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# Advanced Concepts of Broker-Dealer Compliance

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NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS
2001 NATIONAL MEMBERSHIP MEETING

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ADVANCED CONCEPTS OF BROKER-DEALER COMPLIANCE

# I. **Introduction**

The purpose of this panel and the accompanying outline is to focus on four areas of advanced broker-dealer compliance, including the following:

(1) conflict disclosures regarding research and recommendations;

(2) broker-dealer soft dollar §28(e) issues and the impact of best execution;

(3) prime brokerage issues and compliance; and

(4) wrongful discharge, whistle-blowing, defamation and Forms U-4 and U-S.

# II. **Conflict Disclosures Regarding Research Recommendations**

## A. Background

Disclosure of conflicts resulting from a broker-dealer's recommendations to clients and the public and the other activities of the recommending broker-dealer, such as investment banking, market making and its proprietary trading, have been a long-standing issue in the industry. It has recently received renewed emphasis from the Securities and Exchange Commission ("SEC"). The principal catalyst was former SEC Chairman Levitt continuing comments.[2] However, it reached the attention of the media with full force as the result of a speech of Acting SEC Chairman Unger in April of this year.[3]On April 19, 2001, Acting Chairperson Laura Unger at the Northwestern University Garrett Institute politely but firmly urged the securities industry to restore public confidence in recommendations by broker-dealers by prominently disclosing conflicts of interest that analysts face, particularly those involving investment banking relationships. The National Association of Securities Dealers Regulation,

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[1] Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York and is a Senior Member of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois. With respect to Chapter *5,* I would like to recognize the excellent assistance of Paul M. Weltlich, an associate of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., and a member of the bar of the state of Illinois.

[2] sec. gov/news/press/2000.. 183 .txt; sec.gov/news/speeelVspeecharchive/1 999/spch266.htm.

[3] sec. gov/news/speeches/spch477.htm.

Inc. ("NASDR") and the New York Stock Exchange ("NYSE") have long had rules to address conflicts with respect to research recommendations: NYSE Rule 472, NASDR Rule 2210. In late 2000, the NASDR and the NYSE announced that they would consider new rules for addressing disclosure of analysts' conflicts of interest. This announcement was undoubtedly the result of former Chairman Levitt's concerns about conflicts involving investment banking relationships that were not clearly disclosed when a broker-dealer's research department was recommending a buy or sell of a security.[4]

Also driving the revision of the Rule 475 and Rule 2210 was the collapse of the technology markets in year 2000 which led to press articles and public scorn of many recommendations to buy that had been made by research analysts of broker-dealers that had underwritten technology stocks or provided substantial services to issuers of such stock. In addition, many firms did not disclose securities positions held by the firm or the analyst in the securities being recommended. The loss of public credibility spurred not only the SEC but the NASDR and the NYSE to revisit this area. Further, many firms in the industry appear to be supporting broader disclosure with a view to enhancing broker-dealer research recommendation credibility.

B. The Current Rules of NASDR and the NYSE

The current Rules are similar in many respects:

1. Both NYSE Rule 472 and NASDR Rule 2210 require that an analyst making a recommendation have a reasonable basis for the recommendation.

2. Both Rules require that the firm disclose market making activities in the issuer's securities.

3. Both Rules apply to communication to the public in writing sales literature and advertisements.

4. Both Rules require disclosure of underwriting activities as manager or co-manager for the securities.

5. Both Rules apply to communication not only with customers of the firm but any other communication generally made to the public.

The NYSE Rule requires:

1. Disclosure that there may be positions in the securities recommended held by the firm or the analyst involved in the report.

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[4] sec. gov/news/speech/speecharchive/l 999-spch266.htm.

2. Disclosure as to whether a person associated with a broker-dealer is a director of the issuer.

3. Application to electronic communication interviews and press statements

The NASDR Rule does not require disclosure of directorships or stock positions. It does require, though, disclosure if the member firm or persons associated with it own more than a nominal amount of options, rights or warrants to purchase the recommended securities. It is not clear. Further, the NASDR Rule appears not to cover public interviews and similar spontaneous appearances, but this is not clear.

C. The Current Proposals

The NASDR in Notice to Members 01-45 proposes to revise NASD Rule 2210 in a number of respects.

1. The amended rule would apply not only when a member recommends a security in written advertisements and sales literature, but it would also clearly apply to recommendations made by research analysts or other associated persons during public appearances, such as radio, television interviews, seminars or interactive electronic forums.

2. The amended rule would require disclosure of

   (a) any personal financial interest in the recommended security held by the analyst responsible for the recommendation;

   (b) the ownership by the member firm of more than 5% of outstanding shares of any class of security of the recommended security (as computed under Sections 13(d) and 13(g) of the Securities and Exchange Act of 1934 ("34 Act")[5];

   (c) whether the member firm has received compensation from the issuer of the security for investment banking services.

3. Importantly, with respect to written advertising and sales literature, the disclosures would have to be made specifically and prominently. The NASDR stated quite clearly that the terms "specifically and prominently" is "to prohibit the use of boilerplate in footnotes and other inconspicuous locations."[6]

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[5] 15 U.S.C. M (d) and (g). *See also,* SEC Rule 13d-3; 17 C.F.R. 240.13d-3.

[6] NASD Notice To Members *01-45* at p. 2.

4. In public appearances as defined in the rule, not all of the disclosures required would have to be made. However, the following disclosures would have to be made: (a) any financial interest held by the person making the public appearance or statement; (b) any ownership by the firm of *5%* or more of the total outstanding shares of any class of equity in securities of the issuer; and (c) whether the issuer is a client of the firm with which the person recommending the security is associated.

"Client" means an issuer from which the firm has received compensation for investment banking services provided to the issuer within the last twelve months. The term compensation is intended to be broadly construed. The proposed amendments eliminate the requirement to disclose whether the member managed or co-managed a public offering of the recommended security within the last three years. However, the new proposal as stated above does require similar disclosure with respect to any investment banking services, including underwritings managed or co-managed within the last twelve months.

It is important to note that any financial interest in the recommended security includes discretion over managed accounts in which the recommended security is held. If a research analyst has discretionary authority to manage client accounts and a recommended security is in the discretionary accounts, it would be considered a financial interest of the analyst and would have to be disclosed. The industry is expected to object strenuously to this disclosure because it creates a number of practical problems although the general nature of such disclosure is probably something that should be made.

D. Legal and Compliance Issues

Under the new amended Rule, if adopted, the NASDR would be in a much better position to pursue an infraction for conflicts to the extent covered by the specific rule. Under the current rules, an infraction could be pursued respectively by the NASDR or the NYSE under their specific rules. Other conflicts might be pursued under the general rules requiring high standards of commercial honor and just and equitable principles of trade.[7] But since specific SRO rules cover the activity, the more general rules arguably should not be applicable.

Failure to disclose conflicts not specifically required by Rule 472 or NASD Rule 2210 could also be pursued by the SEC, the SROs and state securities commissions under the general antifraud provisions. However, such cases could prove difficult. For example, the SEC would probably have to proceed under SEC Rule l0b-S to bring a claim for failure to disclose conflicts. The burden facing the SEC in such case would be difficult but not impossible. In the first instance, the SEC would have to show that there was scienter either by circumstantial or direct evidence of an intent to deceive, manipulate or defraud which would be relatively difficult but is not an impossible burden. In the appropriate case the SEC could certainly be able to prove that a buy recommendation was either made with no reasonable basis or in response to some sort

[7] [7]NASDR Rule 2110, NYSE Rule 401.

of quid pro quo. In the latter case, the SEC could make the case on the basis of circumstantial evidence, although direct evidence would be preferable. Secondly, an action under Rule l0b-S requires that the failure to disclose be made in connection with the "purchase or sale" of a security. If an analyst opinion impacted the price of stock, it would be relatively easy to argue that it was in connection with a purchase or sale. However, many analysts' opinions will not directly impact the price of the stock. As of the date of this article, there have been no class actions filed against brokerage houses other than in some of the pump and dump securities cases of penny stocks.

If the broker-dealer is also an investment adviser and the recommendation was to an advisory account, a different set of rules would apply. An adviser acts as an agent and as an agent has a duty of loyalty. SEC v. Capital Gains Research Bureau, Inc.[8] recognized this duty and characterized it somewhat inaccurately as a "fiduciary duty." As an agent with a duty of loyalty and a duty of due care, an agent may not purchase shares for his own account and thereafter recommend the security for long-term investment to clients and then immediately sell shares. In such case, the agent not only violates his common law duty of loyalty, but in view of the Supreme Court his quasi-fiduciary duty under the Investment Advisers Act.

