

Portfolio & Investment Management CPM Laws

Legal Issues 2011 and Beyond

More Regulation and Laws Tricks of the Trade

Retirement Issues

- Investment Policy Statement
- Suitability
- Tolerance
- Accredited Investor
- Fiduciary
- Prudent Man
- Honest Services
- Securities Fraud

Fiduciary

- An individual, corporation or association holding assets for another party, often with the legal authority and duty to make decisions regarding financial matters on behalf of the other party

Read more:

<http://www.investorwords.com/1932/fiduciary.html#ixzz125k7B6FQ>

Prudent Man Rule

- The requirement that a trustee, investment manager of pension funds, treasurer of a city or county, or any fiduciary (a trusted agent) must only invest funds entrusted to him/her as would a person of prudence, i.e. with discretion, care and intelligence. Thus solid "blue chip" securities, secured loans, federally guaranteed mortgages, treasury certificates, and other conservative investments providing a reasonable return are within the prudent man rule. Some states have statutes which list the types of investments allowable under the rule. Unfortunately, the rule is subjective, and some financial managers have put funds into speculative investments to achieve higher rates of return, which has resulted in bankruptcy and disaster as in the case of Orange County, California (1994).

Case Study

- If a trust becomes active upon death, does the trustee have a duty to diversify investments? If so When?
- What about insurance? Or hedging?

Accredited Investor

- Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;
- Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
<http://www.sec.gov/answers/accred.htm>
- <http://taft.law.uc.edu/CCL/33ActRls/rule501.html>

Suitability Antifraud Provisions

Anti Fraud Provisions (Sections 9(a), 10(b), and 15(c)(1) and (2))

- **Suitability Requirements**
- Broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules such as NASD Rule 2310 and has been interpreted as an obligation under the antifraud provisions of the federal securities laws. Under suitability requirements, a broker-dealer must have an "adequate and reasonable basis" for any recommendation that it makes. Reasonable basis suitability, or the reasonable basis test, relates to the particular security or strategy recommended. Therefore, the broker-dealer has an obligation to investigate and obtain adequate information about the security it is recommending.

Suitability Broker Dealer

- A broker-dealer also has an obligation to determine customer-specific suitability. In particular, a broker-dealer must make recommendations based on a customer's financial situation, needs, and other security holdings. This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations and to keep such information current. SROs consider recommendations to be unsuitable when they are inconsistent with the customer's investment objectives.

New Rule 2111

The new rules enlarge the scope of member firms' supervisory responsibilities by:

- Expanding the suitability obligations beyond transaction-based recommendations to now expressly include recommendations on "investment strategies"
- Creating a suitability obligation for a "recommendation to hold a security or securities"
- Expanding the factors that normally must be collected and analyzed as part of the "investor profile" to judge suitability
- Expressly incorporating three distinct suitability obligations: (a) reasonable-basis suitability, (b) customer-specific suitability and (c) quantitative suitability.

FINRA Rule 2090 ~ Know Your Customer

Rule 2090 is modeled after former NYSE Rule 405 and requires member firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer." The obligation arises at the beginning of the customer/broker relationship, independent of whether the broker-dealer has made any recommendation, and continues through termination of the relationship. Broker-dealers should take careful note of the new requirement to "retain" the "essential facts" concerning every customer. <http://documents.jdsupra.com/94858b6b-8596-472d-aecc-9f582d4dfae7.pdf>

2111

- FINRA Rule 2111 is notable for four reasons, addressed in detail below:
- It expands the suitability obligation beyond investment transactions to "investment strategies"
- It expands the suitability obligation to include explicit recommendations to hold securities
- It expands the necessary factors for making a suitability determination
- It includes definitions for three specific components of suitability evaluations

<http://documents.jdsupra.com/94858b6b-8596-472d-aecc-94582d4dfae7.pdf>

Duty of Best Execution

- The duty of best execution, which also stems from the Act's antifraud provisions, requires a broker-dealer to seek to obtain the most favorable terms available under the circumstances for its customer orders. This applies whether the broker-dealer is acting as agent or as principal.
- For example, FINRA members must use "reasonable diligence" to determine the best market for a security and buy or sell the security in that market, so that the price to the customer is as favorable as possible under prevailing market conditions.

