only because it is an essential element of the statutory exception, but also for compliance with permitted payment structures for referrals of institutional and high-net-worth clients, as discussed below in this section. In short, allocation of eligibility and disclosure obligations relevant to this part of the exception must be set forth in the agreement.

38. 15 U.S.C. § 78c(a)(4)(B)(i); 17 C.F.R. § 247.700(b).

[B][2] Nominal Fees and Customer Referrals

The definition of "nominal one-time cash fee of a fixed dollar amount" includes four methods by which a bank can compensate its employees for referrals. Under the first two methods, a fee may not exceed either twice the average of the minimum and maximum hourly wage or 1/1,000th of the average of the minimum and maximum annual base salary of the employee (or a similar employee). Under the third method, a fee may not exceed twice the employee's actual base hourly wage. Under the fourth method, a fee may not exceed $25, which will be adjusted for inflation every five years.[39]

A fee may be paid for each referral, including separate referrals of the same individual or entity. All fees must be for fixed amounts and paid in cash; no noncash fees are permitted. Any employee who personally participated in a referral is eligible to receive a fee. Any action to direct a customer of a bank to a registered broker-dealer can be a "referral."

[B][3] Prohibition on Contingent Fees and Incentive Compensation

A referral fee may not be contingent on the successful completion by the broker-dealer of a transaction. Regulation R defines "contingent" to cover fees where payment of the fee is "dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker-dealer; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions." For purposes of this exemption, fees are not considered to be contingent (that is, they are permitted) if they are payable only if: (i) the customer actually meets with a representative of the broker-dealer as a result of a referral and (ii) the customer satisfies any eligibility requirements applicable to the networking program (e.g., an income or net-worth test).[40]

Incentive compensation, which is prohibited as part of a referral fee, is defined as "compensation that is intended to encourage a bank employee to refer potential customers to a broker-dealer or give a bank employee an interest in the success" of a transaction.[41] The SEC and the FRB permitted various types of existing bank bonus programs to continue without regard to the limits on networking arrangements.[42]

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39. 17 C.F.R. § 247.700(c).
40. 17 C.F.R. § 247.700(a).
41. 17 C.F.R. § 247.700(b)(1).
42. 17 C.F.R. § 247.700(b)(2).

[B][4] Exception for High-Net-Worth and Institutional Customers

Banks may pay fees that are both contingent and larger than nominal to employees in connection with a referral of a high-net-worth or institutional customer. This exemption recognizes both that such customers are capable of understanding the relationships among the employees, banks, and broker-dealers, and the impact of those relationships on resulting securities transactions.[43]

"Institutional customer" is defined as any corporation, partnership, limited liability corporation, trust, or other non-natural person that has at least $10 million in investments or $20 million in revenues. However, an institutional customer may be referred solely for investment banking services if it has at least $15 million in revenues.[44]

"High-net-worth customer" is defined as any natural person having (individually or jointly with their spouse) at least $5 million in net worth, including certain trust assets, but excluding a primary residence. These dollar amounts will be adjusted for inflation every five years.[45]

Either a bank or a registered broker-dealer may satisfy the customer eligibility requirements by having a reasonable belief that a customer so qualifies.[46]

[B][5] Shared Spaces/Premises

If a bank enters into an arrangement with a broker-dealer where the broker-dealer offers brokerage services on or off the premises of the bank, the statutory exception requires, in part, that such broker-dealer is clearly identified as the person performing the brokerage services and that such securities brokerage services are performed in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the bank. Furthermore, any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement must clearly indicate that the services are being provided by the broker-dealer and not by the bank.[47]

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43. 17 C.F.R. § 247.701; 72 Fed. Reg. 56,514, 56,523 (Oct. 3, 2007) (final rule of the SEC and FRB regarding "Definitions of the Terms and Exemptions Relating to the 'Broker' Exceptions for Banks") (the "Reg R Adopting Release").
44. 17 C.F.R. § 247.701(d)(2).
45. 17 C.F.R. § 247.701(d)(1).
46. 17 C.F.R. § 247.701(a)(2)(ii).
47. 15 U.S.C. § 78c(a)(4)(B)(i).

[C] Additional Requirements Networking Arrangements: FINRA Rule 3160

According to FINRA, Rule 3160 is designed to harmonize FINRA's rules with those principles found in the GBLA and Regulation R. Rule 3160 requires that dual-hatted broker-dealer bank representatives must clearly identify themselves when they are offering broker-dealer services and must distinguish broker-dealer services from the services of the bank.[48] In addition, there must be clear physical separation between the broker-dealer areas and the retail deposit-taking areas of the bank, and all representatives must conduct broker-dealer services in an area that displays clearly the broker-dealer's name.[49]

At or prior to the time that a dual-hatted representative opens a customer account, there must be written disclosure to the customer (and oral disclosure also if the account is opened on the premises of the bank) that the broker-dealer services are being provided by the broker-dealer and not by the bank, and that the securities products are (i) not insured by the FDIC; (ii) not deposits or other obligations of the bank and are not guaranteed by the bank; and (iii) subject to investment risks, including possible loss of the principal invested.[50] Disclosure of this "not-not-may" warning is a cornerstone of bank-broker networking operations. Such disclosures also need to include material aspects of any unregistered person's compensation (that is, that it may be contingent, incentive-based, and non-nominal).

All customer confirmations and account statements must indicate clearly that the broker-dealer services are being provided by the broker-dealer.[51] Retail communications, including material for use in radio or television broadcasts, ATM screens, billboards, signs, posters and brochures, that include disclosure regarding locations where broker-dealer services are provided on bank premises, must include the "not-not-may" disclosure, which may be provided in the following legend so long as provided conspicuously:

- Not FDIC Insured;
- No Bank Guarantee; and
- May Lose Value.[52]

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48. FINRA Rule 3160(a)(1)(A).
49. FINRA Rule 3160(a)(1)(B), (C).
50. FINRA Rule 3160(a)(3)(A).
51. FINRA Rule 3160(a)(4)(A).
52. FINRA Rule 3160(a)(4)(B).

§ 52:1.5 *FINRA Guidance Regarding the Reduction of Conflicts with Respect to the Compensation of Retail Brokers and Private Bankers*

[A] Broker-Dealer Standards

FINRA has noted that financial compensation can be a major source of conflicts of interest that may influence registered representatives of broker-dealers to behave in ways that affect customer interests negatively.[53]

In the FINRA Conflicts Report, FINRA suggested the following as best practices in designing a compensation program to mitigate conflicts of interest created by compensation of associated persons:[54]

(1) *Compensation thresholds*. Firms should avoid thresholds in their compensation structures that enable a registered representative to increase his/her compensation disproportionately through an incremental increase in sales.

(2) *Monitoring activity of representatives approaching compensation thresholds.* Firms should monitor whether a registered representative's recommendations may be influenced by thresholds in a firm's compensation structure. FINRA noted that some firms performed specialized surveillance as registered representatives approached thresholds that (i) moved the registered representative to a higher payout percentage in a firm's compensation grid; (ii) qualified a representative to receive a back-end bonus; or (iii) qualified a representative to participate in a recognition club.

(3) *Use of compensation grids*. FINRA has noted that paying a registered representative a percentage of gross revenue may legitimately reward effective workers and encourage higher productivity. However, FINRA noted that the use of such compensation grids also creates a conflict with respect to the recommendations that a registered representative may make to customers. FINRA noted that an effective practice was the use of "product neutral" compensation grids to reduce incentives for registered representatives to prefer one type of product over another.

(4) *Commission-based versus fee-based accounts*. FINRA also noted that conflicts may arise in recommending the type of account that a customer should open with a firm. A firm that

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53. The FINRA Conflicts Report, *supra* note 1, at 3.
54. *Id*. at 26.

is dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer.

(5) *Fee-capping*. Firms should reduce incentives for a registered representative to favor one mutual fund or variable annuity fund over another by capping the Gross Dealer Concession that will be credited to a representative's production.

(6) *Compensation for proprietary or preferred provider products*. For comparable products, firms should refrain from providing higher compensation, or providing other rewards, for the sale of proprietary products.

(7) *Customer liquidity events and suitability monitoring*. Firms should monitor the suitability of registered representative's' recommendations around key liquidity events in an investor's lifecycle where the impact of those recommendations may be particularly significant (for example, at the point where an investor rolls over his pension or 401(k)).

(8) *Compensation penalties*. Firms should adjust compensation for employees who do not properly manage conflicts of interest (for example, by using red flag processes and clawbacks). In this respect, note that the SEC has also suggested that an overarching ability to control (including to reduce) compensation in connection with discipline is a critical aspect of broker-dealer management of conflicts of interest.

FINRA noted that there is no "one-size-fits-all" framework through which firms can or should manage conflicts created through compensation of registered representatives, and that firms needed to assess what approach is most effective given their particular circumstances.

[B] Requirement to Disclose Certain Information Regarding Recruitment Compensation for Associated Persons that Change Firms

FINRA Rule 2273 (Educational Communication Related to Recruitment Practices and Account Transfers) requires member firms to deliver an educational communication, which has been prepared by FINRA, to former customers in connection with the transfer or recruitment of broker-dealer personnel. Specifically, Rule 2273 requires member firms that recruit a registered representative to deliver the FINRA-created educational communication to former customers. The communication must highlight key considerations about transferring assets to the recruiting firm, and it must highlight the direct and indirect impacts of such a transfer on those assets. Delivery of such communication must

occur at the time of the first individualized contact with a former customer by the registered person or the member firm regarding the transfer of a former customer's assets to the member.

§ 52:1.6 Regulation of Fees and Charges

[A] FINRA Rule 2121 (Fair Prices and Commissions for Principal Transactions)

[A][1] Principal Transactions

Principal transactions, that is, where the broker-dealer sells (or buys) from (or to) its own account to (or from) the customer, must be at a price that is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that it is entitled to a profit.

[A][2] Agency Transactions

Agency transactions, that is, where the broker-dealer serves as the customer's agent (broker) in its transaction with another counterparty, the broker-dealer must not charge a customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order, and the value of any service it may have rendered by reason of its experience in and knowledge of such security and the market therefor.

[A][3] Acceptable Mark-Up/Commission

FINRA Rule 2121 does not provide absolute-number guidelines for what is an acceptable mark-up/commission, except for certain transactions in debt securities (which are calculated on the basis of the prevailing market price).[55]

55. Traditionally, Rule 2131 and its predecessor rules were thought to set a guideline that total compensation to a broker-dealer of greater than 5% was/is an excessive amount; the rule became generally known as the "5% round-trip rule." As a practical matter, however, FINRA will question transactions with broker compensation of less than 5% if that amount appears to exceed the market for that security at that time.

§ 52:1.7 Reporting Requirements

[A] Broker-Dealer Self-Reporting Requirements

[A][1] FINRA Rule 4530 (Self-Reporting by Broker-Dealers)

FINRA Rule 4530 requires that FINRA members *self-report* certain adverse events that have occurred with respect to the broker-dealer itself or its associated persons (for example, convictions and findings of violations).[56] FINRA Rule 4530(b) requires that FINRA member

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56. Reporting is required if a member or an associated person of the member:

(A) violated securities-, insurance-, commodities-, financial-, or investment-related laws, rules, regulations, or standards of conduct of any domestic or foreign regulatory body, self-regulatory organization, or business or professional organization;

(B) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities, or of forgery;

(C) is named as a defendant or respondent in any proceeding brought by a domestic or foreign regulatory body or self-regulatory organization alleging the violation of any provision of the Exchange Act, or of any other federal, state, or foreign securities; insurance or commodities statute, or of any rule or regulation thereunder; or of any provision of the by-laws, rules, or similar governing instruments of any securities, insurance, or commodities domestic or foreign regulatory body or self-regulatory organization;

(D) is denied registration or is expelled, enjoined, directed to cease and desist, suspended, or otherwise disciplined by any securities, insurance, or commodities industry domestic or foreign regulatory body or self-regulatory organization, or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member of any such self-regulatory organization;

(E) is indicted, or convicted of, or pleads guilty to, or pleads no contest to, any felony; or any misdemeanor that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or a conspiracy to commit any of these offenses, or substantially equivalent activity in a domestic, military or foreign court;

(F) is a director, controlling stockholder, partner, officer, or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter, or insurance company that was suspended, expelled, or had its registration denied or revoked by any domestic or foreign regulatory body, jurisdiction, or organization, or is associated in such a capacity with a bank, trust company, or other financial institution that was convicted of or

firms *self-report* certain violations of law and regulation even if the member firm/associated person has not yet been the subject of any litigation or regulatory enforcement with respect to the same.

Most relevant, 4530(b) requires reporting *if the broker-dealer has concluded or should have concluded that an associated person or the broker-dealer itself has violated any securities-, insurance-, commodities-, financial-, or investment-related laws, rules, regulations, or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization.*

FINRA expects a member to report only conduct that has widespread or potential widespread impact to the member, its customers, or the markets; or conduct that arises from a material failure of the member's systems, policies, or practices involving numerous customers, multiple errors, or significant dollar amounts.

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pleaded no contest to any felony or misdemeanor in a domestic or foreign court;

(G) is a defendant or respondent in any securities- or commodities-related civil litigation or arbitration, is a defendant or respondent in any financial-related insurance civil litigation or arbitration, or is the subject of any claim for damages by a customer, broker, or dealer that relates to the provision of financial services or relates to a financial transaction, and such civil litigation, arbitration, or claim for damages has been disposed of by judgment, award, or settlement for an amount exceeding $15,000. However, when the member is the defendant or respondent, or is the subject of any claim for damages by a customer, broker, or dealer, then the reporting to FINRA shall be required only when such judgment, award, or settlement is for an amount exceeding $25,000; or

(H) (i) is subject to a "statutory disqualification" as that term is defined in the Exchange Act; or

(ii) is involved in the sale of any financial instrument, the provision of any investment advice, or the financing of any such activities with any person that is subject to a "statutory disqualification" as that term is defined in the Exchange Act, provided, however, that this requirement shall not apply to activities with a member or an associated person that has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to be a member or to be associated with a member. The report shall include the name of the person subject to the statutory disqualification and details concerning the disqualification; or an associated person of the member is the subject of any disciplinary action taken by the member involving suspension, termination, the withholding of compensation or of any other remuneration in excess of $2,500, the imposition of fines in excess of $2,500, or is otherwise disciplined in any manner that would have a significant limitation on the individual's activities on a temporary or permanent basis.

[A][2] Form U4 (Disclosures on Associated Person Registration Document)

Broker-dealers must file Form U4 for *every associated person* and update it as required to remain accurate. Portions of the Form U4 are disclosed publicly on FINRA's BrokerCheck website. Item 14 of Form U4 contains various required disclosures based on certain specified events. These include:

(a) Being named as a respondent/defendant in an investment-related, consumer-initiated arbitration, civil litigation, or complaint (written or oral) that alleges that the associated person was involved in a sales practice violation, subject to certain dollar amount and status conditions.

(b) Being notified, in writing, that the individual is now the subject of any regulatory complaint, regulatory proceeding, or investigation that could result in a "yes" answer to certain parts of Item 14 (including certain findings of FINRA or the SEC). An investigation is defined to include a FINRA investigation after notice has been given or after an associated person has been advised by the staff that it intends to recommend formal disciplinary action. An investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.

[A][3] Form U5

When a broker-dealer associated person leaves his or her firm, the firm must file a Form U5 to terminate the association of the individual, which requires disclosure of certain adverse events regarding the associated person. Form U5 requires, first, a narrative description of the reason for termination in any circumstance where the termination reason given is other than "voluntary."

Second, Form U5 inquires into the following relevant questions:

(a) *Item 7A, Investigation Disclosure*. Currently is, or at termination was, the subject individual of an investigation or proceeding by a domestic or foreign governmental body or self-regulatory organization with jurisdiction over investment-related businesses?

(b) *Item 7B, Internal Review Disclosure*. Currently is, or at termination was, the individual under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct?

(c) *Item 7D, Regulatory Action Disclosure*. While employed by or associated with your firm, or in connection with events that occurred while the individual was employed by or associated with your firm, was the individual involved in any disciplinary action by a domestic or foreign governmental body or self-regulatory organization (other than those designated as a "minor rule violation" under a plan approved by the U.S. Securities and Exchange Commission (SEC)) with jurisdiction over the investment-related businesses?

(d) *Item 7E, Customer Complaint/Arbitration/Civil Litigation Disclosure*. In connection with events that occurred while the individual was employed by or associated with your firm, was the individual named as a respondent/defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that the individual was involved in one or more sales practice violations? Customer complaint regarding the same? Disclosures are subject to certain conditions, including monetary thresholds.

(e) *Item 7F, Termination Disclosure*. Did the individual voluntarily resign, or was the individual discharged or permitted to resign, after allegations were made that accused the individual of (a) violating investment-related statutes, regulations, rules, or industry standards of conduct; (b) fraud or the wrongful taking or property; or (c) failure to supervise in connection with investment-related statutes, regulations, rules, or industry standards of conduct?

Portions of the Form U5 disclosure are also excerpted in the public disclosure found at FINRA's BrokerCheck website. Under the laws of some U.S. jurisdictions, broker-dealers are granted immunity from liability for statements made on Form U5.

§ 52:1.8 SEC Rule 15c3-3—The Customer Protection Rule

[A] Generally

SEC Rule 15c3-3, commonly known as the "customer protection rule," is a rule intended to protect customer funds held by their broker-dealers and to prohibit broker-dealers from using customer funds and securities to finance any part of their business that is unrelated to servicing securities customers.

[B] Basic Requirements of the Rule

As a general matter, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash to comply with two primary requirements.

[B][1] Possession and Control

First, the rule requires broker-dealers to maintain physical possession or control over customers' fully paid and excess margin securities. For purposes of the first requirement, physical possession or control means that the broker-dealer must hold fully paid and excess margin securities in certain specified locations, and that the securities remain free of any liens or other security interests. One such permissible location is a U.S. bank. Another (common) location for possession is on the books of a registered clearing agency, such as various affiliates and the Depository Trust Company. A broker-dealer can establish possession and control for purposes of the customer protection rule by holding securities in non-U.S. control locations (called "foreign control locations"), provided that the non-U.S. custodian provides certain representations to the U.S. broker-dealer regarding the status of the securities and the absence of liens.[57]

[B][2] Reserve Account

Second, the broker-dealer must maintain a reserve of cash or qualified securities in an account at a bank that is at least equal in value to the net cash the broker-dealer owes to customers. The calculation of net cash set forth in the customer protection rule requires that the broker-dealer add all customer credit items (such as an amount equal to any free cash in customer securities accounts) and deduct from such credit items, any customer debit items (such as margin loans). The net amount by which customer credit items exceed customer debit items, if any, must be on deposit in the broker-dealer's customer reserve account.[58]

Deposits in the broker-dealer's customer reserve account must take the form of cash or certain qualified securities. Generally, weekly computations of the reserve are required. As the reserve account is for the exclusive benefit of customers, funds may not be withdrawn unless an updated reserve formula calculation reflects that the reserve requirement has decreased.

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57. *See* FINRA Regulatory Notice 97-35; FINRA Regulatory Notice 97-4.
58. For the reserve formula, see SEA Rule 15c3-3, app. C.

§ 52:1.9 Communications with the Customer and the Public

[A] Generally

FINRA Rule 2210 regulates the means by which broker-dealers may communicate with the public. The rule regulates both (i) content standards by which all broker-dealer communications with the public must adhere, and (ii) prior review and filing requirements for certain types of communications.

There are three categories of communications with the public defined and regulated by FINRA Rule 2210:

(1) A "retail communication" consists of any written or electronic communication distributed or made available to more than twenty-five retail investors[59] within a thirty-calendar-day period.

(2) Correspondence is written or electronic communication distributed to twenty-five or fewer retail investors during the same period.

(3) An "institutional communication" refers to any written or electronic communication distributed to only institutional investors, such as banks, investment companies, etc.[60] Internal communications within a firm are not considered communication under FINRA.

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59. Retail investor means any person other than an institutional investor, regardless of whether the person has an account with a FINRA member.

60. FINRA Rules 2210(a)(4), 4512(c): Institutional investor can mean any of the following: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million; (4) governmental entity or subdivision thereof; (5) employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of section 403(b) or section 457 of the Internal Revenue Code, and in the aggregate have at least 100 participants, but does not include any participant of such plans; (6) qualified plan, as defined in section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans; (7) member or registered person of such a member; and (8) person acting solely on behalf of any such institutional investor.

[B] Principal Review

Under FINRA Rule 2210, certain communications require review by an appropriately qualified principal of the firm before they can be used or filed. Specifically, Rule 2210 requires principal approval of each retail communication before the earlier of its use or filing with FINRA.

The rule provides several exceptions for the principal pre-use approval requirement for retail communications, including the following:

(1) Advertisements that another firm has already filed with and had approved by FINRA.

(2) Certain retail communications that are excepted from the definition of "research report" pursuant to NASD Rule 2711 (a)(9)(A).

(3) Retail communications that posted on an online interactive electronic forum.

(4) Any retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the firm.

Principal review may be required for certain types of social media posts and content. This is discussed more fully in section 52:1.9[E].

[C] FINRA Filing Requirements

FINRA requires that certain retail communications be filed at least ten days prior to first use or publication. Certain other retail communications must be filed within ten days of first use. Examples of communications that must be filed prior to first use include any generally accessible website, advertisements, television or radio commercials, and signs or billboards. Some examples of communications that must be filed within ten business days of first use are communications of a registered investment company that promote or recommend a specific registered investment company (generally speaking, including all mutual funds), or family of registered investment companies, as well as those concerning any structured or derivative product registered under the Securities Act of 1933 (the "Securities Act").

[D] Content Requirements: "Fair and Balanced" Standard

FINRA Rule 2210 requires that communications be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any

particular security or type of security, industry, or service. Omission of material fact or qualification is prohibited if the omission, in light of the context of the material presented, would cause the communications to be misleading. Also prohibited is making any false, exaggerated, unwarranted, promissory, or misleading statement or claim in any communication if the member knows or has reason to know of an untrue statement of a material fact, or that is otherwise false or misleading. Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor's understanding of the communication. Statements must be clear and not misleading within the context in which they are made, and must provide balanced treatment of risks and potential benefits. The nature of the audience must be considered, with details and explanations appropriate to the audience. Communications may not predict or project performance, imply that past performance will recur, or make any exaggerated or unwarranted claim, opinion, or forecast.

In addition to these general standards, Rule 2210 also regulates comparisons between investments or services, disclosure of the member's name, tax considerations, disclosure of fees and expenses, recommendations, use of BrokerCheck, and the filing of prospectuses with the SEC.

[E] Social Media/Electronic Communications

[E][1] Overview

Firms must supervise interactive electronic communications, including posts on social media made in connection with the conduct of the firm's business, in a manner reasonably designed to ensure they do not violate the content requirements of FINRA's communications rules as set forth in FINRA Rules 2210 and 2220.

Only "business communications," or communications relating to the products or services of the firm, are subject to the filing and content requirements of Rule 2210. "Personal communications," or communication that "does not concern the firm's products or services," would not be subject to Rule 2210.

[E][2] Adoption or Endorsement

As a general matter, a third-party post on a social media site established by a FINRA member firm would not be considered a communication by the firm or its personnel, and Rule 2210 requirements would not apply. However, under certain circumstances, third-party posts become attributable to the firm and are considered communications by the firm with the public, and subject to Rule 2210, under an "adoption or entanglement theory." FINRA notes that linking to, or sharing, specific content is an adoption by the firm of

such content, and must be evaluated in the same manner as communications created by or on behalf of the firm. Whether links embedded in the linked content are also deemed to be adopted or endorsed by the firm is a facts-and-circumstances determination, which takes into account factors such as: whether the firm has influence or control over the links embedded in the linked content, and whether the content that the firm originally linked or shared is merely a compilation of other links (in the case of the latter, the firm will have adopted the content of the embedded links).

Hyperlinking to or sharing an independent third-party website may or may not be considered an adoption by the firm of such content. Whether the content is adopted is fact-dependent, with two critical factors being whether the link is "ongoing" and whether the firm has influence over the content. A link is ongoing when:

- it is continuously available to investors who visit the member firm's site;
- investors have access to the linked site regardless of whether the content contains favorable material about the firm; and
- the linked site could be updated or changed by the independent third party, and investors would still be able to access the site through the link on the member firm's site.

If these factors are present, and so long as the firm has no control over the content, the content of the third-party website is not attributable to the firm through an entanglement or adoption theory. The language the firm uses to introduce the link to the third-party website, however, must still comply with communications rules, and the firm may not link or share content that it knows or has reason to know is false or misleading.

FINRA does not consider unsolicited opinions of third parties to be either communications of the firm for purposes of Rule 2210 or testimonials subject to the requirements of Rule 2210(d)(6).[61] If the firm or a registered representative "likes" or shares the third party's favorable comments, however, FINRA deems such content as having

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61. Rule 2210(d)(6): (A) If any testimonial in a communication concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion. (B) Retail communications or correspondence providing any testimonial concerning the investment advice or investment performance of a member or its products must prominently disclose the following: (i) the fact that the testimonial may not be representative of the experience of other customers; (ii) the fact that the testimonial is no guarantee of future performance or success; and (iii) if more than $100 in value is paid for the testimonial, the fact that it is a paid testimonial.

been adopted by the firm or the representative and therefore subject to the communications, recordkeeping, and supervision rules.

Disclosures that are required to accompany testimonials in an interactive electronic communication may be provided in the communication itself in close proximity to the testimonial, or by accompanying the testimonial with a clearly marked hyperlink, using language such as "important testimonial information." Firms that are also registered as investment advisers and subject to the Investment Advisers Act are specifically prohibited from using any advertisement that refers to a testimonial concerning an investment adviser or any advice, analysis, report, or other service rendered by the investment adviser.

Member firm-created applications are not subject to the requirement to provide a readily apparent link to FINRA's BrokerCheck, because Rule 2210 specifically references "websites." However, if the application links to or displays a firm's webpage, that webpage would be required to include a link to BrokerCheck, notwithstanding the fact that the content is delivered through an application.

FINRA considers static postings that are accessible to the public to constitute "retail communications" under Rule 2210, and as such requires an appropriately qualified registered principal of the firm to approve each retail communication before the earlier of its use or filing with FINRA. It is also necessary to keep records of all content and changes made. Examples of static content are static postings on blogs, social network profiles (such as LinkedIn profiles), and social network background images.

A registered principal must review, prior to use with consumers, any social media site that an associated person intends to employ for business purposes. Associated persons should receive appropriate training about such policies and procedures prior to engaging in interactive electronic business communications. Prior principal approval is not required under Rule 2210 for interactive electronic forums. However, firms must supervise these interactive electronic communications under FINRA Rule 3110 in a manner reasonably designed to ensure that they do not violate the content requirements of FINRA's communications rules.

[F] Recordkeeping

FINRA Rule 2210(b)(4)(A) sets forth the recordkeeping requirements for retail and institutional communications; generally, these requirements mirror current recordkeeping requirements. In addition to the recordkeeping and retention requirements of SEC Rule 17a-3 and 17a-4, Rule 2210(b)(4)(A) requires the following additional records to be maintained in connection with all communications by a broker-dealer:

(i) a copy of the communication and the dates of first and last use;

(ii) the name of the registered principal who approved the communication and the date approval was given;

(iii) in the case of a communication for which principal pre-use approval was not required, the name of the person who prepared or distributed the communication;

(iv) information concerning the source of any statistical table, chart, graph, or other illustration used in the communication; and

(v) for retail communications that rely on the exception under 2210(b)(1)(C),[62] the name of the firm that filed the retail communication with FINRA and a copy of the Advertising Regulation Department's review letter.

