



## BDQUARTERLY

“As investors turn to financial professionals to help them manage their assets, they often do not know the difference between insurance and securities products, or fiduciary duties versus suitability obligations. They just want someone they can trust to help them put their money to work so they can meet their financial and life goals.”

—Doug Shulman  
Vice Chairman, FINRA

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### Fiduciary versus Suitability—The Debate Continues...

The topic of fiduciary versus suitability obligations has been at the center of a long, controversial debate between the investment adviser and broker-dealer communities. This issue was central to the March 30, 2007 decision by the D.C. Circuit Court of Appeals to vacate the SEC’s adoption of Rule 202(a)(11) under the Investment Advisers Act of 1940 (“Advisers Act”)<sup>1</sup>

This rule, known colloquially as the “Merrill Rule,” because of the significant offering of these accounts by the brokerage firm Merrill Lynch, exempted broker-dealers offering certain fee based advisory and brokerage services from the definition of “investment adviser,” and therefore from regulation under the Advisers Act. Since the SEC’s initial rule proposal in 1999, financial planners have argued that brokers

have been allowed to offer essentially the same services, including financial planning and advice, without adhering to the strict fiduciary standard that governs investment advisers under the Advisers Act.

#### Opposing Parties

The Financial Planning Association (“FPA”), an industry trade group representing the (CONTINUED)

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1– See *The Financial Planning Association v. Securities and Exchange Commission*, No. 04-1145 (D.C. Cir., Mar. 30, 2007).

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interests of the financial planning community, has been on the forefront of challenging the Merrill Rule since its adoption. The FPA's biggest opposition in this spirited dispute has come from the Securities Industry and Financial Markets Association ("SIFMA"), which is an organization that represents some of Wall Street's largest broker-dealers. SIFMA suffered a substantial setback in early May 2007 when the SEC elected not to appeal the Circuit Court's decision to vacate or to request a new hearing concerning the court's decision.<sup>2</sup> SIFMA and its members, including a number of broker-dealers that had been conducting activities pursuant to the Merrill Rule, were left scrambling to make operational and compliance changes in order to bring their business operations into compliance with the scheduled effective date of the court's ruling. In deference to these issues, the SEC applied for and received a stay of the court's order until October 1, 2007.<sup>3</sup>

### Immediate Effects

The vacating of the Merrill Rule resulted in the need for broker-dealers to review over one million fee based brokerage accounts, representing approximately \$300 billion in assets, to determine their future status (brokerage or investment advisory). Broker-dealers and ultimately their customers were presented with two options:

- Change the method of fee payment to transaction based compensation and continue to service the account as a brokerage account (i.e., a traditional, full-service brokerage account that charges standard commission and other transaction fees); or
- Change the status of the account to an investment advisory account serviced through an investment

adviser and continue to charge asset based or flat fees.<sup>4</sup>

To effect these changes, broker-dealers were required to obtain an affirmative, written consent from all client accounts affected by the rule implementation prior to any account transition.

One of the most significant regulatory issues that has been identified in the switch from brokerage accounts to advisory accounts is that related to principal transactions. Principal transactions take place when an adviser buys from/sells to a client a security in to/out of its own inventory (or that of an affiliate). Investment advisers are generally prohibited from engaging in principal transactions unless they provide written disclosure and obtain consent from their client before settlement of each such transaction. Due to the impracticality of obtaining consent from the newly converted advisory accounts the SEC adopted temporary rule 206(3)-3T under the Advisers Act on September 19, 2007.

The temporary rule provides relief to an investment adviser that is registered as a broker-dealer and that provides non-discretionary advisory services. An investment adviser may only rely on the rule after it has provided written disclosure and secured the client's written revocable overall consent.<sup>5</sup> For every principal transaction, the adviser must inform the client, verbally or in writing, of its capacity in acting as a principal and obtain the client's consent, also verbally or in writing. The adviser must also ensure that the client receives a confirmation of the transaction that discloses that the adviser has acted as principal and that the client authorized the transaction. Finally, the adviser must provide to the client an annual report itemizing all the principal transactions that took place within the past year. (CONTINUED)

2- "Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts," U.S. Securities and Exchange Commission press release (Washington, DC, May 14, 2007).

3- *Motion for the Stay of the Mandate in The Financial Planning Association v. Securities and Exchange Commission* (May 17, 2007).

4- Registered representatives must have a Series 65 or a Series 7 and 66 to service such accounts.

