CHAPTER 3: BUSINESS PRACTICES

3a. OVERVIEW

40% of the Series #63 examination (24 questions) covers prohibited actions by agents, broker-dealers, investment advisers and investment adviser representatives. This is the largest portion of the examination and must be studied thoroughly.

3b. ADVISORY CONTRACT AND ANTI-FRAUD RULES

Under the Act, it is unlawful for any person who receives compensation, directly or indirectly, for advising as the value of securities or their purchase or sale, whether through the issuance of analyses, reports or otherwise, to:

> Employ any device, scheme, or artifice to defraud;
>
> Engage in an act, practice or course of business which operates or would operate as a fraud or deceit on any person;
>
> Effect a transaction for a customer, as broker or dealer, without obtaining the consent of the customer to such transaction;
>
> Engage in any dishonest or unethical practice as the Administrator may define by rule.

NASAA Advisory Contract Rules

NASAA requires that advisory contracts with customers must:

> be in writing;
>
> have a fixed life (e.g., 1 year; 2 years);

Can Accept Prepaid Advisory Fees

> detail the advisory fee to be paid - note that prepayment of fees is permitted (such as paying for 6 months of advice up-front);

Early Termination - Refund Prepaid Fees

> detail the refund of any prepaid advisory fee to be made if the contract is terminated early;

Cannot Assign Contract Unless Client Approves

> provide that no assignment can be made unless the customer approves.

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Furthermore, investment advisers are prohibited from entering into, or extending, an advisory contract, unless it provides in writing that:

No Compensation Based On Gain/Loss

the investment adviser shall not be compensated on the basis of capital gains or capital appreciation of funds in the account (however, it is permitted for compensation to be based on the total value of all assets being managed);

Notify Customer Of Changes In Partnership Composition

if the investment adviser is a partnership, the customer shall be notified within a reasonable time of any changes in partnership membership. A change in a majority of the partners is an assignment that requires customer consent.

(Also note that if an advisory contract is assigned from one IAR at a firm to another IAR at the same firm, this is not an assignment of the contract, since the contract was not moved to another firm.)

Regarding compensation, the adviser can charge a percentage of assets under management as a fee, using a schedule that gives a declining percentage fee as assets from the client increase. The adviser can also use a negotiated fee basis, as long as it is consistently applied to customers.

Wealthy Clients Can Be Charged A Performance Fee

An exception to the rule prohibiting compensation based on gains is given to advisers that have very wealthy customers (defined as a customer with either $1,000,000 of assets under management with the adviser or a $2,000,000 net worth). In this case, the Investment Advisers Act of 1940 allows a performance fee, and Federal law has supremacy over State law.

NASAA Required Disclosures If Performance Fee Is Charged

NASAA requires that if an adviser charges a performance fee, it must disclose in writing:

that the fee arrangement may create an incentive for the adviser to make investments that are riskier;

that the investment adviser will get compensation based on both unrealized appreciation and capital gains;

the basis for valuing any illiquid investments used in computing unrealized appreciation;

the periods that will be used to measure performance and their significance to the computation of the fee; and

the nature of an index used as a comparison of investment performance, the significance of the index and the reasons why the adviser believes the index is appropriate.

Wrap Fees

Advisers can take "compensation" in other ways as well. They can earn "wrap" fees that wrap all services, including the cost of all trades, into a single annual fee - either as a flat dollar amount or as a percentage of assets under management. If an adviser has an affiliated broker-dealer, it may send its trades to this firm, and commissions may be earned by the affiliated broker-dealer (but this must be disclosed to the IA's clients). Advisers can also earn so-called "soft dollars."

Commissions

Soft Dollars

A "soft-dollar" arrangement is where an adviser sends its portfolio trades to a brokerage firm that does not discount commissions, which, on its face, would raise costs to its clients and would violate the IA's fiduciary requirement to act in the clients' best interests. However, as a "quid-pro-quo," the broker "gives back" to the adviser research reports, asset allocation software, stock selection software, etc. In theory, these items should allow the adviser to do a better job for his or her customers. The SEC and NASAA permit soft dollar arrangements with the proviso that the "give-backs" benefit the adviser's clients - not the adviser!

12b-1 Fees

Another fee that an adviser can collect is a portion of a 12b-1 fee. SEC Rule 12b-1 permits investment companies to charge their shareholders an annual fee (capped at .75% annually) where the proceeds are used to pay for the cost of getting new investment into the fund. An investment adviser that agrees to place money in a mutual fund can share in these annual fees.

No Hedge Clauses That Are Either Unreasonable Or That Seek To Hold Adviser Harmless For Violations

Advisory contracts cannot contain "hedge clauses" that seek to eliminate the adviser's liability for negative investment results, except due to events beyond that adviser's control such as war, terrorist acts, etc.. In addition, such "exculpatory" clauses cannot be used to "get around" the adviser contract rules. For example, the adviser cannot use such a clause to take a portion of gains and losses in an account, and the customer agrees to "hold the adviser harmless" for doing so.

NASAA Investment Adviser Brochure Delivery Rule

Form ADV Part 2A

Form ADV Part 2B

NASAA requires that any new customer be provided with a copy of the adviser's "Brochure" and "Brochure Supplement" when entering into an advisory contract. This is a copy of Form ADV Part 2A (the "Brochure" which gives information about the adviser's business; and Form ADV Part 2B (the "Brochure Supplement") which gives information about the adviser's key personnel. These are the SEC investment adviser registration forms which are also used by each State for State-registered advisers.

