UNIT 13

Communications with Customers and Prospects

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- › LO 13.a **Identify** the disclosures that must be made to clients and prospects by broker-dealers and investment advisers.
- › LO 13.b **Recognize** the general disclosure requirements.
- › LO 13.c **Indicate** the unlawful representations concerning registrations.
- › LO 13.d **Recall** the restrictions on performance guarantees.
- › LO 13.e **Identify** the required elements of the investment advisory contract.
- › LO 13.f **Recall** the contents of the investment adviser's brochure including wrap fee programs.
- › LO 13.g **Compare** the state and federal brochure delivery requirements.
- › LO 13.h **Describe** the proper use of social media for communicating with customers and prospects.
- › LO 13.i **Recognize** the differences between advertising by broker-dealers and advertising by investment advisers.

Your exam will include approximately ten questions from the topics covered in Unit 13.

INTRODUCTION

Before a person can become a customer, the person is first a prospect. Knowing what can and what cannot be said at all stages of the relationship is critical to not only the protection of the client but to the securities professional as well. One of the most important communication requirements is disclosure of all material information, especially potential conflicts of interest. Failure to abide by the required practices can lead to suspension or a more severe penalty such as a revocation or bar from the industry.

LESSON 13.1: DISCLOSURES

LO 13.a Identify the disclosures that must be made to clients and prospects by broker-dealers and investment advisers.

When asked about the three most important factors affecting the value of real estate, invariably, the response is "Location, location, location." In this industry, the three most important factors involved in avoiding disciplinary actions are "Disclosure, disclosure, disclosure." There is very little that a securities professional cannot do as long as proper disclosure is made.

Disclosure of Capacity by Broker-Dealers

As stated in Unit 11, broker-dealers can operate either in a principal or agency capacity when executing transactions for their clients. When acting in a principal capacity, the BD is the contra party to the trade. That is, they are on the other side of the trade of the client. When the client is buying a security, the broker-dealer is selling it out of inventory. In this case, the firm's profit comes from a markup. If the client is selling a security and the broker-dealer purchases it for its inventory, once again, the firm is acting as a principal (every trade has two principals—the buyer and the seller) and, in this case, the profit comes from a markdown.

When acting in an agency capacity, the firm is acting like any other broker or agent (real estate broker, insurance agent, employment agent) in that they are simply putting the buyer and seller together. And, like all agents or brokers, they earn a commission.

For the exam, it is important to know that broker-dealers must always indicate their capacity on the trade confirmation, sent no later than completion of the trade (settlement date). They will indicate if they acted as a broker (and always disclose the amount of commission) or if they acted as a principal (and depending on the circumstances—not tested—may have to indicate the markup or markdown).

TAKE NOTE

This discussion on broker-dealer capacity will be revisited in Unit 23.

Disclosure of Capacity by Investment Advisers

As stated in Unit 9, the business of an investment adviser is giving advice; that is why they get compensated. They're not in the business of executing securities transactions—that is the role of the broker-dealer.

However, on rare occasions, an investment adviser might buy from or sell to an advisory client in the capacity of a principal. Or the adviser might put together a buyer and seller acting in the capacity of an agent.

The Uniform Securities Act recognizes that both principal and agency transactions create the potential for advisers to engage in self-dealing. Principal transactions, in particular, may lead to abuses such as price manipulation or the placing of unwanted securities into client accounts. When an adviser engages in an agency transaction on behalf of a client, it is primarily the incentive to earn additional compensation that creates the adviser's conflict of interest. Although recognizing the potential for these abuses, the regulators did not prohibit advisers entirely from engaging in all principal and agency transactions with clients. Rather, they chose to address these particular conflicts of interest by imposing the following disclosure and client consent requirements:

- The client receives full written disclosure as to the capacity in which the adviser proposes to act.
- Client consent is obtained.

Consent, which can be oral or written, may be obtained before or after the execution of the trade, but both of these must be done prior to completion of the transaction. This is unlike a broker-dealer, who, when acting as a principal in a trade with a customer or as the customer's agent, need only indicate that capacity on the trade confirmation; consent is not required.

TAKE NOTE

Completion of the transaction is considered to be the day the trade settles. Under current industry practice, that is the 2nd business day after the trade is made.

It is important to remember that:

- an adviser may obtain client consent to a principal or agency transaction after execution, but must obtain it prior to completion of the transaction (settlement date); and
- an adviser is not "acting as broker" within the meaning of the acts if the adviser receives no compensation (other than its advisory fee) for effecting a particular agency transaction between advisory clients. It is primarily the incentive to earn additional compensation that creates the adviser's conflict of interest when effecting an agency transaction between advisory clients.

Unit 13

TEST TOPIC ALERT

What happens if the investment adviser is also registered as a broker-dealer? The requirements just described do not apply to any transaction with a customer of a broker-dealer if such broker-dealer is not acting as an investment adviser in relation to such transaction. In other words, the transaction is not as a result of a recommendation from the adviser.

TAKE NOTE

What is really going on here? As stated previously, the function of an investment adviser is to be compensated for giving investment advice, not trading securities. Buying and selling securities is the job of a broker-dealer. This discussion deals with the odd case where an investment adviser wears "two hats" as it were and, in addition to giving advice, also trades the security.

Agency Cross Transactions

A similar case to the situation just described is the agency cross transaction where the investment adviser acts as an agent for both sides of the trade (hence the term *agency cross transaction*).

In an **agency cross transaction**, the adviser (or IAR acting on behalf of the firm) acts as agent for both its advisory client and the party on the other side of the trade. Both state and federal law will permit an adviser to engage in these transactions provided the advisory client executes a written consent prospectively (in advance) authorizing the investment adviser to effect agency cross transactions for such client, and the adviser discloses the following:

- The adviser will be receiving commissions from both sides of the trade.
- There is a potential conflict of interest because of the division of loyalties to both sides.
- On at least an annual basis, the adviser will furnish a statement or summary of the account identifying the total number of such transactions and the total amount of all remuneration from these transactions.
- In a conspicuous manner, the adviser indicates that this arrangement may be terminated at any time.
- No transaction is effected in which the same investment adviser or an investment adviser and any person controlling, controlled by, or under common control with that investment adviser recommended the transaction to both any seller and any purchaser.

These requirements do not relieve advisers of their duties to obtain best execution and best price for any transaction.

In addition to the prior written consent, at or before the completion of each agency cross transaction, the client must be sent a written trade confirmation that includes:

- a statement of the nature of the transaction;
- the date and, if requested, the time of the transaction; and
- the source and amount of any remuneration to be received by the IA (or IAR) in connection with the transaction.

EXAMPLE

An adviser has a client who is conservative and another who generally looks for more aggressive positions. The conservative client calls and expresses concerns about the volatility of First Tech Internet Services, Inc., stating that he thinks this may be the best time to exit his position. The adviser agrees and mentions that he has a risk-taking client for whom First Tech is suitable and he'd like to "cross" the security between the two clients, charging a small commission to each of them. He then contacts the other client and recommends the purchase of First Tech. With the prior written consent of both parties, this is not a violation because the recommendation was only made to one side (the buyer).

TEST TOPIC ALERT

In an agency cross transaction, the adviser may **not** recommend the transaction to **both** parties of the trade.

TAKE NOTE

In the case of agency cross transactions, permission to engage in them must be obtained in writing prior to the first transaction. In essence, the client is giving blanket authority to engage in this activity. In the case of acting as a principal or agent, as described previously, no blanket authorization is permitted, and oral or written, rather than exclusively written, consent must be obtained prior to the completion of each transaction.

LO 13.b Recognize the general disclosure requirements.

To provide some assurance that the disclosure requirements of the acts will not be violated, the regulators have recommended that each of the adviser's advisory clients be given a written statement (the brochure described shortly) prepared by the adviser that makes all appropriate disclosures.

The securities laws do not prohibit a registered investment adviser representative from being an employee of a registered broker-dealer. However, there would be a duty on the part of both the broker-dealer and the soliciting advisers to inform advisory clients of their ability to seek execution of transactions with broker-dealers other than those who have employed the advisers.

Disclosure must be made to all current clients and to prospective clients regarding material disciplinary action. The broadest definition of *material* would include any actions taken against the firm or management persons by a court or regulatory authority within the past 10 years. Required disclosure would include the following:

- State or regulatory proceedings in which the adviser or a management person was found to have violated rules or statutes that led to the denial, suspension, or revocation of the firm's or the individual management person's registration
- Court proceedings, such as a permanent or temporary injunction, against the firm or management person pertaining to an investment-related activity or any felony
- SRO proceedings in which the adviser or management person caused the business to lose its registration; or the firm or individual was barred, suspended, or expelled; or a fine in excess of $2,500 or a limitation was placed on the adviser or management person's activities

Examples of failures to disclose material information to clients would include the following:

- An adviser fails to disclose all fees that a client would pay in connection with the advisory contract, including how fees are charged and whether fees are negotiable.
- An adviser fails to disclose its affiliation with a broker-dealer or other securities professionals or issuers.
- If a state-registered adviser has discretionary authority or custody over a client's funds or securities or requires prepayment of advisory fees of more than $500 from a client six or more months in advance, the adviser fails to disclose a financial condition that is reasonably likely to impair the ability of the adviser to meet contractual commitments to those clients. In the case of a federal covered adviser, the dollar limit is more than $1,200.
- An adviser may defraud its clients when it fails to use the average price paid when allocating securities to accounts participating in bunched trades and fails to adequately disclose its allocation policy. This practice violates the act if securities that were purchased at the lowest price or sold at the highest price are allocated to favored clients without adequate disclosure.
- Any material legal action against the adviser must be disclosed to existing clients promptly. If the action occurred within the past 10 years, it must be disclosed by a state-registered adviser to prospective clients not less than 48 hours before entering into the contract, or no later than the time of entering into such contract, if the client has the right to terminate the contract without penalty within five business days. In the case of a federal covered adviser, the "48-hour rule" does not apply; disclosure is part of the brochure delivered no later than commencing the advisory agreement.

EXAMPLE

BJS Advisory Service maintains no custody of customer funds or securities, requires no substantial prepayments of fees, and does not have investment discretion over clients' accounts. Which of the following would have to be promptly disclosed to clients?

I. The SEC has entered an order barring the executive vice president of the firm from association with any firm in the investment business.
II. BJS has just been fined $3,500 by the NYSE.
III. A civil suit has just been filed against BJS by one of its clients alleging that BJS made unsuitable recommendations.

A. I and II
B. I and III
C. II and III
D. I, II, and III

Answer: A. Material disciplinary violations must be reported by all investment advisers, regardless of whether they keep custody. The first two answers fit the definition of material actions, but not the third. If the suit goes in favor of the client and the adviser is found guilty, disclosure would need to be made. However, there is something that investment advisers who do not maintain custody or receive substantial prepayments avoid having to do. What is that? They do not have to notify their clients about any financial situation that might impair their ability to meet contractual commitments to clients.

Disclosure of Conflicts of Interest

What is a conflict of interest? One legal definition goes something like this: "A term used to describe the situation in which a person in a position of trust, contrary to the obligation and absolute duty to act for the benefit of a designated individual, exploits the relationship for personal benefit, typically pecuniary."

Because of the fiduciary relationship, clients of investment advisers expect the advisers to do what is best for them, not for the person they're trusting with their money. The best way to avoid these conflicts of interest is to disclose them so that the customer can decide what to do. Some examples of potential conflicts of interest are:

- offering a proprietary product, such as a house fund (a mutual fund where the underwriter or adviser is affiliated with the broker-dealer);
- offering a limited partnership offering (DPP) where the sponsor is an affiliate of the broker-dealer;
- program sponsors, such as investment companies or insurance companies, providing incentives or rewards to agents for selling the sponsors' products;
- a securities professional having a financial interest in any security being recommended;
- a broker-dealer going public and placing shares of its own stock into discretionary accounts; and
- a broker-dealer publishing a favorable research report after underwriting the issuer's stock offering.

This is just a sample. The key point is that if there is any doubt about the transparency of the recommendation or transaction, be sure to make full disclosure.

TEST TOPIC ALERT

Suppose you were selling shares of a company where your sister was a control person. Do you think you'd have to disclose that potential conflict of interest to your clients? Yes!

Disclosure of Fees

Many years ago, NASAA declared that it is a prohibited business practice for a broker-dealer to charge unreasonable and inequitable fees for services performed, including miscellaneous services such as collection of monies due for principal, dividends or interest, exchange or transfer of securities, appraisals, safekeeping, or custody of securities and other services related to its securities business. However, as long as these charges are not unreasonable, they would be permitted for performing these services. But if clients were not aware of those fees, or didn't understand them, firms could take unfair advantage.

NASAA recognizes that not all broker-dealers offer the same level of services and that those who offer a large array of services to their clients may charge more without it being considered an unethical business practice. In other cases, a particular transaction may involve more expense to the broker-dealers, particularly in a thinly traded security, generally defined as one with very low trading volume, and that too would justify a charge that is higher than normal. Of course, all charges must be clearly disclosed to clients. If not, a violation has occurred.

In recent years, attempts have been made to reduce the potential conflict of interest when there are different levels of compensation for different products. One method FINRA has been promoting is the use of "product agnostic" compensation grids (also referred to as "neutral grids"). These can be an effective practice to reduce incentives for agents to prefer one type of product (e.g., equities, bonds, mutual funds, variable annuities) over another. These grids typically pay a flat percentage of the revenue an agent generates, regardless of the product recommended.

In 2015, NASAA published an investor advisory regarding fees charged by broker-dealer firms for services and maintenance of investment accounts. The advisory followed research from NASAA showing that investors are confused about brokerage services and maintenance fees and want clear and easy access to fee information from their broker-dealer firms. A national public opinion poll commissioned by NASAA found that fees are important to investors, but a general lack of standardization and clarity in their disclosures has left investors unaware of how much their broker-dealer firms charge for the service and maintenance of their investment accounts. Here are some ways that broker-dealers can make the disclosures easier for customers to follow:

- Fees are typically disclosed when a customer account is opened. If the firm changes the fee schedule, be clear about it, and be sure to use appropriate methods to give advance notification of the changes to the customer.
- Minimize the fine print, or at least make the fees and charges clear. Whether using a table, a chart, or a list, make sure it is easy for customers to determine what the fees and charges are and how they are computed.
- Use standardized and uncomplicated terms to describe service and maintenance fees in order to help clients compare fees between different firms.

TAKE NOTE

A working group convened by NASAA has developed a model fee disclosure schedule and related accessibility guidelines to help investors better understand and compare various broker-dealer service- and maintenance-related fees. The template and guidelines make fee disclosure easily accessible for prospective retail investors to use to understand and compare fees. Under that guideline, broker-dealers should provide retail customers at account opening written notification of all service charges and fees. In addition, firms should provide retail customers with written notification at least 30 calendar days prior to the implementation or increase of any service charge or fee. These notifications may be made by electronic means. Furthermore, the schedule should be available on the firm's website without needing password access.

Typical Broker-Dealer Fees

Examples of the more common fees that might be charged by a broker-dealer include the following:

- Issuance of a stock certificate. Although most securities are kept in street name, there could be instances where the customer wants delivery of the physical certificate. There is usually a charge for this service.
- Transferring an account. When a client decides to move the account from one broker-dealer to another, there is usually a charge to cover the administrative expenses of the transfer.
- Wiring funds. Although frequently waived for those with large account balances, if the client needs money wired out of the account, a charge, similar to that made by most banks, is levied against the account.
- Margin account interest. When purchasing on margin, money is borrowed, and the rate of interest charged on the borrowed funds must be disclosed.
- Account maintenance fees. Similar to the monthly charge on your bank statement, many firms charge an annual account fee, particularly for small accounts.
- Safekeeping of funds/securities. This is the charge made for maintaining custody of client assets, which is usually waived for larger accounts.
- Late settlement fee. This is similar to the late fee on a credit card. When a client's payment arrives after the settlement date (or is returned due to insufficient funds), the broker-dealer may assess a fee.
- Postage and handling. Although many firms absorb the cost of normal mailings, express or overnight delivery at the request of the client is usually subject to a charge.

This is not a complete list, but it includes the most common charges. What is most important for the exam is that all of the fees must be disclosed.

TEST TOPIC ALERT

Not included in the fee disclosure documents are:

- commissions;
- markups and markdowns; or
- advisory fees.

There are other documents where those disclosures are made.

Regulation Best Interest (Reg BI)

On June 5, 2019, the Securities and Exchange Commission adopted a package of rulemakings and interpretations designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers, bringing the legal requirements and mandated disclosures in line with reasonable investor expectations while preserving access (in terms of choice and cost) to a variety of investment services and products. Specifically, these actions include new Regulation Best Interest and the new Form CRS Relationship Summary. For investment advisers, this form is also known as Form ADV Part 3.

Regulation BI requires most firms to submit a Form CRS (Client Relationship Summary) to the SEC. It is a disclosure document that must be provided to retail investors at the earliest of opening an account, placing an order, or making any recommendation. Form CRS is viewed by the SEC as a document that should be reader friendly, graphical, and short and should be no longer than two 8.5 × 11-inch pages for a broker-dealer or investment adviser and four pages for dually registered firms (registered as both broker-dealers and investment advisers). The summary may be delivered electronically or on paper. When the form is updated, firms must deliver the new one to retail investors within 30 days after the update was filed with the SEC.

A firm's relationship summary tells retail investors about:

- the types of services a firm offers;
- the fees and costs investors will have to pay for those services;
- conflicts of interest a broker or adviser has;
- the required standard of conduct associated with the services a firm offers;
- whether a firm and its financial professionals have reportable legal or disciplinary history;
- key questions (conversation starters) to ask the financial professional; and
- links or other references to more detailed information.

Each firm's relationship summary will have similarly worded headings and cover generally the same topics in the same order to make it easy for investors to compare firms.

With the release of the revised examination on June 12, 2023, Reg. BI is now being tested. We have already received feedback that Form CRS delivery requirements and the fact that Reg. BI has a standard of care obligation are appearing in questions. Please check the Addendum for more information.

KNOWLEDGE CHECK 13.1

1. As called for on the NASAA Model Fee Disclosure Template, which of the following is *not* required to be disclosed on a broker-dealer's fee chart?
   A. The commission schedule
   B. The account maintenance fee
   C. Charges to wire funds
   D. Postage and mailing charges

2. Fiduciary Investment Group (FIG), an investment adviser registered in six states, from time to time acts as a principal in trades recommended to advisory clients. Under the provisions of the Uniform Securities Act,
   A. FIG is engaging in an unlawful practice.
   B. FIG must receive consent of the clients and disclose its capacity no later than execution of the trade.
   C. FIG must receive consent of the clients and disclose its capacity no later than completion of the trade.
   D. FIG does not need consent because the trade was recommended to existing advisory clients.

LESSON 13.2: MISREPRESENTATIONS, INCLUDING GUARANTEES

LO 13.c Indicate the unlawful representations concerning registrations.

Misrepresentations

Misrepresentation is a prohibited practice. There are two areas covered: registration of the securities professional and registration of a security.

Misrepresenting a Securities Professional's Registration

Once you are registered, what can you say about that? Can you say the Administrator has *approved* of you or your registration? Not at all! Representing that your registration implies any kind of approval of you or your qualifications is a prohibited practice. What you can state is that you are a registered agent of ABC Broker-Dealer, or you are a registered investment adviser representative of the XYZ Investment Adviser. This would also include misrepresenting the nature of the services to be provided.

Misrepresenting a Security's Registration

Similar to the above, it is prohibited to imply that *registration of a security* means that the Administrator (or any regulatory body) has *approved* of the issue. In fact, on the front page (or inside cover) of every prospectus is a statement called the disclaimer, which states that the security has not been approved or disapproved, and any representation to the contrary is a criminal offense.

PRACTICE QUESTION

LMN Securities, a broker-dealer registered with the SEC in more than a dozen states, has just become a member firm of the New York Stock Exchange. It would be permitted for LMN to tell its customers that

A. the membership in the NYSE is a testimony to the integrity of the firm.
B. they are now members of the NYSE.
C. they are now federal covered and will no longer have to register in those states where they do not maintain a place of business.
D. this adds one more level of approval of the firm's business.

Answer: B. When it comes to the registration of any securities professional, any statement relating to approval or something similar is prohibited. There is no such thing as a federal covered broker-dealer, and becoming a member of a national stock exchange has no impact on the state registration of a broker-dealer.

LO 13.d Recall the restrictions on performance guarantees.

Guarantees

There is little that can be guaranteed in this industry.

Guaranteed Security

As mentioned in the beginning of this course, a guaranteed security is where a party other than the issuer guarantees the payment of principal and interest (on a debt security) or dividend (on an equity security). The important thing about that guarantee is that there is no guarantee on the performance of the investment; that is, gains cannot be part of the guarantee.

Guarantee Against Loss

Unfortunately, it is not uncommon in the industry for a securities professional to tell a client something to the effect of, "If this stock doesn't earn X% within the next three months, I'll make up the difference," or, "I am so sure you won't lose on this investment that I'll buy it back from you at your cost plus 10%." Both of these are considered performance guarantees and are prohibited actions.

Perhaps the simplest statement regarding guarantees is found in the NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, where it lists "guaranteeing a client that a specific result will be achieved (gain or no loss) with advice which will be rendered" as one of the prohibitions.

TAKE NOTE

Although performance guarantees are prohibited, under certain circumstances, investment advisers can receive performance-based compensation. That means the advisory contract with the client can provide that an investment return that is better than that of a selected index can result in a higher fee to the adviser. Of course, it must go both ways: if the performance of the account is below that of the index, the fee is reduced.

TEST TOPIC ALERT

If justified, a broker-dealer, but not an associated person of the firm, may correct a bona fide error. An associated person of a broker-dealer cannot do this because of the concern that any such payment may conceal individual misconduct.

Unit 13

KNOWLEDGE CHECK 13.2

1. Which of the following statements may be made by an issuer selling securities to the public that are registered with the Administrator?
   A. The Administrator has cleared this issue for sale to the public.
   B. The Administrator has passed on the adequacy of the information provided in the prospectus.
   C. The Administrator has approved the accuracy of the information contained in the prospectus.
   D. The Administrator has affirmed the merits of the security as an investment.
2. As an incentive to encourage clients to invest in a particular stock recommended by the broker-dealer, clients are told that any time within six months after the purchase date, they may sell the stock back to the firm at original cost plus interest at the state's legal rate. This would be
   A. a right of rescission.
   B. a violation of the antifraud provisions of the Uniform Securities Act.
   C. an offer that could only be made to accredited investors.
   D. a prohibited guarantee against loss.

LESSON 13.3: THE CONTRACT FOR ADVISORY SERVICES

LO 13.e Identify the required elements of the investment advisory contract.

The primary relationship between a client and an investment adviser is evidenced by an investment advisory contract. There are three major differences between federal and state law. The USA prohibits entering into, extending, or renewing any advisory services, unless the contract is in writing, while federal law permits the contract to be written or oral. Another difference concerns the amount of the fees. The USA requires that fees be competitive, while federal law only requires that they be reasonable in view of the services rendered. Finally, the NASAA Model Rule on performance-based compensation is a bit more stringent than that of the SEC, as we will cover in the next unit.

Under both acts, the contract must disclose:

- the services to be provided, including custody if appropriate;
- the term of the contract (contracts can be of any length, not necessarily annual, but all renewals under **state law**, just as with initial contracts, must be in **writing**);
- the amount of the advisory fee or the formula for computing the fee;
- the amount or manner of calculation of the amount of any prepaid fee to be returned in the event of contract termination;
- whether the contract grants discretionary power to the adviser or its representatives;
- that no assignment of the contract may be made by the adviser without the consent of the other party to the contract (the client); and
- that if the adviser is organized as a partnership, any change to a minority interest in the firm will be communicated to the other party to the advisory contract (the client) within a reasonable period of time. A change to a majority of the partnership interests would be considered an assignment.