F. Some Practical Considerations

1. Firms will need to carefully monitor the personal holdings of each analyst and their households and any accounts in which the analyst has discretionary authority.

2. Most firms will probably preclude analysts from exercising discretionary authority. But what about the analyst that sits on the investment committee who does the research and whose recommendation is adopted by the committee and implemented by portfolio managers having discretion?

3. Firms will have to carefully monitor and institute compliance procedures to track whether the firm has possession of *5%* or more of the outstanding shares within the meaning of the proposed rules. The rules use the broad definitions of ownership under Section 13(d) and 13(g) of the 34 Act.[9]

4. The broad definition of compensation in the proposed rule will include not only cash compensation but other arrangements for any kind of investment banking services. Firms will need to set up a procedure to track all agreements, formal or informal, with issuers for which they provide investment, banking or other services.

5. Many firms today have fire walls between their research analysts who make recommendations and their investment banking departments. The amended rule will require that these fire walls be breached to a certain extent because the analyst will have to make disclosures with respect to the firm's holdings as well as compensation for investment banking services thereby bringing to the attention of the analysts the firm's interest. These fire walls may still need to be maintained for purposes of avoiding use of inside information or other material undisclosed information in connection with recommendations, but their purpose with respect to walling off the research analyst from the firm's own interest will no longer exist.

[8] 8375 U.S. 180 (1963)

[9] 15 U.S.C. in (d) and (g). *See also,* Rule 13d-3; 17 C.F.R. 240.13d-3.

6. In public appearances, particularly on talk shows and similar appearances, the recitation of disclosures will be cumbersome and difficult. However, it appears that it will become a part of public life. Obviously, it will reduce the spontaneity and eventually result in boilerplate disclosures on such shows as *Wall Street Week* and other prominent shows which will eat up significant amount of time. How much effect it will have remains to be seen.

## III. **Broker-Dealer Section** 28(e) **Soft Dollar and Beyond**

### A. Introduction

While Section 28(e) soft dollar practices, agreements and disclosure are often perceived as being primarily investment adviser compliance problems, in fact, there have been a number of cases by the SEC against broker-dealers. The SEC has brought aiding and abetting cases against broker-dealers for violation of best execution because the services and materials offered to the broker-dealers were outside the protection of the Section 28(e) safe harbor. Further, the scrutiny of broker-dealers will increase as a result of the SEC's order execution disclosure requirements for markets under Rule 11(A)cl-5[10] and for broker-dealers under Rule 11(A)cl-6.[11]

As a result of the SEC soft dollar practices enforcement sweep of investment advisers and broker-dealers, the SEC Office of Compliance, Inspections and Examinations ("OCJE") issued a report entitled *"Inspection Report on Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds"* (the "Report").[12] The SEC found that 35% of the broker-dealers had provided at least one product or service which did not appear to be related to research or executions outside the scope of Section 28(e).[13] In other cases, mixed use materials or services were provided without the reimbursement for the fair value of the non-permitted service or product.[14] The Report found also that 27% of the broker-dealers were paying invoices submitted directly by the advisers where the advisers had contracted for the services which is not permitted under Section 28(e).[15] Of major significance was that only 13% of the broker-dealers had written compliance policies and procedures for soft dollar activities.[16] This outline details the Section 28(e) requirements with particular emphasis on agreements, disclosures, recordkeeping and compliance. Sections D and E below are a series of practice and compliance tips for sophisticated soft dollar broker-dealer compliance.

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[10] 17 C.F.R. 240.11(A)cl-5.
[11] 17 C.F.R. 240.11(A)cl-6.
[12] at p. 13, (September 22, 1998).
[13] at p. 13, (September 22, 1998).
[14] Id. at p. 14.
[15] Id. at p. 15.
[16] Id. at p. 16

B. Background

Prior to May 1, 1975, brokerage commissions were fixed by various stock exchanges. Commencing May 1, 1975, fixed commissions were abolished by legislation. At that time, Section 28(e), an amendment to the 34 Act,[17] became effective.

Prior to the abolition of fixed rates, brokers sought to obtain order flow by providing various services and equipment to customers, including money managers such as investment advisers. These services provided by broker-dealers included research related services, research related hardware, execution equipment, such as direct lines, quotation machines, order entry equipment, order confirmation equipment and a variety of other types of materials. The established broker-dealers who had provided research services and other types of services to obtain order flow sought to protect that business by allowing investment advisers and customers to pay higher commission, part of which would presumably compensate the broker-dealer or its affiliate for research services or equipment. Thus, Section 28(e) was vigorously supported by the broker-dealer community.

Section 28(e) provides a safe harbor to broker-dealers who provide, for a combined fee, transaction "execution and research" services and material within the meaning of Section 28(e). Section 28(e) provides as follows:

> No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange broker, or dealer, would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract. Provided, however, that nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this title or otherwise.
>
> (2) A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commission that will be paid for effecting securities transactions, at such times and in such manner as the appropriate regulatory agency, by rule, may prescribe as necessary or

[17] 15 U.S.C. §78bb(e).

appropriate in the public interest or for the protection of investors.

(3) For purposes of this subsection, a person provides brokerage and research services insofar as he

(A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;

(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement and custody) or required in connection therewith by rules of a Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.[18]

The SEC has issued an extensive release and numerous no action and interpretive letters regarding Section 28(e) the most important being Securities Exchange Act Release no. 34-23170 (the Section 28(e) Release).[19]

C. The Basic Elements of Section 28(e)

1. The Elements

The safe harbor of Section 28(e) has a number of requirements which are the following:

a. A securities transaction;

b. Investment discretion by the adviser:

c. Agency transaction by the broker;

d. Brokerage and research services from the broker;

e. Reasonable commission for combined brokerage and research;

f. Full disclosure of the arrangement.

[18] Id.

[19] Fed.Sec.L.Rep. (CCH) Par. 26,579A (April 23, 1986).

2. Security Transaction

The safe harbor of Section 28(e) applies only to agency securities transactions.[20] It does not apply to futures transactions or principal transactions.

3. Investment Discretion

The safe harbor is available only if the adviser is exercising investment discretion. Investment discretion is defined as follows in Section 3(a)(35) of the 34 Act.

"[a] person exercises 'investment discretion' if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have the responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.[21]

The existence of a power of attorney is good evidence of discretion, but is not definitive. The issue is who generates the ideas. Even absent a power of attorney, there is defacto discretion if most or all of the recommendations are generated by the investment adviser and accepted by the client.

4. Agency Transaction

The SEC takes the position that only agency transactions qualify for the safe harbor. However, certain counsel dispute this contention because Section 28(e) references services provided by a "broker" or "dealer", inferring that principal transactions are covered. Nevertheless, the SEC is unequivocal that Section 28(e) does not apply to dealer, market maker, underwriter, or other principal transaction.[22]The Controller of Currency agrees with the SEC and has taken the position that principal transactions involving municipal bonds are not within the

[20] Letter from Richard Ketchum, Director of Division of Market Regulations, to Charles Lerner, Department of Labor, July 25, 1990.

[21] 15 U.S.C. §3(a)(35)

[22] Hoenig & Co., Inc. [90-91 Transfer Binder] Fed.Sec.2 Rep. (CCH) Par. 79,639 (1990); Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lerner, Department of Labor (July 25, 1990); Duff and Phelps, Inc., SEC No-Action Letter [1976-77 Transfer Binder] Fed.Sec.L. Rep. (CCH) Par. 80,821 (Sept. 27, 1976).

safe harbor of Section 28(e).[23]The SEC also takes the position that riskless principal transactions that are not agency transactions even if only a fee equivalent to a commission is charged as a markup. Further, the SEC questions whether any principal transaction is really executed at best price if a broker is also able to provide an adviser research in addition to the execution. Many in the industry object to the SEC's reasoning because there are incremental efficiencies, which allow a broker to provide research services and principal executions at the best market price (including commissions or markup).

The SEC's position is unfortunate because it in effect creates great uncertainty if a firm does both agency and principal transactions and furnishes research services. Since NASDAQ, government, corporate, municipal and most other debt securities are traded, as principal in over-the-counter dealer markets, a large number of transactions are outside the safe harbor of Section 28(e).

5. Brokerage and Research Services from the Broker

The definition of brokerage and research services is very broad and includes a number of things, including both research and transaction execution services and materials. Section 28(e) includes within the term "brokerage and research services

a. furnishing advice through writings or publication as to the value of securities, advisability of investment and purchasing securities and the availability of securities;

b. furnishing an analysis and reports concerning issuers, industries, securities, economic factors, portfolio strategy and the performance of accounts;

c. services in effecting securities transactions and performing functions incidental thereto, such as clearance, settlement and custody.

It must be emphasized that research, within the meaning of Section 28(e), includes brokerage execution services, reports, and services and materials that are incidental thereto.