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Brochure Delivery

Under NASAA Rules, the Form ADV Part 2A ("Brochure") and Part 2B ("Brochure Supplement") must be delivered to customers:

2 Day Free Look Before Signing

no less than 48 hours prior to entering into either an oral or written advisory contract with a customer (a "2 day free look") - meaning the customer gets the Brochure and Supplement 48 hours prior to signing the contract; or alternatively

If No Free Look, 5 Days To Rescind

the customer can sign the contract and be given the Brochure and Supplement, and then has 5 business days to terminate without penalty.

(Note: This is the NASAA rule - the SEC rule under the Investment Advisers Act of 1940 is **NOT** the same - it simply requires delivery of the Brochure and Supplement, at or prior to, entering into any advisory contract.)

Annual Brochure Update - If Changes Are Material - Send To Customers

At the end of each year, NASAA requires that if there is a material change in the Brochure, it must be provided to existing customers within 120 days of the adviser's fiscal year end (this is the same as the SEC rule).

Firm Can Create Its Own Brochure

Brochure Can Be Delivered Electronically

Note that rather than giving a "boring" document that is filed with the State as the Brochure, the adviser can create its own "livelier" more colorful version, as long as all of the same information is presented. NASAA also states that electronic delivery of the Brochure and Supplement to customers is permitted.

Custody Rules

Finally, it is prohibited for an investment adviser to have, or take custody of, customer funds and securities:

If the Administrator prohibits this by rule; or

If there is no rule, the adviser fails to notify the Administrator that he has, or may take custody.

If an investment adviser wishes to take custody of client funds or securities, NASAA requires that:

Notice To Administrator

It must notify the Administrator in writing on Form ADV (this is the form that advisers use to register with the SEC; and is also used by each State for adviser registration) that it has, or may have, custody;

Securities Held By Qualified Custodian

Custody must be kept by a qualified custodian in a separate account under each client name; or in accounts that only contain client funds and securities, held in investment adviser name as trustee for the clients;

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Prompt Notice To Customer Of Custodian Identity

Prompt notice must be given to the clients in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained;

Quarterly Account Statements

Account statements must be sent at least quarterly to clients; and

Annual Surprise Audit Of Custodian

The qualified custodian must be audited on a surprise basis at least annually to verify all client funds and securities.

File Copy Of Audit Results With State 30 Days After Audit

The investment adviser must file a copy of the audit results with the State Administrator within 30 days of completion of the audit.

Qualified Custodian Definition

Qualified custodians under NASAA's Custody Rule are:

FDIC insured deposit taking institutions;

Registered broker-dealers holding customer assets;

Registered futures commission merchants holding customer assets; and

Foreign financial institutions holding financial assets for customers.

Custody Definition

Note that the definition of taking "custody" includes not only accepting customer funds or securities, but also includes:

Prepaid Advisory Fees Of $500 Or More

the acceptance of prepaid advisory fees of $500 or more, 6 months or more in advance of rendering services (Note 1); or

Account With Full Power Of Attorney

an account that gives a full power of attorney to the adviser, which would allow the adviser to withdraw funds (Note 2).

(Note 1: The Investment Advisers Act of 1940 (Federal law) sets the dollar limit for being defined as "taking custody" at a higher level - $1,200 - for Federal Covered Advisers. State law sets it at the lower $500 level for State-registered advisers.)

(Note 2: If the adviser is given a limited power of attorney, which limits the adviser to trading the account so that funds cannot be withdrawn, then this is not considered to be taking custody.)

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Inadvertent Payments Not Considered To Be "Custody" If Returned Promptly

NASAA has amended its rules regarding custody. It defines "custody" not only as holding customer funds or securities but also as the ability to appropriate them or to obtain possession of them.

If Client Inadvertently Gives Funds To Adviser - If Returned In 3 Days Then No "Custody"

If a client inadvertently gives securities or funds to an investment adviser, as long as they are returned within 3 business days, then the adviser has **NOT** taken custody.

If Client Inadvertently Sends Check Made Out To Third Party - If Mailed To Third Party In 3 Days Then No "Custody"

If an adviser inadvertently receives a check from a customer made out to a third party (for example, the customer mistakenly puts a check made out to another payee in the adviser's envelope), as long as the adviser mails the check to the third party within 3 business days of receipt, then the adviser has **NOT** taken custody.

Annual ADV Update-90 Days Of Fiscal Year End

NASAA requires that each investment advisory firm file an update of their Form ADV (registration) in the State within 90 days of fiscal year end.

Material Change ADV Update-30 Days

If there is a significant material event, an "other-than-annual" amendment must be filed in the State within 30 days.

3c. CONDUCT OF CUSTOMER ACCOUNT RULES

4 Critical Pieces Of Information To Open Account

When opening a new account for a customer, 4 critical pieces of information must be obtained:

Customer Name;

Address;

Date of Birth; and

Social Security Number

Failure to get each of the 4 pieces of information is a violation. This information must be used to independently verify the customer's identity promptly after account opening.