TAKE NOTE

It is necessary for you to understand the technical definition of *assignment* as used in the acts. When an advisory firm is sold, what do you think its major asset is? Furniture? Computers? No. It is the advisory contracts with clients and, legally, that sale means the contracts have been assigned to the new buyer. This does not mean that the clients have to approve of the sale; they only have to approve of letting the new owner(s) manage their money. They can decide to take their money elsewhere. Assignment also includes any direct or indirect transfer or pledge of an investment advisory contract by the adviser or of a controlling block of the adviser's outstanding voting securities by a stockholder of the adviser. If the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the partners or from the admission to the adviser of one or more partners who, after admission, will be only a minority interest in the business, while a change to a majority would be considered an assignment. However, a reorganization or similar activity that does not result in a change of actual control or management of an investment adviser is not an assignment.

TEST TOPIC ALERT

If a broker-dealer forms a subsidiary that registers as an investment adviser, existing clients of the BD wishing to become clients of the IA must enter into a new contract for advisory services.

PRACTICE QUESTION

ABC Investment Advisers, organized as a partnership, has seven equal partners. At ABC's annual partnership meeting, one of the partners announces their retirement, while another is leaving to become a partner in another firm. As a result, ABC must notify

A. the Administrator of the change in partners within a reasonable period of time.
B. the other party to the contract of the change in partners within a reasonable period of time.
C. the SEC of the change in partners within a reasonable period of time.
D. its advisory clients of the change prior to the renewal date of the firm's registration.

Answer: B. When a minority interest changes in an IA structured as a partnership, notification to the firm's advisory clients (the other party to the advisory contract) must be made within a reasonable period of time.

The acts also prohibit waiving fees in the event of losses in the client's account. The Model Rule states that "indicating, in an advisory contract, any condition, stipulation, or provisions binding any person to waive compliance with any provision of the Uniform Securities Act or of the Investment Advisers Act of 1940" is an unethical business practice.

One final prohibition found in both state and federal law deals with performance-based compensation—that is, including in the advisory contract a provision where the adviser's fee will be increased for good performance and decreased for poor performance. On the exam, unless the question refers to one of the exceptions we're going to learn about in the next unit, you should always take the attitude that performance-based compensation is prohibited.

TEST TOPIC ALERT

This point (waivers) sometimes comes up on the exam. What you have to know is that in all cases on the test (remember, this course is about the *test* world and not the *real* world), waivers are not permitted. For exam purposes, if you are given a question where clients agree to waive their rights to sue, the agreement is null and void.

PRACTICE QUESTION

The Investment Advisers Act of 1940 would permit investment advisory contracts to provide for

I. assignment without the client's consent.
II. changes to be made in a partnership with notification to clients within a reasonable period of time.
III. compensation based on average assets under management over a particular time period.

A. I and II
B. I and III
C. II and III
D. I, II, and III

Answer: C. A client's contracts, whether written or oral (technically, the Investment Advisers Act of 1940 does not require written contracts), may not be assigned without the client's consent under any circumstances. If the adviser is a partnership, notice must be made to clients of any changes in the membership of the partnership within a reasonable time period.

It is always permitted to charge a fee based on the average value of assets under management.

Summary of Notice and Consent

- Investment advisers organized as a partnership must notify clients when there is a change involving a minority of the partners (e.g., 5 equal partners, 1 dies, 1 retires—notification within a reasonable period of time).
- Investment advisers organized as corporations do not have to notify clients of changes to shareholders.
- Investment advisers may only assign client contracts with client permission. Assignment occurs when there is a change to a majority of the partners (in our example above, if one more of the partners left, that would be 3 out of 5—a majority). In the case of a corporation, if a majority of the stock is pledged as collateral for a loan, it is considered an assignment.

KNOWLEDGE CHECK 13.3

1. Which of the following fee arrangements is legal under the Investment Advisers Act of 1940?
   A. Adviser B charges an annual fee of 0.075%, guaranteed to be waived if the value of the account does not increase during the year.
   B. Adviser A charges an annual fee of 0.05% of the value of the client's account, due on the first day of the client's fiscal year.
   C. Adviser C charges an annual fee of 0.05%, waived if the account does not grow by at least 5% during the year.
   D. Adviser D guarantees the annual fee will be waived if the account decreases in value while under her management.
2. Unless qualifying for an exemption, which of the following advisory fee structures is *not* allowed under the Uniform Securities Act?
   A. Fees based on a percentage of the change in value of funds from quarter to quarter
   B. Fees based on an hourly rate
   C. Fees based on a fixed dollar schedule tied to the value of funds under management
   D. Fees based on a percentage of the aggregate value of funds under management

LESSON 13.4: THE INVESTMENT ADVISER BROCHURE

LO 13.f Recall the contents of the investment adviser's brochure including wrap fee programs.

As mentioned earlier, Form ADV Part 2 is a disclosure document that, under state and federal securities laws, is required to be given to clients.

Part 2 consists of the following three parts:

- Part 2A of Form ADV: Firm Brochure
- Part 2A Appendix 1 of Form ADV: Wrap Fee Program Brochure
- Part 2B of Form ADV: Brochure Supplement (describes certain supervised persons)

Under SEC and similar state rules, investment advisers are required to deliver to clients and prospective clients a brochure disclosing information about the firm. They also may be required to deliver a brochure supplement disclosing information about one or more of their supervised persons. Part 2 of Form ADV sets out the minimum required disclosure that the brochure (Part 2A for a firm brochure, or Appendix 1 for a wrap fee program brochure) and brochure supplements (Part 2B) must contain. Here are some of the key points of which you should be aware:

- **Narrative Format.** Part 2 of Form ADV consists of a series of items that contain disclosure requirements for the firm's brochure and any required supplements. The items require narrative responses. If an item does not apply to their business, they must indicate that the item is not applicable. There are 18 items on Form ADV Part 2A (with a 19th one for state-registered advisers only). Remember, this is for clients to use to understand what the IA does so that the information disclosed relates to the way the IA operates the business. Some of the items include:

- a description of the types of advisory services provided,
- fees and compensation and if they are negotiable,
- methods of analysis, investment strategies, and risk of loss,
- disciplinary information,
- how you select or recommend broker-dealers for client transactions,
- custody practices, and
- investment discretion.

- **Plain English.** The items in Part 2 of Form ADV are designed to promote effective communication between the firm and their clients. The brochure and supplements must be written in plain English, taking into consideration the clients' level of financial sophistication. Specifically, the SEC states that the brochure should be concise and direct. The brochure should discuss any conflicts the adviser has or is reasonably likely to have and practices in which it engages or is reasonably likely to engage.
- **Disclosure Obligations as a Fiduciary.** Under federal and state law, IAs act in a fiduciary capacity and must make full disclosure to their clients of all material facts relating to the advisory relationship. As a fiduciary, they also must seek to avoid conflicts of interest with their clients and, at a minimum, make full disclosure of all material conflicts of interest between them and their clients that could affect the advisory relationship.
- **Full and Truthful Disclosure.** Obviously, all information in the brochure and brochure supplements must be true and may not omit any material facts.
- **Filing.** The investment adviser must file the brochure(s) (and amendments) through the IARD system. If the IA is federal covered or in the process of registering with the SEC, it is not required to file the brochure supplements through the IARD or otherwise. However, a copy of the supplements must be preserved and made available to SEC staff upon request. If the IA is registered with or is in the process of registering with one or more state securities authorities, a copy of the brochure supplement (Part 2B) must be filed for each supervised person doing business in that state.

TAKE NOTE

Only in the case of state-registered investment advisers is it required to file the brochure supplements. If you think about it, it makes sense because virtually all of the supervised persons described in the supplements are investment adviser representatives, and they are always registered on a state level only, not with the SEC.

The cover page of the brochure must state the name, business address, contact information, website address (if there is one), and the date of the brochure. Furthermore, the cover page of the brochure must state the following (or other clear and concise language conveying the same information) and identify the document as a brochure:

"This brochure provides information about the qualifications and business practices of [firm name]. If you have any questions about the contents of this brochure, please contact us at [telephone number and/or email address]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority. Additional information about [firm name] also is available on the SEC's website at www .adviserinfo.sec.gov."

Brochure Supplement Disclosing Individual Advisory Personnel

As has been mentioned earlier, Part 2B is a brochure supplement that must contain certain information about "advisory personnel on whom clients rely for investment advice." The brochure supplement is also a narrative format in plain English and includes six required disclosure categories:

- **Cover page** identifying the supervised person (or persons) covered by the supplement as well as the advisory firm
- **Educational background and business experience**, including disclosing if the supervised person has no high school education, no formal education after high school, or no business background
- **Disciplinary information** about material events within the past 10 years, although the SEC says that even if more than 10 years have passed since the date of the event, you must disclose the event if it is so serious that it remains currently material to a client's or prospective client's evaluation
- **Other business activities**, including disclosing if the supervised person receives commissions, bonuses, or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative (agent), and including distribution or service (trail) fees from the sale of mutual funds
- **Additional compensation** beyond that paid by the client (such as a sales award or other prizes)
- **Supervision**, including providing the name, title, and telephone number of the individual responsible for supervising the supervised person's advisory activities on behalf of the firm

Who exactly must be included in the brochure supplement? The investment adviser must prepare a brochure supplement for the following supervised persons:

- Any supervised person who formulates investment advice for a client and has direct client contact
- Any supervised person who has discretionary authority over a client's assets, even if the supervised person has no direct client contact

Balance Sheet Requirement for Federal Covered Advisers

Any federal covered investment adviser whose agreement requires *substantial prepayment of fees* (as defined above) from clients must include a balance sheet with the adviser's ADV Part 2A (brochure) for the adviser's most recent fiscal year. The balance sheet must be prepared and audited by an independent public accountant.

Balance Sheet Requirements for State-Registered Advisers

An audited balance sheet must be included with Form ADV Part 2A (brochure) for any state-registered investment adviser whose agreement *requires substantial prepayment of fees* (as defined above) from clients. In addition, even without the fees, those who maintain custody of client funds and/or securities (covered in Unit 14) must include an audited balance sheet with their ADV Part 2A for their most recent fiscal year with the same requirements. The audited balance sheet is also required when the custodian is a related (affiliated) broker-dealer. Furthermore, state-registered advisers who exercise discretionary authority over client accounts but do not maintain custody must file with the Administrator, within 90 days of the end of the adviser's fiscal year, a balance sheet, but this one does not have to be audited.

Wrap Fee Programs

The rules on disclosure are somewhat different for wrap fee programs. A **wrap fee program** is a program under which a client is charged a specified fee, or fees, not based directly on transactions in a client's account, for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and for execution of client transactions.

Any registered investment adviser compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting or providing advice to clients regarding the selection of other investment advisers in the program, does not use the normal brochure or Part 2A of the ADV. Instead, that adviser furnishes clients and prospective clients Part 2A, Appendix 1.

If the investment adviser sponsors a wrap fee program, it must deliver a wrap fee program brochure to their wrap fee clients—Part 2A, Appendix 1 of Form ADV. If the entire advisory business is sponsoring wrap fee programs, the firm does not need to prepare a firm brochure separate from the wrap fee program brochure(s). In other words, if all the IA does is sponsor wrap fee programs, it must prepare and deliver a completed Part 2A, Appendix 1, but not a Part 2A.

Some of the required disclosures required under Appendix 1 include:

- a statement on the cover page of the wrap fee program brochure stating the following (or other clear and concise language conveying the same information) and identifying the document as a wrap fee program brochure:

  "This wrap fee program brochure provides information about the qualifications and business practices of [firm name]. If you have any questions about the contents of this brochure, please contact us at [telephone number and/or email address]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority. Additional information about [firm name] also is available on the SEC's website at www.adviserinfo.sec.gov."
- the amount of the wrap fee charged for the program;
- whether the fees are negotiable;
- the services provided under the program, including the types of portfolio management services;
- a statement that the program may cost the client more or less than purchasing these services separately;
- a description of the nature of any fees that the client may pay in addition to the wrap fee;
- if the person recommending the wrap fee program to the client receives compensation as a result of the client's participation in the program:
  - explain, if applicable, that the amount of this compensation may be more than what the person would receive if the client participated in the firm's other programs or paid separately for investment advice, brokerage, and other services, or
  - explain that the person, therefore, may have a financial incentive to recommend the wrap fee program over other programs or services;
- if a wrap fee program imposes any requirements to open or maintain an account, such as a minimum account size, disclose these requirements—if there is a minimum amount for assets placed with each portfolio manager as well as a minimum account size for participation in the wrap fee program, disclose and explain these requirements;

- describing how portfolio managers are selected and reviewed, the basis for recommending or selecting portfolio managers for particular clients, and the criteria for replacing or recommending the replacement of portfolio managers for the program and for particular clients;
- disclosing whether any of the firm's related persons act as portfolio managers for a wrap fee program described in the wrap fee program brochure:
  - explain the conflicts of interest faced because of this arrangement and describe how these conflicts of interest are addressed,
  - disclose whether related-person portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the wrap fee program, or
  - if they are not, describe how related-person portfolio managers are selected;
- explanation of any restrictions placed on clients' ability to contact and consult with their portfolio managers; and
- descriptions by state-registered investment advisers of any relationship or arrangement that they or any of their management persons have with any issuer of securities that is not already listed in Part 2A.

TEST TOPIC ALERT

It is generally agreed that "buy and hold" clients are not suitable for a wrap fee account because they don't do enough trading to benefit from the fact that commissions are included in the program fee. Because trading costs (commissions and markups) are included in the wrap fee, it is unlikely to see a complaint of churning. After all, churning is done to generate excess commissions, and that could not be the case in a wrap fee program.

LO 13.g Compare the state and federal brochure delivery requirements.

Brochure Delivery Requirements

Both federal and state-registered advisers must prepare and deliver a brochure to their clients. If the question does not specify federal or state-registered (or refer to the Investment Advisers Act of 1940 or the Uniform Securities Act), you should assume they are asking about a state-registered adviser. It is, after all, NASAA's exam. In keeping with modern technology, these brochures may be delivered electronically.

Delivery Requirements for SEC Registered Advisers

A firm brochure must be delivered to each client. It must be delivered even if the advisory agreement with the client is oral (under federal law, contracts may be oral or in writing; under state law, they must be in writing).

The firm brochure must be given to each client before or at the time an advisory agreement is entered into with that client. Thereafter, each year, within 120 days of the end of the fiscal year, a free, updated brochure must be delivered to each client that either includes a summary of material changes or is accompanied by a summary of material changes; or, alternatively, it would be permitted to deliver to each client a summary of material changes that includes an offer to provide a copy of the updated brochure and information on how a client may obtain the brochure.

TAKE NOTE

If there are no material changes, then nothing—not the brochure, nor the brochure supplement, nor the summary—is required to be sent.

Although, as we will see below, the brochure must be updated promptly when something becomes materially inaccurate, the only time that an interim amendment must be delivered to all clients is when there is a disciplinary action. This interim amendment can be in the form of a document describing the material facts relating to the amended disciplinary event.

Delivery Requirements for State-Registered Advisers

The brochure delivery requirements for state-registered advisers are essentially the same as that for covered advisers with one very important exception: under the NASAA Model Rule on adviser brochures, advisers are required to deliver the brochure to the client at least 48 hours before entering into an advisory contract, or at the time of entering into an advisory contract if the advisory client has the right to terminate the contract without penalty within five business days after entering into the contract. Some advisers charge a startup or setup fee. Any new client who does not receive a brochure at least 48 hours before entering into an advisory agreement may terminate the agreement and be refunded the setup fee. However, it would not be considered a penalty for the adviser to make a pro rata charge for management services rendered during that five-business-day period.

Delivery of the Brochure Supplements

Initially and annually, the investment adviser must deliver to a client the brochure supplements for each supervised person who provides advisory services to that client. However, there are three categories of clients to whom the IA is not required to deliver supplements:

- Clients to whom the IA is not required to deliver a firm brochure (Part 2A) or a wrap fee program brochure (Appendix 1 to Part 2A). The logic here is that because the supplement *is a supplement to* the brochure, if there is no brochure, why would there be a supplement?
- Clients who receive only impersonal investment advice, even if they receive a firm brochure. An example of this would include those paying $500 or more per year for a subscription.
- Individual clients who are any executive officers, directors, trustees, or general partners, or people serving in a similar capacity, of that firm; or any employees of that firm (other than employees performing solely clerical, secretarial, or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of that firm and have been performing such functions or duties for at least 12 months.

Exemptions from the Brochure Rule

There are two exemptions under both state and federal law from the delivery requirements of the rule.

- Contracts with an investment company registered under the Investment Company Act of 1940 (e.g., mutual funds) are exempted because those contracts are covered by that act.
- Advisers entering into a contract providing solely for impersonal advisory services—that is, publishers of market letters—are exempt from the rule's initial delivery requirements. If the annual charge for this service is $500 or greater, delivery of the brochure must be offered with the same two timing options listed above.

Updating the Brochure

The brochure must be updated:

- each year at the time of filing the annual updating amendment; and
- promptly, whenever any information in the brochure becomes materially inaccurate.

It is not required to update the brochure between annual amendments solely because the amount of client assets under management has changed. If the fee schedule has changed, then only those clients affected by the change must receive an amended brochure. However, if the brochure is being updated for a separate reason in between annual amendments (a disciplinary action, some other material change, and so forth), the IA should update that item(s) as part of the interim amendment.

If, when preparing the annual updating amendment, there are no material changes to the previous brochure, and there have been no interim amendments making material changes to the brochure that was filed with the previous year's annual updating amendment, a summary of material changes does not have to be prepared (because there is nothing to say). Read what the SEC has to say about that: "If you do not have to prepare a summary of material changes, you do not have to deliver a summary of material changes or a brochure to your existing clients that year. If you are a state-registered adviser, you should contact the appropriate state securities authorities to determine whether you must make an annual offer of the brochure." That means that a new brochure doesn't even have to be offered (in the case of federal covered advisers) if there has been no material change.

Try to follow these next two points.

- Federal covered advisers are required to file amendments to their brochure electronically through IARD. They are not required to file amendments to the brochure supplements with the SEC, but they must maintain a copy of them in their files.
- State-registered advisers are required to file amendments to their brochure and amendments to their brochure supplements with the appropriate state securities authorities through IARD.

Why the difference? I think it just makes it easier for NASAA to write a hard test question. Finally, if the IA has no clients to whom delivery of a brochure is required, they don't have to prepare one.

Form ADV facts: Part 1B is only filed by state-registered advisers; only state-registered advisers file Part 2 with their regulators, while federal covered advisers must keep theirs on hand for inspection; Part 2A is the brochure that must be delivered to clients of all IAs within 120 days of the end of the fiscal year. A brochure supplement may be delivered instead, showing the material changes. If there are no material changes, there is no need to send a brochure. The Part 1A annual amendment must be sent to the SEC or Administrator within 90 days after the end of the fiscal year.

PRACTICE QUESTION

Many students get confused over the 90-day and 120-day requirements. This example should help:

Which two of the following statements accurately describe the time limits for investment adviser documents?

I. Filing of the annual updating amendment to Form ADV with the appropriate regulatory body is within 90 days of the end of the adviser's fiscal year.
II. Filing of the annual updating amendment to Form ADV with the appropriate regulatory body is within 120 days of the end of the adviser's fiscal year.
III. Delivery of the investment adviser's brochure to the customer is due within 90 days of the end of the adviser's fiscal year.
IV. Delivery of the investment adviser's brochure to the customer is due within 120 days of the end of the adviser's fiscal year.

A. I and III
B. I and IV
C. II and III
D. II and IV

Answer: B. Some logic here might help. The investment adviser must get its paperwork into the state (or SEC) prior to the end of the 90-day period. Then, the IA has another 30 days to get the information into the brochure to be sent to the clients.

KNOWLEDGE CHECK 13.4

1. Which of the following legal or disciplinary actions occurring within the past 10 years would *not* have to be disclosed on an investment adviser's brochure?
   A. Conviction of a misdemeanor in a civil action regarding payment of parking tickets
   B. Conviction of a misdemeanor involving an investment-related business
   C. SEC or other federal regulatory agency proceedings in which the person was found in violation of an investment-related statute
   D. A proceeding before FINRA in which the person was barred or suspended from membership
2. With regard to the brochure rule of the Investment Advisers Act of 1940, which of the following is exempt from the delivery requirements of that rule?
   A. An adviser whose only clients are registered investment companies
   B. An adviser whose only clients are insurance companies
   C. An adviser who only provides impersonal advisory services at an annual charge of less than $500
   D. All of the above

LESSON 13.5: CORRESPONDENCE AND ADVERTISING

LO 13.h Describe the proper use of social media for communicating with customers and prospects.

It should be clear that disclosure and fairness are the primary themes underlying all communications with customers. Use of social media websites for business purposes should be treated no differently from any other business-related electronic communication. Firms must ensure they have sufficient systems, policies, and procedures to supervise, review, and retain business communications made using social media sites. In this final segment of the unit, we will address several of the specific methods used to communicate with both existing and prospective clients.

Definition: social media. The SEC's definition of *social media* is "an umbrella term that encompasses various activities that integrate technology, social interaction, and content creation. Social media may use many technologies, including, but not limited to, blogs, microblogs, wikis, photos and video sharing, podcasts, social networking, and virtual worlds." The terms *social media, social media sites, sites*, and *social networking sites* are used interchangeably in the industry.

Social Media, Including Email and Text Messages

Communication with customers has historically been through written correspondence, while the traditional way of reaching prospects has been through print, TV, and radio advertising. In the 21st century, however, snail mail has given way to email, texting, and the broker-dealer's website. Prospects are being reached through various social networks as well as the internet.

At the time of this printing, NASAA's primary concern with social media has been alerting investors to the risks. Although some of that may be tested, it is probable that the Series 65's focus will be on usage of social media by securities professionals. As has been done with other topics not directly addressed by NASAA, we will rely on the policies adopted by other regulators. But first, let's look at some of NASAA's comments regarding investor awareness.

Investor Concerns Regarding Social Media

Social networking in the internet age allows people to connect to one another more quickly and easily than ever before. Investment promoters increasingly are logging on to find investors and their money.

The role of the securities professional is to help protect clients from falling prey to the many phony schemes found on social networks.

While social networking helps connect people with others who share similar interests or views, con artists infiltrate these social networks looking for victims. By joining and actively participating in a social network or community, the con artist builds credibility and gains the trust of other members of the group. In online social networks, a con artist can establish this trust and credibility more quickly. The scammer has immediate access to potential victims through their online profiles, which may contain sensitive personal information such as their dates or places of birth, phone numbers, home addresses, religious and political views, employment histories, and even personal photographs.

The con artist takes advantage of how easily people share background and personal information online and uses it to make a skillful and highly targeted pitch. The scam can spread rapidly through a social network as the con artist gains access to the friends and colleagues of the initial target.

TAKE NOTE

Social media generally takes two forms: static and interactive. **Static content** remains posted until changed by the person who established the account on the site. Generally, static content is accessible to all visitors to the site. Examples of static content typically available through social networking sites include company websites, profiles, backgrounds, or walls.

Interactive content, as the name implies, has input from both the creator and the viewer. Common examples include blogs, Facebook, Twitter, Instagram, and LinkedIn.

