Retail Brokerage and Advisory Issues

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I. INTRODUCTION[1]

This outline highlights several key areas concerning retail brokerage and advisory issues. Specifically, the outline covers the following topics: (1) background information regarding Section 913 of the Dodd-Frank Act concerning standards of care for broker-dealers and investment advisers; (2) retail structured products; and (3) compensation practices.

II. SECTION 913 OF THE DODD-FRANK ACT CONCERNING STANDARDS OF CARE FOR BROKER-DEALERS AND INVESTMENT ADVISERS

One of the most important provisions of the Dodd-Frank Act passed by Congress and signed into law by President Obama in July 2009 concerns the standards of care applicable to broker-dealers and investment advisors. Specifically, Section 913 of the Act requires the SEC to study the effectiveness of the standards of care applicable to broker-dealers and investment advisors for providing personal investment advice to retail investors. The SEC is required to report its findings to Congress within six months. Further, the Commission has been given the authority to draft rules in this area using the findings from its study. Finally, the Act states that any SEC rules with respect to a broker-dealer providing personalized investment advice about securities to a retail customer must be the same as the standard set forth in the Investment Advisers Act.

Because of its importance to the industry, Section 913 has been the subject of much action and commentary. A small sample of resources regarding this provision can be found as follows:

SEC.gov: The Commission's website contains a link to the thousands of comments that have been submitted to the SEC. These comments range from individual investors to securities firms to industry organizations.

SIFMA.org: SIFMA's website is particularly helpful in identifying and tracking issues concerning Dodd-Frank. Of particular note, SIFMA's August 30, 2010 comment letter regarding the SEC's Section 913 study is available on the site. In its letter, SIFMA makes the following seven key points concerning the development of a uniform standard of care:

1. Retail investors' interests must be "put first" in addressing this issue.
2. The standard of care developed by the SEC must be clearly defined and provide guidance to how that standard can be implemented by brokerage firms and investment advisers.

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[1] This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations or the Firm's clients. Portions of this outline were developed by Mr. Indek for this same panel at the 2008 and 2009 SIFMA Compliance & Legal Division Fall Compliance Seminar. Mr. Indek is indebted to the panelists during those years for their input on those outlines.

3. Retail investors should receive the same standard of care regardless of whether they are dealing with a broker-dealer or investment adviser.

4. The Commission's uniform standard of care should not discriminate among types of firms, but rather should be "business model neutral."

5. Investors should continue to be able to have access to a broad array of products and services and have the opportunity to choose among investment firms.

6. Brokerage firms and investment advisers should be able to provide disclosures to investors regarding material conflicts of interest.

7. The standard of care created by the Commission should apply to "personalized investment advice about securities."[2]

Davis Polk & Wardwell LLP: Davis Polk's website includes an outstanding and detailed analysis of the entire Dodd-Frank Act. An examination of the fiduciary standard issue can be found at pages 68-72 of the firm's July 21, 2010 Dodd-Frank analysis.

III. RETAIL STRUCTURED PRODUCTS

Over the last several years, regulators have exhibited significant concerns regarding the so-called "retailization" of complex products to individual investors. These concerns have been set out in various regulatory notices, speeches, examination priorities, and enforcement efforts. This section outlines these issues.

A. Regulatory Notices

1. New Products – NASD Recommends Best Practices for Reviewing New Products.

In Notice to Members 05-26 (September 2005), NASD stated that it was concerned about the rising number of ever increasingly complex products being offered by member firms.

(i) Some products have features that may not be fully understood by investors or registered representatives; and

(ii) Some products raised suitability and conflict of interest concerns.

The NASD urged firms to be proactive in reviewing and improving their procedures for creating and vetting new products. The NASD stated that all firms offering new products should have formal written procedures to confirm that no new product is introduced before it has been fully vetted. At a minimum, such

[2] See SIFMA's August 30, 2010 letter to the SEC concerning the Commission's "Study Regarding Obligations of Brokers, Dealers and Investment Advisers."

procedures should identify what constitutes a new product and confirm that the right questions are asked and answered before a product is offered to clients.

After surveying firms, the NASD noted the following best practices:

(i) "A mandatory, standardized process that requires a written "new product" proposal and thorough accompanying documentation;

(ii) A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;

(iii) For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales and operations;

(iv) A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management; and

(v) If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution."