If Margin Account, Get Customer Signature Promptly After Account Opening

There is no requirement for a customer signature on the new account form when opening a cash account for a client; but it is required when a margin account is opened. The customer must sign the margin agreement "promptly" after the first trade under NASAA rules. By signing the margin agreement, the customer pledges the securities in the account as collateral for the loan.

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Agent Must Sign New Account Form

Approving Manager Must Sign

When opening an account (cash or margin), the agent must sign the new account form (this is the agent's attestation that the information is true as given by the customer); and the manager must sign the new account form, accepting the account for the firm.

No Unauthorized Trading Of Customer Account

When a customer opens an account, only that customer is authorized to place trades (or any one of the customers in a joint account can place trades). Trades from customers can be accepted verbally or in writing. Unauthorized trading of a customer account is a prohibited practice.

Joint Accounts

Regarding joint accounts, a trade can be placed by any one of the account owners; and any one of the account owners can demand that a check be drawn. However, any check drawn on a joint account must be made out to the "full account name" - not to the name of a single tenant.

Third Party Cannot Place Trade Unless Given Written Authorization

A "third party" is prohibited from placing a trade in a customer account unless the customer gave the third party a power of attorney in writing. Note that if an individual is a customer's attorney (like a family lawyer), that person does not have a power of attorney to trade the customer's account (unless the customer gives written authorization).

Discretionary Accounts

An agent or investment adviser representative cannot exercise discretion in a customer's account without written customer authorization.

NASAA Rule For Investment Advisers

Under NASAA rules for investment advisers, written authority to exercise discretion must be obtained from the customer no later than 10 business days after being given verbal discretionary authority by that customer. This rule does not apply to broker-dealers - in this case, the SEC rule prevails.

SEC Rule For Broker-Dealers

Under SEC rules for broker-dealers, written customer authority is required prior to accepting any discretionary orders (remember, Federal law will prevail over State law; if there is no Federal law, the State law applies).

Trade Is Not Discretionary If Agent Only Selects Price And/Or Time Of Execution

Also, note that a trade is only considered to be discretionary if the representative selects the size of the trade or the security to be purchased; it is not considered to be discretionary if the representative only selects the price and time of execution.

Broker-Dealer "Suitability" Standard

Before recommending a security to a customer, the agent of a broker-dealer must first determine that the investment is "suitable" for the customer, based on the customer's investment objectives, needs, risk tolerance and investment time horizon. A broker-dealer that owns a security may sell it to one of its customers, as long as the

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security is suitable (this would be the case if the broker-dealer were a market maker in the security).

Actions that violate the "suitability rule" include:

- Failure to inquire as to a customer's financial situation, needs, and investment objective.
- Recommending securities without regard to the customer's financial situation or objective.
- Recommending a security without having a reasonable basis for the recommendation.
- Churning customer accounts (performing trades of excessive frequency).
- Performing excessively large trades in customer accounts.
- Failure to sufficiently describe important facts and risks concerning a transaction.
- Making blanket recommendations of the same security to all customers.

Investment Adviser "Fiduciary" Standard

The suitability standard used for broker-dealers does **NOT** apply to investment advisers. Rather, investment advisers are fiduciaries, and cannot take the opposite side to a trade. The basic idea is that if an investment is good for the customer, why would an investment adviser that owns it want to sell?

If an investment adviser recommends a security to a customer, the investment adviser can (and should) buy that same security for its personal account. It cannot sell that security to the customer. Thus, investment advisers should be investing alongside their customers.

3d. PAYMENT / MARGIN / COMMINGLING RULES

Regulation T Applies To Both Cash And Margin Accounts

Regulation T of the Federal Reserve Board sets margin requirements for non-exempt securities. Regulation T covers both cash accounts and margin accounts.

Long Sale

In a cash account, the customer pays in full. The customer can sell securities that he or she owns (a "long" sale because the customer owns (is long) the stock.

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Short Sale	In a margin account, the customer puts up the Regulation T requirement (50% for stocks) and is loaned the other 50% by the broker-dealer. In a margin account, securities can be sold "long" and they can be sold "short" - which is the sale of borrowed shares.
Prompt Payment For Purchases	When a customer buys securities, payment must be obtained "promptly" but no later than 5 business days past trade date. If payment is not received, the unpaid securities position must be sold out and the account is frozen for 90 days.
Frozen Account	A "frozen" account does not mean that the customer can't trade the account. Many firms call it putting a "CUF" on the account (Cash Up Front) because in a frozen account, the customer no longer is expected to pay promptly - rather, the customer must have the cash on deposit at the broker to buy securities before the trade is entered. If the customer behaves for 90 days, the freeze comes off the account and the customer is back to paying "promptly" for securities purchases.
Cash / Securities Must Be Delivered On Settlement	In a cash or margin account, a customer cannot make a purchase without intending to pay by settlement. In a cash account, a customer cannot sell long unless he or she intends to deliver the security on settlement. In a margin account, a customer cannot sell short unless the securities to be borrowed are "located" (and this must be documented) and can be delivered on settlement.
Cannot Extend Loan Amount Greater Than Limit Set By Regulation T	Lending money to a customer in contravention of Regulation T requirements in prohibited. For example, if the Regulation T requirement is 75% (this is the margin to buy LEAP (long-term) options, then the "loan value" of the security is 25%. Thus, the maximum loan that can be extended to a customer on this security is 25% of current market value. Any loan percentage that is greater than this violates Regulation T.
Street Name Securities	As part of the margin agreement, a broker-dealer is permitted to place customer securities into "street name" - that is, the securities are kept in the name of the broker-dealer, not the customer. Therefore, if the customer does not pay off the loan when demanded, the broker-dealer can simply sell out the securities without needing a customer signature.
Commingling Rules	As part of the margin agreement, the broker-dealer is permitted to commingle (mix-up) one customer's street name margin securities with those of other customers, and can pledge them to a bank to get a loan to the broker. This loan to the broker funds the loan that the broker made to the customer.

