Chapter 2

Who Are the Players?

On many levels, the investment world is very confusing to investors. First, investments themselves can be exceedingly complex. The number and types of financial products available to consumers today is astounding. Investors are no longer limited to stocks, bonds, and CDs. Today, retail investors are sold annuities, complex derivative products, highly leveraged structured products, collateralized mortgage obligations (CMOs), collateralized debt obligations (CDOs), credit default swaps, and many other complicated investments. Second, the investment process can be very confusing to investors. The financial services landscape is made up of individual stock brokers, broker-dealers, investment advisers, insurance agents, and insurance companies. Each of these players performs a certain role in the industry and each is obligated to follow the rules established by regulators for their particular service. It is easy to see why many consumers simply don’t understand the differences between the various financial service entities. This chapter attempts to clarify the roles and the duties of the major players in today’s securities arena.

FINANCIAL SERVICE PROVIDERS THAT PURCHASE AND SELL SECURITIES

Broker-Dealers

Broker-dealers are firms that engage in the business of buying and selling securities. Individual brokers who buy and sell securities are called associated persons or registered representatives of a broker-dealer. Regulations classify brokerage firms by the capacity in which they act. The Securities and Exchange Act of 1934 defines a broker as “any person engaged in the business of effecting transactions in
securities for the accounts of others” (section 3(a)(4)). Any person who is engaged in the business of buying and selling securities for his or her own account is classified as a “dealer” (section 3(a)(5)). Because most brokerages act as both brokers and dealers, the term broker-dealer is often used to describe them.

Broker-dealers may offer a wide variety of brokerage (i.e., agency) services and products to retail customers. Some of these include providing execution-only services; providing custody and trade execution to customers who have independent financial advisers; executing trades placed by investment advisers in wrap accounts; offering margin accounts; providing generalized research, advice, and education; providing asset allocation services; providing transaction-specific recommendations to buy or sell securities in nondiscretionary accounts for commissions; providing discretionary portfolio management for commissions; providing financial planning for commissions; and providing wealth management for commissions.

Broker-dealers may also offer dealer (i.e., principal) services and products to retail customers, including selling securities out of inventory; buying securities from customers; selling proprietary products; selling initial and follow-on public offerings; selling other underwritten offerings; acting as principal in Individual Retirement Accounts (IRA); and acting as a market maker.

In addition to these broker and dealer services, broker-dealers may also provide ancillary services, such as lending, bill paying, cash sweeps, and debit cards. Compensation in broker-dealer relationships is usually earned through commissions, mark-ups, mark-downs, and sales loads.

**Investment Advisers**

Investment advisers manage portfolios for individuals, hedge funds, pension funds, and registered investment companies. Most investment advisers charge their clients a fee for investment advisory services based on the amount of the assets under management as opposed to commissions on each purchase or sale. Some investment advisers charge by the hour.

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2. Id. § 78(a)(5)(A).
4. Id. at p. 10.
5. Id.
6. Id. at p. 11.
The Securities and Exchange Commission regulates investment advisers, primarily under the Investment Advisers Act of 1940 (the Advisers Act), and the rules adopted under that statute. A person or firm that meets the definition of “investment adviser” under the Advisers Act must register with the SEC unless exempt or prohibited from registration.7

Generally, only larger advisers that have $100 million or more of assets under management or that provide advice to investment company clients are permitted to register with the SEC. Smaller advisers register under state law with state securities regulators.

**Dual Registrants**

Many financial services firms offer both broker-dealer services and investment advisory services. Approximately 5 percent of SEC-registered investment advisers reported that they also were registered as broker-dealers.8 Additionally, approximately 18 percent of broker-dealers registered with FINRA were also registered as investment advisers with either the SEC or a state.9 Finally, many financial services firms’ personnel also have dual registration. Approximately 88 percent of investment adviser representatives were also registered representatives of a FINRA-registered broker-dealer.10

Dual registration allows firms to provide various services not available through entities that are registered only as either broker-dealers or investment advisers. Retail investors may maintain accounts with dual registrants for many reasons. Some of these reasons include (1) using the brokerage account to hold positions for which no investment advice is needed; (2) using the account to access products and services offered by a firm on a principal basis, including proprietary products; or (3) taking advantage of the differing forms of compensation paid to maintain a brokerage or advisory account.11

**REGULATORS**

Broker-dealers and investment advisers must comply with the laws and regulations established by federal and state regulators. The purpose of the laws and regulations is to protect investors and to establish

9. *Id.* at p. 12.
10. *Id.*
11. *Id.* at p. 13.
a standard by which financial services firms must act. The Securities and Exchange Commission, the Financial Industry Regulatory Authority, acting as a self-regulatory organization (SRO), and state regulators are the primary organizations that oversee investment regulation.

