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Advising the Individual Investor: Comparing the Federal Regulation of Investment Advisers, Banks, and Broker-Dealers*

BY ALAN M. AHART**

INTRODUCTION

The individual investor may receive investment advice from a variety of sources. Such advice may be furnished by persons who are gainfully employed as accountants, lawyers, engineers, and teachers, and by publishers of newspapers and magazines.¹ The advice provided by such persons — and indeed by all persons or organizations in the investment advisory business — generally takes one of two forms. First, there is written advice distributed

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1. See *Legislative Proposals Concerning Regulation of Investment Advisers*, 332 SEC. REG. & L. REP. (BNA) E-1, E-7 (Dec. 17, 1975) [hereinafter cited as *SEC Proposals*].

to subscribers or customers. This advice may be furnished free or for an annual subscription charge, and ordinarily involves dissemination of newsletters on a periodic basis (e.g., monthly). The newsletters evaluate the investment prospects of particular stocks and bonds or industry groups. The reports are uniform in nature; they make no attempt to relate recommendations to the specific circumstances of the recipient-client. Second, there is advice, both written and oral, that is continuously rendered to clients in accordance with their particular needs and objectives. This advice, of course, is much more personal, and may be discretionary² or nondiscretionary, depending upon whether the adviser or the client makes the actual investment decisions. Whatever the form of advice, the adviser and the client may enter into a written contract which sets forth the duties the adviser owes to such client and which specifies the compensation that the adviser is to receive for performing these duties.

Banks, broker-dealers,³ and "investment advisers"⁴ also counsel individual investors as to the merits of particular investments. What distinguishes these advisers from those mentioned previously is the fact that banks, broker-dealers, and investment advisers are engaged in the *business* of advising individual investors.⁵

2. Section 3(a)(35) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(a)(35) (1976) indicates that a person exercises "investment discretion" when (1) he is authorized to determine what securities shall be purchased or sold, or (2) he makes decisions as to what securities shall be bought or sold even though some other person may have responsibility for such investment decisions.

3. A "broker-dealer" is any person engaged in the business of effecting transactions in securities for his own account and for the account of others, but does not include a bank. See Securities Exchange Act of 1934 § 3(a)(4), (5), 15 U.S.C. § 80b-2(a)(3),(5) (1976).

4. An "investment adviser" is one who, for compensation: (1) engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities; or, (2) as part of a regular business, issues or promulgates analyses or reports concerning securities. Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (1976). The Act specifically excludes from its coverage "any broker or dealer whose performance [as an investment adviser] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." *Id.* § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (1976) (Emphasis added). Since it is easy for one to assert that investment advisory services are incidental (or perhaps even necessary) to the brokerage business, and since broker-dealers are paid for these services only indirectly in the form of fixed commissions, this provision, in effect, enables broker-dealers to function as investment advisers as long as they also operate a brokerage business. Banks are similarly excluded from this definition of "investment adviser." *Id.* § 202(a)(11)(A), 15 U.S.C. § 80b-2(a)(11)(A) (1976).

5. It might be argued that broker-dealers are not engaged in the *business* of advising investors, but the author disagrees. Broker-dealers have been found to publish an "impressive" volume and variety of investment publications. SEC *Report of Special Study of Securities Markets of the Securities and Exchange Commission*. H. R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1 (1963) [hereinafter cited

That is, they are either primarily engaged in investment advising or advising is a necessary or important part of their primary business.

Although banks, broker-dealers, and investment advisers perform a similar function, there are differences among them. For example, unlike the others, the broker-dealer furnishes investment advice with the primary aim of selling securities. He may not levy a separate fee for advice, and, if he has discretionary authority over an account, he is not only in a position to decide what security to buy or sell, but he is also in a position to execute the relevant transaction.⁶ On the other hand, clients of banks and investment advisers who *pay* for advice can reasonably expect a higher level of impartiality than can non-paying clients of broker-dealers.⁷ If funds are placed in a bank-trustee account, the client is probably more interested in stable, secure management than in achieving maximum return on his investment. This may be especially true where the trust cannot be revoked. Moreover, when a bank manages customer funds, unique conflicts of interest may arise if the trust department is in any way linked to the bank's commercial operation.⁸ Additionally, in the ordinary course of business the bank and the broker-dealer—but not the investment adviser—retain custody of clients' funds or securities.⁹ Nevertheless, because some advisers (notably the smaller organizations)

as *Special Study*]. The *Special Study* further noted that one broker-dealer had a circulation of over 200,000 for its fortnightly investment magazine, while the largest single investment adviser had a circulation of only 80,000. See *id.* 330-31. Broker-dealers also advise investors on an individual basis (including discretionary management of personal portfolios).

Similarly, it seems clear that persons who issue financial publications, excepted from the definition of "investment adviser" (see note 4 *supra*; Investment Advisers Act of 1940, § 202 (a) (11) (D), 15 U.S.C. § 80b-2(a) (11) (D) (1976)), are also engaged in the business of advising individuals on investments. However, because publishers of such reports are exempted from registering as investment advisers, and because they are not specifically governed by any other federal laws, they will not be discussed in this article.

6. See *Special Study*, *supra* note 5, at 369-70.

7. *Id.* at 359.

8. The most obvious example of this is when a bank has discretionary investment authority and thus, is placed in the delicate position of deciding whether to place deposit funds with itself or invest them in municipal securities which it is underwriting. Regulation 9 specifically permits the trust department of a national bank to utilize the personnel and facilities of other departments of the bank to the extent not prohibited by law. 12 C.F.R. § 9-7(d) (1978). The problem is that conflicts of interest may occur in the absence of unlawful conduct.

9. See *Special Study*, *supra* note 5, at 369; SEC INSTITUTIONAL INVESTOR STUDY REPORT. H. R. DOC. NO. 64, 92d Cong., 1st Sess. pt. 2, at 421 (1968).

do have custody, this article will proceed on the assumption that investment advisers have custody of customer funds or securities as well.

The purpose of this article is to compare the federal regulations governing the conduct of banks, broker-dealers and investment advisers rendering investment advice to individuals. Generally, the object or effect of these regulations is to protect investors from unfair, deceptive and manipulative practices. As a consequence, they will be grouped for purposes of discussion into the following categories: controls over competence, controls over integrity, and the mechanisms designed to insure compliance with both. At the conclusion of the article, the regulations will be assessed to determine the extent to which they protect individual investors, and recommendations will be offered to correct perceived deficiencies.

A COMPARISON OF FIDUCIARY PROVISIONS

1. Investment Advisers

Regulating Competence

The only obstacle in the path of becoming an investment adviser lies in the registration process under Section 203 of the Advisers Act. Unless an adviser falls within one of the listed exceptions,¹⁰ he must register with the SEC if he uses interstate commerce to engage in the advisory business.¹¹ Except where the Commission finds that the applicant or any person associated with him has committed any of several offenses,¹² and registration

10. The exceptions are as follows:

- (1) any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;
- (2) any investment adviser whose only clients are insurance companies;
- or
- (3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under subchapter I of this Act.

Investment Advisers Act of 1940, § 203(b), 15 U.S.C. § 80b-3(b) (1976).

11. Investment Advisers Act of 1940, § 203(a), 15 U.S.C. § 80b-3(a) (1976).

12. The "offenses" include: (1) wilful filing of an application for registration or report which omits to state or is false or misleading regarding a material fact, (2) conviction within 10 years of a felony or misdemeanor which bears upon personal integrity or which arose out of conduct in a securities-related business, (3) being subject to an injunction which prevents one from engaging in the securities business, (4) wilful violation of or aiding or inducing someone else to violate any other federal securities laws, (5) reasonable failure to supervise another person who violated such securities law, and (6) being subject to an order of the SEC barring or

of such applicant would not be in the public interest, it will grant registration.¹³

Regulating Integrity

Once registered, the adviser is subject to certain standards pertaining to his dealings with clients. Specific standards apply to the investment advisory contract entered into by adviser and client. These standards nullify the effect of clauses which purport to waive compliance with any provision of the Advisers Act, or any rule, regulation or order thereunder,¹⁴ prohibit assignment of the contract by the adviser without consent of the client,¹⁵ and obligate the adviser, if the adviser is organized as a partnership, to notify the client of any changes in the composition of the partnership within a reasonable period of time.¹⁶

Restrictions are also placed on contractual provisions relating to the adviser's compensation. The adviser may not receive fees based upon the capital gains or capital appreciation of the client's portfolio,¹⁷ but he may receive compensation based upon the *total* value of a fund averaged over a definite period or determined as of definite dates.¹⁸ This is usually expressed as a fixed percentage of the value of assets under management, and reflects changes in the amount of assets which the client entrusts to the adviser as well as capital appreciation and depreciation of securities held in the portfolio.¹⁹ In the event that the total value of assets managed by the adviser exceeds one million dollars, the contract may also provide for compensation

based on the asset value of the . . . fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the . . . fund over a specified period in relation to the investment record of an appropriate index of securities prices. . . .²⁰

This measure permits the wealthy client to pay an advisory fee

suspending one from being associated with an investment adviser. *Id.* § 203(e), 15 U.S.C. § 80b-3(e) (1976).

13. Investment Advisers Act of 1940, § 203(c)(2), 15 U.S.C. § 80b-3(c)(2) (1976).

14. Investment Advisers Act of 1940, § 215, 15 U.S.C. § 80b-15 (1976).

15. Investment Advisers Act of 1940, § 205(2), 15 U.S.C. § 80b-5 (2) (1976).

16. *Id.* § 205(3), 15 U.S.C. § 80b-5(3) (1976).

17. Investment Advisers Act of 1940, § 205(1), 15 U.S.C. § 80b-5(1) (1976).

18. *Id.* § 205(3)(A), 15 U.S.C. § 80b-5(3)(A) (1976).

19. See Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. OF PA. L. REV. 1058, 1065 (1967).

20. Investment Advisers Act of 1940, § 205(3)(B)(ii), 15 U.S.C. § 80b-5(3)(B)(ii) (1976).

which is not tied to infusions or withdrawals of capital, and insures that the adviser's fee will be adjusted to reflect the difference, if any, between the fund's performance and the performance of an appropriate index.

Other specific standards relate to particular functions performed by investment advisers. The first proscribes use of the term "investment counsel." The Advisers Act permits only those persons or organizations whose principal business is investment advising—a substantial part of which involves rendering continuous particularized advice—to hold themselves out as "investment counsel."²¹ Thus, it appears that an adviser issuing investment newsletters could not identify himself as "investment counsel" unless (1) he also acted as an investment counselor, and (2) this activity constituted a "substantial" part of his business. However, an investment adviser may call himself "investment counsel" pursuant to *state* law.²² This is allowed because, under state law, designation as investment counsel is intended to "establish a general descriptive category for administrative purposes rather than to distinguish between investment advisers who give general market advice and those who give individualized service."²³ Unfortunately, some clients may not be aware of this distinction. They may very well regard all "investment counsel" in the same manner. As a result, the federal restrictions placed upon use of this term may not produce the desired effect.

A second such provision deals with the situation where the adviser acts as a broker-dealer for his clients. If he knowingly (1) buys a security from or sells a security to a client while acting as principal for his own account, or (2) effects a purchase or sale of any security for the account of a client, while acting as a broker for someone other than the client, then he must satisfy the two conditions of the provision.²⁴

Other sections of the Advisers Act—206, 207, and 208—pertain to various forms of fraud or deceit. Section 206 states that it shall be

21. Investment Advisers Act of 1940, § 208(c), 15 U.S.C. § 80b-8(c) (1976).

22. See SEC Investment Advisers Act Release No. IA-8 (Dec. 12, 1940).

23. *Id.*

24. See Investment Advisers Act of 1940, § 206(3), 15 U.S.C. § 80b-6(3) (1976). Before the transaction is completed, he must provide the client with a written statement which discloses the capacity in which he is acting, and the client must consent to the transaction. *Id.* The written disclosure and the consent (which may be either oral or written) must be obtained prior to completion of each separate transaction; a blanket disclosure and consent in a general agreement between the client and the advisor is inadequate. SEC Investment Advisers Act Release No. IA-40 (Jan. 5, 1945). Antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 require disclosures in addition to the capacity in which the adviser acts. See SEC Investment Advisers Act Release No. IA-40 (Jan. 5, 1945).

unlawful for any adviser (including those who are exempt from registration) who utilizes interstate commerce:

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
-
- (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.²⁵

Under paragraph (4), the section also provides that the Commission shall define the meaning of "fraudulent, deceptive, or manipulative" business practices and shall prescribe means reasonably designed to prevent such practices.²⁶ Pursuant to this authorization, the Commission has issued Rule 206(4)-1²⁷ which pertains, generally, to advertisements circulated by investment advisers.

Sections 207 and 208, unlike Section 206, deal with specific situations. Section 207 prohibits any person (again, nonregistered ad-

25. Investment Advisers Act of 1940, § 206, 15 U.S.C. § 80b-6 (1976).

26. *Id.*

27. 17 C.F.R. § 275.206(4)-1 (1977). This rule prohibits distribution of any advertisement which (1) refers to a testimonial that praises the adviser; (2) refers to past specific recommendations of the adviser that were profitable; (3) represents that any graph, chart, formula or other device will assist any person in making his own investment decisions or, by itself, can be employed to make such decisions, without disclosing prominently the difficulties associated with such use; (4) contains a statement that any analysis or other report is free unless such item actually will be provided without obligation; or (5) is false, misleading, or includes any untrue statement of a material fact.

The advertisement may, however, state past recommendations or offer to furnish a list of such recommendations if:

- (1) the past recommendations span at least one full year immediately prior to the date of the advertisement;
- (2) the name of each recommended security is given, along with the date and nature of each such recommendation (*e.g.*, whether to buy, sell, or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date;
- (3) a cautionary legend is printed in type as large as the largest type used in the text which says "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."

Id. A proposed amendment to this rule would have clarified that the advertisement must include all of the prior recommendations or an offer to supply a list of all such recommendations; it would not have permitted the inclusion of *some* recommendations and an invitation to furnish a list of the remaining recommendations. Also, it would have required that the advertisement be approved in writing by a supervisor designated to oversee such advertisements. Proposed amendment to Rule 206(4)-1, [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,612. The amendment, however, was rescinded by the SEC. See Wall Street Journal, Feb. 27, 1976, at 32, col. 4.

visers are included) from wilfully making an untrue statement of a material fact in any registration application (Section 203) or report (Section 204) filed with the Commission, or from wilfully omitting to state in any such application or report any material fact which is required to be stated therein.²⁸ Section 208 prohibits a *registered* adviser from representing that its qualifications or abilities have been passed upon by the United States or any agency or officer thereof, although it may indicate, simply, that it is an investment adviser registered under the Investment Advisers Act of 1940.²⁹

Enforcement Mechanisms

An essential component of an effective enforcement scheme is the ability to both discourage and discover violations. The Advisers Act accomplishes these objectives through its provisions relating to recordkeeping and custody of client funds and securities. Such provisions not only deter violations—to the extent that disclosure and possible prosecution discourage illicit conduct—but also protect the financial interest of customers.

Section 204 of the Act provides that investment advisers shall make, keep, disseminate, and furnish copies of records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.³⁰ It also provides that such records are subject to inspection by representatives of the SEC at any time.³¹ Pursuant to Rule 204-2,³² an adviser must preserve various records, including all written agreements (or copies thereof), between him and his customers.³³ If a newsletter sent to clients does not state the reasons for recommendations contained therein, the adviser must draft and keep a separate memorandum stating the reasons for the recommendations.³⁴ The Rule also requires investment advisers who render particularized advice to maintain certain records, primarily dealing with securities transactions, concerning customers' accounts.³⁵ All

28. Investment Advisers Act of 1940, § 207, 15 U.S.C. § 80b-7 (1976).

29. Investment Advisers Act of 1940, § 208, 15 U.S.C. § 80b-8 (1976). Compare this provision with the Securities Exchange Act of 1934, § 26, 15 U.S.C. § 78z (1976). Assuming that subscribers of newsletters published by investment advisers are prospective purchasers or sellers of securities, section 26, *inter alia*, prohibits an adviser from representing to its subscribers that action or failure to act by the SEC regarding reports filed with the agency indicates that such reports are true and accurate or not false or misleading. *Id.*

30. Investment Advisers Act of 1940, § 207, 15 U.S.C. § 80b-7 (1976).

31. *Id.*

32. 17 C.F.R. § 275.204-2 (1977).

33. *Id.* § 275.204-2(a)(10).

34. *Id.* § 275.204-2(a)(11).

35. For example, investment advisers who have discretionary investment au-

records required to be kept by Rule 204-2 must be maintained and preserved in an easily accessible location for at least five years and during the first two of these years they must be held in an office of the adviser.³⁶ Advisers who have custody of client funds or securities must also comply with the terms of Rule 206-4.³⁷

thority over customer accounts must keep a list of all such accounts, must keep copies of evidences granting such authority (including powers of attorney), *id.* § 275.204-2(a)(8), (9) and are required to divulge their practices regarding commissions paid to effect transactions for such accounts. *See* Securities Exchange Act of 1934, § 28(e)(2), 15 U.S.C. § 78bb(e)(2) (1976), added by section 21(2) of the Securities Acts Amendments of 1975. This section applies to *all* persons who manage securities on a discretionary basis, and gives "the appropriate regulatory agency" the authority to require disclosure of practices relating to commissions. For investment advisers and broker-dealers, the appropriate agency is, of course, the SEC. The appropriate agency for national bank trust departments is the Comptroller of the Currency and the Federal Reserve Board is the appropriate agency for investment advisory or trust subsidiaries of bank holding companies. Additionally, if investment advisers have discretionary authority over at least \$100 million in equity securities, they are required to make periodic reports to the SEC regarding such disclosures. Section 13(f) of the Securities Exchange Act, which was added by section 10 of the Securities Acts Amendments of 1975, empowers the SEC to require disclosure of the equity security holdings of institutional money managers who have discretionary investment authority over a specified amount of such funds. The amount specified is \$100 million, but could be as low as \$10 million. Detailed reports may be required as often as once each quarter but not less frequently than once each year. *See id.* This section was implemented by requiring yearly reports only for those institutions with holdings of \$100 million or more. Securities Exchange Act Rel. No. 34-14852, 3 FED. SEC. L. REP. (CCH) ¶ 26,854A (June 15, 1978). All investment advisers must maintain a record of every transaction in a security in which they acquire direct or indirect beneficial ownership. 17 C.F.R. § 275.204-2(a)(12), (13) (1977). For each individual client they are obligated to keep records of the date, amount, and price of securities bought and sold, and must be prepared to furnish the names of clients and the current security holdings of such clients. *Id.* § 275.204-2(c). However, except where disclosure is necessary or appropriate in an enforcement proceeding or investigation, the Commission has no authority to require disclosure of the identity, investments, or affairs of clients of an investment adviser. Investment Advisers Act of 1940, § 210(c), 15 U.S.C. § 80b-10(c) (1976). Rule 204-2 also provides that the identity of an investment adviser's clients may be indicated by a numerical, alphabetical or similar code on the books and records kept by the adviser. 17 C.F.R. § 275.204-2(d) (1977).