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Commingling Rules

The rules on commingling are:

A broker-dealer can commingle one customer's margin securities with those of other customers;

A broker-dealer cannot commingle proprietary positions (securities owned by the firm) with customer securities positions;

An agent of a broker-dealer cannot commingle proprietary positions (securities owned by the firm) with customer securities positions;

An agent of a broker-dealer cannot take customer funds or securities and keep them personally.

The commingling rules also apply to investment advisers and IARs.

Customer Request To Transfer And Ship Securities

When a customer buys securities, the firm can either hold them in street name (margin account) or registered in customer name (in a cash account). If the customer wishes the securities purchased to be "transferred and shipped," this means that the customer actually wants the physical certificates sent to him or her (presumably so they can be kept safely under that customer's mattress).

In this case, the securities are transferred from street name into the customer's name and are actually sent to the customer at his or her address. In order for securities to be transferred and shipped, they must be fully paid. Thus, securities held in a margin account cannot be transferred and shipped unless the loan (called the customer debit) is paid off first.

3e. ORDERS / CONFIRMATIONS

Broker-Dealer Order Ticket Information

An order for a customer cannot be entered by a broker-dealer without the order ticket having the following information:

Customer name or account number;

Agent (registered representative) name or number;

Buy or Sell;

If sale - Long or Short;

Whether order was "Solicited" or "Unsolicited";

Number of shares or bonds to be traded;

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Description of security to be traded; and

Execution price (if the order is a market order, there is no price - only the designation "MKT")..

Note that there is no requirement for customer address, date of birth or social security number on an order ticket.

Solicited Or Unsolicited

Each order ticket must be marked as either a solicited transaction or an unsolicited transaction. This is required because "suitability" complaints have no standing when a trade is unsolicited.

Order Ticket Time Stamps

SEC rules require that order tickets be time-stamped with the following:

Time of order receipt;

Time of order execution;

Time of order cancellation, if canceled.

By requiring these time stamps, front running violations can be easily detected by regulators. In addition, if there is an error in execution, having the time stamp record allows the firm to more easily trace the cause of the error.

NASAA Rule For Investment Adviser Order Tickets

NASAA has a rule for order ticket information that must be retained by Investment Advisers, and of course, it is different than the SEC rules for broker-dealers. Because an IA sends an order to a broker-dealer for execution, the IA must keep a record of the order as sent - there is no requirement for the IA to keep the record of the actual execution - this would be kept by the broker-dealer that filled the order.

The NASAA rule states that Investment Adviser order tickets must contain:

Name of the person at the IA who recommended the transaction;

Name of the person who placed the order;

Date of order entry;

Name of account for which order was entered;

Name of broker-dealer or bank to which the order was sent for execution;

Whether the order was discretionary.

The "Do It" Rule

An order placed by a customer must be filled according to the customer's instructions. If a broker-dealer or investment adviser receives an order from a customer that it believes to be unsuitable, the customer must be told this, and if the customer directs that the trade be done - Do It!

In this theme, if a customer directs that a trade be done in a specific market, then follow the customer's instructions. If a customer directs that a specific percentage of his or her portfolio be invested in a specific stock - Do It! Also note that if a customer directs, you still cannot do anything that is prohibited. For example, if a customer directs that a trade of a listed security be executed privately and not in the public market, this is not permitted.

Not Following Instructions

Also note that NASAA states that deliberately failing to follow a customer's instructions is a prohibited practice - so the "Do It!" rule prevails.

Limit Order Display Rule

The SEC has another rule called the "limit order display rule." This rule requires that market makers in securities that receive customer limit orders that are better priced than their "displayed quote" must show the better priced quote in the market. The market maker cannot bury the customer order!

For example, assume that a market maker has a displayed quote in the market for ABC stock of:

Bid	**Ask**
15.00 (400 shares)	**15.50 (300 shares)**

The market maker currently is willing to Buy 400 shares of the stock at $15.00 (the Bid); and is willing to sell 300 shares of the stock at $15.50 (the Ask).

If the market maker receives a customer limit order to: Buy 200 shares of ABC at $15.20, it must update its Bid (Buy) to reflect the order since it is better priced. The updated quote from the market maker that will show in the market is:

Bid	**Ask**
15.20 (200 shares)	**15.50 (300 shares)**

If the market maker now receives a customer limit order to: Sell 600 shares of ABC at $15.40, it must update its Ask (Sell) to reflect the order since it is better priced. The updated quote from the market maker that will show in the market is:

Bid	**Ask**
15.20 (200 shares)	**15.40 (600 shares)**

(Also note that as exchanges have improved the computer technology by adopting electronic order books that can hold each customer order individually, this rule really now only applies to OTCBB quotes, where market makers still only show 1 quote.)