Online Red Flags for Investors

Online red flags for investors include:

- Promises of high returns with no risk. Many online scams promise unreasonably high short-term profits. Guarantees of returns around 2% a day, 14% a week, or 40% a month are too good to be true. Remember that risk and reward go hand in hand.
- Offshore operations. Many scams are headquartered offshore, making it more difficult for regulators to shut down the scam and recover investors' funds.
- E-currency sites. If investors have to open an e-currency account to transfer money, use caution. These sites may not be regulated, and con artists use them to cover up money trails.
- Recruiting friends. Most cons will offer bonuses if investors recruit their friends into the scheme.
- Professional websites with little to no information. These days anyone can put up a website. Scam sites may look professional, but they offer little to no information about the company's management, location, or details about the investment.
- No written information. Online scam promoters often fail to provide a prospectus or other form of written information detailing the risks of the investment and procedures to get the investor's money out.
- Testimonials from other group members. Scam artists frequently pay out high returns to early investors using money from later arrivals. This type of scam is a Ponzi scheme. Fraud aimed at groups of people who share similar interests is called affinity fraud.

PRACTICE QUESTION

One of your clients approaches you to get your evaluation of an investment opportunity that was received through a Facebook post sent by a friend. The investment promises a monthly return in excess of 1% and claims that it is registered with an offshore regulatory body. You should explain to your client that

A. these are reasonable expectations based on the investment and the location of the issuer.
B. your firm does not sell that security and, as a result, you cannot make any comments about the issue.
C. it is important to check with the friend to find out more about the deal.
D. these are red flags and are a clear warning to stay away from this investment.

Answer: D. Unreasonably high returns and not being registered in the United States are two items on the list of red flag warnings to investors published by NASAA.

Regulatory Concerns About Social Media

Both the SEC and FINRA have established policies, most of which are used as the basis for disciplinary actions when the Administrator's staff conducts an examination of broker-dealers and investment advisers located in her state.

FINRA has offered guidance to broker-dealers and registered personnel in their notices to members regarding the use of different technologies and devices for the delivery of business communications. As the technology, communications platforms, and devices are ever-changing, so will be the guidance, and FINRA will continue to supply interpretive materials to assist in that respect. Currently, the use of email, instant messaging, chat rooms, blogs, bulletin boards, and websites—including social networking sites such as Facebook, LinkedIn, and Twitter—are all included within FINRA's guidance.

While the challenge is generally to determine which category of public communication any piece falls under to then determine its supervisory and filing requirements, FINRA has said that it will always be the **content** delivered that ultimately determines this, and not the technology, platform, or device used to deliver it. In this light, FINRA reminds broker-dealers that compliance responsibilities when communicating via the internet or other electronic media are the same as in face-to-face discussions or in written communications with the public. Therefore, all existing FINRA rules and regulations applicable to communications with the public would also be applicable to communications delivered electronically by any technology or device if the content is business related. In addition, registered representatives (agents) must be aware of internal firm policies and procedures that may restrict or prohibit the use of certain electronic communications, and in those instances, FINRA directs that employees of the firm must abide by the firm's internal policies.

Although social media has been around for some time, it has now caught the attention of the SEC (and every other regulator, for that matter). You might ask, "Why should I be concerned with my emails or Facebook posts?" Well, here are just a couple of examples of how and why the regulators react.

The problem for regulated financial institutions is that inappropriate use of email and other social media can mean noncompliance with government and industry regulations, resulting in hefty fines, potential loss of business, and fraud. A few years ago, a major international bank lost nearly €4.9 billion in fraudulent trades by a rogue employee that used instant messaging to manage the transactions. On a smaller level, in early 2016, an agent was fined $18,000 and suspended from association with any broker-dealer for a period of two years for sending an unapproved email to prospective clients. During the same time period, a broker-dealer was fined $1.3 million, and one of its agents was fined $42,000, for failure to retain emails as required. So, this is serious business to the regulators.

You need to know that agents are duty bound to follow the rules and regulations surrounding electronic communications, even during their own time, if they are identifiable as a representative of the securities firm. Members of the marketing team might understand what is appropriate to post to Facebook or what process to follow to post, but without proper training, average agents may not. Their posts or photographs from weekend parties might not be suitable content.

Review and Supervision of Electronic Communications

When it comes to review and supervision, it is important to note that the terms *electronic communications, email,* and *electronic correspondence* may be used interchangeably and can include such forms of electronic communications as instant messaging and text messaging. This is particularly important for those firms that permit their agents or investment adviser representatives to maintain social media platforms.

Website Storage

Websites are treated as would be any other advertisement. So, the original site design is kept for three years and, whenever revised, the new copy is maintained and starts a new retention requirement for that copy. Therefore, you will likely have several different versions in your advertising file at the same time.

TAKE NOTE

Two related terms may appear on your exam. If a firm permits a third-party post on its website or provides links to a third-party site, it will be considered that the firm is entangled with that post or link if the firm participates in the development or preparation of the content. A firm may be deemed to "adopt" a third-party post or content on a third-party site if the firm or its personnel explicitly or implicitly endorses or approves the post or the content. The key to *entanglement* is that your firm had a part in its authorship, whereas *adoption* is the use of content or a link that is solely the creation of someone else—your firm is just using it.

If you are active on social media, you are no doubt familiar with the term *influencer*. In the investment business, we have seen the rise of the *finfluencers*. These are influencers who produce content on financial topics. In some cases, their popularity is such that a positive comment about a stock can cause its price to soar (and a negative comment the reverse). If a BD or IA adopts any of their posts, the firm is responsible for the content and must be sure it is fair and balanced. We'll mention them again under investment adviser advertising.

LO 13.i Recognize the differences between advertising by broker-dealers and advertising by investment advisers.

Advertising

The NASAA Statement of Policy on Dishonest or Unethical Business Practices of Broker-Dealers and Agents considers it to be an unethical business practice to use any advertising or sales presentation in such a fashion as to be deceptive or misleading. An example of such practice would be:

- a distribution of any nonfactual data;
- any material or presentation based on conjecture;
- exaggerated or unrealistic claims in any brochure, flyer, or display by words, pictures, or graphs; or
- anything otherwise designed to supplement, detract from, supersede, or defeat the purpose or effect of any prospectus or disclosure.

One way in which this violation occurs is when a broker-dealer or agent prepares a sales brochure for a new issue but includes only the positive information from the prospectus. Leaving out risk factors and other potentially deal-killing information is prohibited. Somewhat related, and also prohibited, is **highlighting**, or making any other marks on a prospectus to draw attention to key points.

Broker-Dealer Advertising

At least for exam purposes, every broker-dealer is a FINRA member and must comply with FINRA's rule on communication with the public. The specifics of that rule (2210) are beyond the scope of the exam, so we will focus on NASAA's policies.

Included in advertising is a firm's website. Whether through the website or other social media, an important form of communications with the public is the making of recommendations.

A logical question is, do recommendations made through social media come under the same suitability constraints as any other recommendation? The reply is just what you would expect: of course they do. But it is not always obvious when a particular communication constitutes a recommendation for purposes of the suitability rule. Because so much hinges on what is considered to be a recommendation, let's look further at some examples of what is and what is not a recommendation.

In addition to when a broker-dealer acts merely as an order-taker regarding a particular transaction (an unsolicited transaction, which we know is an exempt transaction—exempt from the registration and advertising filing requirements under the USA), the policy generally would view the following activities and communications as falling **outside** the definition of *recommendation.*

- A broker-dealer creates a website that is available to customers or groups of customers. The website has research pages or electronic libraries that contain research reports (which may include buy-sell recommendations from the author of the report), news, quotes, and charts that customers can obtain or request.
- A broker-dealer has a search engine on its website that enables customers to sort through the data available about the performance of a broad range of stocks and mutual funds, company fundamentals, and industry sectors. The data are not limited to, and do not favor, securities in which the BD makes a market or has made a buy recommendation. Customers use and direct this tool on their own. Search results from this tool may rank securities using any criteria selected by the customer, and may display current news, quotes, and links to related sites.
- A broker-dealer provides research tools on its website that allow customers to screen through a wide universe of securities (e.g., all exchange-listed and Nasdaq securities) or an externally recognized group of securities (e.g., certain indexes) and to request lists of securities that meet broad, objective criteria (e.g., all companies in a certain sector with 25% annual earnings growth). The BD does not impose limits on the manner in which the research tool searches through a wide universe of securities, nor does it control the generation of the list in order to favor certain securities. For instance, the BD does not limit the universe of securities to those in which it makes a market or for which it has made a buy recommendation. Similarly, the algorithms for these tools are not programmed to produce lists of securities based on subjective factors that the BD has created or developed, nor do the algorithms, for example, produce lists that favor those securities in which the BD makes a market or for which the BD has made a buy recommendation.

- A broker-dealer allows customers to subscribe to emails or other electronic communications that alert customers to news affecting the securities in the customer's portfolio or on the customer's watch list. Such news might include price changes, notice of prescheduled events (such as an imminent bond maturation), or generalized information. The customer selects the scope of the information that the firm will send to him.

On the other hand, the regulators generally would view the following communications as falling **within** the definition of *recommendation*:

- A broker-dealer sends a customer-specific electronic communication (e.g., an email or pop-up screen) to a targeted customer or targeted group of customers, encouraging the particular customer(s) to purchase a security.
- A broker-dealer sends its customers an email stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with buy recommendations.
- A broker-dealer provides a portfolio analysis tool that allows a customer to indicate an investment goal and input personalized information such as age, financial condition, and risk tolerance. The BD, in this instance, then sends the customer a list of specific securities the customer could buy or sell to meet the investment goal the customer has indicated.
- A broker-dealer uses data-mining technology (the electronic collection of information on website users) to analyze a customer's financial or online activity—whether or not it is known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security.

It is important to keep in mind that these examples are meant only to provide guidance and are not an exhaustive list of communications that are or are not considered to be recommendations. They recognize that many other types of electronic communications are not easily characterized. In addition, changes to the factual suppositions upon which these examples are based (or the existence of additional factors) could alter the determination of whether similar communications may or may not be viewed as recommendations.

In addition, the rules have always permitted the use of **testimonials** for broker-dealers, but until the new investment adviser marketing rule (see following) they were strictly forbidden for use by IAs.

Broker-dealers, therefore, should analyze all relevant facts and circumstances to determine whether a communication is a recommendation, and they should take the necessary steps to fulfill their suitability obligations.

Investment Adviser Advertising

When it comes to investment advisers, the NASAA Model Rule states that publishing, circulating, or distributing any advertisement which does not comply with the Investment Advisers Act of 1940 would be prohibited. On December 20, 2020, the SEC adopted amendments under the Investment Advisers Act of 1940 that finalized reforms under the act to modernize rules that govern investment adviser advertisements and payments to solicitors. The amendments create a single rule that replaced the previous advertising and cash solicitation rules.

These amendments are known as the Investment Adviser Marketing Rule. NASAA began including material on those amendments on April 1, 2022. Here are some key points that are testable:

Advertisements

The amended definition of *advertisement* includes two separate parts. The first part generally includes the kinds of communications traditionally covered by the advertising rule, and the second generally includes the kinds of activities previously covered by the cash solicitation rule.

- The first part includes any direct or indirect communication an investment adviser makes that (1) offers the investment adviser's investment advisory services with regard to securities to prospective clients or private fund investors, or (2) offers new investment advisory services with regard to securities to current clients or private fund investors.
  - The first part does not include one-on-one communications. However, hypothetical performance information does not qualify for this one-on-one exclusion unless provided in response to an unsolicited investor request or to a private fund investor.
  - The first part also does not include extemporaneous, live, oral communications and information contained in a statutory or regulatory notice, filing, or other required communication.
  - On the other hand, prepared material, such as scripts or slides to be used in a presentation, are likely going to be considered advertisements.
- The second part generally includes any endorsement or testimonial for which an adviser provides cash or noncash compensation directly or indirectly (e.g., directed brokerage, awards or other prizes, and reduced advisory fees).

Under the amendments, the definition of *advertisement* now includes:

- third-party information if the adviser has either endorsed or approved the information after publication or involved itself in the preparation of the information; e.g., it is adopted or entangled. A growing concern of the regulators is the adoption (or even entanglement) with finfluencers;
- communications to "investors in a private fund"; and
- extemporaneous, live, **written** communications such as texts or electronic chats.

Unit 13

General Prohibitions

Under the general prohibitions, an investment adviser's advertisement may not:

- include an untrue statement of a material fact, or omit to state a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
- include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
- include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;
- discuss any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
- reference specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- contain a statement that any analysis, report, or service will be furnished for free when that is not the case;
- represent that a chart, formula, or other device being offered can, by itself, be used to determine which securities are to be bought or sold;

- include or exclude performance results, or presenting performance time periods, in a manner that is not fair and balanced;
- otherwise be materially misleading; or
- represent or imply that the adviser has been sponsored, recommended, or approved, or that its abilities or qualifications have in any respect been passed upon, by the SEC or the Administrator (for example, the SEC has taken the position that the use of the initials *RIA* following a name on printed materials would be misleading because, among other things, it suggests that the person to whom it refers has a level of professional competence, education, or other special training, when in fact there are no specific qualifications for becoming a registered investment adviser; the term *registered investment adviser* may be used, but not the initials).

TEST TOPIC ALERT

One thing to look for on the exam deals with investment advisers who advertise a charting or similar system—they must indicate that there are limitations and difficulties inherent in using such programs.

Testimonials

For the first time since the passage of the act in 1940, the marketing rule permits the use of testimonials (statements from clients about their experience with the investment adviser) and endorsements (statements by persons who are not clients) in an advertisement, if the adviser satisfies the following disclosures:

- Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement (the "promoter") is a client;
- That cash or noncash compensation was provided for the testimonial or endorsement, if applicable;
- A brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person;
- Solicitors may be considered promoters for purpose of the rule; and
- Investment advisers also must enter into a written agreement with promoters, except where the promoter is an affiliate of the adviser or the promoter receives de minimis compensation (i.e., $1,000 or less, or the equivalent value in noncash compensation, during the preceding 12 months). If exceeding the de minimis level, a copy of this agreement shall be made available to those receiving these testimonials and endorsements.

TAKE NOTE

Although the SEC traditionally referred to those who engaged in compensated solicitation activity under the previous rule as **solicitors**, it uses the term **promoter** in the new rule to refer to a person providing a testimonial or endorsement, whether compensated or uncompensated. The rule also uses the term **provider** at times when discussing a person providing an uncompensated testimonial or endorsement. Unless falling under the de minimis rule, when it comes to receiving compensation—**yes** for promoters and **no** for providers. It turns out that there is a serious distinction. Promoters are subject to the "bad actor" rule (LO 8.d and LO 9.c) and are disqualified from receiving compensation while providers are not (because they never receive compensation).

TAKE NOTE

The "like" feature on an investment adviser's social media site could be deemed to be a testimonial if it is an explicit or implicit statement of a client's experience with the adviser. Not included in compensation is salary or bonuses paid to employees of the investment adviser.

Past Performance

The marketing rule allows the inclusion of performance information in an advertisement if certain conditions are met. Specifically, the marketing rule prohibits including in any advertisement:

- gross performance, unless the ad also includes net (after fees) performance;
- any performance results, unless they are provided for specific time periods (the most recent 1-, 5-, and 10-year periods to the extent applicable);
- "cherry-picking" by showing only the best performing portfolios;
- hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the intended audience; and
- predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser.

TEST TOPIC ALERT

Look for the terms *fair* and *balanced* as a description of the content of any advertising.

TAKE NOTE

Under the rule, a promotional piece is an advertisement if addressed to more than one person. As covered in Unit 9, LO 9.g, both NASAA's rule and the SEC require maintaining a copy of all ads distributed to two or more persons.

TEST TOPIC ALERT

In the same manner that the use of the designation *RIA* is prohibited, investment adviser representatives may not use the initials *IAR* on business cards or any other literature. Yes, the exam might use *IAR*, but you can't. What you can use on your business card are certain recognized professional or academic designations (assuming you've earned them). Examples would include *CPA, CLU®, CFA®, CFP®, MBA, JD,* or *PhD.*

These prohibitions are fundamental and sound standards that all investment advisers should follow.

Finally, Form ADV Part 1A has a new item, 5 L, that must be submitted each year as part of the annual updating amendment. It looks like this:

L. Marketing Activities

1. Do any of your advertisements include:
   a. Performance results?
   b. A reference to specific investment advice provided by you?
   c. Testimonials?
   d. Endorsements?
   e. Third-party ratings?
2. If you answered "Yes" to L(1)(c), (d), or (e) above, do you pay or otherwise provide cash or noncash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings?
   - Yes
   - No
3. Do any of your advertisements include hypothetical performance?
   - Yes
   - No
4. Do any of your advertisements include predecessor performance?
   - Yes
   - No

Issues Related to Agents

While much of the supervisory burden revolves around broker-dealer use of various social media tools, the nitty-gritty, day-to-day work relates to their agents. Some things to be aware of include the following:

- In addition to computers in the office, personal devices (Blackberry, iPhone, Android, etc.) used to communicate with clients in a social media setting are covered by the rules.
- Depending on the nature of the media, prior approval by a supervisory person may or may not be required. For example, an "unscripted" participation in an interactive electronic forum (such as Twitter) generally does not require prior supervisory approval. On the other hand, a LinkedIn page would probably require preapproval.
- Look out for the red flags. Certain activities, such as linking to third-party sites or receiving data feeds from outside sources, could contain information that NASAA considers objectionable.
- It is not the device or technology that determines if a piece delivered by a broker-dealer or any agent is subject to approval and recordkeeping. Rather, it should always be the content that determines if a piece delivered by an agent is subject to approval and recordkeeping.

It is suggested that Twitter posts are easy to monitor, but sites such as Facebook are not, given what they've termed *entanglement* issues (i.e., the firm or its personnel is involved with the preparation of a third-party post) and the challenges they pose. Essentially, who is responsible for links to a third-party site, and who is responsible for third-party postings to an agent's Facebook page?

Specifically regarding Twitter, posts do *not* need supervisory preapproval except for an agent's initial tweet.

LinkedIn is considered different from Facebook, as it is more of a business networking site than a social site. With that, it is believed that information limited to your current position, past positions, and job responsibilities allow the site to be left unmonitored, as the firm would have no responsibility regarding that content for any individual. However, if testimonials are used on the site ("Joe is the best stockbroker in the world," or "I've made a ton of money because of Sheila's recommendations"), or if recommendations are posted on the site, then that would make it a business site that the firm is now responsible for.

EXAMPLE

The regulatory bodies are concerned about agents using social media to communicate with clients when they are using their

I. office desktop computers.
II. tablets supplied by the firm.
III. smartphones.
IV. personal laptops while on vacation.

A. I and II
B. I and IV
C. II, III, and IV
D. I, II, III, and IV

Answer: D. The format is not what counts; it is the content that matters.

Supervisory Actions to Be Taken by the Broker-Dealer or Investment Adviser

Prior to allowing associated persons to use social media for business purposes, a firm's policies and procedures must provide for personnel training and education relating to the parameters of permitted use. Both supervisory personnel and agents need to understand the difference between interactive and static content, between business and nonbusiness communications, and whether the communication is a retail communication requiring preapproval. A firm should consider requiring training in the use of social media prior to permitting use. At a minimum, a firm that permits use of social media sites must hold annual training as part of its continuing education obligations. Any such training will reinforce personnel understanding of the firm's policies and procedures as applied to this continuously evolving technology and, in turn, limit the firm's compliance risks.

One of the unintended consequences of the growth of social media has been exposure to privacy issues. The firm's social media policies should include relevant privacy issues. We will cover those in the next unit when we discuss cybersecurity and data protection.

To summarize, because the technology behind social media continues to advance at such a rapid pace, potential damage to both the firm and employee exists. The potential for reputational and financial loss from any employee's or firm's mistake is difficult to quantify. To mitigate these, prior to venturing into any form of social media, it is suggested that firm policies should:

- be committed to writing and communicated firmwide;
- be written in a clear and concise manner so as to eliminate confusion;
- define the responsibilities of all concerned parties to minimize confusion and maximize expectations; and
- clearly describe the monitoring tools to be used by the firm.

Until the law catches up with technology, a useful way to reduce and manage unforeseeable social media risk is to create a work environment that fosters a strong culture of compliance.

PRACTICE QUESTION

Which of the following is **not** a factor when a communication to be distributed to the public is either being reviewed or approved by the investment adviser?

A. Whether statements of benefits are balanced with statements of potential risks
B. The nature of the audience to which the communication is intended to be distributed
C. Whether the piece will be distributed in written form or on the firm's website
D. Whether the communication is targeting existing customers or prospective ones

Answer: C. The format is not what counts; it is the content that matters.

KNOWLEDGE CHECK 13.5

1. One of your customers is a member of a local fraternal organization. He sends you a flyer he received in the mail two days ago. The flyer discusses an investment offering very attractive returns and promotes the fact that the principals of the business are also active in the organization. The flyer closes with an appeal to join in with their "brothers" and prosper. This is an example of
   A. a Ponzi scheme.
   B. an exaggerated claim.
   C. an offshore operation.
   D. possible affinity fraud.
2. One respect in which the rules dealing with broker-dealer advertising differ from those for investment advisers is that
   A. broker-dealers can advertise past performance, while investment advisers cannot.
   B. broker-dealers can use social media, while investment advisers cannot.
   C. broker-dealers can highlight critical information in a prospectus, while investment advisers cannot.
   D. none of the above are true statements.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 13.1

1. **A** Commissions, markups and markdowns, and advisory fees are not part of the NASAA fee disclosure template.

   LO 13.a

2. **C** This practice is not unlawful as long as the investment adviser obtains the required consent and makes the appropriate disclosures on a timely basis. That time limit is no later than the completion of the trade (the settlement date). If FIG is also a broker-dealer and a client makes a trade that is not initiated through an advisory recommendation, then acting as a principal only requires disclosure of capacity, not consent.

   LO 13.b

Knowledge Check 13.2

1. **A** The Administrator does not approve or disapprove of securities. Rather, the Administrator reviews registrations for omission of material facts and clarity of information and makes certain that all supporting documentation is included. If these requirements are met, the Administrator clears or releases the security for sale to the public.

   LO 13.c

2. **D** Offering to buy back a stock at its original cost, even without paying interest, is a prohibited guarantee against loss. Rescission is only when there was something improper about the sale. Technically, this offer is not a case of fraud, and in any event, we must always select the answer that best addresses the question—in this case, a guaranteed price.

   LO 13.d

Knowledge Check 13.3

1. **B** An adviser's fee may not be based on portfolio appreciation or capital gains, except under certain circumstances that are not detailed in the question. Advisory fees may be based on a percentage of assets under management. There should be no question on the exam where "waiving" something will be permitted.

   LO 13.e

2. **A** Unless a specific exception is referred to in the question, fees based on a share of capital gains or appreciation in an account are prohibited. The other choices are acceptable fee structures.

   LO 13.e

Knowledge Check 13.4

1. **A** An investment adviser must disclose, in its brochure, all adverse regulatory events to clients and prospective clients if they occurred within the past 10 years. Examples would include a conviction relating to a misdemeanor involving an investment-related business, SEC or other federal regulatory agency proceedings in which the person was found to have violated an investment-related statute, or proceedings before FINRA in which the person was barred or suspended from membership. Misdemeanors regarding noninvestment-related actions are not considered material and need not be disclosed (e.g., parking tickets).

   LO 13.f

2. **D** An adviser to investment companies and an adviser who provides only impersonal advisory services are specifically listed as being exempt from the delivery requirements of the brochure rule (impersonal advice with a charge of $500 or more would require an offer to deliver). An adviser who provides advice only to insurance companies is exempt from registration as an investment adviser and therefore would also be exempt from the requirements of the brochure.

   LO 13.g

Knowledge Check 13.5

1. **D** An investment promoted to members of a religious or social group are often designed to take advantage of the communal friendship. This is the red flag known as affinity fraud.

   LO 13.h

2. **D** Both BDs and IAs can advertise past performance and use social media as long as the rules are followed. Neither can make any marks on a prospectus or any other type of offering document.

