January 1997

Investment Advisory Regulatory Muddy Waters: Registration and Control Issues are Confused with Issues of Disclosure and Anti-Fraud

Susan Rogers Finneran

Follow this and additional works at: http://scholarship.law.campbell.edu/clr

Part of the Securities Law Commons

Recommended Citation

This Article is brought to you for free and open access by Scholarly Repository @ Campbell University School of Law. It has been accepted for inclusion in Campbell Law Review by an authorized administrator of Scholarly Repository @ Campbell University School of Law.
INVESTMENT ADVISORY REGULATORY Muddy Waters: Registration and Control Issues Are Confused with Issues of Disclosure and Anti-Fraud

SUSAN ROGERS FINNERAN*

I. Introduction

Persons engaged in providing investment advice must register as investment advisers under the Investment Advisers Act of 1940, as amended, (the "Advisers Act") or be subject to the supervision and control of a registered investment advisor ("RIA"). Registration or control effects the statutory purposes and, thus, should also provide the requisite statutory protection for investors. Notwithstanding the foregoing shibboleth and its logic, as well as, the legislatively-recognized distinction between broker-dealers and investment advisers, the staff of the Securities and Exchange Commission and its staff have on numerous occasions confirmed the view that 'a person associated with an investment adviser' as that term is defined in Section 202(a)(17) of the Advisers Act, will not be required to be separately registered as an investment adviser with respect to the activities undertaken on behalf of the adviser in the person’s capacity as an associated person.” Ropes & Gray, 1995 SEC No-Act LEXIS 728 at 24 (Sept. 26, 1995).

2. See infra text at 111-14.
3. “The Commission and its staff have on numerous occasions confirmed the view that ‘a person associated with an investment adviser’ as that term is defined in Section 202(a)(17) [of the Advisers Act], will not be required to be separately registered as an investment adviser with respect to the activities undertaken on behalf of the adviser in the person’s capacity as an associated person.” Ropes & Gray, 1995 SEC No-Act LEXIS 728 at 24 (Sept. 26, 1995).
4. See Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78 (the "1934 Act" or "Exchange Act") with respect to broker-dealers and their associated persons. Although the terms “broker” and “dealer” are defined separately in the 1934 Act, in judicial and administrative analysis, both definitions are discussed and the person referred to is a “broker-dealer”. SEC v. Schmidt, Fed. Sec. L. Rep. (CCH) 93,202 (1971). In some cases, however, the two definitions are distinguished and the person is referred to only as a broker or dealer. Castelman & Co., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 80,260 (1975); Thomas R.
Exchange Commission (the "SEC" or "Commission")\(^6\) has imposed supplementary oversight by requiring broker-dealer supervision and control,\(^7\) and encouraging self-regulatory organizations

---

Vorbeck, SEC No-Action Letter, 1974 SEC No-Act, LEXIS 1823 (Feb. 22, 1974). See infra text at 114 for detailed definition of each term "broker" and "dealer".

5. See infra text at 118-20 for detailed definition of investment adviser.

6. The SEC is the statutorily-created and principal regulator of securities professionals, both broker-dealers and investment advisors.

7. See infra note 10 regarding supervision and control duties imposed on member broker-dealers of the NASD (as hereinafter defined). "The NASD requires that a registered representative who participates in a 'private securities transaction', i.e., a transaction outside the regular course or scope of the person's employment with a broker-dealer, must notify the broker-dealer in writing prior to participating in the transaction. The notification must describe the person's role and whether the person is receiving selling compensation in connection with the transaction (e.g., commissions, finder's fees, rights or expense reimbursements)." In re Eugene T. Ichinose, Jr., Exchange Act Release No. 17381, 1980 SEC LEXIS 105 (Dec. 16, 1980).

For transactions involving the receipt of selling compensation, the broker-dealer must then notify the representative as to whether it approves or disapproves of the representative's participation in the transaction. If the broker-dealer approves of such participation, the transaction must be recorded on the broker-dealer's books and supervised as if it were executed on the broker-dealer's behalf. The record of the transaction would typically include the employee's name, the security involved, amount and source of compensation and details of the transaction. If the broker-dealer disapproves, the representative may not directly or indirectly participate in the transaction. However, the requirements do not apply to personal transactions in investment company and variable annuity securities, transactions among immediate family members where no selling compensation is received, or transactions subject to Article II, Section 28.

The NASD generally prohibits a person associated with an NASD member organization in any registered capacity from being employed by or accepting compensation from any other person as a result of any business activity outside the scope of the person's relationship with the person's employer firm, unless written notice has been provided to the member. See Article II, Section 43 of the NASD Rules of Fair Practice.

However, Section 43 does not apply to passive investments or to activities subject to Section 40 of the NASD Rules of Fair Practice, discussed above. Lemke, Thomas and Lins, Gerald, Regulation of Investment Advisors (New York) Clark Boardman Callahan at 2-63 - 2-64.

Supervision is an essential function of the broker-dealer according the SEC which has "made it clear that it is critical for investor protection that a broker establish and enforce effective procedures to supervises its employees." Donald T. Sheldon, 52 SEC Docket 3826, 3855 (1992). See also In the Matter of Anthony J. Amato, Exchange Act Release No. 10265, 1873 SEC LEXIS 2769 at *6-8 (June 29, 1973).
REGISTRATION AND CONTROL ISSUES

("SRO")\textsuperscript{8} such as the National Association of Securities Dealers,


8. Section 3(a)(26) of the 1934 Act defines "self-regulatory organization" as "any national securities exchange, registered securities association, or registered clearing agency . . ." 15A U.S.C. § 78. In 1938, Section 15A was added to the 1934 Act by the Maloney Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938). The NASD was established primarily to govern trading in the over-the-counter (non-exchange) markets. Its authority arises under 15A of the 1934 Act. The NASD must register with the SEC and maintain rules "to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade in transactions in the OTC market." Sirianni v. United States Securities and Exchange Commission, 677 F.2d 1284, 1288 (9th Cir. 1982).

Under Section 15A(a), "an association of broker-dealers must register as a national securities association pursuant to Section 15(b) by filing with the Securities and Exchange Commission (the "SEC" or the "Commission") an application for registration in such form as the SEC, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 780-3(b)(6) (1976) (§ 15A(b)(6) of the 1934 Act) (permits a national securities association to register with the SEC if it has adopted rules designed to prevent stock fraud and manipulation, promote just and equitable principles of trade, and protect investors and the public interest). The New York Stock Exchange (NYSE), American Stock Exchange (AMEX), the Philadelphia Stock Exchange (PHLYX), Boston Stock Exchange (BSE) are also self-regulatory agencies acknowledged upon the enactment of the 1934 Act. In 1934, when Congress created the SEC, stock exchanges, as private associations, had been regulating their members for up to 140 years. Rather than displace this system of "self-regulation", Congress required every "national securities exchange" to register with the SEC. Congress realized that the SEC lacked the expertise and capabilities to oversee every aspect of the securities markets; therefore, Congress created SROs under § 19 of the 1934 Act. SROs add to the protection of investors.
Inc. (the “NASD”) to assert jurisdiction (albeit indirectly), over certain investment advisory activities.

Through supervision and discipline of member broker-dealers and persons associated with such broker-dealers. Under the 1934 Act, an exchange cannot be registered unless the SEC determines that its rules are designed to “prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to provide for appropriate discipline of its members for any violations of its own rules or the securities laws.”

9. The focus of this article when referencing SROs in this context is on the NASD. There are other self-regulatory organizations, such as the New York Stock Exchange and the American Stock Exchange and various regional stock exchanges. The NASD is composed of broker-dealer firms which sell securities in the over-the-counter market. The principal (as opposed to regional) exchange market consists of the New York Stock Exchange and the Securities and Exchange Commission (“SEC” or “Commission”), but also authorized the creation of self-regulatory organizations for the securities exchange. Securities and Exchange Act of 1934, Pub. L. No. 73-291, 6, 48 Stat. 881, 895-896, reprinted in 15 U.S.C. sec. 78(e), (f)(1988). See also Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 4, H Doc. No. 95, 88th Cong., 1st Sess. 501 (April 8, 1963). No similar self-regulatory authority was established originally in 1934 for the OTC market. Only the SEC was charged with regulatory oversight of this market.

10. Registered investment advisers who are also registered representatives of NASD member broker-dealers are subject to indirect SRO regulation pursuant to certain rule-making and policy promulgations, such as Article III of the NASD Rules of Fair Practice, Section 40. See, e.g., NASD Notice to Members 94-44.

Article III Section 40 of the NASD Rules of Fair Practice provides that any person associated with a member who participates in a private securities transaction must, prior to participating in the transaction, provide written notice to the member broker-dealer with which he or she is associated. Section 40 provides as follows:

(a) Applicability – No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this section.

(b) Written Notice – Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the persons proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

(c) Transactions for Compensation –

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to Subsection (b) shall advise the associated person in writing stating whether the member:
(A) approves the person’s participation in the proposed transaction; or
(B) disapproves the person’s participation in the proposed transaction.

(2) If the member approves a person’s participation in a transaction pursuant to Subsection (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person’s participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person’s participation pursuant to Subsection (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

(d) Transactions Not For Compensation – In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to Subsection (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

The required notice under NASD Section 40 must describe the transaction, the associated person’s role, and whether the associated person has received or may receive selling compensation. The member must respond to the notice in writing indicating whether it approves or disapproves the proposed transaction. Where the registered person has received or may receive selling compensation, the member approving this transaction must record the transaction in its books and records and must supervise the registered persons participation in the transaction as if it were such member’s own under Section 27 of the NASD Rules of Fair Practice. Even if the outside business activity of the registered representative is not brokerage, but investment advisory activities, failure to comply with Rule 40 will expose the parties to sanctions. See, e.g., In the Matter of Richard L. Robinson; Release No. 16597; 1980 SEC LEXIS 2023 (Feb. 21, 1980).

At the very heart of this Rule are the phrases: “private securities transaction”; “selling compensation”; member approval or disapproval; “supervise”; “as if the transaction were executed on behalf of the member”; and “require the person to adhere to specified conditions”. These terms, at least facially, seem inextricably tied to the 1934 Act’s definition of broker-dealer “effecting securities transactions”. Indeed, within Section 40’s definition of “private securities transaction”, the term “securities transaction” is used to define the type of activity considered “outside the regular course or scope” of the registered representatives activities which is the subject of this Section. But what appears is not always so. Indeed, the application of Section 40 extends well beyond securities transactions as envisioned in the 1934 Act. It now reaches investment advisory activities of registered representatives conducted independently of the member broker-dealer. This section applies to investment advisory activities conducted by a duly registered person (i.e., registered representative and RIA) that result in the purchase or sale of securities. Regulation of Investment Advisers at 2-63. To understand how this expansion is justified requires focusing on how the term “private securities transaction” has

For example, an indemnification agreement executed by a registered representative in connection with the pledge of securities of a customer to a bank as collateral for a loan constituted a private security transaction because the indemnity agreement was "inextricably linked to the pledge of stock". In the Matter of William D. George, III, Exchange Act Release No. 17136; 1980 SEC LEXIS 762 at 5 (September 8, 1980). Similarly, a referral fee arrangement entered into between a registered representative and someone other than his employing broker-dealer was held to be subject to Section 40. In the Matter of Allen S. Klosowski, Exchange Act Release No. 25467, 1988 SEC LEXIS 507 (Mar. 15, 1988) (where SEC affirmed NASD sanctions against associated person who referred firm's customers to syndicator in exchange for finder's fees). In the Matter of Philip S. Sirianni, Exchange Act Release No. 17077, 1980 SEC LEXIS 878 at 6 (Aug. 20, 1980).

Section 40 is not limited to outside brokerage activities as indicated, indeed, a registered representative's argument that he had not violated Section 40 because he had acted as an investment adviser was of no avail. In the Matter of Richard L. Robinson, Exchange Act Release No. 16597, 1980 SEC LEXIS 2023 (Feb. 21, 1980).

The language to the introduction of the NASD's Interpretation to Section 40 provides that the involvement of registered representatives in private securities transactions "may raise serious questions regarding their need to register as broker dealers and/or investment advisers under state and federal securities laws". 1980 SEC LEXIS 2023 at 3. The SEC also rejected Robinson's assertion that this language excused his activities since he was a registered investment adviser, in addition to being a registered representatives. The SEC did not see how this warning could be construed as authorizing Robinson to violate the clear terms of the NASD's interpretation because he was registered as an investment adviser. I do.

Two provisions both referring to the same matter should be read consistently, not inconsistently, with one another. If failure to comply with Section 40 can result in one improperly engaged as an unregistered broker-dealer, why does not submission, by registration with the SEC, to the full panoply of the applicable federal securities law solve the problem? Has not registration achieved the purported goal of protecting investors? Has not the integrity of the federal securities laws been preserved? Has not the Congressionally mandated statutory level of regulation over the disparate market functions of broker-dealer and investment adviser been achieved?

Contrary to the SEC contention in the Robinson matter, the public is not "deprived of protection which it is entitled to expect". In the matter of Anthony J. Amato, Exchange Act Release No. 10265, 1973 SEC LEXIS 2769 at 7 (June 29, 1973); In the Matter of Richard L. Robinson, Exchange Act Release No. 16597, 1980 SEC LEXIS 2023 at 4 (Feb. 21, 1980). The public is entitled to expect only that which Congress has provided: in the 1934 Act with respect to brokerage activities; and the Advisers Act with respect to investment advisory activities. Indeed, by expanding, ex cathedra, the statutorily-mandated expectations the SEC has created regulatory unevenness and possibly inconsistently in
"protections" afforded to customers of a registered representative/RIA and customers of an RIA, separate and distinction from his registered representative.

The National Business Conduct Committee (NBCC) of the NASD concluded that Section 40 applied to all investment advisory "activities of individuals who are registered both as representatives of an NASD member firm and with the SEC as a Registered Investment Adviser ("duly registered persons" or "RR/RIA") and who conduct their investment advisory activities 'away from' their NASD member employer." 1994 NASD LEXIS 39, at 2; NASD Notice to Members 94-44 (May 15, 1994). The NBCC also determined that the receipt of compensation as a result of investment advisory activities constituted the receipt of selling compensation as defined in Section 40. The Board focused primarily upon the duly registered persons participation in the execution of the transaction—meaning participation that goes beyond mere recommendation. Section 40, therefore, applies to any transaction in which the duly registered person participates in the execution of the trade. An example would be where the duly registered person enters an order on behalf of the customer for particular securities either with a brokerage firm other than the member they are registered with, directly with a mutual fund, or with any other entity, including another adviser, and receive any compensation for the overall advisory services.

Of particular note is the reference in this NASD Notice 94-44 to the basis upon which the NASD states this matter of a dually registered RR/RIA; namely, "... as a result of a number of requests for interpretations relating to programs under which registered representatives directed securities transactions for their investment advisory clients to a broker-dealer other than the firm with which they are registered" (emphasis added). Id. This concern seems directed more at "selling away" type transactions than supervision and control issues.

