CHANGES TO MARYLAND SECURITIES ACT EFFECTIVE OCTOBER 1, 2017

By Penny Somer-Greif

The Maryland legislature approved, and the Governor signed into law, several amendments to the Maryland Securities Act that became effective on October 1, 2017. These changes are summarized below.

Employee Stock Plans

Pursuant to the amendments, a company need no longer submit a notice filing to the Maryland Division of Securities (the "Division") with respect to the issuance of securities under an employee stock purchase, savings, pension, profit-sharing, stock option, equity compensation or similar benefit plan if no commission or other remuneration is paid in connection with the offering of the securities and (i) the plan is qualified under the Internal Revenue Code (the "Code"), (ii) the plan complies with the exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation pursuant to Rule 701 promulgated under the Securities Act of 1933, as amended (the "Securities Act"), or (iii) the offer and sale of the securities under the plan is registered under the Securities Act.

In other words, the exemption for these plans is now self-executing (no filing required). Prior to October 1, 2017, companies were required to file a notice with the Division, along with a copy of the plan and a $400 filing fee, at least 30 days before the inception of the plan in Maryland unless the plan was qualified under Section 401 of the Code, and had an ongoing obligation to file with the Division material amendments to any such plan.

Form D Filings

The amendments eliminate legal uncertainty for issuers by providing a mechanism to cure late Form D filings in most circumstances if the Form D is filed within one year of the date of first sale. As in most states, when an entity selling its own securities in Maryland relies on the exemption from registration provided by Rule 506 under the Securities Act and the preemption of state registration requirements in connection therewith, the entity must file in Maryland a copy of the Form D notice filed with the Securities and Exchange Commission ("SEC") within 15 days of the first sale of the securities in Maryland. Prior to the amendments, there was no way to "cure" a late Form D notice filing. The amendments provide that any issues that may arise from the late Form D filing will be resolved if the Form D is filed with the Division within one year of the date of first sale in Maryland and the issuer pays a $150 late fee (in addition to the $150 filing fee), as long as (i) the Maryland Securities Commissioner (the "Commissioner") has not issued a stop order suspending the offer and sale of the securities to which the Form D relates, and (ii) no person with the right to do so has relied detrimentally on the absence of the Form D filing in Maryland.

This one-year cure allowance also applies to the notice filing required with respect to the offer and sale of federal covered securities exempt from registration (and for which state registration is preempted) pursuant to Section 18(b)(2) of the Securities Act for registered investment companies or investment companies that have filed a registration statement with the SEC with respect to the securities in
question, Section 18(b)(3) of the Securities Act for sales to "qualified purchasers," and for any securities the offer and sale of which is exempt from registration pursuant to Section 18(b)(4) of the Securities Act.

Broker-Dealers

The amendments provide that a person who is exempt from broker-dealer registration under Section 4(c) of the Securities Act is also exempt from registration as a broker-dealer or agent pursuant to the Maryland Securities Act. Section 4(c) of the Securities Act provides an exemption from broker-dealer registration for persons who, with respect to securities sold in compliance with Rule 506, do no more than (i) maintain "a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means," (ii) co-invests in the securities, or (iii) provides ancillary services (as defined in Section 4(c)) with respect to the securities, in each case as long as such person and each person associated with that person receives no compensation and does not have possession of customer funds or securities in connection with the purchase or sale of such security and are not subject to a "statutory disqualification" as defined in Section 3(a)(39) of the Securities Exchange Act of 1934.

Private Fund Advisers

The amendments provide that an investment adviser that provides advice solely to one or more "qualifying private funds," as defined in Rule 203(m)-1 promulgated under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), but is not registered as an investment adviser under Section 203 of the Advisers Act (i.e. an exempt reporting adviser), must, before acting as a private fund adviser in Maryland, pay a $300 filing fee and file with the Commissioner the documents the adviser filed with the SEC and a consent to service of process as the Commissioner may require by rule or order.

Other

In addition, the amendments implement the North American Securities Administrators Association's Senior Model Act granting the Division new authority to protect senior citizens and vulnerable adults from financial exploitation. Among other things, the amendments require that a broker-dealer, an investment adviser, an agent, an investment adviser representative, or a person who serves in a supervisory, compliance, or legal capacity for a broker-dealer or an investment adviser that reasonably believes that a person who is age 65 or older or a vulnerable adult, as defined therein, has been, is or will be the subject of financial exploitation (as defined in the amendments) or attempted financial exploitation is required to notify the Commissioner and local law enforcement. The provision of this notice allows such a broker-dealer or investment advisor to temporarily delay disbursements from the senior's or vulnerable adult's account under certain circumstances set forth in the amendments.