If a product has both permitted and non-permitted functions, a reasonable allocation of the cost of the product or service according to its use must be made by the investment manager. Only the portion relating to permitted product or services may be paid with soft dollars. The non-permitted portion must be paid in hard dollars by the adviser. The investment adviser has the burden of proving that he used good faith in his allocation procedures.[24] To demonstrate good faith, an investment adviser must maintain current and adequate records, and should not make a retroactive allocation.

[23] In Trust Interpretation 195; (CCH) Banking Law Report, Par. 84962 (January 13, 1998).
[24] Section 28(e) Release at 19,727.

It is important to note that the research must be provided by the broker. A broker may provide research services to or by paying a third party. The broker may acquire the research services or product from a third party, pay for it and furnish it to an investment adviser. It is clear, however, that the adviser may not contract to pay for research services and then bill the broker. The adviser may not incur liability to the third party provider.[25]

6. Commissions Must be Reasonable in Relationship to the Value of Brokerage and Research on a Combined Basis

Section 28(e) provides the safe harbor only if the commissions are reasonable in relationship to the value of the permitted brokerage and research services under Section 28(e). An understanding of best execution is critical to understanding Section 28(e). For purposes of Section 28(e), best execution requires that a money manager make a good faith attempt to "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.[26]Section 28(e) permits the value of research to be considered as part of best execution. The investment adviser is not required to seek the services which carries the lowest cost so long as the difference in cost is reasonably justified by the quality of the service offered.[27]

Best execution also includes execution price paid for the security, the commission, if any, and a host of other factors affecting the full range and quality of a broker's execution services, such as credit worthiness of the executing broker, order execution capability, ability to execute the type of order, past history of execution of such orders, access to market information, past promptness in execution of order, promptness and accuracy of oral and hard copy reports of execution, ability and willingness to correct errors, promptness and accuracy of confirmation and a host of other factors.[28] The value of research is in the eye of the beholder. The value of research can sometimes be measured by its cost if it is priced and firms subscribe to it, [29] but the value to the investment adviser may vary between nothing to a great deal depending upon its use by the adviser. When research is not market priced, the broker's cost to generate the research could be considered, but even this is extremely difficult and certainly not available to an adviser. All in all, evaluating the reasonableness of the value of research is difficult. However, the SEC has recently begun to question research value to the advisers as a whole.

In the past, the SEC has brought a number of cases against broker-dealers where the broker-dealer paid for products or services that were not viewed as within the definition of research and execution services permitted by Section 28(e). SEC cases against broker-dealers concentrated on cases where soft dollar credits were used to pay for obvious personal or business of the investment adviser or individuals associated with the investment adviser with no real benefit to the adviser's clients. As a result of the recent order routing and execution disclosure requirements for market centers and broker-dealers, there will be an abundance of information with which to value the routing and execution of transactions for

[25] Id. at 19,728.
[26] Id. at 19,733, quoting from Securities Fund Monitoring Services [79 Transfer Binder] Fed.Sec.L.Rep. (CCH), par. see also In re: Investment Information, Inc. [76-77 Transfer Binder] Fed.Sec.L.Rep. (CCH), par. 80,816 (1976).
[27] Id. at 19,730 at Footnote 35.
[28] Id. at 19,733.
[29] Id. at 19,727 at Footnote 11.

purposes of Section 28(e). With the new order execution and routing disclosures required by the SEC, the SEC has started to shift its focus to cases against broker-dealers as well as investment advisers involving the quantitative value of research and the quantitative value of execution. Because the SEC will have evidence to allege that the execution, together with the value of the research, was excessive, this information will also make it much easier for the SEC to prove that a broker-dealer violated its best execution obligations or aided and abetted an investment adviser in violating best execution.

Broker-dealers will need to be certain that their routing and execution systems are reasonable and that with the value of research the commissions are fair. The NASDR would also likely pursue broker-dealers in the event that the value of research and the executions are not reasonable under the general principles of fair commission and markups required by NASDR Rules 2430 and 2440.

7. Disclosure

The safe harbor of Section 28(e) is clearly conditioned upon full disclosure by a money manager of its commission and soft dollar research practices and their allocation to customers. Section 28(e)(2) states:

> A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commissions that will be paid for effecting securities transactions, at such times and in such manner as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.[30]

Form ADV, Part II, Items 12 and 13, require specific disclosures related to commissions and soft dollar practices and arrangements relating thereto. ADV disclosure, alone, will not, in some cases, be adequate disclosure. Because of the SEC's order handling routing disclosures by broker-dealers and markets, the SEC expects advisers to expand and to be able to justify their disclosures where soft dollar materials or services are received from broker-dealers. In the event that the order routing and order handling procedures are not reasonable in light of the disclosures, the SEC as well as the SROs may well pursue cases against the broker-dealers as a party to the soft dollar arrangements.

D. Special Section 28(e) Compliance Issues and Practice Tips

1. Directed Brokerage and Referral of Clients

Directed brokerage in return for clients is prohibited without the express consent of a client after full disclosure. This issue presents one of the bigger compliance problems for broker-dealers with respect to Section 28(e). In the usual course when an account

[30] 15 U.S.C. §78bb(e).

executive refers a new client to an investment adviser, the account executive will, in the course of human nature, want to receive brokerage for the transactions executed by the investment adviser for the referred client. This is particularly true with respect to individual clients but also applies to institutional clients. Client referral is not protected by Section 28(e). However, if a client, after specific disclosures of the disadvantages and advantages to the extent that there are some, consents to direct brokerage, it is permissible. Directed brokerage consents should be in writing and written disclosures with respect to various disadvantages of directed brokerage should be in written form and acknowledged by the client.

The SEC expects that the adviser inform the client, preferably in writing, that better commissions may be obtained elsewhere by the adviser, if such is the case. If the client is disadvantaged by reason of its order being executed later than non-directed orders, such disadvantage must be disclosed. Absent disclosure and client direction, trades would not be appropriate unless best price and execution were obtained. However, where the client receives other services or materials from the broker, the client may have other reasons to direct brokerage and pay a higher commission. Full services brokerage sweep accounts, custodial services, check writing and other services are valuable to a client and may more than offset the cost of a higher commission. Since custody services have various fees of $5,000 to $10,000 per account, this service is also not inconsequential and important to many clients.

An institutional client may direct an adviser to direct its institutional brokerage orders to a particular broker-dealer who may provide services or materials directly to the institutional client or purchase them for the client from third parties. *See* Section D-3 below. Large institutions often obtain custody, research, software or other services by a directing that its orders be executed at a specific broker-dealer. Since the client has directed the adviser to place the orders with one or more broker, services and materials may be services and materials not permitted by Section 2 8(e).

2. Order Flow Payments

Payments are made by market makers and specialists for order flow in over-the-counter and certain exchange markets. Generally, the arrangement provides that the broker that is referring the transaction to the market maker or specialist will be guaranteed executions for its customers at the best national bid or offer or better, as the case may be, and in return for the order flow. The broker that is introducing the transaction to the market maker or specialist will receive a rebate of usually 2 or 3 cents per share. The SEC has made clear that execution at the best national bid or offer is no longer best execution and that both the adviser and broker-dealer must attempt price improvement by various means. If the introducing broker receives order flow payments, the usual Section 28(e) analysis will apply. However, if the introducing broker receiving the order flow payments from a market maker or specialist is an affiliate of the adviser, there is a question as to whether the order flow payments received from the affiliated broker-dealer violates the agency obligation of the adviser. *See* Section D-3 below. Clearly, any such conflict or payment should be disclosed and specific client consent obtained. SEC Rule l0b-10 requires disclosure of receipt of the cash rebate by the retail broker from the

dealer.[31]

3. Rebates from a Broker

A cash rebate or order flow payment from a broker to an investment adviser without express client consent with full disclosure would violate the investment adviser's agency fiduciary obligation to the client. It is clear that any rebate is outside the scope of Section 28(e). If an investment adviser receives and retains a cash or order flow rebate resulting from client brokerage, the investment adviser would violate its agency fiduciary obligation. Further, the adviser would also be a "broker" required to register under Section 15 of the 34 Act.[32] However, if the cash or order flow rebate is passed on to a client directly by the adviser or by the broker, the investment adviser will not be considered a broker required to register under the 34 Act. Further, such a rebate to the client would not violate an adviser's fiduciary duty. However, the rebate must relate only to the brokerage for the specific client whose brokerage generates the rebate.

Institutional investors sometimes require investment advisers to arrange for rebates directly from the broker or to a third party to pay for research and services that are obtained by the institutional investor. Although these transactions are not covered by Section 28(e), they do not raise a problem as long as the services are obtained by the investor and paid for by the brokerage for the specific investor. The client may direct the use of a particular broker and receive cash or other services, or the client may direct the broker to pay for research or other services that the client as opposed to the adviser receives.