An RIA under the Advisers Act is required to seek best execution for its clients. The NASD also reported in NASD Notice to Members 94-44 that the NBCC "... focused primarily upon RR/RIA's participation in the execution of the transaction—meaning participation that goes beyond mere recommendations." (emphasis added). Id. at 4-5. Under the Advisers Act, an RIA has the obligation, however, to seek best execution which may not always be possible with the registered representatives employing broker-dealer. Participation in investment advisory activities triggering Section 40 include entering an order for securities with: a brokerage firm (other than the registered representatives employing broker-dealer); a mutual fund; another investment adviser or other entity and receiving compensation for the overall advisory services. Excluded from Section 40, however, are arrangements ... "which the account is 'handed off' to unaffiliated third-party advisors that make all investment decisions ..." Id.

Other SROs such as NYSE also exert authority over outside business activities such as NYSE Rule 346 (b) and (3) and Supplementary Material .10; American Stock Exchange Rule 342(a) and (b) and Commentary .20. The focus of this article will be on the NASD. Persons designated as representatives for the purposes of the NASD include "assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions." Membership, registration and qualifications requirements, '1031(b)(1996).
Turning the NASD and its member broker-dealers into an investment advisory SRO to supplement SEC oversight (no matter how well-intended) is legislatively questionable,\textsuperscript{11} and also results in uneven and non-uniform oversight of the investment advisory business depending upon whether or not the investment advisory function: (1) is completely segregated from any association with a broker-dealer;\textsuperscript{12} (2) is conducted by a registered representative of the broker-dealer (ARR) who is also registered as an investment adviser, whether individually or through a separately incorporated entity owned by the RR;\textsuperscript{13} (3) is conducted by a separately incorporated entity who engages the services of a natural person who is also an RR, or (4) is conducted by the broker-dealer.\textsuperscript{14} Only some, not all, of these enumerated situations trigger supplementary broker-dealer supervision and control over investment advisory activities. This supplementary oversight is imposed by the SEC staff with SRO assistance, but not pursuant to Advisers Act mandate. On what basis can 1934 registered entities, SRO or broker-dealer, assert, with competence and authority, supervision and control over activities subject to the Advisers Act?\textsuperscript{15} Registration by a broker-dealer does not obviate regis-

\textsuperscript{11} Although presently there is no SRO established under the Advisers Act, the SEC is desirous of supplementing its oversight of the investment advisory business with establishment of an SRO, comparable to that extent with respect to broker dealers, such as the NASD, an SRO established under the 1934 Act. \textit{See} Legislation to Amend Investment Advisers Act of 1940 Proposed by Securities and Exchange Commission; Investment Advisers Act Release No. 491 (Dec. 5, 1975; \textit{See also} National Detroit Corporation, SEC No-Action Letter, 1975 SEC No-Act LEXIS 121 (Dec 27, 1974). To date, Congress has not acted favorably upon the creation of an SRO under the Advisers Act.

\textsuperscript{12} There is no SRO oversight of the investment advisory function in this instance and hence only investment advisory activities conducted by a dually registered person trigger additional oversight, directly or indirectly, by a broker-dealer and/or SRO such as the NASD.

\textsuperscript{13} \textit{See} difference between Article III, NASD §§ 40, 43.

\textsuperscript{14} \textit{See} difference between Article III, NASD §§ 40, 43.

\textsuperscript{15} “The purpose of the prohibition against effecting transactions for customers outside the normal procedures and without disclosure to the employer is twofold: (1) to protect the public by ensuring oversight and supervision of a registered representative’s sales activity; and (2) to protect the employer from exposure to loss for transactions about which it is unaware.” “Outside sales activities, even if uncompensated, expose investors to possible losses and employers to possible liability. A securities firm, through which salesmen are registered for the protection of the public, must protect investors as well as itself through supervisory measures that impose conditions on a salesman’s employment. To implement and enforce those measures, the firm must be
tion under the Advisers Act if that broker-dealer engages in investment advisory services on anything other than on an incidental basis. Any broker-dealer asserting supervision and control over a registered investment adviser or its agents and associated persons is inconsistent with the shibboleth of register or be subject to RIA control; arguably, could jeopardize that broker-dealer's exclusion from the definition of investment adviser under the Advisers Act; and, is inconsistent with Advisers Act Section 208(d)'s prohibition against doing indirectly what one can not do directly; namely, engage in the advisory business without registration.

Added to the mix outlined above is the SEC staff insistence in some, but not all, RIA networking arrangements, on RIA sole control over not only investment advisory activities, but all activities of the RIA's associated persons. As indicated above, in some broker-dealer/RIA networking arrangements, an RIA may not be able...
to exercise sole control even over investment advisory services persons since the SEC staff and cooperating SROs, such as, the NASD, insist on broker-dealer supervision and control over investment advisory activities of a person dually registered as a registered representative of a broker-dealer and an RIA (collectively, "RR/RIA"). By contrast in RIA/financial networking arrangements, the SEC staff has insisted on RIA sole control over all activities of its associated persons. In these instances, the staff insistences are inherently contradictory. This is so because I believe the SEC staff confuses issues of registration and control with possible conflict of interest issues. This latter concern can be addressed by disclosure and compliance with the usual conduct necessary to avoid violating antifraud concerns, not by imposing supervision and control. The regulatory inconsistency among SEC staff holdings is apparent. The degrees of RIA control vary. Sole RIA control is insisted upon in RIA/financial institution networking arrangements; broker-dealer supervision and control over the advisory activities, however, is insisted upon when performed by RR/RIA; and RIA control over only investment advisory, as opposed to all, activities is insisted upon in RIA/non-financial institution networking arrangements. If sole RIA control were uniformly insisted upon, perhaps, the prohibition of Section 208(d)

19. In recognition that many registered representatives also act as registered investment advisers, and the resulting potential for conflicts of interests, Regulation of Investment Advisers, at 2-62, NASD Rules of Fair Practice, Article III, Section 1 requires members to "observe high standards of commercial honor and just and equitable principles of trade." NASD Manual (CCH) 2151, p. 2014 - the NASD's Rules of Fair Practice impose standards of conduct "and other requirements" on the activities of broker-dealers and their registered representatives. Regulation of Investment Advisers at 2-62. See, e.g., Article III, Section 28 of the NASD Rules of Fair Practice (relating to requirements imposed when a registered representative opens an account or trades through a broker-dealer other than his/her employing broker-dealer). Sometimes the interrelationship between Section 28 and Section 20 of the NASD Rules of Fair Practice becomes an issue. See, e.g., In the Matter of Richard W. Perkins; Exchange Act Release No. 19345; 1982 SEC LEXIS 120 (Dec. 16, 1982). In an administrative proceeding involving Section 40, the registered representative asserted that the "purpose of the NASD's interpretation is merely to prevent customers from being misled as to the employing firms' sponsorship of their salesmen's transactions." In the Matter of Zester Herbert Hatfield, Exchange Act Release No. 25488, 1988 SEC LEXIS 551 at 6 (Mar. 18, 1988). The SEC in response; however, stated that "the NASD's interpretation also serves the very important functions of protecting employers against investor claims arising from a salesman's private transactions, and protecting public investors by ensuring proper supervision of a broker's sales efforts." Id.
of the Advisers Act could be the rationale. As with the other regulatory shibboleth, register or be supervised and controlled by the registrant, Section 208(d) is also, however, applied inconsistently. These inconsistencies evidence muddled thinking, yielding confusion and unnecessary inconsistency in the regulation of investment advisory activities.

II. DEFINITIONS

A review of basic definition of terms as set forth in the 1934 Act and Advisers Act proves that disparate roles of broker-dealers and investment advisers are acknowledged. Despite these disparate roles, regulated by different statutes, the same regulatory shibboleth echoes in each. Each regulatory scheme insists that anyone engaging in the regulated activity, broker-dealer or investment adviser, as the case may be, register or be subject to the control of the applicable registered entity. This is the regulatory shibboleth proffered by the SEC, but which the SEC seems to have difficulty in adhering to whenever the RIA, is also an RR or owned by an RR; or networks with a financial institution.

1. Broker, Dealer, Associated Persons and Registered Representative.

(a) Broker-Dealer.

A broker is one who effects securities transactions on behalf of another while a dealer is one who buys and sells particular securities. These terms effecting securities transactions, and buying and selling securities may be the result of investment advisory activities, but are clearly distinct regulated functions. Only

20. The term “broker” means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. (emphasis added). Section 3(a) of the 1934 Act.

21. The term “dealer” means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business. Section 3(a) of the 1934 Act.

22. A broker-dealer is not required to register as an investment adviser even if the parent of an advisory subsidiary since the services differ in character and are not performed by the parent broker-dealer. F. S. Mosley & Company, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rptr. Par. 78,063 (19__). Moreover, as discussed earlier and later in the text, a broker-dealer is generally excluded from the definition of an investment adviser.
persons so regularly\textsuperscript{23} engaged in either effecting or buying and selling must register with the SEC as a broker-dealer\textsuperscript{24} or be an associated person subject to the supervision and control of the registered broker-dealer.\textsuperscript{25}


Professor Loss suggests that the phrase "engaged in the business" whether of buying or selling in the instance of a dealer or effecting securities transactions, in the instance of a broker connotes a certain regularity of participation in purchasing and selling activities rather than a few "isolated transactions". II L. Loss, \textit{Securities Regulation} 1295 (1961).

\textsuperscript{24}15 U.S.C.A. § 78(a)(1)(1994): "It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person (other than a natural person . . . ) to make use of the mails or any means of instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered . . . [with the SEC]." All broker-dealers are required to register with the SEC except "such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange . . . " or a broker or dealer whose securities activities relate only to exempted securities, commercial paper, bankers' acceptances or commercial bills. \textit{Id}.

\textsuperscript{25}Acquisition and sale of stock by a registered representative through another broker-dealer, without notice to his employing broker-dealer, is clearly the type of trading activity which rightfully concerns both the SEC and the NASD. "This is precisely the sort of misconduct that Section 40 is designed to prevent by ensuring that all trading by an associated person for compensation will be subject to member firm supervision." In the Matter of Gordon Wesley Sodoff, Jr., Exchange Act Release No. 31134; 1992 SEC LEXIS 2190 at 23 (Sept. 2, 1992). Not only is the securities trade being conducted, if without separate broker-dealer registration by the registered representative, in violation of the 1934 broker-dealer registration requirements, but also outside the prescriptive and proscriptive protections afforded under the existing regulatory scheme.

In concurring with the NASD's actions and sanctions against the registered representative, the SEC noted its prior statements with regards to a salesman's private securities transactions:
(b) Associated Person of Broker-Dealer

Those persons who themselves are not broker-dealers, but who work for broker-dealers as RRs, as well as, certain other persons are persons associated with a broker-dealer. And, although the 1934 Act does not require associated persons to register with

"Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection which it is entitled to expect. Moreover, the employer may also thus be exposed to risks to which it should not be exposed. Thus, such conduct is not only potentially harmful to public investors, but inconsistent with the obligation of an employee to serve his employer faithfully." In the Matter of Anthony J. Amato, Exchange Act Release No. 10265, 1973 SEC LEXIS 2769 (June 29, 1973); In the Matter of Richard L. Robinson, Exchange Act Release No. 16597, 1980 SEC Lexis 2023 at 5 (Feb. 21, 1980). See also In the Matter of Klosowski; Exchange Act Release No. 25467; 1988 SEC Lexis 507 (Mar. 15, 1988) (which involved the claim of Prosen, a registered representative of Private Ledger Financial Services, Inc., that he was not engaged in any private securities transaction when he referred 17 of his private ledger customers to R.M. Silverstein, Inc., a wholly owned corporation of Richard Silverstein, another Private Ledger branch manager who had organized 16 limited partnerships and engaged in a sales campaign to sell those interests to investors).

The issue surrounding the strong sanction for failing to register as a broker-dealer and concealment by a registered representative of his private securities activities from his employer stems from "the requirement that non-exempt broker-dealers register as such is a keystone of the entire system of broker-dealer regulation. An associated person's 'private' securities transactions deprive the public of protection that it is entitled to expect when dealing with a registered broker-dealer, and may expose the firm with which that person is associated to unwarranted risks." In the Matter of Frank W. Leonesio, Exchange Act Release No. 23524; 1986 SEC Lexis 1009 at 16 (Aug. 11, 1986).

26. The 1964 Amendments rationalized and refined the concept of "control" by broker-dealer firms over their sales force by introducing the concept of an "associated person" of a broker-dealer. "An 'associated person' is defined in Section 3(a)(18) of the 1934 Act to include three categories of persons: (i) any partner, officer, director or branch manager of the broker-dealer; (ii) any person directly or indirectly controlling, controlled by, or under the common control with such broker-dealer; and (iii) any employee of such broker-dealer." 14 USC Section 78c(a)(18) (1988). But see, F.S. Mosely & Company, [1970-71 Transfer Binder] Fed. Sec. L. Rptr. (CCH) 78,063 (1971). This term also includes independent contractors. See Alexander C. Dill: Broker-Dealer Regulation Under The Securities and Exchange Act of 1934: The Case Of Independent Contracting, 1994 Colum. Bus. L. Rev. 189 (1994) ("Independent Contracting"). The definition (as modified in 1975), excludes persons whose functions are solely clerical or ministerial for purposes of Section 15(b) of the 1934 Act (except for purposes of Section 15(b)(6), which grants the SEC direct sanctioning authority against associated persons. Id.
the SEC, registration with an SRO, such as the NASD, is required.27

All persons associated with a broker-dealer must be controlled and supervised by that broker-dealer. Supervision and control are viewed as key elements in the regulatory scheme.28 Associated persons are held out to the investing public as representatives of the broker-dealer29 and so as to protect the public, the broker-dealer must supervise and control what is being done by its associated persons. The issue, of course, is the breadth of that supervision and control. It is one thing to supervise and control those activities carried out in its name30 or on its behalf, but it is quite another to extend the broker-dealer responsibility and lia-


28. The SEC has pointed out that the notice requirement of Section 40 of the NASD rules is "not merely to trigger an employer's response, but also to prevent unauthorized transactions and to enable the employer to provide appropriate supervision for transactions that it permits." In the Matter of Zester Herbert Hatfield, Exchange Act Release No. 25488 1988 SEC LEXIS 551 at 6 (Mar. 18, 1988). Moreover, "the purpose of the NASD's interpretation is not merely to prevent customers from being misled as to the employing firms' sponsorship of their salesmen's transactions," but also these NASD interpretations serve the very important functions of protecting employers against investor claims arising from a salesman's private transactions and protecting public investors by ensuring proper supervision of a brokers sales efforts. Anthony J. Amato, 45 SEC 282, 285 (1973). In the Matter of Zester Herbert Hatfield; 1988 SEC LEXIS 551 at 6.

Further relating to the purpose of the NASD's interpretation of Section 40, the SEC has noted that the purpose of the NASD's interpretation is not only to prevent exposure of the employer to investor claims arising from transactions over which it had no control but also to protect public investors by ensuring oversight and supervision of a brokers sales efforts. "Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection of which it is entitled to expect" (emphasis added). Anthony J. Amato, Exchange Act Release No. 10265, 1973 SEC LEXIS 2769 (June 29, 1973).


bility to other activities conducted and regulated by federal regulation, separate and distinct from the 1934 Act.  

(c) Registered Representatives.

Members of the broker-dealer sales force, whether employee or independent contractor, are associated persons of a broker-dealer and must register with the NASD as registered representatives. NASD registration arguably furthers the ability of the NASD to effect its statutorily mandated objective to regulate these market professionals subject to SEC oversight. No such similar self-regulatory scheme exists with respect to investment advisers and/or their associated persons.

