Securities Industry Association

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June 4, 1997

Ms. Leslie Scott
Chairman, NASAA Broker-Dealer
Sales Practice Committee
Assistant Secretary of State
Mississippi Securities Division
P.O. Box 136
Jackson, MS 39201

Re: Draft Policy Statement Concerning Sales Practices and Customer Suitability

Dear Ms. Scott:

The Federal Regulation Committee, the Self Regulation and Supervisory Practices Committee, and the State Regulation and Legislation Committee (the "Committees") of the Securities Industry Association ("SIA")**1** are writing to express their views regarding the draft policy statement entitled "Dishonest or Unethical Sales Practices in Connection with Customer Suitability" (the "Draft"). The Draft covers a wide range of legal issues that are of great concern to the Committees' members. Accordingly, the Committees are appreciative not only of the opportunity to comment on the Draft, but also of the fact that the NASAA Board of Directors postponed its own consideration of the Draft to allow the Committees and other interested persons sufficient opportunity for a detailed review. Unfortunately, this review has led us to conclude that, however well-intentioned the Draft may be, its substantive requirements would work substantial changes in existing law -- perhaps larger changes than the drafters themselves realized -- that are unworkable in many respects.

The Committees wish to make clear that they share certain of the goals expressed in the Draft, including facilitating the ability of State enforcement authorities to take regulatory action against penny stock promoters that abuse the trust of individual investors. Further, the Committees' members share with NASAA a strong interest in assuring that governmental entities invest both prudently and legally. Accordingly, the Committees hope that this letter, in addition to providing comments on the Draft, will serve to open a dialogue between SIA and NASAA that benefits the investors whom we both serve.

The Draft would impose substantive requirements in three principal areas: (i) customer record keeping; (ii) suitability; and (iii) transaction disclosure. Part I of this letter describes the principal concerns the Committees have identified with respect to all three substantive areas

of regulation. Issues raised by the specific requirements imposed in each substantive area are discussed in parts II-IV of this letter.

Part I. General Issues

A. The Draft would make substantial changes in current law.

While the Draft describes itself as "an exercise of incorporation of existing standards," the Committees believe that there is much in the Draft that would change current law in ways that deserve the considered attention of the NASAA Board of Directors.

1. Current suitability "law" and practice treat the requirements applicable to the relationship between a broker and an investor as dependent on the facts of the situation. The Committees do not regard this as a deficiency of existing law, but rather as a reflection of the fact that the application of a "suitability" obligation will (and we believe should) inherently depend upon facts and circumstances of the situation, particularly the type of investment, the type of investor and the relationship between the investor and the broker-dealer.

In contrast, the Draft would have one rule apply to every situation and moreover would adopt this single rule based on the requirements that currently apply to the extreme case.**2** The Committees hope that the NASAA Board of Directors will recognize that, in sharp contrast to the Draft, current law generally strives to give both individual investors and institutional investors the degree of protection that is individually appropriate. An unsophisticated retail investor on a limited income and depending on the securities recommendations made by a single full-service firm is entitled to special protections that are not ordinarily relevant or appropriate to sophisticated institutions.

2. Material portions of the "new" regulatory requirements that would be imposed by the Draft (new, that is, as to broker-dealers) are borrowed from the regulation of investment advisers. The Draft also borrows in significant respects from the guidelines of the Certified Financial Planner Board of Standards ("CFPBOS"). The CFPBOS is a private organization intended to certify, advertise and promote "personal financial planners." In making these borrowings from investment adviser regulation and the CFPBOS guidelines, the Draft does not acknowledge any difference between securities brokerage, the furnishing of investment advice, or the provision of tax and estate planning. The Committees believe that there are material distinctions between these types of services, and that rules that derive from the regulation of, for example, estate planning are a poor fit for the regulation of securities brokerage.

3. Because of the importance of the legal issues raised by the Draft, we have carefully scrutinized the various citations footnoted in the Draft. The results of this review are principally summarized in part III.E and footnote 16 of this letter. While we concede that the "meaning" of any legal decision may be the subject of intellectual dispute, we hope that the NASAA Board of Directors will agree that the Draft finds no more than limited support in much of the case materials it cites.