36. 17 C.F.R. § 275.204-a(e)(1)(1977). If the adviser ceases to do business before the expiration of five years he must notify the Commission of the exact address where the records will be maintained until the period elapses. 17 C.F.R. § 275.204-2(f)(1977). Partnership articles, articles of incorporation, and any amendments thereto, also must be maintained by the adviser in its principal office, and preserved for at least three years after he ceases to do business. *Id.* § 275.204-2(e)(2).

37. Client securities generally must be segregated, identified as to which client has the beneficial interest therein, and held in a safe place. *Id.* § 275.206(4)-2(a)(1) (1977). Client funds must be deposited in bank accounts containing only customer funds, in the name of the adviser as agent or trustee. *Id.* § 275.206(4)-2(a)(2)(i) (ii). Immediately after the adviser takes custody of such funds or securities from

Responsibility for enforcing the Advisers Act is lodged primarily with the SEC. The Commission may censure an investment adviser, place limitations on his activities, or suspend or revoke his registration or the registration of any person associated (or seeking to become associated) with the investment adviser. This can be done if the SEC finds that (1) such action is in the public interest, and (2) the adviser or any person associated with him has committed any of several offenses.³⁸ The Commission has the power to grant exemptions from provisions of the Act, or the rules or regulations thereunder, in appropriate circumstances.³⁹ The Commission may investigate alleged violations, subpoena witnesses, and take evidence.⁴⁰ It may also invoke the aid of a court (and the court's contempt power) to compel the testimony of witnesses and the production of books and records.⁴¹ Any person capable of testifying or furnishing records who, without just cause, fails to do so, is guilty of a misdemeanor and is subject to a fine of up to \$1,000, or imprisonment for up to one year, or both.⁴²

The SEC may hold public hearings.⁴³ It may also issue, amend and rescind rules, regulations and orders pursuant to powers conferred upon it by the Act.⁴⁴ In addition, the SEC may bring suit

any client it is incumbent on him to give written notice to the client stating the place and manner in which such funds or securities will be kept, and if there is any change subsequent thereto, every client affected must receive written notice of such change. *Id.* § 275.206(4)-2(i)(3). At least once every quarter the adviser is obligated to send an itemized statement to each client indicating the funds or securities in his possession and all debits, credits and transactions in such client's account which occurred during the quarter. *Id.* § 275.206(4)-2(a)(4). Finally, all such funds and securities must be verified annually through an actual examination by an independent public accountant without prior notice to the adviser. *Id.* § 275.206(4)-2(a)(5). The accountant then files a certificate with the SEC stating the results of the examination. *Id.*

Various records must also be maintained. A separate record must be kept of each bank account in which client funds are deposited in the name of the adviser as agent or trustee. *Id.* § 275.206(4)-2(a)(2)(iii). The record must contain the name and address of the bank, the dates and amounts of any deposits or withdrawals from the account, and the precise amount of each client's beneficial interest in the account. *Id.* Other records that must be maintained include: (1) a journal showing all debits, credits, purchases, sales, receipts and delivery of securities for each account, *Id.* § 275.204-2(b)(1); (2) a separate ledger which largely duplicates this information (the ledger must show the date and price of each purchase and sale of securities); (3) copies of confirmations of all transactions effected for the account; and (4) a record for each security which shows the client's name, the interest of such client, and the location of the security (or an acceptable identifying code). 17 C.F.R. § 275.204-2(b), (d) (1977).

38. Investment Advisers Act of 1940, § 203(e), (f), 15 U.S.C. § 80b-3(e), (f) (1976).

39. *Id.* § 206A, 15 U.S.C. § 80b-6(a) (1976).

40. *Id.* § 209(b), 15 U.S.C. § 80b-9(b) (1976).

41. *Id.* § 209(c), 15 U.S.C. § 80b-9(c) (1976).

42. *Id.*

43. *Id.* § 212, 15 U.S.C. § 80b-12 (1976).

44. *Id.* § 211(a), 15 U.S.C. § 80b-11(a) (1976).

to enjoin those who have violated or will violate or those who have aided in the violation of any provisions of the Act or of any rule, regulation, or order thereunder.⁴⁵ Upon proper showing, a permanent or temporary injunction will be granted without bond.⁴⁶ Criminal prosecutions are left to the discretion of the Attorney General.⁴⁷ Persons who are convicted of wilfully violating the Act, or any rule, regulation, or order issued by the Commission pursuant thereto, may be fined up to \$10,000, imprisoned for up to five years, or both.⁴⁸

Although the Advisers Act does not explicitly provide for maintenance of a suit by a private plaintiff, some courts have found an implicit private right of action for damages under the Act.⁴⁹ Other courts, however, have held that no such right of action can be implied.⁵⁰ In reaching its holding that no private right of action is sanctioned by the Act, one court relied on the fact that, unlike comparable sections of the Securities Exchange Act of 1934 (Section 27) and the Investment Company Act of 1940 (Section 44), the jurisdictional section of the Advisers Act (Section 214) does not contain the language "actions at law."⁵¹ As a result of the differing judicial interpretations, the SEC proposed to Congress that such language be added to Section 214 to clarify the existence of a

45. *Id.* § 209(e), 15 U.S.C. § 80b-9(e) (1976).

46. *Id.*

47. *Id.*

48. *Id.* § 217, 15 U.S.C. § 80b-17 (1976). The criminal sanction has been employed infrequently. Between 1940 and 1964 there were only two criminal convictions under the Investment Advisers Act. See Comment, *The Regulation of Investment Advice: Subscription Advisers and Fiduciary Duties*, 63 MICH. L. REV. 1220, 1224 n.27 (1965) [hereinafter cited as *Michigan Comment*].

49. *Angelakis v. Churchill Mg't Corp.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95, 285 (N.D. Cal. 1975); *Bolger v. Laventhol, Krekstein, Howarth & Howarth*, 381 F. Supp. 260 (S.D. N.Y. 1974). See generally, Note, *Private Causes of Action Under Section 206 of the Investment Advisers Act*, 74 MICH. L. REV. 308-48 (1975).

50. *Gammage v. Robert, Scott & Co.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94, 761 (S.D. Cal. 1974); *Greenspan v. Eugene Campos Del Toro*, Civil No. 73-638 (S.D. Fla., May 17, 1974).

51. See *SEC Proposals*, *supra* note 1. The relevant language of section 214 reads as follows:

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits *in equity* to enjoin any violation of this title or the rules, regulations, or orders thereunder.

Investment Advisers Act of 1940, § 213, 15 U.S.C. § 80b-14 (1976) (emphasis added).

private right of action under the Act.⁵²

2. Broker-dealers Contrasted with Investment Advisers

The Investment Advisers Act exempts from registration those broker-dealers who provide investment advice solely incidental to their business and for which they receive no special compensation.⁵³ In the case of newsletters distributed to *potential* clients, it is unlikely that any charge would be levied in connection with the solicitation of business. Precisely because such reports are circulated in an attempt to attract clients, a strong argument can be made that this service is "solely incidental" to the business of executing securities transactions so that the exemption would apply.

Similarly, when the broker-dealer merely provides uniform investment reports to existing clients, the same exemption is applicable. As long as these clients use the broker-dealer to effect their securities transactions, it seems that the advisory service is "solely incidental" to the brokerage business. Unless the broker-dealer imposes a fee for the service directly,⁵⁴ or indirectly (by surcharging the transaction costs for those receiving the newsletters), there will be no "special compensation" for the service. Thus, broker-dealers who advise customers or potential customers through a uniform publication are not usually obliged to register as Investment Advisers.

On the other hand, broker-dealers who furnish investment advice to clients in accordance with their individual needs may very well have to register as investment advisers. This is due to the fact that broker-dealers may no longer be able to assert that they receive "no special compensation" for providing this service because commission rates are no longer "fixed."⁵⁵ If such broker-

52. See *SEC Proposals*, *supra* note 1.

53. Investment Advisers Act of 1940, § 202(a)(11)(c), 15 U.S.C. § 80b-2(a)(11)(c) (1976).

54. A few investment advisers also act as broker-dealers. If such an organization is characterized as a broker-dealer, then it must register as an investment adviser. However, to a limited extent, the Advisers Act recognizes that investment advisers who are already registered as broker-dealers ought not be subject to regulatory provisions that substantially duplicate each other. See, e.g., Rules 204-2(h)(1) and 206(3)-1, 17 C.F.R. §§ 275.204(2)(h)(1), 275.206(3)-1 (1977).

55. The essential distinction here is "between compensation for advice itself and compensation for services of another character to which the advice is merely incidental." SEC Investment Advisers Act Release No. 2 (Oct. 28, 1940). One author has stated that broker-dealers who continue to charge uniform commissions will continue to be exempted from the Advisers Act if investment advisory services are solely incidental to the conduct of their business and if no "special compensation" is received in connection therewith. Lovitch, *The Investment Advisers Act of 1940 - Who is an Investment Adviser?* 24 KAN. L. REV. 67, 102 (1975). However, an argument can be made that, because some broker-dealers do not have

dealers are required to register as investment advisers, they are equally subject to the fiduciary provisions described herein.

In any event, broker-dealers must register under the Securities Exchange Act of 1934.⁵⁶ While registration as a broker-dealer is not directly designed to regulate the investment advising function, many provisions of the Exchange Act do, in effect, govern this activity. As a result, consideration will be given to all sections of the Exchange Act (including the rules and regulations thereunder) which apply to the brokerage business, but which are not specifically intended to control *other* functions of broker-dealers (*i.e.*, execution of transactions, market making, and participation in an underwriting).

The rules of self-regulatory organizations also prescribe the conduct of broker-dealers who advise clients on investment decisions. Those who are members of the National Association of Securities Dealers (NASD broker-dealers) must comply with the rules of that body, while nonmembers are subject to a set of similar rules promulgated by the SEC (SECO broker-dealers). Although individual differences will be noted, this article will not attempt to distinguish between the two because their rules closely parallel one another.

Broker-dealers who are members of the securities exchanges are, of course, also governed by their rules. However, only applicable rules of the New York Stock Exchange (NYSE), the largest and most important of the exchanges, will be dealt with here. Many broker-dealers who are members of one or more exchanges belong to the NYSE, and relevant regulations of the other exchanges are likely to duplicate those of the NYSE.⁵⁷ Discussion of the pertinent NYSE rules will be confined to footnotes since these rules, in turn, often duplicate NASD or SECO provisions.

fixed commission rates, the difference (if any) between the market-determined commission for execution only and the commission paid by the advisory client amounts to compensation paid for the advice itself where the spread cannot be attributed entirely to other services rendered by the broker-dealer. See SEC Investment Advisers Act Release No. 2 (Oct. 28, 1940) which intimates that if any relation can be found between the advice rendered and the amount of commission charged, the broker-dealer will be required to register as an Investment Adviser.

56. Securities Exchange Act of 1934, § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1976). See also text accompanying notes 58-60 *infra*.

57. See *Special Study*, *supra* note 5, at 375.

Regulating Competence

Like investment advisers, broker-dealers must register with the SEC.⁵⁸ The only exception to this rule is that broker-dealers whose business is exclusively intrastate⁵⁹ and broker-dealers whose business is to effect transactions in "exempted securities," commercial paper, bankers' acceptances or commercial bills are not required to register.⁶⁰ The Advisers Act also exempts from registration any person whose advice relates only to "exempted securities," though the definition of "exempted securities" is somewhat more limited under that Act.⁶¹ However, unlike the Securities Exchange Act, the Advisers Act not only exempts intrastate advisers (and other advisers that it could reach under the Constitution) but also exempts two classes of advisers who serve specified clients.⁶² Interestingly, the SEC has recognized the discrepancy between the jurisdictional reach of the two statutes and has proposed that the jurisdictional breadth of the Advisers Act also be extended to all intrastate advisers whose activities affect interstate commerce.⁶³ No mention was made, though, of the client-gearred exemptions—one excepting advisers whose only cli-

58. Securities Exchange Act of 1934, § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1976).

59. *See id.* This exemption has a much narrower scope than the intrastate exemption found in the Advisers Act. *Compare id. with* notes 62-64 and accompanying text *infra*. Elimination of the Advisers Act exemption would bring that Act into conformity with the Securities Exchange Act, since there is probably no constitutional authority for federal regulation of activities which are wholly of an intrastate character.

60. *Id.*

61. The Investment Advisers Act exempts from registration those advisers whose advice relates only to securities which are (1) obligations of the United States and (2) securities issued or guaranteed by corporations in which the United States has an interest which have been designated as exempted securities by the Secretary of the Treasury, pursuant to the Securities Exchange Act. Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (1976). The Securities Exchange Act not only defines these securities as exempt, but also exempts the following: (1) any interest in a common trust fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank acting in a fiduciary capacity; (2) any interest in a collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest is issued in connection with (A) a qualified stock bonus, pension, or profit-sharing plan or (B) an annuity plan that meets the requirement for deduction of the employer's contribution contained in section 404(a)(2) of the Internal Revenue Code of 1954, other than any plan described in clause (a) or (b) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code; and (3) such other securities which the Commission may exempt. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1976).

62. *See* text accompanying note 64 *infra*.

63. *See SEC Proposals, supra* note 1, at E-6. The definition of "interstate commerce" would be amended to include intrastate use of any facility of a national securities exchange or of a telephone or other interstate means of communication or of any other interstate instrumentality. *Id.*

ents are insurance companies, the other excepting advisers who have fewer than fifteen clients annually and who neither hold themselves out to the public as investment advisers nor act as investment advisers to registered investment companies.⁶⁴

Another facet of control over competence is the registration process for broker-dealers, which is virtually identical to that for investment advisers.⁶⁵ However, in marked contrast to investment advisers, broker-dealers must meet certain standards of training, qualifications,⁶⁶ and financial responsibility.⁶⁷ Pursuant

64. Investment Advisers Act of 1940, § 203(b)(2), (3), 15 U.S.C. § 80b-3(b)(2),(3) (1976).

65. This process is described in the text accompanying notes 10-12 *supra*.

The NYSE may deny membership to a registered broker-dealer if the broker-dealer does not meet the requisite standards of financial or operations capability, or if such broker-dealer or any associated person thereof fails to satisfy such standards of training, experience, and competence as are prescribed in the rules of the NYSE. Membership may also be denied if a broker-dealer or associated person thereof has engaged, and there is a reasonable likelihood that he may again engage, in acts or practices inconsistent with just and equitable principles of trade. Securities Exchange Act of 1934, § 6(c)(3)(A), 15 U.S.C. § 78f(c)(3)(A) (1976).

Principal executive officers must be designated by the directors as having senior principal executive responsibility for various aspects of the corporation's business. In addition, directors and officers of such corporation must be approved in writing by the Exchange. 2 N.Y.S.E. GUIDE (CCH) ¶ 2320. See also *id.* ¶ 2345.

Employees of NYSE broker-dealers are subject to relatively few restrictions. They should be thoroughly investigated before being employed; if possible the member should have personal conversations with all those who employed the prospective employee during the previous three years. *Id.* ¶ 2345.18. The investigation and verification of a prospective employee's background must be conducted by a partner, voting stockholder, or by any authorized person under his supervision. *Id.* A record of his employment application must be kept on file for three years after he terminates his employment with the broker-dealer. *Id.* Compliance with this rule is deemed to satisfy the recordkeeping requirements of Rule 17a-3, as far as employee records are concerned. See 17 C.F.R. § 240.17a-3(a)(12)(i)(i) (1977). The Exchange reserves the right to disapprove the employment of any person, and ordinarily will not permit an employee to work at a second job. 2 N.Y.S.E. GUIDE (CCH) ¶¶ 2345, 2350.10. Approval will be granted if the employment is of a routine or clerical nature. *Id.* Without approval of the Exchange, employees cannot be connected by employment or otherwise to any other financial or securities-related business. *Id.* ¶ 2346. Part-time clerical work which does not conflict with normal duties or with normal hours of employment would be permitted. *Id.*

A member (and allied member) of the NYSE must pass an examination on the securities business given by the Exchange within nine months of becoming such member. If he exceeds this limit or if he fails to pass the examination in three attempts, he will lose his membership. 2 N.Y.S.E. GUIDE (CCH) ¶ 2304.