2. Investment Advisers, Associated Persons and Advisory Representatives.

(a) Investment Adviser.

Anyone in the business of advising others as to the value of securities or with respect to investing, purchasing or selling secur-

31. This lack of liability presumes no fraud or collusion and that the investor through disclosure has been informed of the distinction in functions and persons responsible for performing each.

32. This is clearly recognized in the broker-dealer/financial institution networking arrangements, both by the SEC and NASD. A broker-dealer has no authority to supervise and control the banking activities of its dually-employed registered representatives. What then explains the extension of SRO oversight and broker-dealer supervision and control over the investment advisory activities of its members' registered representatives? Both activities, banking and investment advisory activities, are subject to regulatory schemes, distinct from that of the broker-dealer activity. While banking activities; however, seem to be exempt from the supervision and control of NASD members, no similar exemption is extended for statutorily regulated investment advisory activity. The NASD mandates through special promulgation that its member broker-dealers supervise the investment activities of its registered representatives who are also separately registered investment advisers. Obviously, the rationale for the foregoing distinction in treatment cannot be rationally attributed to the presence or absence of a separate regulatory scheme. Rather the rationale behind this disparity in treatment of NASD imposed oversight of broker-dealer/investment adviser relationships, but not broker-dealer/banking relationships may better be explained by the SEC's desire "ex cathedra" to do that which it has been unable to achieve legislatively. "... supplement to its own regulatory functions under the [Advisors] Act. ..." Legislation To Amend Investment Advisers Act of 1940 Proposed by Securities and Exchange Commission; Investment Advisers Act Release No. 491, 1975 SEC LEXIS 121 at 2 (Dec. 15, 1975).

ities for compensation is an investment adviser. As with the definitional requirement for the term broker-dealer, to fall within the definitional reach of investment adviser under the Advisers Act requires a regularity of participation in providing investment advice. Regularity does not mean, however, sole, principal or significant. Moreover, as noted earlier, registration as an investment adviser does not obviate the requirement of a person who also with regularity of participation effects securities transactions.

34. Investment adviser means

... any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order. (emphasis added)


36. Applicability of the Investment Advisors Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Rel. No. 1092 1987 SEC LEXIS 9487 (Oct. 8, 1987); Private Ledger, SEC No-Action Letter, 1989 SEC No-Act LEXIS 1152 at 1 (Nov. 17, 1989) (where the staff noted that "... advising others need not be the sole or principal business of a person in order for the person to be an investment adviser").
from registering as a broker-dealer. Of equal force, however, is the fact that registration as a broker-dealer under the 1934 Act does not obviate the need to register under the Advisers Act if the broker-dealer or its associated persons engage in investment advisory activities other than on an incidental basis.

Specifically excluded from this definition of investment adviser and, therefore, registration as an investment adviser, are broker-dealers whose advisory services are merely incidental and who receive no special compensation for these incidental advisory services. This exclusion is equally applicable to any regis-


38. Section 202(a)(11)(c) excludes from the definition of investment adviser "any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore." "Solely incidental" and "special compensation" are key terms in this exclusion. Accordingly, broker-dealers who also manage discretionary accounts or provide advisory services in connection with formulating a financial plan and matching securities products to implement that financial plan would not be considered merely incidental and registration of such broker-dealers as investment advisers would be required. Applicability of the Investment Advisors Act to Certain Brokers and Dealers, Exchange Act Release No. 15215; Investment Advisors Act Release No. 6401, 1978 SEC LEXIS 575 (Oct. 5, 1978). Additional activities not considered solely incidental are advisory services offered as part of overall plan to assess the financial situation of a customer and formulate a financial plan as well as investment services or other investment management services tailored to the specific long-term investment need of individual clients. Townsend and Associates, Inc., SEC No-Action Letter, 1994 SEC No-Act LEXIS 739 (Sept. 21, 1994).

This exclusion from investment adviser registration was included in the Advisers Act because broker-dealers routinely give investment advice as part of their brokerage activities, yet are already subject to extensive regulation under the 1934 Act and possibly state law. As a consequence, Congress determined that if a broker-dealer did not give investment advice other than in the ordinary course of its brokerage business (determined by the "solely incidental" and "special compensation" elements), the additional regulation of the Advisers Act was unnecessary." Thomas Lemke and Gerald Lins, Regulation of Investment Advisers, 1-9 (1996).

39. Special compensation is interpreted to mean a "clearly definable charge for investment advice". According to the SEC's General Counsel, "the essential distinction in considering borderline cases is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental." SEC Inv. Adv. Act. Rel. No. 2. The General Counsel also stated that "when a charge is made only to customers to whom advice is given, the charge constitutes special compensation." Id. See also Townsend, 1994 SEC No-Act LEXIS 739, (No-Act. 2209, 1610, 2016, 2525). A broker-dealer, therefore, may rely on this exclusion of Section 202(a)(11)(C)
tered representative or other employee or independent contractor whose incidental investment advisory activities are subject to control by the broker-dealer.\textsuperscript{40} By contrast, any registered representative who provides advice independent of, or separate from, his broker-dealer employer, may not rely on this incidental exclusion from the definition of an investment adviser.\textsuperscript{41} Reliance on the

under the Advisers Act so long as all of his clients are charged a uniform price, despite the fact that investment advice is rendered and if such advice rendered is solely incidental to the conduct of the broker-dealer's business. A broker-dealer, however, was required to also register as an investment advisor where the broker-dealer received a fee in connection with an arrangement whereby a registered investment adviser provided portfolio management services to the broker-dealer's customers. Reinholdt & Gardner, 70-71 Fed. Sec. L. Rptr. (CCH) 78,120 (1970).

“The focus of the ‘solely incidental’ element is on the nature and amount of the investment advice the broker-dealer provides to clients in its brokerage capacity. While the requirements of this element have not been specifically defined, the SEC has indicated generally that investment advice offered as apart of an overall financial plan for the client is not considered ‘solely incidental’ to brokerage, whereas investment advice on individual securities transactions is.” Investment Advisors Act Release No. 471, 1975 SEC LEXIS 980 (Aug. 20, 1975).

40. Private Ledger, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 1152 (Nov. 17, 1989) at 2. “Incidental” in this context means providing advisory services within the scope of one’s employment with a broker-dealer. Applicability of the Investment Advisors Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, 1987 SEC LEXIS 3487, Investment Advisors Act Release No. 1092 (Oct. 8, 1987). Presumably, the extension of this exclusion is premised not only on the control of the broker-dealer, but also that the investment advisory activities of the registered representative are conducted, on behalf of the controlling broker-dealer and are themselves incidental. Accordingly, the SEC staff opined to an inquiring registered representative that “. . . if you provide information to your clients regarding investment in foreign securities with the knowledge and approval of a broker-dealer employer as part of your regular broker-dealer business, and do not receive any special compensation for the giving of such advice, you would not be required to register with the commission as an investment adviser.” (emphasis added). Private Ledger, SEC No-Action Letter, 1985 SEC No-Act LEXIS 1152 at 2. See also Professional Education and Planning Alliance, 1989 SEC No-Act. LEXIS 826 (July 18,1989).

41. Professional Education and Planning Alliance, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 826 (July 18, 1989). “While the broker-dealer exclusion is silent regarding the status of a broker-dealer's registered representatives, the SEC staff has clarified that a registered representative may rely on the broker-dealer exclusion provided that the representative (1) is giving investment advice within the scope of his employment with the broker-dealer, (2) such advice is solely incidental to the employer's brokerage activities, and (3) there is no special
incidental exclusion in the foregoing instance is not appropriate since the investment advisory activities, are distinct from the services rendered on behalf of the broker-dealer (i.e., not merely incidental to those services), and, according to the SEC would not be subject to control by his/her broker-dealer employer. 42

Similarly, the staff has suggested that separate Advisers Act registration is required if the registered representative’s investment advisory activities are: (1) conducted without the knowledge of . . . [the] employer broker-dealer, (2) conducted with the knowledge but without the approval of . . . [the] employer broker-dealer, or (3) conducted independently of . . . [the] broker-dealer. . . 43

compensation for the advice.” See Institute of Certified Financial Planners, SEC No-Action Letter (Jan. 21, 1986); Regulation of Investment Advisers at 1-10.

42. “Thus, if a registered representative provides advice independent of, or separate from, his broker-dealer employer, by establishing a separate financial planning service or otherwise, he or she may not rely on the exclusion in Section 202(a)(11)(C) with respect to those investment advisory activities because such activities would not be subject to control by his or her broker-dealer employer.” (emphasis added). Regulation of Investment Advisers at 1-10. “If the advice is provided separately from the representative’s employment with the broker-dealer, or without the broker-dealer's approval, the exclusion is not available to the representative.” Elmer D. Robinson, SEC No-Action Letter (Dec. 6, 1985); Amherst Financial Services, Inc., SEC No-Action Letter (May 23, 1995); Regulation of Investment Advisers at 1-10. A registered representative whose relationship to a broker-dealer is that of an independent contractor can give advice about securities in reliance on the broker-dealer exclusion only if these activities are supervised by the broker-dealer. Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, President, NASD, SEC No-Action Letter (June 18, 1982); Regulation of Investment Advisers at 1-10.

43. Elmer D. Robinson, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1610 (Jan. 6, 1986). The staff earlier noted that:

If you, as a financial planner not supervised by the broker-dealer for whom you act as a registered representative, give advice more involved than a mere discussion in general terms of the advisability of investing in securities in the context of a discussion of economic matters or the role of securities investments in a client’s overall financial plan, or discuss, more frequently than on rare and isolated instances, the advisability of investing in, or issue reports or analyses as to, specific securities or specific categories of securities (e.g., bonds, mutual funds, technology stocks, etc.), you would be required to be registered as an investment adviser even if the compensation for such service is only a share, as a registered representative, of any brokerage commissions paid by the client on the purchase of mutual fund shares or private or public offerings.

Requiring registration under the Advisers Act in each of the foregoing instances is rational; indeed, mandated by the regulatory shibboleth. Also imposing the employer broker-dealer supervision over the separately regulated investment advisory activities, however, is not. These functions are acknowledged to be different


44. See In the Matter of J. Frederick Keaton, Exchange Act Release No. 31082 1992 SEC LEXIS 2002 (Aug. 24, 1992) (The SEC reviewed the NASD finding that Keaton, a registered representative of Martin Nelson and Co., Inc., a registered broker-dealer and NASD member, because of Keaton's participation in private securities transactions without giving the broker-dealer prior written notification. While employed by MNC, Keaton organized 8 limited partnerships, only the last 3 of which are challenged as outside the scope of his employment and failing to give notice. With respect to partnerships 1-5 transactions involving the partnerships generated commissions for both Keaton and the firm. No commissions, however, were generated as a result of transactions interests in partnerships 6-8 and Keaton never disclosed his activities in these latter partnerships to MNC.).

It was found that Keaton failed to comply with Section 40 of the NASD Rules of Fair Practice. The SEC noted that "Keaton plainly went beyond a failure to follow the letter of the rule. He knowingly deceived his employer, subverting safeguards that are essential to the securities industry's regulatory scheme. Outside sales activities, even if uncompensated, exposed investors to possible losses and employers to possible liability. A securities firm, through which salesman are registered for the protection of the public, must protect investors as well as itself through supervisory measures that impose conditions on a salesman's employment. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573-4 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991). To implement and enforce those measures, the firm must be apprised of any associated person's outside involvement in securities transactions. Keaton, 1992 SEC LEXIS 2002 at 4. It is important to note, however, that the SEC's potential harm arose from undisclosed and, hence, unmonitored outside sales activities but pointed to the fact that the partnership agreement may have given investors the false impression that MNC was behind the sales as it listed the address of MNC as that of the partnership and that stock certificates would be held in safekeeping by MNC. Also of note is the distinction between NASD Rules 40(c) and 40(d). Rule 40(c) addresses private securities transactions for which the salesman may receive selling compensation while Section 40(d) deals with transactions without sales compensation and provide that the employer may, at its discretion, require the associated person to adhere to specified conditions in connection with his participation in the transaction. The SEC noted that this latter reference to restrictions may embrace a total prohibition. In the Matter of Richard J. Greulich, Exchange Act Release No. 27896 1990 SEC LEXIS 671 (Apr. 11, 1990) (a number of issues of interest were addressed: (1) the issue of whether or not the prohibition against double jeopardy prohibited two private organizations such as the NASD and New York Stock
both by statute and the SEC.\textsuperscript{45} Imposing broker-dealer supervision and control here is inconsistent with the shibboleth and creates a real statutory dilemma. By exerting such supervision and control, is not this broker-dealer engaging in investment advisory services, using the RR/RIA merely as a conduit in violation of Advisers Act Section 208(d)? What should the RR/RIA do if the supervising broker-dealer tells him/her to conduct his/her investment advisory business in a manner the RR/RIA believes incompatible with the Advisers Act? Broker-dealers, not also registered as investment advisers, are not competent to supervise a registered investment adviser or its associated persons in the conduct of their regulated investment advisory business.

Once a registered representative's investment advisory activities are separate and distinct from his/her broker-dealer triggering investment adviser registration, broker-dealer supervision and control should no longer be permitted or required. The investment advisory activities should be: (1) governed by the Advisers Act, not by the broker-dealer; and (ii) should be controlled by the RIA, not the broker-dealer. Indeed, any broker-dealer so supervising and controlling should raise concerns of whether or not such broker-dealer is conducting an investment advisory business indirectly through the RR/RIA in violation of the regulatory shibboleth and Section 208 (d) of the Advisers Act.

\textbf{(b) Associated Persons.}

As with the 1934 Act, persons performing investment advisory services must register under the Advisers Act or be subject to the supervision and control of the RIA.\textsuperscript{46} Those persons subject to RIA supervision and control are its associated persons (officers, directors, partners, employees and other persons in control relationship with the adviser)\textsuperscript{47} and advisory representatives.\textsuperscript{48} So

\textsuperscript{45} See, e.g., F.S. Mosely & Co., 70-71 Fed. Sec. L. Rptr. (CCH) ¶ 78,063.

\textsuperscript{46} Separate registration under the Advisers Act for an employee of an RIA is unnecessary and inappropriate when his advice is provided solely on behalf of the employer RIA. Bruce David Tyler, 1978 CCH Fed. Sec. L. Rptr. 81,683 (1978).

\textsuperscript{47} Ms. Corrinne E. Wood, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2028 (Apr. 17, 1986). The term "person associated with an investment adviser" means any partner, officer, or director of such investment adviser (or any person

---

Published by Scholarly Repository @ Campbell University School of Law, 1997
performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of Section 203 of this title (other than subsection (f) thereof, persons associated with an investment adviser whose functions are clerical or ministerial shall not only be included in the meaning of such term. The commission, may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser. The SEC staff has interpreted the term “employee” for purposes of the foregoing definition to include independent contractors whose activities are controlled by a registered investment adviser. Id.