The amendments also (i) enhance the Division's enforcement authority by including aiding and abetting liability, (ii) revise certain fees, and (iii) make certain updating, administrative and technical revisions to the Maryland Securities Act.

EQUITY INDEXED AND VARIABLE ANNUITIES: WHAT ARE THE LIMITATIONS OF A STATE SECURITIES REGULATOR'S AUTHORITY (IF ANY) OVER THEIR SALES PRACTICES?

By John S. Monical
I. Introduction

Two Illinois cases, Van Dyke v. Jesse White, 2016 IL App (4th) 141109 (currently pending before the Illinois Supreme Court as Docket No. 121452) and Thrivent Investment Management v. Illinois Securities Department, Circuit Court of Cook County Case No. 2016-CH-16406 (currently pending before the First District Appellate Court as Docket No. 1-17-1913), could have broad-reaching implications for the multi-billion dollar annuity marketplace and for financial advisers across the country. In Van Dyke, the Illinois Supreme Court will evaluate the scope of the Illinois Securities Department's authority over the sale of equity indexed annuities ("EIAs"). In Thrivent, the Appellate Court will evaluate the Illinois Securities Department's authority to regulate sales of Variable Annuities ("VAs").

These cases continue a broader debate about which (if any) annuities should be included within the definition of "security" under the various state blue sky laws. The answer may determine: (i) which annuities are regulated by state securities regulators and which are under the exclusive domain of state insurance regulator; and (ii) the applicability and civil remedies under the antifraud provisions of state blue sky laws. These cases also raise questions about a state securities regulators' authority when a financial adviser wears two hats - the hat of an investment adviser representative and the hat of an insurance salesperson, mortgage broker, registered representative, or other professional.

II. The Debate About Which Variable Annuities Should be "Securities" under State Blue Sky Laws:

There has been a long-standing debate among the insurance and securities regulators regarding which annuities should be included within the definition of "security" under state blue sky laws. While there has been relative consensus that fixed annuities were not securities, variable annuities have been subject to discussion. The Model Uniform Securities Act (2005) ("Securities Model Act") neither excludes nor specifically includes VAs in the definition of securities. The drafters of the Securities Model Act found a divide in how states treated variable annuities. A majority of states excluded both fixed and variable annuities from the definition of securities, but a minority of states included variable annuities under the state's blue sky law definition of securities and exempted them only from registration requirements of the state law. Recognizing this split of approaches, the Securities Model Act provides bracketed optional language for variable annuities so that "the decision whether to exclude variable annuities from the definition of security will be made on a state-by-state basis." Securities Model Act p. 32, Official Comments 28; See also Prefatory Note p. 4.

State securities regulators have pressed to include VAs in the definition of securities. When commenting on the Securities Model Act, the North American Securities Administrators Association ("NASAA") argued that including VAs within the definition would align state law with federal law and that, because of "the similarities between variable contracts and other securities products," it would be "incongruous for agents and sales practices involved in variable annuities not to be covered by state securities laws." Uniform Securities Act at 33, Official Comment 28 to §102(28).

The insurance industry, however, pressed for exclusive regulation of VAs by the insurance commissioners. Section 4 of the Variable Contract Model Law (1999) ("VA Model Act") promulgated by the National Association of Insurance Commissioners, states that "[n]otwithstanding any other provision of law, the [state insurance commissioner] shall have sole authority to regulate the issuance and sale of variable contracts." See VA Model Law (1999), http://www.naic.org/store/free/MDL-260.pdf. When commenting on the Securities Model Act, the American Council of Life Insurers argued that "thirty-seven jurisdictions currently exclude all insurance, endowment and annuity contracts
from the definition of security" and that excluding variable annuities from the definition of securities would prevent statutory conflicts with the "48 jurisdictions that grant the insurance commissioner exclusive jurisdiction to regulate the issuance and sale of variable contracts." *Id.* at 33, Official Comment 28, §102 (28).