2. Structured Products – NASD Provides Guidance Concerning the Sale of Structured Products

Definition: according to the NASD, structured products are "securities derived from, or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency." Their characteristics include:

(i) Principal protection varies – may offer full or limited protection of the principal invested, or none at all.

(ii) Most pay an interest rate substantially above prevailing market.

(iii) Are typically issued by investment banks or their affiliates.

(iv) Have a fixed maturity.

(v) Are sometimes listed on an exchange, but in such cases, generally are very thinly traded.

Structured as two components – a note and a derivative (often an option):

(i) Note pays interest to the investor at specified rate and interval.

(ii) Derivative component establishes payment at maturity (effectively acting like a put or call option).

NASD's 2005 guidance (Notice to Members 05-59) on structured products states firms should:

(i) provide balanced disclosure in promotional efforts;

(ii) ascertain accounts eligible to purchase structured products;

(iii) deal fairly with customers with regard to derivative products;

(iv) perform a reasonable-basis suitability determination;

(v) perform a customer-specific suitability determination;

(vi) supervise and maintain a supervisory control system; and

(vii) train associated persons.

Balanced disclosure should not portray a product as "conservative" or a source of "predictable current income" unless such statements are accurate, fair, and balanced. In promoting advantages such as interest rate offered and creditworthiness of the company, a firm must balance its presentation with disclosures concerning risks, e.g., loss of principal and the possibility that at expiration the investor will own the reference asset at a lower price. Sales materials and oral presentations that omit description of the derivative component and instead present such products as ordinary debt securities would violate Rule 2210. Firms should also balance any statements that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop in the future.

The NASD cautioned that presentation of a credit rating for a structured product suggesting that the rating relates to the safety of the money invested or the likely investment returns will be seen as misleading by the staff. The Notice further states "creditworthiness of the issuer does not affect or enhance the likely performance of the investment, other than the ability of the issuer to meet its obligations."

Eligible Accounts:

(i) Firms should consider whether structured products should be limited to clients approved for options accounts.

(ii) Otherwise, the member must develop (and be prepared to defend) comparable procedures designed to confirm that structured products are only sold to persons for whom risk is appropriate.

(iii) Due to potential conflicts of interest, sale of a firm's or affiliate's structured product to a discretionary account requires the client's prior specific written approval of the trade.

Fair Dealing:

(i) "Member must be familiar with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and make every effort to make customers aware of the pertinent information regarding the products."

Reasonable Basis Suitability:

(i) This aspect of suitability includes due diligence.

(ii) NASD expects members to exercise market expertise to identify where a lower yielding instrument does not represent a reasonable rate of return, given the attendant risks, as compared to other similar products or direct investments in the underlying securities with similar risk/reward attributes.

Customer-Specific Suitability:

(i) Derivative component and potential loss of principal may be unsuitable for investors seeking alternatives to debt securities.

(ii) "While structured products pay interest like debt securities, they often exhibit profit and loss potential more like an option contract."

(iii) Where there is a risk of losing all or a substantial portion of the principal in return for above-market rate current income, the volatility of the reference asset upon which total return of the investment depends is an important factor in determining suitability.

3. High Yield Securities – FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment

FINRA Regulatory Notice 08-81 (December 2008) was intended to reiterate to firms their obligations in connection with the sale of certain securities during periods in which yields reached unusually high levels.

Specifically, FINRA's Notice was intended to remind firms of their obligation to balance the discussion of yield with an appropriate description of the features of bonds, bond funds, structured products, and non-conventional investments and the risks associated with such transactions.

4. Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

In Regulatory Notice 09-31 (June 2009), FINRA provided information concerning its views of firms' sales practice obligations that arise in connection with investments in leveraged and inverse ETFs.

In particular, the Notice stated that recommendations must be suitable and based upon a complete understanding of the terms and features of the recommended product. In addition, FINRA cautioned that sales materials relating to leveraged and inverse ETFs must fairly and accurately describe the products. FINRA also emphasized that firms must train their brokers about the terms, features and risks of ETFs. As it relates to leveraged and inverse ETFs, FINRA pointed out that the training should focus on the need to understand an investor's time horizons and the impact of time and volatility on the investment's performance. The Notice stated that firms are obligated to have adequate supervisory procedures in place for these products. Specifically, FINRA noted that firms that permit brokers to recommend leveraged and inverse ETFs must have written supervisory procedures that require:

(i) an appropriate reasonable-basis suitability analysis be conducted;

(ii) brokers to conduct an appropriate customer-specific suitability review;

(iii) sales materials be accurate and balanced presentations; and

(iv) relevant FINRA and SEC rules be adhered to.