**Securities and Exchange Commission**

Congress established the Securities and Exchange Commission (SEC) after the stock market crash of 1929. At this time, the public’s confidence in the stock markets evaporated. In an effort to help the economy recover, Congress held hearings to identify the problems that caused the crash and to discuss possible solutions to those problems. Based on the findings from these hearings, Congress passed the Securities Act of 1933. This law, along with the Securities Exchange Act of 1934, was intended to reestablish investor confidence in the financial markets. The 1934 Act actually created the Securities and Exchange Commission to enforce the new securities laws.

The SEC is made up of five presidentially appointed commissioners who have staggered five-year terms. One commissioner is designated by the president as chairman of the commission. To ensure nonpartisanship, no more than three of the commissioners may belong to the same political party. The SEC is organized into five divisions and 18 offices and is headquartered in Washington, D.C. The SEC’s staff of approximately 3,500 is located in Washington and in 11 regional offices throughout the country.

The SEC’s responsibilities include (1) interpreting federal securities laws; (2) issuing new rules and amending existing rules; (3) overseeing the inspection of securities firms, brokers, investment advisers, and ratings agencies; (4) overseeing private regulatory organizations in the securities, accounting, and auditing fields; and (5) coordinating U.S. securities regulation with federal, state, and foreign authorities.

**State Regulators**

While the SEC regulates and enforces the federal securities laws, each state has its own securities regulator who enforces state securities laws.

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13. Id.
14. Id.
15. Id.
16. Id.
laws, often referred to as “blue sky” laws. Blue sky laws are simply state regulations that govern the purchase and sale of securities. The blue sky laws in each state may vary, but generally, all states require securities, brokers, and brokerage firms to be registered with the state.

In addition to enforcing their own securities statutes against broker-dealers, state securities regulators oversee investment advisers who have less than $100 million in assets under management.

**Financial Industry Regulatory Authority**

In addition to state and federal regulations, broker-dealers and their registered representatives also are self-regulated by the Financial Industry Regulatory Authority (FINRA), the largest such organization in the United States.17

As of December 31, 2011, the Financial Industry Regulatory Authority (FINRA) oversaw approximately 4,500 brokerage firms, approximately 160,000 branch offices, and over 630,000 registered securities representatives.18

See Chapter 3 for a more detailed discussion of FINRA.

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**Practice Pointer**

It is often difficult to determine whether a financial services provider is a broker-dealer or investment adviser based solely on the investor’s description. The easiest way to find the answer is to look up the financial services provider on the FINRA BrokerCheck online search at http://www.finra.org /Investors/ToolsCalculators/BrokerCheck/www.finra.org/brokercheck. If the financial adviser is licensed to purchase or sell securities, his or her name will be listed. If the financial adviser is also dually registered as an investment adviser representative, that information will also be listed on the individual’s BrokerCheck report with a hyperlink to the SEC’s website. If not listed, that individual likely is not licensed to purchase or sell securities or to render investment advice.

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17. http://www.finra.org/AboutFINRA/.
Who Are the Players?

Practice Pointer (continued)
A practitioner should know that a FINRA BrokerCheck report is often a sanitized version of the financial adviser's complete record and may exclude important information. As a result, practitioners may find it helpful to request a more detailed broker background report from state regulators. These reports often are referred to as CRD Reports.

Practice Pointer
In some instances, the misconduct of financial advisers or firms may rise to the level of warranting regulatory action or even criminal prosecution. Practitioners confronted with this situation may be enticed to submit a complaint to a regulator or criminal prosecutor. This is not an easy decision and should not be taken lightly because regulator and/or prosecutor involvement may delay or even negatively impact your client in a civil case. In some cases, it may be beneficial to get these agencies involved in prosecuting a financial adviser or a firm for unlawful conduct. A practitioner confronted with this situation needs to be aware that information collected by regulators during a pending investigation is confidential and, as a result, a practitioner should not expect to receive any investigative materials from regulators to assist in the civil case. On the other hand, in many states, after a regulatory action is closed, the investigative materials become public record. As a result, a public records request may uncover extremely helpful information for the practitioner's case.

Practice Pointer
In some cases, an investor will already have filed a written complaint with a regulator and/or the brokerage firm prior to meeting with an attorney. Counsel should be diligent in obtaining any written statements filed a consumer prior to filing a civil case.