Confirmation Information

After a trade is executed, the customer must be sent a confirmation detailing the specifics of the executed trade.

The exchange where the trade was effected used to be required to be disclosed on the confirm, but this is no longer the case because all markets are linked and trades must be done at the best price in a given market or routed to the better-priced market for execution.

The information that must be disclosed on the confirmation includes:

- Broker-dealer name, address and telephone number;
- Customer name and address;
- Number of shares bought or sold;
- Security description;
- Execution price;
- Commission charge for an agency trade;
- Whether a payment for order flow was received.

No Disclosure Of Whether Trade Was Solicited On Confirm

Note that there is no requirement to disclose whether the trade was solicited or not on the confirm - this is only required on the order ticket copy.

Disclosure Of Payment For Order Flow Was Received On Confirm

Regarding payment for order flow, the SEC permits market makers and exchanges to pay order entry firms for routing their orders to them. In essence, the market maker is "giving up" part of his spread (difference between bid and ask quote) to the order entry firm.

The SEC permits this because it believes that this allows order entry firms to reduce their commission costs to customers (Now you know how discount brokers can charge $8 per trade and make money - they get payments for order flow as well!). However, if a payment for order flow was accepted, this must be disclosed on the customer confirmation.

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3f. BORROWING / LENDING / SHARING / GUARANTEEING / IN CUSTOMER ACCOUNTS

Borrowing From Customer

A broker-dealer is prohibited from borrowing money or securities from customer accounts. Note, however, that a broker-dealer is permitted to borrow a customer's securities if the customer gives written permission by signing a loan consent agreement.

An agent of a broker-dealer or an investment adviser representative cannot borrow money from a customer personally. An exception is granted if the "customer" is a lending institution that is lending to the agent or investment adviser representative on the same terms (not better terms) as it would extend to any other customer.

> For example, if an IAR has a customer that is a savings and loan, the IAR can get a mortgage on a home purchase from that savings and loan as long as it is on the same terms as the S & L offers its other customers.

If an agent of a broker-dealer has a customer that is a relative, NASAA has a very different rule than FINRA. FINRA allows registered representatives to borrow from relatives that are customers; NASAA does not! (Since this is NASAA's test, you must know their rule!)

Lending To A Customer By Agents, IAs And IARs Is Prohibited

Lending money or securities personally to a customer is prohibited. This rule applies to both agents and investment adviser representatives. In addition, investment advisers (IA firms) cannot lend money to customers.

Broker-Dealers And Banks Can Lend

Note, however, that a broker-dealer or bank can lend money to a customer using securities as collateral under the provisions of Regulation T of the Federal Reserve Board.

Agent Cannot Share In Gain / Loss Of Customer Account Unless Joint Account Is Opened With Customer

Sharing in the gains and losses in a customer's account is prohibited. However, an agent of a broker-dealer is permitted to share in the gain and loss of a customer account as long as:

> A joint account is opened with the customer;
>
> Sharing is in proportion to capital contributed; and
>
> Manager approval is obtained.

An agent will often offer to open a joint account with a customer in such a manner, because then the customer knows that the agent is not likely to make bad

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recommendations, since the agent will lose as well. Such an account "aligns the agent's and customer's interests."

Investment Adviser Cannot Share And Cannot Open Joint Account With Customer

The sharing rule is different for investment adviser accounts. Investment advisers and investment adviser representatives are outright prohibited from sharing in customer accounts - they cannot open joint accounts with customers.

Because IAs and IARs are held to a fiduciary standard, while broker-dealers and agents are not, if they make personal investments, IAs and IARs must invest "alongside the customer" - that is, make the same personal investments as they are recommending to customers. Thus, they will experience the same gain and loss personally as their customers anyway!

Cannot Guarantee A Customer Account Against Loss

Finally, guaranteeing a customer account against loss by either a broker-dealer, agent, investment adviser, or investment adviser representative is prohibited. This applies to both exempt and non-exempt securities.

3g. CHARGES TO CUSTOMERS

Broker-Dealer Commission Charges Must Be "Fair And Reasonable"

Commission charges to customers imposed by broker-dealers must be "fair and reasonable." A customer cannot agree to pay a higher commission unless it is justified by extra "value" being offered by the agent or broker-dealer.

> For example, a broker-dealer that gives lots of hand holding, gives proprietary research, has great stock picks, etc., can charge a higher commission than a "bare-bones" discount broker that just does trade executions.

An agent cannot charge a higher commission rate based on the subsequent performance of recommendations.

Commission Disclosed Only On Confirmation

Any commission charge is not required to be disclosed at the time the trade is placed. The only requirement is that it be disclosed in writing on the trade confirmation.

Disclosure Of Unusual Costs / Fees

Because the customer normally does not know the commission charge until he or she gets the confirmation, to avoid "unpleasant surprises," NASAA requires that any unusual fees or costs for a trade be disclosed verbally at the time the trade is placed.

> For example, if a customer wants to buy an "odd lot" (less than 100 shares), the commission charge is usually much higher than normal, and this must be disclosed to the customer in advance.