   LO 13.i

UNIT 14

Ethical Practices and Obligations

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

› LO 14.a **Identify** the important fiduciary responsibilities when providing investment advisory services.
› LO 14.b **Describe** how the Prudent Investor Rule applies to investment advisers and their representatives when making suitable recommendations.
› LO 14.c **Recall** what constitutes compensation to an investment adviser, including the use of solicitors.
› LO 14.d **Recognize** how brokerage relationships affect adviser compensation.
› LO 14.e **Identify** the requirements for keeping custody of customer funds and securities.
› LO 14.f **Recall** the rules on maintaining discretion over customer accounts and complying with the Bank Secrecy Act.
› LO 14.g **Identify** the implication of the NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers.
› LO 14.h **Identify** the kind of reporting required of investment advisers.
› LO 14.i **Recognize** the requirements of the NASAA Statement of Policy on Dishonest and Unethical Practices of Broker-Dealers and Agents.
› LO 14.j **Identify** the requirements when selling securities on the premises of financial institutions.
› LO 14.k **Recognize** potential criminal activities applying to all securities professionals.
› LO 14.l **Recognize** that securities professionals must practice good cybersecurity, privacy, and data protection.
› LO 14.m **Recall** what constitutes an adequate business continuity plan.

Your exam will include approximately eleven questions from the topics covered in Unit 14.

INTRODUCTION

The Uniform Securities Act was drafted for two primary reasons: (1) to eliminate conflicts in state securities legislation and make state securities laws uniform, and (2) to protect the public from unethical securities practices and fraud. Understanding ethical practices, and securities professionals' obligations to follow them, is the subject of this unit. This unit addresses what constitutes unethical and prohibited business practices, as defined in the Statement of Policy on Dishonest or Unethical Business Practices of Broker-Dealers and Agents issued by NASAA (the North American Securities Administrators Association), the NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, as well as what are considered unethical practices under federal securities laws. It will also explain the fiduciary responsibilities of investment advisers and their representatives.

Recognizing that the industry is a dynamic rather than static one, this unit will also deal with the modern challenges of cybersecurity and data protection.

Dishonest and unethical practices are heavily tested topics. You must know what these practices are and be able to apply the principles that guide ethical behavior to specific situations presented on the exam.

LESSON 14.1: FIDUCIARY RESPONSIBILITIES OF INVESTMENT ADVISERS AND THEIR REPRESENTATIVES

LO 14.a Identify the important fiduciary responsibilities when providing investment advisory services.

Fiduciary Responsibility of Investment Advisers

Unlike broker-dealers and their agents, investment advisers and their IARs have a fiduciary responsibility to their customers. That obligates these advisers and their representatives to put their clients' interests ahead of their own. That is the primary reason why advisers need their clients' consent when acting as agents or principals in trades with them (as covered in the previous unit). As fiduciaries, investment advisers must identify and address all material conflicts of interest by eliminating or disclosing such conflicts. Clients rely on the advice of their advisers and must feel confident that those advisers are working in the clients' best interests.

If the adviser also engages in nonsecurities-related activities, such as selling auto insurance or real estate, these represent potential conflicts of interest (time taken away from "watching the market") and must be disclosed.

PRACTICE QUESTION

Investment advisers and their representatives have an obligation to place their clients' needs ahead of their own. This is legally known as

A. avoiding conflicts of interest.
B. making full disclosure.
C. fiduciary responsibility.
D. playing fair.

Answer: C. The obligation of investment advisers and IARs to place clients' interests ahead of their own is known as acting in a fiduciary capacity.

Another responsibility is recognizing your capabilities. It is an unethical business practice to promise to provide services that you know can't be provided. A tested concept is criticizing the work of other professionals. This is not to say that you can't point out suggestions you would have made differently, such as a different clause in a will, but unless you are an attorney or an accountant, be careful of criticizing legal or accounting work performed by those professionals.

Hedge Clauses

A constant concern of the regulators is any attempt by an investment adviser to waive the implied fiduciary responsibilities inherent in the client/adviser relationship. One of the most common methods of doing so is through the use of the *hedge clause*, sometimes referred to as an *exculpatory clause*. This is not a new issue. In 1951, the SEC addressed it in a release stating that "the antifraud provisions of the Securities and Exchange Commission statutes are violated by the employment of any legend, hedge clause, or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have." This test is consistent with the Investment Advisers Act of 1940, which states that "any condition, stipulation, or provision binding any person to waive compliance with any provision of this Act or with any rule, regulation or order thereunder shall be void."

Several recent investment adviser applications filed with the states have contained advisory contracts with hedge clauses that the Administrator believed would be potentially misleading to clients.

As an example, one state took issue with a contract that stated: "It is understood that we will extend our best efforts in the supervision of the portfolio, but we assume no responsibility for action taken or omitted in good faith if negligence, willful or reckless misconduct, or violation of applicable law is not involved."

So, here's the bottom line for the exam. You will be presented with a question or two containing a statement to the effect of, "The client agrees to waive rule violations by the IA (or another securities professional)." The answer to choose is the one that states that "waivers are never permitted."

This is not to say that the acts prohibit the use of all hedge clauses. For example, the SEC has not objected to clauses that limit the investment adviser's liability for losses caused by conditions and events beyond its control, such as war, strikes, natural disasters, new government restrictions, market fluctuations, communications disruptions, and so forth. Such provisions are acceptable because they do not attempt to limit or misstate the adviser's fiduciary obligations to its clients; but it is highly unlikely that one of these choices will be on your test.

LO 14.b Describe how the Prudent Investor Rule applies to investment advisers and their representatives when making suitable recommendations.

Beginning with the dynamic growth of the stock markets in the late 1960s, the investment practices of fiduciaries experienced significant changes. As a result, the Uniform Prudent Investor Act (UPIA) was adopted in 1994 as an attempt to update trust investment laws in recognition of those many changes. One of the major influences on this legislation was the growing acceptance of modern portfolio theory. The UPIA (now used in almost every state) makes five fundamental alterations in the former criteria for prudent investing. Those changes are as follows:

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In this context, the term *portfolio* means all of the trust's or client's assets.
- The trade-off in all investments between risk and return is identified as the fiduciary's primary consideration.
- All categorical restrictions on types of investments have been removed; the fiduciary can invest in anything that plays an appropriate role in achieving the risk/return objectives of the account and meets the other requirements of prudent investing.
- The well-accepted requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
- The much-criticized former rule forbidding the trustee to delegate investment functions has been reversed. Delegation is now permitted, subject to safeguards and the requirement that the fiduciary act with reasonable *care, skill, and caution.*

Because the most practical common application of the UPIA deals with retirement plans covered by Employee Retirement Income Security Act of 1974 (ERISA), we'll go into more detail when that topic is covered in Unit 18.

Due Diligence

SEC studies have indicated that investment advisers, including pension consultants, are increasingly recommending alternative investments, such as leveraged ETFs (covered in Unit 5), to their clients. Investment advisers are fiduciaries and thus must act in their clients' best interests. An adviser that exercises discretion to purchase alternative investments on behalf of its clients or that relies on a manager to perform due diligence of alternative investments must determine whether such investments:

- meet the clients' investment objectives; and
- are consistent with the investment principles and strategies that were disclosed by the manager to the adviser in the offering materials provided by the manager.

The due diligence process can be more challenging for alternative investments due to the characteristics of private offerings, including the complexity of certain alternative investment strategies. Due diligence on the part of the investment adviser requires:

- identifying and disclosing conflicts of interest (e.g., benefits to the adviser or its employees for allocations made to private funds); and
- utilizing experienced investment teams when evaluating complex investment strategies and fund structures.

Advisers utilizing appropriate due diligence methods do so in an attempt to identify certain risk indicators during their investment, operational, and risk management reviews. Failure to meet the adviser's standards can lead to rejection of the manager or alternative investment. Some of these indicators are:

- Managers that were unwilling to provide requisite transparency regarding portfolio holdings to the adviser;
- Performance returns that did not correlate with known factors associated with the manager's strategy as described by the manager;

- Alternative investment portfolio holdings that showed a high concentration in a single investment position, or a heavy concentration in a single sector, for a purportedly diversified investment strategy;
- Manager personnel that appeared to be insufficiently knowledgeable about a sophisticated strategy they were purportedly implementing;
- Manager investment style that appeared to have drifted over time;
- Use of an auditor that may not have significant experience auditing private investment funds or is an unknown auditor;
- Background checks that revealed unfavorable regulatory history, bankruptcy filings, or serious legal issues of the manager or key personnel; and
- Identification of undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates.

KNOWLEDGE CHECK 14.1

1. An investment adviser runs an advertisement in the business section of the local newspaper. The ad describes the nature of the firm's model portfolio and indicates that the firm has outperformed the overall market by 800% over the past 10 years, and, therefore, they guarantee that their clients will more than keep pace with inflation. At the bottom of the ad, in smaller print, is the following statement: "Results are not guaranteed. Past performance is not indicative of future results. These results are not normal and cannot be expected to be repeated." This is an example of
   A. a properly worded disclaimer.
   B. an improper hedge clause.
   C. a violation of an investment adviser's fiduciary responsibility.
   D. a wrap fee account.
2. One of the most significant features of the UPIA is the ability of a trustee to delegate investment decisions to a qualified third party. Delegation is permitted as long as the fiduciary to whom the powers are delegated
   A. acts with skill and caution.
   B. avoids high-risk investments.
   C. considers the risk/reward trade-off of each individual security in the portfolio.
   D. avoids diversification.

LESSON 14.2: INVESTMENT ADVISER COMPENSATION

LO 14.c Recall what constitutes compensation to an investment adviser, including the use of solicitors.

Disclosure of Compensation

One of the areas where the importance of the fiduciary relationship comes into play deals with compensation. As we covered when discussing advisory contracts, compensation details must always be disclosed. This would include:

- the method of computing compensation;
- refunding of prepaid fees;
- the type of compensation (hourly fees, fees based on AUM, commissions, etc.); and
- any incentives or other compensation from the issuer of securities recommended.

That last bullet point is particularly important because of the fiduciary relationship. Incentives or bonuses will undoubtedly present a potential conflict of interest, and the IA must always put the interest of the client first.

We learned in the previous unit that performance-based compensation is prohibited under all circumstances unless there is a qualifying exception. Now, we'll look at those exceptions.

Under state and federal law, the exceptions from the performance fee prohibition apply to contracts with a qualified client, defined as:

- a natural person or company that, immediately after entering into the contract, has at least $1.1 million under the management of the investment adviser;
- a natural person or company that the IA has reason to believe immediately prior to entering into the contract has a net worth exclusive of the primary residence (in the case of individuals, assets held jointly with a spouse, but no one else, can be used) in excess of $2.2 million; or
- a natural person who is an officer or director of the investment adviser, or one of their IARs who has been employed in the industry at least 12 months.

TAKE NOTE

Please notice the inconsistency in the rule. It is *at least* $1.1 million in AUM with the adviser or net worth *in excess of* $2.2 million. Why couldn't they both be *at least*, or *in excess of*? Makes the test tougher, doesn't it?

The test may want you to know that a fee based on the average amount of money under management over a particular period is *not* considered to be a performance fee.

There is one significant difference between the rules for state-registered IAs and federal covered IAs. In order for a state-registered IA to enter into, extend, or renew an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds of the client, the investment adviser must disclose in writing to the client all material information concerning the proposed advisory arrangement, including the following:

- That the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee
- Where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account
- The periods that will be used to measure investment performance throughout the contract and their significance in the computation of the fee
- The nature of any index that will be used as a comparative measure of investment and performance, the significance of the index, and the reason the investment adviser believes that the index is appropriate

None of these disclosures apply to federal covered advisers; however, from a practical standpoint (not on the exam), most of these are made to their clients.

The most common type of performance fee is known as a fulcrum fee. In this case, the fee is averaged over a specified period (at least 12 months) with an increase or decrease in proportion to the investment performance in relation to the performance of a specified securities index (usually the S&P 500). For example, for each 5% that the client's account outperforms the specified index, the adviser would receive an increase to the fee of 10 basis points (.10%). Of course, negative performance would have the opposite results.

TEST TOPIC ALERT

There are two additional points related to performance-based compensation that you must know. First, the adviser must use net performance—that is, consider both gains and losses. Second, as with so many other rules, the Administrator has the power to authorize this type of fee even when the client doesn't meet the financial requirements.

LO 14.d Recognize how brokerage relationships affect adviser compensation.

Section 28(e) Safe Harbor

One specific form of compensation that is unique to investment advisers is soft dollar compensation from broker-dealers. This subject is dealt with in Section 28(e) of the Securities Exchange Act of 1934.

Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research. What does that mean, and how does it work? To find the answers, we must review the provisions of Section 28(e) of the Securities Exchange Act of 1934 and its safe harbor.

Definition: safe harbor. The original use was a maritime one referring to a safe place for a ship to enter, especially during a storm or a war. In the business world, it has come to mean a method of behavior that avoids running afoul of the law. In our case, the Section 28(e) safe harbor describes compensation to an investment adviser from a broker-dealer that will generally not be considered unethical.

Broker-dealers typically provide a bundle of services, including research and execution of transactions. The research provided can be either proprietary (created and provided by the broker-dealer, including tangible research products as well as access to analysts and traders) or third party (created by a third party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has come to be called soft dollars. The SEC has defined soft dollar practices as arrangements under which products or services other than execution of securities transactions are obtained by an investment adviser from or through a broker-dealer in exchange for the direction by the investment adviser of client brokerage transactions to the broker-dealer, frequently referred to as directed transactions on the exam. Under traditional fiduciary principles, a fiduciary cannot use assets entrusted by clients to benefit itself. As the SEC has recognized, when an adviser uses client commissions to buy research from a broker-dealer, it receives a benefit because it is relieved from the need to produce or pay for the research itself.

Because of the conflict of interest that exists when an investment adviser receives research, products, or other services as a result of allocating brokerage on behalf of clients, the SEC requires advisers to disclose soft dollar arrangements to their clients. Section 28(e) provides that a person who exercises investment discretion with respect to an account will not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of his having caused the account to pay more than the lowest available commission if such person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided.

In adopting Section 28(e), Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers. Section 28(e) defines when a person is deemed to be providing brokerage and research services and states that a person provides brokerage and research services insofar as he:

- furnishes advice directly or through publications or writing about the value of securities; the advisability of investing in, purchasing, or selling securities; or the availability of purchasers or sellers of securities;
- furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and performance of accounts; or
- effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody).

An adviser is obligated under both the Investment Advisers Act of 1940 and state law to act in the best interests of its client. This duty generally precludes the adviser from using client assets for its own benefit or the benefit of other clients without obtaining the client's consent based on full and fair disclosure. In such a situation, the antifraud provisions of the federal securities laws also would require full and fair disclosure to the client of all material facts concerning the arrangement. As the SEC has stated, "The adviser may not use its client's assets for its own benefit without prior consent, even if it costs the client nothing extra." Consent may be expressly provided by the client; consent also may be inferred from all of the facts and circumstances, including the adviser's disclosure in its Form ADV.

Section 28(e) does not relieve investment advisers of their disclosure obligations under the federal securities laws. Advisers are required to disclose, among other things, the products and services received through soft dollar arrangements, regardless of whether the safe harbor applies.

Registered investment advisers must disclose certain information about their brokerage allocation policies to clients in Item 12 of Part 2A of Form ADV. Specifically, if the value of products, research, and services provided to an investment adviser is a factor in selecting brokers to execute client trades, the investment adviser must describe in its Form ADV:

- the products, research, and services;
- whether clients may pay commissions higher than those obtainable from other brokers in return for the research, products, and services;
- whether research is used to service all accounts or just those accounts paying for it; and
- any procedures that the adviser used during the last fiscal year to direct client transactions to a particular broker in return for the products, research, and services received.

The purpose of this disclosure is to provide clients with material information about the adviser's brokerage selection practices that may be important to clients in deciding to hire or continue a contract with an adviser and that will permit them to evaluate any conflicts of interest inherent in the adviser's policies and practices. In this respect, the SEC and courts have stated that disclosure is required, even when there is only a potential conflict of interest.

Here is an example of a statement found in one adviser's brochure:

"We may direct transactions for your account to registered broker-dealers in return for research products and services that assist us in making decisions about investments. The research products will be used to generally service all of our clients, so the brokerage commissions you pay may be used to pay for research that is not used in managing your account."

Finally, the SEC believes that an adviser accepting soft dollar benefits must explain that:

- the adviser benefits because it does not have to produce or pay for the research or other products or services acquired with soft dollars; and
- the adviser therefore has an incentive to select or recommend brokers based on the adviser's interest in receiving these benefits rather than on the client's interest in getting the most favorable execution.

TEST TOPIC ALERT

What this all comes down to is knowing what is and what is not included in the safe harbor. Here are some of the items that, if received as soft dollar compensation, would likely fall under the 28(e) safe harbor:

- research reports analyzing the performance of a particular company or stock;
- financial newsletters and trade journals could be eligible research if they relate with appropriate specificity;
- quantitative analytical software;
- seminars or conferences with appropriate content; and
- effecting and clearing securities trades.

On the other hand, likely to fall out of the safe harbor would be:

- telephone lines;
- office furniture, including computer hardware;
- travel expenses associated with attending seminars;
- rent;
- any software that does not relate directly to analysis of securities;
- payment for training courses for this exam; and
- internet service.

PRACTICE QUESTION

The following example should help you better understand 28(e):

Which of the following would **not** be included in the safe harbor provisions of Section 28(e) of the Securities Exchange Act of 1934?

A. Proprietary research
B. Third-party research
C. Rent
D. Seminar registration fees

Answer: C. Section 28(e) provides a safe harbor for those expenses paid with soft dollars that offer a direct research benefit. Rent is not included in the list of acceptable items coming under that safe harbor.

Other Brokerage Practices

In addition to disclosing how soft dollars are handled, there are several other practices involving broker-dealers and investment advisers where disclosure is required. Investment advisers must describe the factors that they consider in selecting or recommending broker-dealers for client transactions and determining the reasonableness of the broker-dealer's compensation.

Client Referrals

It is not an uncommon practice for broker-dealers to recommend their clients to investment advisers. Naturally, the investment adviser is happy to receive the referral, and the broker-dealer hopes to continue to execute the client's trades. This is considered as if the IA is compensating the broker-dealer for the referral. It is not illegal, but the IA must disclose the practice and, as a fiduciary, take steps to ensure that the charges for the services being rendered by the broker-dealer are reasonable.

Directed Brokerage

Directed brokerage is the practice of asking or permitting clients to send trades to a specific broker-dealer for execution. When the IA suggests the client use a specific broker-dealer(s), disclosure of any possible conflicts of interest must be made. There is nothing wrong with urging clients to use specific firms because of the quality of service received, even if the IA is doing so in response to referrals or soft dollars. As long as it is disclosed and the services rendered bear a reasonable relationship to their cost, directed brokerage should be a good deal for both the client and the IA. On the other hand, if the adviser permits the client to direct the brokerage firm to use, certain other disclosures are required. For example, the IA must explain that it may be unable to achieve most favorable execution of client transactions or that directing brokerage may cost clients more money. For example, in a client-directed brokerage account, the client may pay higher brokerage commissions because the IA may not be able to aggregate orders to reduce transaction costs, or the client may receive less favorable prices because the IA has arranged a preferred commission rate with a preferred broker-dealer. Here is an example of how that might appear in the brochure:

"It is important to note that if you do not give KAPCO Advisers discretion to direct trades, you may limit our ability to negotiate favorable commissions and seek best execution for trades in your account. You may also be excluded from block trades and average price transactions."

Trade Aggregation and Allocation

This is the practice of bundling (sometimes called *bunching*) trades to obtain volume discounts on execution costs. It occurs most often when an IA with discretion over accounts has several of them for whom the same security is appropriate and, instead of entering separate orders, enters them as one larger order. This invariably saves on execution costs. Sometimes, the order cannot be filled in one transaction or at a single price. In that case, it is generally considered that the fairest method of allocating the security's cost is on an average basis.

KNOWLEDGE CHECK 14.2

1. State and federal regulations would permit performance-based compensation to be charged to advisory clients with
   A. a minimum net worth in excess of $1 million, exclusive of primary residence.
   B. a minimum net worth in excess of $2.2 million, exclusive of primary residence.
   C. net income of more than $200,000 for the past two years with a reasonable expectation of it continuing.
   D. at least $5 million in investments.
2. When an investment adviser with discretion over a client's account directs trade executions to a specific broker-dealer and uses the commission dollars generated to acquire software that analyzes technical market trends, it is known as
   A. hard-dollar compensation.
   B. indirect compensation.
   C. investment discretion.
   D. soft dollar compensation.

LESSON 14.3: PROTECTING CUSTOMER ASSETS

LO 14.e Identify the requirements for keeping custody of customer funds and securities.

Rules on Custody of Funds and Securities

For the most part, the federal and state rules are identical. Our text will focus on the rule stated in the Investment Advisers Act of 1940 and, where the NASAA Model Rule differs, a notation will be made.

If you are an investment adviser registered or required to be registered under either federal or state law, it is a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of the act for you to have custody of client funds or securities unless the following conditions are met:

- You have a qualified custodian. A qualified custodian maintains those funds and securities in a separate account for each client under that client's name, or in accounts that contain only your clients' funds and securities under your name as agent or trustee for the clients.
- You give notice to your clients. If you open an account with a qualified custodian on your client's behalf, either under the client's name or under your name as agent, you must notify the client in writing of the qualified custodian's name and address and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information, such as a change in the location of the assets.
- Account statements are delivered to clients, either:
  - by qualified custodian: you have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; or

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- by adviser: you send a quarterly account statement to each of your clients for whom you have custody of funds or securities, identifying the amount of funds and of each security of which you have custody at the end of the period and setting forth all transactions during that period. An independent public accountant must verify all of those funds and securities by actual examination at least once during each calendar year, at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year, and file a copy of the auditor's report and financial statements with the SEC/Administrator stating that it has examined the funds and securities and describing the nature and extent of the examination. If the independent public accountant finds any material discrepancies during the course of the examination, the accountant must promptly notify the SEC/Administrator.

- Under the NASAA Model Rule, in the absence of a rule prohibiting custody, the investment adviser notifies the Administrator promptly in writing on Form ADV that the investment adviser has or may have custody.

Definition: custody. For the purposes of this rule, *custody* means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.

Custody also includes:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly, in any case within three business days of receiving them; therefore, you should remember that the SEC never considers the receipt of a third-party check to constitute custody, while the Administrator will if the check is not sent on within three business days (NASAA—under state law, the receipt of checks drawn by clients and made payable to unrelated third parties is considered custody unless forwarded to the third party within three business days of receipt, with the adviser maintaining a record of the event);
  - On the other hand, when an advisory customer sends a check to the adviser as payment for the advisory fee, that is not considered custody because it is no longer the customer's money; it belongs to the adviser.
  - If, by mistake, a client leaves a stock certificate in an investment adviser's office, it would not be considered custody if the certificate were **returned** to the client within three business days.
- any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian;
- any capacity (such as general partner of a limited partnership, managing member of a limited liability company, or a comparable position for another type of pooled investment vehicle or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

A **qualified custodian** is a bank or savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act; a broker-dealer holding the client assets in customer accounts who is registered in the appropriate state and with the SEC; and a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

TEST TOPIC ALERT

Most investment advisers do not take custody and, therefore, are unable to accept direct delivery of customer securities or funds except under the limited conditions described in this section. However, broker-dealers are not constrained by this rule; they are only required to provide receipts anytime they accept customer assets.

TAKE NOTE

There are two major benefits to an investment adviser using a qualified custodian.

- Because the custodian is sending the quarterly reports to the client, that administrative burden is lifted from the investment adviser.
- There is no requirement for a surprise annual audit by an independent accountant.