The key principle in keeping records of communication via social networks remains the same across all communication media: broker-dealers must retain electronic social media in a manner that can be reproduced as of any prior time. Specifically, FINRA states that member firms must be able to retain, retrieve, and supervise business communications regardless of whether they are conducted from a device owned by the firm or an associated person.[63] Firms or associated persons may not sponsor social media sites or use devices that include technology that automatically erases or deletes content. All communications completed by members, brokers, or dealers relating to a firm's business (including originals of all communications received, copies of all communications sent, and approvals granted) must be retained for a period of not less than three years.

The recordkeeping requirements of Rule 17a-4 under the Exchange Act ("Rule 17a-4") also apply to digital communications, including communications made through text messaging and chat services, to the extent that the content of the communications relates to the firm's business. As a result, prior to the use of text messaging and chat

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62. The exception under 2210(b)(1)(C) does not require principal approval of each retail communication before the earlier of its use or filing with FINRA's Advertising Regulation Department ("Department") if, at the time that a member intends to publish or distribute it, the following two requirements are met: (i) another member has filed the communication with the Department and has received a letter from the Department stating that it appears to be consistent with applicable standards; and (ii) the member using it in reliance upon this subparagraph has not materially altered it and will not use it in a manner that is inconsistent with the conditions of the Department's letter.

63. *See* FINRA Regulatory Notice 11-39.

services in the conduct of the firm's business, firms must ensure that they are able to capture and retain records of these communications.

FINRA permits the use of any personal communication device, but requires that business communications of FINRA members be retained, regardless of the storage format. The firm representative must therefore have the ability to retain, retrieve, and supervise the communication, which must be of a business matter. Practically speaking, this means that whether a person is communicating on social networks via a smartphone, tablet, or computer, they must retain their business communications for recordkeeping purposes.

§ 52:1.10 Books and Records

[A] SEC Recordkeeping Requirements

SEC Rules 17a-3 and 17a-4 under the Exchange Act prescribe minimum standards for the creation, retention, and preservation of records that apply to broker-dealers. The general principle behind the regulatory framework governing recordkeeping is that a FINRA broker-dealer must maintain all communications that "relate to the firm's business as such."[64] In that respect, two core aspects of any record retention program relating to an investment banking business are (1) email retention, and (2) retention of customer information and transaction information.

[B] Rule 17a-3 Recordkeeping Requirements

The required retention periods for various types of documents relating to a broker-dealer's business are set forth Rule 17a-3. Most documents must be retained for periods of either three or six years, in either case for the first two years in an easily accessible place. However, certain kinds of documents must be retained for the life of the enterprise. Some examples of applicable retention periods are as follows:

- Trade blotters, ledgers: Not less than six years; two years easily accessible.
- Order tickets: Not less than three years; two years easily accessible.
- Net capital records: Not less than three years, two years easily accessible.
- Business communications: Not less than three years; two years easily accessible.

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64. SEC Electronic Records Release, *infra* note 68.

- Employment records: At least three years after the "associated person" has terminated employment.
- Fingerprint records: Life of enterprise, at least two years easily accessible.
- Regulatory inquiries: Until three years after date of the report, easily accessible.
- Exception reports: Until eighteen months after the report was generated easily accessible and until three years after termination of use.

[C] Retention of Electronic Communications

The Electronic Records Release, issued in 1997, establishes the basic principle underlying recordkeeping requirements applicable to email and text messages. The SEC in the Electronic Records Release stated that for record retention purposes under Rule 17a-4, the content of the electronic communication is determinative. Therefore, broker-dealers must retain those email and Internet communications that relate to the broker-dealer's "business as such."[65] Broker-dealers are required to preserve for a period of not less than three years, the first two years in an easily accessible place, originals of all communications received and copies of all communications sent by the firm or its employees relating to its business. These rules apply to electronic communications, including text messaging, as well.[66] Therefore, firms must ensure that their use of emails and text messages is consistent with these supervisory and retention obligations. As a practical matter, this rule requires the retention of all broker-dealer email in the prescribed format.

Rule 17a-4(b)(4) requires the preservation of almost every electronic document, including email, letter, memoranda, and potentially instant messaging as well.[67] Under the rule, all external and internal communications of the broker-dealer relating to its business must be retained.

FINRA Rules do not specifically require member firms to review or approve internal communications. However, members must be certain that they have established a system that adequately supervises the activities of each registered representative and associated person, including their use of electronic communications technology. For a

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65. SEC Electronic Records Release, *infra* note 68.
66. See, for example, July 2016 FINRA enforcement action against Motilal Oswal Securities, in which FINRA imposed a fine for failure to retain WhatsApp and Bloomberg messages related to its business as such.
67. SEC Rule 17a-4(b)(4).

more in-depth discussion of how this relates to social media, please refer to section 52:1.9[E] above.

Rule 17a-4(b)(3) and FINRA Rule 3110 require firms to preserve for a period of not less than three years, the first two in an easily accessible place, originals of all communications received, and copies of all communications sent by the firm or its employees relating to its business. This includes electronic communications.

Records must be preserved "exclusively in a non-rewriteable, non-erasable format."[68] The archival system must have the ability to download indexes and records to practically any electronic medium required by the Commission or FINRA. A backup archive must be maintained in a separate location. Prior to implementing the electronic storage media system, the member, broker, or dealer is required to provide written notice to its examining authority. In many cases, this notice is required ninety days prior to implementation.

Under Rule 17a-4(f)(3)(vii), broker-dealers must have at least one independent third party with access to and the ability to download all exclusively electronically stored information. The third-party vendor must file a written undertaking with the designated examining authority agreeing to comply with Rule 17a-4 and provide the records upon reasonable request. The vendor must preserve those records in its custody and make them available upon request of the broker-dealer, to the SEC or FINRA.

§ 52:1.11 Supervision of Broker-Dealers and Broker-Dealer Personnel

FINRA Rule 3110 (Rule 3110) requires firms to have a supervisory system that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules.

[A] Designating Principals Responsible for Supervision

Rule 3110(a)(2) requires firms to designate principals with authority to carry out the supervisory responsibilities of each type of business in which the firm engages. Principals are persons associated with a firm who, inter alia, are actively engaged in the management of the firm's investment banking or securities business, which includes supervision. These persons may include sole proprietors, officers,

68. SEC Rule 17a-4(f)(2)(ii)(A). This is colloquially known as the "write-once, read-many" (WORM) format requirement. *See also* Electronic Storage of Broker-Dealer Records, SEC Release No. 34-47806 (May 12, 2003) [hereinafter SEC Electronic Records Release].

partners, managers of Offices of Supervisory Jurisdiction (OSJ), and directors of corporations. To become a qualified principal, persons must pass the general securities principal exam (Series 24 exam).

Rule 3110(a)(3) requires firms to register and designate as a branch office or an OSJ each location, including the main office, if one or more of the following supervisory activities take place there: order execution or market making; structuring of private offerings or private placements; maintaining custody of investors' funds or securities; final acceptance of new accounts on behalf of the member; review and endorsement of customer orders; final approval of retail communications; or responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the firm. Additionally, firms must register and designate other offices as OSJs if necessary to supervise their associated persons.

Firms must designate one or more registered principals in each OSJ and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the firm. The supervisory procedures must be appropriate for a firm's business, size, structure, and customers. Generally, the firm must have procedures in place that prohibit principals from supervising their own activities, or allowing persons being supervised by principals to determine their principals' compensation or continued employment. The rule is designed to eliminate conflicts of interest. However, pursuant to the "limited size" exception, if a firm determines that it is not possible to implement those procedures because of the firm's size or a supervisory personnel's position within the firm, the firm will remain compliant with the rule so long as it documents the factors the firm used to reach the determination and how the current supervisory arrangement otherwise complies with the rule. The firm is not obligated to notify FINRA if it relies on this exception.

[B] Establishing Written Procedures

Rule 3110 requires a firm's supervisory system to provide for the establishment and maintenance of written supervisory procedures. Firms are permitted to use risk-based systems to identify and prioritize areas that pose the greatest risk of potential securities laws and self-regulatory organization rule violations in the course of drafting the written supervisory procedures. However, pursuant to Rule 3110, certain minimum requirements of the written procedures include:

(1) *Transaction review procedures.* Rule 3110(b)(2) requires a firm to have supervisory procedures for the review of all transactions relating to the firm's investment banking or securities business by a registered principal. The review must be evidenced in writing. Note that if a firm does not engage in any

transactions relating to its investment banking or securities business, the firm does not have any review obligations under Rule 3110(b)(2) and may comply with the rule by acknowledging that it does not engage in such transactions.

(2) *Review of correspondence and internal communications*. Firms must have supervisory procedures, which are appropriate for the firm's business, size, structure, and customers, to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business. Note that the rule also requires reviews of correspondence and internal communications to be conducted by a registered principal and be evidenced in writing, either electronically or on paper.

(3) *Review of customer complaints*. Rule 3110(b)(5) requires firms to have supervisory procedures to capture, acknowledge, and respond to all written (including electronic) customer complaints. A failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010.

(4) *Supervision of supervisory personnel*. Rule 3110(b)(6) requires that firms have procedures to prohibit its supervisory personnel from (1) supervising their own activities; and (2) reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising.

[C] Annual Compliance Meeting

FINRA Rule 3110(a)(7) requires each registered representative and registered principal to participate, at least once each year, in an interview or meeting at which compliance matters relevant to the particular representative or principal are discussed. The principal must review compliance issues that have arisen over the preceding twelve months and keep them up to date on changing compliance requirements. Firms must afford registered persons the opportunity to ask questions about the presentation and provide timely answers. These meetings need not be in person, but if a firm chooses to conduct them using other methods (webcast, video conference, interactive classroom, telephone, or online), then the firm must ensure that each registered person attends the entire meeting.

[D] Annual Certification of Compliance and Supervisory Processes

FINRA Rule 3130 requires the firm's CEO to certify annually that the firm has implemented processes to establish, maintain, review, test, and modify policies and procedures reasonably designed to

achieve compliance with securities laws and regulations and FINRA rules. The firm's processes must be documented in a report and submitted to the firm's board of directors and audit committee. Furthermore, the CEO must certify that he or she met with the COO within the last twelve months to discuss the firm's processes.

§ 52:1.12 Regulatory Oversight and Licensing

[A] Generally

Individuals who work for, as a legal matter, people who are "under the day-to-day control of" a registered broker-dealer are referred to as "associated persons."[69] Associated persons of broker-dealers are subject to individual registration under FINRA rules. The broker-dealer with whom associated persons are registered bears the responsibility for monitoring the individual's business dealings. There are two general categories of registration: representatives and principals.

[A][1] Registered Representatives

These are persons associated with a FINRA member "who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions."

[A][2] Principals

The "principal" category encompasses persons "who are actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions." Under FINRA rules, all members are required to have at least two registered principals.

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69. Pursuant to NASD Rule 1011(b), the term "Associated Person" means: (1) a natural person registered under NASD Rules; (2) a sole proprietor, or any partner, officer, director, branch manager of the broker-dealer, or any person occupying a similar status or performing similar functions; (3) any company, government, or political subdivision or agency or instrumentality of a government controlled by or controlling the broker-dealer; (4) any employee of the broker-dealer, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the broker-dealer whether or not such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above.

[B] Licensing Requirements

Both representatives and principals are required to take qualification examinations, often referenced by series numbers, the successful completion of which is a prerequisite for registration. Commonly required licenses for registered representatives are the Series 7 and Series 63 licenses; principals must be Series 24-licensed. A brief description of each exam follows:

- *Series 7* allows the holder to sell all types of securities products with the exception of commodities and futures.
- *Series 63* allows the holder to solicit orders for any type of security in a particular state.
- *Series 24* is required for principals and allows the holder to supervise and manage branch activities.

[C] Exemption from the Registration Requirement for Non-U.S. Broker-Dealers

Broker-dealers located outside the United States that undertake securities transactions in the United States are required to register with the SEC. However, Rule 15a-6 allows foreign broker-dealers (and their accompanying associated persons) who are not registered under the Exchange Act, to conduct certain limited activities in the United States and with U.S. persons (generally institutional investors) without registering with the SEC. Under the rule, foreign broker-dealers may, subject to several conditions:

- effect "transactions in securities with or for persons that have not been solicited by the foreign broker or dealer";
- "induce the purchase or sale of any security by a U.S. institutional investor or a major U.S. institutional investor," provided that a U.S. broker-dealer intermediates such solicitation and transactions, and, among other things,
- enter into securities transactions with SEC-registered broker-dealers, certain qualified U.S. banks, specific multilateral organizations;
- enter into securities transactions with foreign persons temporarily in the United States, U.S. citizens resident abroad, and foreign branches and agencies of U.S. Person; and
- deal with any "U.S.-resident fiduciary" that is acting on behalf of a non-U.S. account.

As a result of its institutional focus, Rule 15a-6 has only limited usefulness in the retail private wealth management context. Further, it is important to note that Rule 15(a)-6 addresses federal broker-dealer

status only, and does not preempt or otherwise impact state broker-dealer licensing requirements. Non-U.S. broker-dealers dealing with retail persons under Rule 15a-6 should carefully consider such requirements.

§ 52:2 Investment Adviser Regulation of Private Banking and Wealth Management

§ 52:2.1 Overview

[A] Standard of Care

As a fiduciary, an investment adviser is held to the highest standard of conduct and must act in the best interest of the client. The fiduciary obligation includes an affirmative duty of utmost good faith and full and fair disclosure of all material facts.[70] An investment adviser's fiduciary duty under the U.S. Investment Advisers Act of 1940 ("Investment Advisers Act") is comprised of a duty of care and duty of loyalty.[71]

[A][1] Duty of Care

The duty of care includes, among other things: (i) the duty to act and to provide advice that is in the best interest of the client; (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and (iii) the duty to provide advice and monitoring over the course of the relationship.[72]

[A][2] Duty of Loyalty

The duty of loyalty requires an investment adviser to put its client's interests first. In meeting the duty of loyalty, an investment adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. An investment adviser must seek to avoid conflicts of interest with its clients and, at minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. Disclosure should be sufficiently specific so a client would be able to decide whether to provide informed consent to the conflict of interest. [73]

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70. Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-48889 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf, at 1–2.
71. *Id*. at 9.
72. *Id*. at 9.
73. *Id*. at 15–16.

[B] Application of the Investment Advisers Act

The application of the Investment Advisers Act can be complex at times so below are a few common themes you should be aware of.

[B][1] Non-Advisory Activities

The Investment Advisers Act does not automatically apply to all activities undertaken by an entity just because it meets the definition of an investment adviser or is registered as an investment adviser. It is intended to apply to the advisory activities carried out by the investment adviser.

[B][2] Foreign Investment Advisers

Foreign investment advisers that register as investment advisers with the SEC will not have the provisions of the Investment Advisers Act applied to their relationships with non-U.S. clients. In contrast, domestic investment advisers will have the provisions of the Investment Advisers Act applied to their relationships with all clients regardless of their location.

[B][3] Non-Registered Investment Advisers

Several of the provisions of the Investment Advisers Act apply to investment advisers whether or not they are registered with the SEC, with the states, or not registered at all. Of particular note is that the anti-fraud provisions, particularly sections 206(1) and 206(2) of the Investment Advisers Act, apply to all investment advisers.

[B][4] Excluded Businesses

As discussed in greater detail below, there are several businesses that can engage in activities that meet the definition of "investment adviser" but that are then excluded from the definition (see section 52:2.2[C]). If such a business relies on one of these exclusions, it should be careful to ensure that it does not engage in an activity that can negatively impact its ability to rely on that exclusion. Some examples relating to the broker-dealer exclusion are:

[B][4][a] Special Compensation

The broker-dealer exclusion contains a provision that the broker-dealer cannot receive any "special compensation." Special compensation has broadly been interpreted to mean any compensation other than commissions. Thus, the receipt of asset-based fees will cause a broker-dealer to be an investment adviser with respect to that account.

[B][4][b] Brokerage Activities

Some activities engaged in by broker-dealers have been determined to not be covered by the exclusion. Some examples are financial planning and discretionary brokerage.

[B][4][c] Remedies

There is no private right of action under the Investment Advisers Act.[74] The sole remedy for a client under the Investment Advisers Act for a breach of the Investment Advisers Act by the investment adviser is to terminate the contract. The SEC can and does enforce the provisions of the Investment Advisers Act, especially the anti-fraud provisions.

[B][4][d] Investment Banking

The provision of investment banking advice as to whether and how an issuer should issue securities, including advice with respect to the structuring, timing, and terms concerning such issue or issues, would not render the investment banker an investment adviser subject to the Investment Advisers Act. However, advice with respect to the investment of the proceeds of the offering may subject the investment banker to the provisions of the Investment Advisers Act.

§ 52:2.2 Who Is an Investment Adviser?

[A] Definition

Under the Investment Advisers Act,[75] an "investment adviser" is generally any person who: (1) for compensation, (2) is engaged in the business of (3) providing advice to others as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities, or issuing reports concerning securities.[76] A person must satisfy all three elements to be considered an "investment adviser" under the Investment Advisers Act.

[B] Elements Under the Investment Advisers Act

[B][1] Compensation

"Compensation" is a broad term and includes the receipt of any economic benefit. This can be in the form of an advisory fee, a fee

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74. *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Teicher v. SEC, 177 F.3d 1016, 1017–19 (D.C. Cir. 1999).
75. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21, https://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf.
76. 15 U.S.C. § 202(a)(11).

relating to the total services rendered, a commission, or some combination. Compensation does not need to be provided by the client but can come from another person for services rendered to the client.

[B][2] Engaged in the Business

A person must be engaged in the business of providing advice. This does not have to be the sole or even the primary activity of the person.

[B][3] Advising about Securities

This includes advice about specific securities, such as stocks, bonds, mutual funds, limited partnerships, and commodity pools as well as more general advice on market trends, selection and retention of other advisers, advantages of investing in securities versus other types of investments (for example, coins or real estate), providing a selective list of securities even if no advice is provided as to any one security, the value of securities, asset allocation, and proxies.

[C] Exclusions

Certain persons or entities may be excluded from the "investment adviser" definition and therefore not subject to any of the Investment Advisers Act's provisions. The following are eligible to be excluded from the "investment adviser" definition and therefore not subject to the Investment Advisers Act:

- *Banks and Bank Holding Companies.* A bank means any of the following: (a) a banking institution organized under the laws of the U.S. or a federal savings association; (b) a bank member of the Federal Reserve System; (c) any other bank institution or savings association, or trust company doing business under U.S. law a substantial portion of the business of which consists of receiving deposits or exercising fiduciary power, and that is supervised and examined by state or federal banking authorities; and (d) a receiver, conservator or other liquidating agent of any entity included in (a), (b) or (c).[77] Any of the above that act as an investment adviser to a registered investment company will, however, not be able to rely on this exclusion and will be an investment adviser required to register as such with the SEC.
- *Lawyers, Accountants, Engineers, and Teachers.* Any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of the profession.[78]

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77. 15 U.S.C. § 202(a)(2), 15 U.S.C. § 202(a)(11)(A).
78. 15 U.S.C. § 202(a)(11)(B).

- *Brokers and Dealers.* Any broker or dealer whose performance of such services is: (i) solely incidental to the conduct of the business as a broker or dealer, and (ii) who receives no special compensation therefor.[79]
- *Publishers.* The publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation.[80]
- *Government Securities Advisers.* Any person or entity whose advice is limited to certain securities issued or guaranteed by the U.S. government. This exception covers persons whose advice is limited to: (a) direct obligations of the federal government; (b) securities subject to guarantees from the federal government; and (c) securities issued by or guaranteed by corporations whose securities are designated by the Secretary of the Treasury as exempted securities.[81]
- *Nationally Recognized Statistical Rating Organizations.* Any nationally recognized statistical rating organization under the Exchange Act.[82]
- *Family Offices.* A family office is excluded if it meets each of the three following conditions: (1) it provides advice about securities only to family clients; (2) the family clients wholly own the family office and family members and/or entities control the family office; and (3) the family office does not hold itself out to the public as an investment adviser.[83]

§ 52:2.3 When Must an Investment Adviser Register Under Section 203 of the Investment Advisers Act?

A person or entity that is considered an "investment adviser" under the Investment Advisers Act must register with the SEC unless it is either: (a) a smaller firm that is prohibited from registering under the Investment Advisers Act and is regulated by a state, or (b) qualifies for an exemption.[84]

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79. 15 U.S.C. § 202(a)(11)(C).
80. 15 U.S.C. § 202(a)(11)(D).
81. 15 U.S.C. § 202(a)(11)(E).
82. 15 U.S.C. § 202(a)(11)(F).
83. 15 U.S.C. § 202(a)(11)(G). For the SEC's definition of "family offices," see Investment Advisers Act Rule 202(a)(11)G-1, https://www.sec.gov/rules/final/2011/ia-3220.pdf.
84. 15 U.S.C. § 202(a).

[A] Registration Requirement

Applicants for registration under the Investment Advisers Act must file a Form ADV with the SEC. Within forty-five days of filing, the SEC must grant registration or institute administrative proceedings to determine whether registration should be denied.

[A][1] Denial of Registration

The SEC may deny registration if the adviser or any "person associated with an adviser" makes false or misleading statements in its registration application; within the past ten years has been convicted of certain felonies or misdemeanors; has been convicted by a court, or found by the SEC to have violated a securities-related statute or rule; or has been the subject of a securities-related injunction or similar legal action.[85]

A person associated with an investment adviser includes the investment adviser's employees and any person who directly or indirectly controls the investment adviser or is controlled by the investment adviser.[86]

[A][2] Qualifications

There are no education or experience requirements for SEC registration as an investment adviser. However, investment advisers must disclose to clients the background and qualifications of certain investment adviser personnel.[87]

[A][3] Form ADV

The Form ADV is the uniform form used by investment advisers to register with both the SEC and the state securities authorities. It consists of two parts:[88]

- *Part 1.* Requires information about the investment adviser's business, ownership, clients, employees, business practices, and any disciplinary events of the investment adviser or its employees.
- *Part 2.* Requires investment advisers to prepare narrative brochures that contain information such as types of advisory services offered, the investment adviser's fee schedule, disciplinary information, conflicts of interest, and the educational

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85. 15 U.S.C. § 203(c)(2), (e).
86. 15 U.S.C. § 202(a)(17).
87. Form ADV, pt. 2B, item 2, https://www.sec.gov/about/forms/formadv-part2.pdf.
88. SEC, Fast Answers, Form ADV (last modified Mar. 11, 2011), https://www.sec.gov/fast-answers/answersformadvhtm.html.

and business background of management and key advisory personnel of the investment adviser. The brochure is the primary disclosure document that investment advisers provide to their clients.

[A][4] Public Filing

All applications for registration as an investment adviser with the SEC must be submitted electronically through an electronic filing system called the Investment Adviser Registration Depository (IARD).[89]

[B] Statutory Exemptions

[B][1] Smaller Firm

Under section 203A of the Investment Advisers Act, firms with less than $25 million in assets under management and certain mid-sized firms must generally register with the state(s) under state law, and are prohibited from registering with the SEC under section 203A of the Investment Advisers Act:

- *Small advisers*, or investment advisers with less than $25 million in assets under management, must register with the state where they have their principal office and place of business, and they are prohibited from registering with the SEC unless an exception to that prohibition is available.[90]
- *Mid-sized advisers*, or investment advisers with between $25 million and $100 million in assets under management, generally must register in the state where they have their principal office and place of business.[91] However, there are two instances where mid-sized advisers must register with the SEC:[92]
  - The investment adviser is not required under state law to be registered with the state where it has its principal office and place of business.[93]
  - The investment adviser is not subject to examination by the securities authority of the state where it has its principal office and place of business.

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89. INVESTMENT ADVISER REGISTRATION DEPOSITORY, https://www.iard.com/.
90. 15 U.S.C. § 203A(a).
91. 15 U.S.C. § 203A(a)(2).
92. 15 U.S.C. § 203A(a)(2)(B).
93. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221 (June 22, 2011); 17 C.F.R. pts. 275; 279, at 37.

- *Large advisers*, or investment advisers with more than $100 million in assets under management, must register with the SEC unless an exception is available.[94]

The following are exceptions to section 203A's provisions regarding the registration of investment advisers with the states based on the amount of assets they have under management. Generally, those investment advisers who qualify for these exceptions are required to register with the SEC and not with the state(s).

- Advisers to investment companies. Investment advisers to investment companies registered under the Investment Company Act of 1940 ("Investment Company Act") must register with the SEC.[95]
- *Advisers to business development companies.* Investment advisers to business development companies must register with the SEC if: (i) they have at least $25 million in assets under management and (ii) advise a business development company.[96]
- *"Pension Consultants."* Investment advisers that provide investment advice to employee benefit, governmental, or church plans that have at least $200 million in assets must register with the SEC.[97]
- *Advisers Related to a Registered Adviser.* Investment advisers that are controlling, controlled by or under common control with an investment adviser that is registered with the SEC must register with the SEC if they have the same principal office and place of business as the registered adviser.[98]
- *Advisers Expecting to Be Eligible for SEC Registration*. Investment advisers that are not registered but have a reasonable expectation that they would be eligible to register with the SEC within 120 days of registration may register with the SEC.[99]
- *Advisers registered with at least fifteen states*. Investment advisers that must otherwise register with fifteen or more states may register with the SEC rather than the states.[100]
- *Internet Adviser.* Investment advisers that provide investment advice to all of their clients exclusively through an interactive

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94. 15 U.S.C. § 203A(a)(2)(B)(i).
95. 15 U.S.C. § 203A(a)(1)(B).
96. 15 U.S.C. § 203A(a)(2)(A).
97. Investment Advisers Act Rule 203A-2(a).
98. Investment Advisers Act Rule 203A-2(b).
99. Investment Advisers Act Rule 203A-2(c).
100. Investment Advisers Act Rule 203A-2(d).

website (although the investment adviser may provide investment advice to fewer than fifteen clients through other means) may register with the SEC.[101]

[B][2] Exemptions from Registration with the SEC

The Investment Advisers Act offers several voluntary exemptions from SEC registration. Investment advisers that are eligible for the following exemptions may nevertheless opt to register with the SEC or the appropriate state:

- *Intrastate Advisers.*[102] An intrastate investment adviser is one (a) whose clients are all residents of the state where the investment adviser maintains its principal office and place of business, (b) that does not act as an investment adviser to a private fund, and (c) that does not give advice about securities traded on any national exchange.
- *Advisers to Insurance Companies.*[103] An investment adviser whose clientele is comprised only of insurance companies.
- *Foreign Private Advisers.*[104] An investment adviser who has (a) no place of business in the United States, (b) has fewer than fifteen clients and investors in the United States in private funds advised by the investment adviser, (c) has aggregate assets under management attributable to clients and investors in the United States of less than $25 million, and (d) does not hold itself out generally to the public in the United States as an investment adviser nor act as an investment adviser to any registered investment company or business development company.[105]
- *Charitable Organizations and Plans.* An investment adviser that is a charitable organization; or a trustee, director, officer, employee, or volunteer of a charitable organization acting within the scope of his or her employment or duties.[106]
- *Commodity Trading Advisors.* A commodity trading advisor who is (a) registered with the Commodities Futures Trading Commission as a commodity trading advisor and whose business does not consist primarily of acting as an investment adviser, and (b) does not act as an investment adviser to a

101. Investment Advisers Act Rule 203A-2(e).
102. 15 U.S.C. § 203(b)(1).
103. 15 U.S.C. § 203(b)(2).
104. 15 U.S.C. § 203(b)(3).
105. 15 U.S.C. § 203(b)(3); 15 U.S.C. § 202(a)(30).
106. 15 U.S.C. § 203(b)(4).

registered investment company or a business development company.[107]

- *Private Fund Advisers.* A private fund adviser must (a) act solely as an investment adviser to private funds and (b) have assets under management in the United States of less than $150 million.[108] Note, however, that while private fund advisers are exempt from the registration provisions of the Investment Advisers Act, they are required to file reports with the SEC and are referred to as "exempt reporting advisers."
- *Venture Capital Advisers.* A venture capital adviser must (a) act as an investment adviser solely to one or more venture capital funds, and (b) one or more small business investment companies.[109]
- *Small Business Investment Companies Advisers.* An investment adviser that solely provides advice to a small business investment company (licensed by the Small Business Administration).[110]

§ 52:2.4 What Obligations Are Imposed on Investment Advisers Under the Investment Advisers Act?