5- The written disclosure must discuss: (i) the circumstances under which the investment adviser may engage in principal transactions with the client; (ii) the nature and significance of the conflicts the investment adviser has with its clients' interests as a result of those transactions; and (iii) how the investment adviser addresses those conflicts.

Advisers should note the limitations contained in this rule. First, the rule may only be relied upon for principal transactions in non-discretionary advisory accounts. The relief extends to all principal security transactions except for securities issued or underwritten by the adviser or an affiliated broker-dealer, other than offerings involving investment grade debt securities. Most importantly, the rule contains a sunset provision that will cause it to expire on December 31, 2009.

#### **Fiduciary and Suitability - Controversy**

Confusion over the concepts of fiduciary and suitability among the investing public have been a major hurdle for most broker-dealers and their customers.

**As a fiduciary**, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser's fiduciary duty depend on the scope of the advisory relationship and generally include the following:

- The duty at all times to place the interests of clients first;
- The duty to have a reasonable basis for its investment advice;
- The duty to seek best execution for client securities transactions where the adviser directs such transactions;
- The duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines and restrictions;
- The duty to treat clients fairly;
- The duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and
- The duty to respect the confidentiality of client information.

Investors want a clear explanation of the difference and financial professionals have turned to the regulators for definitive answers. Unfortunately a clear, definitive explanation has not been rendered to date and further confusing the situation, investment adviser and brokerage professionals have been debating their duties publicly, which in most cases has further confused investors.

According to the Investment Adviser Association's definition found in its *Standards of Practice*, the concept of fiduciary duty is generally considered to be the highest legal duty that one party can owe to another. (*see inset*)

Alternatively, NASD Rule 2310 discusses the suitability requirements that must be followed by a registered representative as they relate to a recommendation or a particular transaction. The suitability obligation, once applied, generally ceases within the timeline of the transaction itself.

Another distinguishing characteristic is that an adviser is primarily held to the fiduciary obligations that are outlined in the anti-fraud provisions of the Advisers Act, while brokers are required to comply with various self regulatory organization rules and interpretations.

While an adviser's duties are much broader than those of a broker, regulatory agencies have implied that both fiduciary and suitability obligations apply to all market participants. This was evident in FINRA Vice Chairman Doug Shulman's speech at the 16th Annual FINRA Spring Securities Conference. Shulman stated:

"As investors turn to financial professionals to help them manage their assets, they often do not know the difference between insurance and securities products, or fiduciary duties versus suitability obligations. They just want someone they can trust to help them put their money to work so they can meet their financial and life goals."<sup>6</sup>

Shulman's comments clearly indicate (CONTINUED)

6- Opening remarks given by Doug Shulman, Vice President, FINRA, at the 16th Annual FINRA Spring Securities Conference, May 23, 2007.

that regulatory agencies consider it the responsibility of securities professionals to properly educate and disclose to investors overall account and service characteristics. Investors primarily put their faith and trust in their investment professionals regardless of title or industry-defined obligations. Most investors would like to believe this standard is the category their investment representative abides by.

Can financial professionals fulfill their obligations to investor protection and market integrity without considering both fiduciary and suitability standards in their actions? FINRA Arbitration statistics would indicate the answer is “No”. The majority of recent arbitration claims have addressed some aspect of the suitability standard. Since 2005, there have been a total of 12,832 arbitration cases filed and two of the issues most consistently arbitrated over are the breach of fiduciary duty and unsuitability.<sup>7</sup> These statistics seem to indicate the financial

industry faces a challenge in trying to define the overall differences between fiduciary and suitability obligations for investors.

#### Debate Conclusion?

With the Merrill Lynch rule officially dead and temporary rule 206(3)-3T firmly in place, is the debate finally over? The answer to this question lies primarily in the hands of the SEC. The SEC completed a study analyzing the ways that broker-dealers and investment advisers operate and their effects on investors.<sup>8</sup> In this study, the participants did not know the difference between suitability and fiduciary duty and they did not think that these practices differed. In the end, investment advisers and broker-dealers could operate under a single regulatory scheme and a defined universal duty of care for all investors.

7– Statistics obtained from data at FINRA Dispute Resolution Statistics, <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm>

8– The completed study by the Rand Institute can be found at [http://www.sec.gov/news/press/2008/2008-1\\_randiab-dreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiab-dreport.pdf)

## Don't Get Caught Under Your Cap

During routine regulatory examinations, FINRA staff typically assesses the broker-dealer's overall financial records, including the accuracy of the broker-dealer's net capital calculation. Due to the variations in net capital requirements and the large number of financial rule interpretations, books and records violations related to net capital calculations, are often a common violation noted during regulatory examinations.