The debate over whether to include variable annuities in the definition of securities is not academic because it determines the applicability of the anti-fraud provisions of the law. The Uniform Act has two anti-fraud provisions. Section 501 generally prohibits fraudulent conduct "in connection with the offer, sale, or purchase of a security." Section 502 generally prohibits fraudulent conduct in providing investment advice - "advising others for compensation … as to the value of securities or the advisability of [buying or selling] securities … or promulgating analyses or reports relating to securities." Even if exempt from registration, a state's determination to include an annuity in the definition of security would determine whether the state securities regulator could bring enforcement actions for alleged fraud "in connection with the offer, sale, or purchase of" the annuity under Section 501 or could regulate "fraud in providing investment advice" about it under Section 502.

The Comments to the Securities Model Act explain that whether VAs is included within the definition of security determines whether these anti-fraud sections apply. "When variable products are included in the definition of security and exempted from registration, state securities administrators can bring enforcement actions concerning variable insurance sales practices." *Id.* at 32. Thus, a State's decision to include or exclude VAs as securities determines "whether variable insurance products are or are not subject to fraud enforcement. Not surprisingly, NASAA promotes including VAs in the definition of securities for this very reason - because "when variable products are included in the definition of security and exempted from registration, state securities administrators can bring enforcement actions concerning variable insurance sales practices." *Id.* at 33.

Illinois has adopted language identical to Section 4 of VA Model Act. See 215 ILCS 245.24 ("Notwithstanding any other provision of law, the [Director of Insurance] shall have sole authority to regulate the issuance and sale of variable contracts.")

Illinois has not adopted the Securities Model Act, but has defined security in a way very similar to it. The Securities Model Act defines security to include a list of categories, then excludes from the definition "an insurance or endowment policy or annuity contract under which an insurance company promises to pay a [fixed or variable] sum of money either in a lump sum or periodically for life or other specified period." Securities Model Act §102(28). Illinois defines security with a virtually identical list, except that Illinois includes "face amount certificates," 815 ILCS 5/2.1, defined as "any form of annuity contract (other than an annuity contract issued by a life insurance company authorized to transact business in this State)" 815 ILCS 5/2.14. Illinois also adopted anti-fraud provisions similar to Section 501 of the Securities Model Act (the "Transaction Provisions"), which prohibit fraud connected to "the offer or sale of a security", 815 ILCS 5/12(A), (B), (F), (G), (I), (K) and a provision similar to Section 502 (the "Investment Advice Provision"), which prohibits fraud while "acting as an investment adviser, investment adviser representative, or federal covered investment adviser." 815 ILCS 5/12(J). Illinois generally defines "investment adviser" to mean a person who engages in the business of advising others about the value of securities or the advisability of buying or selling securities, or who issues analyses or reports concerning securities. 815 ILCS 5/2.11.

**III. The Van Dyke Case**

On July 29, 2016, the Illinois Fourth District Appellate Court rendered a decision in *Van Dyke v. Jesse White*. Van Dyke was an Illinois registered investment adviser and an Illinois insurance producer who recommended EIAs to clients.
After an administrative hearing, the Illinois Securities Department ("Department") revoked Van Dyke's license and imposed a $330,000 fine, holding that EIAs were securities under the Illinois blue sky law and that Van Dyke had violated the anti-fraud provisions of the law by recommending EIAs to 21 separate clients. The Circuit Court upheld the Department order and Van Dyke appealed to the Fourth District Court of Appeals.

Van Dyke argued that the Department had no jurisdiction over the marketing and sales of EIAs because EIAs are not securities under the Illinois law. The Department argued that EIAs were securities, but that even if they were not securities, Van Dyke was acting as an investment adviser when he recommended the EIAs and, accordingly, still was subject to the Department's jurisdiction under the Investment Advice Provision.

The Appellate Court reversed the Department's order. It held that EIAs were not securities. The Court upheld the Department's conclusion that Van Dyke was "acting as an investment adviser," but held that the Department had failed to prove that Van Dyke had committed fraud in violation of the Investment Advice Provision.

IV. The Thrivent Case

On June 20, 2017, the Circuit Court of Cook County, Illinois entered an order dismissing a case brought by Thrivent against the Department. Thrivent Order (June 20, 2017). In the case, Thrivent sought, among other things, a declaratory judgment that the Department did not have authority to regulate Thrivent's sales of variable annuities and an injunction prohibiting the Department from exercising such authority through an administrative action related to Thrivent's variable annuity sales.