66. In order to qualify for registration, a prospective broker-dealer must also meet a negative requirement: no expulsion or present suspension from the NASD or a national securities exchange on his part or on the part of any associated per-

to the Securities Acts Amendments of 1975⁶⁸—which amended

sons for violation of any such exchange or NASD rule which prohibits “any act or transaction constituting conduct inconsistent with just and equitable principles of trade or required any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade.” 17 C.F.R. § 240.15b82(a) (1977). Additionally, in order to qualify, broker-dealer and persons associated with him may not be barred or suspended from being associated with the members of the NASD or any such exchange because of this conduct. *Id.*

The Commission has not specified which rules of the NYSE and the NASD prohibit “conduct inconsistent with just and equitable principles of trade.” However, since the general business standards applicable to NASD broker-dealers, SECO broker-dealers and NYSE broker-dealers contain the same or similar language, at a minimum it should refer to violations of these rules. *See* text preceding note 86 *infra*; *see* 2 N.Y.S.E. GUIDE (CCH) ¶ 2401. With regard to the NYSE rules, it may include conduct which does not violate any specific rule but which is labeled as inconsistent with just and equitable principles of trade. *See id.* ¶ 1656. Interestingly, the Exchange has also declared that wilful violation of any provisions of the Securities Exchange Act of 1934 or any rule or regulation thereunder is conduct inconsistent with just and equitable principles of trade. *See id.* ¶ 1657. Thus, the SEC could disqualify a broker-dealer’s registration on the premise that he had violated a rule of the NYSE, when in fact he had violated the Exchange Act.

The NYSE has elected to implement training and qualifications standards for two classes of employees: “registered representatives” and “supervisory analysts”. The NYSE rules define a registered representative as an employee engaged either in the solicitation of orders for securities for the accounts of customers of his employer or in the solicitation of subscriptions to an investment advisory or investment management service provided by his employer on a fee basis. *Id.* ¶ 2010. Therefore, if the broker-dealer distributes newsletters to potential clients for a fee, all those employees engaged in soliciting subscriptions to the service are “registered representatives”. But many broker-dealers circulate such reports without levying any charge. *See* text preceding note 6 *supra*. Employees who work exclusively on the preparation and dissemination of such letters would *not* be considered registered representatives. Of course, if such employees are also involved in the solicitation of orders, they would satisfy the definition. Moreover, even though an employee may merely execute trades for some customers who regularly receive free copies of the firm’s newsletter, he too may be regarded as a registered representative because he solicits orders from *other* clients. The net result is that employees of the broker-dealer who are involved in performing a service that is comparable to a subscription publication—as well as employees of a broker-dealer who competes with investment counsellors—more than likely fall within the definition of “registered representatives”, even though they may not be actually required to register as such.

This is not an insignificant point, since registered representatives must possess certain qualifications before they can occupy positions in the securities business. Whereas a registered representative has suffered investigations by both the Exchange and the employer in order to determine whether there is adequate evidence of his integrity and a record of “high standards of business conduct,” non-registered representatives have not been subjected to such scrutiny. 2 N.Y.S.E. Guide (CCH) ¶ 2345.18. Note that if the prospective employee already is a member of the Exchange, he will not be required to qualify as a registered representative. *Id.* ¶ 2345.12. However, if a member or allied member lacks experience and intends to service customer accounts in the office of a member organization, he may be required to undergo a period of training and pass the examination for registered representatives. *Id.* ¶ 2304.70. Registered representatives cannot be younger than 21 years of age. *Id.* ¶ 2345.15, *See also* ¶ 1402, and must agree to a series of conditions before they commence employment. *See id.* ¶ 2345.10-16. One of these conditions is that the registered representative will not share in the profits or losses of any customer’s account. *Id.* ¶ 2345.16. If they have not had previous

Section 15(b)(8) of the Securities Exchange Act and redesignated it Section 15(b)(7)—the Commission altered Rule 15b8-1 to require all employees engaged in research or investment advice for broker-dealers who are not members of the NASD to pass a general securities examination.⁶⁹ A comparable requirement exists for employees of members of the NASD.⁷⁰ However, it has been

experience in the securities or a related industry, they must undergo four months of training. *Id.* ¶ 2345.15. Unless waived, they also must pass an examination at the end of their training. *Id.* Additionally, registered representatives shall be full-time employees and, unless permitted by the Board of Directors of the exchange, cannot be financially interested in any other organization involved in the securities or a similar business. *Id.* ¶ 2346. Except for the examination required of broker-dealers, no comparable limitations are placed on the employees of either investment advisers or broker-dealers who are not members of the NYSE. This is true whether or not the broker-dealer is a member of the NASD. It is even doubtful that the NASD or SECO examinations are as comprehensive as the examinations given to registered representatives by the NYSE. However, the SEC has been given authority to standardize these tests. See text accompanying note 72 *supra*.

"Supervisory analysts" are responsible for approving correspondence of a broker-dealer before it is sent out, including so-called "research reports". The analysts must, in turn, be approved by the Exchange, are subject to Exchange investigation of their background, must present evidence of appropriate experience, and must pass an Exchange Supervisory Analysts Examination. 2 N.Y.S.E. GUIDE (CCH) ¶ 2344. If he has earned designation as a Chartered Financial Analyst he need pass only that portion of the examination which deals with Exchange rules on research standards and related matters. *Id.*

67. As part of the registration process a broker-dealer must file a detailed statement of financial condition. This statement must disclose the assets and liabilities of the broker-dealer, must contain a computation of his aggregate indebtedness and net capital in compliance with Rule 15c3-1 under the Exchange Act, and must describe how he will operate his business (including facilities, personnel, supervisory procedures, books and records, and financing arrangements for the first year). 17 C.F.R. § 240.15b1-2 (1977). This rule was promulgated before the Securities Acts Amendments of 1975 were enacted.

A person who applies for membership in the NYSE must post a \$7,500 initiation fee and must be approved by a 2/3 vote of the Board of Directors of the Exchange. 2 N.Y.S.E. GUIDE (CCH) ¶¶ 1403, 1404.

68. Securities Acts Amendments of 1975, § 11(2), 15 U.S.C. § 78o(b)(7) (1976).

69. Formerly, examinations were not required of employees of SECO broker-dealers who effected transactions solely on national securities exchanges.

70. NASD MANUAL (CCH) ¶ 1102A. The NASD distinguishes between two classes of employees with regard to examination requirements: principals and registered representatives. Persons who are actively engaged in the management of a member broker-dealer must register as principals, and must pass Part I of the Qualification Examination for Principals. *Id.* ¶ 1102A, at 1047, 1053. Unless waived by the President of the NASD, a member firm of the NASD must have at least two partners or officers registered as principals. *Id.* ¶ 1102A, at 1048. One principal officer or partner must be designated "financial principal", and must pass both parts of the two part Qualification Examination for Principals. *Id.* ¶ 1102A, at 1047-48. His duties include, but are not necessarily limited to, the actual preparation

revealed that these examinations are not standardized and, perhaps more importantly, that they fail to test on certain subjects vital to the management of a brokerage business.⁷¹ As a consequence, the underlying purpose of new Section 15(b)(7), as amended by the Securities Acts Amendments of 1975, is to give the Commission authority to establish uniform examinations for *all* broker-dealers and their associated persons, and to require that partners, officers, and supervisory employees (or specified classes thereof) be examined on, *inter alia*, the following topics: bookkeeping, accounting, internal control over cash and securities, supervision of employees, and maintenance of records.⁷²

Again, the SEC has recognized the disparity between rules dealing with investment advisers and those dealing with broker-dealers. In response, it has not only proposed Rule 206(4)-4 which would require written disclosure of an adviser's qualifications,⁷³ but, in addition, has asked Congress for the authority to prescribe training and qualification standards for investment advisers.⁷⁴ In support of the latter proposal, the Commission argues that (1) "clients of investment advisers rely as heavily on the competence of their investment advisers as do clients of broker-dealers" and (2) state regulation in this area is inadequate.⁷⁵ The Commission's proposal, styled after Section 15(b)(7) of the Exchange Act,⁷⁶ would provide the Commission with flexibility to create different qualification standards for different types of investment advisers, and for different categories of personnel employed by

and/or approval of financial statements along with net capital calculations and supporting schedules. *Id.*

Employees of a member, other than principals, who are engaged in the supervision, solicitation, or conduct of business in securities (or who train employees to perform these functions) are called registered representatives. *Id.* ¶ 1102A, at 1048-49. They must register, and pass a less rigorous examination. *See id.* ¶ 1102A, at 1048, 1052-53. Employees who previously passed an examination pursuant to section 15(b)(7) of the Exchange Act, as amended, and Rule 15b8-1 thereunder (SECO Examination) or a state securities examination accepted by the SEC are not required to pass the Qualification Examination for Registered Representatives, but must pass a test based upon the rules of the NASD. *Id.* ¶ 1102A, at 1049. Whether a prospective principal or registered representative, each member is under an affirmative duty to investigate the character, reputation, qualifications and experience of such persons before certifying such in the application for registration with the NASD. *Id.* ¶ 2177.

71. H. R. REP. NO. 94-229, 94th Cong., 1st Sess. 105 (1975).

72. *Id.*

73. Rule 206(4)-4 was proposed in Investment Advisers Act Release No. IA-442 (March 5, 1975), [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80, 128. The proposed rule would require investment advisers to furnish prospective clients with a written disclosure statement before they enter into, extend or renew an investment advisory contract with the adviser. *Id.*

74. *See SEC Proposals, supra* note 1, at E-3 to E-6.

75. *Id.* E-4.

76. *See id.* E-1, E-3 to E-4.

them.⁷⁷ In addition, the Commission has requested that it be given explicit authority to establish minimum age requirements for investment advisers and their associated persons.⁷⁸

Broker-dealers are also subject to Rule 15c3-1⁷⁹ (the "net capital" rule). This rule states that broker-dealers who are engaged in a general securities business shall not permit aggregate indebtedness to exceed fifteen times (eight times during the first year of business) the amount of net capital invested in the business, and the value of net capital itself shall at all times be at least \$25,000.⁸⁰ On the other hand, those who promptly transmit all funds and securities, and who do not otherwise hold customer funds or securities, are permitted to operate with as little as \$5,000 or even \$2,500 in net capital.⁸¹

Once again, the SEC has recognized that investment advisers ought to be subject to financial responsibility standards.⁸² However, because the Commission doubts the applicability of the net capital concept in the adviser context, it has only sought the *authority* from Congress to promulgate such standards as it shall see fit.⁸³

Regulating Integrity

Unlike investment advisers, broker-dealers are subject to an ex-

77. *Id.* E-4.

78. *Id.* Unlike the Exchange Act, the Advisers Act and the NASD rules, the NYSE requires that an applicant for membership be at least 21 years of age. 2 N.Y.S.E. GUIDE (CCH) ¶ 1402.

79. 17 C.F.R. § 240.15c3-1(a)(1) (1977).

80. 17 C.F.R. § 240.15c3-1(a)(1) (1977). The capital needed to become a member of the NYSE is identical to that required before one may conduct a general securities business under the Exchange Act. *See also* text accompanying notes 79-83 *supra*. This is true unless one elects to use the alternative net capital requirement: minimum net capital of \$100,000 (using a less rigorous method of computation) without any concomitant aggregate indebtedness criterion. *See* 17 C.F.R. § 240.15c3-1 (f)(1)(a) (1977). However, broker-dealer members of the NYSE are ostensibly susceptible to additional provisions which affect their ability to increase business. *See* N.Y.S.E. GUIDE (CCH) ¶¶ 2326(a), 2326(b). Assuming that broker-dealers are subject to these provisions and that they carry customer accounts, they must not expand their business in such a way as to push aggregate indebtedness beyond 10 times the value of net capital for more than 15 consecutive business days. *Id.* Also, if the ratio should increase to 12 times net capital for the same length of time, they must actually reduce their business so as to bring it back to 10 times net capital. *Id.*

81. *See* 17 C.F.R. § 240.15c3-1(a)(2), (3) (1977).

82. *See SEC Proposals, supra* note 1, at E-4 to E-5.

83. *Id.* E-5.

PLICIT general business standard as well as various antifraud provisions. Article III, Section 1 of the Rules of Fair Practice of the NASD (which is not materially different from SEC Rule 15b10-2⁸⁴ applicable to nonmembers) provides: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."⁸⁵ Although it embodies a broad, all-encompassing requirement, four factors cast doubt on the importance of such a standard. First, the Board of Governors has limited the scope of this standard by rendering various interpretations dealing with specific situations.⁸⁶ As an example, one interpretation discusses only advertising, market letters, and recruiting of sales personnel.⁸⁷ Needless to say, if the fact situation falls within the ambit of one of the specific interpretations, the general business standard is not directly applicable. A second limiting factor of greater significance is the question of the extent to which such a standard covers conduct which cannot be reached by the antifraud provisions governing the behavior of broker-dealers. It seems that the SEC believed it reached some conduct not already made unlawful, otherwise it would not have promulgated such a rule for SECO broker-dealers. However, it may have acted merely with the idea of providing symmetry in the rules governing NASD and SECO broker-dealers. Third, even though such a standard may reach conduct which falls short of "fraud" as defined in the federal securities laws, it still may be unnecessary. If a broker-dealer rendering investment advice is regarded as a

84. 17 C.F.R. § 240.15b10-2 (1977).

85. NASD MANUAL (CCH) ¶ 2151. The general business standard applicable to members of the NYSE is as follows:

Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs.

2 N.Y.S.E. GUIDE (CCH) ¶ 2401.

The chief difference between this standard and the comparable NASD or SECO standard is the absence of the adjective "high", or an equivalent thereof. Whereas the NASD/SECO provision holds broker-dealers to "high standards of commercial honor", the NYSE simply requires adherence to "principles of good business practice". Based upon this discrepancy, and, possibly, the fact that the NASD/SECO standard also demands observance of "just and equitable principles of trade", this norm appears to be somewhat less stringent than the similar NASD/SECO provision. This may make a difference in the duty owed by the broker-dealer to his customer. For example, it could be argued that broker-dealers who issue recommendations concerning the securities of companies, of which they are represented on the board of directors, must disclose this information in the newsletter but that the similarly situated NASD or SECO broker-dealer is under no such obligation.

86. These include, among others, advertising, corporate financing, execution of retail transactions in the over-the-counter market, and receipt and delivery of securities.

87. See NASD MANUAL (CCH) ¶ 2151, at 2017-20.

fiduciary without an explicit provision to that effect,⁸⁸ then he will be held to a high standard of conduct. Fiduciary standards may not be identical to "high standards of commercial honor and just and equitable principles of trade," but the courts may overlook such distinctions.

Finally, in the case of broker-dealers who advise clients on an individual basis, there is the question of the extent to which such a standard covers conduct which cannot be reached by what is known as the "suitability doctrine." For SECO broker-dealers, the doctrine is as follows:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable ground to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.⁸⁹

The NASD rules include a matching suitability standard for member broker-dealers, but it contains some variations which may be of consequence.⁹⁰ For all of the above reasons as well as the fact

88. See *Michigan Comment*, *supra* note 48, at 1228-32.

89. 17 C.F.R. § 240.15b10-3 (1977). SECO broker-dealers are also under an explicit duty to keep records of a customer's occupation, financial situation, marital status, investment objectives, etc., unless the customer refuses to furnish such information after reasonable inquiry. See *id.* § 240.15b10-6(a)(1)(B), (C) and 2 N.Y.S.E. GUIDE (CCH) ¶ 2405(1).

90. The most important of these variations is the omission of language which would require NASD broker-dealers to make a reasonable inquiry of their customers as to investment objectives, financial situation and needs, etc. One author has suggested that the words "if any" be interpreted in such a way as to merely reflect an awareness that, in some situations, a broker-dealer may not be able to obtain all the information that may be necessary to determine the customer's financial situation, investment objectives, etc. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 473. An inquiry is required of both SECO and NYSE broker-dealers. In addition, instead of stating that recommendations shall not be unsuitable, the NASD standard mandates that they actually be suitable. Associated persons are not explicitly covered, and, apparently in place of mentioning "investment objectives", the NASD standard refers to "other security holdings." Compare NASD MANUAL (CCH) ¶ 2152 with 2 N.Y.S.E. GUIDE (CCH) ¶ 2405(1) and 17 C.F.R. § 240.15 b10-3 (1977).

A policy statement accompanying the NASD standard also specifically prohibits (1) recommending speculative low-priced securities to customers without attempting to ascertain the customers' security holdings, financial situation, etc., (2) excessive trading in a customer's account, (3) trading in (as opposed to investing in) mutual fund shares, (4) recommending the purchase of securities in amounts which reasonably exceed the customer's financial capability, and (5) any of several other examples of fraudulent activity. See NASD MANUAL (CCH) ¶ 2152, at 2051-53.

NASD broker-dealers, SECO broker-dealers and NYSE broker-dealers are all

that *investment advisers* rendering particularized advice are also subject to the suitability doctrine,⁹¹ there seems to be no need to develop a general business standard applicable to investment advisers.

The counterpart of the general antifraud provision of the Advisers Act (Section 206) is Section 15(c) of the Securities Exchange Act.⁹² It provides, broadly, that broker-dealers may not engage in

prohibited from "churning" *discretionary* accounts. See NASD MANUAL (CCH) ¶ 2165(a); 17 C.F.R. § 240.15c1-7(a) (1977); 2 N.Y.S.E. GUIDE (CCH) ¶ 2408(c). However, unlike the others, the NYSE provision does not indicate that excessive trading be viewed in terms of both the financial resources of the customer and the *character* of the account. See 2 N.Y.S.E. GUIDE (CCH) ¶ 2408(c). The NYSE also forbids its members from executing purchases or sales which are excessive either in relation to the member's financial resources or the market for the security. *Id.* ¶ 2435(1). NYSE broker-dealers are subject to a standard similar to the suitability doctrine by virtue of the fact that they are under an obligation to diligently discover the essential facts about every customer account. *Id.* ¶ 2405(1).