5. Reverse Convertibles – FINRA Reminds Firms of Their Sales Practice Obligations With Reverse Exchangeable Securities

In Regulatory Notice 10-09 (February 2010), FINRA noted that reverse convertibles had become popular structured products with retail investors because of the high yields offered by such securities. FINRA, however, pointed out that these investments are complex and that investors and brokers may find it difficult to understand their terms, features and risks.

FINRA issued its Regulatory Notice to advise firms of their obligations regarding communications with the public, suitability, supervision and training.

On the same day that FINRA issued this Regulatory Notice, it announced an enforcement action against H&R Block Financial Advisors regarding alleged inadequate supervision of reverse convertible notes sales; FINRA also suspended and fined a broker for unsuitable sales. This case is further described below.

B. Speeches

In his October 2009 speech at the SIFMA Annual Meeting, FINRA's Chairman and CEO, Rick Ketchum, spent considerable time describing new products and sales practices.[3] Although commending firms for developing and implementing protocols to vet the introduction of new products, Mr. Ketchum urged firms to institutionalize their product committees and focus their efforts not solely on the development of new products but how such investments evolve over time. In short, he stated that "product review cannot be a static process and firms must understand when market forces render a change in the risks of a product at the earliest reasonable time."

Mr. Ketchum returned to these same themes in two speeches in May 2010.[4] In these speeches Mr. Ketchum made it clear that FINRA expects firms to not only enforce their procedures but to also periodically reassess and update them as necessary to maintain pace with both product and market developments. Indeed, Mr. Ketchum emphasized that firms must pay attention to market developments and their affect on products already on firms' platforms. Mr. Ketchum stated "this new product-vetting process will continue to be an important regulatory focus for FINRA."

C. Examination Priorities

In its March 9, 2009 letter outlining new and existing areas of importance to its examination program, FINRA described the staff's focus on alternative investments in light of the then-current market conditions. Among other things, the letter describes the suitability, disclosure, and supervisory obligations imposed on firms recommending structured products, high-yield bonds and bond funds, and other alternative investments. Of note, FINRA indicated that there was an increase in firm applications for firms to engage in retail foreign currency exchange business. The staff observed that this business is "particularly risky for individual investors, and has generated problems from abusive sales practices to the financial failure of retail forex merchants." Accordingly, FINRA examiners will closely review firms already engaged in or seeking to conduct retail forex business.

On March 1, 2010 FINRA published its annual examination priorities letter. This year FINRA again took the opportunity to remind firms about their obligations when creating or selling new products. Specifically, FINRA pointed out the growth in the sales of principal-protected notes and reverse convertible notes to retail investors. The letter reiterates firms' suitability, disclosure, supervisory, surveillance and training obligations.

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[3] See remarks of FINRA's CEO and Chairman, Rick Ketchum, at the SIFMA Annual Meeting (October 27, 2009) at finra.org.

[4] See remarks of Rick Ketchum at the SIFMA Compliance and Legal Division's Annual Seminar (May 7, 2010) and remarks from the 2010 FINRA Annual Conference (May 26, 2010) at finra.org.

D. Enforcement Developments

In addition to the foregoing, structured products have also been the focus of various enforcement efforts over the last two years.

First, in early 2009 the new Director of Enforcement at the SEC, Robert Khuzami, announced the formation of five specialized units. In an August 5, 2009 speech, Mr. Khuzami laid out his plans for a Structured and New Products Unit:

> The Structured and New Products Unit will focus on complex derivatives and financial products, including CDS, CDOs and securitized products. These are huge markets, with outstanding notional amounts that at one time came close to the market capitalization of all publicly traded companies in the world. They are also opaque markets due to the complexity of the products, the limited availability of trading information and the prevalence of private offerings. This lack of transparency has become fertile ground for abuse and misconduct, and staying on top of these markets, and whatever new products are next devised, requires specialized knowledge and commitment.

In 2010, this group was up and running and, as described below, played a central role in one of the biggest cases ever brought by the SEC.