The most serious books and records deficiencies are those that result in adjustments to a firm's net capital calculation rendering the firm net capital deficient, which is a violation of Rule 15c3-1 under the Securities Exchange Act of 1934 (“Exchange Act”). Based on its observations from various mock audits conducted throughout the year, ACA has identified some unique issues that often impact the calculation of net capital.

#### What is the difference if any, if a broker-dealer's cash is held in a U.S. based bank versus a foreign bank?

In most cases, cash is considered an allowable asset for net capital purposes with some notable exceptions, which includes cash held in an offshore account. Pursuant to guidance furnished by the SEC to FINRA in June 2006, cash held in an offshore account will have no value for net capital (CONTINUED)

purposes unless it is deposited with a non-affiliated financial institution that meets the following conditions:

- The non-affiliated financial institution issues certificates of deposit, bank deposit notes, bankers acceptances or bills of exchanges that are rated investment grade by at least two nationally recognized statistical rating organization, has shareholders' equity of at least US\$1 billion, and its capital is subject to supervision by an authority of a sovereign national government where a major money market is located; or
- The non-affiliated financial institution has shareholders' equity of at least US\$1.5 billion and its capital is subject to supervision by an authority of a sovereign national government where a major market is located; and
- The deposit must be redeemable, without restrictions, at a major money market.

Therefore, before a firm decides to place cash in an offshore account earning an enticing double digit interest rate, financial principals must ensure that the non-affiliated financial institution meets the aforementioned conditions. The financial benefit that may occur from placing cash in an offshore account may not outweigh the risk of a FINRA examination team classifying the cash balance as a non-allowable asset, thereby resulting in the firm becoming net capital deficient.

**Can a broker-dealer deposit cash at an affiliate or a parent bank? Are the assets considered allowable for net capital purposes?**

Many bank affiliated broker-dealers, in an effort to find a safe, accessible location, deposit cash with their affiliated or parent bank. Unfortunately, FINRA staff commonly cite firms that classify cash held with a parent or affiliated bank as an allowable asset. The SEC issued guidance to FINRA in November 1984 which stated, in effect, that cash deposited with a parent or affiliated bank will only be considered allowable for net capital purposes,

only to the extent that the deposit is equal to the firm's monthly expenses.<sup>1</sup> For example if a firm holds \$350,000 at its parent bank, but the broker-dealer had \$200,000 in monthly expenses, only \$200,000 of the \$350,000 held at the parent bank would be considered allowable for net capital purposes, while the remaining \$150,000 would be considered non-allowable.

**How should the broker-dealer treat or classify a pending lawsuit, which could have a material impact on the firm's net capital position? Should the validity of such claims be factored into the firm's decision?**

A number of firms discuss a pending lawsuit with their in-house counsel and decide that the lawsuit has no merit and simply file the lawsuit in the customer complaint file. During FINRA examinations, the staff often reviews a firm's customer complaint file, which usually results in the discovery of the pending lawsuit without a written outside legal opinion. By failing to obtain an outside legal opinion concerning the merits of the lawsuit, the firm will have to account for this potential liability in the calculation of aggregate indebtedness, as required by Rule 15c3-1(c)(1) under the Exchange Act.

In the event that a plaintiff award results in an arbitration proceeding, a firm should immediately record the award as an actual liability at the time the award decision is rendered, regardless of whether or not the firm plans to appeal the decision. The SEC's guidance to FINRA in September 1988, stated in effect, that awards against firms must be accounted for as an aggregate indebtedness, even if the appeal process has not been exhausted and no judgment has been rendered, since grounds for revisions on appeal are very limited.<sup>2</sup>

1- SEC Staff to NYSE, No. 84-9, November, 1984, (NYSE Interpretation of SEC Rule 15c(c)3-1(c)(2)(iv)(C)/072/72)

2- SEC Staff of Division of Market Regulation Interpretation of Financial and Operational Rules, Rule 15c3-1(c)(1) of the Exchange Act, Adverse Award in an Arbitration Proceeding, September 1988

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## In Case You Missed It!

### **FINRA Announces Major Regulatory Sweeps at Seniors Summit**

#### **Professional Designations, Early Retirement Seminars Targeted**

FINRA CEO Mary Schapiro announced FINRA's current and upcoming regulatory sweeps at the Securities and Exchange Commission's (SEC) Seniors Summit in Washington, D.C. The first new sweep is examining whether brokers are using so-called "professional" designations to mislead and defraud investors.