91. See *SEC Proposals*, *supra* note 1, at E-6.

92. Securities Exchange Act of 1934, § 15(c), 15 U.S.C. § 78o(c) (1976). Section 15(c) applies only to recommendations of or transactions in securities traded on exchanges of which the broker-dealers are not members. Nevertheless, other provisions (namely exchange rules, see *e.g.*, 2 N.Y.S.E. GUIDE (CCH) ¶ 2435(4), (5); rules of the NASD, see NASD MANUAL (CCH) ¶¶ 2161, 2168, and antifraud provisions located elsewhere in the federal securities laws, see Securities Exchange Act of 1934, §§ 9(a)(5), 10b and Rule 10b-5 thereunder, and Securities Act of 1933, § 17(b)) reach situations which involve securities traded on exchanges of which broker-dealers are members.

Rule 10b-3, which contains language closely paralleling the language of section 15(c)(1), is not even as comprehensive as section 15(c)(1). In certain situations it may reach types of securities exempted from the operation of section 15(c)(1) (*e.g.*, commercial paper and commercial bills), but otherwise its repeal would have no effect.

The NYSE rules contain a number of provisions applicable to the investment advisory function of broker-dealers which are directed toward their integrity. First, no member may cause the purchase or sale of any security to be executed on the exchange at successively higher or lower prices, respectively, for the purpose of (1) creating or inducing a misleading appearance of activity in such security, (2) improperly influencing the market price of such security, or of (3) setting a price which does not reflect the true state of the market for such security. 2 N.Y.S.E. GUIDE (CCH) ¶ 2435(3). Second, there is a prohibition against participating in or having an interest in the profits of a manipulative operation. *Id.* ¶ 2435(4). Although "manipulative operation" is nowhere defined in the rules, it seems clear that this term refers to action—either individual or joint—designed to unfairly influence the market price of any security for the purpose of making a profit. See *id.* This provision closely parallels Section 9(a)(3) of the Exchange Act. Unlike section 9(a)(3) of the Exchange Act, 15 U.S.C. § 78i(a)(3) (1976), this provision reaches securities which are not registered on a national securities exchange and covers manipulative statements in a newsletter other than those which simply indicate that the price of a security will rise or fall due to the market operations of certain persons. However, other antifraud provisions applicable to all broker-dealers, see, particularly, text accompanying notes 93-100, *infra*, almost certainly render any distinctions meaningless. A further provision of the NYSE rules forbids circulation of sensational rumors in a way that might reasonably be expected to affect market conditions on the 2 N.Y.S.E. GUIDE (CCH) ¶ 2435(5), but this, too, is an example of conduct which is proscribed by other laws or regulations. See text accompanying notes 93-98 *infra*.

any manipulative, deceptive or other fraudulent act or practice to effect any transaction in, or to induce or attempt to induce the

The only other relevant rules of the NYSE aimed specifically at the integrity of broker-dealers deal with the preparation and distribution of investment newsletters. Prior to dissemination to the public, newsletters must be approved by a member or allied member of the Exchange or by a competent, authorized delegate. 2 N.Y.S.E. Guide (CCH) ¶ 2472. Members who prepare newsletters generally must keep copies thereof for three years. The copies must contain the names of persons who prepared the material and the names of those who approved its distribution. *See id.*

NYSE provisions also regulate the *form* of newsletters (and advertisements). *See id.* ¶ 2474A. Many of the requirements duplicate those contained in the NASD rules, but there are some exceptions. First, although both the NYSE and the NASD require members who issue *current* recommendations in newsletters to indicate whether officers or employees of the issuing organization hold any options in the recommended securities, the NASD provision may provide a loophole by not compelling disclosure where the value of such options is "nominal." NASD MANUAL (CCH) ¶ 2151.01, at 2019. On the other hand, the NASD provision mandates disclosure of *rights* and *warrants* whenever their holding is significant. *Id.* Second, NYSE members—but not members of the NASD—must reveal whether they managed or co-managed the most recent public offering of any securities of the recommended issuer. 2 N.Y.S.E. GUIDE (CCH) ¶ 2474.10, at 4028. Third, if the broker-dealer chooses to disclose any insider relationships (*e.g.*, directorates) between him and the recommended issuer, only the NYSE provisions indicate that the firm "should be careful to avoid exploiting these relationships by implying that the recommendation is based directly or indirectly on privileged information." *Id.*

There are substantial similarities with regard to *past* recommendations as well. The NYSE covers all topics mentioned by the NASD. All of the rules which govern the use of past recommendations—Advisers Act Rule 206-4(1), the NASD interpretation, and the NYSE provisions—provide that the period covered must extend to at least one year. Only the Advisers Act requires inclusion of *all* securities recommendations in the promotional material; both the NASD and the NYSE permit use of all recommendations within a distinct category of securities. Compare 17 C.F.R. § 275.206(4)-1 (1977) with NASD MANUAL (CCH) ¶ 2151.01 and 2 N.Y.S.E. GUIDE (CCH) ¶ 2474A.10. The NYSE covers all topics mentioned by the NASD and adds a few of its own. These place *greater* obligations on the broker-dealer when a list is offered, but not included, in the material (in this instance the offering must state how many issues were recommended, and how many of these advanced and declined), or when a record of past recommendations is presented in summary form. 2 N.Y.S.E. GUIDE (CCH) ¶ 2474A.10. Neither the Advisers Act nor the NASD rules mention use of such a summary; presumably it could not be employed legally under those provisions. If used by a member of the NYSE, a file of the *original* recommendations upon which the summary is based must be kept by the member firm and be available to the NYSE on request for three years. If such a summary is published but subsequently discontinued, it will be allowed to begin again only if the intervening juncture is included in the published summary. Finally, the purchase price of a given number of shares must be shown for each of the recommended securities, commissions must be mentioned, and it must be made clear that the results claimed would have been obtained only if each issue had been purchased when recommended and then sold when sale was recommended. *Id.*

As under the NASD interpretation, the use of testimonials is permitted under limited circumstances. The NYSE rules indicate, however, that payment of nomi-

purchase or sale of, any security other than on a national securities exchange of which they are members.⁹³ As was the case under Section 206 of the Advisers Act,⁹⁴ the Commission may define and prescribe means reasonably designed to prevent "fraudulent, deceptive, or manipulative" practices.⁹⁵ It may also define the meaning of "fraudulent, deceptive, or manipulative" devices or contrivances.⁹⁶

Rule 15c1-2, which was among the first to define the meaning of such devices or contrivances, indicates that the language of the provision is intended to reach:

- (1) . . . any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person⁹⁷ or,
- (2) . . . any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.⁹⁸

If this language is compared with the language of Section 206 of the Advisers Act,⁹⁹ two conclusions emerge. First, subparagraph (2) of Section 206 was probably modeled after paragraph (1) of Rule 15c1-2, above.¹⁰⁰ The Advisers Act provision, however, is restricted to clients and does not include an act which, in the future, would operate as a fraud or deceit. Second, a counterpart to paragraph (2), above, is absent from Section 206 of the Advisers Act, although it does appear in Section 207 of that Act, dealing with registration applications and reports. The logical inference that arises from this omission (and from the insertion of this language in Section 207) is that Section 206 was not intended to provide a cause of action against one who utters an untrue statement of a material fact or a statement made misleading by the omission of a material fact. Therefore, the only way such a suit can be brought against an investment adviser is under Rule 10b-5 of the Exchange Act, in which case the aggrieved party would have to demonstrate that he was the purchaser or seller of a security and that the adviser's conduct was more egregious than mere negli-

nal consideration to obtain the testimonial need not be reported, and that the qualifications of an expert who gives a testimonial need not be disclosed. *See id.*

93. Securities Exchange Act of 1934, § 15(c), 15 U.S.C. § 78o(c) (1976).

94. *See* text preceding note 27 *supra*.

95. Securities Exchange Act of 1934, § 15(c)(2), 15 U.S.C. § 78o(c)(2) (1976).

96. *Id.* § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1976).

97. 17 C.F.R. § 240.15c1-2(a) (1977).

98. *Id.* § 240.15c1-2(b).

99. *See* text accompanying notes 25-26 *supra*.

100. Section 206 of the Advisers Act was enacted after Rule 15c1-2 was promulgated under the Exchange Act, and contains quite similar language. Section 206 and Rule 15c1-2, as well as Rule 10b-5, are all modeled after Section 17(a) of the Securities Act of 1933. *See* 2 L. LOSS, SECURITIES REGULATION 1392; 3 *id.* 1427 (1961).

gence.¹⁰¹ Specific antifraud provisions applicable to broker-dealers also parallel some of the provisions found in the Advisers Act.¹⁰²

101. Cases decided by the United States Supreme Court construing section 10(b) and Rule 10b-5 have held that a private plaintiff who brings an action for damages thereunder must establish scienter on the part of the defendant and must himself have been a purchaser or seller of the securities involved in the lawsuit. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

102. For example, broker-dealers who knowingly file false or misleading documents with the Commission are liable to persons who (not knowing the statement was false or misleading) relied upon it to buy or sell securities and sustained damages as a result. Securities Exchange Act of 1934, § 18(a), 15 U.S.C. § 78r(a) (1976). A person who so relied to his detriment can either sue in equity or at law, and can recover costs plus reasonable attorneys' fees in addition to consequential damages. *Id.* A similar liability arises under Section 207 of the Advisers Act for a false statement or a wilful omission of material fact contained in the registration application (or amendments thereto) or in records required to be filed under Section 204 of the Advisers Act. Investment Advisers Act of 1940, § 207, 15 U.S.C. § 80b-7 (1976). However, this comparable provision fails to reach other documents filed by investment advisers under that Act (*e.g.*, papers and books filed pursuant to an investigation by the SEC). Also, a person who relies upon Section 207 may not be able to bring suit for an injunction or damages, let alone recover attorneys' fees, because it is doubtful whether a person has a right to a private cause of action under any provision of the Advisers Act. See text accompanying notes 49-52 *supra*.

A second example is found in Section 26 of the Securities Exchange Act of 1934, 15 U.S.C. § 78z (1976), and Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1977). These provisions generally do not permit broker-dealers to represent that the Commission or the Federal Reserve Board has passed upon their abilities or qualifications. The only differences between these provisions and Section 208 of the Advisers Act is that the latter (1) covers all agencies of the United States Government, (2) is phrased in somewhat broader language, and (3) explicitly permits registered advisers (or registered broker-dealers) to state that they are registered so long as they do not misrepresent the effect of the registration. For all practical purposes, these prohibitions are identical.

Still another instance of similarity appears in the regulations applicable to investment newsletters or advertisements. Here, the relevant comparison is between an interpretation issued by the NASD pursuant to the general business standard, cited above, (applicable to member broker-dealers only), and Rule 205(4)-1 of the Advisers Act. The text of the NASD interpretation is as follows:

It shall be deemed a violation . . . for a member, directly or indirectly, to publish, circulate or distribute any advertisement, sales literature or market letter that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

NASD MANUAL (CCH) ¶ 2151.01, at 2017.

Except for the phrase "knows or has reason to know," the substantive import of this standard is found in subparagraph (5) of Rule 206(4)-1 under the Advisers Act. Broker-dealers who are not members of the NASD are subject to a similar standard of misrepresentation applicable to both oral and written advice ("any statement") whose purpose is to induce the purchase or sale of a security registered on a national securities exchange. Securities Exchange Act of 1934, §

A comparison of the provisions regulating the integrity of bro-

9(a)(4), 15 U.S.C. § 78i(a)(4) (1976). (This provision also applies to broker-dealers who *are* members of the NASD.)

Considerable explanation accompanies the interpretation. The broad language provides that advertisements and market letters should be premised upon the principles of good faith and fair dealing, should furnish an adequate basis for evaluating the underlying facts, and should not omit material facts or qualifications which would cause the advertisement or newsletter to be misleading. NASD MANUAL (CCH) ¶ 2151.01, at 2017.

Like Rule 206(4)-1, the narrow instructions deal with such items as recommendations, testimonials, and offers of free service. In the case of current recommendations, which are not mentioned in Rule 206(4)-1, the interpretation requires (1) that a reasonable basis for the recommendation exists, and (2) that information supporting the recommendation be furnished to the public upon request. *Id.* ¶ 2151.01, at 2018-19. It also indicates that the following facts are to be disclosed: the price at the time the original recommendation was made, whether the broker-dealer usually makes a market in the recommended securities, and whether the broker-dealer intends to buy or sell recommended securities for his own account or owns the rights to purchase the recommended securities (unless such ownership is nominal). *Id.* As for the use of past recommendations, however, Rule 206(4)-1 mandates the use of a cautionary legend regarding the relevance of past recommendations to future investment performance. *See* note 27 *supra*. In place of the disclaimer required by the interpretation that, if applicable, the recommendations were made during a rising market, Rule 206(4)-1 demands insertion of recent market prices for the securities that were previously recommended. While testimonials are entirely prohibited by Rule 206(4)-1, the interpretation permits them to be employed so long as certain criteria are satisfied. *See* NASD MANUAL (CCH) ¶ 2151.01, at 2019. These criteria include: (1) clarification that past performance is not necessarily indicative of future performance, (2) a statement indicating whether or not any compensation has been paid to the maker of the testimonial, and (3) if the testimonial implies a specialized opinion, there must be a statement listing the qualifications of the person who made the testimonial. *Id.* Offers of free services are treated identically so that, if certain requirements are complied with, they may be utilized.

The interpretation also deals with items ignored by Rule 206(4)-1. For example, newsletters and advertisements issued by member broker-dealers must contain the following information: the name of the person or firm that prepared the material if not prepared by the member, the date on which the material was first published, and if the material is not current, a statement to this effect. *Id.* ¶ 2151.01, at 2018. Members may not imply access to research facilities beyond those that they actually can provide, may not make promises of specific results, may not make exaggerated or unwarranted claims, and may not issue forecasts of future events unless they are clearly labeled as such. *Id.* ¶ 2151.01, at 2019. At the same time, Rule 206(4)-1 contains one provision not found in the interpretation: if an investment adviser asserts that any graph, chart, formula, or similar device can be used to assist in making investment decisions, or can be employed to make such decision, the difficulties associated with such use must be prominently disclosed. 17 C.F.R. § 275.206(4)-1 (1977).

The interpretation does not exhaust the list of specific antifraud provisions applicable to broker-dealers. Those who are members of the NASD may not report purchases or sales of securities or quote the price of securities in their newsletters unless they believe such transactions and/or prices are bona fide. NASD MANUAL (CCH) ¶ 2155; *see also* Securities Exchange Act of 1934, § 11A(c)(1), 15 U.S.C. § 78k-1(c)(1) (1976). Broker-dealers, regardless of affiliation, may not induce the purchase or sale of any security registered on a national securities exchange by circulating a newsletter to the effect that the price of any such security is likely to rise or fall because of the market operations of one or more persons conducted for the purpose of raising or lowering the price of such security. Securities Exchange

ker-dealers to similar provisions applicable to investment advisers indicates that differences exist. Sanctions cannot be invoked against an adviser for conduct which *would* operate as a fraud upon *any* person, or apparently, for the making of an untrue or materially misleading statement where the purchase or sale of a security is not shown.¹⁰³ Nor is an adviser subject to detailed disclosure requirements relating to the issuance of current investment recommendations.¹⁰⁴ If an adviser is to be held liable for being involved in an operation designed to manipulate the price of a security, receipt of consideration must be demonstrated.¹⁰⁵ On the other hand, broker-dealers are not subject to any specific rules governing investment advisory contracts that they enter into with their clients.¹⁰⁶

Act of 1934, § 9 (a)(3), 15 U.S.C. § 78i(a)(3) (1976). Unlike a similar provision which reaches investment advisers, receipt of consideration need not be shown. A like provision in the rules of the NASD prohibits members from giving anything of value to any person for the purpose of influencing such person in connection with the publication or circulation of a newsletter on any matter which is intended to have, or does have, an effect upon the market price of any security. See NASD MANUAL (CCH) ¶ 2161. Also, broker-dealers may not induce the purchase or sale of (1) any security whose registration has been suspended or revoked. Securities Exchange Act of 1934, § 12(j), 15 U.S.C. § 78l(j) (1976); or (2) any security in which trading has been suspended by the SEC. *Id.* § 12(k), 15 U.S.C. § 78l(k) (1976). Finally, broker-dealers may not attempt to induce the purchase or sale of any security that must be validated under any applicable validation law of the Federal Republic of Germany, unless specified conditions are met. 17 C.F.R. § 240.15c2-3 (1977).

103. See text accompanying notes 97-101 *supra*.

104. It should be noted that SECO broker-dealers are also not subject to such detailed requirements. The fact that the SEC abandoned its effort to promulgate a rule in this area—which would have subjected all broker-dealers to detailed standards, Securities Exchange Act Release No. 34-8425 (Oct. 10, 1968), (rescinded on Feb. 25, 1976)—should not be used as an argument against standardizing these requirements. Apparently, the Commission rescinded its proposed rule in response to objections from the NASD and the exchanges that (1) the existing provisions had not been shown to be inadequate, (2) if new standards were needed, the normal procedure would be to amend the provisions of the self-regulatory organization instead of issuing a new SEC rule, and (3) the proposed rule would have been too difficult to administer. Assuming that the NASD interpretation can be enforced and that specific requirements are necessary (as the SEC has asserted), SECO broker-dealers should not be governed solely by a provision which prohibits circulation of misleading or untrue newsletters whose purpose is to induce the purchase or sale of a security registered on a national securities exchange.

105. See last paragraph of note 104 *supra*.

106. The Exchange Act does invalidate waiver of compliance, by contract or otherwise, with any provision of the Act, or any rule or regulation thereunder. Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a) (1976). Compliance with *orders* may be waived under the Exchange Act, see note 174 *infra*, as may compli-

Enforcement Mechanisms

The Exchange Act monitors the behavior of broker-dealers more closely than the Advisers Act monitors the behavior of advisers.¹⁰⁷ As was the case with the Advisers Act, the SEC is re-

ance with the rules of the NASD. *See* Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a) (1976).