The NASAA Model Rule also adds language dealing with direct fee deduction. An adviser who has custody because the adviser's fees are directly deducted from client's accounts must also provide the following safeguards:

- Written authorization—the adviser must have written authorization from each client to deduct advisory fees from the accounts held with the qualified custodian.
- Notice of fee deduction—each time a fee is directly deducted from a client account, the adviser must concurrently
  - send the qualified custodian notice of the amount of the fee to be deducted from the client's account, and
  - send the client an invoice itemizing the fee. Itemization includes the formula used to calculate the fee, the amount of assets under management the fee is based on, and the time period covered by the fee.
- Notice of safeguards—the investment adviser notifies the Administrator in writing on Form ADV that the adviser intends to use the safeguards provided above.

TAKE NOTE

If the above three requirements are satisfied, then the IA who is only considered to have custody because of direct deduction of fees will receive a waiver from the financial requirements for the net worth and bonding requirements described earlier in this unit (usually $35,000). In addition, just as with the IA who uses a qualified custodian, they will be relieved of the obligation to file an audited balance sheet.

EXAMPLE

Let's look at three examples of custody given by the SEC.

- An adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss. The rule, however, expressly excludes inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within three business days of receiving them. The rule does not permit advisers to forward clients' funds and securities without having custody, although advisers may certainly assist clients in such matters. In addition, the rule makes clear that an adviser's possession of a check drawn by the client and made payable to a third party is not possession of client funds for purposes of the custody definition. (Note that this is only true under NASAA rules if forwarded within three business days.)

- An adviser has custody if it has the authority to withdraw funds or securities from a client's account. An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets. An adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account. These advisers might not have possession of client assets, but they have the authority to obtain possession.
- An adviser has custody if it acts in any capacity that gives the adviser legal ownership of, or access to, the client funds or securities. One common instance is a firm that acts as both general partner and investment adviser to a limited partnership. By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets.

TEST TOPIC ALERT

Under the NASAA Model Rule on Recordkeeping of Investment Advisers, if a state-registered investment adviser has custody because it advises a pooled investment vehicle (see Unit 3), the adviser must also keep true, accurate, and current audited account statements. The records required to be made and kept include:

- the date(s) of the audit;
- a copy of the audited financial statements; and
- evidence of the mailing of the audited financial statements to all limited partners, members, or other beneficial owners within 120 days of the end of its fiscal year.

The adviser is not required to keep a copy of the minutes of the board of directors, bank statements, or the trust agreement.

PRACTICE QUESTION

Which of the following advisers would be deemed to have custody of customer funds or securities as defined in the Investment Advisers Act of 1940?

A. The adviser receives the proceeds of sales in the customer's account.
B. The adviser receives a fee of $1,500 as a prepayment for the next contract year.
C. The adviser has investment discretion over the account.
D. All of the above.

Answer: A. Under the Investment Advisers Act of 1940, discretion and substantial prepayments are not considered custody. Access to funds in the client's account is one of the standard tenets of custody.

TEST TOPIC ALERT

Although the general rule is that state-registered investment advisers having custody must maintain a minimum net worth of $35,000 (or an equivalent surety bond), the net worth/bonding requirements are waived in two cases:

- Advisers who have custody solely due to direct fee deduction and who keep the required records and make the required notifications to clients
- Advisers who have custody solely due to advising pooled investment vehicles and who keep the required records and make the required notifications to clients

Form ADV-E

Investment advisers that have custody of client funds or securities are required to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. Form ADV-E is used as a cover page for a certificate of accounting of securities and funds of which the investment adviser has custody (surprise exam report). Form ADV-E contains both information about the adviser and the surprise exam conducted.

The Form ADV-E is filled out by the investment adviser and then submitted along with the surprise examination report or statement by the independent public accountant after a surprise inspection of the adviser.

TEST TOPIC ALERT

Filing of Form ADV-E is required only when the investment adviser, rather than a qualified custodian, maintains custody of customer funds/securities.

LO 14.f Recall the rules on maintaining discretion over customer accounts and complying with the Bank Secrecy Act.

Investment Discretion

Investment discretion is frequently lumped together with *custody*. They are not the same thing, and the exam will want you to know the differences.

A **discretionary account** is an account set up with preapproved authority for a securities professional to make transactions without having to ask for specific approval.

Discretion is defined as the authority to decide:

- which security;
- the number of shares or units; or
- whether to buy or sell.

Normally, an order to buy or sell a security is at the direction of the client, generally via a telephone call (firms will not accept emailed orders without oral verification from the client). Many clients prefer the convenience of letting their securities professional "call the shots." Obviously, the ability to determine the trading activity in a client's account presents a potential conflict of interest. In the case of broker-dealers and agents, their compensation is transaction based—the more trading, the more income. In the case of investment advisers and their IARs, the conflict is less prominent (they are rarely compensated for trading), but, especially with the fiduciary responsibility they carry, there is a burden on them not to incur unnecessary trading costs in their clients' accounts.

TEST TOPIC ALERT

To identify a discretionary order, try this method: an order is discretionary if any one of the **three A's** is missing from the customer order. The three A's are:

- Activity;
- Amount; and
- Asset.

Unit 14

Discretion: Time or Price

Both state and federal law prohibit the exercise of any discretionary power by a broker-dealer or agent in a customer's account unless the customer has given prior written authorization (a power of attorney/trading authorization) to a stated individual or individuals and the account has been accepted by the brokerage firm, as evidenced in writing by the firm. No discretionary transactions can take place without this document on file. Once authorization is given, the firm is legally empowered to make trading decisions for the account, although the customer may also continue to enter orders on her own if she wishes.

There is an exception to this requirement that applies to the exercise of time or price discretion—it is discretion orally granted by the customer to purchase or sell a specific amount of a particular security (e.g., "Buy 100 shares of ABCD and get the best price you can").

An oral grant of time or price discretion is limited to the end of the business day on which the customer grants it. An extension of such time or price discretion requires explicit signed and dated customer instructions. Any exercise of time or price discretion must be reflected on the order ticket (as is the case with regular discretion).

Why is it necessary to have written instructions if the discretion is to carry beyond the date of the order? The concept of time or price discretion has been subject to abuse and/or misunderstanding. At one time, there was no time limit placed on a grant of oral time or price discretion by a customer. This became problematic in instances where an agent was granted such discretion but did not exercise it for an extended period of time, sometimes several weeks. This led to claims of unauthorized trading by customers who may have forgotten that they granted the discretion or assumed it was not valid for such an extended period of time. The written extension requirement under the rules is intended to prevent such misunderstandings.

TAKE NOTE

Discretion does not apply to decisions regarding the timing of an investment or the price at which it is acquired.

EXAMPLE

An order from a customer worded "Buy 100 shares of ABC for my account whenever you think the price is right" is not a discretionary order because the client has specified the action (buy), the amount (100 shares), and the asset (ABC). Time or price are not considered discretion.

Discretion for Investment Advisers

Like anyone else, an investment adviser must have written authorization to exercise discretion in a client's advisory account. However, there is a unique provision found in the NASAA Model Rules that permits oral discretionary authority to be used for the initial transactions in a customer's account during the first 10 business days after the date of the first transaction. After that time, if the written authorization has not been received, no further discretionary activity can take place.

TEST TOPIC ALERT

Be aware of the calendar. The 10-business-day period is equal to two normal work weeks. If a client opens a discretionary account with an investment adviser and gives the OK orally, but three weeks have passed by since the initial trade and the written authorization has not been received, the IA can't exercise discretion in the account, even if not taking action would cause disastrous results to the client's portfolio.

TEST TOPIC ALERT

Probably the greatest concern of the regulators when it comes to discretionary accounts is the possibility of the account being churned. Churning can be described as a securities professional effecting transactions in a discretionary account that are excessive in size or frequency, in view of the financial resources, objectives, and character of the account. To safeguard against the possibility of churning, a designated supervisor or manager must review all trading activity in discretionary accounts frequently and systematically. We will discuss churning again later in this unit.

Third-Party Trading Authorization

In addition to granting a securities professional discretionary trading authorization, there is another common case where clients allow others to exercise control over their accounts. In Unit 16, we will discuss these in greater detail, but at this point, what you need to know is that executing a transaction on behalf of a customer without authorization to do so is a prohibited practice.

Securities professionals may never enter an order for a client without proper written authorization, even when it is in the best interest of the client. You may be asked a question where a spouse of a client or another person with a strong personal relationship contacts an agent with transaction instructions, allegedly on behalf of the client. Unless there is a written third-party trading authorization on file, no activity can take place.

Somewhat related to this activity is deliberately failing to follow a customer's instructions. In this case, the client has given the specific terms of the order, and if the agent decides to purchase more or less than ordered or in any other way changes the nature of the order, it is a prohibited practice.

Commingling of Customer and Firm Assets

Broker-dealers and investment advisers must segregate customers' free securities or securities held in safekeeping. Customer "free" securities are those that have no lien against them (just like one might have a lien against your car). Securities pledged as collateral in a margin account have a lien against them.

Securities that are held in a customer's name must not be **commingled** (mixed) with securities of the firm.

If a firm has 100,000 shares of ABCD common stock in its own proprietary account and its clients separately own an additional 100,000 shares, the firm may not place customer shares in the firm's proprietary account.

To mix shares together would give undue leverage or borrowing power to a firm and could jeopardize the security of client securities in the event of default.

Improper Hypothecation

It is unethical to hypothecate (pledge as collateral) a customer's securities unless the broker-dealer secures from the customer a properly executed written consent promptly after the initial transaction in the client's margin account. This will be explained fully in Unit 23.

Money Laundering

Money laundering involves disguising financial assets so they can be utilized without detecting the illegal activity that produced them. Through money laundering, a criminal transforms the proceeds of illicit activities into funds that appear to have been generated by legal means. Money laundering enables criminals to hide and legitimize the proceeds derived from illegal ventures.

Currency Transaction Reports (CTRs)

The Bank Secrecy Act requires every financial institution to electronically file through the Department of the U.S. Treasury a currency transaction report (CTR) on FinCEN Form 112 for each cash transaction that exceeds $10,000 within 15 days of receipt of the currency. This requirement applies to cash transactions used to pay off loans; the electronic transfer of funds; or the purchase of certificates of deposit, stocks, bonds, mutual funds, or other investments. The act also requires the reporting of wire transfers of $3,000 or more.

If anyone designs deposits to fall under the $10,000 radar, this is a prohibited activity known as structuring. Financial institutions should have systems in place to monitor for and recognize such attempts.

EXAMPLE

A customer makes 25 $500 cash deposits to pay for a $12,500 transaction. This should be recognized at an attempt to structure payments to fall under the $10,000 radar to avoid the filing of a CTR.

KNOWLEDGE CHECK 14.3

1. An investment adviser takes custody of a client's funds and securities. Client account statements must be sent no less frequently than
   A. monthly.
   B. quarterly.
   C. semiannually.
   D. annually.
2. An investment adviser's client has had a discretionary account for three years. Which of the following may the investment adviser determine without written discretionary authority?
   A. The time or price at which to enter an order
   B. Which security should be purchased
   C. Whether to buy or sell a particular security
   D. How many shares of a particular security should be purchased

LESSON 14.4: ETHICAL BEHAVIOR OF INVESTMENT ADVISERS AND THEIR REPRESENTATIVES

LO 14.g Identify the implication of the NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers.

NASAA's Model Rule for investment advisers contains most of the prohibitions on unethical business practices of these securities professionals. Many of these practices have already been discussed previously in the text or will be covered in the following lessons, so we'll limit this coverage largely to new items. Please read Appendix B for the complete listing, because there are several exam questions drawn from that information.

Unethical Practices Relating Solely to Investment Advisers and Their Representatives

Suitability of Recommendations

Because the primary role of an investment adviser and its IARs is the furnishing of advice, it is clearly unethical to make any recommendation that is not suitable for the customer. Suitability depends on a number of factors, and all of them must be considered when making a recommendation.

TEST TOPIC ALERT

An unethical business practice is making blanket recommendations. That is when the investment adviser recommends the same security to most or all clients without regard to individual suitability.

Use of Third-Party Reports

It is considered unethical to provide a report or recommendation to any advisory client prepared by someone other than the adviser without disclosing that fact. (This prohibition does not apply to a situation where the adviser uses published research reports or statistical analyses to render advice or where an adviser orders such a report in the normal course of providing service.)

EXAMPLE

If an investment adviser provides a report to a client that is prepared by a third party, the adviser has a responsibility to disclose that fact to the client. By entering into an investment advisory agreement, the client relies on the expertise of the adviser to provide the advisory service. Thus, if the advice is provided by a third party, it is imperative that the adviser disclose this fact to the client so that the client is not misled. That would be something like turning in a term paper written by someone else and putting your name on it. The prohibition does not apply when an investment adviser gathers and uses research materials before making its recommendation to a client.

Improper Trading Authorization

No trade may be made without proper authorization from the advisory client or an authorized third party. The exam will frequently present a case where a client's spouse or another third party such as a lawyer or an accountant contacts the firm with an order because the client is currently unavailable. If the required authorizations are not on file, the order must be refused.

Lending or Borrowing

Engaging in the practice of lending to or borrowing money or securities from a customer is considered an unethical business practice for all securities professionals.

Securities professionals may not borrow money or securities from a client unless the client is a broker-dealer, an affiliate of the professional, or a financial institution engaged in the business of loaning money.

Securities professionals may not loan money to clients unless the firm is a broker-dealer or financial institution engaged in the business of loaning funds, or the client is an affiliate.

EXAMPLE

An IAR purchases a car from a retail client for $10,000 with a $3,000 down payment. The balance is to be paid over the next 36 months. This is prohibited, because it is borrowing money from a client who is not in the money-lending business.

TEST TOPIC ALERT

As a former president of the United States once said, "Let me make one thing perfectly clear." When it comes to borrowing or lending money, you cannot borrow from *any* client (including your mother) unless that client is a lending institution such as a bank or credit union. Be careful—mortgage brokers are **not** in the business of lending money; they put the borrower and the lender together, which is why they are called *brokers*. Likewise, as an agent or IAR, you can never lend money to any client unless the client has some kind of affiliation with your firm. If your broker-dealer handles margin accounts, then, of course, money can be loaned to clients. Don't take this personally; just get the questions right on the exam.

EXAMPLE Borrowing Money or Securities from Clients

One of the more confusing areas relates to borrowing money from (or lending money to) clients. Part of the reason for the confusion is that FINRA rules (many students taking the Series 65 exam have taken a FINRA test) permit borrowing (lending) to clients under certain conditions that are more liberal than those of NASAA.

The first point to emphasize is that this prohibition only applies when the other side is a client. Securities professionals may borrow (or lend) as much as they want to those who are not clients, but once there is a client relationship, the NASAA policy takes effect.

So, which clients can you borrow from?

- A bank or other financial institution in the business of making loans (e.g., credit union)
- A broker-dealer in a margin account
- A person affiliated with your firm

Which clients can't you borrow from?

- The employee at the lending institution who processes or approves your loan
- The agent at the broker-dealer who services your margin account
- A mortgage broker (one who only arranges the loan)
- A family member

PRACTICE QUESTION

Lending arrangements between registered agents and their customers are permitted if the customer

A. is a member of the representative's immediate family.
B. is the mortgage broker who arranged for the mortgage on your home.
C. was your roommate in college and remains your best friend.
D. works at the desk next to yours.

Answer: D. You can borrow from or lend to another employee of your firm. You can also borrow from clients who are in the money-lending business. Remember, mortgage brokers don't lend the money; they put together the lender and the home buyer. If you'd like to borrow from an immediate family member, unless that individual works for the same or an affiliated firm, the only way to do that is to terminate the client relationship.

Client Confidentiality

Investment advisers and their representatives must respect the confidentiality of the relationship with their clients. It would be an unethical business practice to disclose the identity, affairs, or investments of any client unless required by law to do so, or unless consented to by the client.

EXAMPLE

An investment advisory firm has a responsibility to ensure that all information collected from a client be kept confidential. The only exception to the rule should be in those instances where the client or a joint owner authorizes the release of such information, or when the investment advisory firm is required by law to disclose such information.

TEST TOPIC ALERT

If the advisory account is held in joint names, consent may be granted by any of the joint owners. On the exam, the most common example is from a spouse. Speaking of a spouse, the most common time when the firm could be required by law to disclose account information would be during a divorce proceeding in court. Another time would be during an IRS investigation, when you receive a subpoena from the court to testify.

Conflicts of Interest

SEC Release IA-1092 warns against effecting transactions in which the adviser has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients.

EXAMPLE

Some of the ways this applies are:

- An investment adviser structures his personal securities transactions to trade on the market impact caused by his recommendation to clients without disclosing this to clients;
- An investment adviser fails to disclose if his personal securities transactions are inconsistent with advice given to his clients;
- An investment adviser must disclose compensation received from the issuer of a security being recommended; and
- The SEC staff has taken the position that an investment adviser who sells nonsecurities investments, such as insurance products, to clients must disclose to clients and prospective clients all its interests in the sale of such nonsecurities investments.

LO 14.h Identify the kind of reporting required of investment advisers.

In addition to the reporting related to updating Form ADV and the brochure, here are several other cases where investment advisers must report to the regulators.

Section 13(f) Filings

There is a reporting requirement that applies to SEC registered investment advisers. Section 13(f) of the Securities Exchange Act of 1934 requires that any institutional investment manager that exercises investment discretion over an equity portfolio with a market value on the last trading day in any of the preceding 12 months of $100 million or more in 13(f) securities must file a **Form 13F** with the SEC quarterly, within 45 days of the end of each quarter.

The purpose of this rule is to require institutional investment managers who exercise investment discretion over accounts holding certain levels of securities to make periodic public disclosures of significant portfolio holdings.

What Are 13(f) Securities?

At the end of each calendar quarter, a list of these securities—called the Official List of Section 13(f) Securities—may be found on the SEC's website.

Generally, the list includes exchange-traded (e.g., NYSE) or Nasdaq-quoted stocks, equity options and warrants, shares of closed-end investment companies, and certain convertible debt securities. Shares of open-end investment companies (i.e., mutual funds) are not included. Shares of exchange-traded funds (ETFs), however, are on the official list and would be reported on Form 13F.

Investment Adviser Code of Ethics

In order to ensure that investment advisers and their representatives will act in an ethical manner, all advisers are required to prepare a code of ethics. Although this code is part of the Investment Advisers Act of 1940, NASAA considers it binding on state-registered advisers as well. This code is under the jurisdiction of the chief compliance officer (CCO).

Rule 204A1, Investment Adviser Code of Ethics, requires each adviser's code of ethics to mandate that an adviser's access persons (defined below) report their personal securities transactions and holdings to the adviser's chief compliance officer or other designated persons. Access persons must each submit a *holdings* report:

- no later than 10 days after the person becomes an access person, and the information must be current as of a date no more than 45 days prior to the date the person becomes an access person.
- at least once each 12-month period thereafter on a date the adviser selects and the information must be current as of a date no more than 45 days prior to the date the report was submitted.

Access persons must submit to the chief compliance officer or other persons designated in the firm's code of ethics quarterly securities *transactions* reports within 30 days of the end of each quarter.

The code of ethics must also require the CCO or her designee to review those reports. Reviewing these reports will allow advisers as well as the SEC's examination staff to identify improper trades or patterns of trading by access persons.

Access Person

An **access person** is any of the adviser's supervised persons who

- has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund; or
- is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic. If providing investment advice is the adviser's primary business, all of the firm's directors, officers, and partners are presumed to be access persons.

The rule requires that the firm maintain a record of the names of persons who are currently, or have been within the past five years, access persons of the investment adviser. It is also required to keep a record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons for at least five years after the end of the fiscal year in which the approval is granted.

These procedures are designed to prevent violations by IARs and others in the firm who have access. Advisory firms should include the following elements, or address the following issues, when crafting their procedures for employees' personal securities trading:

- Prior written approval before access persons can place a personal securities transaction (i.e., preclearance)
- Maintenance of lists of issuers of securities that the advisory firm is analyzing or recommending for client transactions, and prohibitions on personal trading in securities of those issuers. Remember, the regulators consider the use of a firm's internal research prior to public release to be potential insider trading.
- Maintenance of restricted lists of issuers about which the advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers
- Reminders that investment opportunities must be offered first to clients before the adviser or its employees may act on them, and procedures to implement this principle

There are several exceptions where access persons may be permitted to trade in securities, such as when the person is participating in an automatic dividend reinvestment program (and does not alter the program to take advantage of the IA's recommendations or other information), but it is unlikely that these will be tested.

TEST TOPIC ALERT

Preapproval is necessary for an access person to acquire a beneficial interest in an IPO or a private placement. Transaction reporting is not required when the security purchased is any of the following:

- Direct obligations of the government of the United States;
- Bankers' acceptances, bank certificates of deposit, commercial paper, or high-quality short-term debt instruments, including repurchase agreements;
- Shares issued by money market funds; or
- Shares issued by open-end funds.

PRACTICE QUESTION

The primary business of ABC Advisers is providing investment advice. Therefore, under the Code of Ethics, all of its directors, officers, and partners are

A. access persons.
B. automatically registered as investment adviser representatives.
C. required to post a surety bond.
D. prohibited in engaging in personal securities transactions other than in U.S. government securities.

Answer: A. As stated previously, if providing investment advice is the adviser's primary business, all of the firm's directors, officers, and partners are presumed to be access persons. The automatic registration provision applies only to those who function as IARs. There are no bonding requirements for IARs, and access persons can engage in personal securities transactions under the conditions of the Code of Ethics.

PRACTICE QUESTION

Alberto is an IAR with Exceptional Analysis and Results (EAR), an investment adviser registered in three Southwestern states. Although Alberto relies heavily on the recommendations furnished by EAR's research department, he occasionally does his own research for his personal account. As an access person, Alberto

A. would be prohibited from trading in his personal account.
B. would be prohibited from trading these securities in his personal account until his research was made publicly available.
C. must report any personal transactions on a quarterly basis.
D. can only use personal research to benefit clients.

Answer: C. Alberto is considered an access person. As such, any personal securities transactions must be reported on a quarterly basis. Alberto could not use research reports developed by the firm until they were made publicly available, but his own personal research doesn't come under that requirement.

Political Contributions by Investment Advisers (Pay to Play Rule)

This is an SEC rule that prohibits investment advisers from receiving compensation for advisory services to a government entity (any agency, authority, or instrumentality of a state or political subdivision) for **two** years after the advisory firm or any covered associate makes a political contribution to a public official or candidate who is or would be in a position to influence the award of investment advisory business by public retirement funds. Please note that the advisory relationship can continue, just without any compensation. There are some exceptions, listed below.

De Minimis Exception

The rule allows covered associates to make contributions up to **$350** per official or candidate per election in which they can vote, or **$150** for other elections. Contributions by investment firms in any amount would trigger a violation of the rule.

Covered Associates

Covered individuals include:

- any general partner, managing member or executive officer, or other individual with a similar status or function;
- any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such an employee; and
- any political action committee controlled by the investment adviser.

New Hire Exception

When an investment adviser hires a new covered associate, political contributions made by that individual more than six months prior to coming on board do not trigger the ban. However, if the new person's role is soliciting clients on behalf of the investment adviser, rather than rendering advice or other functions, this exception does not apply. In that case, there is a two-year "look back" period.

Returned Contributions Exceptions

An investment adviser can be excepted from the prohibition if the contribution is returned under certain conditions:

- The investment adviser must have discovered the contribution that resulted in the prohibition within four months of the date of such contribution;
- Such contribution must not have exceeded $350; and
- The contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.

Although unlikely to be tested, an investment adviser with more than 50 employees is entitled to no more than three exceptions, and one with 50 or fewer employees is limited to two exceptions during any single calendar year.