The second new sweep will be targeting early retirement seminars conducted by securities firms. FINRA will be specifically reviewing seminars that it believes are designed to entice senior workers to liquidate their retirement funds and to invest their assets with a specific firm or registered representative.

### **Advertising Regulation Electronic Files (AREF) System Changes**

Advertising Regulation Electronic Files (AREF) is a Web-based application that enables FINRA member firms to file communications with the public for review by FINRA's Advertising Regulation Department. AREF contains a number of functionalities including allowing member firms to access real-time filing fee information along with information concerning Batch Submissions, which facilitates the submission of a very large volume of communications (typically around 500 per year or more). The use of AREF is currently voluntary.

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## Did You Know?

### **Anti Money Laundering**

A broker-dealer that does not: (1) execute transactions for customers or otherwise hold customer accounts, and (2) act as an introducing broker-dealer with respect to customer accounts, is permitted to test its AML program once every two years (on a calendar-year basis) rather than on an annual basis.

### **Websites**

If a broker-dealer includes "SIPC" and/or "FINRA" on its website, a hyperlink must exist to the SIPC and/or FINRA websites.

### **Clearing Agreement**

Whenever a clearing broker-dealer enters into a new clearing agreement with an introducing broker-dealer, the clearing broker-dealer must submit the agreement to FINRA for review and approval.

### **Financials**

In order to treat cash held in a checking account as allowable for net capital purposes, authorized check signatories on the broker-dealer's bank account must be principals of the broker-dealer.

## Regulatory Notices, Updates, and Rule Changes

### FINRA – REGULATORY NOTICES

#### DECEMBER

**Regulatory Notice 07-64** SEC approves amendments to NASD Rule 3010(g)(1) to Exempt Locations that Solely Conduct Final Approval of Research Reports; Effective Date: December 19, 2007.

**Regulatory Notice 07-63** FINRA Adopts Rule Amendments Relating to Reporting of Odd-Lot Transactions; Effective Date: March 3, 2008.

**Regulatory Notice 07-62** Revisions to the Series 23, 24, 42, 55, 62, 72 and 82 Examination Programs; Implementation Date: February 12, 2008.

**Regulatory Notice 07-59** FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications; Effective Date: Immediately.

#### NOVEMBER

**Regulatory Notice 07-56** Securities Industry/Regulatory Council on Continuing Education Issues Firm Element Advisory Update. The notice identifies regulatory and sales practice topics that firms should consider in their Firm Element training plans.

**Regulatory Notice 07-55** FINRA released this notice to remind Member Firms of their Obligations Regarding Background Investigations of Prospective Personnel; Effective Date: Immediately.

**Regulatory Notice 07-54** SEC Approves New NASD Rule 2290 Regarding Fairness Opinions; Effective Date: December 8, 2007.

**Regulatory Notice 07-53** SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions; Effective Date: May 5, 2008.

#### OCTOBER

**Regulatory Notice 07-50** SEC Approves Amendments to NASD Rule 11870 and NYSE Rule 412 to Conform with NSCC's ACATS Transfer Cycle Time Frames; Effective Date: October 22, 2007.

**Regulatory Notice 07-47** Amendments to NASD IM-2210-4: Web Site References to FINRA Membership and Limitations on the Use of FINRA's Name and Other Corporate Names Owned by FINRA; Effective Date: November 17, 2007.

### SEC RELEASES

#### DECEMBER

**Release No. IA-33-8869** Revisions to Rules 144 and 145 (Conforming Version). Effective Date: February 15, 2008.

#### NOVEMBER

**Release No. IA-33-8860** Mechanisms to Access Disclosures Relating to Business Activities in or With Countries Designated as State Sponsors of Terrorism. Comments due: January 22, 2008.

### MSRB NOTICES

#### DECEMBER

**MSRB Notice 2007-38** SEC Approves Amendments to Rule G-40 on E-Mail Contacts; Effective December 31, 2007.

#### NOVEMBER

**MSRB Notice 2007-37** Announcing MSRB 529 Compliance Seminars in 2008.

**MSRB Notice 2007-32** MSRB Notice issues Guidance on Implementation of New Supervisory Requirement under Rule G-27; Technical Amendments filed.