Minor differences between regulation of broker-dealers and investment advisers also exist in the situation where an investment adviser acts in a broker or dealer capacity for an advisory client. *Compare* Securities Exchange Act of 1934, § 11(d)(2), 15 U.S.C. § 78k(d)(2) (1976) *with* Investment Advisers Act of 1940, § 206(3) (1976).

107. Section 17 of the Exchange Act requires broker-dealers who transact a business in securities through a member of a national securities exchange, *inter alia*, to make and keep records, and to maintain these records for inspection, at any time, by representatives of the Commission. Securities Exchange Act of 1934, § 17(a),(b), 15 U.S.C. § 78q(a),(b) (1976). The records required to be kept are enumerated in Rules 17a-3 and 17a-4. 17 C.F.R. § 240.17a-3, 17a-4 (1977). These include ledgers which itemize purchases and sales for each customer account, ledgers which reflect all assets, liabilities, income, expense and capital accounts. *Id.* § 240.17a-3(a)(2), (3), copies of all communications sent by the broker-dealer relating to the business, and all written agreements (or copies thereof) between the broker-dealer and his customers. *Id.* § 240.17a-4(b)(4), (7). Some records must be kept for six years, others for three years, but all must be preserved for the first two years in an easily accessible location. *See id.* §§ 240.15b10-6(e), 17a-4(a), (b). These rules apply to all registered broker-dealers. If the broker-dealer is a member of the NASD or NYSE, and if his employees are registered with either organization, then the retention of a copy of the complete registration application is deemed to satisfy the requirement in Rule 17a-3 that an application for employment executed by each employee shall be kept by the broker-dealer. *See id.* § 240.17a-3(a)(12).

Section 17 also mandates that all broker-dealers (including partners, directors, officers and employees thereof) shall be fingerprinted. Securities Exchange Act of 1934, § 17(f)(2), 15 U.S.C. § 78q(f)(2) (1976). The SEC has, however, adopted a rule that permanently exempts certain classes of employees from being fingerprinted. These exempted personnel are temporary employees, persons not engaged in the sale of securities, persons who have no access to the handling or processing of securities or original books and records relating thereto, and persons who do not have direct supervisory responsibility over persons engaged in the above activities. Securities Exchange Act Release No. 34-12214 (Mar. 16, 1976). All registered broker-dealers shall annually file a certified balance sheet and income statement with the Commission. *Id.* § 17(e)(1)(A), 15 U.S.C. § 78q(e)(1)(A) (1976). Unless the broker-dealer is a member of a national securities exchange or of the NASD, which organization maintains the required information and transmits such information to the SEC pursuant to a plan approved by the SEC, he will also be required to file monthly and quarterly reports on his financial condition. *See* 17 C.F.R. § 240.17a-5(1)-4 (1978). Similarly, if at any time during a single month a broker-dealer's aggregate indebtedness exceeds 12 times the value of his net capital, or if his total net capital falls below 120 percent of the minimum net capital required of him, he must give appropriate notice to the Commission. *See id.* § 240.17a-11(b). Reports must be filed monthly until, for three consecutive months, aggregate indebtedness is not greater than 200 percent of net capital and total net capital does not fall below 120 percent of the required level. *Id.* A broker-dealer is also under an obligation to notify the SEC and the appropriate regulatory organization whenever his net capital falls below that required of him by *any* net capital rule to which he is subject. *See id.* § 240.17a-11(a). Except where the broker-dealer is either (1) granted an exemption by the Commission or (2) trades only shares of registered investment companies and participations in insurance com-

sponsible for enforcing the provisions of the Securities Exchange

pany separate accounts and does not handle the funds or securities of customers, he must verify the whereabouts of securities under his control once each quarter. *See id.* § 240.17a-13(a) (2), (b). Unless an exception applies, all registered broker-dealers generally must file annual audited reports containing a statement of financial condition, a statement of changes in the equity of the owners, and a statement of changes in liabilities which are subordinated to the claims of general creditors along with various supporting documents. *See id.* § 240.17a-5(d)(2)-(6). (One exception may be relevant to broker-dealers who advise individual clients: broker-dealers who forward all transactions to a clearing broker on a fully disclosed basis and who do not hold client funds or securities may be exempted (1) if the clearing broker records such transactions on his book in the names of the customers of the originating broker-dealer and (2) if the originating broker-dealer's business is limited to this activity or this activity in combination with other exempted activities. *See id.*) Within 45 days after these materials are filed with the Commission the broker-dealer must furnish additional financial reports to the Commission, to the NYSE and NASD if he is a member thereof, and to his customers. *See id.* § 240.17a-5(c)(1), (2). The NASD also requires a member to disclose financial information contained in its most recent balance sheet to customers upon request. NASD MANUAL (CCH) ¶ 2172.

Section 17 and the rules thereunder do not, however, exhaust the list of monitoring requirements. Broker-dealers must keep and preserve information on customer accounts and written complaints submitted by customers. *Id.* 17 C.F.R. § 240.15610-6(a)-(d) (1977). If they are members of the NASD they must retain a separate record of both payments made and gifts or gratuities received, of written employment contracts between the member and outside persons, and the compensation paid pursuant thereto. NASD MANUAL (CCH) ¶ 2160. Each broker-dealer must organize a system for supervising employees according to written procedures which, among other things, provide that a designated supervisor shall review and give written approval to newsletters before they are circulated. *Id.* ¶ 2177; 17 C.F.R. § 240.15b10-4 (1977). The supervisor may be a partner, officer or manager, or any other qualified person. The supervisor of an NASD member must be a partner, officer, or office manager. *See* NASD MANUAL (CCH) ¶ 2177. Subscription investment advisers are not under an affirmative duty to keep any of these records or to organize such a system of supervision, but in the latter instance, sanctions may be placed upon them for failing to reasonably supervise their employees. Investment Advisers Act of 1940, § 203(e)(5), 15 U.S.C. § 80b-3(e)(5) (1976).

Within six months of the grant of registration, each broker-dealer must be inspected by the SEC, or an industry regulatory organization appointed by the SEC, to ascertain whether the broker-dealer is operating in conformity with the Securities Exchange Act and the rules and regulations thereunder. Securities Exchange Act of 1934, § 15(b)(2)(C), 15 U.S.C. § 78o(b)(2)(C) (1976). The inspection is performed because various studies demonstrated that, of those broker-dealers whose businesses eventually failed, many experienced difficulties during the first few months following registration.

The rules governing use of customer funds and securities are substantially similar to the requirements pertaining to investment advisers. *See* 17 C.F.R. §§ 240.8c-1(c); 240.15c2-1(c) (1977). Rule 15c2-1 and Rule 8c-1 are identical except that Rule 8c-1 applies only to members of national securities exchanges and to broker-dealers who transact a securities business through a member of such exchange, while Rule 15c2-1 reaches all broker-dealers. *Compare id.* § 240.8c-1(a) *with id.* § 240.15c2-1(a). Rule 15c2-1 represents another exercise by the Commission of its

Act applicable to broker-dealers. Here, however, it is clear that

power to define a "fraudulent, deceptive, or manipulative act or practice" under section 15(c)(2) of the Exchange Act.

Unless an exemption applies, a broker-dealer may not hypothecate or pledge customer securities if this would allow customer securities to be commingled, without first obtaining the written consent of all customers involved. *Id.* §§ 240.8c-1(a)(1); 240.15c2-1(a)(1). NASD members may not lend customer's securities without such a written authorization even where commingling would not result. *See* NASD MANUAL (CCH) ¶ 2169(b). Except where the authorization specifies the particular securities to be pledged, NASD broker-dealers may not lend a customer's securities in an amount which is not reasonably related to the customer's indebtedness to them, nor may they lend securities of customers which have been fully paid for. *See id.* ¶ 2169, at 2091, 2092. NASD broker-dealers are also subject to a general standard which states that no member or person associated with a member may use customer funds or securities improperly. *Id.* ¶ 2169(a). A broker-dealer is not generally permitted to pledge customer securities if the value of loans thereon would exceed the value of such customers' indebtedness to him. *See* 17 C.F.R. §§ 240.8c-1(a)(3), 240.15c2-1(a)(3) (1977). A NASD broker-dealer may not enter into any *agreement* with a customer which would allow the broker-dealer to lend customer securities for an amount in excess of the customer's indebtedness to the broker-dealer. NASD MANUAL (CCH) ¶ 2170(b).

Certain safeguards must be provided which protect customer funds under the control of a broker-dealer from being used in his business. *See* 17 C.F.R. § 240.15c3-2 (1977). Unless a broker-dealer is subject to state or federal banking authorities, or does not carry any customer funds which customers may withdraw at any time, or segregates such funds as to preclude their use by him, he must adhere to certain practices if he wishes to use the funds. *See id.* Ordinarily the broker-dealer is obligated to promptly obtain and keep control of customer securities to the extent that such securities exceed the amount owed to him by customers, and to maintain a separate bank account for the exclusive benefit of customers which holds the excess of total credits over total debits required to be deposited. *See id.* § 240.15c3-3(b), (e). These securities include those that have been fully paid for by customers, and "excess margin securities". Excess margin securities are defined as securities placed in margin accounts which have a market value in excess of 140 percent of the total debit balances in such accounts. *See id.* § 240.15c3-3(a)(3)-(5).

NASD broker-dealers may share in the profits or losses of customer accounts. *See* NASD MANUAL (CCH) ¶ 2169(f). A NASD member or person associated therewith may participate in the profits or losses of a customer's account only if (1) he obtains prior written authorization from such member and (2) he shares in the gains or losses in direct proportion to the financial contributions made to the account by him. SECO broker-dealers may do likewise, as apparently there is no provision which prevents them from acting in this manner. NYSE members are flatly prohibited from participating in customer accounts. *See* N.Y.S.E. GUIDE (CCH) ¶ 2369. By virtue of the provision in the Advisers Act which forbids fees based upon the capital appreciation of a client's portfolio, investment advisers are presumably prohibited from sharing in the profits or losses of customer accounts only if such gains or losses can be regarded as fees for services rendered.

A number of additional procedures must be complied with if the broker-dealer wishes to manage discretionary accounts. Prior written authorization must be obtained from the customer in order to manage the account on a discretionary basis, and such authorization is required to be approved in writing by a designated supervisor. 17 C.F.R. § 240.15b10-4(c)(4), 5(a) (1977); NASD MANUAL (CCH) ¶ 2165(b); 2 N.Y.S.E. GUIDE (CCH) ¶ 2408(a), (b). SECO broker-dealers must also be informed of the reasons why such discretionary authority has been granted. *See* 17 C.F.R. § 240.15b10-5(a) (1977). Orders entered on a discretionary basis must be identified as such, and also must receive prompt written approval by the supervisor. 17 C.F.R. § 240.15b10-4(c)(4), 17a-3(a)(6) (1977); NASD MANUAL (CCH) ¶

this is a shared responsibility: private plaintiffs may sue to en-

2165(c); 2 N.Y.S.E. GUIDE (CCH) ¶ 2408(b). If the broker-dealer is a member of the NASD or NYSE, he is under an explicit duty to review all discretionary accounts at frequent intervals. NASD MANUAL (CCH) ¶ 2165(c); 2 N.Y.S.E. GUIDE (CCH) ¶ 2408(b). On the other hand, SECO broker-dealers are subject to specific provisions which require them to keep detailed records of all transactions for discretionary accounts. See 17 C.F.R. §§ 240.15b10-6(d), 240.15c1-7(b) (1977). NASD broker-dealers must record the age and occupation of the customer and the signature of each person authorized to exercise discretion over the account. NASD MANUAL (CCH) ¶ 2171(b). Like investment advisers, all broker-dealers who have investment discretion must maintain records of the granting of discretionary authority, 17 C.F.R. § 240.17a-4(b)(6) (1977), and are required to make disclosure of commission practices and holdings of equity securities. See note 35 *supra*.

The NYSE monitors compliance with the law in basically three different ways. It requires each member to organize its own supervisory procedures, conducts audits of members, and requires members to submit financial statements to the Exchange and to other interested persons.

Supervisory procedures comport with those found in the NASD or SECO rules, but there are some differences. For instance, a broker-dealer who is not a NASD member could delegate overall responsibility to a "qualified person", 17 C.F.R. § 240.15b10-4(b) (1977); under NYSE rules such a person *must* be a general partner or principal executive officer. 2 N.Y.S.E. GUIDE (CCH) ¶¶ 2342, 2405. However, unlike the SECO or NASD rules, the NYSE explicitly directs the partner or officer in charge of overall supervision to *delegate* responsibility for supervision to qualified employees. *Id.* ¶ 2342. This directive probably also accounts for the fact that only the NYSE provides for the creation of a separate system to monitor the performance of persons to whom supervisory authority has been delegated. *Cf. Id.* The SECO rules, however, contemplate that such authority will in fact be designated. See 17 C.F.R. § 240.15b10-4(b), (d) (1977). They provide that broker-dealers who have designated more than one person as a supervisor must designate another person or persons to supervise such supervisors and to periodically inspect each business office of the broker-dealer to insure compliance with written procedures. 17 C.F.R. § 240.15b10-4(d) (1977).

Persons who are delegated supervisory power over one or more offices of a NYSE member must have a creditable record as a NYSE registered representative (or equivalent experience) and must pass a special examination. 2 N.Y.S.E. GUIDE (CCH) ¶ 2342.13. There is an exception for small offices supervised by a non-resident supervisor. In this case a resident registered representative may serve as an ancillary supervisor, and is not required to pass the examination or meet the experience requirements (*e.g.*, creditable record as a registered representative). *Id.* ¶ 2342.15.

The examination and experience qualifications also apply to a person who supervises an organized group of registered representatives. *Id.* ¶ 2342. No such requirements are imposed upon branch managers by either the SECO or NASD provisions. The same can be said for investment advisers under the Advisers Act; they are subject to general guidelines only.

NYSE member organizations are audited at least once a year. See *id.* ¶ 2418.10. The member may select the independent public accountant who will perform the audit, and is aware of when the audit will occur. See *id.*

Finally, NYSE members must file documents with the Exchange or send them to interested parties. Each month they must file a statement on financial and operating condition. *Id.* ¶ 2416. Individual members must file the monthly reports only if the Exchange requests them to do so, and are required to file an income

force provisions of the Exchange Act or Rules of the NASD, and the NASD and the NYSE may enforce their rules against member broker-dealers.

The NASD may investigate complaints submitted to it by aggrieved persons or it may initiate its own investigation.¹⁰⁸ It can

and expense report (as well as additional financial information) when requested to do so by the Exchange. *Id.* ¶¶ 2416, 2425. Member organizations are required to send quarterly statements of accounts to customers who had a transaction during the preceding quarter. *Id.* ¶ 2409. The statement must include a legend informing the customer that a financial statement of such organization is available for personal inspection at the offices of the organization or that a copy of it will be mailed upon receipt of written request. *Id.*

When this description of monitoring requirements is compared with the previous description for investment advisers and broker-dealers who are not members of the NYSE it becomes clear that broker-dealers are monitored more closely than investment advisers. The *only* provision applicable to investment advisers which is not substantially duplicated by the Exchange Act is that investment advisers must maintain a record of the reasons underlying their recommendations. *See* 17 C.F.R. § 275.204-2(a)(11) (1977). On the other hand, the Advisers Act does not mandate either submission of monthly or quarterly financial statement nor does the Act require post-registration inspection (although advisers are routinely inspected once every eight years). NYSE members are governed by the strictest standards of all, followed by nonmember broker-dealers and then investment advisers.

One must ask whether such an elaborate compliance system is necessary for broker-dealers, especially those who render investment advice in the same manner as subscription advisers, and who do not have custody of their customers' funds or securities. Although this lack of custody may lead to an exemption from filing of some of the documents, if *other* conditions are met, broker-dealers who do not handle client funds or securities will not have to file with the SEC, nor furnish to self-regulatory organizations or customers an annual balance sheet and net capital calculation, and will not be required to verify securities under his control on a quarterly basis. *See* 17 C.F.R. § 240.17a-5(c)(1), § 240.17a-13(a) (1977). Nevertheless, most filing requirements remain in force because they apply to *all* broker-dealers. For the broker-dealer who competes with the subscription adviser, this amounts to a case of overkill. A more reasonable scheme would subject such broker-dealers to recordkeeping burdens in accordance with the Advisers Act and to a periodic audit primarily directed towards preserving the solvency of the adviser and preventing misappropriation of prepaid fees.

108. NASD MANUAL (CCH) ¶ 2202-03. Like the NASD, the NYSE may investigate alleged violations of Exchange rules and may require the parties involved to produce books and papers or to testify before the Board of Directors (or a duly authorized committee). *See* 2 N.Y.S.E. GUIDE (CCH) ¶ 1659. If a member, allied member or approved person fails to comply, he may be suspended or expelled. *Id.* Suspension, expulsion, or withdrawal may be invoked if a member, allied member or approved person is found guilty of either making a material misstatement to the Exchange or of making one in his application for approval. *Id.* ¶ 1655. Similarly, if a member or allied member is adjudged guilty of a fraudulent or dishonest act which was not disclosed in the application, or if he is found guilty of fraudulent acts thereafter, he *must* be expelled from membership. *See id.* ¶ 1651-52. The approved person's approval would be withdrawn.

A member or allied member who engages in manipulative market operations *may* be suspended or expelled. *Id.* ¶ 1652. If such a person is a general partner, stockholder, officer or director of a member organization, he may be subject to the same sanctions for any act or omission of such organization as for his own personal conduct. *Id.* ¶ 1667. As long as designated procedures are followed, members and allied members may be investigated and disciplined even after their

require a member or any associated person thereof to provide an oral or written report of facts involved in the investigation and may inspect relevant books and records.¹⁰⁹ If the member fails to furnish duly requested documents, it may be suspended from membership.¹¹⁰ Violation of the rules, orders, directions, decisions, or interpretations issued by the proper enforcement body may result in a variety of sanctions. These include: censure, a fine of up to \$5,000, suspension of membership for a stated period, expulsion from membership,¹¹¹ suspension or barring a member or associated person from association with other members, or any other appropriate penalty.¹¹² Disciplined parties may also have to bear the costs of proceedings.¹¹³ Finally, if any costs or fines are imposed, the violator may be summarily suspended or expelled

association with the Exchange has been terminated. *Id.* ¶ 1674. In that case, the former member or allied member may be fined up to \$25,000, censured, and permanently or temporarily barred from being a member, allied member, or employee of a member organization. *Id.* ¶ 1674.