48. The term “advisory representative” under Rule 204-2(a)(12)(ii)(A) means:

any partner, officer or director of the investment adviser; any employee who makes any recommendation, who participates in the determination of which recommendation shall be made, or whose functions or duties relate to the determination of which recommendation shall be made; any employee who, in connection with his duties, obtains any information concerning which securities are being recommended prior to the effective dissemination of such recommendations; and any of the following persons who obtain information concerning securities recommendations being made by such investment adviser prior to the effective dissemination of such recommendations or of the information concerning such recommendations: (i) any person in a control relationship to the investment adviser; (ii) any affiliates person of such controlling person; and (iii) any affiliated person of such affiliated person.

Rule 204-2(a)(12)(ii)(A) of the Advisers Act. The distinguishing factor between the definition of an associated person and of an advisory representative focuses upon the relationship between the actor and the conduct in which he engages. In contrast, the basis of the term associated person, rests predominantly upon the mere connection, or relationship, of the actor in respect to the investment adviser.

Rule 204-2(a) of the Advisers Act imposes record-keeping with respect to advisory representatives. The purpose of this record keeping is to expose and deter improper trading practices violative of the fiduciary duty of RIA’s owed to their clients, such as scalping, illegal “soft dollar arrangements” and other brokerage practices that might create conflicts of interest. Investment Advisers Act Release No. 203, 1966-1967 Fed. Sec. L. Rptr. (CCH) ¶77,401 (Aug. 11, 1966); Aetna Realty Investors, Inc. (July 11, 1986). No record keeping is required of advisory representatives’ personal securities transactions in shares of unaffiliated opened funds. Similarly, the SEC staff excused record keeping requirements with respect to certain so-called “Outside Limited Partners” who were analogized “. . . to an incorporated investment adviser’s non-controlling shareholders, who are not included within the definition of advisory representative unless they also have another relationship with the adviser that is specified in the rule.” W.R. Huff Asset Management Co., L.P., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 669 (Aug. 10, 1994). The Commission adopted Rule 204-2(a)(12) as a means of preventing “scalping” which it described as a practice whereby an investment adviser, or any person who obtains information
long as the activity is conducted by an SEC registered entity or controlled by such SEC registered entity, the desired regulatory scheme is achieved. No additional oversight is warranted, legislatively or otherwise. Moreover, the RIA, not the broker-dealer, should control the investment advisory activities of its associated persons; no further control should be required. Persons dually registered or acting as dual agents, both for the RIA and another, raise anti-fraud and disclosure issues, not registration or control issues. 49 Registration and control issues should not be confused with disclosure and anti-fraud issues.

III. CONSEQUENCES OF SATISFYING THE DEFINITION.

Generally, anyone satisfying the statutory definitions of either a broker-dealer or investment adviser must register as such under the applicable statutory scheme, the 1934 Act or Advisers Act, or be an associated person, subject to the supervision and control of the applicable registered entity. And, as noted above, registration under the 1934 Act does not obviate registration under the Advisers Act.

49. The only control issue raised is whether or not the RIA will permit their respective associated persons to act contemporaneously for another or be independently registered as a broker-dealer or RR, but control by a non-registered entity under the Advisers Act should not also extend to the conduct of these independent activities carried on pursuant to a separate regulatory scheme.
1. Register or Be Subject to the Control of the Registered Entity.

(a) Broker-Dealer

Any person who meets the definition of a broker-dealer under the 1934 Act must register as a broker-dealer or be an associated person of a broker-dealer.\(^{50}\) This exemption from registration for natural persons associated with a broker-dealer; however, is not applicable where this associated person engages in securities transactions outside the scope of his/her employment with the registered broker-dealer. If the associated person engages in these independent securities transactions, s/he must separately register as a broker-dealer.\(^{51}\)

(b) Investment Adviser

Similarly, any person who meets the definition of an investment adviser under Section 202(a)(11) of the Advisers Act must register with the SEC unless otherwise excluded, exempt, or subject to the supervision and control of the RIA.\(^{52}\) And, by definition


Section 40 has also been extended to apply to a situation where a registered representative assisted an issuer in reacquiring its securities, see, e.g., Roth, 1992 SEC LEXIS 2006, and an indemnification agreement offered by a registered representative in connection with the pledge of stock. See, e.g., William D. George, Exchange Act Release No. 17136, 1980 SEC LEXIS 762 (Sept. 8, 1980). In other words, the emphasis seems to have shifted from the phrase "securities transaction" to the word "transaction". The SEC has stated that a duty exists under Section 1 of the NASD Rules of Fair Practice "... to report to an employer certain non-securities transactions." In the Matter of William Louis Morgan, Exchange Act Release No. 32744, 1993 SEC LEXIS 2027 at 7 (Aug. 12, 1993) (emphasis added).

\(^{52}\) The following persons need not separately register as an investment adviser:

(i) persons excluded from the definition such as a broker-dealer whose advisory services are "solely incidental" to its brokerage business and receives no special compensation for such services; or

(ii) is exempt from registration, or,
one is deemed under control of an RIA "if it performs investment advisory services on behalf of, and under the supervision or oversight of, the [RIA]."\(^\text{53}\) If one performs investment advisory services independent of the RIA, s/he must register under the Advisers Act.

2. **Duties and Liabilities.**

Whether a registered broker-dealer\(^\text{54}\) or RIA,\(^\text{55}\) each has the statutory responsibility to supervise and control their respective

---

(iii) is controlled by an RIA and, thus, an associated person of an RIA. See Ms. Corinne E. Wood, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2028 (Apr. 17, 1986).


(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer of it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940 . . . the rules or regulations under any of such statutes . . . or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. (Emphasis added.) For purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.


Published by Scholarly Repository @ Campbell University School of Law, 1997
sanctioned only if the firm was found to have committed a violation, and the 
supervisor was found to have been the “cause” of the firm’s violation. See, e.g., 
Reynolds & Co., 39 SEC. 902 (1960). The only sanctions available to the 
Commission for such violations were suspensions or revocations of registration, 
and these sanctions were generally brought against firms, not the supervisors 
themselves. In 1963, the Special Study of the Securities Markets noted the need 
for greater supervision by broker-dealers over their increasingly far-flung branch 
offices and salespersons. See Report of the Special Study of the Securities 
(1963), pt. 1 at 290-91, 328. The Commission then requested greater authority 
from Congress to proceed directly against individuals for failures to supervise. 

15 U.S.C.A. § 780(b)(4)(E) and (b)(6) of the Exchange Act were adopted as a 
result of the Special Study. (These sections include language that allows the 
Commission to sanction broker-dealer employees for “failing to reasonably 
supervise” a person who commits a violation, with the important protection for 
the supervisor that the violator must be subject to that employee’s supervision. 
The “safe harbor” provisions of 15 U.S.C.A. § 780(b)(4)(E) add that if a supervisor 
has reasonably discharged the appropriate supervisory duties under procedures 
established by the brokerage firm, and has no reason to believe that such 
procedures were not complied with, the supervisor cannot be charged with 
failure to supervise. Unfortunately, Congress did not specify what it meant by 
the phrase “subject to the supervision”. At a minimum, the phrase has been 
interpreted to mean both that the Commission is limited as to whom it can 
sanction for failure to supervise, and that Congress and the Commission 
intended that the brokerage community move toward more self-regulation.). The 
Commission then stated that the duty of supervision could not be avoided by 
pointing to the difficulties involved where facilities were expanding or by placing 
the blame upon inexperienced personnel or by citing the pressures inherent in 
the Commission reemphasized the importance of self-regulation it had stated in 
earlier cases. See In the Matter of Universal Heritage Investments Corp., 
Exchange Act Rel. No. 19308, 1982 SEC LEXIS 210 (December 8, 1982); In the 
LEXIS 2434 (Jan. 19, 1982); Reynolds & Co., 39 SEC. 902, 916 (1960). In large 
organizations it is especially imperative that those in authority exercise 
particular vigilance when indications of irregularity reach their attention.

Self-regulation was also a key component of the Commission’s 1985 case, In 
the Matter of Smith Barney, Harris Upham and Co., Inc. and Robert G. Heck, 

55. Sections 203(e)(5) and 204A of the Advisers Act is the statutory basis of 
the requirement of supervision and control. Section 203 (e)(5) empowers the SEC 
to sanction any person who:

has willfully aided, abetted, counseled, commanded, induced, or 
procured the violation by any other person of any provision of the 
Securities Act of 1933, the Securities Exchange Act of 1934, the 
Investment Company Act of 1940, this title, the Commodity Exchange 
Act, the rules or regulations under any of such statutes, or the rules of 
the Municipal Securities Rulemaking Board, or has failed reasonably to
associated persons. Liability is unlikely where the control person did not know, nor have reason to know, in the exercise of due care in the selection and supervision of his/her employees, of the employee's action(s) or inaction(s). Notwithstanding the forego-

supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph (5) no person shall be deemed to have failed reasonably to supervise any person, if—

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.


"An adviser's or broker-dealer's officers and employees - including attorneys and compliance personnel - may be sanctioned for failure to supervise others. Unfortunately, the SEC has not clearly delineated when a person or officer is in a 'supervisory' position. Rather, this is a facts-and-circumstances determination which turns upon the degree of responsibility, ability or authority of the supervisory person to affect the conduct of the wrongdoing employee." In the Matter of Exchange Act Release No. 31554, 1992 SEC LEXIS 2939 (Dec. 3, 1992), Regulation of Investment Advisors at 2-89.


ing, however, where the controlling person benefits from the improper acts of his/her agents, even if unaware of these acts, liability may attach. On the other hand, where the activity engaged in is not in the name of, or on behalf of, the employer and the employing broker-dealer or RIA, as the case may be, does not benefit, how can responsibility or liability be reasonably imposed upon such employing broker-dealer or RIA? Indeed, liability should not attach for the actions of one who is separately registered and engaged in activities, not carried on in the name of or on behalf of the employer broker-dealer or RIA, as the case may be. Moreover, even if a controlled person is not registered under a separate federal regulation, the issue should be disclosure sufficient to avoid confusion and misleading the public. The purpose of requiring supervision and control is to prevent violation of the federal securities laws. In addition to this statutorily-mandated

(Where SEC staff opined that broker-dealer consent required in order for his/her registered representative to register as an RIA under contract law or otherwise).


59. See Huaser v. Farrell, 14 F.3d. 1338 (9th Cir.) (broker-dealer held not liable under the federal securities laws or respondeat superior for misrepresentations of its registered representatives in connection with an investment which was not a promotion of the broker-dealer and investors could not reasonably have believed the broker-dealer had anything to do with that promotion).

60. See, e.g., Harrison v. Dean Witter Reynolds, Inc., 89-90 CCH Fed. Sec. L. Rptr. ¶ 94,760 (N.D. Ill. June 27, 1989) (where liability under respondeat superior was not imposed because of the lack of the fact finder's finding that the fraud was perpetrated within the scope of the employees' employment). See also Safeco Securities, Inc., 45 SEC. 303 (1973) (where the SEC overruled the NASD's earlier findings against a member firm stating that the investment club in which the registered representative had no connection with his broker-dealer firm's business and the broker-dealer was not a member of the investment club (i.e. the investment club was outside the scope of his employment with the broker-dealer and therefore, the broker-dealer had no duty to supervise.)).

61. To assist this broker-dealer supervision and control is the RR notice provision of Article III, Sections 40 and 43 of the NASD Rules of Fair Practice. According to the SEC, "[The duty of a member firm's employee to inform his employer regarding certain private securities transactions is both longstanding and essential. It protects the firm from exposure to loss and litigation, and investors from the hazards of unmonitored sales. The obligation arises under the general ethical considerations of Section 1 and under the specific requirements of
supervision and control requirement, broker-dealer members of the NASD must also comply with the NASD imposed requirements and procedures.\(^\text{62}\) There is no such comparable dual regulatory oversight statutorily imposed on registered investment advisers, albeit, as noted here, some registered investment advisers are subjected to the SRO broker-dealer oversight of the NASD.\(^\text{63}\)

Expanding the supervision and control responsibilities of broker-dealers in no-action positions and by means of its power over NASD rule-making, the SEC has conscripted 1934 Act broker-dealers and enlisted the NASD, a self-regulatory organization

Section 40." In the Matter of William Louis, Exchange Act Release No. 32744; 1993 SEC LEXIS 2027 (Aug. 12, 1993). \textit{But see} In the Matter of Zester Herbert Hatfield, Exchange Act Release No. 25488; 1988 SEC LEXIS 551 at 4 (March 18, 1988) (where the SEC refers to concerns related to a salesman's "private transactions"). Moreover, there is also a shift from effecting the securities transaction to playing a "substantial role" in the sales of securities, In the Matter of the Application of Allen S. Klosowski, Exchange Act Release No. 25467; 1988 SEC LEXIS 507 at 2 (March 15, 1988) (where a violation of Section 40 was found where the registered representative had referred clients to a sponsor of limited partnerships, but did not handle the resulting sales), or the matter being "inextricably linked to a securities transaction." In the Matter of William D. George, Exchange Act Release No. 17136, 1980 SEC LEXIS 762 (Sept. 8, 1980).


63. There is no comparable self-regulatory organization for investment advisers. Indeed, although there have been proposals or calls for an agency comparable to the NASD to regulate investment advisers, to-date no such self-regulatory authority has been approved. Even if these proposals or calls evidence a need, this need does not warrant assertion of jurisdiction over Advisory activities by the NASD since neither it nor its members are necessarily experienced or skilled in bringing to bear the level, scope or breadth of accountability necessary or appropriate to investment advisory activities. Moreover, for NASD member firms to assert authority and power over the investment advisory activities of their registered representatives may obviate the present exclusion for broker-dealers from the definition of investment adviser under the Advisers Act, thus requiring that they themselves become separately registered as investment advisers.
established under the Exchange Act, not the Advisers Act, to assert oversight jurisdiction over investment advisory activities separately registered under the Advisers Act of persons dually registered as RIAs, individually or through separately incorporated entities, and registered representatives. Not only is this a usurpation of authority, but it also cloaks supplementary regulatory authority and responsibility on a brokerage firm to regulate an investment advisory function, more suitably subject to the control of the RIA, registered under the Advisers Act. Moreover, any broker-dealer asserting this authority should raise both the issue of the continuing applicability of Advisers Act Section 202(a)(11)(C) exclusion as well as the concern over structural arrangements in which the RIA is used merely as a conduit for an unregistered entity in violation of Advisers Act Section 208(d).

And, if the foregoing issues and concerns were not enough, the additional concern of the resulting uneveness in regulation of investment advisory activities is extant. For only RR/RIA arrangements have not only SEC oversight, but also the supplementary oversights of 1934 Act entities. This is not good policy and is inconsistent with the regulatory shibboleth.

As noted above, persons in control of others have liability for the action(s) or inaction(s), conducted on their behalf or in their names, by these controlled persons under the federal securities laws or the common law. Accordingly, RIAs must supervise

64. Imposing the requirement of notice as required under Article III, Sections 40 and 43 is eminently reasonable and the supervisory broker-dealer then exercising control by approving or disapproving is also consistent with the regulatory shibboleth. Requiring broker-dealer supervision and control over any separately regulated activity for which the RR has registered does not, however, make sense.

65. Broker-dealers are specifically excluded from the definition of investment adviser under the Advisers Act and, thus, registration under the Advisers Act so long as their investment advisory activities are "incidental".