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Broker-Dealers Can Charge For Clerical Services But Not For Recommendations

Also note that broker-dealers can charge for clerical services, such as safekeeping of securities and appraisals of securities. However, they cannot charge for recommendations of securities - if they do, they become "statutory" investment advisers that must register as such and that are subject to all of the investment adviser rules.

Investment Advisers Cannot Charge Excessive Fees

For investment advisers, NASAA states that charging an excessive advisory fee to a customer is a prohibited practice. Fees for services rendered must be comparable to other investment advisers who operate in similar situations.

Failing To Disclose The Availability Of Discounts To All Customers

Failing to disclose to all customers the availability of fee discounts. Fee discounts cannot be made available on a "selective" basis to customers. If a discount is offered to given customers, any other customers that meet the qualifications for that discount must be given the discounted rate. The availability of discounts must be disclosed in the adviser's brochure (Form ADV Part 2A).

3h. PROHIBITED STATEMENTS TO CUSTOMERS

The list of prohibited statements to customers is extensive. The basic idea is that one must be ethical and not lie to, or mislead, customers.

Misleading Or Untrue Statements

Misleading or untrue statements are prohibited, such as:

Inaccurate market quotations.

Incorrect statements of an issuer's past earnings or future earnings projections.

Inaccurate statements as to the amount of commission or mark-up charged in a securities transaction.

Advising a customer that an exchange listing is anticipated for a security, without knowing whether the statement is true.

Telling a customer that registration of the security means that either the SEC or the State "approves" of that security.

Telling a customer that a mutual fund is "no-load" when it charges 12b-1 fees in excess of .25% annually. 12b-1 fees are charges against net assets that a mutual fund can charge for the cost of soliciting new investment to the fund. (FINRA has a rule that states that a mutual fund cannot be called

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no load if its 12b-1 fees exceed this limit; it also sets a maximum .75% annual 12b-1 fee for any fund).

Telling a customer that registration of an agent means that either the SEC or the State Administrator "approves" of that agent.

Promising to perform services for a customer without any intent or ability to do such.

Making exaggerated claims about investment performance.

Misrepresenting the status of a customer's account.

Telling a customer that registration as an adviser means that the State Administrator "approves" of the firm or "endorses" the firm (note however, that investment advisers are permitted to call themselves "investment counsels," as long as this is the principal business of the firm - otherwise they cannot do so).

Telling a customer that an asset allocation program is "proven and tested," when in fact, no one has ever used the program.

Omissions Of Material Fact

Omissions of material fact are a violation under the Act. Examples are:

Deliberately being selective in the information which is given to a customer.

Failure to inform a customer that a transaction will incur larger than normal commission, tax, or transaction costs (note that there is no requirement to disclose normal commission charges to a customer prior to executing a securities transaction, but all commissions must always be disclosed on customer trade confirmations).

Failure to bring customers' written complaints to the attention of the broker-dealer. SEC and NASAA rules require that original copies of all written complaints with their resolution be retained as a required record.

Giving the customer a research recommendation prepared by someone other than that firm, without disclosing that fact (this is called "Third Party Research").

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Failure to tell a mutual fund customer about breakpoints. A breakpoint is a sales charge reduction based on the dollar amount invested in a mutual fund. The customer must be made aware of the dollar threshold for the sales charge reduction and also must be made aware of a letter of intent (LOI) feature, if offered by the fund. The LOI gives the customer up to 13 months to complete the breakpoint if the letter is signed.

Also prohibited are the following:

Soliciting Orders For Unregistered Non-Exempt Securities

Soliciting orders for unregistered non-exempt securities. For example, soliciting a customer to buy unregistered common stock is prohibited; soliciting a customer to buy unregistered municipal bonds is permitted (since these are exempt securities).

Recommending Stock Of Publicly Traded Parent Company

A broker-dealer or agent recommending the purchase of the firm's publicly traded parent company. For example, an agent at Merrill Lynch cannot recommend the purchase of Bank of America stock (which owns Merrill Lynch) unless this is disclosed verbally at the time of recommendation; and in writing on the confirmation.

3i. CUSTOMER COMPLAINTS / MAIL / INCAPACITATION / DEATH

A customer complaint is defined as one received in writing (e-mail counts here). A customer calling up and yelling is not a complaint. If a written complaint is received by an agent or an IAR, it must be given to a manager for resolution.

If a customer sends a written complaint and then changes his mind about the complaint and asks for it back, the original written complaint must be retained as a record and a copy returned to the client.

Any mail that the firm sends to a customer, such as confirmations and account statements, must be sent to the customer at the mailing address provided by the customer (e-mail is OK). Customer mail cannot be suppressed; and cannot be directed to be sent to a branch office or a P.O. box designated by an agent.

The "idea" is that the customer must know what is going on in his or her account. There have been many frauds, especially with elderly customers, where an agent who had discretion over the account, churned it to generate commissions, and directed that the customer mail be sent to

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a different address, so the customer did not know what was going on until it was too late!

Death Of Customer

If a broker-dealer or adviser is notified that a customer has died, the firm must:

cancel all open orders;

note the date of death on the account;

freeze the account from removal of assets; and

wait for the proper paperwork (copy of the death certificate, last will and testament, and probate court filings, if required) needed to transfer the account or assets to an executor or beneficiary.