Members, allied members, and member organizations may also be disciplined for what might be called general violations. Where any of them is adjudged guilty of an act that "may be determined to be detrimental to the interest or welfare of the Exchange" it may be suspended for as many as five years. *Id.* ¶ 1660. In addition, violation of the Exchange Constitution, rules, or any resolution of the Board of Directors may result in suspension or expulsion. *Id.* ¶ 1656. (This provision also applies to a director who is an approved person. In this case, the sanction is withdrawal of approval. *Id.*). Wilful violation of any provision of the Exchange Act or of a rule or regulation thereunder similarly may lead to suspension or expulsion. *Id.* ¶ 1657. In lieu of suspension or expulsion, when any current member, allied member, or member organization commits any of the above-mentioned offenses, a fine of up to \$25,000 (up to \$100,000 for a member organization) may be levied, or the guilty party may be censured. *See id.* ¶ 1663.

The strength of these sanctions, when compared to those available under the NASD rules, depends largely on the relative advantage of belonging to one organization as opposed to the other. If, for example, Exchange membership promises greater rewards than does NASD membership (in terms of the cost of becoming a member), then the sanctions available to the NYSE probably provide a better deterrent. This would be so even though members of the NYSE, unlike NASD members, cannot be saddled with multiple penalties. In any event, because both may discipline the individual, as well as the organization, and because both may invoke the ultimate sanction—expulsion—there is little doubt that they can provide effective enforcement so long as membership is of economic value. No such claim can be made for investment advisers. They belong to no organized self-regulatory body, and it is difficult to conceive of any economic inducement which would encourage them to join such an organization.

109. NASD MANUAL (CCH) ¶ 2205.

110. *Id.* ¶ 2205, at 2112-13.

111. An associated person of a member may also be censured, fined, suspended or expelled. *See id.* ¶ 2301.

112. *Id.*

113. *See id.* ¶ 2303.

from membership if he does not pay them promptly.¹¹⁴

Provisions of the Exchange Act dealing with the Commission's ability to investigate alleged violations (including violations of NASD rules) are substantially the same as those found in the Advisers Act.¹¹⁵ Equally similar are provisions relating to the use of public hearings,¹¹⁶ and those dealing with the Commission's power to enjoin persons who violate or who assist in the violation of any provision of the Act, of any rule, regulation or order thereunder, or of any rule of the NASD.¹¹⁷ Under the Exchange Act, though, the Commission may not bring suit against any person for violation of the rules of the NASD unless it appears that the NASD is unwilling or unable to take appropriate action or it appears that such action is otherwise necessary or appropriate in the public interest or for the protection of investors.¹¹⁸ The Commission may, of course, promulgate rules under the Exchange Act¹¹⁹ as it does under the Advisers Act but the Exchange Act mandates that it cannot adopt any rule or regulation which would impose an unnecessary or inappropriate burden on competition.¹²⁰

Similarly, the Commission's remedies parallel those contained in the Advisers Act.¹²¹ The Commission may censure, place limitations on the activities of a broker-dealer or any associated person of the broker-dealer or suspend or revoke their registration if

114. *Id.* ¶ 2302.

115. *Compare* Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u (1976), *with* Investment Advisers Act of 1940, § 209, 15 U.S.C. § 80b-9 (1976). It should be noted that, while the Commission is given discretion to publish information it has collected concerning violations of the Exchange Act, it may not do so under the Advisers Act unless the information is obtained in the course of a public hearing or is requested by either house of Congress. *Compare* Securities Exchange Act of 1934, § 21(b), 15 U.S.C. § 78u(a) (1976), *with* Investment Advisers Act of 1940, § 212, 15 U.S.C. § 80b-12 (1976).

116. *Compare* Securities Exchange Act of 1934, § 22, 15 U.S.C. § 78(v) (1976), *with* Investment Advisers Act of 1940, § 212, 15 U.S.C. § 80b-12 (1976).

117. *Compare* Securities Exchange Act of 1934, § 21(d), (e), 15 U.S.C. § 78u(d), (e) (1976), *with* Investment Advisers Act, § 209(e), 15 U.S.C. § 80b-9(e) (1976).

118. *See* Securities Exchange Act of 1934, § 21(f), 15 U.S.C. § 78(u)(f) (1976). This also applies to other self-regulatory organizations, namely the exchanges.

119. *Id.* § 23, 15 U.S.C. § 78w (1976).

120. *Id.* § 23(a)(2), 15 U.S.C. § 78w(a)(2) (1976).

121. The SEC may cancel the registration of a broker-dealer if he is no longer in business or has ceased to do business as a broker-dealer. A broker-dealer also may withdraw his registration upon terms and conditions as the Commission deems necessary or appropriate in the public interest, or for the protection of investors. Securities Exchange Act of 1934, § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1976). The Commission possesses these same powers under the Adviser's Act, with minor variations. An adviser's registration may be cancelled for the same reasons even though it is still pending. However, with respect to withdrawal of registration by an adviser, apparently, the Commission has less latitude to attach conditions thereto: only *necessary* conditions may be imposed. *See* Investment Advisers Act of 1940, § 203(h), 15 U.S.C. § 80b-3(h) (1970).

it finds (1) such action is in the public interest and (2) the broker-dealer or associated person has committed any of several offenses.¹²² It may also suspend the registration of a broker-dealer for an interim period pending final determination as to whether registration will actually be revoked.¹²³ However, this sanction is not available under the Advisers Act. The Commission may exempt broker-dealers from the *registration* provisions of the Exchange Act, but, unlike its power under the Advisers Act, this authority does not extend to *other* provisions of the Exchange Act.¹²⁴ Thus, while it could exempt investment advisers not only from registration but also from the bookkeeping requirements of Section 204, the contractual requirements of Sections 205 and 215, and perhaps even the antifraud requirements of Section 206, it does not have the power to free broker-dealers from similar provisions contained in the Securities Exchange Act (unless such provisions apply only to *registered* broker-dealers).

Criminal prosecutions of broker-dealers, as is the case for investment advisers, are left to the discretion of the Attorney General.¹²⁵ Violators are subject to the same set of penalties: up to a \$10,000 fine, five years imprisonment, or both.¹²⁶ The Exchange Act explicitly states that lack of knowledge of the rule or regulation allegedly violated will prevent imprisonment,¹²⁷ but this defense may also be embraced by the "wilful" requirement found in the Advisers Act.¹²⁸

Another difference between the two Acts concerns the general scope of the criminal sanction. Unlike the Advisers Act, the Exchange Act reaches directly only persons who *knowingly* and *wilfully* make or induce false or misleading statements in documents required to be filed with the Commission.¹²⁹ Both Acts, of course, extend to those who intentionally violate any provision of the respective Acts, or any rule or regulation thereunder.¹³⁰ So, in

122. Securities Exchange Act of 1934, § 15(b)(4), 15 U.S.C. § 78o(b)(4) (1976). The criteria are the same as when the Commission decides to deny registration.

123. *Id.* § 15(b)(5), 15 U.S.C. § 78o(b)(5) (1976).

124. *See id.* § 15(a)(2), 15 U.S.C. § 78o(a)(2) (1976).

125. *Id.* § 21(d), 15 U.S.C. § 78u(d) (1976).

126. *Id.* § 32(a), 15 U.S.C. § 78ff(a) (1976).

127. *Id.*

128. *See* Investment Advisers Act of 1940, § 217, 15 U.S.C. § 80b-17 (1976).

129. Securities Exchange Act of 1934, § 32(a), 15 U.S.C. § 78ff(a) (1976).

130. *Compare id. with* Investment Advisers Act of 1940, § 217, 15 U.S.C. § 80b-17 (1976). Interestingly, no penalties are provided for wilful violation of an order issued by the SEC pursuant to the Exchange Act.

the case of investment advisers, the question is whether wilful violation of Section 207 of the Advisers Act (which deals with either making an untrue statement or failing to state a material fact in a registration application or a report filed under Section 204) means that the same conduct is, in essence, made criminal under the two Acts. If one assumes that "knowingly" adds nothing to "wilfully"¹³¹ then this may very well be the case.¹³² On the other hand, one could argue that, because the Advisers Act was passed six years after the Exchange Act, and because the Advisers Act requires wilfulness but not knowledge, the Advisers Act provision is applicable to a wider range of conduct.

The Exchange Act not only provides a means of discovering, discouraging, and prosecuting violations, but also sees to it that a personal action for recovery can be maintained where a broker-dealer's carelessness, insolvency, misappropriation or embezzlement causes losses to the funds or securities of the clients he advises.¹³³ The vehicles providing such protection are bonding and insurance.

Unlike investment advisers, broker-dealers generally must maintain a blanket fidelity bond which provides insurance against several specified types of loss.¹³⁴ Usually, a minimum coverage of

131. This may be a difficult assumption to make. First, if knowledge is included in willfulness, then there would have been no need to add "knowingly" to that part of Section 32(a) of the Exchange Act which deals with misleading statements in documents filed with the Commission. Second, it may be possible to do something willfully without knowledge, as where the actor intended to perform an act and did so, but was unaware that such act constituted a violation of the law. The Commission, however, has recently taken the view that a person does not commit a willful violation if he neither has knowledge of nor should have known that his conduct amounted to a violation. See Securities Exchange Act Release No. 34-12389 (Apr. 29, 1976). This interpretation, of course, would mean that "knowingly" is surplusage where a statutory provision requires willfulness.

132. Even if the conduct is made criminal under both the Advisers Act and the Exchange Act, the Advisers Act provision does not cover such a wide range of documents. It includes only registration applications and reports filed under section 204 of the Advisers Act. Compare Securities Exchange Act of 1934, § 32(a), 15 U.S.C. § 78ff(a) (1976), with Investment Advisers Act of 1940, § 207, 15 U.S.C. § 80b-7 (1976).

133. See *SEC Proposals*, *supra* note 1, at E-5.

134. NASD MANUAL (CCH) ¶ 2182; 17 C.F.R. § 240.15b10-11 (1977). Broker-dealers who are not required to become members of the Securities Investor Protection Corporation are not required to be bonded. *Id.* However, broker-dealers who are members of the NYSE must be bonded. NASD and SECO broker-dealers, who are required to be bonded, may have deductibles included in their bonds of up to 10 percent of the minimum insurance requirement. NASD MANUAL (CCH) ¶ 2182; 17 C.F.R. § 240.15b10-11 (1977). The blanket bond must also include minimum coverage of \$100,000 for the following offenses: misplacement, fraudulent trading, check forgery, and securities forgery. 2 N.Y.S.E. GUIDE (CCH) ¶ 2319.11. The \$100,000 minimum for fraudulent trading is not required of individual members of the NYSE or of partnerships that have no employees. *Id.*

These obligations generally parallel those applicable to NASD and SECO bro-

\$25,000 must be carried for each category, with the amount increasing in relation to the amount of net capital required under Rule 15c3-1.¹³⁵ Cash and securities in the custody of a broker-dealer are insured to \$20,000 and \$50,000 respectively.¹³⁶ As in previously discussed areas, the SEC has acknowledged the discrepancy between advisory and broker-dealer requirements, and has asked for authority to establish bonding standards for investment advisers.¹³⁷

3. Banks vs. Broker-dealers and Investment Advisers

Banks provide both personal advisory and personal trust services. Personal advisory services—which can be directly compared to the particularized investment advice rendered by investment advisers and broker-dealers—are offered by a bank trust department or by the investment advisory subsidiary of a bank holding company. With respect to advising individuals, it should be mentioned that the only federal law specifically applicable to such a subsidiary states that it “shall observe the standards of care and conduct applicable to fiduciaries.”¹³⁸ On the other hand, such sub-

ker-dealers. It is not surprising, then, that compliance with the bonding requirements of the NYSE ordinarily satisfies the bonding provisions for SECO broker-dealers. 17 C.F.R. § 240.15b10-11(a) (1977). This is probably the case because coverage under the NYSE equals or exceeds the SECO or NASD coverage. This is especially true with regard to the basic required coverage. The NYSE specifies at least \$100,000 in every instance, while the SECO and NASD provisions begin at only \$25,000. Compare 2 N.Y.S.E. GUIDE (CCH) ¶ 2319 with NASD MANUAL (CCH) ¶ 2182 and 17 C.F.R. § 240.15b10-11 (1977).

The only area in which the NYSE provisions are arguably weaker than the NASD or SECO provisions relates to insurance against loss which stems from fidelity, on premises, or in transit occurrences. These three events are explicitly provided for under the NASD/SECO rules. However, since the blanket bond specified in the NYSE provisions covers these situations, this is more a difference in form than in substance. For the reasons discussed above, investment advisers and broker-dealers who perform the same narrow function ought to be subject to bonding requirements more in accord with the basic coverages provided under the NASD or SECO rules.

135. See note 134, *supra*.

136. Note, *The Legality of Bank-Sponsored Investment Services*, 84 YALE L.J. 1477, 1499 & n.141 (1975) [hereinafter cited as *Yale Note*].

137. See *SEC Proposals*, *supra* note 1, at E-5.

138. 12 C.F.R. § 225.4(a)(5)(iii) n.2 (1977). The penalty for a company that violates this standard is a \$1,000 fine for each day the violation continues. See 12 U.S.C. § 1847 (1976). Since § 1847 does not refer to violations of *regulations* issued by the board when spelling out the penalties for individuals, it appears that there may be no recourse under federal law against individuals who breach their fiduciary duties but who are not guilty of criminal offenses.

Bank holding companies have also registered investment advisory subsidiaries

sidiaries must register under the Advisers Act and are subject to the full range of that Act's provisions.

To a certain extent, the same statement can be made with regard to bank trust operations as there are no specific federal fiduciary provisions applicable to the trust operation of a state bank which is a member of the Federal Reserve System,¹³⁹ or to a

which manage individual funds under the Investment Advisers Act of 1940. See Investment Advisers Act of 1940, §§ 202(a)(11)(A), 203, 15 U.S.C. §§ 80b-2(a)(11)(A), 80b-3 (1976), and SEC, SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES 8 (1973).

The Federal Reserve Board may require the holding company and its subsidiaries to provide it with reports from time to time or to undergo examinations. However, to the extent possible the Board is under an obligation to use the reports of examinations made by the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC) or the appropriate state bank supervisory authority. Bank Holding Company Act of 1956, § 5(c), 12 U.S.C. § 1844(c) (1976). An officer, director, agent or employee of the holding company who makes a false entry in any book or report with intent to deceive the Comptroller, the FDIC, the Federal Reserve Board, or an examiner appointed to examine the affairs of the holding company, may be fined not more than \$5,000 or imprisoned for not more than five years, or both. *Id.* § 8, 12 U.S.C. § 1847, 18 U.S.C. § 1005 (1976).

139. Prior to September 1, 1948, all state banks exercising trust powers that were members of the Federal Reserve System were subject to certain restrictions provided for in section 6(b) of former Regulation H. 3 FED. BANKING L. REP. (CCH) ¶ 35,301 at 17,180 (1968). These restrictions, not unlike those contained in the current Regulation 9, pertained to self-dealing, collective investment of funds, segregation of investments, and security for deposit of trust funds placed in the bank's commercial or savings department or otherwise used in the conduct of its business. *Id.* These requirements were repealed, but this does not mean the Federal Reserve Board altered its position regarding the undesirability of practices that were previously prohibited. *Id.* In fact, failure on the part of state member banks to conduct their trust business in accordance with applicable state laws and sound principles of trust administration may violate section 208.7(a)(1) of current Regulation H. *Id.* Section 208.7(a)(1) reads:

[A] bank at all times shall conduct its business and exercise its powers with due regard to the safety of its depositors and shall not cause or permit any change to be made in the general character of its business or in the scope of the corporate powers exercised by it at the time of admission to membership.

Id. ¶ 30,961, at 14,454; 12 C.F.R. § 208.7(a)(1) (1978).

A similar regulation has been promulgated by the Federal Deposit Insurance Corporation, the body which oversees the trust activities of insured state banks who are *not* members of the Federal Reserve System. It provides that these non-member banks are under a duty to conduct their operations in a "safe and sound manner", and that the Corporation retains "authority to deal with any banking practice which is deemed to be unsafe or unsound". 12 C.F.R. § 337.11 (1978). State member banks must still obtain permission from the Federal Reserve Board before they may open a trust department. See 2 FED. BANKING L. REP. (CCH) ¶ 35,301, at 17,181. Similarly, state *nonmember* insured banks that contemplate establishing a trust department must also get prior written consent from the Federal Deposit Insurance Corporation. See 12 C.F.R. §§ 333.1, 333.2 (1978).

State member banks may, however, act as trustees of Individual Retirement Accounts (established pursuant to ERISA) and self-employed retirement plans (H.R. 10 trusts) *without* prior approval of the Federal Reserve Board if these funds are invested in a savings account or time deposit of the bank and if such an arrangement is not contrary to state law. [1973-1978 Transfer Binder] FED. BANKING L.

state nonmember bank which is insured by the Federal Deposit Insurance Corporation (FDIC),¹⁴⁰ or to a *trust* subsidiary of a bank holding company organized pursuant to state law.¹⁴¹ Only the trust department of a national bank — whether or not such bank is part of a bank holding company¹⁴² — is subject to a set of specific provisions dealing with investment counseling. These provisions are embodied in Regulation 9 promulgated by the Comptroller of the Currency.¹⁴³ This regulation will be considered below, along with other rules that affect the activities of national banks as providers of investment advice.