4. Order Errors

It has been common practice in the securities industry for many years that order errors be settled between the party giving the order and receiving the order by some sort of accommodation or a compromise. However, it is clear that the SEC condemns such practice if additional brokerage is to be provided to the broker by an investment adviser. The SEC staff takes the position that an investment adviser may not settle a trade or error by providing additional client brokerage business to a broker-dealer. Further, a broker-dealer would become an aider and abettor by accepting such.[33] As a result, broker-dealer compliance policies should provide that either the broker-dealer accepts the error for the account or the adviser settles the error out of its own account, not using client brokerage or funds.

5. Third Party Research

If a broker incurs a direct legal obligation to a third party to pay for research, third party research is permissible under Section 28(e). However, an investment adviser

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[31] Securities Exchange Act Release No. 16,679, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) par. 82,481 (Mar. 19, 1980).

[32] 15 U.S.C. §780.

[33] Letter from Richard Ketchum to Charles Lerner. SEC No-Action Letter [1988 Transfer Binder] Fed.Sec.I.Rep. (CCH) par. 78,871 (Oct. 25, 1988).

who is placing a transaction with a broker-dealer cannot contract for the research itself and then have the broker-dealer pay the invoices when they come to the investment adviser. The Section 28(e) release states: "Section 28(e) might, under appropriate circumstances, be applicable to situations where a broker provides a money manager with research provided by third parties."[34] In another report, the SEC stated:

> "It is not necessary that a broker produce the research services 'in house' in order to obtain the protection afforded by Section 28(e)... .It is necessary, however, in order to satisfy the statutory requirement, that the research services be 'provided by' the broker. While a broker may, under appropriate circumstances, arrange to have research materials or services provided by a third party, it is not 'providing' such research services when it pays obligations incurred by the money manager to the third party."[35]
>
> In another matter, the SEC stated:
>
> "The Commission believes that a broker-dealer may be deemed to have provided third party research when it has incurred a direct legal obligation to a third party producer to pay for the research (regardless of whether the research is then sent directly to the broker's fiduciary customer by the third party, or instead is sent to the broker who then sends it to his customer... .The Commission does not believe, however, that Section 28(e) would apply where the broker was merely used as an alternative means of paying obligations incurred by the fiduciary in its direct dealings with the third party.... In that regard, a broker-dealer may be deemed to have provided third party research that it is legally obligated to pay for even if its fiduciary customer participates in the selection of the research services or products to be provided to it by the broker-dealer."[36]

6. <u>Introducing Broker Transactions</u>

The SEC has made it clear that the safe harbor of Section 28(e) is available when an individual adviser uses an introducing broker who clears its transactions with a clearing firm.[37]

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[34] Section 28(e) Release at 19,728.

[35] Investors Information, Inc. [1979-80 Transfer Binder] Fed.Sec.L. Rep. (CCH) par. 82,481 at 83,011 (Mar. 19, 1980).

[36] In the Matter of the National Association of Securities Dealers, Inc. [1980 Transfer Binder] Fed.Sec.L.Rep. (CCH) par. 82,705 at p. 83,858 n. *54* (Dec. 12, 1980).

[37] SEI Financial Services Co., SEC No-Action Letter [1984 Transfer Binder] Fed.Sec.L. Rep. (CCH) par. 77,631 (Nov. 14, 1983) Becker Securities Corp. [76-77 Transfer Binder] Fed.Sec.L.Rep. (CCH) par. 80,641 (1976).

7. Prime Brokerage

An executing broker in a prime brokerage relationship who gives up an order for clearance by another firm can also be protected. However, in this case, the introducing broker must do no more than merely receive commissions, and is responsible for paying the clearing broker whatever fees are charged by the clearing broker.[38]

8. Principal or Riskless Principal Trades

The safe harbor does not apply to principal or riskless principal trades even when the markup is the equivalent of a commission.[39] Dealer transactions are not covered by Section 28(e).

9. Futures Transactions

Since Section 28(e) applies only to securities transactions, it does not cover futures transactions, including futures on treasury bonds or financial indices.[40] This is a problem because many advisers use financial futures as an integral part of a securities investment. Financial futures are used in a variety of ways to hedge portfolios, anticipate cash flows, or to liquidate part of a portfolio. Today, most broker-dealers are also futures commission merchants and the futures commission dollars are de facto considered in furnishing research. Since futures transactions are agency exchange execution transactions, an adviser must be careful not to pay up for "research" using futures commissions.

10. ERISA

To the extent applicable, Section 28(e) preempts the Employee Retirement Income Security Act, as amended ("ERISA").[41] However, if a soft dollar transaction is outside of the safe harbor, ERISA's standards apply. ERISA requires a fiduciary (such as a broker-dealer or adviser with discretion over plan assets) to use plan assets for the exclusive benefit of the plan's beneficiary.[42] Thus, if a soft dollar arrangement is outside of Section 28(e), a broker-dealer or, if applicable, an adviser must be able to demonstrate that the services and research received actually benefited the specific client who pays the commissions for the soft dollar services and research. Section 28(e), however, has a lesser standard in that the broker-dealer or adviser need only demonstrate that the services or research received by the adviser benefited some clients over

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[38] Data Exchange Securities, SEC No-Action Letter [1981-82 Transfer Binder] Fed.Sec.L.Rep. (CCH) Par. 77,016 (Apr. 20, 1981).

[39] Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lemer, Department of Labor (July 25, 1990); Duff and Phelps, Inc. SEC No-Action Letter [1976-77 Transfer Binder] Fed.Sec.L. Rep. (CCH) par. 80,821 (Sept. 27, 1976).

[40] Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lemer, Department of Labor (July 25, 1990).

[41] ERISA §2, et seq.

[42] ERISA §~403, 404 and 406.

all. Thus, it is extremely important that if a broker effects transactions for ERISA clients, all transactions involving the ERISA plan be within the safe harbor.

If an adviser receives services for which the investment manager is obligated to pay from fees charged the client, the adviser may violate the various provisions of ERISA.[43]

E. Practice Tips

1. Introduction

In the Report on soft dollar practices as a result of the sweep, the SEC emphasized that written compliance policies and procedures for soft dollar activities were required.

2. Directed Brokerage

Broker-dealer compliance procedures should have policies and procedures regarding directed brokerage compliance. If an individual broker is receiving a significant amount of brokerage from an investment adviser, particularly for individual clients but also for institutional clients, the firm should make inquiry to be certain that directed brokerage letters have been signed by the customer consenting to the directed brokerage arrangement. Furthermore, the broker-dealer should obtain copies of the consent and the disclosures that were made to the customer by the investment adviser and ascertain if they are adequate. In the event that they are not, it is reasonably clear that the SEC will and have pursued cases against the individual account executives and their firms. Copies of the disclosures to the customer and the customer's consent to directed brokerage should be maintained.

Compliance procedures should also cover the review of materials or services furnished directly to a client of an investment adviser at the request of the adviser. This should include cash rebates or order flow rebates. In any case, the specific written consent of a client receiving the services or materials, whether the services or materials are permitted under Section 28(e) or not, should be documented. The broker-dealer's procedures should not rely on the representations of the investment adviser alone. The broker-dealer should obtain from the adviser a written representation that the orders are being directed by the client and obtain from the client a specific direction with respect to payment of the rebate or the furnishing of material or services to the client.

[43] ERISA §~403(O(i), 404(a)(i), 406(g).

3. Order Flow Payments

If a broker-dealer is making order flow payments directly to a customer whose assets are managed by an investment adviser, the arrangement should be documented and a file maintained. Broker-dealer compliance procedures should prohibit payment of order flow payments to investment advisers without express consent of a senior official. Such consent should be given only if it is demonstrated that the order flow payments are directed to the specific client whose brokerage transactions result in the order flow.

4. Documentation of Soft Dollar Arrangements

The broker-dealer's compliance procedures should provide for documenting all soft dollar arrangements with respect to the terms and conditions. There should be a central file maintained within the broker-dealer where these agreements are retained. The compliance procedures should provide for periodic review of soft dollar arrangements to determine if the terms of the agreement are being followed.

5. Appropriate Research Services or Materials

As explained above, only certain materials are within the definition of research services or materials. The supervisory procedures should provide for approval of services or materials to be furnished by the broker-dealer or by third parties to investment advisers pursuant to any soft dollar arrangement and a record of the same should be maintained. The approval should be by a senior level supervisor who has a very good knowledge of the SEC Section 28(e) Release defining what is appropriate research and execution services. In the event that there is a reasonable possibility that the investment adviser may use the service or materials for itself and not for the benefit of clients, the broker-dealer's compliance procedures should provide for a representation from the investment adviser that the materials will be used only for clients' services, research and execution and not for the investment adviser's administration or operations. In the event that the services and materials have a joint use, there should be an allocation and recapture of the cost for the services and materials to the extent used by the investment adviser for its own purposes and not for the purposes of clients. Records of the above should be maintained.