Confirmation

- **Customer Confirmation Rule (Rule 10b-10 and MSRB rule G-15)**

- A broker-dealer must provide its customers, at or before the completion of a transaction, with certain information, including:
 - the date, time, identity, price, and number of shares involved;
 - its capacity (agent or principal) and its compensation (for agency trades, compensation includes its commission and whether it receives payment for order flow;⁵ and for principal trades, mark-up disclosure may be required);
 - the source and amount of any third party remuneration it has received or will receive;⁶
 - other information, both general (such as, if the broker-dealer is not a SIPC member) and transaction-specific (such as the yield, in most transactions involving debt securities).

Credit and Margin

- **Disclosure of Credit Terms (*Rule 10b-16*)**
- Broker-dealers must notify customers purchasing securities on credit about the credit terms and the status of their accounts. A broker-dealer must establish procedures for disclosing this information before it extends credit to a customer for the purchase of securities. A broker-dealer must give the customer this information at the time the account is opened, and must also provide credit customers with account statements at least quarterly.

Fair Dealing

- **Duty of Fair Dealing**

- Broker-dealers owe their customers a duty of fair dealing. This fundamental duty derives from the Act's antifraud provisions mentioned above. Under the so-called "shingle" theory, by virtue of engaging in the brokerage profession (*e.g.*, hanging out the broker-dealer's business sign, or "shingle"), a broker-dealer represents to its customers that it will deal fairly with them, consistent with the standards of the profession. Based on this important representation, the SEC, through interpretive statements and enforcement actions, and the courts, through case law, have set forth over time certain duties for broker-dealers. These include the duties to execute orders promptly, disclose certain material information (*i.e.*, information the customer would consider important as an investor), charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest.

Analysts and Research

- **Analysts and Regulation AC**
- Regulation AC (or Regulation Analyst Certification) requires brokers, dealers, and persons associated with brokers or dealers that publish, distribute, or circulate research reports to include in those reports a certification that the views expressed in the report accurately reflect the analyst's personal views. The report must also disclose whether the analyst received compensation for the views expressed in the report. If the analyst has received related compensation, the broker, dealer, or associated person must disclose its amount, source, and purpose. Regulation AC applies to all brokers and dealers, as well as to those persons associated with a broker or dealer that fall within the definition of "covered person." Regulation AC also requires that broker-dealers keep records of analyst certifications relating to public appearances.

Honest Services Fraud

The Supreme Court's Ruling on 'Honest Services' Theft Former Enron chief executive Jeffrey Skilling scored a partial victory on Thursday when the Supreme Court sharply limited a law that prosecutors routinely rely on to convict corporate executives and government officials, the "honest services" law. The honest-services law purports to make it a federal crime to deprive someone of honest services to which that person is entitled. If that sounds unbelievably broad and vague, it is. And the court agreed. Read more:

<http://www.time.com/time/business/article/0,8599,1999768,00.html#ixzz129WD4jlf>

Other Key Legal Terms

- Front Running
- Shadowing
- Reg T
- 10 (B) 5
- Arbitration
- AML
- SIPC
- Sue Your Broker
- Class Actions
- Research

Insider Trading

- *General.* The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

<http://taft.law.uc.edu/CCL/34ActRls/rule10b5-1.html>

Front Running

- Entering into an equity trade, [options](#) or [futures contracts](#) with advance knowledge of a [block transaction](#) that will influence the price of the [underlying security](#) to [capitalize](#) on the [trade](#). This practice is expressly forbidden by the [SEC](#). Traders are not allowed to act on nonpublic information to trade ahead of customers lacking that knowledge.
- <http://financial-dictionary.thefreedictionary.com/Front+Running>

Shadow Trades

- This would be placing orders based on what your clients are buying.
- <http://www.nytimes.com/1999/05/21/business/6-plead-guilty-to-charges-of-illegal-stock-trading.html>
- That type of trading violates Federal law and New York Stock Exchange rules, which generally prohibit brokers on the floor of the exchange, who are in a position to see large, potentially market-moving orders being placed, from trading for their own benefit.

Reg T

- **What Does *Regulation T - Reg T* Mean?**

The Federal Reserve Board regulation that governs customer cash accounts and the amount of credit that brokerage firms and dealers may extend to customers for the purchase of securities.

- <http://www.sec.gov/investor/pubs/margin.htm>

Penny Stocks

- **Penny Stock Rules** (*Rules 15g-2 through 15g-9, Schedule 15G*)
- Most broker-dealers that effect transactions in "penny stocks" have certain enhanced suitability and disclosure obligations to their customers.⁸ A penny stock is generally defined as any equity security other than a security that: (a) is an NMS stock (*See Rule 600(b)(47)*) listed on a "grandfathered" national securities exchange, (b) is an NMS stock listed on a national securities exchange or an automated quotation system sponsored by a registered national securities association (including Nasdaq) that satisfies certain minimum quantitative listing standards, (c) has a transaction price of five dollars or more, (d) is issued by a registered investment company or by the Options Clearing Corporation, (e) is a listed security futures product, or (f) is a security whose issuer has met certain net tangible assets or average revenues (*See Rule 3a51-1*). Penny stocks include the equity securities of private companies with no active trading market if they do not qualify for one of the exclusions from the definition of penny stock.