The Investment Advisers Act imposes the following obligations on the conduct of investment advisers in order to protect clients against potential fraudulent activity on the part of investment advisers:

[A] Client Transactions

Regardless of whether an investment adviser is registered under the Investment Advisers Act, an investment adviser is prohibited from acting as a principal for his or her own account, knowingly selling any security to or purchasing any security from a client, or acting as a broker for a person other than the client, knowingly effecting the sale or purchase of any security for the account of such a client without disclosing to the client in writing before the completion of the transaction the capacity in which the investment adviser is acting and obtaining the consent of the client to the transaction.[111] Note that this provision requires transaction-by-transaction disclosure and consent.

[B] Advertising

An investment adviser that is registered or required to be registered under the Investment Advisers Act is prohibited from using any

107. 15 U.S.C. § 203(b)(6)(A).
108. 15 U.S.C. § 203(m)(1).
109. 15 U.S.C. § 203(l).
110. 15 U.S.C. § 203(b)(7).
111. 15 U.S.C. § 206(3).

advertisement that contains any false statement of material fact or is otherwise false or misleading.[112] This rule applies prohibitions or restrictions on the use of:

- Testimonials
- Past recommendations
- Graphs, charts, formulas, or other devices
- Free reports, analysis, or other services

[C] Custody of Client Assets

An investment adviser that is registered or required to be registered under the Investment Advisers Act is prohibited to have custody of client funds or securities unless the investment adviser meets certain requirements to protect client assets.[113]

"Custody" means holding client funds or securities, including any arrangement under which the investment adviser is allowed to withdraw client funds or securities maintained with a custodian or any capacity that gives the investment adviser legal ownership of, or access to, client funds or securities.

An investment adviser may have custody of client funds and securities if the following requirements are met:

- The investment adviser is a qualified custodian and maintains those funds and securities in separate accounts for each client under the client's name or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients.[114]
- The investment adviser, upon opening an account with a qualified custodian on the client's behalf, gives notice to the client in writing of the qualified custodian's name, address, and manner in which the funds or securities are maintained.[115]
- The investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the investment adviser has custody of client funds or securities.[116]

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112. Investment Advisers Act Rule 206(4)-1.
113. Investment Advisers Act Rule 206(4)-2.
114. Investment Advisers Act Rule 206(4)-2(a)(1).
115. Investment Advisers Act Rule 206(4)-2(a)(2).
116. Investment Advisers Act Rule 206(4)-2(a)(3).

- Client funds and securities under the investment adviser's custody are subject to an examination by an independent public accountant at least once during each calendar year.[117]

[D] Use of Solicitors

An investment adviser that is registered or required to be registered under the Investment Advisers Act is prohibited from paying a cash fee to a solicitor with respect to solicitation activities, unless the following requirements are satisfied: [118]

- The solicitor is not subject to a Commission order under section 203(f) of the Investment Advisers Act and has not been convicted within the previous ten years of any applicable felony, misdemeanor, judgment, or order;[119]
- The cash fee is paid under a written agreement to which the investment adviser is a party;[120]
- The cash fee is paid to the solicitor with respect to solicitation activities for the provision of impersonal advisory services only;[121]
- The solicitor is (i) a partner, officer, director, or employee of such investment adviser, or (ii) a partner, officer, director, or employee of a person that controls, is controlled by, or is under common control with such investment adviser; or [122]
- The cash fee is paid as per written agreement that contains certain additional required elements and the investment adviser receives from the client, at the time of or prior to entering into any contract, an acknowledgement of receipt of the investment adviser's and the solicitors' written disclosure statements.[123]

[E] Political Contributions

An investment adviser that is registered or required to be registered under the Investment Advisers Act, exempt from registration as a foreign private adviser, or an "exempt reporting adviser," and any "covered associate," is prohibited from receiving compensation for providing advice to a government entity for two years after making a

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117. Investment Advisers Act Rule 206(4)-2(a)(4).
118. Investment Advisers Act Rule 206(4)-3(a).
119. Investment Advisers Act Rule 206(4)-3(a)(1)(ii).
120. Investment Advisers Act Rule 206(4)-3(a)(1)(iii).
121. Investment Advisers Act Rule 206(4)-3(a)(2)(i).
122. Investment Advisers Act Rule 206(4)-3(a)(2)(ii).
123. Investment Advisers Act Rule 206(4)-3(a)(1)(iii); Investment Advisers Act Rule 206(4)-3(a)(2)(A).

political contribution to elected government officials or candidates who are responsible for or can influence the outcome of the hiring an investment adviser.[124]

A "covered associate" of an investment adviser means: (i) any general partner, managing member, executive officer, or person with similar status or function; (ii) any employee who solicits a government entity for the investment adviser and anyone who supervises such an employee; and (iii) any political action committee that an investment adviser or person described under (i) or (ii) controls.[125]

There are cases where individuals are permitted to make political contributions without being subjected to the two-year time out:

- Contributions up to $350 per election to a government official or candidate for whom the contributing individual is entitled to vote, and up to $150 per election for a government official or candidate for whom the contributing person is not entitled to vote.[126]
- Contributions made more than six months before becoming a covered associate of an investment adviser as long as such person did not solicit clients on behalf of the investment adviser after becoming a covered associate.[127]
- Where the investment adviser, among other things, demonstrates to the SEC that the investment adviser (i) has adopted and implemented policies and procedures reasonably designed to prevent violations of the rule, (ii) did not have actual knowledge of the contribution prior to or at the time the violation occurred, and (iii) made reasonable efforts to obtain a return of the contribution.[128]

[F] Proxy Voting

An investment adviser that is registered or required to be registered under the Investment Advisers Act is prohibited from exercising voting authority with respect to client securities unless the investment adviser meets certain requirements.[129]

An investment adviser may vote with respect to client securities if the following requirements are met:

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124. Investment Advisers Act Rule 206(4)-5(a)(1); Political Contributions by Certain Investment Advisers Investment Advisers Act Release No. IA-3043 (July 1, 2010), https://www.sec.gov/rules/final/2010/ia-3043.pdf.
125. Investment Advisers Act Rule 206(4)-5(f)(2).
126. Investment Advisers Act Rule 206(4)-5(b)(1).
127. Investment Advisers Act Rule 206(4)-5(b)(2).
128. Investment Advisers Act Rule 206(4)-5(e).
129. Investment Advisers Act Rule 206(4)-6.

- The investment adviser adopts and implements written policies and procedures that are reasonably designed to ensure that the investment adviser votes client securities in the best interest of the client.[130]
- The investment adviser discloses to the client how the client can obtain information from the investment adviser concerning how the investment adviser voted with respect to the client's securities.[131]
- The investment adviser describes to the client the proxy voting policies and procedures, and gives to the client a copy of the policies and procedures upon request.[132]

[G] Duty to Supervise

The SEC may sanction an investment adviser, or any person associated with such investment adviser, who has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation if such other person is subject to his or her supervision.[133]

[G][1] Definition of a Supervisor

The president or chief executive of an investment advisory firm is generally responsible for the firm's compliance with applicable requirements unless such person reasonably delegates a particular function to another person, and neither knows nor has reason to know that such person is not properly performing the duties.[134]

[G][2] Supervisor's Obligations

Supervisors are obligated to oversee employees of an investment adviser in a manner that is reasonably designed to ensure compliance with the securities laws.[135]

[G][3] Safe Harbor

A person will not be considered to have failed to reasonably supervise any person if (i) there have been established procedures and a system for applying such procedure, which would reasonably be

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130. Investment Advisers Act Rule 206(4)-6(a).
131. Investment Advisers Act Rule 206(4)-6(b).
132. Investment Advisers Act Rule 206(4)-6(c).
133. 15 U.S.C. § 203(e)(6).
134. In the Matter of Richard F. Kresge, Exchange Act Release No. 55,988 at 14 (June 29, 2007), https://www.sec.gov/litigation/opinions/2007/34-55988.pdf.
135. 15 U.S.C. § 203(e)(6).

expected to prevent and detect the violating conduct, and (ii) such person has reasonably discharged his supervisory duties and had no reasonable cause to believe that such procedures and systems were not being complied with.[136]

[H] Compliance Programs

An investment adviser that is registered or required to be registered under the Investment Advisers Act must adopt and implement a compliance program that satisfies the following requirements:[137]

- Adopt and implement written policies and procedures reasonably designed to prevent violation of the Investment Advisers Act and the regulations thereunder.[138]
- Review, at least annually, the adequacy of such policies and procedures as well as the effectiveness of their implementation.[139]
- Designate an individual (who is a supervised person) to be responsible for administering such policies and procedures.[140]

The SEC expects that an investment adviser's policies and procedures, at minimum, should address the following issues as they are relevant to that investment adviser:[141]

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions.
- Trading practices, including procedures by which the investment adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients.
- Propriety trading of the investment adviser and personal trading activities of supervised persons.
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.

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136. *Id.*
137. Investment Advisers Act Rule 206(4)-7.
138. Investment Advisers Act Rule 206(4)-7(a).
139. Investment Advisers Act Rule 206(4)-7(b).
140. Investment Advisers Act Rule 206(4)-7(c).
141. 17 C.F.R. pts. 270, 275, and 279, Compliance Programs of Investment Companies and Investment Advisers; Final Rule (Dec. 24, 2003), https://www.sec.gov/rules/final/ia-2204.pdf.

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel.
- Accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use, and protects them from untimely destruction.
- Marketing advisory services, including the use of solicitors.
- Processes to value client holdings and assess fees based on those valuations.
- Safeguards for the privacy and protection of client records and information.
- Business continuity plans.

[I] Misuse of Non-Public Information/Code of Ethics

An investment adviser other than one exempt under section 203(b) of the Investment Advisers Act must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the investment adviser or any person associated with the investment adviser.[142]

An investment adviser that is registered or required to be registered under the Investment Advisers Act must establish, maintain, and enforce a written code of ethics that at minimum includes:[143]

- A standard of business conduct that is required of supervised persons, which standard must reflect the investment adviser's fiduciary obligations and those of supervised persons.
- Provisions requiring supervised persons to comply with a wide array of federal securities and related laws.
- Provisions that require all access persons to report, and the investment adviser to review, personal securities transactions and holdings periodically.
- Provisions requiring supervised persons to report any violations of the code of ethics promptly to the chief compliance officer or other person designated in code of ethics.
- Provisions requiring that the investment adviser provide each supervised person with a copy of the code of ethics and any amendments, and that supervised persons provide the investment adviser with written acknowledgment of their receipt of the code and any amendments.

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142. 15 U.S.C. § 204A.
143. Investment Advisers Act Rule 204(A)-1(a).

[J] Fraud Against Investors in Pooled Investment Vehicles

Generally, an investment adviser is prohibited from defrauding or deceiving investors with respect to the pooled investment vehicles the investment adviser advises.[144]

An investment adviser to a pooled investment vehicle is prohibited from:[145]

- Making any untrue statement of a material fact or failing to state a material fact necessary to make a statement not misleading to any investor or prospective investor in a pooled investment vehicle.
- Otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a pooled investment vehicle.

[K] Brochure Rule

An investment adviser registered under the Investment Advisers Act must deliver a brochure and one or more brochure supplements to each client or prospective client that contains information required by Part 2 of Form ADV.[146]

[L] Systemic Risk Reporting on Form PF and Form ADV for Exempt Reporting Advisers

An investment adviser that is registered or required to be registered under the Investment Advisers Act with at least $150 million in private fund assets under management must submit periodic reports on Form PF.[147]

An investment adviser who is relying on its status as a private fund adviser or venture capital adviser under the Investment Advisers Act may, in lieu of registering, file reports with the SEC on Form ADV including Form PF where applicable. If an investment adviser qualifies for either the private fund adviser or venture capital adviser exemption, the adviser is exempt from registering with the SEC. An exempt reporting adviser must file Form ADV within sixty days of relying on the exemption.[148] An exempt reporting adviser is subject to regulation under state laws, as it is exempt from registering with the SEC. States

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144. Investment Advisers Act Rule 206(4)-8(a).
145. *Id.*
146. Investment Advisers Act Rule 204-3.
147. Investment Advisers Act Rule 204(b)-1.
148. Form ADV, General Instruction 13.

may require advisers taking advantage of the exemption to register under state law.

§ 52:2.5 State Laws Applicable to SEC-Registered Advisers

While investment advisers that are registered or required to be registered with the SEC under the Investment Advisers Act are not subject to state investment adviser statutes, they are still subject to certain state laws. State laws may require SEC-registered investment advisers to comply with:

- State anti-fraud prohibitions.[149]
- State notice requirements. A state may require investment advisers registered with the SEC to make a notice filing with the states where they have clients and places of business, including a copy of any document filed with the SEC along with a consent to service and the payment of any required fees.[150]
- States may impose licensing, registration, examination, or qualifications on investment adviser representatives of SEC-registered advisers that have a place of business in the state.

§ 52:2.6 Investment Advisers' Contractual Requirements

The Investment Advisers Act requires all advisory contracts to include certain provisions, discussed below.

[A] Advisory Fees

An investment adviser that is registered or is required to be registered under the Investment Advisers Act is prohibited from entering into a contract with a client that provides for compensation to the investment adviser on the basis of a share of capital gains or appreciation of a client's funds.[151] However, the following are exceptions to this prohibition:

- *Assets Under Management*. Fees charged based on amount of assets under management are allowed.[152]

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149. NASAA, IA: FAQS, http://www.nasaa.org/industry-resources/investment-advisers/ia-faqs/.
150. NASAA, INVESTMENT ADVISER GUIDE, http://www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide/.
151. 15 U.S.C. § 205(a)(1).
152. 15 U.S.C. § 205(b)(1).

- *Fulcrum Fee*. Performance fees for clients where the investment advisory contract relates to the investment of assets of over $1 million or with investment companies are allowed. However, the fee must be based on the asset value of the funds under management over a "specific period" and must change proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices.[153]
- *Non-U.S. Clients*. Performance fees under a contract with persons who are not residents of the United States are allowed.[154]
- *Qualified Clients*. Performance fees under a contract with certain qualified clients are allowed. A qualified client is one of the following: (i) a natural person or company with at least $1 million under management with the investment adviser; (ii) a natural person or company that the investment adviser reasonably believes has a net worth of more than $2 million or is a "qualified purchaser"; or (iii) a natural person who is an officer, director, trustee, or general partner of the investment adviser, or an employee who has participated in the investment adviser's investment decisions over the past twelve months.[155]
- *Qualified Purchaser Funds*. Performance fees under contracts with certain funds exempt from registration under section 3(c)(7) of the Investment Company Act are allowed.[156]
- *Other Funds*. Performance fees under contracts with other types of funds are allowed if each equity owner of the fund is a qualified client with whom the investment adviser could enter a performance fee contract under the rule.[157]

[B] Assignment of Advisory Contract

The contract must provide that no assignment of the investment advisory contract can be made without the consent of the client. If the investment adviser is a partnership, the contract must also provide that the client will be notified within a reasonable time of any change in the membership of the partnership.[158]

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153. 15 U.S.C. § 205(b)(2); *see also* Investment Advisers Act Rules 205-1, 205-2.
154. 15 U.S.C. § 205(b)(5).
155. Investment Advisers Act Rule 205-3.
156. 15 U.S.C. § 205(b)(4).
157. *Id*.
158. 15 U.S.C. § 205(a)(2)–(3).

§ 52:2.7 *Investment Advisers' Recordkeeping Requirements*

[A] Generally

An investment adviser that is registered or required to be registered under the Investment Advisers Act must make and maintain the accurate books and records related to the investment advisory business, as provided under section 204 of the Investment Advisers Act and Rule 204-2. The following is a sample of records that investment advisers are required to maintain:

- Business Records
  - All of the investment adviser's check books, bank statements, cancelled checks, and cash reconciliations.[159]
  - All bills or statements relating to the business of the investment adviser.[160]
  - All trial balances, financial statements, and internal audit working papers related to the investment adviser's business.[161]
  - General and auxiliary ledgers reflecting asset, liability, reserve, capital, income, and expense accounts.[162]
- Additional Records
  - Memorandum of each order given by the investment adviser for the purchase or sale of any security, and any instruction from a client concerning such purchase and sale.[163]
  - Copies of all circulars, advertisements, letters, etc., sent to ten or more persons.[164]
  - A list of all accounts over which the investment adviser has discretionary authority.[165]

[B] How Records Are Maintained

All books and records required to be made under this rule must be maintained and preserved in an easily accessible place for at least five

159. Investment Advisers Act Rule 204-2(a)(4).
160. Investment Advisers Act Rule 204-2(a)(5).
161. Investment Advisers Act Rule 204-2(a)(6).
162. Investment Advisers Act Rule 204-2(a)(2).
163. Investment Advisers Act Rule 204-2(a)(3).
164. Investment Advisers Act Rule 204-2(a)(11).
165. Investment Advisers Act Rule 204-2(a)(8).

years from the end of the fiscal year during which the last entry was made on record.[166]

In the case of electronic records, the investment adviser must maintain duplicate copies, and establish and maintain procedures to: (i) maintain and preserve records to reasonably safeguard them from loss, alteration, or destruction; (ii) limit access to the records to authorized personnel; and (iii) reasonably assure that any reproduction of the record is complete, true, and legible.[167]

§ 52:2.8 *When Are Private Fund Advisers Exempt from Registration?*

Certain investment advisers to privately offered investment funds may be exempt from registration requirements under section 203 of the Investment Adviser's Act.[168] Exemptions are available for private fund advisers, foreign private advisers, and venture capital advisers.[169]

[A] What Is a Private Fund?

A private fund is an issuer that would be an investment company under section 3 of the Investment Company Act, but is excluded pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act. Section 3(c)(1) excludes an issuer whose outstanding securities are beneficially owned by 100 persons or fewer, and neither makes nor proposes to make a public offering of its securities.[170] Section 3(c)(7) excludes an issuer, the outstanding securities of which are owned exclusively by persons who at the time of acquisition of such securities, are qualified purchasers, and that neither makes nor proposes to make a public offering of such securities.[171]

[B] Who Is a Private Fund Adviser?

Private fund advisers enjoy exemption from registration under section 203 of the Investment Advisers Act. Private fund advisers are those that solely advise private funds and small business investment companies (SBIC) and that have less than $150 million in assets under

166. Investment Advisers Act Rule 204-2(e)(1).
167. Investment Advisers Act Rule 204-2(g)(3).
168. 15 U.S.C. § 203(m).
169. Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers Investment Advisers Act Release No. IA-3222 (June 22, 2011), https://www.sec.gov/rules/final/2011/ia-3222.pdf [hereinafter Release No. IA-3222].
170. 15 U.S.C. § 80a-3(c)(1).
171. 15 U.S.C. § 80a-3(c)(7).

management. An investment adviser that has one or more clients that are not private funds or SBICs is not eligible for the exemption and must register under the Investment Advisers Act unless another exemption is available. An investment adviser can advise an unlimited number of private funds, as long as the aggregate value of the assets is less than $150 million.[172] However, such exempted investment advisers must maintain records and provide to the SEC annual or other reports that the SEC deems necessary or appropriate to public interest or for the protection of investors.[173]

For non-U.S. advisers—advisers with a principal office and place of business outside of the United States—the exemption is available as long as all of the investment adviser's clients that are U.S. persons are qualifying private funds and total in value less than $150 million.[174]

[C] Reporting Requirements for Private Fund Advisers

Certain investment advisers who are exempt from the registration requirements as private fund advisers are required to file an abbreviated Form ADV and a Form PF. In addition to completing and filing a report on Form PF and Form ADV, such investment advisers must observe several requirements, including the following:

- The Form PF and Form ADV must be filed electronically with the Form PF and Form ADV filing system on the Investment Adviser Registration Depository.[175]
- The investment adviser must pay the operator of the Form PF and Form ADV filing system filing fees as per instructions to the Form PF and Form ADV.[176]
- The Form PF and Form ADV must be updated at least annually by the date specified in the instructions to the Form PF and Form ADV.[177]

[D] Who Is a Foreign Private Adviser?

A foreign private adviser is exempt from registration, reporting, recordkeeping, and SEC examination obligations under the Investment Advisers Act. A foreign private adviser is an investment adviser who meets the following criteria:

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172. Release No. IA-3222, *supra* note 169, at 76.
173. 15 U.S.C. § 203(m)(2).
174. Investment Advisers Act Rule 203(m)-1(b)(1).
175. Investment Advisers Act Rule 204(b)-1(b).
176. Investment Advisers Act Rule 204(b)-1(d).
177. Investment Advisers Act Rule 204(b)-1(e).

- Has no place of business in the United States.[178]
- Has a total of fewer than fifteen clients and investors in the United States in private funds that are advised by the investment adviser.[179] An investment adviser may treat the following as a "single client":
  - A natural person and: (i) that person's minor children; (ii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence; (iii) all accounts of which the natural person and/or the persons under categories (i) and (ii) are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or persons under categories (i) and (ii) are the only primary beneficiaries.[180]
  - A corporation, general partnership, limited partnership, limited liability company, trust or other legal organization for which the adviser gives investment advice based on the entity's investment objectives and two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.[181]
- Has aggregate assets under management attributable to clients and investors in the United States of less than $25 million.[182]
- Does not hold itself out generally to the public in the United States as an investment adviser.[183]

[E] Who Is a Venture Capital Adviser?

A venture capital adviser is not required to register under section 203 of the Investment Advisers Act. Venture capital advisers are investment advisers that solely advise venture capital funds and small business investment companies.[184] While venture capital advisers are exempt from the registration provisions of the Investment Advisers Act, they are required to file reports with the SEC and are referred to as "exempt reporting advisers."

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178. 15 U.S.C. § 202(a)(30)(A).
179. 15 U.S.C. § 202(a)(30)(B).
180. Investment Advisers Act Rule 202(a)(30)-1(a)(1).
181. Investment Advisers Act Rule 202(a)(30)-1(a)(2).
182. 15 U.S.C. § 202(a)(30)(C).
183. 15 U.S.C. § 202(a)(30)(D).
184. 15 U.S.C. § 203(l)(1); Release No. IA-3222, *supra* note 169, at 78.

§ 52:2.9 Sample Focuses of SEC Examinations

The Office of Compliance Inspections and Examinations (OCIE) has identified and prioritized examination of several areas of potentially heightened risk to investors or the integrity of the U.S. capital markets. A sample of areas of focus of SEC examinations that impact investment advisers is presented below. For a full list of the OCIE's 2018 examination priorities, or greater detail, please see *SEC 2018 National Exam Program Examination Priorities*.[185]

[A] OCIE Examination Priorities

[A][1] Disclosure of the Costs of Investing

Investment advisers must properly disclose and calculate fees, expenses, and other charges investors pay. Examiners will review, among other things, whether fees and expenses are calculated and charged in accordance with disclosures provided to investors, and consistent with the firm's policies and procedures. Examiners focus on business practices that may increase risks to investors, including where certain advisory personnel who may receive financial incentives to recommend that investors invest, and advisers that have changed the manner in which fees are charged from commission on executed trade to percentage of client assets under management.[186]

[A][2] Mutual Funds and Exchange-Traded Funds

OCIE will focus on examining mutual funds (i) that have experienced poor performance or liquidity in terms of their subscriptions and redemptions relative to their peer groups, (ii) that are managed by advisers with little experience managing registered investment companies, or (iii) that hold securities that are potentially difficult to value during times of market stress, including securitized auto, student, or consumer loans; or collateralized mortgage-backed securities.[187]

[A][3] Electronic Investment Advice

OCIE examines registered investment advisers and broker-dealers that offer such services, including "robo-advisers" that primarily interact with clients online and firms that utilize automation as a component of their services while also offering clients access to

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185. SEC 2018 NATIONAL EXAM PROGRAM EXAMINATION PRIORITIES, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf [hereinafter SEC 2018 NATIONAL EXAM PRIORITIES], at 4.
186. *Id.* at 4–5.
187. *Id.* at 6.

financial professionals. Such examinations may focus on registrants' compliance programs, marketing, formulation of investment recommendations, data protection, disclosures relating to conflicts of interest, and compliance programs for overseeing algorithms that generate recommendations.[188]

[A][4] Wrap-Fee Programs

OCIE will expand its focus on registered investment advisers and broker-dealers associated with wrap-fee programs, which charge investors a single bundled fee for advisory and brokerage services. OCIE may review whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients. Areas of interest may include wrap account suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices, including best execution and trading away.[189]

[A][5] Never-Before Examined Investment Advisers

OCIE will expand its Never-Before Examined Adviser initiative to include focused, risk-based examinations of newly registered advisers, as well as of selected advisers that have been registered for a longer period but have never been examined by OCIE.[190]

[A][6] Cryptocurrency and ICO

OCIE will continue to monitor the sale of these products, and where the products are securities, examine for regulatory compliance. Areas of focus will include, among other things, whether financial professionals maintain adequate controls and safeguards to protect these assets from theft or misappropriation, and whether financial professionals are providing investors with disclosure about the risks associated with these investments, including the risk of investment losses, liquidity risks, price volatility, and potential fraud.[191]

[A][7] Senior Investors and Retirement Accounts and Products

Seniors and those saving for retirement are increasingly reliant on returns from their investments. OCIE will review how broker-dealers oversee their interactions with senior investors, including the ability of firms to identify financial exploitation of seniors. OCIE will also focus

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188. OCIE EXAMINATION PRIORITIES FOR 2017, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf, at 1–2.
189. *Id*.
190. *Id*.
191. SEC 2018 NATIONAL EXAM PRIORITIES, *supra* note 185, at 7.

on internal controls at firms designed to supervise their representatives, particularly relating to sales of products and services directed at senior investors.[192]

[B] OCIE Risk Alerts

OCIE has also issued Risk Alerts that address areas of concern that affect registered investment advisers. For a full list of and greater detail on the OCIE's Risk Alerts refer to the OCIE website. The Risk Alerts that OCIE has issued since January 1, 2017, affecting investment advisers are:

- Risk Alert: Most Frequent Best Execution Issues Cited in Adviser Exams: July 11, 2018.
- Risk Alert: Most Frequent Advisory Fee and Compliance Issues Identified in Examinations of Investment Advisers: April 12, 2018.
- Risk Alert: Observations from Municipal Advisor Examinations: November 7, 2017.
- Risk Alert: The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers: September 14, 2017.
- Risk Alert: Observations from Cybersecurity Examinations: August 7, 2017.
- Risk Alert: Cybersecurity Ransomware Alert: May 17, 2017.
- Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers: February 7, 2017.