B. The Draft neither recognizes the benefits of a uniform regulatory system nor acknowledges that the National Securities Markets Improvement Act ("NSMIA") imposes limits on State regulation.

1. As any type of business that operates nationally, broker-dealers will be substantially injured if they are required to comply with a different regulatory system in every State. Indeed, broker-dealers simply do not have the operational capabilities to comply with different record keeping and confirmation regulations in every State. The Committees observe that each substantive area of regulation addressed in the Draft is also the subject of the national regulatory system. Accordingly, the Committee urges the NASAA not to adopt the Draft without first determining not only that the national regulatory system is deficient, but also that NASAA cannot address its regulatory concerns by working with the SEC and other federal regulators within the national system.**3**

2. NSMIA provides that the individual States may not adopt regulations regarding the making and keeping of records that go beyond the regulations imposed under the federal securities law.**4** On the one hand, the Draft describes its requirements as being in the nature of information-gathering rather than record keeping; on the other hand, the Draft acknowledges that the requirements in its Section 2(a), which are the heart of the Draft, are principally drawn from (but, we note, dramatically extend) (i) NASD Rule 2860 (providing for the making and keeping of customer records) and (ii) NASD Rule 3110 (titled "Books and Records"). It thus seems likely that any broker-dealer that might be found to have violated the Draft (were the Draft adopted by any State) would appeal such finding to the courts, arguing that the Draft violates federal law. The Committees believe that any such appeal would have a clear likelihood of success. While the NASAA Board of Directors may not agree with the Committees as to the eventual outcome of such an appeal, the Committees believe that the Board should at a minimum be concerned that the prospect of numerous such appeals would be a considerable waste of both Statend broker-dealer resources. Accordingly, we urge the NASAA Board of Directors to consider our view that the Draft's proposals would likely conflict with NSMIA. **5**

C. The Draft would not well serve the purposes for which it is intended.

1. The Draft argues that the traditional approach to "suitability" regulation, which is one where conclusions are dependent upon the "facts and circumstances" of every case, is too difficult to implement for State hearing officers and courts that lack experience in securities industry custom and usage.**6** We question this broad conclusion. Even were the NASAA Board of Directors to share the views expressed in the Draft, we do not believe that the asserted problem would justify a change in existing law, as opposed to a change in the manner in which that law is administered. That is, the problem of judicial inexperience, if it exists, would seem to argue that NASAA, or State regulators generally, should support the use of the National Association of Securities Dealers ("NASD") arbitration process, or of another specialized judicial or arbitration process. The Committees do not believe that the problem identified by the Draft supports discarding existing law, as opposed to re-examining the administrative system enforcing that law.

2. While the Draft does not assert this directly, the Draft's reference to unspecified "fiascoes" involving investors that include State investment funds strongly suggests that the Draft is intended to respond to losses by State funds. Here again, the Committees ask the NASAA Board of Directors to consider whether the "cure" fits the disease. As a starting matter, the Committees request that the NASAA Board of Directors consider whether the Draft is

even-handed in its presentation of past problems. The Committees note that independent reviews of several of the most highly publicized losses found a principal cause was inadequate risk management and ineffective controls **on the part of the investors who experienced the losses**.**7** Further, while the Committees recognize that the possibility of losses by governmental entities in the securities markets is a subject of particular concern to the NASAA, we also note that this concern is one that is peculiarly within the power and the resources of the individual States to address directly. For example, a State may ensure that it has a reasonable procedure for hiring experienced investment advisers and monitoring their performance. Further, a State may establish investment protection measures such as diversification requirements, or the State may require that local government entities invest only through a pooled investment vehicle that would be controlled by the central State government. For example, the State of California has substantially modified its investment regulations in response to the losses suffered by Orange County. The Committees believes that it is within the power of the NASAA Board of Directors to advance significantly further efforts of this type.