66. Generally, any person who has the power by agreement, stock ownership, or otherwise, to control the direction, management or policies of another is a controlling person. Kennedy v. Tallant, Fed. Sec. L. Rptr. (CCH) 95, 779 (1976).

The good faith requirement of Section 20 has been interpreted to be satisfied when it is "shown that the controlling person maintained and enforced a reasonable and proper system of supervision and internal control over controlled person so as to prevent, as far as possible violations of Section 10(b) and Rule 10(b)(5)." Zweig v. The Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir.), cert denied, 423 U.S. 1025 (1975).

67. If investment advisory activities are not conducted in the RIA's name, additional RIA registration is required by the person performing these services.
The regulatory concern whenever a registered representative engages in activities outside the scope of his employing broker-dealer is that "the public is deprived of protection which it is entitled to expect". Moreover, in such an instance, if the outside business activities involved effecting securities transaction, because the activities are not conducted for or on behalf of the employing broker-dealer, the registered representative would acting in violation of the 1934 Act registration requirements unless such registered representative separately registered under the 1934 Act. Only where the registered representative/associated person is conducting activities, on behalf, of his employing broker-dealer, is such a registered representative exempt from registration requirements of Section 15(a)(1) of the 1934 Act. See generally In the Matter of Gordon Wesley Sodoroff, Exchange Act Release No. 31134; 1992 SEC LEXIS 2190 at 21 (Sept. 2, 1992); Private Ledger, SEC No-Action Letter, 1990 SEC No-Act LEXIS 1221 at 5 (Sept. 5, 1990); Hunt v. Miller, 1990 Fed. Sec. L. Rptr. (CCH) 95, 392 (July 18, 1990); In the Matter of Kemper Financial Services, Inc., Investment Advisors Act Release No. 1387, [1993 Transfer Binder] Fed. Sec. L. Rptr. (CCH) 85, 237 (Oct. 20, 1993). Violations of Section 15(b)(4)(E) and 15(b)(6)(A) are predicated on a violation of the federal securities laws by a person associated with a broker-dealer and under the supervisory jurisdiction of that broker-dealer supervisory principals or staff. The elements of proof necessary in finding a violation are:

1. An underlying securities law violation;
2. Association (employment) of the registered representative or other person who committed the violation;
3. Supervisory jurisdiction over that person; and
4. Failure of the broker-dealer and/or supervisory personnel to reasonably supervise the person who violated the securities laws, with the standard of reasonableness being whether supervision was conducted with a view to preventing violations of the securities laws.

The so-called safe harbor provision of Sections 15(b)(4)(E) and 15(b)(6)(A) provide that a broker-dealer or associated person shall not be deemed to have failed reasonably supervise if procedures and a system for applying those procedures have been established which "would reasonably be expected to prevent and detect, insofar as practicable, any such violation" and the person as "reasonably discharged the duties and obligations incumbent upon him . . . without reasonably cause to believe that such procedures and systems were not complied with." Exchange Act, Section 15(b)(4)(E) 1-2. The standard of reasonableness applicable to remedial actions for failure to supervise under Section 15(b) is measured as "reasonable supervision under the attendant circumstances" Arthur James Huff, 48 SEC Docket 878, 883 (1991) (citing Louie R. Trujillo, 43 SEC Docket 690, 695). It is important to note that the SEC acknowledges that the factual analysis required to determine whether supervision is or is not reasonable is not res ipsa loquitur or strict liability (i.e., whereby the finding of an underlying violation requires a finding of failure to supervise). The Congress in adopting the supervision provision stated: "[because of the provisions Section 15(b)(4)(E) 1-2 of the Exchange Act] a supervisory employee is . . . not an absolute guarantor of the conduct of those whom he has the power to supervise." S. Rep. No. 379, 88th Cong., First Session (1963).
and control their associated persons and, if they fail do so, may have liability for such persons actions and inactions. Similarly, RRs are controlled by their employing broker-dealer and, accordingly, that broker-dealer may have liability for the action(s) or inaction(s) of such employed registered representatives. The

On its face, the broker-dealer supervision statute provides a much “clearer statement of the applicable standard, namely whether a broker-dealer or associated person has ‘failed reasonably to supervise, with a view to preventing violations of the provisions of the securities statutes and rules, another person who commits such a violation . . . unless ‘there have been established procedures and a system of applying such procedures which could reasonably be expected to prevent and detect, insofar as practicable, any such violations by such other person.’” Exchange Act, 15 U.S.C.A. 780(b)(4)(E). Under Section 780(b), the court must only determine whether the supervisory procedures in system of applying those procedures could have reasonably been expected to prevent and detect fraudulent activities. Accordingly, only under Section 20(a) controlling person liability determinations is it appropriate to determine whether supervision would have prevented the loss. SEC v. Lums, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973) (where the brokerage house was not held liable when the court could not construct any system of supervision that would have prevented the injury that occurred).

In assessing sanctions for violation of Section 15(b)(4)(E), due regard must be given to the facts and circumstances of each case since sanctions are not intended to punish but rather to protect the public from future harm. Berko v. SEC, 316 F.2d 137, 141 (2d Cir. 1963); Leo Glassman, 46 SEC 209, 211 (1975). Sanctions, however, should also serve as a deterrent to others. Richard C. Spangler, Inc., 46 SEC 238, 254 N.67 (1976). The following factors are often considered when imposing administrative sanctions:

“... the egregiousness of the defendant’s actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant’s assurances against future violations, the defendant’s recognition of the wrongful nature of his conduct, and the likelihood that his occupation will present opportunities for future violations.” Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff’d. 450 U.S. 91 (1981).

68. Respondeat superior, for example, is a common law doctrine which may result in liability to the employer occasioned by an action or inaction of his/her employee. See, e.g., Carroll v. John Hancock Distributors, Inc., 93-94 Transfer Binder Fed. Sec. L Rptr. (CCH) 98,200 (March 14, 1994) (where the court stated that the employer broker-dealer, who failed to supervise, could be liable under respondeat superior for securities fraud perpetrated by its employees). The imposition of broker-dealer liability is justified on the basis of the duty owed by the broker-dealer to supervise in an adequate and reasonable manner its registered representatives. Isaacs v. Chartered New England Corp., 378 F. Supp. 370 (S.D.N.Y. 1974).

69. The imposition of broker-dealer liability under the federal securities laws is justified on the basis of the duty owed by the broker-dealer to supervise in an adequate and reasonable manner its registered representatives. Isaacs, 278 F. Supp. 370.
question, of course, is under what circumstances does or should liability attach to an RIA or broker-dealer for the separate and distinct regulated activities of their respective associated persons conducted independently and pursuant to registration under other federal statutes. Achieving consistency in answers to this question is elusive. SEC staff holdings, as highlighted above and discussed below, in RIA networking and other strategic alliance relationships is varied. The difficulty seems in the consistent SEC staff application of the simple truths of the regulatory shibboleth and Section 208(d), principally in the contexts of RR/RIA and RIA/financial institution arrangements. But why there is difficulty is not easily explained. If the registered representative engages in outside business activities which do not involve effecting securities transactions or the RIA associated person engages in non-advisory services, and assuming disclosure and no fraud, are not the foregoing regulatory concerns addressed. All activities governed by the 1934 Act or the Advisers Act, as the case may be, would be performed consistent with the statutory mandate. Notwithstanding this compelling simplicity, the SEC and the NASD have insisted on extending a broker-dealer's supervision over non-brokerage advisory activities of RR/RIAs through Section 40 of the NASD Rules of Fair Practice and the SEC staff has wiggled and waffled on the degree of RIA control required depending upon the alliance being forged.

Regulated activities governed by distinct federal registration appears to explain the duality permitted in broker-dealer/financial institution networking arrangements without requiring broker-dealer supervision over financial institution-type activities. The regulatory emphasis here is on avoiding public misperception, remedied by disclosure and the like. For whatever reason, these same regulators in RR/RIA and RIA/financial institution situations confuse regulation and control concerns with disclosure, deception, public misperception and other anti-fraud concerns. When investment advisory activities are supervised and controlled only by an RIA, notwithstanding any duality extant between the RIA and a broker-dealer and/or RIA/financial institution, the objectives of the regulatory shibboleth and the statute

---

70. Section 202(a)(ii)(A) excludes banks and bank holding companies from the definition of investment adviser.

are effected. No regulated entity is being used merely as a conduit; and no regulated activity is being conducted, or supervised, by an unregistered entity.

If the investment advisory activities conducted by the associated person or advisory representative of an RIA, on its behalf or in its name, are supervised and controlled by the RIA, why should any non-RIA (i.e., broker-dealer) supervision be required? Further, why should RIA's responsibilities extend to non-advisory services of that controlled person (i.e., banking)? Why is sole RIA control insisted upon in RIA/financial institution networking arrangements, but not in instances involving dual agents who serve both as broker-dealer and an RIA (RR/RIA)? Indeed, in this latter instance the SEC staff appears to insist that the RIA yield to the broker-dealer. The issues in these dual relationships and/or networking arrangements should not be control by one registered entity over the activities governed by separate registration, but rather whether the registered entity, broker-dealer or RIA, as the case may be, will permit such duality by its agents and, if so, the requisite disclosure to avoid public misperception. 72 Duality

72. In 1988, the NASD announced the SEC approval of Section 43 of the NASD Rules of Fair Practice, 1988 NASD Notice to Members 86; 1988 NASD LEXIS 207 citing SEC approval in SEC Release No. 34-26178 (Oct. 13, 1988) which provides:

In divining the boundary between Sections 40 and 43, the NASD suggested that all transactions executed on behalf of a client in which the RR/RIA participated would be subject to Section 40. “Transactions executed on behalf of the customer in which the RR/RIA participated in the execution would be subject to the full ‘for compensation’ provisions of Section 40 . . . .” Id. at 7. “Transactions executed without compensation would be subject to the ‘non-compensation’ provision of Section 40.” Id. Investment advisory activities that do not include the RR/RIA’s “participation in the execution” would be subject to Section 43. Id. For example, securities transactions effected by customers through a broker-dealer or mutual fund even if based on specific recommendations of the dually registered RR/RIA would be governed by Section 43, not Section 40. The NASD noted that Section 43, not Section 40, would apply to those. Id. at 8. Similarly, RR/RIA's providing financial plans which do not include specific securities purchase recommendations or executions or who participate in a wrap-fee program where the transactions are not handled by the RR/RIA. Id. at 9. “Some asset management firms offer ‘wrap fee’ programs to registered investment advisers. The ‘wrap fee’ includes a fee for management, accounting, and reporting. This fee is shared with the investment adviser who is also a registered representative. Portfolio transactions are handled through a broker-dealer firm at substantial discounts and are not known to or handled by the RR/RIA. Investment advisers receive a part of the asset management fee only and receive no part of any transaction fee. The adviser is registered with
raises conflict of interest, disclosure and anti-fraud concerns, not supervision and control.

IV. THE POSSIBILITIES OF DUALITY

There is no statutory prohibition against the same person registering as a broker-dealer and investment adviser with SEC and/or serving as a registered representative of a broker-dealer while also being independently registered as an investment adviser. This duality has been accepted by the industry and regulators for some time.

the Sec and any states as necessary. This activity would be subject to Section 43 rather than Section 40 of the Rules of Fair Practice." Id. Each adviser can produce statements for clients based on downloaded information. The RR/RIA receives a portion of the asset-based fee for his or her monitoring of the account. The firm to which the account is referred actually handles all implementation, and the dually registered person has no part in the actual transactions. These third-party arrangements are covered by Section 43. Id. At 11. In each of the foregoing, the RR/RIA did not receive compensation from the effecting of the securities transaction nor handle, directly or indirectly, the execution of any trade. By contrast, where the RR/RIA charged an advisory fee to "time" a group of mutual funds and the exchange of funds was handled by the RR/RIA, the NASD determined Section 40 would apply. Id. at 10. But see where "there are firms offering market timing services where the firm, operating an independent investment adviser, directs the switches within a family of mutual funds, either load or no-load. There are no transaction charges and the investment adviser, also a registered representative, is not involved in handling switches among funds. The dually registered person does receive some part/percentage of the market timing fee. If the customer or timing firm effects the switches with no involvement by the RR/RIA, this fact pattern would be considered as falling under Section 43." Id.

Section 43, not 40, applies so long as the RR/RIA is not involved in implementation or execution of the investment advice. Id. at 11. The issue or the justification behind Section 40 is the NASD and SEC’s view that "by engaging in private securities transactions without [the broker-dealer’s] knowledge, [a registered representative] deprived his customers of the protection they were entitled to expect." In the Matter of Gordon Westley Sodoroff, Jr., Exchange Act Release No. 31334, 1992 SEC LEXIS 2190 at 23 (September 2, 1992). Similarly, it has been held that "where [registered representatives] effect transactions for customers outside the normal channels and without disclosure to the [firm], the public is deprived the protection which it is entitled to expect.” Anthony J. Amato, 45 SEC. 282, 285 (1973). See also In the Matter of Terry Don Wamszan, Exchange Act Release No. 22411; 1985 SEC LEXIS 695 (Sept. 16, 1985) (citing the foregoing approvingly).


74. See Financial Planning Service, 1984 SEC No-Act. LEXIS 2522 at 2 (Aug. 20, 1984) where it was noted:
Similarly, the duality of a registered representative also serving contemporaneously as: an associated person of an RIA; an RIA advisory representative, or an employee of a federal or state banking or savings and loan association has also now been accepted. The key to the permitted duality of a registered representative also serving as an employee of a financial institution appears to be the ongoing supervision and control to be exercised by the broker-dealer over such a dual agent’s performance of brokerage activities. This regulatory position is consistent with the

If you, as a financial planner not supervised by the broker-dealer for whom you act as a registered representative, give advice more involved than a mere discussion in general terms of the advisability of investing in securities in the context of a discussion of economic matters or the role of securities investments in a client’s overall financial plan, or discuss, more frequently than on rare and isolated instances, the advisability of investing in, or issue reports or analyses as to, specific securities or specific categories of securities (e.g., bonds, mutual funds, technology stocks, etc.), you, or [the company], if you provide such advice as an officer of [the company], would be required to be registered as an investment adviser even if the compensation for such service is only (1) a share, as a registered representative, of any brokerage commissions paid by the client on the purchase of mutual fund shares or insurance products that are deemed to be securities under the securities laws, or (2) a share of the sales commissions paid by the client on insurance products not deemed to be securities under the securities laws.

See also Financial Service Corp. Of America, [1974-1975 Transfer Binder] Fed. Sec. L. Rptr. (CCH) ¶80,017 (Oct. 9, 1974).

75. American Capital Equities, Inc., SEC No Action Letter, 1987 SEC No-Act. LEXIS 2328 (Apr. 13, 1987). But note that in American Capital Equities, Inc., the SEC could not assure enforcement action would not be recommended because representatives of broker-dealer were also associated persons of RIA and requested for tax-planning reasons that broker-dealer make all checks representing all commissions earned by associated persons in their capacity as representatives of the broker-dealer be made payable to the RIA rather than to each individual representative; however, RIA retains significant portion of the commission. Gordon Capital, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 3088 (Jul. 3, 1973) and 1976 SEC No-Act. LEXIS 85.