[C] Division of Investment Management Guidance Updates and Information Updates

The Division of Investment Management has also issued Guidance Updates and Information Updates that are of interest to registered investment advisers. For a full list of and greater detail on the Guidance Updates and Information Updates, refer to the Division of Investment Management website. The Guidance Updates and Information Updates that have been issued since January 1, 2017, affecting investment advisers are:

- IM Guidance Update 2017-02: Robo-Advisers: February 2017.
- IM Guidance Update 2017-01: Inadvertent Custody: Advisory Contract versus Custodial Contract Authority: February 2017.

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192. *Id.* at 6.

- IM Information Update: INFO-2018-01: Updates to Custody Rule Frequently Asked Questions: June 2018.
- IM Information Update: INFO-2017-06: Information Update for Advisers Filing Certain Form ADV Amendments: August 2017.
- IM Information Update: INFO-2017-05: Updates to Mid-Sized Adviser Frequently Asked Questions: June 2017.
- IM Information Update: INFO-2017-04: Updates to Form ADV Frequently Asked Questions: June 2017.
- IM Information Update: INFO-2017-03: Information Update for Advisers Relying on the Unibanco No-Action Letters: March 2017.
- IM Information Update: INFO-2017-02: Letters to Support Tax Claims in Foreign Jurisdictions: March 2017.
- IM Information Update: INFO-2017-01: Updates to Form PF Frequently Asked Questions: January 2017.

[D] SEC Division of Enforcement Key Initiatives on the Enforcement of Securities Law

The SEC Division of Enforcement has issued the key initiatives on the enforcement of securities law. For a full description of the SEC's 2018 key initiatives in enforcement, please see the SEC's *Division of Enforcement Annual Report and A Look Back at Fiscal Year 2017*.[193]

§ 52:3 Compensation, ERISA, and the Proposed "Best Interest" Standard

§ 52:3.1 ERISA and Section 4975 of the Internal Revenue Code

The key issues involved in structuring the compensation for registered representatives and other client-facing professionals at broker-dealers may be summarized as follows:

- Designing pay practices and incentive arrangements to mitigate or eliminate conflicts of interest that might preclude compliance with existing law and regulation, or with the SEC's proposed "best interest" standard.

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193. SEC, DIVISION OF ENFORCEMENT ANNUAL REPORT/A LOOK BACK AT FISCAL YEAR 2017 (Nov. 2017), https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

- Recalibrating pay practices and incentive arrangements in light of the vacatur by the Court of Appeals for the Fifth Circuit[194] of the U.S. Department of Labor's final rule[195] revising the definition of fiduciary[196] for purposes of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and section 4975 of the Internal Revenue Code of 1986, as amended (the "Code").
- Structuring retail client relationships to avoid, where possible, unintended fiduciary status for purposes of ERISA and the Code, and compliance with the five-factor test under ERISA.[197]
- Controlling the cost of recruiting and retaining key talent.
- Developing pay practices and other arrangements that foster the goal of institutionalizing client relationships, so that the relationships do not part with the departure of client-facing investment professionals.

§ 52:3.2 Fiduciary Standard of Care

[A] ERISA and Section 4975 of the Code

[A][1] Background—Fiduciary Status

ERISA fiduciary status directly impacts the type of pay and remuneration that can be paid to registered representatives or received by the financial organizations that employ them. Under ERISA, fiduciaries are broadly prohibited from exercising their discretion as a fiduciary in a manner that directly or indirectly increases compensation or confers a benefit upon the fiduciary or certain of its affiliates.

This section describes the evolving approach to determining fiduciary status under ERISA and the standards of care that apply to

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194. Chamber of Commerce of U.S. v. U.S. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018) (vacating the Fiduciary Rule (as defined below) *in toto* as beyond the Department of Labor's regulatory authority).
195. Definition of "Fiduciary," 29 C.F.R. § 2510.3-21 (2016).
196. Definition of "Fiduciary," 26 C.F.R. § 54.4975-9(c)–(e) (1975).
197. 26 C.F.R. § 54.4975-9(c) (1975). A DOL regulation issued in 1975 provides that a person who does not have discretionary authority or control with respect to the assets of a plan will not be treated as a fiduciary by reason of providing investment advice unless: (1) such person renders advice with respect to the value of securities or other property, (2) on a regular basis, (3) the advice is provided pursuant to a mutual agreement, arrangement, or understanding with the plan that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and (5) the advice is individualized to the plan based on the needs of the plan (the "five-factor test").

service providers ("Service Providers"); and to clients, customers, or accounts that are subject to ERISA (such clients, customers, or accounts, "ERISA Clients") or section 4975 of the Code (such clients, customers, or accounts, "IRAs").

As a general matter, ERISA Clients such as employee pension benefit plans sponsored by private employers or unions—including both traditional pension benefit plans and so-called "401(k) plans"—are subject to both Title I of ERISA and section 4975 of the Code. Such ERISA Clients would also include individual 401(k) plan accounts. Collective investment funds and other vehicles that manage the assets of employee pension benefit plans may also be ERISA Clients.

ERISA's fiduciary standards apply based on the type of plan or account involved and the type of services rendered to that plan or account, and are not based upon the labels used to describe the function or employee's responsibilities. For instance, a registered representative making investment recommendations relating to an IRA may be subject to ERISA's fiduciary standards, even if the registered representative is not in a business unit focusing on retirement assets. ERISA's fiduciary standards are always applicable when a financial organization or its representatives are making investment decisions with respect to assets of retirement plans, such as traditional pension plans and 401(k) plans.

IRAs, which for these purposes include traditional individual retirement accounts, Roth individual retirement accounts and individual retirement annuities, are subject to the prohibited transaction provisions of section 4975 of the Code (henceforth, "Section 4975"), but are typically not subject to ERISA.[198] IRAs are at the heart of the retail retirement market and are a key source of asset accumulation by financial organizations such as banks and broker-dealers.

In an effort to address the applicability of ERISA's fiduciary rules to IRAs, the U.S. Department of Labor (DOL) promulgated the Fiduciary Rule (as defined below), which was principally intended to expand the

198. In some circumstances, IRAs can become subject to ERISA. This may occur if an employer provides access to an IRA program to its employees. Regulations at 29 C.F.R. 2510.3-2(d) provide a "safe harbor" for such arrangements; such a program will not be subject to ERISA provided that (i) the employer makes no contributions to the IRAs; (ii) participation in the IRA program is completely voluntary for employees; (iii) the employer's sole involvement in the program is to permit the sponsor of the program to publicize the program, to collect contributions through payroll deductions and to contribute such deductions to the sponsor; and (iv) the employer receives no consideration in connection with the program other than reasonable compensation for services actually rendered in connection with payroll deductions.

circumstances when a Service Provider would be acting as a "fiduciary" with respect to an IRA. As a result of the Fiduciary Rule, many broker-dealers, banks, and investment advisers made significant revisions to their fee arrangements with retail clients, to their compensation arrangements for registered representatives and other client-facing professionals, and to their institutional arrangements related to the marketing and distribution of financial products, particularly registered and unregistered funds. The vacatur of the Fiduciary Rule (noted below) may result in the revision, abandonment, or curtailment of certain of these revisions.

Generally, ERISA and Section 4975 do not impose standards of care on Service Providers dealing with persons who are neither ERISA Clients nor IRAs. This means that FINRA and SEC rules would apply to a registered representative's actions with respect to the assets of clients that are not part of an ERISA Client or IRA, and additional rules under ERISA and Section 4975 would apply to the assets of the same client held in an ERISA Client or IRA. In addition, ERISA and Section 4975 each impose a standard of care on a Service Provider only when it serves as a "fiduciary" with respect to an ERISA Client or IRA. Determining a Service Provider's status as a "fiduciary" is therefore a threshold inquiry for determining that Service Provider's standard of care under ERISA or Section 4975.

In response to the promulgation of the Fiduciary Rule and its more recent vacatur by the Court of Appeals for the Fifth Circuit, the standards of conduct for registered representatives and financial organizations acting as Service Providers with respect to ERISA Clients or IRAs have shifted dramatically over the last several years and, in light of the SEC's proposed "best interest" standard, continue to be in flux.

Figure 52-1

Chronology: Evolving Standards for Determining "Fiduciary" Status

The chart below provides a brief summary of the applicable standards for determining "fiduciary" status, over time:

Type of Client	Standards for Determining "Fiduciary" Status			
	Prior to June 9, 2017 ("Original Law Period")	**From June 9, 2017 until a proposed date of July 1, 2019 ("Phase-In Period")**	**From March 15, 2018 date of vacatur until mandate issuance ("Vacatur Period")**	**Post-vacatur mandate issuance until additional rule-making or court decisions ("Reinstatement Period")**
ERISA Clients	Section 3(21) of ERISA and the "Five-Factor Test"	Section 3(21) of ERISA and the "Fiduciary Rule," with phase-in of compliance with key class exemptions	Section 3(21) of ERISA and the Fiduciary Rule, with transitional enforcement relief	Section 3(21) of ERISA and return to the Five-Factor Test, with transitional enforcement relief continuing until further guidance from the DOL
IRAs	Section 4975(e)(3) and the Five-Factor Test	Section 4975(e)(3) and the Fiduciary Rule	Section 4975(e)(3) and the Fiduciary Rule	Section 4975(e)(3) and the Five-Factor Test

[B] Determining Fiduciary Status

[B][1] Management Fiduciaries

Under both ERISA and Section 4975, Service Providers are "fiduciaries" with respect to ERISA Clients or IRAs, respectively, to the extent they have or exercise any discretionary authority or control over the assets of the ERISA Client or IRA (such fiduciaries, "Management Fiduciaries"). This test is functional, so that a Service Provider can be deemed to be a Management Fiduciary even if no contract or arrangement specifically provides it with the authority to act on behalf of the ERISA Client or IRA, as long as it exercises the requisite degree of authority or control over ERISA Client or IRA assets. Conversely,

Service Providers are not Management Fiduciaries to the extent they are acting solely on the lawful direction of another fiduciary of the ERISA Client or IRA. For instance, an ERISA Client may direct a Management Fiduciary to invest a set allocation of the ERISA Client's assets in accordance with a specific investment strategy. The Management Fiduciary would be a "fiduciary" for purposes of ERISA with respect to that investment management, but generally not with respect to setting the allocation or selecting the investment strategy (as long as the Management Fiduciary complies with such directions).[199]

[B][2] Advice Fiduciaries—Original Law and Reinstatement Periods

Under both ERISA and Section 4975, Service Providers may also be deemed to be "fiduciaries" with respect to ERISA Clients or IRAs to the extent they provide investment advice for a fee or other compensation, direct or indirect, with respect to the assets of the ERISA Client or IRA (such fiduciaries, "Advice Fiduciaries"). During the Original Law Period, status as an Advice Fiduciary was determined according to the "Five-Factor Test." Under the Five-Factor Test, Service Providers are Advice Fiduciaries if they (for a fee or other compensation, direct or indirect):

(1) render advice as to the value of securities or other property, or make 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 ERISA Client or IRA that

(4) the advice will serve as a primary basis for investment decisions with respect to the assets of the ERISA Client or IRA, where

(5) the advice is individualized based on the particular needs of the ERISA Client or IRA.

During the Original Law Period, it was typical for Service Providers to ERISA Clients and IRAs to structure their services, to the extent

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199. Questions can sometimes arise where an ERISA Client or IRA purports to "direct" a Management Fiduciary to effect a transaction that had previously been recommended or suggested by the Management Fiduciary. As a general rule, such direction will not "bless" the transaction—that is, by limiting the Management Fiduciary's discretion, and so its fiduciary status and potential fiduciary liability with respect to the transaction—particularly where the Management Fiduciary might have a conflict of interest in the transaction.

practicable, so that one or more of the above factors of the Five-Factor Test would not be satisfied. This would allow such Service Providers to avoid being deemed Advice Fiduciaries and thereby to avoid the restrictions and duties that ERISA and Section 4975 impose upon such fiduciaries. For example, one-time advice to a 401(k) plan participant considering a rollover into an IRA would fail to satisfy condition (2); general advice not individually tailored to an ERISA Client or IRA would fail to satisfy condition (5); and disclaimers would be used to establish that there was no *mutual agreement* that any advice provided would serve as the *primary* basis of any investment decisions. Other approaches have also been used to avoid fiduciary status under the Five-Factor Test, largely to avoid having potential conflicts of interest related to advice or recommendations trigger a breach of fiduciary duty or a prohibited transaction.[200]

It appears that, beginning with the Reinstatement Period, the Five-Factor Test will once again be the applicable standard for determining status as an Advice Fiduciary, subject to future rule-making by the DOL. While the DOL, in any future rulemaking, may seek to harmonize the Advice Fiduciary standard with the final version of the SEC's proposed "best interest" standard, the proposed "best interest" standard will provide a separate and independent regulatory overlay on Service Providers to ERISA Clients and IRAs. The status of such Service Providers as "fiduciaries" for purposes of ERISA and

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200. Section 404(a)(1) of ERISA provides four guiding principles of fiduciary responsibility, including the exclusive benefit rule. Under section 404(a)(1), a fiduciary is required to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV [of ERISA]." [29 U.S.C. § 1104(a)(1)]. In addition, section 406(b) of ERISA prohibits a fiduciary from engaging in certain transactions where they have certain conflicts of interest. Specifically, fiduciaries may not "(1) deal with the assets of the plan in his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan." [29 U.S.C § 1106(b)].

Section 4975 of the Code will continue to be determined pursuant to DOL guidance.[201]

[B][3] Advice Fiduciaries—During the Phase-In and Vacatur Periods

Effective as of the beginning of the Phase-In Period, the DOL replaced the Five-Factor Test with the "Fiduciary Rule." The Fiduciary Rule was in many respects designed to curb some of the "work-arounds" the market had developed under the Five-Factor Test, particularly with respect to providing advice to retail retirement investors, both generally and in connection with making rollover decisions. Accordingly, the Fiduciary Rule eliminated the "regular basis" and "primary basis" prongs of the Five-Factor Test; expanded the scope of potential "fiduciary advice"; and attempted to conform in certain respects to FINRA's "suitability" standards.

In order to determine whether a Service Provider was an Advice Fiduciary under the Fiduciary Rule, one had to first determine whether the Service Provider has provided a "recommendation"[202] to an ERISA Client or IRA (for a fee or other compensation, direct or indirect) as to either (i) the advisability of any investment decision regarding property held by the ERISA Client or IRA, including after any rollover, transfer, or distribution from the ERISA Client or IRA; or (ii) any management or investment strategy with respect to the ERISA Client or IRA, including whether and in what amount or form to roll over, transfer, or distribute the assets of the ERISA Client or IRA.

The Fiduciary Rule explicitly carved out several categories of communications that did not constitute "recommendations." These categories were highly technical, but generally included: (i) providing a

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201. Regulation Best Interest, 83 Fed. Reg. 21,574, 21,580–82 (proposed on May 9, 2018) (to be codified at 17 C.F.R. pt. 240). The SEC discusses the similarities and differences between the proposed "best interest" standard and the DOL's Fiduciary Rule.

202. Under the Fiduciary Rule, a "recommendation" was a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The more tailored to a particular recipient's individual investment needs and circumstances, the more likely that a communication would have been deemed to be a "recommendation" for purposes of the Fiduciary Rule. This recommendation standard was intended by DOL to be concordant—though not necessarily co-extensive—with "recommendations" for purposes of FINRA 211, relating to FINRA's suitability standards. If engaging in a particular communication requires a broker-dealer to comply with FINRA's "suitability" requirements, the communication would be a "recommendation" for purposes of the Fiduciary Rule.

general platform of investment alternatives from which plan participants may select, without tailoring to the specific needs of the plan or its participants; (ii) selecting and monitoring investment alternatives pursuant to objective criteria specified by a plan fiduciary and providing objective financial data regarding such alternatives; (iii) general communications that would not reasonably be viewed as "recommendations"; and (iv) various kinds of investment education.

If Service Provider communications with an ERISA Client or IRA constituted a "recommendation" within the meaning of the Fiduciary Rule and were (i) provided by a Service Provider who has represented or acknowledged it is acting as a "fiduciary" within the meaning of ERISA or Section 4975; (ii) rendered pursuant to any agreement, arrangement, or understanding that the recommendation is provided on the particular investment needs of the ERISA Client or IRA; or (iii) directed to a specific recipient regarding a particular investment or management decision (for example, rolling over a 401(k) account balance into an IRA), then, in each case, the Service Provider would generally have been an Advice Fiduciary for purposes of ERISA and Section 4975.

As noted more fully below, fiduciary status has a direct consequence on the design of incentive compensation arrangements applicable to the fiduciary, as an ERISA fiduciary generally cannot take actions that result in a direct or indirect increase in remuneration payable to the client-facing representative acting in that capacity or the financial organization that employs the registered representative. As a result of the implementation of the Fiduciary Rule, many broker-dealers, banks, and other financial organizations invested heavily to revise market and internal business practices to either avoid fiduciary status, or to redesign compensation practices and the remuneration generated from the marketing and distribution of financial products so as to eliminate conflicts associated with recommendations to ERISA Clients or IRAs. Financial organizations are broadly assessing which of these changes to modify or unwind, as certain of the changes made in response to the Fiduciary Rule impacted business models, business generation, and profitability.

[C] Fiduciary Duties

ERISA imposes several fiduciary duties on Management Fiduciaries and Advice Fiduciaries when such fiduciaries are exercising the authority, control, or responsibility that makes them a "fiduciary" with respect to ERISA Clients. These duties are primarily the duty of loyalty, duty of prudence, duty of diversification, and duty to follow plan documents. Fiduciaries also have a general duty to avoid prohibited transactions under ERISA and Section 4975, which are described

below in further detail in section 52:3.4. These duties have largely remained unchanged since the passage of ERISA.[203]

The duty of loyalty requires fiduciaries to act solely in the interest of ERISA Clients and for the exclusive purpose of providing benefits to their underlying participants and beneficiaries, and defraying reasonable expenses of administering the plan. Harm or loss to an ERISA Client is not required to breach this fiduciary duty. A fiduciary is in breach of its duty of loyalty whenever it exercises its fiduciary authority or control in a manner intended to benefit itself, an affiliate, or any third party in which it has an interest that would affect its best judgment as a fiduciary. For these reasons, providing full-brokerage services to an ERISA Client can be problematic for an individual or firm acting as a fiduciary, because broker-dealer compensation is often commission-based and typically varies based on the type and frequency of trades. Therefore, advice that results in an increase of such compensation could result in a violation of ERISA's duty of loyalty.

The duty of prudence requires fiduciaries to act prudently with the care, skill, prudence, and diligence of a similarly situated prudent person when exercising their fiduciary authority or control with respect to an ERISA Client. This standard, being derived from the law of trusts, is also described as a "prudent expert" standard. In practice, this duty is generally treated as a duty of "procedural prudence," and not of perfect foresight. Fiduciaries generally meet this standard by carefully considering alternatives and supplementing their expertise, as necessary, while documenting the steps they have taken. For instance, "prudent" fiduciaries may typically survey a number of potential vendors, providing the same requirements and requesting the same information, in order to demonstrate that a meaningful, appropriate, and objective comparison and selection process had taken place.

The duty of diversification requires fiduciaries to diversify the investments made with ERISA Client assets to help minimize the risk of large investment losses to the ERISA Client. Fiduciaries may achieve this by considering potential investments or strategies as part of the plan's entire portfolio, and documenting that consideration and selection process. The duty of diversification, however, typically does not expand beyond the fiduciary's mandate. A fiduciary may often be retained to advise or manage only a specified portion of an ERISA Client's assets in accordance with a specific strategy or investment focus. Such a fiduciary would be required to "diversify" the ERISA Client's exposure only within the scope of that allocation, strategy, and focus, with no responsibility to "balance" exposures the ERISA Client

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203. Contrast this with the DOL's efforts to expand the category of Service Providers deemed to be Advice Fiduciaries and so subject to ERISA's fiduciary duties, through the implementation of the Fiduciary Rule.

may have in other areas. This is in contrast to certain aspects of FINRA suitability requirements, which focus consideration of all of the client's assets, to the extent known, and overall investment objectives in formulating investment recommendations.

While Section 4975 does not generally impose any fiduciary duties on fiduciaries when they are managing or advising IRAs, the changes contemplated by the Fiduciary Rule would have rendered many common practices of Service Providers to IRAs problematic, because these practices typically resulted in increases in the pay of registered representatives or payments to the financial organization based on investment recommendations made to the IRA's owner. Among the practices that would have become problematic under the Fiduciary Rule were recommendations from registered representatives to their clients to roll over assets from retirement plans to IRAs at the financial organization with whom the registered representative was affiliated.

§ 52:3.3 *ERISA Standards for Compensation*

[A] ERISA and Section 4975 of the Code

[A][1] Reasonable Compensation

ERISA and Section 4975 generally require compensation paid to Service Providers to be "reasonable" in amount, pursuant to "reasonable arrangements" for services that are "necessary." The DOL has not provided definitive guidance on each of these elements.[204] In practice, compensation is typically considered to be "reasonable" if the amount of consideration is consistent with what would be negotiated on an arm's-length basis by independent parties, considering all of the relevant facts and circumstances.[205]

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204. Service Providers are "parties in interest" and/or "disqualified persons" with respect to the ERISA Clients to which they provide services, pursuant to section 3(14) of ERISA and section 4975(e)(2) of the Code. In addition, section 406(a)(1)(C) of ERISA and section 4975(c)(1)(C) of the Code prohibit the provision of services between an ERISA Client and any "party in interest" or "disqualified person." Accordingly, the provision of services by Service Providers to ERISA Clients is technically a "prohibited transaction" for purposes of ERISA and section 4975 of the Code. (Note that, while counterintuitive, this interpretation has been effectively adopted by the DOL and is followed by most ERISA practitioners.) Section 408(b)(2) of ERISA and section 4975(d)(2) provide exemptive relief for such service arrangements, the conditions for which are generally described in the main text.

205. The DOL has specified, at 29 C.F.R. § 2550.408c-2(b)(5), that any compensation that would be considered "excessive" under 26 C.F.R. § 1.162-7 (a Treasury regulation relating to compensation for personal services that constitute an "ordinary and necessary trade or business expense") would

A "reasonable arrangement" is one that is terminable by the ERISA Client or IRA without penalty to the ERISA Client or IRA on reasonably short notice under the circumstances. For example, most arrangements with Service Providers providing investment advisory or brokerage services to ERISA Clients or IRAs will be terminable at will by the ERISA Client or IRA. However, practitioners generally understand this requirement to permit longer advance notice periods where immediate termination of the arrangement is not practicable or typical in the relevant market. For example, investments in collective investment pools holding illiquid assets may permissibly be subject to longer mandatory holding periods. Services are "necessary" if they are appropriate and helpful to the ERISA Client or IRA receiving the services in carrying out the purposes for which the ERISA Client or IRA is established or maintained.

If compensation to Service Providers fails to meet these requirements, the compensation may be subject to excise taxes, but generally the Service Provider is not otherwise civilly or criminally liable for having provided the services or receiving prohibited compensation. That said, if the Service Provider could be said to have knowingly "aided or abetted" entering into a prohibited arrangement for services to an ERISA Client, the Service Provider could be liable to the ERISA Client.

[A][2] Compensation Disclosures

Certain Service Providers to ERISA Clients must make various compensation-related disclosures to such ERISA Clients prior to entering into arrangements to provide services to such ERISA Clients. These "covered service providers" (CSPs) must reasonably expect to earn at least $1,000 in compensation (direct or indirect) over the course of the arrangement and provide one of a specified set of services. These rules do not apply to IRAs that are not subject to ERISA.

Covered services include:

- Services provided directly to the ERISA Client as a fiduciary within the meaning of ERISA or as an investment adviser registered under the Investment Advisers Act or any state law.
- Recordkeeping or brokerage services relating to an individual account plan (for example, a 401(k) plan) that permits participants to direct the investment of their accounts, if one or more designated investment alternatives are made available to

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not be "reasonable compensation." The Treasury regulation itself does not provide much clarity, explaining, for example, that "reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

participants in connection with such services. For these purposes, "recordkeeping services" are generally services related to administering individual account plans (for example, tracking enrollment, payroll deductions and contributions, offering investments, administering loans, withdrawals, and distributions, etc.) and maintenance of participant accounts, records, and statements.

- Services other than those described above, but where the Service Provider expects to receive compensation from a third party other than the ERISA Client, the ERISA Client's sponsor/employer, or an affiliate of the Service Provider (called "indirect compensation").

The CSP generally must provide the relevant disclosures reasonably in advance of the date on which a contract or arrangement for the provision of covered services is entered to, extended, or renewed. Changes to previous disclosures generally must be disclosed as soon as practicable, but not later than sixty days following the date the CSP is informed of the change. The disclosures must be in writing and must detail: (i) the services provided under the arrangement; (ii) the status of the CSP as a fiduciary for purposes of ERISA or as a registered investment adviser; (iii) a description of all direct and indirect compensation the CSP (or an affiliate or subcontractor) expects to receive; (iv) certain specific disclosures required for certain fiduciary and recordkeeper CSPs; and (v) a description of the manner of the compensation's receipt.[206]

The disclosures must be made to the "responsible plan fiduciary" of the ERISA Client, which is the fiduciary responsible for retaining the CSP in order to provide services to the ERISA Client. Most often, CSPs are retained by sponsors of employee benefit plans in order to provide services to the plan or its participants; in such circumstances, the responsible plan fiduciary would typically be a plan committee or other employee of the sponsor. However, if an individual participant of a 401(k) plan (for example) were to retain the CSP independently to provide services or advice relating to his or her account, that individual may be deemed to be the responsible plan fiduciary for these purposes.

While these requirements are technical and detailed, as a practical matter, most institutional CSPs have well-developed disclosure materials that will satisfy the requirements. In addition, the rules include a good-faith "safe harbor" for disclosure errors, provided that corrections are made within thirty days of discovery.

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206. The precise requirements of the disclosures are not detailed in full here, and may be found at 29 C.F.R. § 2550.408b-2(c)(iv).

[B] Compensation for Fiduciaries

Service Providers that are fiduciaries are generally prohibited from using the authority, control, or responsibility that makes them a fiduciary to increase the amount or affect the timing of the compensation the Service Provider or an affiliate (broadly construed) receives. This means, for instance, that a fiduciary may not generally cause an ERISA Client or IRA to invest in a product that makes revenue-sharing payments to the Service Provider or an affiliate of the Service Provider, or advise the ERISA Client or IRA to make such an investment. Effecting such transactions or providing such advice could constitute a "prohibited transaction" under ERISA and Section 4975, unless exemptive relief is available.