6. Third Party Research or Materials

The broker-dealer should be certain that it does not pay invoices for materials or services contracted by the adviser. As discussed above, Section 28(e) allows a broker-dealer to pay only for third party services or material within the definition and for which the broker-dealer itself contracts to pay. The compliance procedures should provide a review procedures for all invoices for third party research or material to be certain that the broker-dealer and not the adviser contracted for the materials or services.

7. Order Errors

Broker-dealers should have in their trading compliance procedures a specific provision providing that traders and other personnel of the firm are prohibited from resolving errors with investment advisers by obtaining future brokerage from the investment adviser.

## IV. Prime Brokerage Arrangements

### A. Introduction

Since the early 1990's, prime brokerage has become an increasingly important part of the securities business. Compliance with prime brokerage arrangements have presented a number of compliance and risk management issues to broker-dealers of all sizes and types.

Prime brokerage consists of executing a transaction with one broker-dealer (the executing broker-dealer) who transfers the position to another broker-dealer (the clearing or prime broker) that carries the customer's account and clears the transaction. The use of the prime brokerage account has increased significantly for institutions as well as for high net worth individuals because of market dynamics and perceived advantages. Since institutions and individual customers increasingly have large positions, which are carried at their broker-dealers, a customer, institutional or individual wants to be certain that the broker-dealer carrying its account is a financial institution with significant financial resources and credit rating. Furthermore, because of the increased size of transactions, small broker-dealers may not have the capital to carry and clear very large transactions. Nevertheless, institutions and customers often prefer to use a broker-dealer that has a certain expertise in executing transactions in particular market, such as the options exchanges, the over-the-counter market, or for other types of securities. For these reasons, the number of prime brokerage transactions has increased dramatically. The purpose of this subsection is to discuss the requirements for prime brokerage and some of the practical practice tips for compliance.

### B. Background

In the early 1990's, the Prime Brokerage Committee of the Credit Division of the Securities Industry Association ("SIA") requested a no action position from the SEC to clarify that prime brokerage arrangements were permissible. At that time, there were concerns with respect to margin requirements and the applicability of Sections 7,10,11(d), 15(c)(3) and 17 of the 34 Act,[44] Regulation T[45] and SEC Rule l0a-1 (short sales), l0b-b (confirmations), l1d-1, 15c3-1 and [46] 1 5c3-3 under the 34 Act regarding prime brokerage arrangements. The SEC, in a no-action letter dated January 25, 1994, to the Prime Brokerage Committee of the SIA granted a no-action position from the various statutory sections and rules provided certain requirements were

[44] 15 U.S.C. ~(g), (j), (k), (o)c3 and (q).
[45] .12 C.F.R. 220 *et. seq.*
[46] 17 C.F.R. 10a-1, l0b-1, lid-1, 15c3-1 and 15c3-3.

met in connection with prime brokerage transactions.[47]

The requirements for a prime broker are as follows:

1. The prime broker must notify its Designated Examining Authority it intends to act as a prime broker.

2. The prime broker must have net capital of at least $1,500,000. If the net capital of the prime broker drops below this amount, immediate notice must be given to all parties with whom it engages in prime brokerage activity, either individually or through the facilities of a clearing agency.

3. The prime broker may not settle prime broker trades for a customer unless the customer keeps a minimum net equity with the prime broker of at least $500,000 in cash or securities with a ready market. If market fluctuations cause the customer's net equity to drop below this level, the customer will have until noon on the fifth business day after the date when the net equity fell below the minimum to restore it to the $500,000 level. If the customer fails to do so, the prime broker must, by the close of business on the fifth business day, notify all broker-dealers with whom it has a prime broker contract on behalf of the customer that it is no longer acting as a prime broker for the customer.

4. The prime broker may settle prime broker trades on behalf of customer accounts managed by a registered investment adviser, if each account has a minimum net equity of $100,000.

5. The prime broker may settle prime broker transactions on behalf of a customer who keeps a minimum net equity with the prime broker of $100,000 if the account is subject to a written cross-guarantee by another customer of the prime broker. The guarantor account must have net equity of at least $500,000. Each additional cross-guarantee requires an additional net equity of $400,000 for each individual account that is cross-guaranteed.

6. Prior to commencement of prime brokerage, the prime broker and the executing broker must execute a written contract that specifies obligations and responsibilities of the parties regarding the prime brokerage relationship. This contract must be consistent with the conditions in the January 25, 1994 SEC letter;

[47] SEC No-Action Letter January *25,* 1994.

7. The prime broker must execute a contract with each customer on whose behalf the prime broker will settle prime brokerage transactions. This contract must be signed by the customer and must specify the obligations and responsibilities of the prime broker arrangement. The customer contract and the contract with the executing broker referenced above must be maintained in an easily accessible place and produced upon request of the SEC or self-regulatory organization ("SRO").

8. The prime broker must keep separate records identifying all customers using a prime broker arrangement, and executing brokers used. These records must be maintained in an easily accessible place and produced upon request of the SEC or SRO.

9. Parties to a prime brokerage arrangement must use a clearing agency for issuance of trade confirmations and affirmations.

10. The prime broker must be responsible to settle each of the customer's transactions placed with executing broker and confirmed to and received by the prime broker, unless the prime broker disaffirms or DKs a particular transaction no later than the close of business on T±1.

11. The prime broker must keep a record of all trades disaffirmed during previous three years, specifying the identity of the customer and the executing broker.

12. If the executing broker sends confirmation under l0b-b to the prime broker, then the prime broker must inform the customer in writing that the confirmation is available to the customer without charge.

13. On the day following the transaction, the prime broker must send the customer notification of each trade placed with the executing broker based upon information provided by customer.

14. If the prime broker disaffirms a transaction, it must send a cancellation notification to customer to offset the notification sent on the day following trade date.

15. The prime broker may not extend credit on a security that it has sold or arranged for the executing broker to sell to the customer if the prime broker was a member of a selling syndicate or group for the security in the prior thirty days. However, a prime broker may extend credit in a prime brokerage account for a security sold by the executing broker if the prime broker has not otherwise arranged for that sale.

16. The prime broker must treat the customer as its own customer for all purposes if it does not disaffirm or DK the trade as provided above.

17. The prime broker may not engage in prime brokerage activities with executing brokers or customers if they actually or have reason to know that the other party is not in compliance with the January *25,* 1994 SEC letter.

The requirements for an executing broker are as follows:

1. The executing broker must have net capital of at least $1,000,000. If the net capital of the executing broker drops below this amount, immediate notice must be given to the other parties.

2. Prior to commencement of prime brokerage, the executing broker and the prime broker must execute a written contract that specifies obligations and responsibilities.

3. The executing broker must execute a written contract with each customer.

4. For all transactions, the executing broker must inform the prime broker of the following: (i) contract amount; (ii) security involved; (iii) number of shares or units; and (iv) whether the transaction was a long or short sale or a purchase. The executing broker must do so by the morning of the next business day following the transaction. The parties must use a clearing agency for issuing trade confirmations and affirmations.

5. The executing broker must undertake its own credit review of the customer to ensure that it knows the customer.

6. The executing broker must comply with all applicable short sale provisions. Prior to executing any short sale, the executing broker must determine that securities can be borrowed to deliver against the short sale.

7. Rule l0b-b requires that the executing broker must send confirmations of transactions directly to the customer. However, confirmations may be sent to the customer do the prime broker if the customer and the prime broker have a written agreement to that effect.

8. If the prime broker disaffirms a transaction, the executing broker must immediately send a confirmation of the replacement transaction to the customer.

9. The executing broker must keep and preserve all records required under (a)(6), (a)(7) and (a)(9) of Rule 1 7a-3. These subparagraphs relate, respectively, to the obligation to make the following: (i) a memorandum of each brokerage order; (ii) a memorandum of each purchase and sale; and (iii) a record of each cash and margin account, including the name and address of the beneficial owner. Whether the beneficial owner objects to disclosure of its identity to issuers, and the signature of the owner for margin accounts.

10. If the executing broker was part of a selling syndicate or group for a security within the previous thirty days, the executing broker may not extend credit on that security.

These requirements are relatively straightforward. However, in practice, a number of issues of compliance have arisen. In documenting prime brokerage agreements, most firms use SIA Form 150 and SIA Form 151 (for use with agent such as an investment adviser).