Second, regulators have initiated disciplinary action against firms and individuals in connection with improper sales practices relating to structured products. Some of these cases include the following:[5]

1. *SEC v. Goldman Sachs & Co.* ("Goldman Sachs") *and Fabrice Tourre*, 10-CV-3229 (S.D.N.Y. filed Apr. 16, 2010)

   The SEC brought an action in federal district court against Goldman Sachs and one of its employees, Fabrice Tourre, alleging fraud in connection with the sale and marketing of a synthetic collateralized debt obligation ("CDO").

   The SEC alleged that, in 2007, as the U.S. housing market and related securities were beginning to decline, Goldman Sachs created and marketed a synthetic CDO that was connected to the performance of subprime residential mortgage-backed securities. The marketing materials for the CDO, including the offering memorandum and term sheet, stated that the portfolio of residential mortgage-backed securities underlying the CDO was selected by an experienced third party, ACA Management LLC ("ACA").

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[5] The summaries of these cases are taken from the "Year in Review" publications issued by Morgan Lewis. These reports are available at morganlewis.com.

According to the SEC complaint, a hedge fund, Paulson & Co. ("Paulson"), played a major and undisclosed role in the portfolio selection process, despite the fact that its economic interest was adverse to investors. Specifically, Paulson allegedly sold short the securities portfolio after helping to select it by entering into credit default swaps with Goldman Sachs, which provided protection on certain elements of the CDO's structure. Accordingly, Paulson allegedly had an incentive to choose securities for the portfolio that would ultimately decline in credit quality.

The SEC also alleged that Tourre was primarily responsible for structuring the relevant CDO and that he prepared the marketing materials and communicated with investors. The complaint alleged that Tourre knew about Paulson's short interest and its participation in selecting the portfolio but did not disclose this information to investors. The SEC further alleged that Tourre was responsible for misleading ACA into believing that Paulson was an equity investor in the CDO and therefore had interests aligned with ACA Management.

Paulson allegedly paid Goldman Sachs approximately $15 million to create and market the CDO, which was finalized on April 26, 2007. By late October 2007, most of the residential mortgage-backed securities in the portfolio had declined in credit quality, and by the end of January 2008, 99% of the portfolio securities had been downgraded.

The SEC alleged that investors in the CDO lost more than $1 billion, while Paulson's short positions resulted in an approximately $1 billion profit.

Paulson was not charged with any wrongdoing in this matter.

The SEC's lawsuit alleged that Goldman Sachs and Tourre's conduct violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act ("Exchange Act") of 1934 and Rule 10b-5 thereunder and sought injunctive relief, disgorgement, and penalties.

On July 15, 2010, the SEC announced a $550 million settlement with Goldman Sachs, which is the largest SEC penalty ever assessed against a Wall Street firm. In its settlement, the Commission stated that $250 million of the penalty will go to harmed investors and $300 million will be paid to the U.S. Treasury. In addition to the monetary sanction, Goldman Sachs agreed to comply with a number of undertakings for three years, including actions regarding its product review and approval process, the role of both internal and external legal counsel, and the education and training of certain personnel involved in the structuring or marketing of mortgage securities offerings.

Although the SEC's complaint charged the firm with violations of Section 10(b) of the 1934 Act and Rule 10b-5 and Section 17(a) of the 1933 Act, the final judgment enjoined Goldman Sachs only from violating Section 17(a) of the 1933 Act.

As is typical in such resolutions, Goldman Sachs neither admitted nor denied the SEC's allegations, but as part of the settlement, it acknowledged that the marketing materials for the CDO product "contained incomplete information," and that it was a "mistake" not to disclose Paulson's role in the selection of the portfolio and its adverse economic interest.

The SEC's case against Tourre is ongoing.

2. *H&R Block Financial Advisors, Inc.* ("H&R Block") *and Andrew MacGill* (Feb. 16, 2010)

FINRA settled a matter with H&R Block in which it alleged that the firm failed to establish adequate supervisory systems and written procedures for supervising retail sales of reverse convertible notes ("RCNs").

An RCN is a structured product that consists of a high-yield, short-term note of an issuer and a put option that is linked to the performance of a "linked" asset. Upon maturity of an RCN, the investor receives either the full principal of his investment plus interest, or a predetermined number of shares of the linked asset. In addition to the ordinary fixed income product risks, RCNs carry the additional risk of the underlying linked asset, which, depending on performance, could be worth less than the principal investment.