Any Power Of Attorney Ceases Upon Customer Death

Durable Power Stays In Force If Customer Is Mentally Incapacitated

If the account had a power of attorney, that "died" with the customer and is now invalid. Also note that a "so-called" durable power of attorney also dies with the customer - the only distinction is that if a customer is incapacitated, the durable power of attorney remains in effect. If the account has a "non-durable" power of attorney, the authorization expires upon the customer's incapacitation (most powers of attorney are "durable").

3j. TRADING PRACTICES

Inside Information

Inside information is defined as information about an issuer that has not been made public. "Material" inside information is information that is not public that would have an effect on the value of the issuer's securities in the marketplace. The Act prohibits persons from:

Cannot Trade Based On Inside Information

effecting securities transactions based on material inside information.

making recommendations to either buy or sell based on material inside information.

Tipper - Tippee

The Act prohibits persons from transmitting material inside information to someone else, who might trade based on that information (the so-called "tipper-tippee" doctrine, that holds not only the person who traded as liable; but also holds liable the person who gave the tip that resulted in the trade).

Note that the "tipper" is not held liable if the information that results in the trade is accidentally or unintentionally transmitted to the "tippee." Also note that there is no violation for either the tipper or tippee if no trade results from the transmittal of the inside information.

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Broker-Dealers Must Have Procedures To Prevent Misuse Of Material Non-Public Information

Federal insider trading law requires broker-dealers to establish, maintain, and enforce written policies and procedures designed to prevent the misuse of material, non-public information by any associated person.

In particular, this legislation was aimed at investment bankers engaged in takeovers. Large broker-dealers have divisions for investment banking; mergers and acquisitions; trading; and retail. Inside information is routinely received through investment banking and merger activities. It is not a violation to receive inside information. It is a violation to use the information to trade for profit.

> For example, if a broker-dealer is hired to advise on the potential takeover of a publicly traded company, investment bankers at the firm who work on the deal possess inside information about the potential takeover. If an investment banker at the firm buys the stock of the target company personally, the investment banker has violated the insider trading laws.
>
> For example, if a broker-dealer's research department is about to come out with a favorable research report on a publicly traded stock and a financial adviser at the firm gets an advance copy of the report and buys the stock personally based on the report, the financial advisor has violated the insider trading laws.

The issue for broker-dealers is that, because of the "tipper-tippee" doctrine, the broker-dealer can be viewed as the "tipper" if one of the firm's employees trades based on inside information received from the broker-dealer. Furthermore, the potential liability for the tipper is huge ($25 million fine per trade). However, this penalty is only imposed if the "tipper" recklessly disregards the insider trading laws.

Thus, the broker-dealer must put policies and procedures in place that:

> train employees about the insider trading rules;
>
> demonstrate that the employee received such training and understands the insider trading laws;
>
> impede the flow of inside information between different departments of the broker-dealer.

Chinese Walls

To insure that such inside information is not communicated to the firm's trading or retail operations, all

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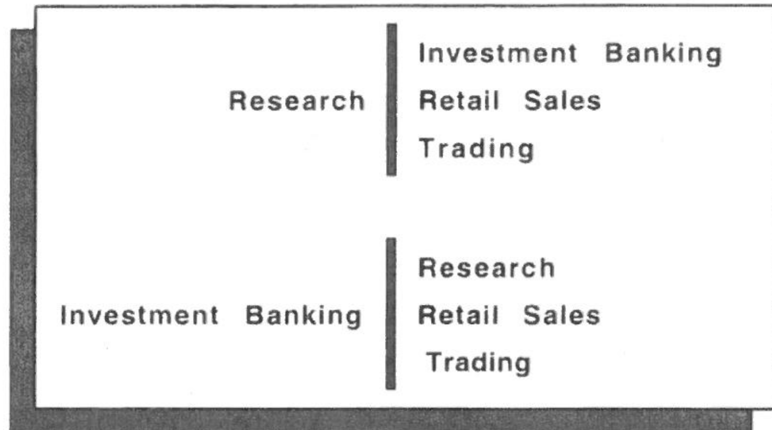
firms set up "Chinese Walls" that fully segregate the information flow. For example: The name of the company that is the target of a takeover may only be known to one or two top people; all communications about that company use a pseudonym.

Required "Chinese" Walls



If Agent Receives Inside Information, Report To Regulator

If "inside information" of a material nature is received by an agent, it must be reported to the exchange where the security trades (via that firm's compliance department).

Inducing Trading Based On Rumors Is Prohibited

Inducing customers to trade based on hearsay or rumor is also prohibited. While this is not "inside information" because the truth of the information is not known, it is a violation to use rumors to generate customer trades.

Front Running Is Prohibited

If a broker-dealer or adviser receives a large customer trade order that is likely to influence the price of the security, the firm cannot "front run" that trade - that is, place an order for its own account ahead of the placing that customer's order.

Manipulation Is Prohibited

Participating in manipulative market activities such as giving fictitious quotes; effecting "wash trades" and "matched orders" (these are not free market trades, but rather these are trades between co-conspirators who are attempting to make it look like there is trading in the stock at ever higher or lower prices) is a prohibited practice.

Painting The Tape

Participating in transactions only to give the appearance of trading activity in the security, also known as "painting the tape," is a prohibited practice.