C. Practical Issues and Practice Tips

1. Execution of the Prime Broker a 2e Agreements

Execution of the prime brokerage agreements between the prime broker and the executing broker is critical for risk compliance and for the protection of both parties. The prime brokerage agreement provides that the executing broker may transfer a transaction to the clearing broker for clearing and settlement pursuant to the agreement. However, the SIA forms of prime brokerage agreement also provide that the prime broker, who is the clearing broker, may reject trades of the executing broker within certain time frames. Without the agreement in place, the executing broker has the capital charges and Rule 1 5c3-3[48] obligations for the transaction and also must be certain that the customer meets the margin and other requirements. With respect to the clearing broker-dealer, the clearing broker-dealer wants to be certain that it does not have to accept a trade if the customer does not have the financial ability to finance the transaction. For example, if the customer's account at the clearing broker has approximately $2,000,000 and the executing broker executes a transaction for $50,000,000, the clearing broker would need additional margin from the customer, and the firm would be exposed to significant credit risk of the customer being unable to pay for the transaction. For this reason, the clearing broker has the right to reject under certain circumstance trades within a short period of time and of notification pursuant to the prime brokerage agreements.

[48] 17 C.F.R. 240.15c3-3.

2. Lack of Appropriate Customer Documentation

As explained above, both the prime broker and the executing broker must have full customer documentation with the customer. The SEC and the SROs insist on documentation at both the executing broker and the clearing broker because the clearing broker has the right to refuse to accept the transaction under certain circumstances if prompt notice is given. Sweeps of the NYSE and the NASDR have found significant deficiencies in this regard. If a broker-dealer engages in prime brokerage, compliance procedures of both the executing broker and the prime broker should provide that prime brokerage documentation and all customer documentation should be in place prior to the first transaction. Systems should be set up to prevent transactions without the documentation. The executing broker must have full customer documentation, including margin agreement, margin disclosure and other documents. Even though the executing broker doesn't propose to clear the transaction because if the clearing broker rejects the transaction, the executing broker must be able to clear the transaction and needs to have customer documentation in place.

3. Customer Credit and Suitability Obligations

Although prime brokerage transactions are effected only for large institutions and high net worth customers, the suitability obligations still are applicable to the executing broker and in certain cases the clearing broker-dealer. More importantly, the executing broker must, in its risk control procedures, have knowledge of the customer's financial position even if it has an agreement with a clearing broker under which the clearing broker will accept any transactions executed by the executing broker. In the usual situation under the SIA forms, the clearing broker need not accept a transaction from an executing broker. Sometimes clearing brokers will provide they will accept certain types of transactions or accept up to a certain dollar amount or number of shares. It is rare that the clearing broker will accept any transaction without the right to reject from an executing broker. For this reason, it is critically important that the executing broker know that the customer has the financial capability to pay for or finance transactions in accordance with their terms in case the transactions are rejected by the clearing broker. Obviously, the clearing broker also needs to be certain that the customer and the clearing broker has the wherewithal to pay for the transactions or finance them once they are accepted.

4. Customer Qualification

It is important that compliance procedures have a procedure to ensure that the client meets the minimum cash requirement of $500,000 in cash or securities or in the case of an investment adviser managed account, at least $100,000.

5. Executing Broker Risk Control

An executing broker should have a risk control procedure with respect to any trades that it executes with a customer pursuant to a prime brokerage arrangement to ensure that the clearing broker will clear the transaction and not reject it. This means that the executing

broker must either have an agreement with the prime clearing broker, that the clearing broker will accept trades up to a certain number of shares or size for the particular customer or, alternatively, the executing broker must make certain that the transactions are within the credit capabilities of the customer because if the transaction is rejected by the clearing broker, the executing broker must clear the transaction itself or through its own clearing firm.

6. Clearing (Prime) Broker Risk Control

The clearing broker must have risk control to know the customer's positions when the executing broker notifies it of a transaction. The clearing broker at that point must make a decision as to whether to accept or reject the trade. If there is an agreement with the executing broker, the firm is contractually obligated to accept the trade. If the trade is rejected there may be claim. The critical issue is that the clearing broker have in place risk control procedures to evaluate the transactions that have been executed for a customer through an executing broker that the clearing broker proposes to clear.

7. Confirmations

The executing broker is required to send a confirmation to the primary broker and the primary broker must inform the customer that the confirmation is available and the primary broker must send the customer notification of each trade with the AB based upon information provided by the customer. The executing broker must send confirmation of the transaction directly to the customer.

8. Extension of Credit on Syndicated and Other Public Offerings

The compliance procedures should have procedures to ensure that the prime broker will not extend credit on a security that it has sold or arranged to be sold through the executing broker or otherwise to sell to the customer if the clearing broker was a member of the selling syndicate or a group for the securities in the prior thirty days. However, the prime broker may clear the transaction and extend credit in a prime brokerage account for a security sold by an executing broker if the prime broker has not arranged for that sale.

## V. Wrongful Termination, Whistle Blower and Defamation Claims, U-4 and U-5 Disclosure Compliance

### A. Introduction

Litigation and arbitration claims alleging defamation, wrongful termination and whistle blower claims have exploded in recent years. Compliance procedures to avoid civil claims and enforcement proceedings have become far more complicated because of the recent amendments to Forms U-4 and U-S. Failure to accurately complete Form U-S can result in civil claims by other broker-dealers if a rogue employee commits violations that were not clearly disclosed in a way to put other firms on notice of conduct by the rogue employee at his former

firm. Further, customers may bring claims against a broker-dealer because disclosures about a former rogue employee were not carefully made with respect to complaints in Form U-4 or in Form U-S. On the other hand, employees increasingly are suing for defamation alleging that the disclosures in the Form U-S and in some cases the Form U-4 were inaccurate. Employees are also suing firms for wrongful termination under a variety of theories including whistle blower claims. This is an area that has been and will continue to be the topic of seminars lasting several days. Consequently, this outline is just a summary of the some of the key issues which will be discussed by the panel and some practical tips to prevent claims.

B. Regulatory Requirements for Forms U-4 and U-S

1. Introduction

Form U-4 is filed to report the hiring of a registered person by a broker-dealer and Form U-S is filed to report an employment termination. Forms U-4 and U-S must be amended to report changed events. Compliance officers and counsel should be aware that there is a set of guidelines on the NASDR website with respect to interpretive advice with respect to answering questions on Forms U-4 and U-S.[49]

2. Forms U-4 and U-S Reporting

a. General

Most of the problems in reporting on Form U-4 revolve around Question 23. Question 23 has a series of subquestions that ask about a significant amount of activity that might reflect on a registered person's integrity. If the answer to any of the subquestions of Question 23 is affirmative, a further page known as a disciplinary report page, or DRP, must be completed with a brief explanation and additional questions answered. The instructions for Form U-4 contain an explanation of certain key terms that should be understood. Several key terms include "self-regulatory organization," "resigned," "enjoined," "investment related," "investigation," "proceeding" and "sales practice violation." There are other terms that should also be understood. Furthermore, the specific instructions should be carefully read.

Questions 23A and 23B deal with criminal felony and misdemeanor matters. Questions 23C, 23D and 23E deal with required disclosure regarding proceedings or threatened proceedings by the United States and foreign financial regulators, including the SEC and the Commodity Futures Trading Commission ("CFTC") and self-regulatory organizations, exchanges and markets. Proceedings involving violations of rules or investment related activities also need to be disclosed. Question 23F inquires about whether a person's authorization to act as an attorney, accountant or federal contractor has ever been revoked or suspended. Question 23G asks for disclosure if one is subject to any regulatory complaint that could result in a "yes" answer to any of the preceding Questions in 23C, D or E or whether there is any investigation that could result in a "yes" answer with respect to anything

[49] NASDR.com/3470.htm.

covered by questions 23A-E. Question 23H inquires about injunctions and equitable relief proceedings with respect to investment related activities or statutes, including settlements regarding the same. Question 23K, which has not been problematic, deals with bankruptcy and association with firms that have been bankrupt. Question 23L asks whether a bonding company has revoked a bond, denied coverage to the reporting person or paid out on claims regarding the reporting person. Question 23M asks whether there are any unsatisfied judgments or liens.

The more difficult questions, Questions 231 and 23J, have been the focus of litigation. Question 231 inquires about investment related consumer complaints and is a problem which involves difficulty in reporting as discussed below. Question 23J of Form U-4 asks about whether a person has voluntarily resigned, been discharged or permitted to resign after allegations were made of a violation of investment related statutes, fraud or willful taking of property or failure to supervise in connection with investment related activities.