#### OCTOBER

**MSRB Notice 2007-31** MSRB Notice of Filing of Proposed Amendments to Rule G-40 on Electronic Mail Contacts.

### FinCEN RULES AND RELEASES

#### NOVEMBER

**Financial Crimes Enforcement Network;** Bank Secrecy Act Advisory Group Solicitation of Application for Membership. FinCEN is inviting the public to nominate financial institutions and trade groups for membership on the Bank Secrecy Act Advisory Group.

#### OCTOBER

**FinCEN Offers Compliance Tips** for MSBs and Other SAR Filers.

**FINCEN Advisory** (FIN-2007-A001) Advisory provides Guidance to Financial Institutions on the Increasing Money Laundering Threat Involving Illicit Iranian Activity.

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## Conferences/Roundtables/Webcasts

### ACA – 2008

#### ACA's Spring 2008 Compliance Conference

March 11 – March 13, 2008

Explore the most challenging issues affecting compliance with industry experts and SEC officials in a forum that only ACA can deliver.

**Topics Include:** Soft Dollars, the Compliance Program, Personal Trading, Best Execution, Dealing with Problems, Advertising, Gifts, Testing, SEC Inspections, ERISA, Books and Records, Valuation, and more.

**Conference Highlights:** ACA's Compliance Conference will cover the core curriculum of topics that every competent and knowledgeable advisory firm compliance officer should master. All of the sessions will focus on the compliance issues unique to specific types of firms including large and small investment advisers, private fund managers, and mutual fund advisers

### ACA ROUNDTABLE EVENTS

April 2008 • San Francisco/Los Angeles

May 2008 • Fort Lauderdale, FL

If you are interested in more information about attending one of our complementary roundtable events please email us at [dstafford@acacompliancegroup.com](mailto:dstafford@acacompliancegroup.com).

### ACA WEBCASTS – 2008

#### Broker-Dealer Branch Office Examinations

June 17, 2008

**Leigh Vazquez**, Managing Director, ACA Compliance Group; **Wesley L. Ringo**, Senior Vice President and Chief Compliance Officer, J.J.B. Hilliard

### FINRA CONFERENCES

#### Securities Conferences—Spring and Fall

May 21–23, 2008 • Hollywood, FL

October 22–24, 2008 • Carlsbad, CA

### SEC CCO Outreach BD REGIONAL SEMINARS

#### Atlanta Regional Office

June 5, 2008 (Atlanta, GA) 9:00 am – Noon

#### Boston Regional Office

May 16, 2008 (Boston, MA) 9:00 am – Noon

#### Chicago Regional Office

April 29, 2008 (Chicago, IL) 1:00 – 5:00 pm

June 23, 2008 (Minneapolis, MN) 1:00 – 4:00 pm

#### Denver Regional Office

July 29, 2008 (Denver, CO) 1:00 – 4:00 pm

#### Fort Worth Regional Office

June 5, 2008 (Austin, TX) 1:00 – 4:30 pm

#### Los Angeles Regional Office

April 11, 2008 (San Diego, CA) 1:00 – 4:00 pm

April 29, 2008 (Los Angeles, CA) 1:00 – 4:00 pm

#### Miami Regional Office

July 16, 2008 (Miami, FL) 10:30 am – 1:30 pm

#### New York Regional Office

May 13, 2008 (New York, NY) 8:30 – 11:30 am

June 3, 2008 (New York, NY) 9:00 am – Noon

July 8, 2008 (Long Island, NY) 8:30 am – Noon

#### Philadelphia Regional Office

May 13, 2008 (Philadelphia, PA) 1:00 – 4:00 pm

#### San Francisco Regional Office

July 23, 2008 (San Francisco, CA) 1:00 – 4:00 pm

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## Filing Dates

### 2008 Monthly/Quarterly FOCUS

#### Part II/IIA Filings

MONTH ENDING	DUE DATE
January 31, 2008	February 26, 2008
February 29, 2008	March 26, 2008
April 30, 2008	May 23, 2008
March 31, 2008	April 23, 2008

### 2008 Annual Audit Filings

FISCAL YEAR END	DUE DATE
January 31, 2008	March 31, 2008
February 29, 2008	April 29, 2008
March 31, 2008	May 30, 2008

### 2008 Customer Complaint Filings

QUARTER ENDING	DUE DATE
1st quarter 2008	April 15, 2008

Nothing herein should be construed as legal advice or as a legal opinion for any particular situation. ACA makes no representations about the accuracy of the information contained herein or its appropriateness for any given situation.