Regulating Competence

Like broker-dealers, national banks wishing to furnish investment advice to individuals in the form of personal trust services are subject to both financial and qualifications standards. Financial standards are imposed, in part, by virtue of the fact that a bank must satisfy certain conditions precedent to commencing business as a national bank. Among these conditions precedent

REP. (CCH) ¶ 96.564. National banks and federal savings and loan associations may also act as trustees for these accounts without prior approval of their respective regulatory agencies if similar conditions are observed. *Id.* ¶ 96,445; 3 *id.* ¶ 40,404, at 19,509-2. Federal savings and loan associations, but not national banks (unless these banks have a trust permit), may commingle these funds for "appropriate purposes of investment," although detailed individual records of transactions must be kept. *Id.*

140. The author could find only one regulation issued by the FDIC dealing with the trust powers of state nonmember insured banks. The regulation disclaims any express or implied approval by the FDIC of the legality of commingling "general trust accounts." 12 C.F.R. § 331.1 (1978).

141. Regulation Y permits a bank holding company to control a trust subsidiary that does not engage in commercial banking. See 12 C.F.R. § 225.4(a)(4), (5) (1978). Thus, where a state requires a trust company to make loans or accept deposits, it appears that a trust subsidiary cannot be established pursuant to the law of such state. This dilemma may be avoided by organizing a trust company subsidiary under federal law. In recent years the Comptroller of the Currency has granted four national bank charters to banking concerns offering trust services only. *Wall Street Journal*, Nov. 3, 1975, at 4, col. 2. Such concerns cannot insure their trust funds with the FDIC. See note 166 *infra*. In any event, in the case of a trust subsidiary established by a bank holding company, Regulation Y does not even provide a general standard as it does for the investment advisory subsidiary that advises individuals. Compare 12 C.F.R. § 225.4(a)(4) (1978) with *id.* § 225.4(a)(5) n.2.

142. Prior approval of the Federal Reserve Board is needed for any action that causes a bank to become a subsidiary of a bank holding company. 12 U.S.C. § 1842 (1976).

143. 12 C.F.R. § 9 (1978). Paragraph 9.18 will not be considered since it deals exclusively with the management of pooled funds.

is the requirement that each national bank have an average capital of at least \$100,000 per office. Also, there is a requirement that paid-in surplus equal 20 percent of such capital.¹⁴⁴ By contrast, broker-dealers need only raise \$25,000 of net capital before engaging in a brokerage business which, *inter alia*, renders investment advice to customers based upon the individual needs and objectives of such customers. Investment advisers are currently subject to no net capital requirements whatsoever.

Financial and qualifications standards also come into play when the Comptroller considers whether or not to grant a national bank a permit to engage in fiduciary activities.¹⁴⁵ Such a permit can be granted if doing so would not contravene the state law where the national bank is located, and if competing state institutions are also permitted to act as fiduciaries.¹⁴⁶ Similarly, if the applicable local law requires corporate fiduciaries to deposit securities with state authorities for the protection of trusts, then a national bank must make a similar deposit before exercising any fiduciary powers.¹⁴⁷

It seems clear that, vis-a-vis investment advisers and broker-dealers, national banks are subject to the strictest financial requirements. Thus, the client of a bank which provides such client with investment advice has comparatively greater security in knowing that the bank must raise considerably more capital to prove its sincerity in engaging in the banking business. This means that the client has somewhat more assurance that, if he elects to do so, he can consult with the bank concerning investment questions on an on-going basis.

Such an unequivocal observation cannot, however, be made regarding other qualifications standards. Broker-dealers are governed by specific qualifications criteria, whereas bank personnel

144. 12 U.S.C. § 51 (1976).

145. 12 C.F.R. § 9.3 (1978). The factors:

- (1) whether the bank has sufficient capital and surplus, which cannot be less than that required by state law of state banks;
- (2) the needs of the community for fiduciary services and the probable volume of such fiduciary business;
- (3) the general condition of the bank, including the adequacy of its capital and surplus in relation to its assets, its deposit liabilities, and its corporate responsibilities;
- (4) the general character and ability of management;
- (5) the nature of the supervision to be given to fiduciary activities, including the qualifications, experience, and character of the proposed officers of the trust department;
- (6) whether legal counsel is available to advise on fiduciary matters.

Id. In actuality, a national bank desiring to operate a trust department *must* have legal counsel readily available to pass upon fiduciary matters. See 12 C.F.R. § 9.7(c) (1978).

146. 12 U.S.C. § 92a(a) (1976).

147. 12 U.S.C. § 92a(f) (1976); see 12 C.F.R. § 9.14 (1978).

competence is a question left to the Comptroller's discretion. The Comptroller is required to assess the "ability of management" and the "nature of the supervision to be given to fiduciary activities, including the qualifications, experience, and character of the proposed officers of the trust department."¹⁴⁸ Note that he is not required to consider the qualifications of persons *other than* officers. For this reason one could conclude that employees and officers of broker-dealers are subject to more rigorous qualifications standards than bank personnel (since employees of broker-dealers are not exempted). However, without actually surveying the qualifications of trust department personnel, it is impossible to reach any firm conclusion.

Regulating Integrity

Federal banking law does not regulate the integrity of national bank trust departments *per se*, other than to provide that funds held in a fiduciary capacity "shall be invested in accordance with the instrument establishing the fiduciary relationship and local law."¹⁴⁹ This means, of course, that the *contract* between adviser and client, in conjunction with state law, creates the applicable standard.

What federal banking law does regulate is the potential for conflict of interest or self-dealing which arises in connection with the management of trust accounts. Thus, ordinarily, funds held in a fiduciary capacity by a national bank cannot be invested in the stock or bonds of the bank, its directors, officers, employees or anyone else connected with the bank, and cannot be sold or transferred to or used to acquire property from same, if the bank has any interest in such person or organization which "might affect the exercise of the best judgment of the bank . . ."¹⁵⁰ If such

148. See note 145 *supra*.

149. 12 C.F.R. § 9.11 (1978). If the trust department does not have discretionary investment authority over an account and the governing instrument does not indicate the type of investments to be made, funds are to be placed in any investment which corporate fiduciaries may invest in under local law. See *id.* § 9.11(a) (1978).

150. 12 C.F.R. § 9.12(a), (b) (1978). Funds may be so invested, sold or transferred by the bank if the governing instrument, a court order, or local law lawfully authorizes it to do so. *Id.* Where the bank is permitted to purchase its own stock or obligations or the stock or obligations of its affiliates for fiduciary accounts it enjoys other specified rights. See *id.* § 9.12(c). Similarly, funds may be sold or transferred from fiduciary accounts to the bank or to persons affiliated with the bank if required by the Comptroller, or in certain other limited circumstances. See *id.* § 9.12(b).

funds are lent to any officer, director, or employee of the bank, such person—as well as the person who made the loan—may be fined up to \$5,000, imprisoned up to five years, or both.¹⁵¹ However, a national bank may make a loan to an account and take the assets of such account as security if the transaction is fair and not unlawful under local law.¹⁵² Transactions *between* accounts are also permitted if certain conditions are satisfied.¹⁵³

Although neither the Investment Advisers Act nor the Securities Exchange Act has specific provisions regulating such forms of self-dealing, the antifraud provisions of the two Acts might very well be construed to prohibit the same sort of practices. Similarly, state law (especially state securities law fashioned after the federal securities laws) may in fact outlaw dealings which amount to fraud under the Advisers Act and Exchange Act. The net result is that it is difficult to conclude whether the integrity of banks is more closely regulated than the integrity of broker-dealers and investment advisers, or vice versa.

Enforcement Mechanisms

The Comptroller of the Currency is vested with virtually exclusive responsibility for enforcing the laws, rules, regulations or orders governing the trust operations of national banks. Although a private cause of action has been found under the Comptroller's Regulation 16.4,¹⁵⁴ the only court to consider the same question under Regulation 9 found the remedies enumerated therein to be exclusive.¹⁵⁵ This holding apparently means that private damage suits can be brought only against directors of a national bank who knowingly violate or knowingly permit any of the bank's officers or employees to violate applicable federal banking laws.¹⁵⁶ Unlike suits against broker-dealers (and perhaps investment advisers)

151. 12 U.S.C. § 92a(h) (1976).

152. 12 C.F.R. § 9.12(f) (1978).

153. *See id.* § 9.12(d), (e). The assets of one fiduciary account may be sold to another fiduciary account if the transaction is fair to both accounts and is not prohibited by the governing instrument or local law. *Id.* § 9.12(d). The assets of one fiduciary account may be lent to another such account if the instrument creating the mortgagee account authorizes such loan and such loan is not prohibited by local law. *See id.* § 9.12(e).

154. *Little v. First Calif. Co.*, Civil No. 74-71 (D. Ariz. July 11, 1974), [1973-1978 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 96,305.

155. *Blaney v. Florida Nat'l Bank*, 357 F.2d 27, 30 (5th Cir. 1966). This case was brought under the predecessor of Regulation 9 (Regulation F of the Federal Reserve System), but the court indicated its analysis would be the same pursuant to Regulation 9. *See id.*

156. The court in *Blaney* specifically noted that it was not addressing the question of whether a private suit could be brought against the directors. *Id.* Such a suit should be actionable under either 12 U.S.C. § 93 (1976) (violations of 12 U.S.C. §§ 92a, 161(a)) or 12 U.S.C. § 503 (1976) (violation of 12 U.S.C. § 481).

direct actions by private parties against such officers or employees would not be entertained in court, except where a violation of Section 10b of the Securities Exchange Act (and Rule 10b-5 thereunder) can be demonstrated.

The Comptroller possesses enforcement authority equivalent to the SEC's power under the Securities Exchange Act or the Investment Advisers Act. National banks are subject to an elaborate monitoring scheme, the purpose of which is to ensure financial soundness of the bank rather than to protect the investor. This scheme provides for detailed supervision of accounts,¹⁵⁷ periodic audits¹⁵⁸ and financial reports,¹⁵⁹ and restrictions on the

157. The board of directors of the bank is responsible for the proper exercise of fiduciary powers, but it may designate officers, directors, or employees of the bank to administer these powers. 12 C.F.R. § 9.7(a)(1) (1978). It is incumbent on such person or persons to approve in writing the opening of fiduciary accounts, and a record must be kept of all openings and closings of fiduciary accounts. *Id.* § 9.7(a)(2). A record must also be kept of each fiduciary account itself as well as of all pending litigation involving these accounts in which the bank is a party. *Id.* § 9.8. Fiduciary records are required to be kept "separate and distinct" from other bank records for such time as to permit the bank to provide information to the Comptroller. 12 C.F.R. § 9.8(a) (1978). Separation of trust assets from the other assets of the bank—without segregation of assets in individual accounts—is sufficient. *Am. Legion Post No. 90 v. First Nat'l Bank & Trust Co.*, 113 F.2d 868 (2d Cir. 1940).

Fiduciary records must be reviewed by both the bank and outside parties, and reports must be filed with the Comptroller. When an account is opened for which the bank has "investment responsibilities", a prompt review of the assets therein is conducted. 12 C.F.R. § 9.7(a)(2) (1978). "Investment responsibilities" presumably includes discretionary management authority as well as a more limited discretion to invest within designated classes of investments. Thereafter, the board of directors must ensure that a similar review shall be made once every 15 months to determine the advisability of retaining or disposing of the assets. *Id.*

158. Every 15 months a suitable audit must be made to ascertain whether the trust department has been operated in accordance with law, Regulation 9, and "sound fiduciary principles". *Id.* § 9.9. A continuous audit system may be adopted in lieu of such periodic audits. In any case, the auditors must be answerable only to a committee of directors which excludes any active officers of the bank. *Id.* The same determination is made by the Comptroller in connection with the general examination of national banks conducted at least three times every two years. *See id.* § 9.11(d); 12 U.S.C. § 481 (1976). Banks that are members of the Federal Reserve System (including national banks) also are subject to special examinations by the Federal Reserve Bank located within their district. 12 U.S.C. § 483 (1976). Refusal to allow such an examination may result in forfeiture of all rights of the bank in the Federal Reserve System. 12 U.S.C. §§ 481, 501a (1976). The examiners who perform these examinations prepare a detailed report of the bank's condition, and such report may be published by the Comptroller in proper circumstances. *Id.* § 481.

159. A national bank insured by the FDIC must file four reports of condition each year with the Comptroller, and the amount of trust funds held in the trust department must be stated separately in these reports. 12 U.S.C. §§ 222,

handling of investments held in fiduciary accounts.¹⁶⁰

1817(a)(3), (4), (1976) (if a national bank is located in any state of the Union it must be a member of the Federal Reserve System and must be insured by the FDIC. 12 U.S.C. § 222 (1976)). For each day a bank delays in submitting such reports it may be fined \$100. *Id.* § 164. Insured national banks must, in addition, file certified statements semiannually showing their average assessment base and the amount of assessment due to the FDIC. *Id.* § 1817(c). If a bank continues to withhold either of these two types of reports from the appropriate regulatory agency, it may forfeit all its rights under the National Bank Act and the Federal Reserve Act, and may be sued by the FDIC. *Id.* § 1817(f), (g), (h).

Unless an exemption is granted upon request, 12 C.F.R. § 9.103(c) (1978), trust departments which have \$75 million or more in equity securities are further required to file annual reports with the Comptroller which provide various details of such holdings. *Id.* §§ 9.101, 9.102(a). The details include the name of the issuer, the title and class, the number of shares and the aggregate fair market value of each security held in accounts for which the bank acts as trustee, executor, administrator or guardian, whether or not the bank has investment authority either alone or with someone else (sole investment authority, shared investment authority, or no investment authority), the amount of equity securities within each category and the total number of shares of each such security for which the bank enjoys the exclusive voting rights. *See id.* However, any equity security, the aggregate holding of which does not exceed 10,000 shares, and the assets of any registered investment company which the bank advises, need not be included in the annual report. *Id.* § 9.103(a), (b).

The Comptroller has indicated that this would require reports from 197 of the approximately 2,000 national banks that exercise trust powers, but the covered banks would account for more than 90 percent of the holdings of all national bank trust departments. 39 F.R. 28144 (1974). A trust department is also under an obligation to report quarterly on trades of equity securities valued at \$500,000 or more, or involving ten thousand or more shares, for any fiduciary account over which it has investment discretion. 12 C.F.R. § 9.102(b) (1978). Both this report and the annual report required to be filed must be made available for public inspection, except where any portions thereof are designated as confidential by the Comptroller. *See id.* §§ 9.101, 9.102(d). Even these portions, however, must be made available to the public after a reasonable period of time. *See id.* § 9.101. Finally, as for investment advisers and broker-dealers, national banks are required to disclose their commission practices and holding of equity securities. *See* note 35 *supra*.

160. Inasmuch as fiduciary records must be segregated from other records, similarly, the investments of each account must be kept separate from the assets of the bank and from all other accounts. 12 C.F.R. § 9.13(a), (b)(1) (1978). (Alternatively, individual accounts may be adequately identified as the property of the relevant account. *Id.* § 9.13(b)(1), (2)). Such investments are required to be placed in the joint custody or control of at least two officers or employees of the bank. *Id.* § 9.13(a). These officers or employees must be designated by the board of directors or by one or more officers who have been designated by the board of directors. *See id.*

If permitted by the governing instrument and local law, investments may be deposited in the commercial department of the bank—provided that adequate collateral is set aside under control of the trust department. *Id.* § 9.10(b). The collateral must generally be in the form of readily marketable securities, and must be equal in amount to the amount of trust funds deposited. However, to the extent that the funds so deposited are insured by the Federal Deposit Insurance Corporation no collateral is required. *Id.* Currently, funds are insured up to \$40,000. The result is that in many instances no collateral need be set aside. If for some reason the bank wishes to deposit the investments of a fiduciary account outside the bank it may do so if permitted by law. *Id.* § 9.13(a). At the same time, funds held in a fiduciary capacity awaiting investment must be carried in a separate account and may not be used by the bank in the conduct of its business unless U.S. bonds or

The Comptroller may investigate violations, and may seek to employ a variety of remedies. If he believes that the trust department of a national bank is engaging in or is about to engage in a violation of any relevant provisions or in an unsound practice, he may initiate proceedings to obtain a cease-and-desist order.¹⁶¹ Where such violation or practice is likely to cause substantial dissipation of the bank's earnings or assets, or is likely to otherwise seriously prejudice the interests of depositors, a temporary cease-and-desist order may be issued *ex parte*.¹⁶² If such violation or practice is not corrected after notice thereof is given to the bank, the bank's insured status may be terminated.¹⁶³ The Comptroller may also proceed against directors, officers, and other individuals participating in the conduct of the trust department. Such persons may be suspended from office or prohibited from further participation in the bank's business for commission of any of several designated offenses.¹⁶⁴ These powers are analogous to the SEC's power to enjoin violations of the Securities Exchange Act and Investment Advisers Act and to suspend or revoke the registration of persons registered under said Acts.

As was the case for broker-dealers, the advisory clients of national bank trust departments are provided with a "fund" for recovery of losses caused by such departments. All officers and employees engaged in the trust operation of a national bank, including the officers or employees who have joint custody or control of the investments in each fiduciary account, must be

other securities approved by the Comptroller are set aside in the trust department. 12 U.S.C. § 92a(d) (1976). If the bank fails, the owners of the funds held in trust for investment will have a lien on these bonds or securities in addition to their claim against the estate of the bank. *Id.* § 92a(e). Funds held in trust by the bank either awaiting investment or distribution may not remain uninvested or undistributed longer than is reasonable under the circumstances. *See* 12 C.F.R. § 9.10(a) (1978). In the absence of an agreement or of any applicable local law, the bank may charge a reasonable fee for the fiduciary services it provides. *Id.* § 9.15(a). None of the officers or employees of a national bank without specific approval of the board of directors, may receive any compensation for acting as co-fiduciary of an account with the bank. *Id.* § 9.15(b).