77. Laughlin Group Advisers, Inc., 1992 SEC No-Act LEXIS 361 and Chubb Securities Corporation, 1993 SEC No-Act. LEXIS 1204 (where CSC, a registered broker-dealer, will exclusively control, supervise, and be responsible for all securities business conducted in its locations at the financial institutions);
regulatory shibboleth and common sense! The permissibility of a registered representative also acting as an RIA or associated person of an RIA, however, seems to hinge on the broker-dealer supervising and controlling not only the brokerage activities, but also the investment advisory activities of the registered representative. What can possibly rationalize limiting broker-dealer supervision to brokerage activities in the former instance, but expanding it in the latter? The foregoing non-broker-dealer type activities, banking and investment advisory, are each subject to separate regulation. Registration carries with it the responsibilities of compliance with the statute under which such registration was obtained. No further supervision and control should be required.

Muddying the regulatory waters even further is the inconsistency between SEC staff pronouncements when dealing with broker-dealer/financial institution networking arrangements on the one hand, and RIA/financial institution networking arrangements on the other. In the former, not only are such networking arrangements permitted and broker-dealer supervision and control limited to brokerage activities, but no separate registration of the financial institution is required under the 1934 Act. By con-


78. An individual may be dually registered under the 1934 Act and Advisers Act and a person may be an associated person of both a broker-dealer and registered investment adviser.
trast, when dealing with RIA/financial institution networking arrangements, the SEC staff has insisted upon additional registration under the Advisers Act of the financial institution or, possibly, even the networking arrangement itself, because in these networking arrangements the RIA was viewed as not having sole control.\textsuperscript{79} Sole control is \textit{not} required in broker-dealer/financial institution networking arrangements; why should it be required in RIA/financial institution networking arrangements? Section 208(d) of the Advisers Act can not explain the difference since RIA sole control is not required where the networking arrangement is between an RIA and non-regulated entity, such as a publishing house, or where a registered representative is an associated person of an RIA or separately registered him/herself as an RIA, each as discussed below. Structural arrangements are understandably closely scrutinized to ensure that the RIA is not merely a conduit for advisory services being performed by personnel of an unregulated entity.\textsuperscript{80} If registration and/or control are extant, however, the regulatory shibboleth and Section 208(d) are satisfied and, therefore, the regulatory focus should then shift to disclosure and related anti-fraud concerns.

A brief overview of certain instances in which the SEC staff has considered dual registration and/or persons acting as dual agents as well as the conditions imposed by the SEC staff on structural arrangements, satisfaction of which is required, to garner SEC staff favor illustrates the murkiness of the regulatory waters. The shibboleth of registration or be an associated person, subject to the supervision and control of the registered entity, is extant in the SEC staff’s construction in all of the foregoing instances. The application and results, however, inexplicably differ depending upon whether or not the RIA affiliation is with a broker-dealer, financial institution or other entity. This regulatory inconsistency muddies the regulatory focus.


\textsuperscript{80} Investment Advisers Act Release No. 353 (Dec. 18, 1972; 38 FR 1649, Proposing Rule 202-1.)
A. Dual Registration

1. Being Both A Registered Broker-Dealer and Registered Investment Adviser.

Consistent with the shibboleth, dual registration as an investment adviser and broker-dealer is clearly permitted. Dual registration ensures that the respective regulated activity has submitted and is being undertaken pursuant to the appropriate regulations. Moreover, with dual registration, Section 208(d) is honored, as no person is engaging indirectly in advisory activities without proper registration.

Affiliated arrangements between a broker-dealer parent and investment advisory subsidiary are also permitted. Indeed, notwithstanding the usual control of corporate parent over its subsidiary, the broker-dealer parent was not even required to register under the Advisers Act.

2. Being Both A Registered Representative and A Registered Investment Adviser.

(a) Natural Person Dually Registered.

Similarly, consistent with the shibboleth, there is no prohibition against one serving as a registered representative of a broker-dealer and also being individually and separately registered as an investment adviser under the Advisers Act. Caveats to this arrangement imposed by the SEC staff are: (i) "that the self-regulatory organization of which a broker-dealer is a member have no objection to the proposed arrangement"; and (ii) the broker-dealer (for whom the registered representative acts) would be responsible for supervising the activities of the registered repre-


83. It is not uncommon for registered representatives also to perform investment advisory activities through their own separately incorporated RIA or otherwise. Terwilliger, John, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1769 at 2 (June 27, 1977); Gordon Capital Management, 1973 Fed. Sec. L. Rptr. (CCH) 79,433.

sentative. At what point does broker-dealer supervision and control of investment advisory services of its RR/RIA become the broker-dealer rendering investment advisory services? By this supervision and control is the broker-dealer doing indirectly that which is prohibited without that broker-dealer registering? Clearly, this insistence by the SEC staff is inconsistent with (i) the shibboleth; (ii) the acknowledged statutory distinctness in function between an investment adviser and broker-dealer; (iii) the insistence by this same staff that the RIA exercise supervision and control over advisory services; (iv) Section 208(d)'s prohibition against doing indirectly what it could not do directly without registration under the Advisers Act, namely, provide advisory service; (v) the separateness and independence between an RIA and any affiliate insisted upon by the staff in other RIA structural arrangements; and (vi) the fact that the Advisers Act does not contemplate supervision and control by a broker-dealer or SRO.

85. At one time, registered representatives had to obtain their broker-dealer's consent prior to registration as an investment adviser, as a matter of staff policy. Elmer D. Robinson, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1610 at 2 (Jan. 6, 1986) (where the staff stated that although broker-dealer consent is "... no longer require[d] ... as a matter of policy, ... contract law or other considerations may dictate the same result.")

86. A general partner of a limited partnership was required to register under the Advisers Act where that general partner had responsibility for the partnership's investment advisory services. William M. Ryan, [1970-71 Transfer Binder] Fed. Sec. L. Rptr. (CCH) 81, 507. But see Corbyn Associates, Inc. [1977-78 Transfer Binder] Fed. Sec. L. Rptr. (CCH) 81,252.

87. Although the outside investment advisory activities of a registered representative may be subject to NASD regulation, no similar SRO-imposed regulation is extant for many other non-investment advisory outside business activities of registered representative. See, e.g., Chubb Securities Corporation, 1993 SEC No. Act. LEXIS 1204 (1993). For example, the broker-dealer has no authority to supervise and control the banking activities of its dually-employed registered representatives. What then explains the extension of NASD oversight to the investment advisory activities of its members' registered representatives? Both activities, banking and investment advisory activities, are subject to regulatory schemes, distinct from that of the broker-dealer activity. While banking activities; however, seem to be exempt from the supervision and control of NASD members, no similar exemption is extended for statutorily regulated investment advisory activity. The NASD mandates through special promulgation that its member broker-dealers supervise the investment activities of its registered representatives who are also separately registered investment advisers. Obviously, the rationale for the foregoing distinction in treatment cannot be rationally attributed to the presence or absence of a separate regulatory scheme. Rather the rationale behind this disparity in treatment of NASD imposed oversight of broker-dealer/investment adviser relationships, but
How is it that networking arrangements involving dual agents in the registered representative/financial institution employee context do not require that the broker-dealer supervise and control the financial institution activities of the dual agent? In this latter context, all that is required is broker-dealer supervision and control over the brokerage activities of the dual agent, registered representative/financial institution employee. Why are not broker-dealer supervision and control responsibilities likewise limited in the above-described RR/RIA contexts? The purported SEC staff rationale for the expanded broker-dealer supervision and control over the investment advisory activities of a duly registered representative and RIA is because of the difficulties of separating the functions of a broker-dealer firm from the investment advisory activities of its registered representative. This is poppycock! The activities and functions of a broker-dealer and investment adviser, as envisioned by the statutory schemes of the 1934 Act and Advisers Act, have embraced the distinction and separateness in functions and the staff has acknowledged the same.

Requiring this involvement of the NASD and/or other SRO as well as broker-dealer supervision and control over investment advisory activities of a registered representative is not only inconsistent with the permissible lack of broker-dealer supervision and control over financial institution activities of its dual agents, but is also curious given the disparate statutory treatment of broker-dealer and investment advisory activities and lack of SRO man-

88. Id.
dated under the Advisers Act. Under the Exchange Act, the NASD is charged with regulating the conduct of its broker-dealer members.\textsuperscript{90} Broker-dealers are in the business of effecting securities transactions, \textit{not} providing investment advice.\textsuperscript{91} If a broker-dealer is not providing investment advice or registered as an investment advisor, how can such a broker-dealer supervise one who is? This SEC staff insistence on broker-dealer and NASD jurisdiction could be viewed as nothing more than a veiled attempt to impose supplementary oversight where none has been Congressionally mandated; indeed, has been Congressionally resisted.

\begin{itemize}
  \item \textbf{(b) Registered Representative Also Owner of Separately Incorporated RIA.}
  
  Rather than registering individually as an RIA under the Advisers Act, a registered representative may also register his/her separately incorporated entity under the Advisers Act. Again, such dual registration is consistent with the shibboleth and Section 208(d) and, accordingly, should effect the investor protection envisioned under the applicable federal securities laws. Notwithstanding this dual registration, however, the SEC staff has insisted upon broker-dealer supervision and control even over the RR and his/her separately incorporated RIA.\textsuperscript{92} Such insistence is inconsistent with the shibboleth, register or be subject to the supervision and control of the registered entity and the statutory schemes of the 1934 Act and Advisers Act. Broker-dealer supervision and control is not required; it muddies the regulatory waters. Indeed, this same staff insists upon separateness and independence in other structural and/or networking arrangements. Why should not the same separateness and independence between an RR and his/her RIA insulate the RIA from SEC staff concern? The SEC staff has confused disclosure/anti-fraud concerns with supervision and control issues. This is not to say that the staff has pro-
\end{itemize}

\textsuperscript{90} NASD Rules of Fair Practice are designed to protect investors and to promote just and equitable rules of trade.

\textsuperscript{91} Indeed, if broker-dealers do provide investment advice other than on an incidental basis, these broker-dealers must also register as investment advisers. Moreover, a registered broker-dealer networking with an RIA who receives a portion of the advisory fee must register under the Advisers Act. Reinholdt & Gardner, [1970-71 Transfer Binder] Fed. Sec. L. Rptr. (CCH) 78, 120 (1971).

\textsuperscript{92} \textit{But see} the distinction between Article III NASD Rules of Fair Practice Sections 40 and 43.
hibited structural arrangements where a registered representative also owned a separately incorporated RIA. Indeed, although the contemplated fee arrangement was questioned, the structural arrangement between a registered broker-dealer and a registered investment adviser, all of whose officers, directors, shareholders and employees were also registered representatives of the registered broker-dealer was not questioned. This is surprising given the assertion in this no-action request that the broker-dealer . . . assumes no supervisory responsibility over the financial advisory activities of the RIA. The SEC staff, however, has questioned a like characterization of a division of responsibilities made in another no-action request where a registered representative of a broker-dealer also owned a separately incorporated RIA. There the representative had suggested that he would be solely responsible for the investment advisory activities of his separately incorporated RIA while his broker-dealer would be responsible only for supervising his RR's securities activities effected through the broker-dealer. In response to that characterization, the SEC noted that Article III, Section 40, of NASD's Rules of Fair Practice and its requirement that the broker is required to supervise any transaction for which its representative receives selling compensation and participates in the execution of the trade. These latter NASD Section 40 terms selling compensation and private securities transaction facially, at least, appear tied to, and are consistent with, the 1934 Act's definition of a broker-dealer which is tied to effecting securities transactions. These terms, however, have consistently been expanded. Indeed, now, the foregoing term selling compensation forms the basis for the NASD's assertion of jurisdiction over the investment advisory activities of registered representatives. Why should the investment advisory

93. The fee arrangement by which the registered broker-dealer proposed to pay all commission earned by the registered representatives by checks made payable to the RIA affiliate of these registered representatives, however, was questioned. The staff opined that this payment arrangement would necessitate broker-dealer registration of the RIA. American Capital Equities, Inc., 1987 SEC No-Act. LEXIS 2328 (May 15, 1987).

94. Id.


97. The NASD had issued two notices to members, #91-32 (June, 1991) and #94-44 (May, 1994), discussing when a broker is obligated to supervise activities
fee governed by the Advisers Act trigger 1934 Act concerns? What if the investment advisory activities of the RR/RIA or RR/associated person’s RIA result neither in any securities transactions being effected through the RR’s broker-dealer nor, indeed, in any securities transactions being effected?

Although there may be a basis for a broker-dealer employer to prohibit or prescribe by contract conditions under which its registered representative may engage in non-broker-dealer activities, there should not be any basis for suggesting that broker-dealers are statutorily required or permitted to exercise supervision and control over an RIA and the conduct of its RIA business. Moreover, the suggestion rejected by the SEC staff that the RIA be solely responsible for the investment advisory activities of his separately incorporated RIA is precisely what this same staff insists upon in other contexts. And, typically, to assert supervision and control, one must be an associated person which the staff has suggested is not typically extant with respect to an unrelated corporation.

Clearly, the concern about registered representatives acting contemporaneously for, and on behalf of, another person is understandable. However, this concern should be ameliorated, if not eliminated, whenever the registered representative is acting also as an associated person of a separately incorporated RIA owned by him/her or is him/herself registered as an investment adviser. The regulatory scheme of the Advisers Act should provide the requisite investor protection mandated by Congress over the investment advisory activities and the regulatory scheme of the 1934 Act, as supplemented by the NASD Rules of Fair Practice and/or

of its representatives that are outside the scope of the representatives employment with the broker.

98. Receipt of any portion of the advisory fee by the broker-dealer, on the other hand, is of concern and may trigger the requirement of registration under the Advisers Act for that broker-dealer.


100. Thomas A. Busson, 1976 SEC No-Act. LEXIS 1874 (Aug. 27, 1976). Obviously, RR/RIA instances may involve a relationship between the broker-dealer and the RIA, but the RIA and broker-dealer in these instances are unrelated in terms of stock ownership and interlocking deputized officers and directors.
otherwise\textsuperscript{101}, should provide ample investor protection for the brokerage function.

3. \textbf{Muddled Regulatory Thinking Exposed}

Broker-dealer supervision and control over the investment advisory activities of the person dually registered as the broker-dealer's registered representative and separately, registered as an RIA, individually or through his/her separately incorporated entity is required. Where the RR is not dually registered as a registered representative and RIA, however, but rather acts as an RR and associated person or advisory representative of an RIA (not owned by the RR) RIA, not broker-dealer, supervision and control over the performance of investment advisory services is insisted upon. This clearly exposes muddled regulatory thinking! In the former instance (RR/RIA), the RR is actually registered under the Advisers Act, while in the latter, is not. In the latter instance, unlike instances involving a dually registered RR/RIA, but consistent with the shibboleth and the statutory scheme, RIA supervision and control is required, not broker-dealer supervision and control over RIA activities. Say what!

\textbf{B. Dual Agent.}

1. \textit{Registered Representative Also Acting As An Advisory Representative and/or Being An Associated Person of RIA.}\textsuperscript{102}

The Commission staff in 1975 permitted registered representatives of a broker-dealer to refer clients to an RIA affiliate and receive a referral fee without separately registering under the Advisers Act.\textsuperscript{103} In so doing, however, the staff conditioned its permissive view on the \textit{RIA controlling} the marketing activities

\textsuperscript{101}. It is also important to note that Article III, Section 1 of the NASD's Rules of Fair Practice require the observation of high standards of commercial honor and just and equitable principles of trade.