Privacy

- **Privacy of Consumer Financial Information (*Regulation S-P*)**
- Broker-dealers, including foreign broker-dealers registered with the Commission and unregistered broker-dealers in the United States, must comply with Regulation S-P, (*See 17 CFR Part 248*) even if their consumers are non-U.S. persons or if they conduct their activities through non-U.S. offices or branches.
- Regulation S-P generally requires a broker-dealer to provide its customers with initial, annual and revised notices containing specified information about the broker-dealer's privacy policies and practices. These notices must be clear and conspicuous, and must accurately reflect the broker-dealer's policies and practices. *See 17 CFR 248.4, 248.5, 248.6 and 248.8.* Before disclosing nonpublic personal information about a consumer to a nonaffiliated third party, a broker-dealer must first give a consumer an opt-out notice and a reasonable opportunity to opt out of the disclosure. *See 17 CFR 248.7 and 248.10.*

Investment Adviser Registration

- Broker-dealers offering certain types of accounts and services may also be subject to regulation under the Investment Advisers Act.¹⁰ (An investment adviser is defined as a person who receives compensation for providing advice about securities as part of a regular business.) (See Section 202(a)(11) of the Investment Advisers Act .) In general, a broker-dealer whose performance of advisory services is "solely incidental" to the conduct of its business as a broker-dealer and that receives no "special compensation" is excepted from the definition of investment adviser. Thus, for example, a broker-dealer that provides advice and offers fee-based accounts (i.e., accounts that charge an asset-based or fixed fee rather than a commission, mark-up, or mark-down) must treat those accounts as advisory because an asset-based fee is considered "special compensation."

Binding Arbitration

- **ARBITRATION**
- Pursuant to the rules of self-regulatory organizations such as FINRA/NASD, broker-dealers are required to arbitrate disputes with their customers, if the customer chooses to arbitrate. *See e.g.*, NASD Code of Arbitration Procedure for Customer Disputes, Rule 12200; American Stock Exchange, Rule 600; and Chicago Board of Options Exchange, Rule 18.1.

Broker Dealers

- broker-dealers must comply with other requirements. These include:
- submitting to Commission and SRO examinations;
- participating in the lost and stolen securities program;
- complying with the fingerprinting requirement;
- maintaining and reporting information regarding their affiliates;
- following certain guidelines when using electronic media to deliver information; and
- maintaining an anti-money laundering program.

AML

- **Anti-Money Laundering Program**
- Broker-dealers have broad obligations under the Bank Secrecy Act ("BSA")¹³ to guard against money laundering and terrorist financing through their firms. The BSA, its implementing regulations, and Rule 17a-8 under the Exchange Act require broker-dealers to file reports or retain records relating to suspicious transactions, customer identity, large cash transactions, cross-border currency movement, foreign bank accounts and wire transfers, among other things.

<http://www.sec.gov/divisions/marketreg/bdguide.htm#V>

Securities Investor Protection Corporation (SIPC)

- If your brokerage firm goes out of business and is a member of the Securities Investor Protection Corporation (SIPC), then your cash and securities held by the brokerage firm may be protected up to \$500,000, including a \$100,000 limit for cash. Some firms obtain private insurance policies to provide protection beyond SIPC limits. When a SIPC member becomes insolvent, SIPC will ask a court to appoint a trustee to supervise the firm's liquidation and to process investors' claims.
- <http://www.sipc.org/>
- <http://www.sec.gov/answers/sipc.htm>

LAWSUIT – Sue Your Broker

- Considering the [volatility](#) of investments and varied [time horizons](#), investors have historically experienced investment losses over some periods of time. If the customer has already used legal assistance at this point, the legal team will most likely retain an expert witness and look for clues. The witness (who is typically an [analyst](#) with an accounting and financial background) will be looking for tell-tale signs of unsuitability, [churning](#), failure to supervise or negligence. Finding footprints of at least one of these violations is essential to defining a valid case. The use of an expert witness is vital in determining the measurement of recovery and setting forth the fact of damage. (Read about more signs of a bad broker in [Is Your Broker Acting In Your Best Interest?](#))
- <http://www.investopedia.com/articles/stocks/08/filing-claims-for-investment-losses.asp>

Arbitrators

- **What duties does an Arbitrator perform?**

Arbitrators serve as decision makers, weighing the facts of each case presented. As an arbitrator you will hear all sides of the issues as presented by the parties, study the evidence, and then decide how to resolve the matter. You will work in this capacity either as the sole arbitrator or as part of a three-person arbitration panel.