The litigation and problems of Forms U-S focus principally on the answers to Questions 13-19. Question 13 requests the reason for termination. Questions 14 and 15 ask whether the individual was under investigation or a party to proceedings by a financial regulator or SRO with jurisdiction over investment related business activities. Question 15 inquires about whether the individual being terminated was under internal review for fraud, wrongful taking of property or violating investment related statutes, regulations or industry standards of conduct. Questions 1 6A and 1 6B ask concerning whether the individual was charged with a felony, convicted or plead guilty or no contest to a felony. The same questions are asked in Questions 1 6C and 1 6D regarding charges, conviction, guilty plea or no contest with respect to misdemeanors involving investments or investment related business or any fraud, false statements, omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion or conspiracy with respect to any of the foregoing. Question 17 asks about disciplinary proceedings by foreign or United States regulators or SROs. Question 1 8A inquires about events regarding any investment related" consumer initiated arbitration or civil litigation that allege the individual is involved in one or more sales practice violations and which is still pending or resulted in a judgment or award or was settled for the amount of $10,000 or more. Question 1 8B asks about any other investment related consumer initiated complaint involving one or more sales practice violations which was settled in the amount of $10,000 or more. Question 1 8C asks with respect to investment related consumer initiated complaints not reported in answers to Questions 1 8A or 1 8B which are reportable under Form U-4 Questions 231(3)(a) or 231(3)(b) not previously reported by the firm on Form U-4. Question 19 is a certification:

1. there is either no additional information to be reported at this time,

2 there is additional information to disclose that is reported on the appropriate DRP page, or

3. there is updated information reported on the appropriate DRP page relating to prior disclosures.

Questions 14 through 18 apply to the employee while employed or to the extent known by the broker-dealer after employment if the activity occurred during employment.[50]

b. Customer Complaints

"Investment related" "consumer initiated" written complaints must be reported if made within the 24 or more months preceding the filing and (1) if the complaint alleges that a registered person "is involved in one or more sales practice violations" and claims compensatory damages of $5,000 or (2) if the complaint alleges "forgery, theft, misrepresentation or conversion of funds or securities."[51] It should be noted that the NYSE requires also that all oral complaints be reported.[52] It should also be noted that settlements over $10,000 also have to be reported.[53]

c. Arbitration and Lawsuits

Arbitration and lawsuits are reportable under the following circumstances:

1. "Sales practice violation" is involved;
2. The registered person is named as a respondent or defendant and the proceeding is pending at the person's termination;
3. If there is a judgment or award against the registered representative; or
4. The matter was settled for more than $10,000.

d. Disposition of Complaints and Arbitrations

Dispositions or withdrawals are always reportable even with an immediate withdrawal of complaint.

e. Settlements

Any settlement over $10,000 must be reported for all complaints, oral and written and any arbitration or litigation. Any withdrawal or dismissal must be reported, even where the party does not contribute directly or indirectly to a settlement.[54] However, a

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[50] *See* Interpretive Questions Form U-4 and U-5, 16 and 17Q1.
[51] Form U-4 231(3)(a)&(f); Form U-5 18C.
[52] NYSE Information Memo No. 98-16 (Apr. 14, 1998).
[53] *See* Interpretive Questions Form U-4 231(2) Question 1.
[54] *See* Interpretive Question Form U-4, 231 Q1-3, Q8.

withdrawal where the respondent does not contribute directly or indirectly to the settlement is reportable but a change of an answer from yes to no in Form U-4 231(1)(a)&(c) is permitted.[55]

f. Regulatory Investigations and Proceedings

Regulatory investigations and proceedings must be reported on Form U-4 or Form U-S when they reach the Wells submission stage. In the event of termination, a firm still has an obligation under Form U-S to report with respect to a terminated employee if the firm has actual notice.[56]

C. Defamation Claims

Almost every broker-dealer of any size has experienced a possible claim for defamation by a terminated employee alleging that the grounds for termination set forth in Form U5 are defamatory. Disclosure of even the possibility of an investigation of unethical or illegal conduct may expose the broker-dealer to defamation liability. On the contrary, nondisclosure or failure to candidly disclose a terminated employee's unethical conduct rule violation, illegal activities or contractual violations may subject the broker-dealer to liability from other broker-dealers or investors damaged by the former employee as well as regulatory disciplinary actions by the securities self-regulatory organizations.

1. Elements of a Defamation Claim

The law of defamation varies from state to state, but generally includes the following elements:

a. a false statement;

b. publication to a third party without a privilege;

c. fault, either intentional or negligence on the part of the party publishing the statement; and

d. the statement is per se defamatory (the defamation may be proved without proving special damage) or the existence of special harm (damages caused by the statement and its publication).[57]

2. Defenses

a. Truth. Truth is an absolute defense to defamation in all jurisdictions.

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[55] Id.
[56] *See* Interpretive Questions Forms U-4 and U-5 16 & 17Q1.
[57] *See e.g.,* Krasinski v. United Parcel Service, Inc., 124 Ill.2d 483, 490, 530 N.E.2d 468, 471 (1988).

b. Qualified Immunity – NASDR Proposed Rule 1150. The NASDR proposed a rule change to provide qualified immunity in arbitration proceedings for statements made in good faith in disclosures filed with the NASDR on Forms U-4 and U-S.[58] The NASDR Rule remains pending.

c. Qualified Privilege. Under state law, in most jurisdictions there is a qualified privilege to a claim of defamation.[59] The qualified privilege may be raised by the respondent. The claimant must then show that the firm intentionally made a false report, *i.e.,* did so maliciously or was reckless.

d. Absolute Privilege. An absolute privilege has been recognized in several New York cases.[60] However, the federal courts in New York in applying New York law have reached a different conclusion.[61]

3. State Statute of Limitations

In most states, the statute of limitations for defamation is one year.[62]

D. Whistle Blower Claims

1. Federal Law

Various federal statutes provide that an employee may not be fired in retaliation for bringing misconduct or illegal activities of the person's employers to the attention of authorities. Examples of these statutes are as follows:

a. Occupational Safety and Health Act of 1970.[63]

b. False Claims Act.[64]

c. Fair Labor Standards Act.[65]

d. Federal Deposit Insurance Act.[66]

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[58] NASDR Notice to Members 97-77.
[59] *See e.g.,* Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704 (7th Cir. 1994); Prudential Sec. v. Dalton, 929 F. Supp. 1411 (N.D. Okla. 1996); Glennon v. Dean Witter Reynolds, Inc., 183 F.3d 132 (6th Cir. 1996).
[60] Hertzfeld & Stem, Inc. v. Beck, 175 A.D.2d 689, 572 N.Y.S.2d 683 (1st Dept. 1991).
[61] Fahnestock & Co. v. Waltman, 935 F.2d 512 (2d Cir.), cert. denied, 502 U.S. 942 (1991), and cert. denied, 502 U.S. 1120 (1992).
[62] *See e.g.,* 735 ILCS 5/13-201.
[63] 29 U.S.C. §§651 *et. seq.*
[64] 31 U.S.C. 9 §3729-3731.
[65] 29 U.S.C. §215(a)(3)
[66] 12 U.S.C. 1831 (j)

2. State Law

In Illinois, there are a number of statutes as well as in other states that specifically prohibit an employer from terminating an employee for bringing to the attention of public officials activities of the employer that are illegal or contrary to public policy.[67]

E. Wrongful Termination

1. Introduction

There are numerous cases, arbitrations and civil litigation involving terminated employees. These cases allege claims under contract theories or under tort theories including defamation claims and whistle blowing claims.

2. Contractual Claims

Under the law of most states, an employee is a contractor at-will whose employment can be terminated by the employer at will absent a written agreement with the employee defining contractual terms.[68]

a. Written Contracts

In the securities industry, senior executives, traders and large producers often have written contractual arrangements. In many cases, these agreements are somewhat informal in the form of letters, a memorandum, a series of letters and in other cases more formal agreements. In these cases, the employee generally will rely on the contractual agreement unless the termination provisions are clear. In the less formal agreements, there are usually no provisions with respect to termination. In many cases, if there are any provisions, they are vague since the agreements have a term, but nothing regarding termination for cause. Unfortunately, many of these contracts do not spell out that violation of company policies, the company rules, rules of the self-regulatory organizations or the financial institutions regulations are cause for termination. Unfortunately, because of the informal nature of many of these agreements, there are disputes dealing with the terms of the contract and what is a termination for cause.

b. Implied Contracts and Oral Agreements

Many times employment agreements in the securities industry have only oral terms. Where there is only an oral agreement, generally the employment is at-will. However, a number of courts have found that a contract has been created where employee

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[67] *E.g.,* Whistle Blower Protection Act, 5 ILCS 395/1; Prevailing Wage Act, 820 ILCS 130/11b; Nursing Home Care Act, 210 ILCS 4513-608.