Because the Fiduciary Rule would have expanded the scope of Service Providers who could be deemed to be Fiduciaries with respect to ERISA Clients and IRAs, several previously permitted compensation practices for Service Providers to such clients would arguably have been effectively prohibited by the Fiduciary Rule. These would include any forms of compensation to the fiduciary or an affiliate whose amount or timing could be affected by the fiduciary management or advice provided to the ERISA Client or IRA by the fiduciary.

Some of the problematic pay practices noted by the DOL in connection with the promulgation of the Fiduciary Rule included (i) compensation thresholds that enable an Adviser to increase his or her compensation disproportionately through an incremental increase in sales; (ii) compensation thresholds such as higher payout percentages, back-end bonuses, or participation in a recognition club, such as a President's club; and (iii) providing higher compensation or rewards for the sale of proprietary products or products for which the firm has entered into revenue sharing arrangements.[207]

The DOL offered several exemptions in connection with the adoption of the Fiduciary Rule that would have permitted Fiduciaries to receive "conflicted compensation," provided that their conditions are satisfied. The vacatur of the Fiduciary Rule had the effect of mooting these exemptions.

§ 52:3.4 Prohibited Transactions and Related Exemptions Currently in Effect

ERISA and Section 4975 impose several "prohibited transaction" (PT) rules on ERISA Clients and IRAs and the fiduciaries that provide services to them. Under these rules, fiduciaries are generally prohibited from causing ERISA Clients and IRAs to engage in transactions

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207. Employee Benefits Security Administration, 80 Fed. Reg. 21,960 (Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550).

that the fiduciaries know or should know would be direct or indirect PTs, unless an exemption applies. Service Providers that are not fiduciaries do not generally have any duty under ERISA or Section 4975 to avoid entering into PTs with ERISA Clients or IRAs.

Broadly speaking, the PT rules are designed to prohibit transactions between ERISA Clients and IRAs, and certain "parties in interest" or "disqualified persons" (collectively, "Parties in Interest") that pose a heightened risk of involving a conflict of interest that could harm the ERISA Client or IRA. Accordingly, Parties in Interest are broadly defined to include various persons—for example, employers, service providers, fiduciaries, relatives and various affiliates, owners, and subsidiaries thereof—with some relationship to the ERISA Client or IRA. Given the broad reach of the PT rules, several exemptions to them have also been provided by statute or regulation. The conditions for these exemptions are typically designed to minimize the conflicts of interest inherent to any transaction involving an ERISA Client or IRA, and a Party in Interest.

In practice, because the PT rules are wide-ranging and Party in Interest status often difficult to discern, exemption compliance is an essential part of providing fiduciary services to ERISA Clients or IRAs. The PT rules and exemptions regulate both what fiduciaries do and how they are compensated, so they transcend the categories described in other sections of this treatise while still being relevant under several of them.

[A] "Per se" PTs

The so-called "per se" PTs are PTs that involve some kind of direct or indirect transaction between an ERISA Client or IRA, and a Party in Interest, such as a sale or exchange of property, an extension of credit; a provision of goods, services, or facilities; or a transfer of assets. They are described as "per se" PTs because the PT results whenever a covered transaction occurs between an ERISA Client and a Party in Interest, regardless of who benefits from the transaction or whether any person is harmed. These PTs are primarily a concern for Management Fiduciaries, who are responsible for causing ERISA Clients or IRAs to engage in such transactions, and not generally for Advice Fiduciaries. As noted above, since Party in Interest status is difficult to discern, most Management Fiduciaries treat all transactions involving ERISA Clients or IRAs as effectively PTs, such that they seek to structure all such transactions in compliance with an applicable exemption.

Broad exemptive relief is available for the "per se" PTs, with conditions for relief that are generally straightforward to satisfy. Notable examples of these exemptions include the "qualified professional asset manager" (QPAM) exemption, which exempts transactions that are directed by certain sophisticated and independent

Management Fiduciaries, and section 408(b)(17) of ERISA (also described as the "Service Provider Exemption"). These exemptions are favored because they apply regardless of transaction type, provided their conditions are satisfied. Other, narrower exemptions are also available that depend on the nature of the PTs involved.

While PT exemptions (PTEs) are typically technical in nature and application of them can be subtle, most sophisticated Service Providers that are Management Fiduciaries should have processes and practices in place that are sufficient for ensuring ongoing compliance with them. For example, the QPAM Exemption has been available for more than thirty years and has been a primary source of exemptive relief for much of that time. So, while it is important to confirm that Management Fiduciaries have taken steps to comply with applicable exemptive relief in the course of providing services to ERISA Clients or IRAs, it is unlikely that established Management Fiduciaries will have significant compliance problems on that front.

[B] "Conflict of Interest" PTs

ERISA and Section 4975 also prohibit fiduciaries from engaging in transactions—including providing non-discretionary investment advice—in circumstances that result in a conflict in interest for such fiduciaries. These "conflict of interest" PTs result if (i) the fiduciaries "deal with" ERISA Client or IRA assets in their own interest or for their own account; (ii) the fiduciaries receive consideration for their own personal account from any other person dealing with the ERISA Client or IRA, in connection with a transaction involving the assets of the ERISA Client or IRA; or (iii) with respect to ERISA Clients only, the fiduciaries act in any transaction involving an ERISA Client on behalf of a party whose interests are adverse to the interests of the ERISA Client. In contrast with the more generic "per se" PTs, the so-called "conflict of interest" PTs are transactions where conflict of interest concerns are particularly acute.

Compensation practices where Management Fiduciaries or Advice Fiduciaries (or their affiliates) receive additional compensation for directing or advising ERISA Clients or IRAs to engage in certain courses of action are likely to result in "conflict of interest" PTs, as well as violate such fiduciaries' more general fiduciary duties with respect to ERISA Clients. The primary import of the Fiduciary Rule was arguably to result in a number of common compensation and remuneration practices for Service Providers to IRAs being deemed "conflict of interest" PTs.

The broadest exemptive relief—like the QPAM Exemption and the Service Provider Exemption—is expressly *not* available for the "conflict of interest" PTs. Other, narrower and more burdensome exemptions are sometimes available. But as a general matter, potential "conflict of

interest" PTs should be regarded with a much higher degree of scrutiny, both because there are fewer applicable exemptions for such activity and because they are more fact-specific.

[C] Temporary Enforcement Relief

As noted above, one of the primary consequences of the Fiduciary Rule was to cause Service Providers to certain retail ERISA Clients and IRAs to be deemed to be Advice Fiduciaries and, in so doing, to prohibit certain common compensation practices of such Service Providers. Rather than flatly prohibit such practices, however, the DOL also promulgated two new PTEs (the "Best Interest Contract Exemption"—or "BIC Exemption"—and the "Principal Transactions Exemption") and revisions to existing PTEs (collectively with the BIC Exemption and the Principal Transactions Exemption, the "Fiduciary Rule Exemptions") that would allow Service Providers to such retail ERISA Clients and IRAs to continue to earn such compensation, provided that certain conditions were satisfied.

As originally contemplated, during the Phase-In Period (and through the Vacatur Period), Service Providers would be able to comply with the Fiduciary Rule Exemptions by complying with a simplified set of conditions. These conditions were further simplified and extended by subsequent rulemaking by the DOL, before being vacated in their entirety along with the Fiduciary Rule, as discussed above. Thus, beginning with the Reinstatement Period, the Fiduciary Rule Exemptions will no longer be technically available for Service Providers to ERISA Clients and IRAs.[208]

Because the vacatur of the Fiduciary Rule and Fiduciary Rule Exemptions created significant uncertainty among Service Providers that had adapted their practices to comply with the Fiduciary Rule, the DOL has issued a temporary enforcement policy describing its approach to certain PT claims during and after the Vacatur Period. That policy—generally described as DOL Field Assistance Bulletin 2018-2 or "FAB 2018-2"—provides that the DOL will not pursue prohibited transaction claims against Service Providers to certain retail ERISA Clients or IRAs provided that such Service Providers are complying in good faith with the simplified conditions of relief required under the BIC Exemption or Principal Transactions Exemption during the Phase-In Period. This temporary enforcement policy will apply until the DOL provides further guidance or rulemaking relating to the Fiduciary Rule (or its replacement).

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208. Note, however, that at the same time, fewer Service Providers to ERISA Clients and IRAs will be Advice Fiduciaries in the first place, meaning that certain conflicted compensation practices would no longer be prohibited under ERISA or section 4975 of the Code.

In order to fall within the temporary enforcement policy described by FAB 2018-2, Service Providers must (i) engage in the kinds of transactions contemplated by the BIC Exemption or the Principal Transactions Exemption, and (ii) comply with the "Impartial Conduct Standards" described in these exemptions. These Impartial Conduct Standards generally require Service Providers to act in accordance with ERISA's duties of exclusive benefit, loyalty, and prudence, as described above; to receive no more than "reasonable compensation," as described above; and not to make any materially misleading statements about covered transactions, fees and compensation. The Impartial Conduct Standards are also subject to certain exceptions and safe harbors not described in detail here.

Note that, while FAB 2018-2 was intended to provide enforcement relief for Service Providers that had adapted their practices to the Fiduciary Rule, many of those same Service Providers may no longer be Advice Fiduciaries during the Reinstatement Period, so their compensation practices may no longer require the kind of enforcement relief that the DOL has provided in the first place. As such, FAB 2018-2 may have limited practical effect except for Service Providers to retail ERISA Clients and IRAs that are deemed to be Advice Fiduciaries under the Five-Factor Test during the Reinstatement Period.

[D] Current Law

Service Providers to ERISA Clients and IRAs typically rely on several other PTEs available under ERISA and Section 4975. These PTEs are available both for specific types of "per se" PTs not covered under the "broad" PTEs described above as well as for "conflict of interest" PTs where the broader PTEs are usually not available. These PTEs are typically fact-specific and technical in application, and are not detailed here. However, the need for an exemption should be considered with legal or compliance counsel in situations where either of the following questions is answered in the affirmative:

- Are fiduciaries causing or advising ERISA Clients or IRAs to engage in investment activities that would directly or indirectly increase the fiduciaries' compensation, or directly or indirectly affect the payment of compensation or other remuneration to the individual fiduciary or the financial organization?
- Are fiduciaries causing or advising ERISA Clients or IRAs to transact directly or indirectly with the financial organization, or to purchase financial products managed by the financial organization or in respect of which the financial organization receives fees or other remuneration?
- Are fiduciaries also acting in the transaction for a party whose interest may be adverse to the interest of the ERISA Client or

IRA (for example, as might occur in a cross trade between accounts managed by the fiduciary or its affiliate)?

§ 52:3.5 SEC's "Best Interest" Standard

The proposed "best interest" standard seeks to enhance the standard of conduct of broker-dealers and investment advisers when they interact with retail investors. This standard differs from the now-vacated Fiduciary Rule, but has similarities to those proposed by the DOL in its Best Interest Contract Exemption.[209] The proposed "best interest" standard requires broker-dealers and associated persons to act in the best interest of a retail customer when recommending a securities transaction or investment strategy involving securities to a retail customer, without placing the financial or other interests of the broker-dealer or associated person ahead of the customer when making an investment recommendation.[210] The broker-dealer satisfies the "best interest" standard by fulfilling the disclosure obligation, care obligation, and conflict of interest obligation.

The disclosure obligation requires the broker-dealer to reasonably disclose, in writing, to the retail investor the material facts both with regard to the scope and terms of their relationship, and with respect to any specific investment recommendation.[211] The two sets of written disclosures would include a short, high-level relationship summary, and a more specific and comprehensive disclosure with detailed fees and all material conflicts of interest relevant to the recommendation to the retail customer.[212] The "material facts" include disclosure of applicable fees and charges, types of services provided, and all material conflicts of interest.[213]

The care obligation requires the broker-dealer to exercise reasonable diligence, care, skill, and prudence with regard to its recommendations.[214] As noted in more detail above, the broker-dealer must understand the potential risks and rewards associated with the recommendation; have a reasonable basis to believe that the recommendation could be in the best interests of at least some retail customers; have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile, and the potential risks and

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209. *See* Regulation Best Interest Release, *supra* note 18. The SEC believes that the principles underlying the proposed best interest obligation generally draw from principles similar to the principles underlying the DOL's best interest standard, as described by the DOL in the BIC Exemption.
210. *Id*. at 21,585–99.
211. *Id*. at 21,599–608.
212. *Id*.
213. *Id*.
214. *Id*. at 21,608–17.

rewards associated with the recommendation; and have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest.[215] While the "best interest" standard is not the same as the fiduciary standard applicable to investment advisers, the SEC explains that the proposed care obligation is designed to be similar to the standard of conduct that has been imposed on broker-dealers found to be acting in a fiduciary capacity.[216] In determining whether this obligation has been satisfied, the SEC would look to the facts and circumstances of a given situation and the importance of each factor as applied to a particular recommendation.[217]

The conflict of interest obligation requires broker-dealers to establish and maintain conflict of interest policies that, at minimum, (1) disclose, or eliminate, all material conflicts of interest associated with the recommendation; and (2) disclose and mitigate, or eliminate, material conflicts arising from financial incentives associated with the recommendation.[218] Under the Proposed Rule, the broker-dealer would apparently have to adopt policies to affirmatively mitigate conflicts arising from financial incentives.[219] These types of conflicts include (1) compensation practices established by the broker-dealer; (2) employee compensation or incentives; (3) compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity; (4) receipt of commissions or sales changes, or other fees or financial incentives or differential or variable compensation; (5) sales of proprietary products or services, or products of affiliates; and (6) transactions that would be effected by the broker-dealer in a principal capacity (see section 52:1.3 above for further discussion on "best interest" standard).[220]

§ 52:3.6 *Regulations and Supervisory Guidance Regarding Incentive Compensation at Financial Institutions*

[A] Background

Following the financial crisis, the Troubled Asset Relief Program, or "TARP," which was established under the Emergency Economic Stability Act of 2008 and amended by the American Recovery and

215. *Id.*
216. *Id.*
217. *Id.*
218. *Id.* at 21,617–28.
219. *Id.*
220. *Id.*

Reinvestment Act, set forth incentive compensation and corporate governance standards for recipients of governmental financial assistance under TARP, and created the Office of the Special Master, or "OSM."

The OSM imposed compensation-related requirements on TARP recipients based on the following principles:

- For the top twenty-five individual pay packages: (i) limit cash salary, (ii) pay incentives in long-term restricted stock, (iii) limit perquisites and "other" compensation, and (iv) limit executive pension and retirement programs; and
- For the next 26–100 employees' compensation structures: (i) restrict short-term cash compensation, (ii) tie incentive compensation to real achievement, (iii) make sure compensation structures have a long-term focus, and (iv) align pay practices with shareholder and taxpayer interests.

Among the specific mandates introduced by TARP were clawbacks of incentive compensation (referred to in the rules as "bonus compensation" but not limited to annual bonuses) to the extent based on either materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

In 2009, the FRB issued proposed guidance on incentive compensation design for banking institutions, which guidance was finalized pursuant to the issuance in June 2010 of the Guidance on Sound Incentive Compensation Policies (the "Interagency Guidance") by the FRB, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC). As a general matter, the Interagency Guidance observed that: "Flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employee's activities posed to the organization." The contents of the Interagency Guidance are discussed below.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law by President Obama. Section 956 of Dodd-Frank directed six federal agencies (the FRB, the OCC, the FDIC, the National Credit Union Administrative Board, the SEC, and the Federal Housing Finance Agency) to jointly promulgate rules (1) prohibiting incentive-based compensation arrangements that encourage inappropriate risks by covered financial institutions and (2) requiring the disclosure to the agencies of the structure of all incentive-based compensation arrangements offered by

a covered institution sufficient to determine whether the arrangements encourage inappropriate risks. According to section 956, an incentive-based compensation arrangement encourages inappropriate risks when it (1) provides an executive officer, employee, director, or principal shareholder of the covered institution with excessive compensation, fees, or benefits; or (2) could lead to material financial loss of the covered financial institution.

A proposed joint rule was issued in March 2011, and re-proposed rules were issued in the spring of 2016. Eschewing the principles-based approach of the Interagency Guidance, the latest proposed rules under section 956 of Dodd-Frank are highly prescriptive, particularly for "Level 1" and "Level 2" institutions (institutions with average consolidated assets of greater than or equal to $50 billion, but less than $250 billion, and institutions with average total consolidated assets of $250 billion or more, respectively). The re-proposed rule's basic requirements include (1) a prohibition against excessive compensation; (2) a mandate that arrangements appropriately balance risk and reward; (3) compatibility of arrangements with effective risk management and controls; (4) board oversight and approval of senior executive compensation; and (5) a seven-year recordkeeping requirement. The enhanced requirements for Level 1 and Level 2 covered institutions include (1) making all incentive-based compensation payable to senior executive officers and "significant risk-takers" subject to a seven-year clawback; (2) subjecting a significant portion of incentive-based compensation payable to senior executive officers and significant risk-takers to potential deferral, forfeiture, and downward adjustment; (3) implementation of an independent risk-monitoring framework; and (4) implementation of specific policies and procedures.

[B] Interagency Guidance

The principles-based Interagency Guidance is designed to ensure that the incentive compensation of senior executives—as well as non-executive employees who, either individually or as a group, have the ability to expose an institution to material amounts of risk—does not undermine the safety and soundness of covered financial institutions. To that end, the Interagency Guidance posits three guiding principles, directing that incentive compensation at banking organizations should (1) provide employees incentives that appropriately balance risk and reward in a manner that does not encourage imprudent risk-taking; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance, including vigorous oversight by the institution's board of directors.

"Large banking organizations," because of their size and complexity, were instructed to establish and adhere to systematic and formalized policies, procedures, and processes relating to incentive compensation,

and forewarned to expect to be subject to more active supervision in this area by the relevant regulatory agencies. The Interagency Guidance also instructed each banking organization to thoughtfully consider which employees could subject the organization to material risk, considering the full range of risks arising from or generated by an employee's, or group of employees', activities.

In determining whether incentive compensation arrangements appropriately balance risk and reward, the Interagency Guidance indicates that organizations also should consider the relevant time horizon for risk outcomes, with special attention to "bad tail risks" that might have a low probability of occurring but nevertheless represent a potentially highly adverse impact on the organization. In the absence of reliable quantitative measures regarding certain risks, financial institutions should apply informed judgment.

The Interagency Guidance suggests that unbalanced incentives may be made more balanced and sensitive to risk by a number of methods, four in particular: (1) risk-adjusting payouts, either formulaically or by application of judgment; (2) deferring payment beyond the performance period to permit adjustments based on risk outcomes; (3) using longer performance periods, which also makes it more likely that amounts are not paid before risk outcomes are known; and (4) reducing sensitivity to short-term performance, by reducing the rate at which awards increase as an employee achieves higher levels of the relevant performance measures. The Interagency Guidance recognizes that "one-size-fits-all" incentive compensation design is not appropriate, and that balanced incentive compensation should be tailored to account for the differences between financial organizations and between different employees within financial organizations. Large banking organizations are instructed to actively monitor developments in incentive compensation risk mitigation, as well as best practices developed by other financial institutions and regulators, to improve their institution's long-term financial well-being, safety, and soundness.

In addition to the guidance regarding the design of incentive compensation, the Interagency Guidance also focuses on the role of risk management processes and internal controls to support the development and maintenance of balanced incentive compensation arrangements, and the necessary involvement of risk management personnel (who themselves should be compensated in amounts that attract qualified individuals but in a manner that avoids conflicts) in designing incentive compensation and assessing whether such design is effective in "restraining imprudent risk-taking." Banking organizations are directed to monitor the performance of their incentive compensation arrangements and modify them as needed if they do not appropriately reflect risk, and boards of directors (especially in large banking organizations) are expected to "actively oversee the

development and operation of the organization's incentive compensation policies, systems and related control processes."

§ 52:3.7 Financial Adviser and Client Retention

Financial advisers and other client-facing investment professionals typically have strong relationships with clients, which can make the business associated with these clients portable when these investment professionals move from one firm to another. This, in turn, results in the sometimes competing objectives of attracting and retaining investment professionals with an established book of business, while also placing reasonable restrictions on the ability of departing investment professionals to migrate from an existing employer with their full book of business. The tension between these competing objectives plays out in the context of FINRA rules that foster access by clients to preferred investment professionals,[221] U.S. Department of Justice (DOJ) prohibitions against anti-poaching agreements between employers that may violate federal antitrust laws,[222] and the considerable compensation that is often necessary to compensate and retain financial advisers with significant books of business.

[A] Restrictive Covenants and Garden Leave Clauses

Financial organizations not uncommonly ask newly hired investment professionals to sign non-competition, non-solicitation, "no poach," non-disclosure, and other restrictive covenants that obligate these professionals to refrain from certain competing activities, and from actively soliciting existing clients and workforce employees for a stated period of time following termination or resignation of employment. The enforceability of these covenants is often a matter of state law and varies considerably between and among jurisdictions.[223] An employer's ability to obtain these covenants from a financial adviser without substantial payments in support of them is also a function of

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221. FINRA Rules § 2140, Interfering With the Transfer of Customer Accounts in the Context of Employment Disputes, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7457; FINRA Rule 11870, Customer Account Transfer Contracts, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9704.

222. U.S. DEP'T OF JUSTICE ANTITRUST DIVISION & U.S. FEDERAL TRADE COMMISSION, ANTITRUST GUIDANCE FOR HUMAN RESOURCE PROFESSIONALS (2016).

223. *Compare* TEX. BUS. & COM. CODE ANN. § 15.50(a) (non-compete allowed if "time, geographical area, and scope of activity to be restrained . . . are reasonable and do not impose a greater restraint than necessary"), *with* CAL. BUS. PROF. CODE §§ 16600 *et seq.* (covenants not to compete are generally void).

the negotiating leverage between the in-bound investment professionals and the financial organizations seeking to hire them. There is also, as noted above, a concern under the DOJ's Antitrust Guidance for Human Resource Professionals that certain "no poach" and "no hire" covenants may result in anti-competitive activity in violation of U.S. antitrust laws.[224]

The uncertainty surrounding the use and enforceability of traditional non-compete agreements has led some firms to adopt so-called "garden leave provisions" as an alternative to these covenants. Garden leave provisions require departing employees to give a specified period of advance notice of resignation. During the notice period, the departing employees continue to receive, at a minimum, their base compensation without having the obligation, at the employer's discretion, to perform any prescribed duties.

Courts have enforced garden leave provisions in some instances, but found them unreasonable in others. Generally, for garden leave provisions to be reasonable, the provisions should be relatively short in duration, be clearly disclosed in advance to the employee who is to be bound by the provisions, and be necessary to protect a legitimate employer interest. In two relatively recent cases, a thirty-day garden leave provision was found to be reasonable; however, at least one court has determined a ninety-day provision to be unreasonable.[225] Courts generally find that these provisions and other restrictions are enforceable when necessary to protect a legitimate business interest or proprietary information. In enforcing these provisions, courts are reluctant to require employees to continue involuntarily an at-will employment relationship, and instead will focus on issuing an injunction prohibiting competition during the applicable notice period.[226]

FINRA rules further limit the ability of broker-dealers to prevent departing employees from servicing their former clients. A non-compete is not enforceable under FINRA Rules 2140 and 11870,[227]

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224. *See supra* note 101.

225. *Compare* Credit Suisse First Bos., LLC v. Vender, No. 04 C 7631, 2004 U.S. Dist. LEXIS 24525, *and* Natsource LLC v. Paribello, 151 F. Supp. 2d 465, 472 (S.D.N.Y. 2001), *with* Bear Stearns & Co. v. McCarron, 2008 WL 2016897 (Mass. Super. Ct. Suffolk Cty. Mar. 5, 2008).

226. Smiths Grp., plc. v. Frisbie, No. 13-52, 2013 WL 268988, at *3 (D. Minn. Jan. 24, 2013).

227. FINRA Rules § 2140, Interfering with the Transfer of Customer Accounts in the Context of Employment Disputes, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7457 (describing the rule against interference with the transfer of customer accounts in the context of employment disputes); FINRA Rule 11870, Customer Account Transfer Contracts, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9704 (describing the responsibility to expedite customer's request in the context of customer account transfer contracts).

if enforcement could prevent a customer from continuing to use the services of its registered representative.

[B] Duty of Loyalty

In New York, employees generally owe a duty of loyalty to their employers and cannot compete with their employers during the employment relationship. Employees must exercise good faith and loyalty during the employment relationship.[228] To comply with the duty of loyalty, employees generally cannot aid competitors; solicit co-workers, clients, or customers to follow them to a competitor; or use or disclose the current employers' confidential or trade secret information. Many other states also impose a duty of loyalty on employees and restrict permissible activity while employed by the employer.[229]

The duty of loyalty has implications where groups of employees may be contemplating a collective departure to another employer.[230] Moreover, in certain circumstances, the new employer may be liable for the departing employees' breach of a duty of loyalty, particularly in situations where one departing employee solicits other employees to depart while all of them are still employed by the first employer.[231]

In the financial services industry, several employers are signatories to the Protocol for Broker Recruiting, which sets out procedures applicable when a financial adviser departs for another signatory firm. Under the protocol, departing employees and their new employer will have no monetary or other liability if the departing employees both: (i) are leaving one signatory firm to join another signatory firm and (ii) follow the procedures set out in the Broker Protocol related to the account information that may be taken in connection with the departure.[232] Withdrawals from the protocol of key signatory firms can have a marked influence on competitive practices in the industry and in key jurisdictions covered by these firms.

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228. *See, e.g.*, Duane Jones Co. v. Burke, 306 N.Y. 172, 188 (1954) (establishing that the duty of loyalty exists under the common law).
229. *See, e.g.*, Augat, Inc. v. Aegis, Inc., 565 N.E.2d 415 (Mass. 1991).
230. *But see* Dominion Enters. v. Dataium, LLC et al., No. M2012-02385-COA-R3-CV, 2013 WL 6858266 (Tenn. Ct. App. 2013) (the court found that the conduct of the defendants did not rise to the level of preparing to compete, because the business joined was not a direct competitor, establishing that multiple employees planning a consecutive departure to another employer does not necessarily constitute a breach of loyalty to the previous employer).
231. *See supra* note 109.
232. THE BROKER PROTOCOL: RECRUITING AND TRADE SECRETS LAW IN THE FINANCIAL INDUSTRY, http://www.thebrokerprotocol.com/index.php/authors.

[C] Employee Forgivable Loans

Leaving one firm for another can have a significant economic impact on the departing financial adviser. Deferred compensation and equity incentives often contain forfeiture provisions that are tied to short-service departures, resignations without "good reason,' or to departures to accept employment with a competitor. Conversely, the new (recruiting) employer can incur a significant initial compensation cost if it makes an effort to compensate sought-after financial advisers for some or all of the lost value resulting from the departure from their prior employers.

Employee forgivable loans (EFLs) are a tool used widely in the financial services industry to balance the need to compensate financial advisers for lost compensation while also linking the value received by the financial adviser to the adviser's future service with the new employer.