- <http://www.finra.org/ArbitrationMediation/Neutrals/BecomeAnArbitrator/FAQ>

Are arbitrators paid for their service?

While not employees of FINRA, arbitrators receive an honorarium at the rate of \$200 per single-session hearing; \$400 per double session. (A single-session lasts up to four hours and a double-session hearing lasts for more than four hours, with hearings averaging approximately two-and-a-half days.) Honorarium for service on cases decided without an in-person hearing is \$125 per case.

- **How can I become a FINRA Arbitrator?**

Download, complete and return the arbitrator application form found on this Web site, or call (212) 858-4327 (212) 858-4327

Class Actions

- The rules governing all class actions are dictated by the Federal Rules of Civil Procedure, Rule 23. Once a class action suit has been filed, a federal court will determine whether the complaint fulfills the necessary requirements to move forth as a class action lawsuit. In securities class actions, the court approves a Lead Plaintiff under the Private Securities Litigation Reform Act of 1995. The role of the Lead Plaintiff is to represent the interests of the other plaintiffs in the case. Typically, a Lead Plaintiff has the largest financial interests sought by the complaint. In some instances, depending on the size of a class action case, the court may appoint Co-Lead Plaintiffs.

Case Studies

- To sue or not to sue
- Broker may settle.
- Institutions suing one of their holdings...company.
- What about your Clients and how they view lawsuits
- Do you admit to making a mistake?
- Hold the stock and don't sue
- Arbitrator & representing clients.
- <http://www.investorprotection.com/securities-class-action.php>

Research NASD Unveils Free Arbitration Awards Online Database; Award Searches Now Faster and Easier

- Arbitration awards can be viewed online, printed or downloaded as text-searchable PDF files. The awards will be posted to the site within a week of being served on the parties. The new Arbitration Awards Online system can be accessed at www.nasd.com, through the [Get Arbitration Awards](#) link under the [Arbitration and Mediation](#) button. Paper copies of arbitration awards will still be available directly from NASD by calling the Arbitration Awards Toll-Free Hotline at (866) 689-0849 (866) 689-0849
- <http://www.finra.org/Newsroom/NewsReleases/2007/P018198>

State Financial Regulators

- State Licensing

http://www.nasaa.org/industry_regulatory_resources/investment_advisers/456.cfm

- State Regulators in relation to SEC and FINRA

<http://www.regulatorycompliance.com/registration.aspx>

- Reference for Seniors

<http://www.ofi.louisiana.gov/Consumer%20Senior%20Guide.pdf>

Recommended Reading

- BROKER-DEALER REGULATION: FROM SELF-REGULATION, ARBITRATION, AND SUITABILITY TO FEDERAL REGULATION, LITIGATION, AND FIDUCIARY DUTY
http://works.bepress.com/cgi/viewcontent.cgi?article=1004&context=matthew_allen
- Uniform Prudent Investor Act
<http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf>
- ABCs of Broker Dealer Regulation <http://www.klgates.com/files/Publication/58c1a4c0-410f-4336-ad62-5b8964641fc7/Presentation/PublicationAttachment/95759e46-d65c-4c7d-a808-66170d18d977/Mills5.pdf>
- Fiduciary Law <http://www.dol.gov/ebsa/pdf/1210-AB32-PH029.pdf>
- Sample **Written Supervisory Procedures Manual**
<http://www.paulsoninvestment.com/broker/2010-07%20Paulson's%20Written%20Supervisory%20Procedures%20Manual.pdf>
- http://en.wikipedia.org/wiki/Category:Financial_regulation_in_the_United_States
- FDIC Trust Manual
http://www.fdic.gov/regulations/examinations/trustmanual/section_3/fdic_section_3-asset_management.html

End of Class

- Thanks for being here.

Sincerely and Kindest Regards, George

References

- **SEC.GOV**
- **Investopedia**
- **[Sue Your Broker](http://www.investopedia.com/articles/stocks/08/filing-claims-for-investment-losses.asp)**
<http://www.investopedia.com/articles/stocks/08/filing-claims-for-investment-losses.asp>
- **Class Actions**
<http://www.investorprotection.com/securities-class-action.php>