[68] *E.G.,* Fisher v. Lexington Health Care, Inc., 188 Ill.2d 455 (1999) (affirming common law doctrine that an employer may discharge an employee at-will for any reason or for no reason).

manuals or other employer furnished materials have alluded to a continuing employment relationship without explicitly stating that the employment is at-will and can be terminated at-will.[69] These materials are held to be an offer of employment that is in turn accepted by continuing employment with the employer. In other cases not involving an enforceable employment contract, courts have used a promissory estoppel theory to enforce unambiguous promises of employment.[70]

3. Tort Claims

In addition to defamation claims previously mentioned and discussed in section C, tort claims generally involve some violation of public policy manifested in statutory or case of law. In most cases, these claims are in the nature of whistle blower claims. In these cases, the claimant must show that the discharge was wrongful in that it violated some major public policy.[71] Generally, the public interest must be substantial and affect the public at large. The public policy must be clearly mandated by statute, court decisions or a specific whistle blowing statute. Many courts today will not recognize a wrongful discharge tort claim unless it is in connection with a specific whistle blowing statute or has been previously adjudicated by a court involving a major public policy.

F. Practical Suggestions

1. Compliance Procedures

Compliance procedures should have a clear definition of complaints both oral and written. The procedures should have a process for reviewing complaints, cataloguing them and maintaining them. It is the author's experience that a central complaint file in the compliance department is generally the most appropriate place. In any event, the compliance department or the senior supervisor should maintain copies of all complaints. When a complaint is filed, it should be investigated by interviewing the account executive. The interview should be conducted by someone in the compliance department or an executive who is not directly involved in the chain of command. The person that contacts the claimant should also be someone to whom the account executive does not report and it should not generally be the branch manager. In many cases, it is the experience of the author that a prompt call to a claimant by someone outside of the branch in many cases will result in a quick and graceful resolution. In any event, all applicable documents should be maintained in the claimant file. If there is a written response to the complaint, this should also be maintained.

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[69] *E.G.,* Duldulao v. St. Mary of Nazareth Hosp. Ctr., 115 Ill.2d 482 (1987) (employee handbook provisions may give rise to binding contract with at-will employees).
[70] *E.G.,* Taylor v. Canteen Corp., 69 F.3d 773 (7th Cir. 1995).
[71] *See, e.g.,* Parr v. Triplett Corp., 727 F.Supp. 1163 (N.D. Ill. 1984) (a clear mandate of public policy is violated when an employee is discharged for reporting criminal activity).

2. Responsibility for Forms U-4

Most broker-dealers provide that amendments to Form U-4 are the responsibility of the account executive. Nevertheless, most broker-dealers also have a system in their compliance procedures to bring to the attention of an account executive any complaint that has been filed, either orally or written, with a reminder that the account executive's Form U-4 must be amended. Most firms also have as part of their compliance manuals for account executives a requirement that a copy of any proposed amendment to Form U-4 with respect to any convictions, investigations, complaints, litigation, or arbitration be reported to and reviewed by the compliance department or law department prior to filing. The author has seen account executives amend their own Form U-4, file it and make statements that come back to haunt the broker-dealer in a subsequent litigation or arbitration. Consequently, review of a Form U-4 amendment relating to an investigation, proceeding, complaint, arbitration or litigation should be reviewed by the compliance department, the in-house general counsel or by outside counsel if the matter is being handled by outside counsel in connection with an arbitration or litigation.

3. Form U-S

It is obvious from the foregoing discussions that Form U-S must be carefully prepared by a broker-dealer. Forms U-4 and the associated DRP pages should be prepared by the compliance department and checked by counsel. If there are major issues involved, it may be appropriate to consult with outside counsel.

In first instance, Question 13 indicating the reason for termination should be accurate. An explanation is usually appropriate and required. Many of the cases resulting in defamation claims are based on answers to Question 13. If Question 15 is answered that the individual is under internal review or if under investigation under Question 14, the report will need to be amended when the investigation is complete. If the investigation is an internal investigation by the broker-dealer, the broker-dealer should be certain that it conducts the investigation, completes the investigation and documents its findings, conclusions and reasons. At the conclusion of the investigation, the Form U-S must be amended and updated to indicate the result of the investigation.

Questions 16, 17 and 18 of Form U-4 also present problems in that the charges in the matters need to be summarized for the DRP pages. This is difficult in many cases because the charges may be complex, involving many different legal claims involving the same facts. The summary is necessarily not complete and is an open invitation for claim for defamation by an account executive. For this reason, experienced counsel familiar with defamation claims and with Form U-S should assist in completion or review the answers on the DRP pages in connection with Questions 15, 16 or 17.

4. Changes In Connection With Settlements

If Form U-S is going to be amended in connection with the settlement of litigation or arbitrations involving the account executive, an amended U-S must be filed. Changes to the Form U-S responses and the reasons for them should be documented. The broker-dealer should be very careful if it is settling litigation in a defamation claim by an account executive that the firm can justify any change to the Form U-S which ameliorates any previous statement regarding the account executive. The firm, if it ameliorates a prior statement about the account executive, must be prepared to forward to regulators facts and documents or testimony in connection with the settlement and explain why the firm's prior statements were either inaccurate or incomplete. As noted above, Questions 14 through 17 require an amendment to Form U-S if an answer to a question changes after an employee terminates but the activity relates to the period when the employee was employed.

5. Written Contracts. Formal or Informal, with Account Executives and Other Employees of Broker-Dealers

Much litigation and many arbitrations could be avoided if agreements with employees of broker-dealers are clear that the broker-dealer has the right to terminate employment in the event the employee violates the broker-dealer written policies, code of ethics, trading parameters, SRO rules or the rules and laws of the financial regulators (including the SEC and the CFTC) and other illegal conduct. Vague definitions as to the right to terminate for cause result in court battles in which arbitrators and judges are left to guess what the results should be. However, generally, "cause" terminations require some serious rule violation and in many cases does not include violation of the company's policies, code of ethics or similar internal rules, including trading parameters.

6. Employee Manuals

Employee manuals and employee materials should explicitly and clearly disclaim the creation of a binding contract and state that employees are "at-will" and may be terminated at any time with or without cause or notice. These manuals also should state that employees may be terminated in the discretion of management for violation of company policies, trading restrictions, rules or code of ethics, or SRO rules, the rules or laws of applicable financial regulators, and similar violations, including felonies. Many firms track the language of reportable offenses under Form U-4 or Form U-S.

7. Arbitration Provisions

In Circuit City Stores, Inc. v. Adams,[72] the United States Supreme Court affirmed the use of mandatory arbitration provisions required by employers as a condition of employment. Accordingly, with a broadly written clause, employers may be able to keep virtually every dispute with its employees out of court. This would include cases involving

[72] 121 S.Ct. 1399 (March 21, 2001).

federal discrimination statutes, federal wage and hours laws, state common law claims involving contract rights and torts, state statutes, and state constitutional provisions. At least one federal court, citing Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991) has required the following five safeguards for an arbitration provision involving federal statutes: (1) neutral arbitrators, (2) more than minimal discovery, (3) a written award, (4) all of the types of relief that would otherwise be available in court, and (5) does not require employees to pay either unreasonable costs or any arbitrators' fees or expenses as a condition of access to the arbitration forum.[73]

As with all contracts, an arbitration agreement must be supported by consideration. In most states, however, this requirement will be satisfied if the employer simply agrees to do anything, including agreeing to be bound by the arbitration.

8. Termination Agreements and Releases

Termination agreements are beyond the scope of this panel. However, termination agreements have to be carefully drafted if releases are to be effective. Although the topic of severance agreements and releases is beyond the scope of this article, employers who have departing employees sign severance agreements containing general releases in an attempt to limit future lawsuits, should be aware of a 1990 amendment to the Age Discrimination in Employment Act of 1967 ("ADEA"),[74] known as the Older Workers Benefit Protection Act **("0** WBPA").[75]

Pursuant to OWBPA, among other things, a release must advise the employee to seek the advice of an attorney; must give the employee 21 days to consider the release before signing, as well as seven days to revoke the release; and must specifically state that the employee is releasing the claims based on age discrimination.

The U.S. Supreme Court has further held that a release that does not fully comply with the requirements of OWBPA is void in its entirety and unenforceable, and in such a case, an employee can proceed with an age discrimination suit without being required to return any severance pay paid in exchange for the faulty release.[76]

[73] Cole v. Burns Intl. Security Services, 105 F.3d 1465 (DC Cir. 1997).
[74] 29 U.S.C. §621 *et seq.*
[75] 29 U.S.C. §626(f).
[76] Oubre v. Entergy Operations, Inc., 522 U.S. 422 (1998).