Rejecting Thrivent's position, the Circuit Court held that the Department "has the authority to investigate and discipline any fraudulent business practice, whether or not such practices involve the sale of a security." Id. at p. 7. Relying upon Van Dyke, the Court ruled that, the Department has grounds to investigate its registrants' purportedly fraudulent or manipulative conduct" under the Investment Advice Provision "whether or not it has authority to regulate variable annuities." Id. p. 9. Thrivent has appealed the decision to the First District Appellate Court.

V. Questions for the Illinois Supreme Court in Van Dyke and the First District in Thrivent

The Illinois Supreme Court in Van Dyke and the First District Appellate Court in Thrivent have several questions to answer, including the following:

a. Are annuities "securities" under the Illinois blue sky law?

In Van Dyke, the Illinois Supreme Court will determine whether "annuities contracts issued by a life insurance company" are excluded from the Illinois blue sky law definition of security, 815 ILCS 5/2.1, 2.14, or are only excluded from registration requirements. 815 ILCS 5/3(M). Although Van Dyke involves EIAs, the statutory sections being interpreted do not distinguish EIAs from fixed annuities or VAs. If the Court concludes that annuities are securities, the ruling would overturn prior Illinois appellate court precedent. See Rasgaitis v. Waterstone Financial Group, Inc., 2013 IL App (2d) 111112 (holding that fixed and equity indexed annuities were not securities); Babiarz v. Stearns, 2016 IL App (1st) 150988 (holding that fixed annuities were insurance products, not securities). It also may have broad reaching consequences on the Department's enforcement authority and on claims for civil liability under the Illinois blue sky law.

b. If annuities are Not securities, when a registered investment adviser wears an insurance producer hat, what does it mean to be "acting as an investment adviser"?
The Court in *Van Dyke* concluded - with very little analysis - that Van Dyke "acted...as a registered investment adviser" under the Investment Advice Provision. *Van Dyke, supra* at ¶ 30-31. The Court noted that Van Dyke was registered as an investment adviser under the Illinois blue sky law, that he marketed and otherwise held himself out to clients as a registered investment adviser, and that "one client paid him a $1,975 retainer for future investment advice and received over $360,000 in commissions". *Id.* at ¶ 31. The Investment Advice Provision, however, requires that the person be "acting as" (not simply "registered as") an investment adviser when committing the alleged fraud. The definition of investment adviser under the Illinois Blue Sky Law indicates that a person acts as an investment adviser when that person engages in the business of providing advice relating to securities. 815 ILCS 5/2.11. The *Van Dyke* Court found that the EIAs were not securities. It did not analyze whether each of the 21 clients separately engaged Van Dyke to provide advice or whether Van Dyke did provide any advice regarding something that was a security. It did not analyze whether Van Dyke recommendation of EIAs were part of a broader investment adviser relationship with each of the 21 separate clients at issue. It is entirely possible that some of them had no investment adviser relationship with Van Dyke whatsoever. If a client did not engage Van Dyke to be an investment adviser and the only advice received related to a non-security, can Van Dyke have been "acting" as an investment adviser? If Van Dyke had more than one relationship with a single client - as an investment adviser and as an insurance producer - what does it mean to be "acting" in an investment adviser capacity as opposed to the insurance producer capacity?

c. *When a product is a "security" under federal law, but not state law, what does it mean to be "acting as a federal covered investment adviser"?*

The analysis of Investment Advice Provision for *Thrivent* is even more complicated. The Investment Advice Provision applies to a person "acting as an investment adviser, investment adviser representative, or federal covered investment adviser". 815 ILCS 5/12. While Van Dyke is a state registered investment adviser, Thrivent is registered under the Federal 1940 Investment Advisers Act ("1940 Act") and is a "federally covered investment adviser." So, while the question under the Investment Advice Provision in *Van Dyke* is whether Van Dyke was "acting as an investment adviser" under the state's definition, the question for *Thrivent* is whether it was "acting as a federal covered adviser".