161. 12 U.S.C. § 1818(b)(1) (1976).

162. *See id.* § 181(c).

163. *Id.* § 181(a).

164. *See id.* § 181(e)(2), (4), (6)-(8), (g). Persons who are so suspended or prohibited, or who have received notice of such an intention, may be fined up to \$5,000, or imprisoned up to one year, or both, if they participate further in the bank's affairs. *Id.* § 181(j).

adequately bonded.¹⁶⁵ However, unlike comparable provisions pertaining to broker-dealers, Regulation 9 neither specifies particular bond amounts nor minimum coverage. Except where the bank is not engaged in receiving deposits (*i.e.*, a trust company), trust funds placed in fiduciary accounts must be insured to \$40,000 by the FDIC (twice the amount applicable to broker-dealers).¹⁶⁶ Banks are not required to insure customer securities in any amount.¹⁶⁷ Investment advisers, it will be recalled, are subject to neither bonding nor insurance requirements.

CONCLUSIONS AND RECOMMENDATIONS

Those who provide investment advice—investment advisers, broker-dealers, and banks—are subject to varying regulatory burdens. Generally, broker-dealers are governed by the most rigorous scheme. In many respects national banks are subject to standards comparable to those applicable to broker-dealers, though such standards are usually left to be defined by the Comptroller of the Currency. Investment advisers, on the other hand, are subject to a regulatory scheme much less demanding than that applicable to banks or broker-dealers.

Since these three groups perform a common function, uniform regulation seems clearly appropriate. The reason for this is simple: competing institutions should be placed on the same regulatory footing so that any competitive advantages accruing to one type of institution flow from such institution's ability to serve its customers, not from idiosyncratic regulation. The difficulty lies in establishing the appropriate *level* of regulation.

The approach adopted by the recommendations that follow is, generally, to model the regulation of banks and investment advisers after the rules governing broker-dealers registered under the Securities Exchange Act. Standardization of regulation is not based upon the regulation of investment advisers because, in certain areas, it affords inadequate protection for investors: a dubious right to bring private lawsuits, no financial or qualifications standards, and no bonding or insurance requirements. The regulation of national bank trust departments is not followed, prima-

165. 12 C.F.R. §§ 9.7(b), 9.13(a) (1978).

166. Although all trust funds held in a fiduciary capacity by an insured bank must be insured to \$40,000, a bank which does not receive deposits other than trust funds will have its insured status terminated. 12 U.S.C. §§ 1817(i), 1818(p) (1976). Thus, a trust company is not permitted to have its trust funds insured by the FDIC. The \$40,000 in insurance is in addition to the insurance covering other deposits of the owners of the trust funds or the beneficiaries of such trust funds. *Id.* § 1817(i).

167. This conclusion is based upon the author's examination of the banking laws.

rily because the author prefers a regulatory scheme which sets forth explicit norms.

1. Investment Advisers

Standardization of regulation at a point which provides a reasonable degree of investor protection will have its most dramatic effect on investment advisers. With regard to the need for general training and qualifications standards, disclosure of an adviser's background might ordinarily be sufficient to inform the investor of the adviser's competence to render investment advice. However, since the general level of expertise in the industry is apparently inadequate,¹⁶⁸ satisfaction of formal standards ought to be mandatory. As is the case with broker-dealers, this should be implemented by administering a written examination which tests the knowledge necessary to advise clients on the merits of investments.

A minimum age standard is also of concern. Clearly, the Commission is disturbed by the fact that there is currently no barrier preventing minors from registering as investment advisers.¹⁶⁹ The lack of a minimum age requirement probably undermines public confidence in investment advisers, since it permits immature (and hence incompetent) individuals to render investment advice. Moreover, as the Commission has pointed out,¹⁷⁰ underage individuals who serve as investment advisers may elect to disaffirm contracts with customers under state law. This could create disastrous consequences for clients if there were no bonding requirements and if private parties were denied the right to sue for damages under the Advisers Act (both of which may be the case at present). Under these circumstances a customer would be left with two alternatives if the adviser should cease to do business or abscond with prepaid fees: quasi-contractual recovery under state law or a federal action pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. To recover under the latter, intent or scienter would have to be shown and the client would have to be a purchaser or seller of securities. In either case, the lack of any bonding requirements

168. The *Special Study* suggested that the lack of qualification standards produces substandard personnel in the entire industry. See *Special Study, supra* note 5, at 146-48, 158-59; *Michigan Comment, supra* note 48, at 1224 n.25.

169. See *Wall Street Journal*, Feb. 19, 1976, at 36, col. 1.

170. *SEC Proposals, supra* note 1, at E-4.

may leave the customer remediless if there are little or no assets out of which to satisfy a judgment.

Thus, the question whether minimum age requirements should be imposed not only involves consideration of the competence of the adviser, but also requires an examination of the remedies available to the customer. Interestingly enough, in the case of broker-dealers (who are subject to both bonding requirements and private suits) the SEC does not have explicit authority to establish minimum age requirements (except by refusing to validate a rule of a self-regulatory organization¹⁷¹ which sets an age requirement that the Commission regards as too low).

Investment advisers also should be subject to financial responsibility requirements. The SEC has recognized as much, asking for the authority from Congress to promulgate such standards.¹⁷² The Commission has sought this authority instead of directly resorting to the net capital concept governing broker-dealers because, apparently, it believes financial responsibility standards serve different purposes as between investment advisers and broker-dealers:

A primary objective of any financial responsibility rule under the Advisers Act would be the existence of the investment adviser as a going concern to provide the requisite continuity to long-range investment planning. In contrast, the primary concern in the broker-dealer industry, where the mere execution of transactions does not necessarily involve a continuing relationship, is the safeguarding of monetary and proprietary obligations to customers which an unhealthy level of indebtedness might endanger.¹⁷³

However, this observation is not entirely correct. First, the importance of a subscription adviser as a going concern would appear to be much less than for an adviser providing particularized advice to individual customers. In the former case, the client is responsible for investment decisions, relying on the adviser mainly as a source of investment information. Of course, if the adviser ceases to do business, the client might lose subscription fees paid in advance. His investment plan (if he had one) would possibly be disrupted, but, more than likely, he could switch to another adviser (or place greater reliance on general financial publications) without any detrimental effect. Second, because broker-dealers not only execute trades but also provide advice on an on-going basis, there is often-times a continuing relationship between the broker-dealer and his client. Thus, it would seem appropriate to apply the net capital concept to investment advisers,

171. Securities Exchange Act of 1934, § 19(c), 15 U.S.C. § 78s(c) (1976).

172. *SEC Proposals*, *supra* note 1, at E-5.

173. *Id.*

but to distinguish between the two types of advisers when formulating net capital criteria.

If the standards of financial responsibility applicable to broker-dealers are applied to investment advisers who perform similar functions, subscription advisers should be held to a standard not unlike that for broker-dealers who do not carry customer accounts or handle customer funds or securities. This would embody the \$5,000 in net capital and the fifteen to one (eight to one in the first year) debt/capital ratio referred to previously. Similarly, investment advisers who render particularized advice to their customers should be required to raise \$25,000 of net capital.

Unless an adviser invests a substantial amount of capital into his business, he should be covered by a basic bond which, in appropriate circumstances, will adequately compensate customers for (1) loss of profits where the adviser "trades on a recommendation,"¹⁷⁴ (2) damages caused by the adviser's issuance of intentionally false information, (3) loss of prepaid fees where the adviser misappropriates them or goes out of business, and (4) loss of funds and securities held in the custody of the adviser. In the case of a subscription adviser (who does not have custody of funds or securities) the bond should be equal to the value of fees held by the adviser plus an additional amount. One author has suggested that \$15,000 would be sufficient in this circumstance, but this figure apparently does not include coverage of prepaid fees.¹⁷⁵ For the adviser who handles client funds and securities a basic bond of at least \$25,000 should be required.

Using the Exchange Act as a model for revamping the regulation of investment advisers would result in various other changes as well. The "intrastate" and client-based exemptions found in the Advisers Act would be eliminated,¹⁷⁶ consistent with the re-

174. Cf. Note, *The Regulation of Investment Advisers*, 14 STAN. L. REV. 827, 838-42 (1962). This situation arises where, in reliance on the adviser's recommendation, subscribers either buy or sell the recommended security. This action may lead to an artificially high or low market price if the recommendation was issued merely to enable the adviser to take advantage of the ensuing short-term price swing. The price of the security will then return to its "real" level, with subscribers suffering a loss equal to the difference in prices multiplied by the number of shares traded.

175. *Id.* 842.

176. It should be mentioned that broker-dealers whose business is exclusively *intrastate* are also exempted from registration under the Exchange Act. Securities Exchange Act of 1934, § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1976). But this exemption has a much narrower scope than does the intrastate exemption found in the

cent trend whereby federal domain over the securities markets has increased.¹⁷⁷ This would provide investors residing in states which do not regulate investment advisers with at least some protection. Private plaintiffs would be afforded the right to sue under the Advisers Act, and, restrictions would be placed upon the form in which certain written recommendations are made.¹⁷⁸ Finally, the Commission would be granted interim suspension power over investment advisers,¹⁷⁹ the criminal sanction would be amended to conform to the comparable Exchange Act provisions,¹⁸⁰ and the Commission would be required to consider the effect on competition when it promulgates rules under the Advisers Act.¹⁸¹

Advisers Act. Compare *id.* with notes 62-64 and accompanying text *supra*. Elimination of the intrastate exemption found in the Advisers Act would bring said Act into conformity with the Securities Exchange Act, since there is probably no constitutional authority for federal regulation of activities which have an exclusively intrastate character.

177. See *SEC Proposals*, *supra* note 1, at E-7 & n.20. Also, the Securities Acts Amendments of 1975 amended section 3(a)(17) of the Securities Exchange Act of 1934 so that broker-dealers who trade exclusively on a national securities exchange are now under the domain of the Exchange Act.

178. Unlike the standards applicable to NASD and NYSE broker-dealers, investment advisers (and SECO broker-dealers as well) are not subject to any specific guidelines when they present current recommendations in newsletters. See note 104 and accompanying text *supra*. The Commission has articulated some standards in this area on an *ad hoc* basis but these have not proved adequate. Michigan Comment, *supra* note 48, at 1236. If investment advisers are subjected to the same guidelines as broker-dealers when they recommend securities they would be required to disclose such items as the price when the original recommendation was made, whether the adviser intends to buy or sell recommended securities for his own account or owns rights to purchase the recommended securities, the name of the party who prepared the recommendation if other than the adviser himself, the date the material was first published, and if not current, a statement to this effect. Investment advisers would also be prohibited from claiming research capability they do not possess, from making exaggerated claims or promises of specific results, and from issuing forecasts of future events unless they are clearly labeled as such. Also, before a newsletter is distributed by a broker-dealer it must be approved in writing by a supervisor. See NASD MANUAL (CCH) ¶ 2177, 17 C.F.R. § 240.15b10-4(c)(3) (1978). If the broker-dealer is a member of the NYSE and if the newsletter is a detailed analysis of a single company or industry, the supervisor who gives approval must qualify as an "Exchange Supervisory Analyst". See note 66 *supra*. Although investment advisers are under an obligation to establish and enforce reasonable supervisory procedures, there is no explicit requirement that the market letters they issue be approved in writing before release.

Broker-dealers, as well as subscription advisers, should also be prohibited from circulating newsletters first to favored institutional clients and then to ordinary customers. See *Special Study*, *supra* note 5, at 373-74. An argument can be made that broker-dealer members of the NASD who follow such practice and who charge a uniform fee for receipt of the newsletter are in violation of a provision of the NASD rules which prohibit making unfair discriminatory charges between customers. See NASD MANUAL (CCH) ¶ 2153.

179. See text accompanying note 123 *supra*.

180. See text accompanying notes 127-31 *supra*.

181. See text accompanying note 120 *supra*.

2. Broker-dealers

Except for provisions pertaining to the investment advisory contract between adviser and client, the Securities Exchange Act regulates investment advising activities of registered broker-dealers in a more stringent manner than the Investment Advisers Act regulates the activities of investment advisers.¹⁸² The Exchange Act contains essentially all of the basic ingredients to provide for an advisory industry composed of individuals competent to furnish on-going advice on an impartial basis, who can be held accountable for monetary losses for which they are responsible. Thus, broker-dealers who are registered under the Exchange Act and who comply with Section 205 of the Advisers Act (dealing with the investment advisory contract) should be *permanently* exempted from registering under the Advisers Act.

Broker-dealers, however, occupy a unique position in that they are providers of investment advice who are also in a position to execute the relevant securities transactions. In order to reduce the incentive for broker-dealers to trade discretionary accounts excessively — and thereby generate increased commissions — consideration should be given to prohibiting such indirect charges for these accounts. Unfortunately even with a direct levy, broker-dealers who are in a position to execute transactions for discretionary accounts may be inclined to encourage unnecessary trades. Congress addressed a related problem in the Securities Acts Amendments of 1975, forbidding discretionary authority for certain types of accounts.¹⁸³ Individual accounts were not among these. However, the SEC was given authority, *inter alia*, to pre-

182. Compare text accompanying notes 10-52 with text accompanying notes 58-137 *supra*. If a broker-dealer prepares and distributes investment newsletters, there are slight differences between the NASD treatment and the Advisers Act treatment of such letters. Compare note 27 *supra* with NASD MANUAL (CCH) ¶ 2151.01. Minor differences also exist in the situation where an investment adviser acts in a broker or dealer capacity for an advisory client. Compare Securities Exchange Act of 1934, § 11(d)(2), 15 U.S.C. § 78k(d)(2) (1976) with Investment Advisers Act of 1940, § 206(3) (1976). There are two respects in which the Advisers Act is more stringent than the Securities Exchange Act. A broker-dealer registered under the Exchange Act who effects a transaction for a client when acting as principal for his own account or as a broker for someone other than the client (1) may wait until the transaction takes place to disclose to the client the capacity in which he is acting and, (2) need not obtain consent of the client to act in such capacity.

183. Securities Acts Amendments of 1975, § 11(a)(1), 15 U.S.C. § 78k(a)(1) (1976). These provisions did not take effect until May 1, 1978 for members of national securities exchanges who were members thereof on May 1, 1975. *Id.* § 11(a)(3), 15 U.S.C. § 78k(a)(3) (1976).

vent broker-dealers from managing individual accounts on a discretionary basis.¹⁸⁴ If this were done, and if indirect fees on nondiscretionary accounts were banned as well, reasons to distinguish between the advising activities of investment advisers and broker-dealers would be virtually nonexistent.

3. Banks

Any contemplated revision of federal regulations governing banks acting as providers of investment advice should initially recognize that standards presently applicable to such banks are by no means uniform. Unless a bank-adviser is a trust department of a national bank (governed by Regulation 9) or a subsidiary of a bank holding company (required to register as an investment adviser under the Investment Advisers Act), it is not subject to any specific federal laws or regulations. Comparable standards ought to apply to a bank-adviser whether such adviser is a national bank trust department, a subsidiary of a bank holding company, a state member bank, or a state nonmember bank insured by the FDIC.

Since subsidiaries of bank holding companies are subject only to the Investment Advisers Act, they may be treated as investment advisers for purposes of discussing regulatory reform. This means that the recommendations cited above¹⁸⁵ should be applied to these subsidiaries as well. On the other hand, if the Advisers Act is amended in accordance with the SEC's proposals¹⁸⁶ (requiring satisfaction of financial and qualifications standards) a more persuasive case can be made to support the claim that additional protection for investment advisory clients of bank subsidiaries is unnecessary.

As for amending the regulations concerning national bank trust departments, there does not appear to be a significant lack of investor protection. Such trust departments are subject to standards comparable to those applying to registered broker-dealers, although, in most instances, the trust department standards are not as well defined as those for registered broker-dealers. There are a couple of exceptions, however; non-officer bank employees are not required to satisfy qualifications standards¹⁸⁷ and banks are not subject to the "suitability" doctrine. These may be trivial exceptions, though. It may be of little importance that ordinary trust employees are not experts in investment advice so long as

184. *Id.* § 11(a)(2), 15 U.S.C. § 78(a)(2) (1976).

185. *See* text accompanying notes 168-78 *supra*.

186. *See SEC Proposals, supra* note 1.

187. *See* text at note 148 *supra*.

their superiors are. Similarly, banks *are* subject to a federal regulation resembling the suitability doctrine,¹⁸⁸ and may be held to a comparable obligation pursuant to state law proscribing the behavior of "fiduciaries."¹⁸⁹ National bank trust departments, like registered broker-dealers, should also be bound by Section 205 of the Advisers Act dealing with the contract between client and adviser.¹⁹⁰

This leaves for consideration the regulation of state member banks and state nonmember banks insured by the FDIC. Pursuant to the above analysis, they should be brought within the aegis of Regulation 9 and Advisers Act Section 205 (or equivalent provisions), or they should be regulated in the same manner as recommended for investment advisers, *supra*.

188. Yale Note, *supra* note 136, at 1501 n.156, 1502. This is a required review of assets held in fiduciary accounts, conducted once every 15 months. *See id.*; 12 C.F.R. § 9.9 (1978). It appears that such review does not consider the peculiar circumstances of each account. This *may* be appropriate for personal estates and trusts since the owners of these accounts are likely to comprise a fairly homogeneous group. On the other hand, this review (even if one is willing to agree that an evaluation every 15 months is sufficient) would be an inappropriate substitute for the suitability rule with regard to managing agency accounts. These accounts may be established by an individual with assets of \$10,000 or \$10,000,000; the needs and objectives of such persons are not likely to be compatible.

189. For example, a bank acting as trustee is under a state law duty "to make such investment as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived". III SCOTT ON TRUSTS § 227, at 1660 (2d ed. 1956). This duty, however, does not appear to take into account the particular needs and objectives of individual trust beneficiaries.

190. *See* text accompanying notes 15-20 *supra*.