A typical EFL provides for a loan to the financial adviser that is forgiven over a number of years based upon the performance of future services by the financial adviser. Occasionally, EFLs are forgiven based upon the achievement of specified performance goals related to asset accumulation, client transfer, or client retention. An EFL is typically documented through the issuance of a note payable to an affiliate of the financial adviser's employer. The loan bears a market rate of interest; is often secured by equity or long-term incentive awards to the financial adviser from the employer or other acceptable collateral; and represents an unconditional obligation to repay principal and accrued interest upon an acceleration or payment event prior to forgiveness (for example, resignation of employment prior to the forgiveness of all outstanding principal). To accomplish the "loan forgiveness" portion of the arrangement, a well-drafted EFL often will use a companion bonus feature timed to make bonus payment coinciding with the principal repayment dates, with the bonus paid by the financial adviser's employer and the loan repayments being made by the financial adviser to the affiliate of the employer that originated the loan. The bonus amounts are typically not "grossed-up" for tax purposes, so the financial advisor must meet the shortfall by utilizing a portion of the original principal amount or other cash resources.

The IRS has failed to respect the tax character of EFL arrangements as loans where the IRS found that the EFL arrangements did not represent ["bona fide indebtedness,"] with the result that the EFL was recharacterized for tax purposes as a signing bonus.[233] The regulations under section 409A of the Code also indicate that, in certain instances, loans between a service recipient (employer) and service provider (employee)

233. I.R.S. Tech. Adv. Mem. 200040004 (Oct. 6, 2000).

may be treated as deferred compensation for purposes of the Code and, therefore, subject to the payment and election timing rules applicable to deferred compensation. Failure to scrupulously comply with these rules can have adverse tax consequences to the service provider (employee).

In promulgating the now Fiduciary Rule, the DOL indicated that, in certain instances, EFLs may be a form of pay practice that may encourage behavior by a fiduciary that is inconsistent with the fiduciary's duties owed to its clients.[234] It is unclear how these concerns may spill over to conflicts of interest arising under the SEC's proposed "best interest" standard.[235]

§ 52:4 Bank Regulation

§ 52:4.1 Overview

[A] Banking Structure

Banks frequently operate as part of larger organizations that include broker-dealers as well as FDIC-insured banks, often in a holding company structure. Banking organizations often provide wealth management services through their bank and nonbank entities. As such, the business is generally subject to supervision and regulation by (i) FRB, which supervises bank holding companies (BHCs)[236] and state-chartered banks that are members of the Federal Reserve System; (ii) the FDIC, which supervises state-chartered banks that are not members of the Federal Reserve System; (iii) the OCC, which charters and supervises national banks; (iv) state banking supervisors, which charter and supervise state-chartered banks; (v) the SEC, which, as discussed above, supervises securities broker-dealers and registered investment advisers, including those that are controlled by a BHC; and (vi) FINRA, the self-regulatory organization for broker-dealers.

[B] Standard of Care

As a general matter, a bank will be subject to a fiduciary standard of care when acting as trustee or fiduciary, or providing investment

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234. U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., CONFLICT OF INTEREST FAQS: PART I—EXEMPTIONS (2016), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf.

235. U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., FIELD ASSISTANCE BULLETIN NO. 2018-02 (2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-02.

236. A BHC is generally a company that controls a U.S. bank. *See* 12 U.S.C. § 1841. Most large domestic banks in the United States are subsidiaries of a BHC. Non-U.S. banks that operate a branch or agency office in the United States are also generally treated as BHCs.

advice with discretion or for a fee. What constitutes providing investment advice for a fee is described above in section 52:2.1. The fiduciary standard of care is generally established under applicable state law, while federal law also imposes certain obligations and limitations on bank fiduciaries.

[C] Non-Fiduciary Activities

When not acting in a fiduciary capacity, such as effecting securities transactions, a bank would typically be subject to the same suitability standards as a broker-dealer engaging in the same activity.[237]

[D] Limitations on Bank Securities Activities

Although national banks have authority as a matter of banking law to provide securities brokerage services, and similar authority often exists for state-chartered banks under state law, federal securities limit that authority. In particular, the so-called "push-out" provisions of the GLBA,[238] enacted in 1999, ended a blanket exemption that banks had from broker-dealer registration requirements. Since 1999, only specific exemptions are now available to banks. Certain of these exemptions, which are discussed below, include various limitations on bank securities-related activities, including certain limits on the type of compensation that a bank and its employees may receive in connection with effecting securities transactions.

[E] Bank and Broker-Dealer Arrangements

In addition to restrictions that apply under the Networking Exception of Regulation R discussed in section 52:4.3[A][1] below, the banking regulators have issued special rules for sales of non-FDIC-insured investment products on bank premises or resulting from a referral from bank employees. One of the primary purposes of such guidance is to prevent customer confusion between FDIC-insured deposits and risky investments in securities.

[F] Other Considerations

This section does not address several topics that are often important in providing wealth management services, such as compliance issues related to: (i) information security; (ii) customer privacy (and sharing of customer information among affiliates and with unaffiliated parties) under Title V of GLBA; or (iii) disclosure requirements applicable to loan and deposit products under Regulations Z and DD

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237. *See* OCC, COMPTROLLER'S HANDBOOK: SAFETY AND SOUNDNESS: RETAIL NONDEPOSIT INVESTMENT PRODUCTS (Jan. 2015) [hereinafter OCC RNDIP HANDBOOK], at 61–62.

238. Pub. L. No. 106-102.

of the Consumer Financial Protection Bureau (CFPB), which generally focus on the calculation and disclosure of interest rates and fees. This section also does not address the conversion of bank common trust funds to mutual funds.[239] In addition, this section does not address third-party risk management guidance from bank regulators, which is of particular importance when independent contractors and outsourcing arrangements are involved.[240] Considerations relating to customer due diligence, the Bank Secrecy Act of 1970, and anti-money laundering requirements, which are typically of considerable significance to private banking operations, are addressed in section 52:6 below.

§ 52:4.2 Standards of Care

[A] National Bank Fiduciary Activities

Federal law empowers national banks to act in various fiduciary capacities, and a combination of state and federal laws govern the fiduciary activities of a national bank.[241] The primary federal regulation governing national bank fiduciary activities is known as Regulation 9 of the OCC, 12 C.F.R. Part 9. 12 C.F.R. Part 9 authorizes specific fiduciary activities for national banks unless the activities are restricted or prohibited by "applicable law." The governing instrument, such as a will, trust agreement, court order, or agency contract, controls the administration of a fiduciary account. State statutes and provisions of 12 C.F.R. Part 9 take precedence when the governing instrument is silent or when state law or federal regulations include provisions that cannot be waived or altered.[242]

A "fiduciary account" is defined in 12 C.F.R. Part 9 as "an account administered by a national bank acting in a fiduciary capacity."[243] For the purposes of 12 C.F.R. Part 9, "fiduciary capacity" is defined as:

(1) a trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian,

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239. *See* FRB, Conversion of Common Trust Funds to Mutual Funds, SR Letter 97-3 (SPE) (Feb. 26, 1997).

240. Typically, a bank is required to ensure that third-party contractors follow bank policies and requirements in marketing bank products and services.

241. 12 U.S.C. § 92a. This chapter does not specifically address the fiduciary powers of state-chartered banks under state law, but the fiduciary powers and duties of a state-chartered bank are often similar to those of a national bank.

242. OCC, COMPTROLLER'S HANDBOOK, PERSONAL FIDUCIARY ACTIVITIES, https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/personal-fiduciary-activities/pub-ch-personal-fiduciary.pdf [hereinafter OCC FIDUCIARY ACTIVITIES HANDBOOK], at 2.

243. 12 C.F.R. § 9.2(d).

(2) assignee, receiver, or custodian under a uniform gifts to minors act;

(3) an investment adviser, if the bank receives a fee for its investment advice;[244]

(4) any capacity in which the bank possesses investment discretion on behalf of another;[245]

(5) any other similar capacity that the OCC authorizes pursuant to 12 U.S.C. § 92a.[246]

OCC regulations include a list of circumstances under which a national bank that provides investment advice would not be deemed to be providing investment advice for a fee. Exceptions of particular relevance to private wealth management include the following:

(1) Financial advisory and counseling activities, including strategic planning of a financial nature, merger and acquisition advisory services, and providing market economic information to customers in general;

(2) Client-directed investment activities (that is, the bank has no investment discretion) where investment advice and research may be made available to the client, but the fee does not depend on the provision of investment advice;

(3) Real estate consulting services, including acting as a finder in locating, analyzing, and making recommendations regarding the purchase of property; and making recommendations concerning the sale of property;

(4) Advisory activities concerning tax planning and structuring; and

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244. "Investment adviser" generally means a national bank that provides advice or recommendations concerning the purchase or sale of specific securities, such as a national bank engaged in portfolio advisory and management activities (including acting as investment adviser to a mutual fund). 12 C.F.R. § 9.101. A national bank may, in addition to providing portfolio management and advisory services, also provide trade processing, performance measurement, and securities safekeeping and custody services.

245. In a discretionary investment agency account, the bank is given the sole or shared authority to purchase and sell assets and execute transactions for the benefit of the principal, in addition to providing investment advice. The bank's investment authority is usually subject to investment policy guidelines established in the investment account contract.

246. 12 C.F.R. § 9.2(e). A national bank may also act in any other fiduciary capacity in which state banks, trust companies, or other corporations that come into competition with national banks are permitted to act under the laws of the state in which the national bank is located. 12 U.S.C. § 92a; OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 2.

(5) Investment advisory activities authorized by the OCC under 12 U.S.C. § 24 (Seventh) as incidental to the business of banking.[247]

[B] Fiduciary Standards for National Banks (12 C.F.R. Part 9)

The fiduciary standards and obligations that apply to a national bank are based on a combination of federal law and applicable state law. The basic standard of care typically derives from the trust instrument itself. Part 9 sets forth the federal standards that apply to the fiduciary activities of national banks. These rules are often viewed as an industry standard for fiduciary activities of all financial institutions operating in the United States.[248]

A body of common law (court rulings) has developed over time to help determine a fiduciary's responsibilities when neither statute nor the governing instrument specifically addresses a particular issue.[249]

The OCC has described a number of duties that apply to a national bank that acts as fiduciary:[250]

(1) Duty of loyalty (which includes a prohibition on self-dealing), which is of paramount importance and underlies the entire administration of personal fiduciary accounts;

(2) Duty of administration (administering a trust according to its terms and incurring only reasonable costs);

(3) Duty to control and protect trust property;

(4) Duty to keep property separate and maintain adequate records;

(5) Duty of impartiality (applicable to trusts with multiple beneficiaries);

(6) Duty to enforce and defend claims;

(7) Duty to inform and report (some jurisdictions require a trustee to provide an accounting to beneficiaries); and

(8) Duty of prudent investment.[251]

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247. 12 C.F.R. § 9.101. As noted above, fiduciary activities of a national bank are authorized under 12 U.S.C. § 92a.

248. *See* FRB, COMMERCIAL BANK EXAMINATION MANUAL: FIDUCIARY ACTIVITIES, sec. 4200.1 (Apr. 2013).

249. OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 2. *See also* 12 C.F.R. § 9.2(b).

250. OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 19.

251. According to the FRB, as of 2012, the majority of states adopted laws concerning the prudent investor rule (PIR) with respect to the investment

The conflict of interest provisions of 12 C.F.R. § 9.12 prohibit a national bank from engaging in self-dealing or entering into conflict situations unless expressly authorized by applicable law.[252] These restrictions include (among others) (i) investments for a fiduciary account in the stock or obligations of, or assets acquired from, the bank, an affiliate of the bank, or officer, director, or employee thereof; and (ii) sales, loans, or other transfers of assets from a fiduciary account to a bank, affiliate, or officer, director, or employee thereof.

FRB guidance regarding conflicts of interests notes that institutions should have detailed policies and procedures to address and manage potential conflicts of interest, including bringing such conflicts to the attention of management and the trust committee (of the bank's board of directors). Fiduciary business lines are cautioned to manage conflicts of interest between fiduciary business lines and other business lines (including other fiduciary business lines).[253]

[C] Regulatory Requirements for National Bank Fiduciary Activities

Part 9 sets forth a number of specific requirements for fiduciary accounts, several of which are directly applicable to wealth management operations:

- Pursuant to 12 C.F.R. § 9.6(c), the bank must review, at least once during each calendar year, all assets in each fiduciary account for which it has investment discretion.
- National banks should also perform an "administrative review" of fiduciary accounts on a periodic basis.[254] The administrative review should ensure that the account is being administered in a manner consistent with the governing instrument (and should ensure, for example, that the account is properly coded in the bank's systems).

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of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, the standard is traditionally applied to all accounts for which the institution is managing funds. FRB, [BHC] SUPERVISION MANUAL: SUPERVISION OF SUBSIDIARIES (PRIVATE-BANKING FUNCTIONS AND ACTIVITIES), sec. 2010.11.2.3 (July 2012) [hereinafter FRB, BHC MANUAL].

252. *See also* OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 3.

253. FRB, BHC MANUAL, *supra* note 251, sec. 2010.11.2.3 (July 2012); *see also* FDIC, TRUST EXAMINATION MANUAL (last updated May 12, 2005) [hereinafter FDIC, TRUST EXAMINATION MANUAL], https://www.fdic.gov/regulations/examinations/trustmanual/, § 8.E.

254. OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 33.

- 12 C.F.R. § 9.13(a) requires joint custody over fiduciary assets, and 12 C.F.R. § 9.13(b) requires the separation of fiduciary assets from the assets of the bank.
- 12 C.F.R. § 9.15 authorizes a bank to charge a reasonable fee for its services unless compensation terms are set or governed by other applicable law.[255]

[D] Bank Fiduciary Standards: Certain Activities Highlighted in Regulatory Guidance

[D][1] Investment of Fiduciary Assets in Mutual Funds

The investment of fiduciary assets in mutual funds raises potential conflicts of interest.[256] Mutual fund providers may offer compensation in the form of various types of service fees (shareholder, subaccounting, or administrative fees; or a lump-sum payment) to fiduciaries that invest in the fund. The primary supervisory concern with such investments is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment.[257] Such fees may be consistent with fiduciary obligations under certain circumstances.[258] These conditions often include compliance with standards of prudence, quality and appropriateness for the account, and a determination of the "reasonableness" of the fees received by the institution.[259] ERISA generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions. ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.[260]

Conflict of interest concerns also arise when a fiduciary account invests in a mutual fund advised by the fiduciary or an affiliate (a "proprietary fund") because the institution receives the management fee for managing the proprietary fund.[261] Within a BHC, such

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255. *See also supra* section 52:1.6.
256. *See, e.g.*, FRB, SR Letter No. 99-7 (SPE) (Mar. 26, 1999) [hereinafter FRB, SR Letter No. 99-7]; OCC Letter No. 704 (Feb. 1996).
257. FRB, SR Letter No. 99-7, *supra* note 256.
258. *See* FRB MANUAL: FEES INVOLVING INVESTMENTS OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST, sec. 2010.12; FRB, SR Letter No. 99-7, *supra* note 256.
259. The OCC has also adopted these general standards for national banks. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with established state law fiduciary requirements. This includes a "reasonableness" test for any fees received by the institution. *See* OCC Interpretive Letter No. 704 (Feb. 1996).
260. FRB, SR Letter No. 99-7, *supra* note 256. *See also infra* section 52:3.3[A][2].
261. FRB, SR Letter No. 99-7, *supra* note 256.

investments are generally prohibited unless the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.[262]

FRB guidance directs institutions to ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above (or placing fiduciary assets in proprietary mutual funds, if permitted). Measures include: (i) obtaining a reasoned legal opinion as to the permissibility of the arrangement; (ii) establishing written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds; and (iii) documentation of an institution's analysis supporting its investment decision.[263]

[E] Section 23B of the Federal Reserve Act

Section 23B of the Federal Reserve Act imposes limits on an FDIC-insured bank's purchases of securities from an affiliate or securities underwritten by an affiliate for a fiduciary account of the bank.[264]

Section 23B generally prohibits an FDIC-insured bank that is acting in a fiduciary capacity from acquiring securities (or other assets) from an affiliate unless such purchase is permitted (i) under the instrument creating the fiduciary relationship, (ii) by court order, or (iii) by law of the jurisdiction governing the fiduciary relationship.[265] Section 23B also prohibits a bank that is acting in a fiduciary capacity from acquiring, during the existence of an underwriting or selling syndicate, securities underwritten by an affiliate, unless the purchase is authorized by a majority of the directors of the bank based on a determination that the purchase is a sound investment for the account.[266]

Even when not prohibited under section 23B, a fiduciary should document that such purchases are consistent with fiduciary principles.[267]

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262. 12 C.F.R. § 225.125(g).
263. FRB, SR Letter No. 99-7, *supra* note 256.
264. 12 U.S.C. § 371c-1; 12 U.S.C. § 1828(j)(1).
265. 12 U.S.C. § 371c-1(b)(1)(A).
266. 12 U.S.C. § 371c-1(b)(2).
267. *See, e.g.*, FDIC, TRUST EXAMINATION MANUAL, *supra* note 253, § 8.E.6.

[F] Retail Securities Brokerage Services

[F][1] Generally: Interagency Statement on Retail Sales of Nondeposit Investment Products

Outside of the fiduciary context, the federal banking agencies have issued the Interagency RNDIP Statement, which applies to sales of nondeposit investment products.[268]

An RNDIP is any product with an investment component that, in most instances, is not an FDIC-insured deposit. Common RNDIPs include mutual funds, ETFs, variable and fixed rate annuities, equities, and fixed-income securities, both taxable and non-taxable.

The Interagency RNDIP Statement establishes minimum operating standards for retail brokerage programs intended to mitigate risks to both the bank and the consumer. The Interagency RNDIP Statement covers retail nondeposit investment activities involving:

(i) Sales or recommendations to individuals made by bank employees or employees of affiliated or unaffiliated broker-dealers occurring on bank premises;

(ii) Sales resulting from bank referrals of retail customers to an affiliated broker-dealer; and

(iii) Sales resulting from bank referrals of retail customers to a third party when the bank receives a benefit for the referral.[269]

[F][2] Suitability Standard

The OCC has essentially adopted the FINRA suitability standard for bank brokerage services. Even though the FINRA suitability rule does not expressly apply to sales or recommendations made directly by a bank, the OCC has stated that it is an appropriate reference for a bank compliance program designed to ensure that the bank's sales of RNDIPs are operated in a safe and sound manner.[270]

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268. As noted above, the Interagency RNDIP Statement was issued in 1994. *See also* Joint Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products ("Joint RNDIP Interpretations") (Sept. 12, 1995) [hereinafter Interagency RNDIP Statement] (issued by the OCC, FDIC, FRB and the OTS (OCC Bulletin 1995-52)). The Joint Interpretations provide further clarification of the Interagency RNDIP Statement's guidelines. The Interagency RNDIP Statement generally does not apply to fiduciary accounts. *See* Joint RNDIP Interpretations. The OCC's *RNDIP Handbook* provides further guidance on bank activities involving the recommendation or sale of nondeposit investment products to retail customers.

269. Interagency RNDIP Statement, *supra* note 268.

270. OCC RNDIP HANDBOOK, *supra* note 237, at 61–62. As discussed in *supra* section 52:2.1, FINRA's Rule 2111 establishes suitability requirements applicable to broker-dealers engaged in securities sales activities.

[F][3] Sales Practice Considerations

Bank examiners will generally consider the following matters when reviewing a bank's RNDIP sales practices:

- *General Improper Sales Practices* such as excessive trading, churning, or switching of investments; or misleading or high-pressure sales practices; and, in extreme cases, fraud, front-running, unauthorized trading, late trading, and market timing.[271]
- *Senior Clients*. Sales practices involving seniors, who should receive heightened investor protection depending on their needs, objectives, risk tolerance, investment experience, and understanding.[272]
- *Automated Investor Profiles, Investment Analysis, and Financial Plan*s. The OCC generally takes the position that automated profiles and reviews can be appropriate in some cases (typically involving model portfolios consisting of mutual funds or other collective funds), but they are not substitutes for professional judgment and should not favor proprietary products.[273]
- *Mutual Funds.* As discussed above, sales of mutual funds raise various potential conflicts of interest. Among other issues, OCC examiners will focus on matters such as missed "breakpoints" (reduced sales charge), which may arise if a client is sold several different fund shares each at just below the level that would qualify for a breakpoint, the appropriateness of the share class sold to an investor, and the characteristics of the fund, including complex investment features and potential liquidity issues with the underlying holdings of a fund.[274]

[F][4] ETFs

Sales practices involving ETFs raise issues when complex ETFs are involved (for example, leveraged ETFs, inverse ETFs, and leveraged inverse ETFs). These are viewed as speculative investments that are appropriate only for sophisticated clients.[275]

- *Annuities.* Issues relating to annuities sales practices typically arise from (i) the fact that commissions are typically higher

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271. OCC RNDIP HANDBOOK, *supra* note 237, at 64–65.
272. *Id*. at 65.
273. OCC RNDIP HANDBOOK, *supra* note 237, at 65–66. The OCC's guidance on model risk management also applies to the use of models for financial planning purposes. *See* OCC Bulletin 2011-12 (Apr. 4, 2011).
274. *Id*. at 66–67.
275. *Id*. at 67.

compared to other products, which can provide an incentive for inappropriate sales; (ii) the appropriateness of underlying sub-account selections; (iii) surrender penalty periods (especially involving sales to younger investors; and (iv) sales of annuities to 401(k) plans and IRAs because the earnings in a 401(k) or IRA already are tax advantaged.[276]

- *Complex Securities*. Complex securities (such as ETFs, hedge funds, and private equity funds) are often illiquid, employ leverage, involve complex payout structures, experience greater volatility, may be hard to value, have an increased potential for principal losses and can be difficult to understand, thus calling for heightened supervision of sales practices over these products.[277]
- *Proprietary Products*. While banks may be permitted to offer products that are managed, sponsored, underwritten, or syndicated by the bank or its affiliated entities, the affiliation and resulting conflicts should be properly managed and disclosed.[278]

[F][5] Disclosures

The banking agencies have also issued guidance calling for clear and conspicuous disclosures regarding RNDIPs, in particular to ensure that retail investors understand the differences between RNDIPs and FDIC-insured deposits.

As discussed above, the disclosures should include the "not-not-may disclosures" to the effect that: (i) RNDIPs are not insured by the FDIC; (ii) RNDIPs are not obligations of, or guaranteed by, the bank involved; and (iii) nondeposit investments will subject the purchaser to investment risk, including possible loss of the principal amount invested.

These disclosures should be provided to the customer: (i) orally during any sales presentation; (ii) orally when investment advice concerning RNDIPs is provided; (iii) orally and in writing prior to or at the time an investment account is opened to purchase these products; and (iv) in advertisements and other promotional materials, as described below. A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures.

Confirmations and account statements should contain these disclosures if the confirmations or account statements contain the name

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276. *Id*. at 67–68.
277. *Id*. at 68.
278. *Id*. at 68–69.

or the logo of the depository institution or an affiliate.[279] Also, if a customer's deposit account statement includes account information concerning the customer's RNDIPs, the information concerning the RNDIPs should be clearly separate from the information concerning the deposit account, and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.[280]

[F][6] Advertisements and Other Promotional Materials

Advertisements and other promotional and sales material, written or otherwise, about RNDIPs sold to retail customers should conspicuously include at least the minimum disclosures discussed above, and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance.[281]

[F][7] Additional Disclosures

A bank should disclose the existence of any advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing RNDIPs. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products.[282]

[F][8] Insurance Other Than FDIC Insurance

Representations regarding insurance other than FDIC insurance (for example, SIPC or private insurance) must also include an explanation of such coverage so as to minimize any confusion with FDIC insurance.[283]

[F][9] Setting and Circumstances

Because sales of RNDIPs on bank premises may give the impression that the products are FDIC-insured or are obligations of the depository institution, such sales (or recommendations) should be conducted in a

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279. These disclosures should be made in addition to any other confirmation disclosures that are required by law or regulation, for example, 12 C.F.R. pts. 12, 344; 12 C.F.R. § 208.34.
280. Interagency RNDIP Statement, *supra* note 268.
281. *Id.*
282. *Id.*
283. *Id.*

physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area. If physical considerations prevent sales of RNDIPs from being conducted in a distinct area, the bank institution has a heightened responsibility to minimize customer confusion.[284]

[F][10] Dual Employees

Dual-hatting arrangements between banks and nonbank subsidiaries within a bank holding company structure are permitted and common in larger institutions. A bank employee holding a securities license may be authorized to recommend and sell securities to the bank's customers in the employee's capacity as an employee of a broker-dealer. These dual employees are bank employees who can also offer clients banking products such as loans, deposits, and trust accounts. A bank employee may also be an employee of an affiliated or unaffiliated registered investment advisory firm.

Dual employee arrangements that involve an individual acting as a bank employee and a broker-dealer or investment adviser employee require heightened supervision of such an employee's total activities. Banks that use dual employees authorized to market banking and brokerage products and services should take additional actions to distinguish these employees' multiple capacities. Such actions may include separate business cards per capacity, physically changing sales locations depending on the product or service offered, and requiring that signage be displayed or removed depending on the banking or brokerage activity.[285]

[G] Additional Considerations—Bank and BHC Products and Services

[G][1] Federal Anti-Tying Rules

Under the Bank Holding Company Act Amendments of 1970,[286] banks are generally prohibited from conditioning the availability (or pricing) of credit from the bank (or other bank products) on a customer obtaining certain other products (including securities, insurance, or annuities offered by the bank or a bank affiliate), subject to certain exceptions. This prohibition applies whether the customer is retail or institutional.

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284. *Id.*
285. *Id. See also* OCC RNDIP HANDBOOK, *supra* note 237, at 53.
286. *See* 12 U.S.C. § 1971, 12 U.S.C. § 1972(1); *see also* 12 U.S.C. § 1464(q), 12 U.S.C. § 1467a(n) (applicability to thrifts and savings and loan holding companies).

The tying standards are complex, and not all tying or linking relationships involving banks are prohibited. For example, a prohibited tying arrangement relative to a bank's RNDIP sales programs would be that the bank conditions the availability or pricing of a loan on the customer purchasing securities using a broker-dealer affiliate.[287]

Under the combined balance discount exception, a bank generally may vary the consideration for any product or package of products based on a customer's maintaining a combined minimum balance in certain products specified by the bank (eligible products) if: (i) the bank offers deposits and all such deposits are eligible products, and (ii) balances in deposits count at least as much as nondeposit products toward the minimum balance.[288]

§ 52:4.3 Regulation of Space-Sharing Arrangements

[A] Rules for Shared Spaces/Premises

[A][1] GLBA and Regulation R Networking Exception

As noted in section 52:1.4 above, networking rules impose limitations on sharing of space by banks and broker-dealers.

[A][2] Sharing Space and Employees (12 C.F.R. § 7.3001)

National banks are authorized under 12 C.F.R. § 7.3001, "Sharing Space and Employees," to share space on bank premises and to share bank employees with other businesses. This authority is subject to supervisory conditions and other legal requirements. Supervisory conditions include requiring that the other business is conspicuously, accurately, and separately identified; shared employees clearly and fully disclose their capacity as bankers or agents of the other business that is providing the product and service; the activities of the other business do not adversely affect the bank's safety and soundness; and the shared employees or the other business entity meet applicable licensing and qualification requirements.[289]

[A][3] Shared Electronic Space (12 C.F.R. § 7.5010)

Under 12 C.F.R. § 7.5010, "Shared Electronic Space," national banks are also permitted to share electronic space, including a

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287. *See* OCC RNDIP HANDBOOK, *supra* note 237, at 45; *see also* OCC News Release 2004-23, OCC Issues Contact Information for Questions Concerning Tying (Mar. 23, 2004); OCC Bulletin 1995-20, Tying Restrictions: Guidance on Tying (Apr. 24, 1995).
288. 12 C.F.R. § 225.7(b)(2).
289. OCC RNDIP HANDBOOK, *supra* note 237, at 9–10.

co-branded website, with a bank subsidiary, affiliate, or another third party. National banks must take reasonable steps to clearly, conspicuously, and understandably distinguish between products and services offered by the bank and those offered by the bank's affiliated entities or a third party.