The definition of investment adviser under the 1940 Act is nearly identical to the definition of investment adviser under the Illinois Act and both appear to require advice relating to a "security". Compare 815 ILCS 5/2.11; 1940 Act §202(11). However, the definition of security is different. Assuming VAs were not securities under Illinois law, they still would be securities under federal law. 15 U.S.C. §77c(a)(8); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §989J, 124 Stat. 1376, 1949-50 (2010). Could recommending the same VA constitute acting as a federal covered adviser (i.e., giving advice about a security as defined by federal law), but not acting as an investment adviser under the state definition (i.e., giving advice about a security as defined by state law)?

d. *When a registered investment adviser wears a broker-dealer hat, what does it mean to be "acting as an investment adviser"?*

By its terms, the language of the Investment Advice Provision does not apply to broker-dealers, only to investment advisers (state or federal covered). At both the state and federal level, a registered broker-dealer is not an investment adviser. 815 ILCS 5/2.11(3); 1940 Act §102(11)(C). Thrivent is not only an investment adviser, but also a registered broker-dealer. The *Thrivent* Court appears to have made no distinction between variable annuities recommendations by registered representatives of Thrivent's broker dealer on the one hand and recommended by investment adviser representatives of Thrivent's investment adviser on the other.
If the recommendation to a specific client came solely through a broker-dealer account, can Thrivent have been acting as a federally covered investment adviser?

e. Is the Securities Administrator’s investigatory power limited to investigations of conduct while “acting as an investment adviser”?

The Thrivent Court accepted the Department's position that it "has the authority to investigate and discipline any fraudulent business practice." Thrivent at p. 7. In support of this position, the Department cited 815 ILCS 5/11 and the Investment Advice Provision. Most of the subsections of 815 ILCS 5/11, however, appear to have language limiting the Department to investigations of violations of the Illinois blue sky law and as noted above, the Investment Advice Provision appears limited to business practices when a person is "acting as an investment adviser, investment adviser representative, or federal covered investment adviser". 815 ILCS 5/12(J); See 5/11(C)(limited to times when it appears "this Act or any rule or regulation prescribed under authority thereof, has been or about to be violated"), 5/11(D) (limited to investigations "necessary for enforcement of the Act"), but of 5/11(B) (granting the power to require financial statements and reports from investment advisers and investment adviser representatives). If the investigatory power of the Department is not limited to investigations of violation of the blue sky law, what are the limits (if any) of the investigatory power?

f. What Does it mean to Regulate "the Sale of Variable Annuities" Under the Illinois Insurance Code and Section 4 of the VA Model Act?

As noted above, the Illinois Insurance Code and Section 4 of the Model Act both provide that "[n]otwithstanding any other provision of law, the [state insurance commissioner] shall have sole authority to regulate the issuance and sale of variable contracts". The Thrivent Court misread Van Dyke decision as acknowledging that "even if a particular investment instrument falls within the sole jurisdiction of the Department of Insurance, the Department may address its registrants’ purported fraudulent or manipulative conduct" pursuant to the Investment Advice Provision. The Van Dyke Court never, in fact, came to this conclusion. In fact, the Van Dyke decision did not analyze whether EIAs are ‘variable contracts’ under the Illinois Insurance Code, but assumed the provision applied solely to VAs, not EIAs. Van Dyke p. 10-11. As a result, neither the Van Dyke nor Thrivent Courts have analyzed the effect of this provision on VAs.

Is an investigation or a disciplinary action by the Securities Administrator an exercise of “authority to regulate”? If so, does the Insurance Code preempt any investigation or disciplinary action related to sales practices of VAs? If not, what limit (if any) does this provision place on the Department's authority over VA sale practices?

VI. Conclusion

When decisions come down in Van Dyke and Thrivent, they could significantly change the regulatory and civil liability landscape for annuities in the state of Illinois. They also could inform similar arguments in cases interpreting the VA Model Act and Securities Model Act and could set the stage for a renewed legislative debate over whether annuities should be regulated by the state insurance or securities regulator. Players in both the insurance and securities industries should watch Van Dyke and Thrivent very closely.

THE SEC'S CLOSER LOOK AT WRAP FEE PROGRAMS

By Michael Rasmussen

Effective October 1, 2017, Part 1 of the Uniform Application for Investment
Adviser Registration (the "ADV Part 1") has been updated to include further inquiry into the wrap fee program business of registered investment advisors. Specifically, Item 5.I of the ADV Part 1 has been amended to ask whether the firm participates in a wrap fee program and if so the total amount of regulatory assets under management attributable to the wrap fee program.

What is a wrap fee program?