Compliance Programs

We have just completed a very comprehensive description of the many rules and regulations imposed upon investment advisers. How do the regulators ensure compliance with these rules? Effective October 2004, the Investment Advisers Act of 1940 was amended to require each investment adviser registered with the SEC to adopt and implement written policies and procedures designed to prevent violation of the federal securities laws, review those policies and procedures **annually** for their adequacy and the effectiveness of their implementation, and designate a **chief compliance officer (CCO)** to be responsible for administering the policies and procedures. An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures. In fact, the CCO's identity must be disclosed on Form ADV. However, the SEC does not set a standard of competency such as a specific qualification exam or number of years of experience. By and large, the states have followed suit for investment advisers registered with them.

Under Rule 206(4)-7, it is unlawful for an investment adviser registered with the Commission to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. The rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.

Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. The SEC and the Administrators expect that an adviser's policies and procedures, at a minimum, should address the issues covered in this unit to the extent that they are relevant to that adviser.

Although the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.

KNOWLEDGE CHECK 14.4

1. An investment adviser who recommends the same security to a majority of her clients is probably guilty of
   A. improper use of discretionary authority.
   B. bunching orders.
   C. blanket recommendations.
   D. using third-party reports without attribution.
2. An investment adviser who falls under the requirements of Section 13(f) of the Securities Exchange Act of 1934 must file Form 13F
   A. monthly.
   B. quarterly.
   C. semiannually.
   D. annually.

LESSON 14.5: ETHICAL BEHAVIOR OF BROKER-DEALERS AND THEIR AGENTS

LO 14.i Recognize the requirements of the NASAA Statement of Policy on Dishonest and Unethical Practices of Broker-Dealers and Agents.

NASAA's policy lists many business practices that, when engaged in by broker-dealers or agents, are deemed dishonest or unethical. Subsequently, NASAA has issued several Model Rules that have expanded the list. Most students report seeing at least five questions on their Series 65 exam relating to this material. In most cases, the listed prohibition is logical common sense: "don't lie, don't cheat, and don't steal." However, due to the nature of this exam and their legal interpretations, particularly for those of you without a securities or law background, further explanations will be supplied.

The premise of the policy is that each broker-dealer and agent shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. Acts and practices, including but not limited to those enumerated below, are considered contrary to such standards and may constitute grounds for denial, suspension, or revocation of registration or such other action authorized by the Uniform Securities Act.

Dishonest or Unethical Practices of Broker-Dealers and Agents

Delivery Delays

A broker-dealer engaging in a pattern of unreasonable and unjustifiable delays in the delivery of securities purchased by any of its customers and/or in the payment upon request of free credit balances reflecting completed transactions of any of its customers is unethical. A free credit balance is just like a credit balance on your charge card—it is your money and must be sent to you upon request. In the event that the client requests a certificate for the security purchased, it would be considered an unethical business practice for the firm to delay delivering it to the client.

Unsuitable Recommendations

Just as with investment advisers and their IARs, unethical activity includes recommending to a customer the purchase, sale, or exchange of any security without reasonable grounds to believe that such a transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the securities professional.

Securities professionals must always have reasonable grounds for making recommendations to clients. Before making recommendations, the securities professional must inquire into the client's financial status, investment objectives, and ability to assume financial risk. What about the client who refuses to give any financial information or discuss objectives? In that case, all a broker-dealer or agent can do is accept unsolicited orders, because there is no basis for making any recommendation. As far as investment advisers and their representatives are concerned, because they are paid for their advice, if they don't have the requisite information, they won't open the advisory account.

TAKE NOTE

So, what do you do when you think you've made a totally appropriate recommendation to your client, but your client is not happy with it? Upon reflection, you realize the client's problem is a lack of understanding of both the recommendation and the marketplace. What should you do? Most would agree that the first step would be to attempt to impart some education to the client in an effort to make your recommendation clearer. However, as with all customer issues, the client is the one who has to make the final decision.

Free Lunch Seminars

Although not specifically included in the NASAA Statement of Policy, a Model Rule regarding unfair business practices, especially with regard to seniors, may be included on your exam. The most common instance is the so-called *free lunch seminar*. These seminars are widely offered by financial services firms seeking to sell financial products, and they often include a free meal for attendees. Even though many of these seminars are promoted as being educational or workshops accompanied by the statement ("nothing will be sold at this meeting") the seminars are clearly intended to result in the attendees' opening new accounts with the sponsoring firm and, ultimately, in the sale of investment products, if not at the seminar itself, then in follow-up contacts with the attendees.

If not clearly presented, NASAA will consider that both the sponsoring firm and those individuals involved in the delivery of the seminar are committing a prohibited business practice.

Churning

Churning is generally defined as inducing trading in a customer's account that is excessive in size or frequency in view of the financial resources, objectives, and character of the account for the purpose of generating commissions. A key here is the word *excessive*. By definition, anytime something is excessive, it is too much. The regulators understand that different clients have different needs and abilities to take risks, so what is excessive for the 80-year-old pensioner is probably not going to be so for the 40-year-old partner in a major law firm.

TEST TOPIC ALERT

Excessive trading may be used on the exam instead of the word *churning*.

Unfair Pricing

A broker-dealer would be engaging in an unethical business practice when entering into a transaction with or for a customer at a price not reasonably related to the current market price of the security or receiving an unreasonable commission or profit. This is particularly an issue with stocks that trade infrequently on marketplaces such as the OTC Link®.

Withholding Shares of a Public Offering

Failing to make a bona fide public offering of all of the securities allotted to a broker-dealer for distribution, whether acquired as an underwriter, as a selling group member, or from a member participating in the distribution as an underwriter or selling group member, is unethical. If the firm is fortunate to be part of the underwriting of one of these IPOs that skyrockets in price because the issue is oversubscribed, they'd better be sure to allocate the shares to clients in an equitable manner and not keep any for themselves.

Responding to Complaints

Failing or refusal to furnish a customer, upon reasonable request, information to which he is entitled, or to respond to a formal written request or complaint, is unethical.

When a written complaint is received by the firm (and only written complaints are recognized), action must be taken. The complainant (customer) would be notified that the complaint had been received and an entry would be made in the firm's complaint file. If an agent were the subject of the complaint, the agent would be notified but would *not* be given a copy of the complaint (agents do not have recordkeeping requirements). If the complaint is received by the agent rather than the firm, the agent must report the complaint to the appropriate supervisor. If the complaint is sent by email, that is *considered in writing.*

TEST TOPIC ALERT

A complaint received by electronic means (email) is considered a written complaint.

EXAMPLE

A customer is upset with her agent for not servicing her account properly and sends him a complaint via text message about her actions. Under the Uniform Securities Act, the agent should

A. call the customer, apologize, and attempt to correct the problem.
B. tell the customer he is willing to make rescission.
C. do nothing because the complaint is not in writing.
D. bring the customer complaint to his employer immediately.

Answer: D. Any written customer complaint (an email or text message is considered *written*) must be brought to the attention of the agent's supervisor without hesitation.

TAKE NOTE

Written complaints must be kept on file by broker-dealers for three years and by investment advisers for five years. Do not confuse this with FINRA's four-year requirement; this is a NASAA exam.

Reporting Errors

In order to keep from generating complaints, any trade or other operational error, once discovered, must be reported by the agent to the appropriate supervisory person.

Front Running of Block Transactions

Front running is the unethical business practice of a securities professional placing a personal order ahead of a previously received customer order. It occurs most frequently when the firm has received an institutional order of sufficient size, a block order, to move the market. By running in front of the order, the firm or agent can profit on that movement.

Spreading Rumors

Any agent or IAR hearing a rumor must report it to the appropriate supervisor. Firms must ensure that rumors they become aware of are not spread or used in any way, particularly not as the basis for recommendations.

PRACTICE QUESTION

An agent hears a rumor concerning a security and uses the rumor to convince a client to purchase the security. Under the Uniform Securities Act, the agent may

A. recommend the security if it is an appropriate investment.
B. recommend the investment if the rumor is based on material inside information.
C. recommend the security if the rumor came from a reliable source.
D. not recommend the security.

Answer: D. Rumors must be promptly reported to the appropriate supervisory personnel and may never be used as the basis for a recommendation.

Backdating Records

All records and documents must reflect their actual dates. Although there can be tax or other benefits to clients when their trade confirmations are backdated, it is an unethical business practice to do so.

Lending or Borrowing Securities or Money

The rules are essentially the same as for investment advisers, with the exception that any broker-dealer offering margin accounts is authorized to lend to customers and borrow securities for short sales.

Breakpoint Sales

Review the discussion at LO 3.c for an understanding of this unethical business practice.

Practices Relating Solely to Agents

Fictitious Accounts

Establishing or maintaining an account containing fictitious information in order to execute transactions that would otherwise be prohibited is unethical. Examples of this kind of conduct sometimes given on the exam are "beefing up" a client's net worth to enable him to engage in margin or options trading, or making him appear to have more investment experience than is true.

Sharing in Accounts

Sharing directly or indirectly in profits or losses in the account of any customer without the written authorization of the customer and the broker-dealer that the agent represents is unethical.

Agents cannot share in the profits or losses of client accounts unless the client and the broker-dealer supply prior written approval. In such a situation, it would be permissible to commingle the agent's and the customer's funds if they have a joint account. Unlike FINRA rules, a joint account is not required, nor is the sharing required to be proportionate to the agent's financial contribution.

TEST TOPIC ALERT

Unlike agents, broker-dealers, investment advisers, and investment adviser representatives are never permitted to share in the profits or losses in their client's accounts.

Splitting Commissions

Dividing or otherwise splitting the agent's commissions, profits, or other compensation from the purchase or sale of securities with any person not also registered as an agent for the same broker-dealer, or for a broker-dealer under direct or indirect common control, is unethical. Interestingly enough, they can do this without disclosing the split to their clients *unless* it increases the transaction cost to the client. This is one of the very rare cases where disclosure is not necessary.

Selling Away (Private Securities Transactions)

Effecting securities transactions not recorded on the regular books or records of the broker-dealer that the agent represents, unless the transactions are authorized in writing by the broker-dealer prior to execution of the transaction, is unethical.

TEST TOPIC ALERT

The exam may refer to this as a trade made off the books of the broker-dealer. Just remember that it is considered to be a prohibited practice anytime an agent engages in a securities transaction not recorded on the regular books or records of the broker-dealer that the agent represents, unless the transaction is authorized in writing by the broker-dealer before execution of the transaction.

EXAMPLE

An agent was approached at a party by a friend and was asked if she knew anyone who might like to invest in a movie the friend was making. One of the agent's clients was there and was interested, so much so that he ended up writing a check for $50,000. When the investor received his next account statement, he called the agent's broker-dealer because he didn't see the $50,000. The call was escalated up to the compliance officer, and the agent lost her license for *selling away*—engaging in a transaction "off the books" of the firm without prior authorization.

Agent's Account at a Different Broker-Dealer

Although unusual, there are cases where an agent registered with a broker-dealer will open an account at another broker-dealer. The most common case is when that other BD offers a product that is not available at the agent's firm. Under the rule, no person associated with a broker-dealer shall, without the prior written consent of that BD, open or otherwise establish at a broker-dealer other than the employer BD any account in which securities transactions can be effected and in which the associated person has a beneficial interest. The requirements of this rule do not apply to transactions in unit investment trusts, municipal fund securities (529 plans) variable contracts, or redeemable securities of companies registered under the Investment Company Act (e.g., variable annuities/life and mutual funds).

LO 14.j Identify the requirements when selling securities on the premises of financial institutions.

Sales of Securities at Financial Institutions

The 1990s saw a proliferation of broker-dealer services being offered on the premises of financial institutions, particularly banks. In response to the potential for confusion as well as conflicts of interest, NASAA prepared Model Rules for sales of securities at financial institutions. Here are the key points for you to know.

No broker-dealer shall conduct broker-dealer services on the premises of a financial institution where retail deposits (deposits from ordinary customers like you and me) are taken unless the broker-dealer complies initially and continuously with the following requirements.

Setting

Wherever practical, broker-dealer services should be conducted in a physical location distinct from the area in which the financial institution's retail deposits are taken. In situations where there is insufficient space to allow separate areas, the broker-dealer has a heightened responsibility to distinguish its services from those of the financial institution. The broker-dealer's name should be clearly displayed in the area in which the broker-dealer conducts its services.

Customer Disclosure and Written Acknowledgment

At or prior to the time that a customer's securities brokerage account is opened by a broker-dealer on the premises of a financial institution where retail deposits are taken, the broker-dealer must:

- disclose, orally and in writing, that the securities products purchased or sold in a transaction with the broker-dealer
  - are not insured by the Federal Deposit Insurance Corporation (FDIC),
  - are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution, and
  - are subject to investment risks, including possible loss of the principal invested; and
- make reasonable efforts to obtain from each customer, during the account opening process, a written acknowledgment of the disclosures.

Communications with the Public

The following logo format disclosures may be used by a broker-dealer in advertisements and sales literature, including material published or designed for use in radio or television broadcasts, automated teller machine (ATM) screens, billboards, signs, posters, and brochures, to comply with the requirements, provided that such disclosures are displayed in a conspicuous manner:

- Not FDIC Insured
- No Bank Guarantee
- May Lose Value

As long as the omission of the disclosures would not cause the advertisement or sales literature to be misleading in light of the context in which the material is presented, such disclosures are not required with respect to messages contained in:

- radio broadcasts of 30 seconds or less;
- electronic signs, including billboard-type signs that are electronic, time and temperature signs, and ticker tape signs, but excluding messages contained in such media as television, online computer services, or ATMs; and
- signs, such as banners and posters, when used only as location indicators.

KNOWLEDGE CHECK 14.5

1. On occasion, two registered agents cooperate on a sale. In that case, the commissions earned may be split in all of the following cases **except**
   A. when the agents are not registered with the same or an affiliated broker-dealer.
   B. when one of the individuals is the other's supervisor.
   C. when consent to the split was not obtained from the customer.
   D. when only one of the individuals has made an investment into the account.
2. The regulators are concerned when a broker-dealer operates on the premises of a financial institution. However, the rules only apply when which of the following activities takes place on those premises?
   A. Personal loans are made
   B. Retail deposits are taken
   C. Mortgage loan applications are accepted
   D. Safe deposit boxes are available

LESSON 14.6: POTENTIAL CRIMINAL ACTIVITIES

LO 14.k Recognize potential criminal activities applying to all securities professionals.

As with the previous learning objectives, it is easiest to list the criminal activities of securities professionals with explanations or comments.

Using Inside Information

Because the potential rewards are so great, using inside information is one of the most commonly violated rules by both investors and securities professionals. Some go to extreme lengths to try to hide the activity in an effort to make it difficult to uncover. Making recommendations on the basis of material inside information about an issuer or its securities is prohibited. Should an agent or IAR come into possession of inside information, she must report the possession of the information to a supervisor or compliance officer. Even the use of a broker-dealer or investment adviser's internally generated research report prior to public release can be considered use of inside information.

TAKE NOTE

Material nonpublic inside information (MNPI) under securities law is any information about a company that has not been communicated to the general public and that would likely affect the value of a security. Even if you acquire the information "accidentally," you cannot use it until it becomes public.

An **insider** or **control person** is defined as an officer, director, or owner of more than 10% of the voting stock of the company, or the immediate family of any of these persons. After the tremendous insider abuses of the mid-1980s, the SEC took steps to beef up its enforcement of insider trading; hence this act. This act incorporated all of the other prohibitions against the activities of insiders and the use of inside information and also increased the penalties that could be levied and made the recipient of inside information as guilty as the insider who passed on that information. In other words, the tippee would be just as guilty as the tipper.

An insider is in violation of SEC rules when he trades securities on the basis of material nonpublic information (MNPI) or when he passes on this information to another who subsequently acts on it. It is critical to remember that no chargeable violation has occurred unless a transaction has taken place.

Even persons who do not meet the definition of an insider are subject to the rules governing the use of nonpublic information and could be liable for any actions taken. When it comes to who could potentially be an insider—that is, who could possibly possess material inside information—the list is virtually endless. One could therefore say that a potential insider could be anyone coming across information dealing with a company, other than those individuals who, by virtue of their title or other circumstance, are definitely insiders.

The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)

This act gave the SEC authority to seek *civil* penalties against persons violating the provisions of the act in amounts up to the greater of $1 million or treble damages. **Treble damages** means that the guilty party could be fined up to three times any ill-gotten gains or up to three times any losses avoided by using inside information to get out before a market drop. The Federal Civil Penalties Inflation Adjustment Act of 2015 changed the way the civil penalty is applied for insider trading. The new penalties were applied as of August 1, 2016. The $1,000,000 is now indexed for inflation to $1,978,690 and represents the maximum civil penalty for insider trading to be compared to the treble damages. Historically, the exam stays away from numbers that change such as this one.

These civil penalties are in addition to any disgorgement of profits made or losses avoided as a result of the insider trading. From this fine, the SEC is authorized to award bounties to informants. If the SEC should elect to pursue *criminal* action, then penalties would include potential jail time with a maximum sentence of 20 years.

Chinese Wall Doctrine

It is plain that regulators wish to maintain a level playing field for all, and if those with material nonpublic information were to let it leak out to favored interests, a prohibited activity would be taking place. This is particularly an issue with those broker-dealers who engage in investment banking, especially mergers and acquisitions. In order to do their job, they must have access to confidential information that is not publicly available—at least not yet. Therefore, in order to ensure that this information does not become available, for example, to the research department or the retail sales staff, these firms must erect (figuratively) a wall as impenetrable as the Great Wall of China between these departments. In essence, *Chinese Wall* is the term used to describe the procedures followed by these firms to insulate information from reaching the wrong hands.

TAKE NOTE

Although you might see the term *Chinese Wall* on your exam, the preferred term in the industry is *information barrier*.

EXAMPLE

As an example of the type of returns that can be made, Mr. H, a convenience store employee, has a sister whose boyfriend worked for a company that was about to be bought out by another company. The boyfriend mentioned that to the sister, who in turn told her brother. The day before the announcement was made public, Mr. H. took his life savings of $8,000 and invested in options in that company. The next day, after the announcement and the jump in price, he sold and reaped a profit of over $295,000 (almost 37 times his investment in one trading day). Yes, he was caught (which is how we know the story) and had to return his profits and then some interest.

Another case involved getting access to a law firm's computer. The law firm specialized in mergers and acquisitions, and those with access were able to learn of upcoming takeover bids being made at prices significantly higher than the current trading price. To avoid being noticed, the trades were placed through the account of the mother of one of the participants, who was based in China. Total penalties in this case were almost $6 million plus interest of about $125,000.

In our first example, Mr. H wasn't looking for the information, but when it came his way, he used it. In the second example, the perpetrators hacked into the computers with malice aforethought.

PRACTICE QUESTION

Which of the following employees of a publicly traded company would most likely have access to MNPI?

A. VP of Human Resources
B. Receptionist
C. Chief Financial Officer (CFO)
D. VP of Marketing

Answer: C. Although any of these employees could obtain access to MNPI, because the CFO is the individual who sees the financial numbers first, it is part of the job to have access to earnings numbers before anyone else.

TEST TOPIC ALERT

The exam may ask you to identify who is guilty of insider trading violations—a corporate officer of the issuer who divulges material inside information to a friend, but no transaction takes place, or an agent who executes a trade for a client who is acting on inside information? Simply giving someone inside information, although imprudent, is not a violation of the law. Only when the information is used for trading does a violation occur. In our question, the agent is in violation for accepting an order on the basis of material nonpublic information that results in a trade.

Market Manipulation

Effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive, or fraudulent device, practice, plan, program, design, or contrivance is generally considered a fraudulent practice.

Securities legislation is designed to uphold the integrity of markets and transactions in securities. However, market integrity is violated when transactions misrepresent actual securities prices or market activity. The most common forms of market manipulation are matched orders and wash trades.

Matched Orders

These occur when an order to buy or sell securities is entered with knowledge that a matching order on the opposite side of the transaction has been or will be entered for the purpose of (1) creating a false or misleading appearance of active trading in any publicly traded security or (2) creating a false or misleading appearance with respect to the market for any such security.

Increased volume in a security can induce unsuspecting investors to purchase the security, thereby bidding up the price. As the price rises, participants who initiated the matched orders sell their securities at a profit.

Wash Trades

This is an order to buy or sell securities resulting in no change of beneficial ownership for the purpose of (1) creating a false or misleading appearance of active trading in any publicly traded security or (2) creating a false or misleading appearance with respect to the market for any such security. This is typically done by an investor buying in one brokerage account and simultaneously selling through another. No real change in ownership has occurred, but to the marketplace, it appears that volume and/or price is increasing.

TEST TOPIC ALERT

A **wash sale** for tax purposes is not related to this in any way. A wash sale for tax purposes occurs when a person sells a security and repurchases it within 30 days prior to or after the sale—this is covered in Unit 15 of this course.

TAKE NOTE

An industry term used to describe this increased volume and/or price caused by matched orders and wash trades is *painting the tape*. The term is derived from the old days when market activity was reported on ticker tape.

Accurate recording of orders and subsequent trades is one way that regulators monitor for attempts to manipulate the market.

TAKE NOTE

So, what is the difference between a matched order and a wash trade? Keeping it simple (because the exam only wants you to know they're both illegal), *wash trades* are trades in which the (natural or legal) person who is the beneficial owner of the traded securities does not change, even though this is the impression conveyed to the public. In other words, in a wash trade, it is the same investor trading in two or more accounts owned or controlled by that single investor. In the case of *matched orders*, these are prearranged entries of equal but opposite buy and sell orders in the same security made between different parties with the intention to distort the public impression of actual liquidity or prices. There is a change in ownership, but the attempt is to deceive.

TAKE NOTE

Arbitrage is the simultaneous buying and selling of the same security in different markets to take advantage of different prices; it is not a form of market manipulation. Simultaneously buying a security in one market and selling it in another forces prices to converge and, therefore, provides uniform prices for the general public.

KNOWLEDGE CHECK 14.6

1. A company leaks some inside information to some key employees but not the public. One of those employees tells the agent servicing his brokerage account, and the agent tells another customer who trades on the information before it becomes public. In this situation, who would be guilty of insider trading?
   I. The person at the company who leaked the information
   II. The employee who told the registered representative
   III. The registered representative
   IV. The customer who traded on the information
   A. I only
   B. I and IV
   C. I, II, and III
   D. I, II, III, and IV
2. An investor receives an unsolicited email about a startup company trading for pennies. The email notes that a patent for a new technology is forthcoming and investors need to get in now. The next day the investor sees lots of information on the same stock in an internet chat room. The hype seems to be similar to what was received in the email blast. Being cautious, the investor senses that this could be
   A. an effort to spread market rumors in an attempt to manipulate the stock.
   B. a front running scheme to get ahead of large buy orders.
   C. an attempt to generate commissions by churning investors' accounts.
   D. a fraudster attempting to peg the price of the stock.

LESSON 14.7: PROTECTING CUSTOMER DATA

LO 14.l Recognize that securities professionals must practice good cybersecurity, privacy, and data protection.

Cybersecurity, Data Protection, and Privacy

Hardly a day goes by without news of a hacking attempt that has compromised the security of a company, its clients, or both. There are steps that can be taken by securities professionals to reduce the potential for loss to the firm and its clients.

Cybersecurity

In September 2014, NASAA released results of a pilot survey designed to better understand the cybersecurity practices of state-registered investment advisers. Based on that survey, in setting up a cybersecurity program, NASAA suggests addressing the following points:

- Cyber preparedness: Has the firm addressed which cybersecurity threats and vulnerabilities may impact its business?
- Cybersecurity compliance program: Does the firm have written policies, procedures, or training programs in place regarding safeguarding client information?