\textsuperscript{102}. American Capital Equities, Inc., 1987 SEC No-Act. LEXIS 2328 (May 15, 1983) (where SEC could not assure enforcement action would not be recommended because representatives of broker-dealer were also associated persons of RIA and requested for tax-planning reasons that broker-dealer make all checks representing all commissions earned by associated persons in their capacity as representatives of the broker-dealer payable to the RIA rather than to each individual representative; however, RIA retains significant portion of commission).

associated with this referral arrangement; and an acknowledgment that the registered representatives participating in this referral arrangement were associated persons, of the RIA, subject to the supervision and control of the RIA with respect to those activities. 104

Interestingly, here the duality of being a registered representative/advisory representative, consistent with the shibboleth, triggered the supervision and control by the RIA. Presumably, this also means that here the employer broker-dealer’s supervision and control is limited to brokerage activities. This would make sense, and would be consistent with the shibboleth and Section 208(d) but inconsistent with the staff’s rejection of a like position asserted in Hornor Townsend & Kent, Inc. noted earlier. 105 There an RIA unsuccessfully asserted that it would be solely responsible for investment advisory activities while the broker-dealer employer of its principal would be responsible for brokerage activities engaged in by the registered representative principal. 106 SEC insistence on RIA control over its associated persons is logical and consistent with the Advisers Act. SEC insistence, however, on broker-dealer control over RIA associated persons defies logic and is inconsistent with Section 208(d) and the general scheme of the Advisers Act and the regulatory shibboleth. How can the SEC insist on broker-dealer supervision over the investment advisory activities of a registered representative who performs those advisory services on behalf of an RIA?

104. We would not recommend that the Commission take any action if registered representatives of IDS do not register individually as investment advisers under the Act if you acknowledge that, for purposes of the Act, (1) IDSAC controls the activities of IDS Marketing and the registered representatives in soliciting Potential Accounts in a manner which makes them associated persons of IDSAC within the meaning of Section 202(a) (17) of the act; (2) such registered representatives are advisory representatives within the meaning of Rule 204-2(a) (12) under the Act; and (3) IDS Marketing and the participating registered representatives will fulfill the same obligations of IDSAC toward IDSAC’s present and prospective investment advisory clients. Investor Diversified Services, Inc. and IDS Advisory Corp., 1975 SEC No-Act Lexis 1800 (Sept. 7, 1975).


106. Id.
2. Networking Arrangements Between RIA and Others.

As the shibboleth suggests, registration and control are inextricably linked. Whenever one performs investment advisory services or receives compensation from investment advisory activities, one must either be registered as an investment adviser or be an associated person of the RIA, subject to control by that RIA. As noted earlier, however, supplementary broker-dealer supervision and control in some instances is staff imposed, making this shibboleth a hollow truth! Moreover, no registration under the Advisers Act may be required of that broker-dealer, while registration under the Advisers Act is required in RIA-financial institution networking arrangements. Consistency may be the hobgoblin of little minds and statesmen, but regulatory inconsistency of this magnitude muddies the regulatory waters and results in uneven regulation and inconsistent protection of investors.

(a) Non-Financial Institution / Non-Broker-Dealer Networking Arrangements.

Consistent with the regulatory shibboleth, control by the RIA over the investment advisory activities of a dual agent, acting as an associated person of the RIA and an employee of an unrelated publishing house obviated the need for Advisers Act registration. Employees of Commerce Clearing House, Inc. ("CCH") engaged in marketing type activities connected with selling the publication of a registered investment adviser, Evaluation Associates, Inc., were not required to separately register under the Advisers Act. The staff based its permissive view on the basis of: (i) the RIA's representation of its right to, and its actual exercise of "direct control with respect to sales of its publication." and; (ii) the fact that all those CCH employees participating in this sales effort would, according to the staff, be associated persons of EAI subject to

111. "Based on . . . a representation that . . . [EAI] a registered investment adviser, will have the right to, and will in fact exercise, direct control with respect to sales of its publication, we would not recommend that the Commission take any action under the Investment Advisers Act of 1940. . . against EAI or the employees of [CCH]. . . if such CCH employees do not register under the Act." Id.
EAI's supervision and control "with a view to preventing violations of the federal securities laws in connection with their activities on behalf of EAI. . ."\textsuperscript{112} (Emphasis added). This holding is consistent with the shibboleth, register or be an associated person under the control of RIA, as well as with the staff holding that the RIA, not the broker-dealer, exercises supervision and control over the investment advisory activities of that RIA's associated person contemporaneously acting as a registered representative discussed above. Moreover, this holding is of note on two additional scores: (i) these dual CCH employees/RIA associated persons were not under the sole control of the RIA although that has been required by the SEC in other contexts and (ii) no additional layer of supervision and control or SRO oversight was extant as is presently required whenever the duality involves a broker-dealer's registered representative who is also an RIA, whether individually or through a separately incorporated entity.

Shortly after issuance of the CCH No-Action letter referenced above, the staff declined to issue a no-action letter under similar, but possibly dispositively different, circumstances.\textsuperscript{113} Flow of Money, Inc., a registered investment adviser ("FOM"), provided a statistical service. FOM proposed to enter into an arrangement with an unrelated corporation which would provide sales services in marketing FOM's service. The SEC staff emphasized two points: (i) any person receiving compensation for selling an advisory publication would normally be required to register. . . unless it is an associated person, and subject to the supervision and control, of a registered investment adviser, either as an employee or otherwise;\textsuperscript{114} and (ii) [a]s a general matter, we would not regard a corporation as an associated person of an unrelated corporation.\textsuperscript{115} Accordingly, this unrelated corporation would either have to register separately as an investment adviser or establish sufficient facts showing how it is an associated person of FOM. Here, the SEC adheres to the shibboleth register or be an associated person under the control and supervision of an RIA, but as discussed above and below, waivers in other RIA networking relationships. Why does this shibboleth breakdown: when the relationship is

\textsuperscript{112} Id. Moreover, the staff noted that failure reasonably to supervise could subject EAI and/or its supervisory personnel to sanctions under Section 203(e)(5) of the Advisers Act (Id.)


\textsuperscript{114} Id. at 1.

\textsuperscript{115} Id.
between a broker-dealer and a registered representative who is also separately registered as an investment adviser, individually or through a separately incorporated entity or when the relationship is between an RIA and a financial institution? How is any regulatory scheme thwarted if investment advisory activities are conducted by a registered investment adviser, exercising supervision and control over its associated persons’ conduct of investment advisory activities pursuant to the provisions of the Advisers Act?

(b) RIA / Financial Institution Networking Arrangements.

Further evidence of regulatory muddled thinking and the hollowness of the shibboleth: register or be an RIA associated person under supervision and control of an RIA, is the SEC staff insistence in First Federal Savings and Loan Association of Rochester (First Federal)\(^\text{116}\) on Advisers Act registration notwithstanding the RIA’s assertion of supervision and control. The foregoing together with the assurance that certain joint employees would be associated persons of an RIA (i.e., subject to the supervision and control of the RIA) was not enough. The SEC staff, nonetheless, insisted that registration under the Advisers Act was required by one or more of: First Federal Savings and Loan Association of Rochester (First Federal); its service corporation subsidiary, First Diversified Financial Services, Inc. (Service Corporation;) or the contemplated networking arrangement between the Service Corporation and New England Financial Advisors, Inc. (NEFA), a registered investment adviser. Under this contemplated networking arrangement, NEFA would offer financial planning services to customers of First Federal and Service Corporation, using Service Corporation employees (“Joint Employees”).

In considering whether or not registration of Service Corporation, First Federal and/or the Service Corporation/NEFA networking arrangement itself was required, the staff noted that the issue was “whether the advisory activities of the Joint Employees would be performed solely under the control of NEFA, such that the Joint Employees would be considered associated persons only of NEFA” (Emphasis added).\(^\text{117}\) If not solely an associated person of NEFA, registration would be required according to the SEC

---

117. Id. at 2-3.
Neither sole control nor sole associated person status, however, was required in the non-financial institution/RIA networking arrangement or in a broker-dealer/RIA arrangements summarized above.

In First Federal, the staff found that the Joint Employees were “not only associated persons of NEFA but also of Service Corporation and, possibly, First Federal.” This characterization by the staff seems tied to two (2) factors concerning the Service Corporation Joint Employees. These Joint Employees would be (i) providing investment advice not only to their customers, but also to the general public; and (ii) receiving incentive based compensation from Service Corporation. These two (2) factors suggested to the staff that Service Corporation and/or First Federal “would be engaged in the business of advising others.” Moreover, simply because neither the Service Corporation nor First Federal received the advisory fee directly from an advisory client was not determinative in deciding whether or not either or both was engaged in the business of advising others. That is, these Joint Employees, although associated persons and, therefore, under the control of NEFA with respect to Service Corporation customers, were also associated persons of the Service Corporation to the extent their investment advisory services were being performed on behalf of the Service Corporation.

118. If the Joint Employee is not an associated person only if NEFA,) “... either First Federal, Service Corporation, or the Networking Arrangement itself... may be deemed investment advisers...” Id. at 3.


121. Id.

122. Id. Section 202(a)(11) defines an investment adviser as one who is engaged in the business of advising others.” Receipt of incentive based compensation in the broker-dealer bank networking arrangements, however, is not dispositive. See also Kingland Capital, 1991 SEC No-Act. LEXIS 623 (March 29, 1991).

123. “... in order to satisfy the compensation element of the definition of an investment adviser, it is not necessary that investment adviser’s compensation be paid directly by the person receiving investment advisory services, but only that the investment adviser receive compensation from some source for his services” First Federal Savings and Loan Assoc., at 5 n.6, (citing Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987)).

124. In the context of Section 202(a)(17), a person can be considered under the control of another person if investment advisory services are performed by that person on behalf of, and under the supervision or oversight of, the other person.
The applicant in NEFA analogized the proposed RIA/financial institution networking arrangement to the accepted networking arrangements between registered broker-dealers and financial institutions. Notwithstanding NEFA’s assurance that:

(i) NEFA, not First Federal or Service Corporation, would be providing all investment advisory services under the Networking Arrangement;

(ii) all Joint Employees engaged in investment advisory services would be subject to the authority and supervision of NEFA with regard to the federal securities laws; and

(iii) all investment advisory activities would be segregated from First Federal activities.

---


127. Id.

128. Id.
the SEC staff opined that registration was required by one or more of the Service Corporation, First Federal and/or the networking arrangement. Query why compliance with the above in the context of broker-dealer/financial institution networking arrangements obviates separate registration under the 1934 Act, but does not obviate registration under the Advisers Act? Why isn’t NEFA’s Advisers Act registration and its compliance with the federal securities laws, including supervising and controlling the advisory activities of its associated person/Joint Employees, sufficient to protect the public and satisfy the purposes of the Advisers Act?

How can advisory activities under the control of the RIA also be attributed by the SEC staff to the other employer? It does not seem enough under First Federal’s rationale that the advisory activities be under the sole control of the RIA. This is not always so! Sole and exclusive control over all activities of a dual agent is not required in either the broker-dealer/financial institution networking context nor in the broker-dealer/dual registered RR/RIA. Clearly, the concern for the public and that all personnel engaged in securities activities will be fully subject to the regulatory requirements of the federal securities laws and rules of self-regulatory organizations is the same, no matter the context.

129. No registration was required, however, in a networking arrangement between a service corporation broker-dealer, Columbia Securities Corp. (“CSC”) and its affiliate Columbia Savings, A Federal Savings and Loan Assoc., pursuant to which CSC provided incidental advisory services to the customers of Columbia Savings. Columbia Savings, 1986 SEC No-Act. LEXIS at 1 and 28 (Jan. 9, 1986).

130. Id. The applicant in Laughlin Group Advisers, Inc. referred to the staff’s refusal to grant a no-action position in First Federal Savings and Loan Assoc. and suggested the justification for same was that “...the Staff could not conclude that the advisory activities were under the sole control of the registered investment adviser. As a result, the staff appeared unable to conclude that the investment advisory services provided by the dual employee were provided solely on behalf of and under the supervision of the registered investment advisor.” (Emphasis added). Laughlin Group Advisors, Inc., 1992 SEC No-Act. LEXIS 361 at 21.

131. Note, attribution was not required in Laughlin Group Advisers, Inc: “Control with respect to such activities would lie solely with LGA. Therefore, we do not believe it is appropriate to attribute these advisory activities to the Participant.” Id. 121.

132. Why in an RIA/bank networking arrangement, are the advisory activities deemed to be conducted not only on behalf of the RIA, but also the bank under the networking arrangement? But see Kingland Capital, 1991 SEC No-Act. LEXIS 623 (March 29, 1991).

Indeed, this concern is the very basis of the regulatory shibboleth: register or be an associated person subject to the supervision and control of the registered entity. How can this concern be met without requiring additional registration under the 1934 Act, involving networking arrangements between broker-dealers and financial institutions, but rather relying on the registered broker-dealer simply exercising supervision and control over the brokerage activities of the joint employee/dual agent, superseded by the Advisers Act in RIA/financial institution networking arrangements? Further, what different, albeit incomprehensible, rationale seems to compel the staff to hold differently in the contexts of broker-dealer and dually registered RR/RIA arrangements?

Surprisingly, in a subsequent no-action letter, Kingland Capital, the staff appears to have taken a position at variance with the First Federal described above. As with First Federal, Kingland Capital Corporation (Kingland Capital), a registered investment adviser, proposed to enter into a networking arrangement with commercial banks. Under this arrangement, Kingland Capital would provide financial plans to bank customers and share the fee with the bank. In acquiescing to non-registration, the staff stated:

Notwithstanding the staff's statement in [First Federal]. . . that the networking arrangement itself could be required to register as an investment adviser, we believe that, as a general matter, registration of a networking arrangement is unnecessary where the registered [investment] adviser is responsible for the networking arrangement and supervises all employees of the organizations that provide services on behalf of the networking arrangement.

The difference in result cannot be explained by the representations in Kingland Capital that: (1) the only responsibility of the bank would be to compensate the dual employee; and (2) the RIA, Kingland Capital, would have all responsibility for the activities of dual employees. There was a like representation in First Federal that [A]ll activities of Joint Employees which in any way

134. See, e.g., id.
135. See, e.g., Laughlin Group Advisors, Inc. where no registration as a broker-dealer was required of joint employees and/or the financial institution in a networking arrangement, but where no similar non-registration.
137. Id. at 3.
138. Id. at 2.
relate... to the sale of financial planning services will be supervised by... [the RIA] NEFA\textsuperscript{139} and that First Federal and/or the Service Corp. would compensate the dual employee.\textsuperscript{140} Moreover, unlike First Federal, the staff does not require that the dual employee be solely associated\textsuperscript{141} with the RIA, Kingland Capital.

3. **Being Both a Registered Investment Adviser And An Associated Person Of Another Registered Investment Adviser.**

In a situation where an individual is both separately registered as an investment adviser and an associated person of another investment adviser, the staff has cautioned that issues under Section 206(4) of the Advisers Act \textsuperscript{142} may arise. This is so because of the possible confusion in a client's mind as to who is performing the advisory activities.\textsuperscript{144} The issue here is recognized as not involving registration or control, but rather anti-fraud concerns, which are typically addressed under the federal securities laws by disclosure.