The glossary to Form ADV defines a wrap fee program as "[a]ny advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions." In other words, a wrap fee program occurs when a client pays a single flat fee (based on assets under management within the program) and where that fee covers associated brokerage fees (transactions costs) that occur when trading takes place within the wrap fee program. As such, there are three key players in a standard wrap fee program: 1) the client, 2) the wrap fee program sponsor (the firm who coordinates and offers the wrap fee program to clients), and 3) the wrap fee program manager (the firm charged with executing the trading strategy). A sponsor and manager can be the same firm.

Instruction Changes

In Release No. IA-4509 the Securities and Exchange Commission (the "SEC") stated that the increased inquiry into wrap fee programs was to better help it develop their risk assessment of a firm by identifying "the extent to which the firm acts as sponsor or portfolio manager of wrap fee programs and collect information across investment advisers involved in a particular wrap fee program." As discussed below, there are several areas that an SEC examination team could potentially look at regarding your firm's wrap fee program. It can be expected that the SEC will focus on these matters in greater detail after analyzing the information gathered through the amended ADV Part 1.

Those firms who either act as sponsor or manager (or both) to a wrap fee program are now asked to state the "amount of [the firm's] regulatory assets under management attributable to acting as" either a wrap fee program sponsor or manager. Managers to wrap fee programs are required to provide further detail in Section 5.I.(2) of Schedule D to the ADV Part 1. Previously, a manager to a wrap fee program had only been required to provide the name of the wrap fee program. In addition to the RAUM amounts, the following information is now required:

- Name of Sponsor,
- Sponsor's SEC File Number (if any), and
- Sponsor's CRD Number (if any).

For firms that both sponsor and manage a wrap fee program this information is easily found. Firms that manage, but do not sponsor a wrap fee program should have collected much of this information during their due diligence process when reviewing the sponsoring firm.

Calculating Regulatory Assets Under Management

An immediate question arises as to what constitutes regulatory assets under management ("RAUM") for wrap fee program reporting concerns. RAUM includes securities portfolios for which a firm provides continuous and regular supervisory or management services. Both a sponsor and a manager to a wrap fee program could make a claim to providing assets in a wrap fee program with continuous and regular supervisory or management services. Therefore, because a wrap fee program could be sponsored by one firm and managed by another, RAUM could be reported twice (once with the sponsoring firm and once with the managing firm). If the firm is both the sponsor and manager of a wrap fee program, the ADV
allows for a single line reporting where the firm is "sponsor to and portfolio manager of the same wrap fee program." As such, a dual-role firm should only report the combined RAUM number once.

Compliance Concerns

While responding to the SEC's updated ADV Part 1 wrap fee program questions, it may be a good time for your firm to consider other compliance issues surrounding wrap fee programs.

- **Proper Disclosure.** In addition to responding to ADV Part 1 inquiries a firm that participates in a wrap fee program must also disclose the program in its ADV Part 2A. Furthermore, the firm must provide clients participating in a wrap fee program with an Appendix 1 (Wrap Fee Program Brochure).
- **Client Contract Agreement.** When a client agrees to participate in a wrap fee program they are actually agreeing to entering into two types of accounts: an advisory account and a brokerage account. Therefore, firms should ensure that the terms and language of each contract are in agreement.
- **Best Execution.** Firms that offer wrap fee programs are still responsible for conducting appropriate best execution reviews to ensure that clients are receiving favorable execution.
- **Suitability.** Wrap fee programs are designed to remove transaction costs in exchange for a slightly higher management fee. Therefore, wrap fee programs are not meant for accounts that have limited trading activity. Accounts that are charged the higher wrap fee program fee but that do not do enough trading to validate such a higher fee may be in violation of "reverse churning", or similar rules.

Conclusion

The SEC's ADV Part 1 updates concerning wrap fee programs should be understood as an information gathering process that will help the SEC focus on customer harm issues, such as reverse churning, during future firm examinations. As such, firms should approach the updated reporting as an opportunity to review how wrap fee programs are being managed and overseen. If your firm is involved with wrap fee programs, you can expect to see the SEC's testing of your wrap fee program compliance policies and procedures during your next examination or as part of a sweep.

"SUITABILITY" AND "FAILURE TO SUPERVISE" HAVE NO PLACE IN FINRA ARBITRATIONS

By Philip A. Feigin

Mandatory FINRA arbitration of brokerage client complaints has led to some lazy law. Not just lazy, but plain wrong. It is commonplace, if not boilerplate, for FINRA Dispute Resolution claimants' counsel to allege in statements of claim that the respondent brokers ("reps") and broker-dealer firms ("BDs") recommended unsuitable securities to their clients and that the BD failed to supervise the rep who made the offending sales.