- Cybersecurity and social media: Does the firm have written policies, procedures, or training programs in place relating to the use of social media for business purposes (e.g., Linkedin, Twitter, Facebook)?
- Cyber insurance: Does the firm maintain insurance coverage for cybersecurity?
- Cyber expertise: Has the firm engaged an outside consultant to provide cybersecurity services for your firm?
- Cyber confidentiality: Does the firm have confidentiality agreements with any third-party service providers with access to the firm's information technology systems?
- Cyber incident: Has the firm ever experienced a cybersecurity incident where, directly or indirectly, theft, loss, unauthorized exposure, use of, or access to customer information occurred? If so, has the firm taken steps to close any gaps in its cybersecurity infrastructure?
- Cyber disposal: Does the firm have a procedure for the disposal of electronic data storage devices?
- Cyber continuation: What are the plans for the firm's continued operation during a cyber-event or cybersecurity incident?
- Cyber losses: Are there plans for treating the loss of electronic devices (e.g., loss of a laptop containing personal and confidential client information)?
- Cybersecurity safeguards: Does the firm use safeguards, such as encryption and antivirus or antimalware programs? Does the firm contact clients via email or other electronic messaging, and if so, does the firm use secure email or any procedures to authenticate client instructions received via email or electronic messaging to work against the possibility of a client being impersonated?

Safeguarding Client Information

Broker-dealers have a great deal of information about their clients that would be highly valuable to persons with evil intentions. Our primary concern here is with identity theft, which may be used to falsify client requests for funds and/or securities. In order to combat identity theft, securities professionals must be aware of the red flags.

TAKE NOTE

Identity theft means a fraud committed or attempted using the identifying information of another person without authority. *Red flag* means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

The regulators are concerned when broker-dealers (or other financial professionals) maintain what are referred to as "covered accounts." The term *covered account* is defined as:

- an account that a financial institution offers or maintains—primarily for personal, family, or household purposes—that involves or is designed to permit multiple payments or transactions (not a business account—it is felt that there is much less identity theft risk there); or
- any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft, including financial, operational, compliance, reputation, or litigation risks.

TAKE NOTE

The definition includes a margin account as an example of a covered account. Also included is a brokerage account with a broker-dealer or an account maintained by a mutual fund (or its agent) that permits wire transfers or other payments to third parties.

Investment advisers who have the ability to direct transfers or payments from accounts belonging to individuals to third parties upon the individuals' instructions, or who act as agents on behalf of the individuals, are susceptible to the same types of risks of fraud as other financial institutions. Individuals who hold accounts with these investment advisers bear the same types of risks of identity theft and loss of assets as consumers holding accounts with other financial institutions. If such an adviser does not have a program in place to verify investors' identities and detect identity theft red flags, another individual may deceive the adviser by posing as an investor.

It is required that each financial institution that offers or maintains one or more covered accounts must develop and implement a written program designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. These provisions also require that each program be appropriate to the size and complexity of the financial institution and the nature and scope of its activities.

The program must include reasonable policies and procedures to:

- identify relevant red flags for the covered accounts that the financial institution offers or maintains and incorporate those red flags into its program;
- detect red flags that have been incorporated into the program of the financial institution;
- respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and
- ensure the program (including the red flags determined to be relevant) is updated periodically to reflect changes in risks to customers and to the safety and soundness of the financial institution or creditor from identity theft.

Identity Theft Red Flags

Following is a list of some of the most common warnings that firms should include in their identity theft programs as is appropriate to the nature of the firm's business:

- Alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services or a notice of credit freeze in response to a request for a consumer report;
- Presentation of suspicious documents, such as documents that appear to have been altered or forged;
- The photograph or physical description on the identification is not consistent with the appearance of the applicant or customer presenting the identification;
- Presentation of suspicious personal identifying information, such as a suspicious address change;
- Unusual use of, or other suspicious activity related to, a covered account;
- Notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution;

- Personal identifying information provided by the customer is not consistent with other personal identifying information provided by the customer (e.g., there is a lack of correlation between the Social Security number range and date of birth);
- Personal identifying information provided is of a type commonly associated with fraudulent activity as indicated by internal or third-party sources used by the financial institution. For example,
  - the address on an application is fictitious or is of a mail drop or a prison, or
  - the phone number is invalid or is associated with a pager or an answering service;
- For financial institutions that use challenge questions (what is the name of your first pet?, etc.), the person opening the covered account or the customer cannot provide authenticating information beyond that which generally would be available from a wallet or consumer report; and
- Mail sent to the customer is returned repeatedly as undeliverable, although transactions continue to be conducted in connection with the customer's covered account.

Please note that this is not meant to be an exhaustive list. Your firm will make you aware of its program and the specific red flags they are addressing. The exam is more concerned about the concept than an actual list, although you should be able to recognize obvious patterns of misuse in an account.

PRACTICE QUESTION

A great concern to broker-dealers is the theft of the identity of a client. To reduce the possibility of a client's assets being improperly taken, most firms would consider all of these to be red flags **except**

A. almost one year since your last contact with your client, you receive a phone call requesting that funds be wired to an offshore account.
B. a client regularly visits your office to pick up a check representing the proceeds of recently settled transactions.
C. when running a credit report on a new client's application, there is a discrepancy between the home address listed on the report and the one on the new account form.
D. the photograph on the identification documents provided does not resemble the individual opening the account.

Answer: B. There is nothing wrong with a client picking up a check for the proceeds of a securities transaction, even if done on a regular basis (some folks don't trust the mail). Each of the other choices should raise a red flag as being something needing further investigation.

Methods for Protecting the Firm and Its Customers

What are the methods of authentication used by customers or employees to access electronic data storage devices that allow access to client communications, client information, or both?

- Single-factor authentication (e.g., ID/password)
- Dual-factor authentication (e.g., key fobs, secure IDs)
- Adaptive-factor authentication (e.g., challenge questions)
- Biometric authentication (e.g., fingerprint scan)
- Antivirus software installed on electronic devices used to access client information

Some questions to ask regarding the security methods used include the following:

- How often are updates downloaded to antivirus software?
- Does your firm utilize encryption on its files or devices?
- Does your firm utilize online or remote backup of electronic files?
- Does your firm allow remote access to servers or workstations via a virtual private network (VPN) or similar technology?
- Does your firm use free Cloud services, such as iCloud, Dropbox, or Google Drive, to store personal and confidential client information?
- Does your firm utilize your firm's website to use or access client information data?
- Does your firm's website include a client portal?

As you can see from the many questions posed, protecting data is not a simple issue. Although the decision as to what will be used and how it will be used is that of the firm, agents must be aware of the tools being employed and how they work. That is why so much emphasis is placed on initial and continual training.

TEST TOPIC ALERT

Broker-dealers and investment advisers backing up client data should make sure it is **encrypted**.

Privacy: Regulation S-P

Regulation S-P, mandated by the Gramm-Leach-Bliley Act, requires that firms take identity theft seriously and have adequate safeguards in the form of privacy policies to protect nonpublic personal information from unauthorized access or use. Member firms must provide an initial privacy notice to new customers when an account is opened and must provide an annual privacy notice to all customers. Regulation S-P permits firms to disclose nonpublic personal information to unaffiliated third parties unless the customer has elected to opt out of the disclosure. Examples of nonpublic personal information include a customer's Social Security number, account balances, transaction history, the fact that the individual was at one time a customer, and any information collected through a consumer reporting agency or an internet cookie. Furthermore, the regulation requires that the customer be given 30 days to opt out before disclosure of nonpublic personal information may be made.

TAKE NOTE

An internet cookie is created with a view that allows the member firm to collect information about the customer and is an example that illustrates one of the many ways that any financial institution may obtain information about a consumer in connection with providing a financial product or service to that specific consumer. If the information is not specific, it is known as blind data or aggregate information that contains no personal identifiers. It is not deemed to be personally identifiable information and, therefore, not subject to Regulation S-P requirements.

Regulation S-P distinguishes between a consumer and a customer. A consumer is an *individual* who obtains a financial product or service from a firm and has no further contact with the firm. A customer is an *individual* who has an ongoing relationship with a firm. Consumers are given an initial privacy notice only, while customers must be given both an initial and an annual privacy notice. Only individuals, not businesses or institutions, are covered by the regulation.

Regulation S-P also requires members to adopt policies and procedures that provide adequate safeguards of confidential customer information and records. Not a month goes by without a headline of a major break in security at a large company. Technological advancements, such as public access WiFi, present many confidentiality issues for firms. Among the many security concerns is that data are broadcast out into the airwaves, making interception easier. Wireless connections present an attractive mechanism for hackers to tap into the user's workstation to gain access to the corporate network. Before permitting employees to access customer information remotely, members must implement and update appropriate measures to secure customer information. These measures may need to go far beyond a firewall and off-the-shelf defensive software to stay ahead of criminals who want to access your systems.

TAKE NOTE

Reasonable opt-out methods available to members include providing a reply form with the opt-out notice, an electronic means to opt out if the customer has agreed to the electronic delivery of information, and a toll-free number that customers may call.

The SEC has stated that members are not providing a reasonable means to opt out if the only method to do so is by writing a letter to the member.

PRACTICE QUESTION

Under Regulation S-P, if an investment adviser sends a customer an initial privacy notice that contains an opt-out provision, the firm may not disclose nonpublic personal information about that customer for how many days from the mailing?

A. 10
B. 15
C. 20
D. 30

Answer: D. An investment adviser (or broker-dealer) must give a customer 30 days to implement any opt-out provision in the privacy notice.

KNOWLEDGE CHECK 14.7

1. Protection of customer confidential information is an obligation of the
   I. agent servicing the customer's account.
   II. broker-dealer maintaining the account.
   III. customer.
   IV. investment adviser in an advisory account.
   A. I and II
   B. II and IV
   C. III and IV
   D. I, II, III, and IV
2. A broker-dealer's cybersecurity procedures should address all of the following **except**
   A. the music played while customers are placed on hold.
   B. office desktop computers.
   C. agents' personal smartphones used on occasion to communicate with clients.
   D. remote access to servers or workstations via a virtual private network (VPN).

LESSON 14.8: BUSINESS CONTINUITY AND SUCCESSION

As mentioned previously several times, NASAA does not have a separate principal's registration category like FINRA does. This means that registrants passing the Series 65 exam can go to the Administrator's office with a completed Form ADV and, in most states, a check for $200 and become a registered investment adviser. Because there is no way for NASAA to know if you will be opening your own IA firm or simply working as an IAR, some of the information tested goes into detail that one would expect to be limited to the owners of the firm. This lesson is an example of that.

LO 14.m Recall what constitutes an adequate business continuity plan.

Business Continuity and Succession Plans

In April 2015, NASAA released a Model Rule dealing with business continuity plans for state-registered investment advisers. In most respects, it mirrors FINRA Rule 4370 dealing with their member broker-dealers. The rule requires that every investment adviser shall establish, implement, and maintain written procedures relating to a Business Continuity and Succession Plan (BCP). The plan should be based upon the facts and circumstances of the investment adviser's business model, including the size of the firm, the type(s) of services provided, and the number of locations of the investment adviser. The plan shall provide for at least the following:

- The protection, backup, and recovery of books and records
- Alternate means of communication with customers, key personnel, employees, vendors, service providers (including third-party custodians), and regulators, including, but not limited to, providing notice of a significant business interruption or the death or unavailability of key personnel or other disruptions or cessation of business activities
- Office relocation in the event of temporary or permanent loss of a principal place of business
- Assignment of duties to qualified responsible persons in the event of the death or unavailability of key personnel
- Otherwise minimizing service disruptions and client harm that could result from a sudden significant business interruption

Purpose of a Business Continuity Plan

The most common purpose of a BCP is to have processes and procedures in place to ensure that critical business functions can continue during and after a disaster or other significant business interruption. BCPs outline actions advisers should take if utility outages, catastrophic natural disasters, national emergencies, acts of terrorism, or other types of disturbances disrupt day-to-day business operations. Advisers' BCPs should reflect comprehensive approaches to reduce and manage risks associated with disasters, significant business interruptions, and work stoppages. All BCPs should include Succession Plans. Advisers have a fiduciary duty to act in the best interest of their clients, and it is in the best interest of clients for advisers to adopt a Succession Plan with procedures to ensure continuity of services and the day-to-day operations of the business, or to smoothly wind down advisers' businesses in the event of death, disability, or incapacity. Without proper planning, the unexpected loss of executives, key personnel, or owners can be disastrous to the business and to clients.

Succession Issues

Planning for an unexpected succession situation is an important part of a BCP. While there are some succession issues that apply to every adviser (e.g., every adviser needs a designated regulatory contact person), each adviser must also tailor its Succession Plan to the adviser's needs. An adviser's business entity structure will affect the types of items that should be addressed in the adviser's Succession Plan.

For example, in a sole proprietorship, the client's legal relationship is with the sole proprietor, who is often the only investment adviser representative. With the death or permanent disability of the owner, the sole proprietorship itself may legally terminate as an entity, as would any powers of attorney, advisory contracts, and other client agreements. The deceased (or otherwise incapacitated) sole proprietor is likely to be the only regulatory contact and may be the only person who would be able to access electronic client files or authorize rebates of prepaid fees. There are many additional issues, such as probate, that are unique to sole proprietorships and affect the implementation of a Succession Plan. Therefore, the adviser should have a Succession Plan that will immediately address these issues when an IAR becomes unavailable. Regardless of who takes over, a person cannot provide advisory services for compensation unless she is registered with the state's securities regulator(s) or exempt from registration.

Advisers should consider the following items when drafting a Succession Plan to ensure that the Succession Plan adequately accounts for the risks related to the business entity.

- Are the clients' investment advisory contracts with an individual or a legal entity?
- Does an IAR's death or unavailability affect the advisory agreement?

PRACTICE QUESTION

A BCP should be designed to protect the firm's clients in the event of which of the following?

I. A natural disaster such as a hurricane or tornado
II. Acts of terrorism
III. Pregnancy of one of the firm's IARs
IV. Climate change

A. I and II
B. I and IV
C. II and III
D. III and IV

Answer: A. Business Continuity Plans are designed to provide for the sudden unexpected events that can disrupt day-to-day business operations.

KNOWLEDGE CHECK 14.8

1. The first step in developing a Business Continuity Plan (BCP) is to identify the risks that could cause a service interruption. Such risks would include:
   A. a natural disaster (such as storms, earthquakes, or flooding).
   B. the death or disability of a key employee.
   C. a service provider interruption (such as the internet going down).
   D. all of these.

2. The death of an investment adviser's key person would *most likely* have the greatest immediate effect when the firm is organized as
   A. a C corporation.
   B. an LLC.
   C. an S corporation.
   D. a sole proprietorship.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 14.1

1. **B** Hedge clauses may not be used to disclaim statements that are inherently misleading.

   LO 14.a

2. **A** The UPIA specifically uses the terms *skill and caution* when describing the actions of the fiduciary. Other components of the UPIA state that, rather than viewing individual securities, the overall effect on the entire portfolio is considered. This means that high-risk securities can have a place as long as the overall portfolio meets the objectives. That is the benefit of diversification—something that is considered essential to the prudent investment of money belonging to others.

   LO 14.b

Knowledge Check 14.2

1. **B** Earlier in this course, we told you that investment advisers are never permitted to receive performance-based compensation. That is, an advisory contract cannot be structured so that the investment adviser's compensation is increased if the advisory account's performance is superior. This question deals with the exception, and only when an exception is part of the question can those fees be paid. The term used to describe those eligible for this type of arrangement is *qualified client.* There are two ways to qualify: one is the net worth in excess of $2.2 million (don't count the home) and the other is having at least $1.1 million in the account with the IA. Don't confuse that with the *qualified purchaser* in Lesson 3.3's discussion of private funds. The $1 million in net worth and the $200,000 in net income describe an *accredited investor*, and they don't make the cut here.

   LO 14.c

2. **D** Soft dollar compensation is when an investment adviser derives an economic benefit from the use of a client's commission dollars. Software of the type mentioned here is allowable under the safe harbor provisions of Section 28(e) of the Securities Exchange Act of 1934. It is true that this is indirect compensation and that it is a discretionary account, but the answer that best matches the question is *soft dollar.* Many times on the exam, you have to select the best of the choices given.

   LO 14.d

Knowledge Check 14.3

1. **B** Whether custody is maintained by the investment adviser itself or by a qualified custodian, statements must be sent at least quarterly.

   LO 14.e

2. **A** Time or price decisions alone do not require any discretionary authority. This account is well past the 10 business days where oral authorization is permitted. If it was not time or price alone being determined, this IA must have written discretionary authority to determine which security, what action, and how many shares to purchase or sell.

   LO 14.f

Knowledge Check 14.4

1. **C** When an IA recommends the same security to a high percentage of her clients, it is generally considered that individual suitability was ignored. After all, it is unlikely that the same security is a fit for all of these clients. There is no discretion because it is simply a recommendation—no trade is made unless ordered by the clients. Bunching orders is the permitted activity of combining several small orders into a larger one, frequently saving commissions for the clients.

   LO 14.g

2. **B** Just something to memorize—Form 13F is filed quarterly. We've heard of students who remember this by observing that there are 13 weeks in a quarter of a year. We think that's pretty good.

   LO 14.h

Knowledge Check 14.5

1. **A** Splitting commissions is permitted among individuals registered as agents for the same or affiliated broker-dealers. Splitting with your supervisor is fine and, unless something indicated there would be additional expense, consent of the customer is not required. It would not be expected that any agent is investing in customer accounts.

   LO 14.i

2. **B** Because of the potential for misunderstanding the difference between bank retail products (savings accounts, CDs, money market checking accounts) and brokerage accounts, the rules on BDs operating on the premises of a financial institution apply only when that location accepts retail deposits. In most cases, these other activities will take place, but it is the accepting of retail deposits that triggers the "on the premises" rule.

   LO 14.j

Knowledge Check 14.6

1. **D** It is illegal to trade on inside information, and it is also illegal to disseminate the information if someone else trades on it.

   LO 14.k

2. **A** This is an example of potential market manipulation by spreading rumors. Regulators have issued alerts to warn investors about fraudsters who may attempt to manipulate share prices by spreading false or misleading information about stocks. This is often done through social media platforms where large numbers of people can be contacted.

   LO 14.k

Knowledge Check 14.7

1. **D** Although any securities professional handling a customer account is obligated to follow all necessary procedures to protect client data, customers themselves also bear a responsibility. Customers ignoring the cybersecurity safeguards put not only their own data at risk, but also that of other customers, by potentially opening the door to hackers.

   LO 14.l

2. **A** It is hard to imagine how the music on hold would present a security risk. All of the other choices clearly offer potential for loss.

   LO 14.l

Knowledge Check 14.8

1. **D** Each of these choices is an event that could lead to an interruption in an investment adviser's ability to provide service to clients.

   LO 14.m

2. **D** Although each these business structures could consist of a single key individual, that would always be the case with a sole proprietorship.

   LO 14.m

UNIT 15

Tax Considerations

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 15.a **Recognize** income tax fundamentals for individuals.
- LO 15.b **Identify** the different sources of income and loss.
- LO 15.c **Distinguish** between income and capital gains and how they are taxed.
- LO 15.d **Recall** the preference items included in the AMT computation.

Your exam will include approximately two questions from the topics covered in Unit 15.

INTRODUCTION

Taxes on income and capital gains diminish the amount of money available to the person who earns it. As a result, personal and business investment decisions are often influenced by the tax implications.

LESSON 15.1: INDIVIDUAL TAXATION

LO 15.a Recognize income tax fundamentals for individuals.

Taxes function as either regressive or progressive. Regressive taxes (e.g., sales, excise, payroll, property, and gasoline taxes) are levied at the same rate regardless of income and thus represent a smaller percentage of income for wealthy taxpayers than for taxpayers with lower incomes. Because low-income families spend a larger percentage of their incomes than they save or invest, regressive taxes consume a larger fraction of the income of the poor than of the wealthy. Progressive taxes (e.g., estate, gift, and income taxes) increase the tax rate as income increases. Progressive taxes are costlier to people with high incomes than to people with low incomes. This unit will deal with taxation on the federal level with specific reference to state taxes when necessary.

TEST TOPIC ALERT

In a progressive tax system, the term used to describe the highest rate paid on income (sometimes referred to as the *next dollar* received, or the *last dollar received*) is the individual's *marginal tax rate*. For example, in 2021, a single individual with taxable income in excess of $209,425 was taxed on each dollar earned above that amount at a rate of 35% until reaching $523,601, at which time the excess is taxed at 37%. Therefore, if this individual reported earnings of $250,000, it is proper to say that the marginal tax rate is 35%. If the individual earned $550,000, then it would be 37%.

Please note that the actual tax brackets are never tested on the exam because they change every year—we are showing them only as examples. The only tax-related numbers that might appear on the exam are the annual IRA maximum and the annual gift exclusion.

EXAMPLE

Based on the above information, a single taxpayer with taxable income of $220,000 is given a $10,000 bonus. The federal income tax on that bonus is taxed at the individual's marginal (or top) tax bracket rate of 35%, so the tax would be **$3,500**. This individual won't move into another bracket until taxable income exceeds $523,601.

Besides the amount of income, the most important factor in determining an individual's income tax bill is the choice of filing status.

The choice of filing status one makes has a major impact on the amount of taxes levied. There are five different filing statuses:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying widow(er) with dependent child

Filing status is determined by your marital status as of the last day of the year. If more than one filing status applies to the taxpayer, the IRS suggests using the one resulting in the lowest tax obligation. Generally, that will be married filing jointly. For those who are not married, if qualifying, the lowest rate is usually obtained by filing as head of household.

TEST TOPIC ALERT

How you file a return can impact your taxes. Your tax-filing status is based on your marital status as of the end of the year (December 31). In the case of a "single" parent with dependent children, it will generally be most advantageous to use the filing status "head of household."

EXAMPLE

In most cases, the tax-filing status that results in the highest income tax is

A. head of household.
B. married filing jointly.
C. qualifying widower with a dependent child.
D. single.

Answer: D. In general, for the same amount of income, filing single will result in the highest income tax while married filing jointly, the lowest. Head of household is usually the best for those who are not married but do have children.

Other factors include:

Age: Taxpayers who are 65 or older receive an addition of $1,300 each if married and filing a joint return, or $1,600 if single, to the standard deduction. This additional amount is also available to those who are blind or disabled. This increased standard deduction can lower the tax bill.

State of residence: If the taxpayer lives in a state with a state income tax, up to certain limits, the amount paid can be taken as a deduction on the federal return, thus lowering the tax due.

Citizenship: An individual who is not a citizen of the U.S. may pay taxes at a different rate than citizens and may also receive certain tax credits due to tax treaties. Much of this depends on whether the individual is a resident alien or a nonresident alien, and the details are beyond the scope of the exam.

PRACTICE QUESTION

Under current tax law, which of the following would **not** be a factor in determining an individual's federal income liability?

A. Age
B. Citizenship
C. Filing status
D. Sex

Answer: D. One area in which the federal tax laws do not discriminate is the individual's sex. Those 65 and older are entitled to an additional exemption; non-U.S. citizens may pay more or less tax based on tax treaties and other factors; and filing status has a major impact on taxes.

KNOWLEDGE CHECK 15.1

1. One of your customers received a $5,000 year-end bonus. You explain that the bonus is really worth $3,250 in after-tax funds. This is because
   A. the customer's effective tax rate is 35%.
   B. the customer's marginal tax rate is 35%.
   C. the customer's median tax rate is 35%.
   D. the customer's marginal tax rate is 65%.
2. Which of the following is an example of a regressive tax?
   A. Federal fuel excise tax
   B. Gift tax
   C. Estate tax
   D. Income tax

LESSON 15.2: TAXATION OF INCOME VERSUS THE SALE OF CAPITAL ASSETS

LO 15.b Identify the different sources of income and loss.