If a consumer chooses to file a written complaint with a regulator or firm, that information may be used in the defense of any civil claims filed. As a result, practitioners should encourage clients to permit an attorney to draft any consumer complaint prior to its submission to a regulator or firm.
All broker-dealers and registered representatives are required to be members of FINRA in order to conduct business. FINRA’s stated mission is to protect America’s investors by ensuring that the securities industry operates fairly and honestly. As stated in the previous chapter, it oversees over 4,500 brokerage firms, about 160,000 branch offices, and approximately 630,000 registered securities representatives.

FINRA’s duties include (1) registering and educating industry participants; (2) examining securities firms; (3) writing rules; (4) enforcing those rules and the federal securities laws; (5) informing and educating the investing public; and (6) providing trade reporting and other industry utilities; and FINRA also performs market regulation under contract for the major U.S. stock markets, including the New York Stock Exchange, NYSE Arca, NYSE Amex, the NASDAQ Stock Market, and the International Securities Exchange.

2. Id.
3. Id.
4. Id.
WHERE ARE SECURITIES DISPUTES RESOLVED?

In addition to regulating the securities industry, FINRA also sponsors the arbitration forum to resolve disputes between FINRA members and their customers. This is accomplished through a separate entity called FINRA Dispute Resolution. The vast majority of all investment disputes are resolved through an arbitration procedure sponsored by FINRA Dispute Resolution.

FINRA is divided into four Regional Offices—West, Midwest, Northeast, and Southeast. FINRA offers 72 hearing locations in which final evidentiary hearings may be held. There is at least one hearing location in each state of the United States, one in San Juan, Puerto Rico, and one in London, England. For a complete list of locations, please see Appendix 1.

Prior to 1987, when a customer had a dispute with a brokerage firm or investment professional it was unclear as to whether he or she could resolve it in court or in an arbitration proceeding. In 1987, the United States Supreme Court in the case of Shearson/American Express, Inc. v. McMahon, held that predispute arbitration clauses were enforceable.

Following the McMahon decision, virtually all brokerage firms included arbitration clauses in their agreements with customers. The arbitration provisions are typically included in the proverbial “fine print” of the customer agreements. As a result, consumers rarely know that they have agreed to give up their rights to go to court and to arbitrate their disputes until problems arise with the brokerage firms. Steps were taken in the late 1980s to require broker-dealers to make the arbitration language in the agreements more visible. However, it is still in the fine print, and customers rarely know that they are usually required to arbitrate their disputes and that they are waiving their right to trial by a jury of their peers.

In some situations, a party can successfully challenge the enforceability of an arbitration provision. The arguments to nullify enforceability are grounded in common law contractual defenses such as duress, lack of signature, unconscionability, lack of capacity, mistake of fact, etc. Practitioners contemplating challenging the enforceability of an arbitration clause, however, should be aware that state and federal cases consistently hold that public policy dictates that arbitration provisions

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Where Are Securities Disputes Resolved?

are presumptively enforceable. Further, challenging the enforceability of an arbitration provision can substantially delay the resolution of the case. As a result, practitioners should carefully weigh the presumed advantages of possibly resolving the case in court against the likelihood of success and possible delay of the proceeding.

**Practice Pointer**
Forced arbitration is governed by contract. Because not all brokerage firms include arbitration provisions in their client contracts, it is important to make sure that one does not give up his or her right to a jury trial by stipulating to arbitration. If a client cannot provide the practitioner with a copy of any applicable arbitration provisions, the practitioner should consider requesting a copy from the brokerage firm prior to filing arbitration. If no arbitration provision exists, then the practitioner should consider the pros and cons of arbitration versus an in-court proceeding. As discussed in Chapter 4, a customer is permitted to force a FINRA member (financial advisers and/or firms) to resolve disputes in arbitration even when there is no arbitration provision.

**Practice Pointer**
The FINRA Dispute Resolution forum often cannot be used to pursue claims against many registered investment advisers because these entities are not FINRA members. Importantly, FINRA Dispute Resolution exists to resolve disputes between FINRA member firms and customers. As a result, non-FINRA member investment advisers frequently incorporate arbitration provisions that force customers to resolve disputes in accordance with the American Arbitration Association (AAA) arbitration, which is a different forum than FINRA arbitration. AAA arbitration is often more expensive than FINRA arbitration, and this cost may impact a practitioner’s decision about whether to attempt to file an action in court.