I generally do not serve as counsel to claimants or respondents in FINRA arbitrations, but I am regularly asked to serve as an expert witness for one side or the other. Given my 20 years as a state securities regulator and more than 17 years in private practice, call me antiquated, a wet blanket or a Luddite, but simply stated, claimant claims of unsuitability or failure to supervise is nothing but junky law.
Where are the concepts of suitability and failure to supervise found in securities law? Generally, in the Securities Exchange Act of 1934 and state securities statutes, the SEC and state securities administrators are given the authority to suspend or revoke a BD's or rep's registration, or to impose a fine, limitation or bar or all of them on a registrant if they find it is in the public interest and for the protection of investors and that one or more grounds for sanction has occurred or is present.

Among the grounds for sanction are lying on an application, failing to pay a fee, conviction of a felony, being enjoined by a court or sanctioned by the SEC, state or other authority, insolvency, lack of training, engaging in dishonest or unethical business practices, or failing reasonably to supervise. Again, these are grounds for a regulator to sanction a registrant. While the FINRA model varies a bit, for these purposes, there is no substantive difference. Suitability and failure to supervise are regulatory grounds for regulatory sanction.

Using their rulemaking authority, regulators have defined what some of those "dishonest or unethical business practices" are. The non-exclusive list includes things like churning, unauthorized trading, using unauthorized discretion beyond time and price, and, yes, making an unsuitable recommendation.

These grounds for sanction are not provisions that can be "violated." There are plenty of "it is unlawful to" provisions in the securities statutes. Those provisions can be "violated." Though pleaders and commentators may get sloppy and write that a BD or rep "violated the suitability rule" or something along those lines, the grounds for BD and rep sanctioning cannot be "violated."

The provisions that can be "violated" are enforceable by the securities authorities in regulatory actions, and willful violations may also be pursued as crimes by prosecutors. In addition to those provisions that securities regulators and prosecutors may enforce, the securities statutes contain various express private rights of action that private litigants may utilize. Generally, under federal law, there are, for example, express private remedies for sale of unregistered securities, making untrue statements in registration statements and for short-swing profits. At the state level, again for example, there are express private remedies for sale of unregistered securities, acting as a BD, rep, investment adviser or IA representative without being registered or licensed, and against a seller who makes untrue statements or omits to state material facts to a buyer. There are no express private rights of action in the FINRA rules.

You cannot spend much time around securities law without hearing about the implied private right of action under '34 Act Rule 10b-5. This implied right of action arises under a rule adopted by the SEC under '34 Act Section 10(b), a provision that starts with "[i]t shall be unlawful for any person to" engage in various forms of conduct, including subsection (b), "to use or employ...any manipulative or deceptive device or contrivance..." in selling a security on a national exchange. In other words, the implied private right of action under Rule 10b-5 arises under a statutory provision that can be "violated" and pursued by regulators and prosecutors.

As important and widespread is private litigation under Rule 10b-5, the Supreme Court (in Central Bank v. First Interstate) has held that such actions are akin to the common law tort of misrepresentation, i.e., requiring a showing of intent to deceive, reliance and causation. Perhaps taking a lesson from this federal implied right anomaly, the drafters of the state Uniform Securities Acts included a provision expressly precluding the creation of any implied right of action in the state securities law.

There is no express private right of action federal or state for conduct constituting a ground for sanction against a registrant. To my knowledge, no federal or state court has ever found there to be an implied right of action under any of the grounds for BD or rep sanctioning, let alone the rules adopted under those...
statutory grounds.

There is simply no basis in law for a private party to assert in a complaint in court or in a statement of claim in arbitration that he or she was sold an unsuitable security or that a BD or supervisor failed to supervise a rep. And yet it happens virtually every day. FINRA arbitrators have been so bludgeoned by FINRA urgings against granting motions to dismiss that these claims go to hearing over and over again. That is simply lazy and wrong. Given that FINRA arbitrators are not required to explain their decisions and that, even if they were, the decisions are not appealable to courts of review, there is no appellate court case, no legal precedent to stop the abusive and flawed practice from perpetuating.