Types of Income and Losses

Individuals can receive income from a number of sources. Let's discuss the most important ones for the exam.

Earned Income

Earned income includes salary, bonuses, tips, and income derived from active participation in a trade or business.

Alimony

Alimony is payment made under a (divorce) court order (or under a legal separation agreement) to an ex-spouse. Alimony may be paid directly to the ex-spouse or to a third party on the ex-spouse's behalf (e.g., to pay premiums on the ex-spouse's life insurance or contribute to the ex-spouse's IRA). Alimony payments, within limits, are generally deductible to the spouse making the payments and includable in income for tax purposes by the spouse receiving them.

TAKE NOTE

Effective January 1, 2019, the tax treatment of alimony was reversed. That is, the former spouse paying the alimony won't get to deduct the payment and the former spouse receiving the alimony won't report it as income. That change means that anyone receiving alimony from a divorce decree entered into after December 31, 2018, cannot declare that as income for IRA purposes. It does not affect earlier divorces.

Child Support

Alimony should not be confused with child support. **Child support** is a legal obligation of a parent to provide financial support for a child (typically occurring when the parent providing the support is not the parent with whom the child or children live). Child support is not deductible by the parent who pays it, nor is it includable in income by the recipient, who is often the other parent receiving the support on behalf of the child of the dissolved marriage.

EXAMPLE

Chuck and Alice divorced on November 2, 2018, after a 10-year marriage that produced two children—Tim, age 6, and Kim, age 8. Under a court order, it is decided that Chuck will pay Alice $1,000 per month in alimony and $600 per child per month ($1,200 in total child support). Chuck may deduct $12,000 of alimony payments for the tax year ($1,000 × 12 months) on his federal income tax return. Alice must report $12,000 of alimony payments for the tax year on her federal income tax return. Chuck cannot deduct any of the $14,400 in child support, nor is any of it reportable for income tax by Alice or their children.

Had the divorce taken place two months later (in 2019), then Chuck would not have been able to deduct the alimony and Alice would not report it as income. That means the alimony would not count as earned income for IRA purposes.

TEST TOPIC ALERT

For purposes of an IRA contribution, alimony from pre-2019 is considered eligible income while alimony from a divorce after 2018 is not. Child support is never eligible income.

Passive Income and Passive Losses

Passive income and **passive losses** come from rental property, limited partnerships, and enterprises (regardless of business structure) in which an individual does not actively participate. For the general partner, income from a limited partnership is earned income; for the limited partner, the income is *passive*, not *earned*. Passive income is netted against passive losses to determine net taxable income, which is then taxed at ordinary income rates. Passive losses may be used to offset only passive income.

Do not confuse passive losses, which are investment related, with casualty losses, which are not. You may be able to deduct losses based on the damage done to your property during a disaster. A casualty is a sudden, unexpected, or unusual event. This may include natural disasters like hurricanes, tornadoes, floods, and earthquakes. It can also include losses from fires, accidents, thefts, or vandalism. But, because these losses are not investment related, the exam should not get into any detail as to how much can be deducted from taxable income.

Portfolio Income

Portfolio income includes dividends, interest, and net capital gains derived from the sale of securities. No matter what the source of the income, it is taxed in the year in which it is earned. Capital gains and capital losses will be covered separately.

Dividend Income

If the dividend qualifies (you don't need to know the technical points that make a dividend qualify), the tax rate is generally a maximum of 15%. (It can be as high as 20% or more for very high-income taxpayers, but that is unlikely to be tested.) Otherwise, the dividend is taxed at ordinary income rates. For test purposes, assume that any dividend from a U.S. corporation, including stock mutual funds, is qualified, unless the question states otherwise.

PRACTICE QUESTION

An investor who would like to increase current income from investments and, at the same time, pay taxes on that income at less than her marginal tax rate would probably find which of the following to be most suitable?

A. U.S. Treasury bonds
B. Public utility stock
C. Growth stock
D. Money market mutual fund

Answer: B. The key to this question is that dividends paid on stock issued by American companies (and certain qualified foreign corporations) generally qualify for a reduced tax rate (maximum 15 to 20%). No such benefit accrues to money market funds (their dividends are generated from interest income), and government bond interest is always taxed as ordinary income (although state income tax free). The dividends on a growth stock would also qualify, but, because the question deals with increasing current income, public utility is a more sensible approach. This is an example of how the test might present you with two answer choices that could be correct, and you must choose the one that is more correct.

Interest Income

Interest on any debt security (other than tax-free municipal issues) is always taxed at ordinary income rates. Please note that interest on U.S. Treasury securities (but not GMNA and FNMA debt) is exempt from state and local taxation, but not federal. Furthermore, income distributions from bond funds are not qualified dividends and are taxed fully as ordinary income.

TAKE NOTE

Although interest income from municipal bonds is tax free, capital gains are fully taxable. Capital gains occur when the bond is sold for a price that is greater than the investor's cost basis (investment) in the bond. This is also true of capital gains distributions from municipal bond mutual funds. While the income distributions may be tax free, capital gains from any source are always taxable.

TEST TOPIC ALERT

In the case of TIPS, the taxation is a bit different. Being Treasury securities, they are exempt from state and local income tax. However, the annual interest payment received is taxable on a federal basis as ordinary income and, what is reminiscent of the tax treatment of a zero coupon bond discussed in Unit 2, the annual increase to the principal is taxed as well.

What about income from foreign issuers? Dividend and interest income received from foreign securities, including ADRs, is normally subject to withholding tax, typically about 15%, by the issuer's country of domicile. Current U.S. tax law allows many investors to reclaim the withheld tax as a credit against taxes owed on their tax returns, and it is not a preference item for AMT (LO 15.d). For example, if you purchased some Matilda (also called kangaroo) bonds (remember them from Unit 2: they are issued in the Australian marketplace by non-Australian entities), the Australian government requires that a withholding tax be placed on the interest, but U.S. taxpayers can take that tax withheld as a credit against U.S. income tax due on the interest. In almost all cases, income from foreign securities is taxed in the U.S. at all levels (federal and state).

Taxation of Reinvested Distributions

Distributions are taxable to shareholders whether the distributions are taken in cash or reinvested. The issuer must disclose whether each distribution comes from income or realized capital gains. **Form 1099**, which is sent to shareholders after the close of the year, details tax information related to distributions for the year. Dividends must be reported as dividend income and will be taxed either as ordinary income or as a qualifying dividend, generally with a maximum rate of 15%; capital gains distributions from mutual funds are generally reported as a long-term capital gain. Reinvesting distributions has a compounding effect.

TEST TOPIC ALERT

One term you might see on the exam refers to an *interest-on-interest plan*, and it will be compared to a dividend reinvestment plan. What is the exam referring to? This is nothing other than a typical bank savings account where your interest compounds, usually quarterly. Therefore, you are earning interest on the interest. From a tax standpoint, this interest, just like reinvested dividends, is taxable in the year received.

Dividend Reinvestment Plans

Some corporations offer their shareholders the opportunity to purchase additional shares of the company's common stock using their cash dividend. Under most **dividend reinvestment plans (DRIPs),** the shareholder automatically purchases the additional shares directly from the issuer, paying little or no commission and often at a discount to market price. In fact, most companies permit investors in these plans to add money along with the reinvested dividend. As was covered above, reinvesting dividends does **not** mean they are not currently taxed. However, the amount of reinvested dividends increases the investor's cost basis, thereby reducing the amount of capital gains if the position is later sold at a profit.

The Effect of Reinvestments on Cost Basis

Because the taxes have already been paid on any income reinvested, when the investor sells the asset, the cost basis is increased so that the income is not taxed again.

EXAMPLE

An investor purchases 100 shares of KAPCO common stock for $100 per share and elects to participate in KAPCO's Dividend Reinvestment Plan (DRIP). During the next five years, the investor receives dividends totaling $2,200, which has allowed the purchase of 20 additional shares through the DRIP. With KAPCO selling at $110 per share, the investor liquidates the entire position. For tax purposes, the investor has a capital gain of $1,000, even though the proceeds are $3,200 more than the original investment. Here's the math:

Purchase – 100 shares @ $100 = $10,000. Add the reinvested dividends of $2,200 to increase the cost basis to $12,200. Sell all the shares (100 + the 20 acquired through the DRIP) = 120 × $110 = $13,200. The proceeds exceed the adjusted cost basis by $1,000, and that is the amount of the capital gain.

PRACTICE QUESTION

An investor purchases 100 shares of DERP common stock @ $50 per share and elects to have all cash dividends reinvested through the DRIP being offered by DERP. After holding the stock for five years, the investor has reinvested $1,200 and acquired 20 additional shares. If the market price of DERP is $55 per share and the investor liquidates the position, the tax consequences will be

A. a loss of $700.
B. a gain of $400.
C. a gain of $600.
D. a gain of $1,600.

Answer: B. The investor establishes the position at a cost of $5,000. To that, we add the $1,200 cost of the reinvested dividends, bringing the investor's tax cost basis to $6,200. When all of the shares are sold, the proceeds are $6,600 (120 shares x $55). Subtracting the $6,200 cost from the $6,600 proceeds results in a capital gain of $400.

TEST TOPIC ALERT

Regardless of fluctuations in the market price, as long as a dividend is paid, investors participating in a DRIP will *always* have more shares in their account at the end of the year than at the beginning.

Retirement Plan Distributions

Qualified retirement plan distributions are, with few exceptions, taxed at the investor's ordinary income tax rate when funds are withdrawn from the plan. Distributions from a qualified plan before the investor reaches age 59½ are also subject to a 10% early withdrawal penalty. Distributions from a qualified plan must begin by April 1 following the year the participant reaches age 72 (more on this in Unit 18).

Margin Expenses

Margin interest is a tax-deductible expense (margin accounts are covered in Unit 23). The one exception is interest expenses incurred in the purchase of municipal securities. Because municipal interest income is federally tax exempt, the IRS does not allow taxpayers to deduct the margin interest expenses for municipal securities. Investors can deduct interest expenses incurred when borrowing money to purchase other securities to the extent those interest expenses do not exceed their net investment income, which includes interest income, dividends, and all capital gains.

Effective Tax Rate

In an earlier Test Topic Alert, we introduced you to the term *marginal* tax rate. That should not be confused with the individual's effective tax rate. What is the difference? As stated earlier, the marginal tax rate is the rate you pay on each additional dollar you receive as income. The effective tax rate, however, is the overall rate of tax you pay on your total taxable income. The following example should help you visualize the difference.

EXAMPLE

In the Test Topic Alert, we showed you how a single person with $250,000 in taxable income was paying taxes at a *marginal* rate of 35%. That is, a bonus of $10,000 would result in an additional tax liability of $3,500. That 35% rate was in effect for all income in excess of $200,000. According to the tax tables (and absolutely not tested), the tax on that first $209,425 is $47,843, and then everything above that (until $523,601) is taxed at 35%. So, for the single individual with $250,000 of taxable income, the total tax bill would be $47,843 + (35% × $40,575) or $47,843 + $14,201, which is a total tax of $62,044. That means that out of $250,000 in income, slightly less than 25% of it ($62,044 divided by $250,000) went to pay tax. This works out to be an *effective* tax rate of 24.82%.

LO 15.c Distinguish between income and capital gains and how they are taxed.

Whereas income is generally money received from the ownership of an investment (e.g., dividends on a stock, interest on a debt security, or earnings from personal work, such as salary), capital gains and losses always involve the sale of an asset. The sale of a security can result in a **capital gain** or a **capital loss**. A **capital gain** occurs when a security is sold for a price higher than its cost basis. If the selling price is lower than the cost basis, a **capital loss** occurs. Please note that it is realized gains and losses that have tax consequences; unrealized gains and losses do not.

Capital Gains

A **capital gain** occurs when capital assets (securities, real estate, and tangible property) are sold at prices that exceed the adjusted cost basis. Usually, computing the capital gain or loss on an asset is a matter of comparing the purchase price with the selling price less commissions.

TAKE NOTE

A lower cost basis results in a larger capital gain. The gain is determined by comparing the sales proceeds with the cost basis.

EXAMPLE

If the investor's cost basis in stock is $50 per share and shares are sold for $60, the investor has a capital gain of $10. However, if the investor's cost basis is $55 and the shares are sold for $60, the investor's capital gain is only $5.

Adjusting Cost Basis

An investment's **cost basis** (total cost of the investment) is used to determine whether a capital gain or a capital loss occurs when an asset is sold. Because many factors affect an asset's cost basis, the IRS requires the cost basis to be adjusted for such occurrences as stock splits and stock dividends.

EXAMPLE

A client buys 100 shares of RST at $55. Later, the company declares a stock dividend, and the investor receives 10 more shares. The client's total investment remains $5,500, but there are now 110 shares of RST in the account. The investor's adjusted cost basis per share is now $50 ($5,500 ÷ 110). When the securities are sold, the holding period is based upon the original purchase date; the date(s) of the acquisition of the shares through the stock dividend(s) or stock split(s) are of no consequence. If the sales price exceeds the adjusted cost basis, the investor realizes a capital gain; if they are lower, a capital loss.

Effects of Reinvesting on Cost Basis for Computing Capital Gains/Losses

A few pages ago, we discussed the fact that any distributions received, whether taken in cash or reinvested, were reported on Form 1099 as taxable for that year. In the case of reinvestments, because they have already been taxed, when a sale takes place, they are not taxed again—the amount reinvested adds to the investor's tax basis (or cost).

EXAMPLE

An investor purchases 100 shares of XYZ common stock for $100 per share. Total cost is $10,000. After enrolling in the DRIP offered by XYZ, the investor receives dividends for three years in the total amount of $1,200. Let's say that these reinvested dividends have purchased 10 shares. The investor now sells all of the XYZ for $125 per share. For tax purposes, there is a capital gain of $2,550. This is computed by subtracting the cost ($10,000 + $1,200 = $11,200) from the proceeds (110 shares × $125 = $13,750).

Capital Losses

A **capital loss** occurs when capital assets are sold at prices that are lower than the adjusted cost basis.

Net Capital Gains and Losses

To calculate tax liability, a taxpayer must first add all short-term capital gains and losses for the year. (Short-term gains are investments held 12 months or less and are taxed at the investor's ordinary income tax rate.) Then all long-term capital gains and losses are added. (A long-term capital gain or loss only occurs after the investor has held the investment at risk for a period exceeding one day plus 12 months.) Finally, the taxpayer offsets the totals to determine the net capital gain or loss for the year. If the result is a net long-term capital gain, it is taxed at the capital gains rate, currently at 15% for most taxpayers. If the net is a short-term gain, it is added to the taxpayer's ordinary income.

Capital losses that exceed capital gains are deductible against taxable income up to a maximum of $3,000 per year. Any capital losses not deducted in a taxable year may be carried forward indefinitely as a deduction to offset capital gains in future years. When you carry over a loss, it remains long term or short term. A long-term capital loss that you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains. When you figure your capital loss carryover, use your short-term capital losses first. If you have not reached the $3,000 limit on the capital loss deduction against income after using the short-term capital losses, use the long-term capital losses until you reach the limit.

Determining Which Shares to Sell

An investor holding identical securities, each with a different acquisition date and cost basis, may determine which shares to sell by electing one of three accounting methods: first in, first out (FIFO); share identification; or average cost basis. If the investor fails to choose, the IRS assumes the investor liquidates shares on a FIFO basis.

When FIFO shares are sold, the cost of the shares held the longest is used to calculate the gain or loss. In a rising market, this method normally creates adverse tax consequences.

When using the **share identification** accounting method, the investor keeps track of the cost of each share purchased and uses this information to liquidate the shares that would provide the lowest capital gain. Share identification is used to identify the specific per-share cost basis when shares are sold. The investor keeps track of the cost of each share purchased and specifies which shares to sell on the basis of that investor's specific tax needs.

A shareholder may elect to use an **average cost basis** when redeeming mutual fund shares (but not shares of specific stocks). The investor would calculate average basis by dividing the total cost of all shares owned by the total number of shares. The shareholder may not change the decision to use the average basis method without IRS permission.

TAKE NOTE

Share identification may result in more advantageous tax treatment, but most accountants prefer the convenience of the averaging method for mutual fund shares. Share identification is most commonly used with stock sales.

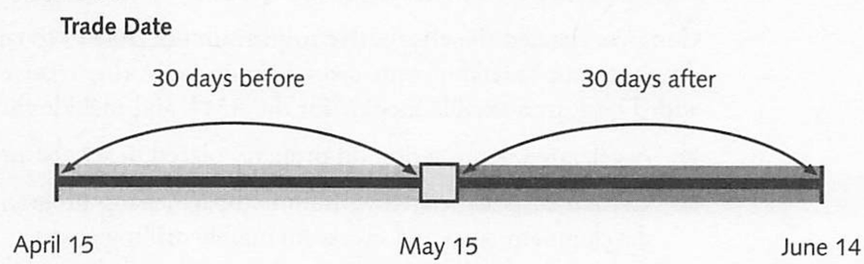
Wash Sale

An investor may not use capital losses to offset gains or income if the taxpayer sells a security at a loss and purchases the same or a substantially identical security within 30 days before or after the trade date establishing the loss. The sale at a loss and the repurchase within this period is a **wash sale**. The loss that was disallowed, however, is added to the repurchased shares' cost basis.

EXAMPLE

An investor buys 100 shares of ABC for $50 per share. One year later, the investor sells those shares for $40 per share. Fifteen days after the sale, 100 shares of ABC are repurchased for $42 per share. The investor's new cost basis is $52 because the $10 loss that was disallowed is added to the repurchase price of $42.

Wash Sale



Substantially identical securities include stock rights, call options, warrants, and convertible securities of the same issue.

The IRS compares three qualities of debt securities in determining whether they are substantially identical: the maturity, coupon, and issuer. A bond is substantially identical if all three qualities of the bond sold at a loss and the newly purchased bond are the same.

After selling a bond, an investor can buy another bond with a different maturity, coupon, or issuer without violating the wash sale rule.

EXAMPLE

An investor could sell an ABC 8% bond that matures in 2030 at a loss and buy back an XYZ 8% bond that matures in 2031 and claim the loss. This is commonly called *tax-swapping*.

TAKE NOTE

The wash sale rule applies only to realized losses—not to realized gains.

Sale of a Primary Residence

The final example of capital gains taxation deals with the unique treatment offered on the sale of a primary residence. There are special tax benefits available to those selling their primary residence as long as it has been lived in as the primary residence for at least two of the past five years. For a couple, the first $500,000 in profit is excluded from capital gains taxation; for a single person, it is the first $250,000.

EXAMPLE

Chloe and Edgar bought their home 30 years ago for $50,000. Now that the children are all on their own, they decide to downsize and move to a retirement village. If they sell their home for $600,000, what is the tax consequence?

Chloe and Edgar are selling their home for a profit of $550,000. However, the first $500,000 for a couple is excluded from taxation. Therefore, they will only have to report the remaining $50,000 as a long-term capital gain.

LO 15.d Recall the preference items included in the AMT computation.

Alternative Minimum Tax (AMT)

Congress enacted the **alternative minimum tax** (AMT) to ensure that high-income taxpayers do not escape federal income taxes. Certain items that receive favorable tax treatment must be added back into taxable income for the AMT and include the following:

- Accelerated depreciation on property placed in service after 1986
- Certain costs associated with limited partnership programs, such as research and development costs and excess intangible drilling costs
- Local tax and interest on investments that do not generate income
- Tax-exempt interest on private purpose municipal bonds issued after August 7, 1986. Examples of these private purpose or private activity bonds subject to the AMT would be those issued to finance sports stadiums, hospitals, housing projects, and so forth.
- Incentive stock options (ISOs), to the extent that the fair market value of the employer's stock is in excess of the strike price of the option, even when the stock is not sold in that year

To determine if you owe AMT, you compute your regular tax and then you compute the AMT and pay whichever is the higher amount. The IRS has an unusual way of stating this. They say that the AMT is the regular tax plus the amount by which the AMT exceeds the regular tax. So, if the AMT computation shows $12,000 due and the regular shows $10,000 due, you take that $10,000 and add the amount by which $12,000 exceeds $10,000 ($2,000) to arrive at $12,000. Wouldn't saying "Pay the higher of the two" be easier? It sure would, but then that might put some accountants out of business, just like simplifying the tax code would do.

TAKE NOTE

Items that must be added back in for the purpose of the AMT computation are sometimes called **tax preference items**. If the tax liability computed under the AMT computation is greater than the taxpayer's regular tax computation, the taxpayer must pay the AMT amount.

KNOWLEDGE CHECK 15.2

1. Your customer in the 24% federal income tax bracket would probably pay the most tax on a $5,000 investment into
   A. dividends received on domestic common stock.
   B. dividends received on domestic preferred stock.
   C. interest received on U.S. Treasury bonds.
   D. interest received on municipal bonds.

2. A taxpayer has realized short-term capital gains of $50,000 and long-term capital gains of $75,000 during the taxable year. Over the same period, the individual realized short-term capital losses of $40,000 and long-term capital losses of $100,000. The tax consequences of these transactions are
   A. a net short-term capital gain of $10,000 and a net long-term capital loss of $25,000.
   B. a net long-term capital loss of $15,000 and no gain carryover.
   C. a $3,000 deduction from income and a long-term capital loss carryover of $3,000.
   D. a $3,000 deduction from income and a long-term capital loss carryover of $12,000.

3. Which of the following is considered a tax preference item for the purposes of calculating the alternative minimum tax?
   A. Incentive stock options (ISOs) to the extent that the fair market value of the employer's stock is in excess of the strike price of the option
   B. Depreciation on property placed in service after 1986
   C. Intangible drilling costs to a limited partnership program
   D. Tax-exempt interest on general purpose municipal bonds issued after August 7, 1986

KNOWLEDGE CHECK ANSWERS

Knowledge Check 15.1

1. **B** The definition of the marginal tax rate is "the rate of tax charged on a taxpayer's last dollar of income." Basically, as you make more money, you pay tax at a higher rate incrementally. If this customer's actual benefit is $3,250, it is because $1,750 was paid in income tax. Dividing $1,750 by $5,000 reveals that the tax rate was 35%.

   LO 15.a

2. **A** Regressive taxes are those where the rate remains the same, regardless of the cost of the item subject to the tax. For example, the federal fuel excise tax is 18.4 cents per gallon. It makes no difference if you are pumping one gallon or 20 gallons—the tax rate is the same 18.4 cents on every gallon. The other choices are progressive taxes, where the tax rate increases as the dollar amount being taxed increases.

   LO 15.a

Knowledge Check 15.2

1. **C** Interest received on Treasuries will be fully taxable on a federal basis. That means 24% to this customer. Unless stated to the contrary, you can assume that dividends paid on stock (common and preferred) issued by domestic corporations are qualified. That means the tax rate will be 15%. Interest received on municipal bonds will be tax free.

   LO 15.b

2. **D** This investor has a $10,000 short-term capital gain ($50,000 minus $40,000) and a $25,000 long-term capital loss ($75,000 minus $100,000). Why isn't that choice the correct answer? Because the exam will always want the choice that most completely answers the question. In this case, the net of the gain and the loss is a $15,000 long-term capital loss. Why isn't that correct? Same reason—it is not the most complete answer: $3,000 of that $15,000 loss is deductible against earned income and the balance of $12,000 is a carryover to the next year. This is a very common type of question on the actual exam, where you must select the choice that covers all of the details. By the way, there is no such thing as a carryover of a gain; all net gains are taxed.

   LO 15.c

3. **A** The excess of the fair market value of the strike price of an ISO, known as the *bargain element*, is included as a tax preference item for the AMT. It is *accelerated* depreciation, *excess* intangible drilling costs, and interest on *private* purpose municipal bonds that are all tax preference items.

   LO 15.d