FINRA alleged that, between January 2004 and December 2007, H&R Block sold RCNs without having in place an adequate surveillance system to monitor for overconcentration in RCNs. As a result, the firm failed to detect and address such overconcentrations in customer accounts.

FINRA alleged that H&R Block failed to provide guidance to its supervising managers to enable them to effectively assess suitability related to RCNs.

FINRA alleged that, between May 2007 and November 2007, H&R Block broker Andrew MacGill made unsuitable sales of RCNs to a retired couple who invested nearly 40 percent of their total liquid net worth in nine RCNs.

H&R Block consented to a censure and to pay a $200,000 fine and $75,000 in restitution.

MacGill consented to a fine and disgorgement totaling $12,023 and a 15-day suspension from associating with any FINRA member firm in any capacity.

3. *Brian Berkowicz* (July 22, 2008), *Cindy Schwartz* (July 24, 2008), and *John Webberly* (June 16, 2008)

Three SAMCO Financial Services, Inc. brokers settled FINRA actions in connection with misconduct in marketing and sales of Collateralized Mortgage Obligations to retail customers.

FINRA alleged that between June 2004 and September 2006, Berkowicz, Schwartz, and Webberly recommended inverse floaters to non-sophisticated retail investors for whom the securities were not suitable. As a result of these recommendations, nine clients collectively lost approximately $535,000.

FINRA also alleged that the brokers allowed the SAMCO head trader, who was also their supervisor, to exercise discretion to purchase CMOs in the clients' accounts.

Berkowicz and Schwartz each consented to be barred from the industry. Webberly consented to a two-year suspension and to assist FINRA in its ongoing prosecution of matters regarding sales of CMOs at the SAMCO Financial branch office involved in the case.

This case reflected FINRA's first enforcement action involving allegations of unsuitable recommendations of mortgage-backed securities to retail clients.

IV. COMPENSATION PRACTICES

A. Background

In the aftermath of the 2008 economic crisis, much attention has been paid to the compensation of senior executives, investment bankers and traders at the country's largest financial institutions. That scrutiny has ranged from comments from President Obama, Congressional hearings, potential legislation, the selection of a pay czar, and extensive media coverage.

Of relevance to this panel, is SEC Chairman Mary Schapiro's August 31, 2009 letter to broker-dealer chief executive officers.[6] Rather than focusing on the pay packages of high-ranking executives and those in banking and trading, Chairman Schapiro's letter spotlights concerns regarding the recruitment of and inducements to registered representatives.

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6 Chairman Schapiro's letter is available at sec.gov.

Specifically, Chairman Schapiro noted that media reports had suggested that broker-dealers are both engaged in energetic recruiting programs and are offering significant inducements to new brokers, including substantial up-front bonuses and enhanced commissions. Chairman Schapiro's letter was intended to remind broker-dealers and their CEO's of their supervisory responsibilities.

In particular, Chairman Schapiro's letter noted that certain types of increased compensation practices may lead brokers to believe that they are obligated to sell enough securities products to justify their special arrangements. In turn, such pressures may create incentives for brokers to engage in sales practice misconduct. As examples of such improper conduct, Chairman Schapiro noted that brokers could churn accounts, recommend unsuitable investments or engage in transactions that generate commissions without regard to investors' best interests.

Chairman Schapiro's short letter encouraged CEOs and other supervisors to take particular care to closely monitor sales practices and to assure that an increase in a firms' sales force is accompanied by equal efforts to develop and implement sufficient supervisory and compliance protocols for such increased sales presence.

Chairman Schapiro's letter was described at length in FINRA's March 1, 2010 annual examination priority correspondence sent to all firms.

B. FINRA Examination and Firm Issues

The FINRA priority letter specifically noted that FINRA examiners will identify and analyze the activities of newly hired brokers who have been provided with enhanced compensation packages and the supervision of those persons. The letter also reiterated to firms their obligations concerning the liquidation of proprietary and non-proprietary products of newly hired brokers that could not be transferred to their new firms.

C. Dodd-Frank Act

Section 913 of the Dodd-Frank Act requires the SEC to examine and, where necessary, make rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation practices that the Commission deems contrary to the public interest and the protection of investors.