Trading Ahead Of Underwriting Or Research Is Prohibited

A broker-dealer that has a research or underwriting department cannot "trade" its own account based on information that is received from either of these departments.

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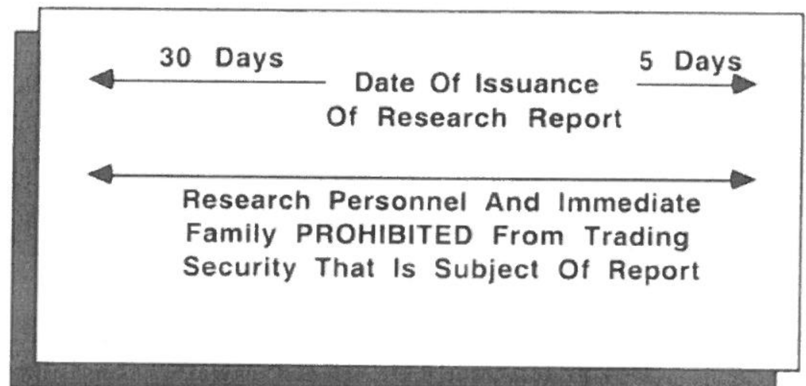
For example, an underwriter that is advising on a takeover deal cannot "tip off" the firm's trading desk about the impending offer, since this is likely to raise the market price of the stock and the firm's trading desk could profit from this. This is a type of inside information.

For example, a research department that is about to release a favorable research report on a company cannot "tip off" the firm's trading desk about the report, since this is likely to raise the market price of the stock and the firm's trading desk could profit from this. This is a type of inside information.

Research Personnel Cannot Trade Securities That Are Recommended For Prescribed Time Window

There are specific prohibitions on the activities of research personnel who publish research reports. Research personnel (and immediate household members) cannot trade in any of the recommended subject company's securities or equivalents for the window of time from 30 days prior to, until 5 days after, the issuance of a research report.



3k. NEW ISSUE RULES / RESEARCH RULES

Failure To Deliver A Prospectus When Selling A New Issue

Selling a non-exempt new issue security to a customer without providing a final prospectus to the customer, at or prior to, confirmation of sale, is a prohibited practice.

For example, a new issue of common stock cannot be sold to a customer without delivering a prospectus. A new issue of municipal bonds can be delivered to a customer without a prospectus delivery because the securities are exempt.

Marking-Up Or Highlighting A Prospectus

Marking up or highlighting a prospectus delivered in connection with the sale of a new issue is prohibited. Doing so alters the legal content of the prospectus and is therefore prohibited.

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Third Party Research Disclosure

If a broker-dealer or investment adviser prepares a research report, it can be distributed to customers with no special disclosures other than the standard "conflict of interest" disclosures that any research report must contain. If a broker-dealer or investment adviser buys or uses "third party research (this is research prepared by another firm) and distributes it to customers, the fact that it was prepared by an outside firm must be disclosed.

IPO Allocations To Broker-Dealers And Their Employees Are Prohibited

It is very common in a common stock Initial Public Offering (IPO) that the underwriter prices the issue a "bit low" to make sure that the issue is sold out to investors. This creates a conflict, because industry insiders know this and want to buy the issue from the underwriters (since it is likely to trade higher once it opens for trading in the market). It is unethical for employees of broker-dealers to buy IPOs from underwriters.

Free Riding And Withholding

This is a prohibited practice called "free riding and withholding" - which is withholding an IPO from sale to the public by a broker-dealer or associated person, with the intention of keeping it personally so that a "free ride" can be taken on the issue's price rise when it opens for trading.

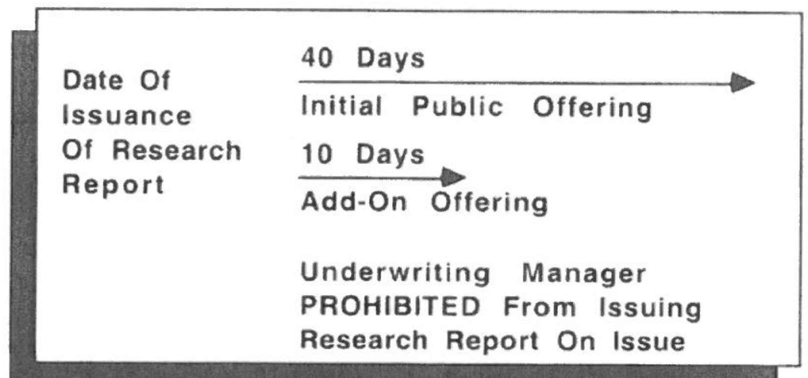
IPO allocations can be made to employees and officers of the issuer, the issuer's suppliers, and the general public. They cannot be made to broker-dealers, broker-dealer officers and broker-dealer employees.

IPO Allocations To Investment Advisers Are Permitted

IPO allocations can be made to investment advisers, but the adviser must buy the allocation for all of its clients - it cannot keep the allocation for the IA's account or an IAR's personal account.

Underwriting Manager Cannot Issue Research Report On Issue For Prescribed Time Windows

A member firm that acted as a manager or co-manager in an underwriting of that issuer's securities cannot issue a research report on that company for 40 days following the effective date for an initial public offering and 10 days following the effective date for a secondary offering.



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