Accordingly, if the dual agent "provides investment advice solely within the scope of his employment," \textsuperscript{145} for the other registered investment adviser and this is clearly disclosed to the client and in disclosure statements, no misrepresentation is likely, and, thus, no violation of Section 206(4) should lie. Similarly, disclosure and anti-fraud concerns, not broker-dealer supervision and control, should be the issue focused upon whenever an RR contemporaneously acts as an RIA, whether individually or through his/her separately incorporated entity and disclosure and anti-fraud concerns, not RIA sole control should be the regulatory focus when the RIA networks with a financial institution or other entity.

\textsuperscript{139} First Federal Savings & Loan Ass'n, 1989 SEC No-Act LEXIS 48 at 20.
\textsuperscript{140} Id. at 4.
\textsuperscript{141} "The issue presented is whether the advisory activities of the Joint Employees would be performed \textit{solely} under the control of NEFA, such that the Joint Employees would be considered associated persons \textit{only} of NEFA." Id. at 2-3.
\textsuperscript{142} Section 206(4) prohibits an investment adviser from engaging in fraudulent, deceptive or manipulative acts, practices or courses of business.
\textsuperscript{143} Corinne E. Wood, 1986 SEC No-Act LEXIS 2028 (April 17, 1986).
\textsuperscript{144} Id. at 3.
\textsuperscript{145} Id. at 4.
V. REGULATORY SHIBBOLETH AND SECTION 208(d):

Taken together, the registration concerns of Section 203 and the prohibitions of Section 208(d) raise concerns about "structural arrangements in which a registered investment adviser is merely a conduit for advisory services provided by personnel of an unregistered affiliate."\(^{146}\) Stated differently, the issue is whether or not the unregistered entity is engaging indirectly in activities that would require it to register if engaged in directly, in violation of Section 208(d).\(^ {147}\) The foregoing Section 208(d), however, does not prohibit separate entities engaged in different activities from being related by stock ownership or otherwise.\(^ {148}\) So long as the regulated activities are conducted pursuant to the Advisers Act and the regulatory shibboleth, the relationship between the separate entities does not thwart the regulatory scheme. And to ensure the relationship does not result in the unregistered entity conducting advisory services, the Commission has insisted upon establishing the separateness and independence of unregistered affiliates of an RIA.\(^ {149}\)

If independence and separateness are the basis for permitting unregistered RIA affiliates, why does not this same criteria of independence and separateness provide the basis for permitting networking arrangements between RIA and a financial institution or other affiliate or non-affiliate? So long as the entity rendering the investment advisory services is registered under the Advisers Act and, if any persons who act both for the RIA and the non-registered is an RIA associated person with respect to such person’s investment advisory activities, the goals of the Advisers Act are ensured and both the provisions of Section 208(d) and the reg-

---

147. Id. at 4.
148. The SEC has acknowledged “valid business reasons for a company to form a separate registered entity.” Ropes & Gray at 5.
149. See, e.g., Investment Advisers Act Release No. 353 (Dec. 18, 1972), 38 FR 1649 (proposing Rule 202-1 under the Advisers Act. Under the proposed Rule, a registered entity would have been deemed separate from its unregistered affiliate if the registrant met the following conditions: “(1) it had a majority of directors that was independent of the controlling entity or its affiliate; (2) it was adequately capitalized; (3) its officers were independent of the controlling entity or its affiliates; (4) its advisory representatives were independent of the controlling entity or its affiliate and made recommendations independent from such persons; and (5) it did not use advice from the controlling entity or its affiliates other than statistical and factual information.” This Rule was withdrawn in Investment Advisers Act Rel. No. 497 (Feb. 19, 1976).
ulatory shibboleth are honored. There is no lack of policing. No advisory activities take place outside of the Commission’s jurisdiction and, for that reason, there is no concern that an unregistered affiliate would be engaging in activities that would (1) require it to register under the Advisers Act, or (2) adversely affect the registrant’s advisory client. Further, so long as the unregistered affiliate does not conduct investment advisory activities outside the scope of its activities for the RIA no intolerable danger persists.

Based upon the foregoing rationale, the SEC staff recently did not require registration of various general partners and other affiliates to registered investment advisers partnerships stating that:

“The concerns underlying the conditions of proposed Rule 202-1 and Section 208(d) of the Advisers Act, are adequately addressed when (i) the unregistered affiliate of a registered adviser does not provide investment advice; (ii) the unregistered affiliate and each of its employees are deemed associated persons of the [RIA] when they have access to the investment recommendations of the [RIA] or information concerning the recommendations prior to the effective dissemination of the recommendations; and (iii) the Commission has access to the unregistered affiliates books and records to the extent necessary to examine the business of the registered adviser." (Emphasis added).

The Big Eight accounting firm, Arthur Andersen & Co. (AA) was permitted to establish Arthur Andersen Financial Advisers (AAFA), a registered investment adviser, without requiring the additional registration of AA under the Advisers Act. Under this arrangement not only was AA a general partner of AAFA, but the advisory board governing AAFA was comprised of seven or more partners, principals and managers of AA. Further, AA

150. One concern previously expressed by the Commission was structural arrangements between RIA and their unregistered affiliate because “these arrangements make difficult for the Commission to police conduct that may harm clients of the registered adviser.” Ropes & Gray, 1995 SEC No-Act. LEXIS 748 at 2.
151. Id. at 7-8.
152. Id. at 10.
153. Id. at 12.
154. Id. at 12.
156. This advisory board “will establish, and supervise compliance with, policies regarding the scope and content of any investment advice rendered by [AA] personnel in the course of providing personal financial planning or
stated that AA would provide subject to AAFA's supervision, investment consulting services to clients, including employee benefit plans, relating to asset allocation, portfolio diversification, managing portfolio risk . . . 157 [and] will, if a client desires, identify categories of mutual funds that satisfy the client's investment objectives. . . . 158 In permitting this arrangement without requiring [registration under the Advisers Act, the staff noted its reliance 159 on AA assurance that [AA] personnel who provide investment advice in connection with personal financial planning or employee benefit consulting services or hold themselves out as providing these services [would] be deemed to be advisory affiliates and persons associated with an investment adviser for purposes of . . . the Advisers Act. 160 The foregoing staff position is of interest for two reasons, both of which expose the inconsistency in staff reasoning. 161 First, the staff insists on AA personnel rendering investment advice to be treated as associated persons of AAFA, 162 while earlier in this same no-action request approvingly noting AA's representation that its recommendations would be "part of the traditional accounting services generally rendered by certified public accountants and are consistent with the exception to the definition of investment adviser in Section 202(a)(11)(B) of the Advisers Act." Id. at 2 (emphasis added).

157. Id.
158. Id.
159. Id. at 5-6.
160. Id. at 6.
161. What makes the SEC permissive view in this instance even more surprising is the fact that AA also indicated that it might also recommend the purchase or sale of specific securities in certain instances. AA assured the SEC staff, however, that these recommendations would be driven by tax or estate planning considerations and would be "part of the traditional accounting services generally rendered by certified public accountants and are consistent with the exception to the definition of investment adviser in Section 202(a)(11)(B) of the Advisers Act." Id. at 3.

162. Id. at 7 n.3, where staff noted that "[t]hose persons who exclusively provide investment advice in reliance on Section 202(a)(11)(B) of the Advisers Act would not be considered associated persons of AAFA."

163. Id. at 3.
Why is the finding of sole RIA control dispositive in some instances, but not in others? What makes this distinction more surprising is the fact that the AA/AAFA arrangement was one between affiliates and the First Federal instance was between non-affiliates. One might think that a networking arrangement between affiliates would be more problematic than between non-affiliates, but apparently not, as evidenced by the disparity in regulatory thinking between the staff holdings in First Federal and AA/AAFA.

164. See Commerce Clearing House, Inc., 1976 SEC No-Act LEXIS 2863 (July 21, 1976) where the SEC accepted RIA control over only the investment advisory activities of joint employees. Koyen, Clarke & Associates, Inc., 1986 SEC No-Act. LEXIS 2882 (November 10, 1986), solicitors for Koyen, Clarke & Associates, Inc., a registered investment adviser, were not required to register separately as investment advisers, notwithstanding the receipt of compensation received indirectly from the sale of advisory services. The lack of need for registration was based upon assurance that the solicitors would comply with the cash solicitation rule under the Advisers Act and that the solicitors . . . will be at least with respect to those [solicitation] activities, an associated person of the investment adviser and therefore will not be required to register individually under the Advisers Act solely as a result of those activities. Id. at 2-3. (Emphasis added). But see Thomas A. Busson, 1976 SEC No-Act. LEXIS 1874. (August 27, 1976) where the staff opined that receipt of compensation for selling advisory services normally triggered the registration requirements under the Advisers Act. See also Rule 206(4)-3(a)(2)(iii); Koyen, Clarke & Associates, Inc., 1986 SEC No-Act LEXIS citing Investment Advisers Act Rel. No. 688 (July 12, 1979); Hornor Townsend & Kent, Inc., SEC No-Ac LEXIS 495 (April 4, 1995) where the SEC staff questioned the assertion of sole control over a dual agent who was a registered representative/RIA. First Federal Savings and Loan Ass'n, 1989 SEC No-Ac LEXIS 48 (Jan. 19, 1989) where the SEC staff insisted on RIA sole control over joint employees. But see, Kingland Capital, 1991 SEC No-Ac. LEXIS 623 (March 29, 1991).

165. Arthur Anderson & Co., 1994 SEC No-Ac. LEXIS 617 at 31-32. AA in its request for no-action noted that:

Traditionally, the SEC staff has been concerned that a parent company may engage in the investment advisory business by operating a controlled entity to avoid registration under the Advisers Act. In the staff's view, such a situation may give rise to abuses, including, among other things, the possibility that the affiliate might be an undercapitalized shell organized to limit the parent's liability or that the affiliate might be used to shield the activities of the parent and its employees from regulatory scrutiny under the Advisers Act.

166. Arthur Anderson & Co., 1994 SEC No-Ac. LEXIS 617 at n. 16. AA, in support of its request also noted that the SEC staff:

. . . at least with respect to a foreign parent, has indicated that it would not require the registration of the parent if: (i) the affiliate was organized as a separate legal entity, (ii) the affiliate is staffed with
VI. CONCLUSION

To perform either of the regulated activities brokerage or investment advisory services, described above, the choice is register or be subject to the supervision and control of the registered entity. And, registration under one Act, the 1934 Act or Advisers Act, does not obviate the need to register under the other Act. Registration is specific to the function. Accordingly, broker-dealers are not required to register as investment advisers unless such broker-dealers also engage in other than incidental investment advisory activities.\(^{167}\) Similarly, persons engaged as investment personnel capable of providing investment advice, (iii) personnel providing investment advice and their supervisors are "associated persons of the affiliate and subject to its supervision, and (iv) the Commission is given access to the books and records of the affiliate and its personnel. Division of Investment Management, Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 233-234 (May 1992). Although the staff has not indicated that it is prepared to apply such conditions to domestic entities, and, accordingly, we have not specifically discussed the application of such conditions to Arthur Andersen's proposal, we believe that Arthur Andersen's proposal would satisfy these conditions.\(^{16}\)

167. As noted previously, pursuant to Section 202(a)(11)(c) of the Advisers Act, certain activities of broker-dealers will not trigger registration under the Advisers Act. Broker-dealers may only engage in "incidental" investment advisory activities for which no "special compensation" is charged without registering as an investment adviser. In explaining the foregoing, the SEC stated that:

Clause (C) of section 202(a)(11) [of the Advisors Act] amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to special compensation amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transaction in securities. It is well known that may brokers and dealers have investment advisory departments which furnish investment does an investment adviser who operates solely in an advisory capacity. The essential distinction to be borne in mind in considering borderline cases, such as those which you have presented, is the distinction between compensation for advise itself and compensation for services of another character to which advice is merely incidental.

1940 SEC LEXIS 1466 (Oct. 28, 1940).
advisers, but not effecting securities transactions or buying and selling are not required to register as broker-dealers. Investment advisory and brokerage service differ in character and are subject to distinct regulatory schemes. Given the foregoing, how can a broker-dealer who itself is not also an RIA, statutorily or by experience, exercise supervision and control over an RIA or a broker-dealer SRO established under the 1934 Act assert jurisdiction over the Advisers Act investment advisory activities of an RIA, even if owned and operated by its members' registered representatives?

If separately registered, how can such an RIA, even if both an RR and RIA, be simultaneously under the control of the broker-dealer with respect to investment advisory services performed on behalf of the RIA? Should not the present regulatory insistence on broker-dealer supervision and control over RR/RIA arrangements shift to insistence upon separateness and independence? Will not separateness and independence between the functions of RR and RIA be sufficient to effect the dictates of the shibboleth and conform to the mandate of Section 208(d)? Indeed, without such separateness and independence between the RR's broker-dealer and his RIA, could it not be viewed that the broker-dealer, not registered under the Advisers Act, was doing indirectly that which it could not do directly; namely, providing investment advisory services, using the RR/RIA merely as a conduit, in violation of Section 208(d) of the shibboleth?

If the investment advisory activities of a registered representative are subject to the control of a separately incorporated RIA or, if conducted by the registered representative, as an RIA pursuant to the Advisers Act, no additional supervision and control is required. Sole RIA control over the investment advisory activities conducted on its behalf and in its name should be uniformly demanded. No further or less RIA control should be tolerated. This is precisely the call of the regulatory shibboleth repeated by the SEC staff and the mandate of Section 208(d) of the Advisers Act.

168. The staff stated that a broker-dealer parent was not required to register under the Advisers Act notwithstanding its contemplated establishment of an investment advisory subsidiary since the services provided by each differ in character. F.S. Mosely & Co., 70-71 CCH, Fed. Sec. L. Rptr. 78,063.


170. The Commission and its staff have on numerous occasions confirmed the view that "a person associated with an investment adviser" as that term is
A registered investment adviser does not have the expertise to supervise and control a registered broker-dealer nor does a registered broker-dealer have the expertise to supervise and control a separately registered investment adviser. The SEC should not ex cathedra impose supplementary oversight on some advisory activities. The conduct of investment advisory activities by all RIAs should be subject to the same oversight, not heightened scrutiny for RR/RIAs and lesser scrutiny for other RIAs.

The present regulatory focus in RIA networking arrangements once the shibboleth has been satisfied, should shift to disclosure and anti-fraud concerns.

The regulatory waters need not be muddied. The regulation should not be uneven. The shibboleth of register or be an associated person subject to control of the registered entity should be consistently applied. The required degrees of RIA control should not vary depending upon whether the arrangement is with a financial institution, or broker-dealer or other entity. Section 208(d) should be consistently applied. Regulatory insistence in RIA dual or networking arrangements should shift from imposing broker-dealer supervision and control in the RR/RIA arrangements; and imposing various degrees of RIA control depending upon the networking partner, to insistence on independence and separateness as well as disclosure and anti-fraud concerns.

defined in Section 202(a)(17) of the Advisers Act, will not be required to be separately registered as an investment adviser with respect to the activities undertaken on behalf of the adviser in the person's capacity as an associated person. Ropes & Gray, 1995 SEC No-Act. LEXIS at 26 (Sept. 26, 1995).