§ 52:4.4 Regulation of Fees and Charges

[A] Fiduciary Compensation Generally, 12 C.F.R. § 9.15

If the amount of a national bank's compensation is not set or governed by applicable law, the bank may charge a reasonable fee for its services.[290]

A national bank may not permit any officer or employee to retain any compensation for acting as co-fiduciary with the bank in the administration of a fiduciary account, except with the specific approval of the bank's board of directors.

[B] OCC Guidance Regarding Performance-Based Compensation for Portfolio Managers

OCC guidance provides that performance-based compensation may be charged for services provided by portfolio managers provided that such arrangements are: (i) constructed in accordance with permissible law; (ii) addressed in the governing document or contract (specifically the basis of calculation and circumstances under which the fees will or will not be payable); and (iii) disclosed in a written statement to each principal or beneficiary whose interest will bear the fee.[291]

[C] Fees Charged for Conversions of Common Trust Funds to Mutual Funds

Relevant FRB guidance addresses issues related to the permissibility of tax-free conversions of common trust funds to mutual funds, including the potential conflicts that may arise; for example, if a bank were to charge a customer a trustee fee while also collecting an advisory fee for managing a mutual fund.[292]

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290. In this context, "applicable law" refers to the law of a state or other jurisdiction governing a national bank's fiduciary relationships, any applicable federal law governing those relationships, the terms of the instrument governing a fiduciary relationship, or any court order pertaining to the relationship. 12 C.F.R. § 9.2.

291. OCC, COMPTROLLER'S HANDBOOK: INVESTMENT MANAGEMENT SERVICES (Aug. 2001), at 30.

292. FRB, SR Letter No. 97-3 (1997).

[D] Fee Restrictions Related to Trust and Fiduciary Exception Under Regulation R

The GLBA's trust and fiduciary activities exception permits a bank to effect securities transactions while acting in a "trustee" or "fiduciary" capacity in the bank's trust or other department "that is regularly examined by bank examiners for compliance with fiduciary principles and standards."[293] Among other requirements, the bank must be "chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee . . . , a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions . . . , or any combination of such fees."[294]

[E] Fee Restrictions Related to Custody and Safekeeping Exception Under Regulation R

National banks have long provided custody and security-holder services incidental to the delivery of other fiduciary services. Under the Exchange Act, the safekeeping and custody exception permits a bank, as part of its "customary banking activities," to: (i) provide safekeeping or custody services with respect to securities; (ii) facilitate the transfer of funds or securities in connection with the clearance and settlement of its customers' transactions in securities; (iii) effect securities lending or borrowing transactions with or on behalf of customers as part of services provided to customers pursuant to (i) or (ii) above, or invest cash collateral pledged in connection with such transactions; (iv) hold securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitate the pledging or transfer of such securities; and (v) serve as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.[295]

The SEC and FRB have specifically noted that the terms "custody" or "related administrative services" do not include accepting orders from investors to purchase or sell securities. Instead, various exemptions under Regulation R allow banks to engage in such activities, subject to various conditions and limitations.[296] These exemptions allow banks to engage in order-taking activities for specific types of accounts, including: (i) employee benefit plan accounts, IRAs, and

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293. 15 U.S.C. § 78c(a)(4)(B)(ii).
294. *Id*. The terms are defined in 12 C.F.R. § 218.721.
295. 15 U.S.C. § 78c(a)(4)(B)(viii).
296. *See* Regulation R Adopting Release, 72 Fed. Reg. at 56,536 (Oct. 3, 2007).

similar accounts;[297] and (ii) accounts other than employee benefit plans or IRAs if the bank accepts orders on an "accommodation" basis only.[298]

Both the accommodation exemption and order-taking exemption for employee benefit plans and IRAs are subject to various limits on the ability of a bank to accept such orders, including limits on employee compensation. Bank employees that accept orders for securities transactions pursuant to these exemptions may not receive compensation from the bank, the executing broker-dealer, or any other person based on: (i) whether a securities transaction is executed for the account; or (ii) the quantity, price, or identity of the securities purchased or sold for the account.[299]

[F] RNDIP and Push-Out Restrictions on Compensation

As more fully described in section 52:1.4[A] above, banks and bank personnel are subject to limits on compensation when engaging in activities that are subject to the Interagency RNDIP Statement or that rely on the networking exemption to the push-out rules.

§ 52:4.5 Regulatory Approval to Exercise Trust Powers

[A] National Banks

A national bank must obtain specific approval from the OCC to exercise fiduciary powers.[300] Engaging in fiduciary activities generally obliges a bank to establish a separate governance and management framework for such activities separate from the commercial department of the bank.[301]

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297. 12 C.F.R. § 218.760(a).
298. 12 C.F.R. § 218.760(b). Under each of the conditional exemptions that allow the bank to accept orders for securities transactions, the bank must direct the transactions to a registered broker-dealer for execution or conduct the trade directly as otherwise permitted pursuant to sections 3(a)(4) or 3(a)(5) of the Exchange Act, or Regulation R.
299. 12 C.F.R. § 218.760(c). However, these restrictions do not prevent employees from receiving compensation pursuant to the networking exception or under a bonus or similar plan that is otherwise permissible under other provisions of Regulation R. The employee compensation restriction also does not prohibit an employee from receiving compensation that is tied to whether customers establish custody accounts or the amount of assets customers place in such accounts. If the bank's compensation practices are not consistent with these limitations, the bank may not accept securities orders in a custodial capacity in reliance on the exemption.
300. *See* 12 C.F.R. § 9.3.
301. *See* OCC FIDUCIARY ACTIVITIES HANDBOOK, *supra* note 242, at 26.

[B] State-Chartered Banks

FDIC-insured state-chartered banks must generally obtain fiduciary powers from their state regulators. In addition, such banks must obtain authorization from the FDIC to exercise trust powers.[302] Like national banks, state banks generally must establish a governance and management framework for such activities separate from the commercial department of the bank. In addition, the FDIC requires a state-chartered bank to adopt the FDIC's form of "Statement of Principles" for operation of a trust department.[303]

[C] Federal Oversight and Examination of Bank Fiduciary Activities

Both the OCC and the FDIC have issued extensive supervisory guidance regarding fiduciary activities of banks. Each agency examines the trust departments of the banks they supervise. In addition, banks are subject to certain regulatory reporting obligations with respect to their fiduciary activities, including completion of Schedule T to the bank Call Report. Trust departments must also be subject to annual audit (or be subject to audit as part of a continuous audit program).[304]

§ 52:5 Products

§ 52:5.1 Alternative Investments

[A] What Are Alternative Investments?

Alternative investments are, broadly speaking, investments in assets that do not fall within traditional investment categories, such as stocks, bonds, and cash (or cash equivalents). Alternative investments are often added to an investor's portfolio with a view of providing broader diversification, returns that are uncorrelated (or less correlated) to market or index returns, and enhancing overall returns. These investments can include venture capital, private equity, hedge funds, real estate investment trusts, and commodities.

Alternative investments frequently involve long-term strategies that involve the use of derivatives, the ability to sell short, and the ability to hold illiquid assets.

Many alternative investments have high minimum investments and fee structures, and thus are often held by institutional investors or high-net-worth individuals.

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302. *See* 12 C.F.R. § 303.242.
303. *See* FDIC, TRUST EXAMINATION MANUAL, *supra* note 253, at § 1.B.
304. 12 C.F.R. § 9.9; FDIC, TRUST EXAMINATION MANUAL, *supra* note 253, § 2.S.

[B] Selling Alternative Investments to Retail Clients: Suitability Concerns

Pursuant to FINRA 2111, any recommendation made by a broker-dealer, including recommendations to purchase or sell interests in alternative investments, must be suitable for that particular customer.[305] In making those separate determinations, firms must consider the following common suitability concerns that alternative investments can present:

- *High-Risk Strategies*. While alternative investments may be suitable for many investors, they often involve the use of high-risk strategies. For example, hedge funds frequently use speculative investment and trading strategies, including leverage and short selling, that may increase the risk of investment loss.
- *Illiquidity*. Alternative investments are generally more illiquid than traditional investments. Unlike trading in highly liquid securities (for example, NYSE-listed equity), which are valued daily (if not more frequently) and where a return of capital can occur within days, alternative investments often require investors to pre-notify the issuer or investment manager of their intention to withdraw capital, and payment of the proceeds does not occur until a specified later redemption date. Moreover, long-term investments, such as private equity, may require investors to wait for a period of five or ten years before they can withdraw capital or see meaningful returns.
- *Leverage*. Alternative investments may involve the use of leverage, which results from using borrowed capital as a funding source to increase the potential return on investment. Leverage will magnify gains and losses.
- *Valuation Uncertainty*. The value of alternative investments can be difficult to assess. Traditional investments, such as listed equity, are traded on markets that allow investors to readily identify a trading price. For many alternative investments that are non-public in nature, or that invest in non-traditional or illiquid assets, it is difficult to collect data or track the last market price.

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305. For a discussion of the suitability standards imposed by FINRA Rule 2111, see *supra* section 52:1.2[A].

[C] Sales Practice Considerations for Alternative Investments

In light of the above suitability concerns, FINRA has issued guidance about navigating sales practice obligations when selling direct interests in hedge funds or indirect interests through funds of hedge funds.[306]

Specifically, FINRA has expressed concern that because retail clients may not fully understand the risks associated with investments in alternative investments, all marketing material produced and distributed by a broker-dealer in connection with the promotion of an alternative investment should include a clear statement of risks and potential disadvantages of the investment. Such a statement should include clarification of, among other things, the use of speculative investment practices, the illiquid nature of hedge funds, and valuation uncertainty.[307]

Under the reasonable-basis suitability rule, members that recommend hedge funds must have a belief that the product is suitable for at least some investor.[308] FINRA takes the view that broker-dealers fulfill this obligation by conducting due diligence with respect to the investment, which should include an investigation of the background of the investment manager or other control person, reviewing the offering memorandum, reviewing subscription agreements, examining references, and examining part performance of the investment.

Finally, to fulfill their requirements under the customer-specific suitability rule,[309] members must determine that their recommendation to invest in a hedge fund is suitable for that particular investor, which requires an examination of the customer's financial status, tax status, investment objectives, and any other information used or considered to be reasonable by members in making recommendations.[310] Members cannot rely on an investor's status as an accredited investor under Regulation D of the Securities Act as the sole criterion for fulfilling its obligation under the rule.

[D] Sales Practice Considerations Relating to New Products

In the event that firms are developing new alternative investments to be introduced, such new products must be reviewed for any

306. NASD Notice to Members 03-07.
307. *Id*.
308. FINRA Rule 2111.
309. *Id*.
310. For a discussion of the suitability standards imposed by FINRA Rule 2111, see *supra* section 52:1.2[A].

suitability concerns or conflicts of interest. Such review would include identifying important features of the product for the sales and marketing team, as well as adequate training and supervision.[311]

In addition to the suitability and other sales practice obligations that attach to the recommendation and sale of a product, firms should also implement procedures for reviewing new products before they are offered to customers or the public in order to allow a firm to reduce conflicts and to avoid unsuitable recommendations. In its guidance, FINRA noted five commonalities of best practices in this area: (1) a mandatory, standardized process that requires a written new product proposal; (2) a preliminary assessment of a proposed product by compliance and or legal personnel to determine if it is a new product or material modification of an existing product; (3) a detailed review of new products and material modifications by a committee made up of representatives from relevant sectors of the firm; (4) a formal decision to approve, disapprove, or table the proposal by the committee that includes members of the firm's senior management; and (5) if the product is approved, a post-approval follow-up and review.[312]

§ 52:5.2 *Structured Notes*

[A] What Are Structured Notes?

Structured notes are securities issued by financial institutions whose returns are based on specified reference assets or indices, such as equity indexes, a single equity, a basket of equities, interest rates, commodities and/or foreign currencies. As a result, an investor's return is linked to the performance of the underlying asset, group of assets, or index. For example, a structured note may derive its interest and principal (or payment rates), and therefore performance, from a broad-based stock index. Fundamentally, a structured note is used to benefit from the asset's upside potential while also limiting exposure to its downside. Note that the structured note itself is not the security of a vehicle that actually owns the asset; rather, it is a promise by the issuing financial institution to pay the returns generated by the reference instrument, or modified by the terms of the note.

Structured notes have two components: (1) a note and (2) an embedded derivative. The note portion pays interest to the investor at a specified rate and interval. The derivative component establishes the payment at maturity.

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311. FINRA Notice to Members 05-26.
312. *Id.*

[B] Selling Structured Notes to Retail Clients: Suitability Concerns

Firms must consider the following common suitability concerns that structured notes can present:

- *High-Risk Reference Assets*. While structured products may be suitable for many investors, they often involve the use of high-risk reference assets. Therefore, retail investors should be apprised about the nature of the underlying reference asset and the features of the note, and how each will be incorporated in the note structure when determining whether or not to purchase structured notes.
- *Illiquidity*. Structured notes are not typically listed for trading on security exchanges, which makes it very hard for interested parties to buy or sell a structured note on a secondary market. As a result, they tend to be illiquid. Investors should be apprised of this fact as they should either expect to hold structured notes to its maturity date, or sell the notes back to the original issuer, often at a discount.
- *Leverage*. Structured products may involve the use of leverage, which results from using borrowed capital as a funding source to increase the potential return on investment. Leverage will magnify gains and losses.
- *Credit Risk and Reference Asset Performance Risk*. Unlike an equity security, the price of which is based on the issuer's performance, structured notes carry both the risk of poor performance in the underlying reference instrument *and* the credit risk of the note issuer.

[C] Disclosure Concerns

[C][1] Disclosure to Customers

FINRA has expressed concern about the manner in which structured products may be marketed to retail investors and the types of investors purchasing the products.[313]

Rule 2210 requires that all sales materials and oral presentations regarding structured products present a fair and balanced picture regarding both risks and benefits. Required disclosures during public offerings must be consistent both in the preliminary and final prospectus supplements and the supplemental sales materials. For example, sales materials that omit a description of the derivative

313. NASD Notice to Members 05-59.

component of the product and instead present such products as ordinary debt securities would be problematic. Additionally, when presenting credit ratings of structured products, suggesting that the rating pertains to the safety of the principal invested or the likely investment returns will be viewed as misleading.[314]

[C][2] Customer Understanding of Product

The complexity of structured products may make it difficult for retail investors to understand (1) the characteristics of the product and (2) its risks. As a result, FINRA rules require firms to determine whether a recommendation to purchase a security is suitable to the particular customer involved, which includes consideration of client's investment experience and risk tolerance when recommending a transaction or strategy to the customer.[315]

In recommending complex products, FINRA recommends firms adopt the approach required for options trading accounts, which requires the registered representative to "have a reasonable basis for believing at the time of making the recommendation, that the customer has the knowledge and experience in financial matters," that the investor will be able to evaluate the risks of the recommended transaction, and can financially bear the risk.[316] In order to ensure that they meet this standard, firms often make approval of complex products contingent upon specific limitations or conditions such as (1) investment concentration limitations or (2) limitations on the type of investors to whom the product may be sold.

Any registered representative who intends to recommend a complex product should explain to the client (1) the features of the product; (2) how it is expected to perform under different market conditions; (3) the risks and the possible benefits; and (4) the costs of the product.[317] Furthermore, the representative should discuss scenarios in which the product may perform poorly. After doing so, the representative must determine whether the client appears to understand the basic features of the product (for example, the fundamental payout structure and the nature of the underlying collateral or a reference index or asset).

[C][3] Disclosure of Credit Risk

Part of explaining the benefits and risks of structured products includes disclosing credit risks. In particular, since the investor bears

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314. *Id.*
315. NASD Notice to Members 05-59; FINRA Rule 2111.
316. Rule 2360(b)(19)(B).
317. FINRA Regulatory Notice 05-59.

the risk that the issuer may forfeit on its obligation, the investor should understand that even though the underlying reference instruments may still produce a positive return, the notes would, in the event of default by the issuing financial institution, be worthless.

[C][4] Disclosure of Affiliation between the Recommending Institution and the Issuer of the Note

As discussed in detail earlier in this chapter, FINRA requires that firms identify, mitigate, and manage conflicts of interests. To that end, it has implemented several rules that govern the ethical obligations of both firms and brokers. Fundamentally, FINRA has encouraged firms to implement conflicts management procedures to mitigate conflicts of interest or the appearance of conflicts of interest. These procedures include supervision and disclosure.[318] With respect to a public offering of structured notes, a firm should disclose an affiliation between the underwriter and the issuer of the note.[319]

[D] FINRA Guidance

[D][1] Sales Practice Considerations for Structured Notes

FINRA has issued guidance regarding sales practice obligations when selling structured products. The main obligations include (1) providing balanced disclosure in promotional efforts; (2) ascertaining accounts eligible to purchase structured products; (3) dealing fairly with customers with regard to derivative products; (4) performing a reasonable-basis suitability determination; (5) performing a customer-specific suitability determination; (6) supervising and maintaining a supervisory control system; and (7) training associated persons.[320]

Firms should consider whether purchases of some structured products should be limited to investors that have accounts that have been approved for options trading. In light of the similar risk profile that many structured products and options have (for example, those where the principal invested is at risk from market movements in the reference security), FINRA recommends that members impose an "investor safeguard," such as requiring that structured products only be purchased in accounts approved for options trading. In the

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318. FINRA, CONFLICTS OF INTEREST, http://www.finra.org/industry/conflicts-of-interest.

319. For structured notes that are publicly offered, note that FINRA Rules 5110 and 5121 may add significant and complex regulation to the terms and conditions of note distribution.

320. NASD Notice to Members 05-59.

event that firms do not limit these purchases, firms should be ready to show their reasonable basis for allowing investors to purchase structured products, or specific structured notes.

[D][2] Heightened Supervision of Structured Products

FINRA has issued guidance about the supervision of complex products, which may include a security or investment strategy with novel, complicated, or intricate derivative-like features, such as structured notes. The complexity may make it difficult for retail investors to understand (1) the characteristics of the product and (2) its risks. Therefore, heightened scrutiny and supervision is required by the firm, which involve procedures for enhanced oversight.[321]

Moreover, the SEC has expressed concern about complex products, and has addressed conduct such as (1) the misrepresentation of complex investments as appropriate for retail investors seeking safe investments; (2) fraud in collateralized debt obligation marketing materials; and (3) misrepresentations about the extent to which an investment exposes the owner to risky assets, such as the subprime real estate market.[322]

Complex products include those with multiple features that affect its investment returns differently under varying scenarios. Examples of complex products would be structured notes with an embedded derivative for which the reference asset is a constant maturity swap rate, or products with complicated limits or formulas for the calculation of investor gains. The operative question is whether it would be unreasonable to expect an average retail investor to identify the existence of these features and understand the basic manner in which the features interact to produce a return.

[D][3] Actions Related to Suitability of Structured Notes Sales

FINRA and the SEC have identified alleged wrongdoing related to the sale of structured notes on multiple occasions.

For example, FINRA has found that despite a broker-dealer's use of various exception-based reporting systems, it did not specifically monitor potentially unsuitable concentration levels in structured products in customer accounts, which according to FINRA, violated NASD and FINRA Rules that focus on supervision. The broker-dealer was censured and fined $450,000.[323]

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321. FINRA Regulatory Notice 12-03.
322. *Id.*
323. FINRA Letter of Acceptance, Waiver and Consent: No. 2010022011901.

Similarly, FINRA took issue with a circumstance where FINRA found that a broker-dealer did not have a firm-wide structured product-specific suitability policy in place. The broker-dealer developed concentration and net-worth guidelines, but did not have a procedure in place to notify supervisors whether structured product purchases complied with those internal guidelines. FINRA found that a broker-dealer's fourteen recommendations for eight customers was also inconsistent with the customers' financial situation and investment objectives. FINRA concluded that the foregoing conduct violated various NASD Conduct Rules. The broker-dealer was censured and fined $600,000.[324]

Finally, the SEC has instituted Cease and Desist Orders against a broker-dealer for violating section 17(a)(2) of the Securities Act, which prohibits obtaining money or property by means of misstatements and omissions in the offer or sale of securities. The broker-dealer issued structured notes, which were linked to a proprietary foreign exchange strategy called the V10 Currency Index (the "V10"). The broker-dealer stated that the V10 was a transparent and systematic currency trading strategy and that it was calculated using market prices for the relevant underlying financial instruments. However, the SEC found that the broker-dealer engaged in conduct that negatively impacted the pricing inputs used to calculate the V10[325] and market prices were not consistently used to calculate the index. As a result, the investors were misled as to the key features of the index, and the broker-dealer's actions negatively impacted the performance of the notes. The broker-dealer was ordered to pay a total of $11.5 million consisting of disgorgement of $10 million and prejudgment interest of $1.5 million.[326]

§ 52:5.3 *Collective Investment Vehicles*

[A] Registered Investment Funds

Investment companies that are registered under the Investment Company Act are broken down into three principal types: open-end funds, closed-end funds, and unit investment trusts. Their shares are usually registered for sale under the Securities Act, but they don't need to

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324. FINRA Letter of Acceptance, Waiver and Consent: No. 2008015963801.
325. Cease and Desist Order: File No. 3-16891.
326. The broker-dealer allegedly engaged in the following conduct that impacted the pricing inputs: (1) taking unjustified markups and adding to hedge transactions executed on switch days; (2) engaging in hedging trades with non-systematic spreads—the prices of the hedge trades were then used as inputs to calculate the index; and (3) trading in advance of certain hedging transactions. The broker-dealer did not have in place meaningful controls or restrictions over trading ahead of internal V10 hedging transactions.

be if sold pursuant to an available exemption (such as Regulation D). The shares of registered investment companies are typically distributed by a broker-dealer and that distribution is subject to certain rules of FINRA. The typical registered investment fund seeks to avoid taxation by complying with certain provisions of subchapter M of the Internal Revenue Code, which requires a certain level of diversification of the fund's assets and the distribution by the fund of substantially all its income and capital gains to shareholders each year. Registered funds sell their shares pursuant to a statutory prospectus that must be delivered to investors (open-end funds can utilize a summary prospectus).

[A][1] Open-End Funds

Open-end funds are funds that are required to redeem a shareholder's shares at net asset value (NAV) upon a shareholder's request and typically continuously issue shares. These funds are often referred to as mutual funds. These funds encompass a variety of investment strategies and can also be broken down into: (a) active and passive funds; and (b) diversified and non-diversified funds. Passive funds often replicate an index and are also known as index funds. Active funds involve the investment manager managing a portfolio and selecting portfolio investments and strategies. Diversified funds must meet certain diversification requirements under the Investment Company Act. Non-diversified funds are all other funds.

[A][1][a] Typical Mutual Fund

The typical mutual fund seeks an investment objective such as growth, income, tax-exempt income, or similar objectives by investing in a portfolio of securities and other investments. The portfolio of a mutual fund consists of stocks, bonds, or other types of investments, domestic or foreign.

[A][1][b] Money Market Funds

Money market funds are a special category of mutual funds that seek to maintain a stable per share value and generate income. Their investments are limited to high quality short-term instruments and the provisions of Rule 2a-7 under the Investment Company Act imposes a variety of limitations on the composition of the portfolio, its weighted average life, and weighted average maturity, as well as requirements regarding the maintenance of necessary liquidity. Institutional money market funds cannot use $1.00 per share and must mark investments to market every time the NAV is calculated. Retail money market funds are permitted to use $1.00 per share. All money market funds, except government money market funds, are subject to the imposition of fees and gates under certain circumstances.

[A][1][c] Target Date Funds

Target date funds are mutual funds designed to satisfy their investors objective by a particular target date and that have a portfolio that changes its portfolio composition as the fund moves toward the target date. This change in portfolio composition is often referred to as the funds glide path. These types of funds have been popular in 401K retirement plans and in 529 plans where money is invested for education.

[A][1][d] Exchange-Traded Funds (ETF)

Exchange-traded funds are a type of open-end fund (except for a very few that are organized as unit investment trusts) that issue and redeem shares only in large creation units and then only with authorized participants. The shares of the ETFs trade on an exchange, and investors can purchase and sell shares of the ETF during the day at market prices. There are currently (a) ETFs that seek to replicate an index, and (b) ETFs that are actively traded and disclose their portfolio every day. There are other products that are not exchange traded funds registered under the Investment Company Act often referred to as Exchange-Traded Products, which consist of: (a) exchange-traded notes issued by an issuer that will pay at maturity a certain return based on the performance of another asset; and (b) commodity-based exchange-traded products that are registered under the Securities Act, but are not subject to the Investment Company Act.

[A][1][e] Exchange-Traded Managed Fund

A new type of fund is an exchange-traded managed fund. These funds trade on an exchange and an investor can agree to purchase or sell shares of an exchange-traded managed fund during the day, negotiate the spread that the investor will pay the broker-dealer, and then the trade will occur at that evening's NAV plus or minus that spread.

[A][2] Closed-End Funds

Closed-end funds are funds that are like mutual funds, but a closed-end fund does not stand ready to redeem shares at NAV. These funds typically issue a fixed number of shares and trade on an exchange, or on an inter-dealer market, or through brokers, which is where investors can purchase or sell their shares.

[A][3] Interval Funds

Interval funds are registered closed-end funds that periodically offer to buy back their shares from investors every three, six, or twelve months, and that are permitted to continuously offer their shares at

NAV. The shares of an interval fund typically do not trade on a secondary market.

[A][4] Unit Investment Trusts (UIT)

Unit investment trusts are investment companies that issue a fixed number of shares, have a fixed portfolio, and no portfolio management. Shares of UIT typically trade in the aftermarket with a broker-dealer making a market, but are redeemable by the trust and have a fixed term.

[A][5] Business Development Companies (BDC)

Business Development Companies (BDC) are companies that are operated for the purpose of making investments in certain eligible portfolio investments (generally smaller companies with limited trading) and that offer to make available significant managerial assistance to them. BDCs are subject to certain provisions of the Investment Company Act, and they may engage in greater leverage than open-end and closed-end funds. The shares of a BDC are not redeemable, and they trade either in the over-the-counter market or on an exchange.

[B] Private Funds

Private funds are investment vehicles that pool investors' money and invest them to seek a particular investment objective. They are not publicly offered and would be investment companies under the Investment Company Act, but qualify for one of two exemptions therefrom. Section 3(c)(1) exempts funds that are not making a public offering and have no more than 100 investors. Section 3(c)(7) exempts funds that are not making a public offering and that only have qualified purchasers as investors. Private funds do not register their shares under the Securities Act and thus must rely on an exemption such as Regulation D. Shares of private funds are offered via an Offering Memorandum. There are several types of private funds that are described below.

[B][1] Hedge Funds

Hedge funds are private funds that can have a wide range of securities and other assets they can invest in, can frequently go long or short, and utilize leverage and derivatives. Hedge funds typically invest in public securities and offer investors varying liquidity terms.