The misconduct of unsuitability and failure to supervise is not necessarily immune from private redress. A claimant can try to describe recommending an unsuitable security as a basis for liability under some express private right of action, e.g., describing that a rep stated a trade was suitable when it wasn't; and that constitutes making an untrue statement of material fact, but that is a much tougher case to make than simply stating it was unsuitable. Coupling such a recommendation in a 10b-5 claim is even harder, because the intent, reliance and causation elements are called into play. Probably the truest course, if there is one, is to describe it as negligence, urging the suitability rule as an industry standard for duty and breach.

The same goes for failing to supervise. It is difficult to describe such an alleged failure under any of the express private rights of action, but the duty and breach concepts of common law negligence may be a better fit if there is any. Further, the failure to supervise ground for sanction contains a qualifying adverb well known to regulators but one that claimant counsel are often wont to acknowledge. The provision reads failed reasonably to supervise. ["Failing to reasonably supervise" is probably the most blatant and pervasive split infinitive in securities law.] A firm is required to have in place written policies and procedures and a system for applying them that are designed reasonably to prevent and detect violations of the law. Regulators know that not every act of rep misconduct necessarily means there was a failure to supervise.

Any statutory scheme, particularly one involving a regulator, is a result of balancing the rights, powers and liabilities of the various interests involved. The securities regulatory system is no exception. Securities law felonies must be "willful." The SEC and state regulators are faced with establishing their statutory standards to prevail in their disciplinary and enforcement actions. They all must deal with various statutes of limitation and repose. Grounds, standards and statutes of repose and limitation in express private rights of action are different for private litigants. While there are a few strict liability express private rights of action, others (as well as Rule 10b-5 actions) have higher and more difficult standards, like mental state, to establish than are the regulatory actions, and private litigants have less time to bring their cases as well. Those higher hurdles and shorter fuses are not imposed by accident. They are the result of a hard won balancing set by policymakers. You may disagree with the result, but it is the result.

For this reason, even findings of fact and conclusions of law rendered after a regulatory hearing that some statute or rule was violated do not necessarily equate to private liability. Standards are usually different. Given that settled regulatory actions almost always resolve with the respondent neither admitting nor denying the truth of any allegation, making such actions very difficult to use in a claimant's res judicata or collateral estoppel argument.

Granted, FINRA arbitrators sit in equity as well as law. Notwithstanding that a claimant in hearing may not succeed in establishing a claim under some express private right of action by law, the panel may still find that-as a matter of equity-restitution, disgorgement or whatever is an appropriate remedy.
A panel's equitable authority may also give rise to the kind of result many private claimants' counsel and critics call a FINRA arbitration "loss," e.g., they claimed $1 million in "damages" but the panel only awards $85,000. The panel may have started their analysis with some mechanical measure of damages and then worked that amount up or down in consideration of the equities given their assessment of the mutual fault of the parties. The panel didn't get it wrong and the system isn't inadequate or rigged—the claimant's counsel oversold the client on, and over-plead the value of, the claim.

Engaging in a dishonest or unethical business practice and failure reasonably to supervise are no more or less emphasized in the statutes than are insolvency or failure to meet net capital requirements or the like. If private clients can sue for unsuitable trades or failure to supervise, why shouldn't they be able to sue for a net capital violation or failure to pay a fee? Maybe that's next!

Federal and state securities statutes are replete with "it is unlawful to" provisions, but only a few have any kind of private remedial complement. We all know both from general legal principles as well as Ernst & Ernst v. Hochfelder that a rule cannot be broader than the statute under which it is promulgated. Suitability and failure to supervise are not "violations" in the first place, and are not private rights of action, express or implied. Undoubtedly, some investors have justifiable grievances against their BD or rep or both, but not every grievance qualifies for remedy under securities law.

Suitability and failure to supervise are not valid private causes of action and should be dismissed from statements of claim in FINRA arbitrations. FINRA and FINRA members would be well served if FINRA Dispute Resolution were to include in its arbitrator training not only what these concepts mean but as well that they are not lawful grounds for claimant relief, and should be stricken from statements of claim on proper motion by respondent counsel. Perhaps this is taught in arbitrator training, but if it is, the message is not getting through. Pleading suitability or failure to supervise in a FINRA statement of claim is wrong and flat out lazy. That "everybody does it" is evidence of either the lack of experience or just incompetence of panel members, too high a standard for granting motions to dismiss, lack of accountability, or a bit of all three. It's about time the practice is stopped.

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