[B][2] Private Equity Funds

Private equity funds are similar to hedge funds in many respects, but focus more on long-term investment opportunities and invest typically in non-public investment opportunities. Private equity funds

do not offer the liquidity to investors that hedge funds do, and generally require investors to commit their funds for a minimum period of time, usually at least three to five years and often from seven to ten years.

[B][3] Venture Capital Funds

Venture capital funds are private funds that invest in private equity stakes typically in non-public startups and small to medium-sized enterprises. They are significantly limited in their use of leverage and do not offer investors the ability to redeem or exit the investment.

[C] Bank Funds

Banks offer a variety of commingled investment vehicles in their trust departments. These commingled vehicles are similar to mutual funds but are exempt from the provisions of the Investment Company Act provided they meet the requirements for that exclusion. Common trust funds and collective investment funds that are used exclusively by the bank for money it contributes as trustee, executor, administrator, or guardian and that are subject to other limits are entitled to rely on that exclusion.

§ 52:6 Anti-Money Laundering (AML)

§ 52:6.1 General

As a general matter, all U.S. broker-dealers and banks must comply with the U.S. Bank Secrecy Act (BSA) and its implementing regulations, together with selected SEC and FINRA regulations, collectively referred to as the AML rules.

Broker-dealer AML programs must include the following five essential "pillars":[327]

(1) *Establishment and Implementation*. Firms must establish and implement policies, procedures, and internal controls, approved in writing by a senior manager, that are reasonably designed to achieve compliance with the applicable provisions of the BSA and the implementing regulations thereunder.

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327. *See* FINRA, REGULATORY NOTICE 17-40 (Nov. 21, 2017). The first four pillars were enumerated in the statute. 31 U.S.C. § 5318(h)(1) (2012). The fifth pillar was clarified by the new Customer Due Diligence Requirements for Financial Institutions rule. *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,420 (May 11, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf. *See generally infra* section 52:6.3[D].

(2) *Independent Testing*. Independent testing of the AML program must be conducted by the broker-dealer's personnel or by a qualified outside party.

(3) *Designation of Individuals*. Firms must designate an individual as its AML Compliance Officer, who will be responsible for implementing and monitoring the operations and internal controls of the program.

(4) *Ongoing Training*. Firms must engage in ongoing training for appropriate persons.

(5) *Customer Due Diligence*. Firms must establish and implement risk-based procedures for conducting customer due diligence both at the customer on-boarding stage and on an ongoing basis.

§ 52:6.2 AML Regulatory Regimes

Broker-dealers are required to comply with the rules and regulations under the following AML regulatory regimes:

(1) *USA PATRIOT Act*. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act")[328] requires financial institutions to establish AML programs reasonably designed to ensure that the firm detects and reports suspicious activity.

(2) *Office of Foreign Assets Control (OFAC)*. Financial institutions are further required to comply with the economic and trade sanctions programs administered by OFAC. Prior to the opening of a new account or commencement of a transaction, financial institutions, including broker-dealers, must ensure that potential clients are not listed on the OFAC's Specifically Designated Nationals and Blocked Persons List ("SDN List"), or are "Prohibited Persons" under OFAC's sanctions program, and that prohibited financial instruments are not involved in the transaction.

(3) *Financial Crimes Enforcement Network ("FinCEN")*. FinCEN is a bureau of the U.S. Department of the Treasury that processes and distributes financial transactions data to safeguard the financial system and combat money laundering.[329]

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328. Pub. L. No. 107-56, 115 Stat. 272 (codified as amended in scattered sections of the U.S. Code).

329. FINCEN, WHAT WE DO, https://www.fincen.gov/what-we-do (last visited June 29, 2018).

A key aspect of FinCEN's regulation of broker-dealers is the requirement that broker-dealers establish and maintain procedures that are reasonably designed to identify and verify the identities of their customers, including with respect to the beneficial owners of certain legal entity customers. This is discussed in greater detail in section 52:6.3 below.

(4) *FINRA AML Rules*. FINRA Rule 3310[330] sets forth minimum standards for a member firm's written AML compliance program.

§ 52:6.3 *Customer Identification Program and Customer Due Diligence*

[A] Customer Identification Programs for Broker-Dealers[331]

[A][1] Overview

On April 29, 2003, FinCEN and the SEC issued a joint final rule requiring broker-dealers to implement, document, and maintain a written customer identification program (CIP) that is integrated within the firm's general AML program (the "CIP Rule").[332] The rule requires that a firm's CIP must provide it with grounds to form a reasonable belief that the firm knows the persons with whom it transacts.[333]

[A][2] Requirements

To comply with the CIP Rule, broker-dealers must:

(1) obtain certain specified information regarding each customer before opening an account;[334]

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330. FINRA, Rule 3310 (2018).

331. For more discussion on the Customer Identification Programs for broker-dealers discussed in this section, you may wish to refer to SHEARMAN & STERLING LLP, NEW CUSTOMER IDENTIFICATION PROCEDURE RULES FOR BROKERS AND DEALERS TAKE EFFECT (Oct. 2003), https://www.shearman.com/~/media/files/newsinsights/publications/2003/10/new-customer-identification-procedure-rules-for-__/files/download-pdf-new-customer-identification-procedu__/fileattachment/cm_1003.pdf.

332. Joint Final Rule: Customer Identification Programs for Broker-Dealers, SEC Release No. 34-47752 (Apr. 29, 2003), https://www.sec.gov/rules/final/34-47752.htm.

333. *Id*.

334. 31 C.F.R. § 1023.220(a)(2)(i)(A)(2011). With respect to broker-dealers, under the CIP Rule the term "account" means "a formal relationship

(2) verify such information within a reasonable time before or after the opening of the account;[335]

(3) specify in their CIP procedures when they will rely on identification procedures that are documentary (for example, photographic ID) or non-documentary (for example, checking the customer's references with other financial institutions);[336] and

(4) maintain records of the preceding measures and the descriptions of the manner in which discrepancies discovered in the client identification process are resolved.[337]

[A][3] Definition of "Customer"

Under the CIP Rule, a "customer" is a person who opens a new account with a broker-dealer, or a person who opens a new account on behalf of an entity or another person.[338] The term does not include entities that have existing accounts with a broker-dealer; entities that present little danger of money laundering, such as government entities; and certain entities otherwise subject to federal or state regulation.[339]

If a broker-dealer's customer has an account at another financial institution, the broker-dealer may rely on that other financial institution's CIP performance to satisfy its CIP obligations, provided that:[340]

(1) reliance is reasonable under the circumstances;

(2) the other financial institution is regulated by a federal functional regulator and required to implement an AML compliance program; and

(3) the broker-dealer has annually certified to the relying financial institution requiring the latter to attest that it has an AML

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with a broker-dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral." 31 C.F.R. § 1023.100(a)(1). The term "account" does not include those acquired by broker-dealers acquired "through any acquisition, merger, purchase of assets, or assumption of liabilities" or those "opened for the purpose of participating in an [ERISA employee benefit plan]." 31 C.F.R. § 1023.100(a)(2).

335. 31 C.F.R. § 1023.220(a)(2)(ii).
336. *Id.*
337. 31 C.F.R. § 1023.220(a)(3).
338. 31 C.F.R. § 1023.100(d)(1).
339. 31 C.F.R. § 1023.100(d)(2).
340. *See generally* 31 C.F.R. § 1023.220(a)(6).

program meeting the applicable requirements and will undertake the performance of specified CIP obligations.

[B] Correspondent Accounts Established for Foreign Financial Institutions

[B][1] Overview

Certain accounts, such as correspondent accounts, are subject to more detailed requirements under the AML rules. Specifically, rules implementing the correspondent account provisions of section 312 of the USA PATRIOT Act (the "Correspondent Account Rule") require covered financial institutions, including broker-dealers, to establish and maintain risk-based procedures to detect and report known or suspected money laundering (or other suspicious) activity involving any correspondent account established by the financial institution on behalf of a foreign financial institution.[341]

A "foreign financial institution" includes:[342]

(1) A foreign bank, as that term is defined for purposes of the BSA;

(2) Any branch or office located outside the United States of certain broker-dealers, futures commission merchants or introducing brokers, and mutual funds;

(3) Any other person organized under foreign law (other than a branch or office of such person in the United States) that, if it were located in the United States, would be a covered broker-dealer, futures commission merchant or introducing broker, or mutual fund; and

(4) Any person organized under foreign law (other than a branch or office of such person in the United States) that is engaged in the business of, and is readily identifiable as: a currency dealer or exchanger; or a money transmitter.

[B][2] Requirements

Under the Correspondent Account Rule, the policies, procedures, and controls required for applicable correspondent accounts must include:[343]

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341. The correspondent account provisions of the USA PATRIOT Act define a "correspondent account" as an account established to "receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution." 31 U.S.C. § 5318A(e)(1)(B). The correspondent account rule's definition is substantially similar to the statutory definition. *See* 31 C.F.R. § 1010.605(c).

342. *See generally* 31 C.F.R. § 1010.605(f).

343. 31 C.F.R. § 1010.610(a)(1)–(3).

- Determining whether any such correspondent account is subject to enhanced due diligence.
- Assessing the money laundering risk presented by the applicable correspondent account, based on a consideration of relevant factors.[344]
- Applying risk-based procedures and controls to each applicable correspondent account reasonably designed to detect and report known or suspected money laundering activity, including a periodic review of the correspondent account activity sufficient to determine consistency with information obtained about the type, purpose, and anticipated activity of the account.

Risk-based procedures under the Correspondent Account Rule must take into account:[345]

- the nature and market of the foreign financial institution's business;
- the type, purpose, and anticipated activity of the correspondent account established;
- the nature and duration of the covered financial institution's relationship with the foreign financial institution and its affiliates;
- the foreign jurisdiction's AML regime; and
- information reasonably known to the covered financial institution regarding the foreign financial institution's AML record.

These due diligence procedures must be part of a firm's AML program.

The Correspondent Account Rule also requires that the AML program of the covered financial institution include special procedures in situations when due diligence or enhanced due diligence cannot be performed. These procedures must specify when the institution should:[346]

- refuse to open an account;
- suspend transaction activity in an account;
- file a suspicious activity report in relation to the account or a transaction (or series of transactions) therein; or
- close an account.

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344. The factors are listed in 31 C.F.R. § 1010.610(a)(2)(i)–(v); *see supra* note 20 and accompanying text.
345. 31 C.F.R. § 1010.610(a)(2).
346. 31 C.F.R. § 1010.610(d).

[C] Due Diligence Programs for Private Banking Accounts

[C][1] Overview

Rules implementing the private banking provisions under section 312 of the USA PATRIOT Act (the "Private Banking Rule") require covered financial institutions, which include U.S.-registered broker-dealers, to establish and maintain procedures that are reasonably designed to detect and report known or suspected money laundering (or other suspicious) activity conducted through or involving any private banking account. The rule also requires enhanced scrutiny of private banking accounts held by senior foreign political figures[347] (commonly referred to as "Politically Exposed Persons").

For purposes of the Private Banking Rule, "private banking account" refers to any account or combination of accounts maintained at a covered financial institution that:[348]

(1) requires a minimum aggregate deposit of assets of $1 million or more;

(2) is established for the benefit of one or more non-U.S. persons that are the direct or beneficial owners of the account; and

(3) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a covered financial institution acting as liaison between the covered financial institution and the owner(s) of the account.

[C][2] General Requirements

At a minimum, the due diligence programs required under the Private Banking Rule must ensure that the financial institution takes reasonable steps to (1) identify all nominal and beneficial owners of a private banking account; (2) determine whether any nominal or beneficial owner of any such account is a senior foreign political figure; (3) ascertain the sources of funds deposited into, the purpose of, and the use of the account; and (4) review the activity of the account to ensure consistency with the information obtained about the account, and report known or suspected money laundering or suspicious activity.[349]

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347. For the definition of "senior foreign political figure," see 31 C.F.R. § 1010.605(p)(1).
348. 31 C.F.R. § 1010.605(m).
349. 31 C.F.R. § 1010.620(b)(2012).

As with the Correspondent Account Rule, the procedures required under the Private Banking Rule must be risk-based. Consequently, the extent of diligence that is conducted in relation to private banking accounts should be proportional to the money laundering risks posed by the specific client.

The Private Banking Rule requires enhanced scrutiny of private banking accounts held by or on behalf of senior foreign political figures to detect and report transactions that may involve proceeds of foreign corruption.[350]

[D] Customer Due Diligence Requirements for Financial Institutions (the "CDD Rule")[351]

[D][1] Overview

May 11, 2018, marked the compliance date for the CDD Rule issued by FinCEN on May 11, 2016[352] (as later amended on September 28, 2017, to make certain technical corrections[353]). The CDD Rule requires broker-dealers to "look through" and identify the beneficial owners of certain legal entity customers.[354] The CDD Rule represents a departure

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350. The term "proceeds of foreign corruption" is defined as "any asset or property that is acquired by, through, or on behalf of a senior foreign political figure through misappropriation, theft, or embezzlement of public funds, the unlawful conversion of property of a foreign government, or through acts of bribery or extortion, and shall include any other property into which any such assets have been transformed or converted." 31 C.F.R. § 1010.620(c)(2).

351. For more discussion on the customer due diligence rule, you may wish to refer to SHEARMAN & STERLING LLP, FINCEN'S CUSTOMER DUE DILIGENCE RULE BECOMES EFFECTIVE; FINCEN AND FINRA GUIDANCE PROVIDES INTERPRETIVE COLOR FOR FIRMS WORKING TO COMPLY (May 21, 2018), https://www.shearman.com/perspectives/2018/05/fincens-customer-due-diligence-rule; SHEARMAN & STERLING LLP, FINCEN ISSUES FINAL BENEFICIAL OWNER IDENTIFICATION RULES (June 14, 2016), https://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/FinCEN-Issues-Final-Beneficial-Owner-Identification-Rules-FIAFR-061416.pdf.

352. *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

353. Customer Due Diligence Requirements for Financial Institutions; Correction, 82 Fed. Reg. 45,182 (Sept. 28, 2017), https://www.gpo.gov/fdsys/pkg/FR-2017-09-28/pdf/2017-20777.pdf.

354. The CDD Rule requires covered financial institutions to obtain beneficial ownership information for a "corporation, limited liability company or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership and any similar entity formed under the laws of a foreign jurisdiction that opens an account." Entities that are excluded from the definition of legal entity customer include:

from prior FinCEN rules, under which financial institutions exercised their own judgment, making risk-based assessments as to when and how to identify and verify beneficial owner information for legal entity accounts, except with respect to specific cases.[355]

- financial institutions regulated by a federal functional regulator or banks regulated by a state bank regulator;
- departments or agencies of the United States, of any state, or of any political subdivision of a state;
- entities (other than a bank) whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchange ("listed entities");
- any entity (other than a bank) organized under the laws of the United States or of any state at least 51% of whose common stock or analogous equity interests are held by a listed entity;
- issuers of securities registered under section 12 of the Securities Exchange Act of 1934 or that are required to file reports under section 15(d) of the Securities Exchange Act of 1934;
- investment companies, as defined in section 3 of the Investment Company Act, registered with the Securities and Exchange Commission (SEC);
- SEC-registered investment advisers, as defined in section 202(a)(11) of the Investment Advisers Act;
- exchanges, clearing agencies, or any other entity registered with the SEC under the Securities Exchange Act;
- registered entities, commodity pool operators, commodity trading advisors, retail foreign exchange dealers, swap dealers, or major swap participants, defined in section 1a of the Commodity Exchange Act, registered with the Commodity Futures Trading Commission;
- public accounting firms registered under section 102 of the Sarbanes-Oxley Act;
- bank holding companies, as defined in section 2 of the Bank Holding Company Act of 1956;
- pooled investment vehicles operated or advised by a financial institution excluded from the beneficial ownership requirement;
- insurance companies regulated by a state;
- financial market utilities designated by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Act;
- non-U.S. financial institutions established in a jurisdiction where such institution's regulator maintains beneficial ownership information regarding such institution;
- non-U.S. governmental entities that only engage in governmental rather than commercial activities; and
- legal entities opening private banking accounts.

31 C.F.R. § 1010.230(e)(2) (2016).

355. For example, the CIP Rule requires that the CIP "include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable." 31 C.F.R. § 1023.220(a)(2) (2011).

Under the CDD Rule, covered financial institutions must establish procedures to:

- identify each natural person that directly or indirectly owns 25% or more of the equity interests of a "legal entity customer" (the "ownership prong");[356]
- identify one natural person with "significant responsibility to control, manage or direct" a legal entity customer,[357] including an executive officer or senior manager (for example, a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or any other individual who regularly performs similar functions (the "control prong"), which may be a person reported under the ownership prong; and
- verify the identities of those persons according to risk-based procedures, which procedures must include the elements currently required under the CIP Rule at a minimum.[358]

FinCEN has stated that financial institutions should use the collected beneficial ownership information as they use other information they gather regarding customers (for example, through compliance with CIP requirements), including for compliance with OFAC regulations and currency transaction reporting (CTR) aggregation requirements.[359]

There may be circumstances where, based upon a financial institution's risk assessment of a particular customer, the financial institution may determine there is a need to collect beneficial ownership information for individuals below the 25% threshold.[360] Alternatively,

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356. If an individual owns 25% or more of the legal entity customer's equity through the aggregation of holdings across multiple parent entities, the financial institution must treat the individual as a beneficial owner. U.S. DEP'T OF TREASURY, FIN. CRIMES ENF'T NETWORK, FREQUENTLY ASKED QUESTIONS REGARDING CUSTOMER DUE DILIGENCE REQUIREMENTS FOR FINANCIAL INSTITUTIONS (Apr. 3, 2018), https://www.fincen.gov/sites/default/files/2018-04/FinCEN_Guidance_CDD_FAQ_FINAL_508_2.pdf [hereinafter FinCEN 2018 FAQs], Question 3. Covered financial institutions, however, do not need to independently investigate the ownership structure of the legal entity customer, and may rely on the information presented by the legal entity customer's representative, provided that the institution does not have knowledge of any facts that would reasonably call into question the validity or reliability of that information. *Id*.

357. 31 C.F.R. § 1010.230(d)(2) (2016).

358. 31 C.F.R. § 1010.230(b)(2).

359. FinCEN 2018 FAQs, *supra* note 356, Question 36.

360. *Id*. Question 2.

a financial institution may determine that any heightened risk associated with a particular legal entity customer could be mitigated through other means, such as enhanced monitoring or collection of other information.[361]

[D][2] CDD Rule Procedures

Under the CDD Rule, broker-dealers must establish procedures that verify the identity of each beneficial owner according to risk-based procedures whenever reasonable and practicable.[362] Key aspects of such procedures are set forth below.

[D][2][a] Scope

The CDD Rule only applies to accounts opened on or after May 11, 2018, but institutions may, as a prudential matter, decide to collect the same information from accounts opened prior to May 11, 2018.[363] Covered institutions, however, must obtain or update beneficial ownership information for accounts established before May 11, 2018, if circumstances warrant assessing or re-assessing the risks that the customer poses.[364]

[D][2][b] Timing

The broker-dealer must identify those beneficial owners of the legal entity customer at the time when such customer opens a new account[365] with the broker-dealer.[366]

[D][2][c] Minimum Requirements

Procedures required under the CDD Rule must at least satisfy the requirements under the CIP Rule, although the institution's CDD Rule procedures do not have to be identical to its CIP procedures.[367] For example, reproduced copies of documents are permitted under the CDD Rule.[368]

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361. *Id*.
362. 31 C.F.R. § 1010.230(b)(2).
363. FinCEN 2018 FAQs, *supra* note 356, Question 13.
364. *Id*.
365. The term "new account" means "each account opened at a covered financial institution by a legal entity customer." 31 C.F.R. § 1010.230(g). For the definition of "account" in the context of broker-dealers, see *supra* note 334.
366. 31 C.F.R. § 1010.230(b)(1).
367. FinCEN 2018 FAQs, *supra* note 356, Question 4.
368. 31 C.F.R. § 1010.230(b)(2).

[D][2][d] Required Information to Be Collected

At a minimum, the information that broker-dealers must collect to verify beneficial ownership includes the beneficial owner's name, date of birth, address, and identification number.[369] The broker-dealer does not need to obtain this information directly from the beneficial owners; rather, it can rely on information supplied by the legal entity customer, provided that the broker-dealer has no knowledge of facts that would reasonably call into question the reliability of such information.[370]

In addition, broker-dealers must obtain a certification from whoever opens the account on behalf of the legal entity customer, which identifies each beneficial owner of the legal entity customer.[371]

[D][2][e] Reliance on Existing CIP Information

When an individual named as a beneficial owner of a new legal entity customer account is an existing customer of the covered financial institution subject to the institution's CIP, the institution may rely on such existing CIP if the individual is named as a beneficial owner of the new legal entity customer.[372] The information on file must be accurate and up-to-date, and the representative opening the account on behalf of the legal entity customer must certify verbally or in writing that the pre-existing CIP information is accurate.[373]

[D][2][f] Reliance on Legal Entity Customer's Certification

If an existing legal entity customer of a covered financial institution already certified to its beneficial ownership information, the financial institution may rely on that certification when that existing customer opens new accounts to fulfill its verification and identification burdens, provided that the legal entity customer certifies verbally or in writing that the information is accurate and up-to-date at the time of each subsequent account opening, that the institution maintains a record of each certification or confirmation, and that the institution does not have knowledge of any facts that would reasonably call into question the validity or reliability of that information.[374]

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369. 31 C.F.R. § 1023.220(a)(2)(i)(A) (2011).
370. 31 C.F.R. § 1010.230(b)(2) (2016).
371. 31 C.F.R. § 1010.230(b)(1).
372. FinCEN 2018 FAQs, *supra* note 356, Question 7.
373. *Id*. Question 7.
374. *Id*. Question 10.

[D][2][g] Covered Financial Institutions Generally Not Required to Update Beneficial Ownership Information

Covered financial institutions are not required to solicit or update beneficial ownership information absent specific risk-based concerns, although institutions do have discretion to collect and update beneficial ownership information as often as they deem appropriate.[375] Covered financial institutions are, however, required to have policies and procedures in place to, among other responsibilities, maintain and update customer information on a risk basis, and obtain and update information, if, in the course of normal monitoring, the institution becomes aware of information about a customer or account, including a potential change in beneficial ownership, relevant to the assessment or reassessment of that customer's overall risk profile.[376]

Covered financial institutions are not required to obtain beneficial ownership information from certain entities, including:

- *Pooled Investment Vehicles*.[377] Certain pooled investment vehicles are excluded from the CCD Rule entirely. For pooled investment vehicles not otherwise excluded under the CDD Rule, it would be impractical for covered financial institutions to attempt to collect and verify the 25% ownership information for these types of entities, given how ownership interests fluctuate.[378] Covered financial institutions are, however, required to collect beneficial ownership information for these types of entities under the control prong of the CDD Rule.[379]
- *Non-U.S. Financial Institutions Already Subject to the Collection and Maintenance of Beneficial Ownership Information by the Foreign Jurisdiction's Regulator*. If the non-U.S. regulator in the legal entity customer's jurisdiction already collects and maintains beneficial ownership information for the customer, the covered financial institution does not need to collect beneficial ownership information from such legal entity customer.[380] Covered financial institution may rely on a representation by the legal entity customer that this exclusion applies, barring circumstances

375. *Id*. Question 14.
376. *Id*.
377. 31 C.F.R. § 1010.230(e)(2)(xi).
378. FinCEN 2018 FAQs, *supra* note 356, Question 18.
379. *Id*.
380. 31 C.F.R. § 1010.230(e)(1)(xiv).

questioning the reliability of such representation.[381] Correspondent accounts established for non-U.S. financial institutions, however, continue to be subject to the due diligence and beneficial ownership identification requirements that were already in place prior to the implementation of the CDD Rule.[382]

- *Non-U.S. Governmental Entities That Only Engage in Governmental Activities.*[383] The CDD Rule does not apply to a "non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities."[384] This exclusion, however, does not cover state-owned enterprises engaged in profit-seeking activities, such as sovereign wealth funds, airlines, or oil companies.[385] If the state-owned enterprise does not have any individual who meets the ownership prong under the CDD Rule because the equity interest is held entirely by a governmental entity, covered financial institutions would only be required to obtain beneficial ownership information under the control prong of the CDD Rule.[386] Furthermore, the covered institution may rely on a representation by the legal entity customer with respect to whether this exclusion applies, provided that the institution does not have knowledge of any facts that would reasonably call into question the validity or reliability of that information.[387]

[E] Proposed AML Regulation for Investment Advisers

In 2015, FinCEN proposed a rule that will expand the obligation to implement and maintain AML programs to investment advisers that are registered or required to be registered with the SEC.[388] The proposal would define the term "financial institution" in the AML rules to include investment advisers and would require investment advisers to implement AML programs similar to those required of

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381. FinCEN 2018 FAQs, *supra* note 356, Question 26.
382. *Id.*
383. 31 C.F.R. § 1010.230(e)(2)(xv).
384. *Id.*
385. FinCEN 2018 FAQs, *supra* note 356, Question 28.
386. *Id.*
387. *Id.*
388. Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (proposed Sept. 1, 2015), https://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf.

other covered financial institutions, and require investment advisers to report suspicious activities.[389]

§ 52:6.4 Suspicious Activity Reporting

Every broker or dealer in securities within the United States is required to report any suspicious transaction relevant to a possible violation of law or regulation to FinCEN.[390] A transaction must be reported if it is conducted or attempted by, at, or through a broker-dealer, it involves or aggregates funds or other assets of at least $5,000, and the broker-dealer knows, suspects, or has reason to suspect that the transaction: (i) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity; (ii) is designed, whether through structuring or other means, to evade any requirements under the AML rules or any other regulations promulgated under the BSA; (iii) has no business or apparent lawful purpose, or is not the sort in which the particular customer would normally be expected to engage; or (iv) involves use of the broker-dealer to facilitate criminal activity.[391]

The obligation to identify and report a suspicious transaction rests with each broker-dealer involved in the transaction, provided that no more than one report is required to be filed by the broker-dealers involved in a particular transaction, so long as the report filed contains all relevant facts.[392]

A Suspicious Activity Report (SAR) is required to be filed with FinCEN no later than thirty calendar days after the date of the initial detection by the reporting broker-dealer of facts that may constitute a basis for filing a SAR. In situations involving violations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, the broker-dealer is required to immediately notify an appropriate law enforcement authority by telephone, in addition to timely filing a SAR.[393]

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389. For more discussion on the proposed rule to include "investment advisers" in the definition of "financial institution," you may wish to refer to SHEARMAN & STERLING LLP, FINANCIAL CRIMES ENFORCEMENT NETWORK: ANTI-MONEY LAUNDERING PROGRAM AND SUSPICIOUS ACTIVITY REPORT FILING REQUIREMENTS FOR REGISTERED INVESTMENT ADVISERS (Sept. 8, 2015), https://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/09/Financial-Crimes-Enforcement-Network-Anti-Money-Laundering-Program-and-Suspicious-Activity-Report-Filing-Requirements-for-Registered-Investment-Advisers-IF-090815.pdf.
390. 31 C.F.R. § 1023.320(a)(1) (2011).
391. 31 C.F.R. § 1023.320(a)(2).
392. 31 C.F.R. § 1023.320(a)(3).
393. 31 C.F.R. § 1023.320(b)(3).