II. Record keeping Obligations

A. Current Law

Section 17(a) of the Exchange Act provides the SEC with authority to prescribe the record making and record keeping obligations to which broker-dealers are subject. The principal requirements that the SEC has adopted under this Section are set out in Rule 17a-3 and 17a-4. In addition, the suitability rules adopted by the self-regulatory-organizations ("SROs") may require that broker-dealers attempt to obtain, and maintain records of, certain customer information. For example, NASD Rule 2310 (the "Suitability Rule") requires a broker-dealer to make reasonable efforts to obtain information concerning a non-institutional customer's financial and tax status, investment objectives, and any other information the broker-dealer needs to make recommendations to the customer.**8** Certain of the SRO suitability rules applicable to specific products, investment techniques or market segments impose additional information obligations on a broker-dealer because of heightened risk or other factors. For example, the NASD requires that members seek to obtain additional information when opening options accounts for natural persons.

B. The Draft

Section 2(a) of the Draft would impose additional customer record keeping requirements, which requirements go substantially beyond those imposed by existing law. The Committees oppose these requirements because (i) they are not mindful of the severe costs imposed on broker-dealers by the imposition of individual State record keeping requirements, (ii) it is the Committees' view that the Draft's requirements likely violate NSMIA, and (iii) it will be impossible as a practical matter to satisfy the proposed requirements because many customers (particularly institutional customers) will simply refuse to supply such detailed information.

In addition to its objections based on the need for a uniform national regulatory system, the Committees also object to the substantive requirements that would be imposed by the Draft. Consistent with the Draft's general philosophy, the Draft takes as its starting point the most

extreme case under current law -- the records that broker-dealers are required to make and keep when retail customers trade options -- applies that extreme rule to all situations, and then goes further. For example, the Draft would require that broker-dealers obtain the identity of "consultants, advisers or individuals regularly relied upon by the customer in making investment decisions." Read for its plain meaning, this provision seems to require that broker-dealers obtain the identity of an investor's family members, friends and work colleagues from whom the investor obtains advice. The Draft does not examine whether there is value to be found in this or in the other information that broker-dealers would be required to collect.Accordingly, the Committees urge the NASAA Board of Directors to give careful consideration to whether the information that the Draft would require can be justified in light of the efforts and costs that the collection and maintenance of such information would entail.

C. Alternative

If NASAA believes that there is value in the individual States adopting an additional record keeping regulation, the Committees propose that NASAA consider recommending a regulation that would simply provide: "In connection with any transaction recommended by a broker-dealer to a customer, a broker-dealer should make reasonable efforts to obtain such information, if any, as is required concerning such transaction and customer by the rules of any broker-dealer self-regulatory organization having authority over the transaction." We believe that this approach would be consistent with NSMIA and provide investors and the securities markets generally with the benefits that derive from a uniform national regulatory system.

III. Suitability.

Insofar as the Draft deals directly with the issue of suitability (and does not extend into books and records or disclosure requirements) there are four issues on which the Committees would like to focus our comments: (i) the meaning of the term "recommendation"; (ii) the elements required to be considered in making a suitability determination; (iii) the treatment of institutional investors; and (iv) the "duty" to warn of unsuitable transactions.

A. Recommendation

A broker-dealer becomes subject to a suitability obligation by making a "recommendation" to a customer. **9** The Committees understand that the term "recommendation" should be used in accordance with its plain English meaning; *e.g.* , "to endorse" or "to commend."

By contrast, the Draft defines the term "recommendation" to include "endorsing," "commending," "requesting" or "soliciting" a securities transaction. This definition goes well beyond plain English; we think it obvious that a "request" is distinct from a recommendation. For example, broker-dealers may distribute daily to certain institutional investors a list of securities that are available for sale. While such lists may be regarded as "requests" to transact, they are obviously not "recommendations." Further, the term "solicit" has come to be used by the SEC as a term of art to describe any activity requiring broker-dealer registration. For example, a broker-dealer has engaged in "solicitation" if it distributes quotations by means of an electronic trading system or through a Web site on the Internet. Again, it would seem obvious that such "solicitation" does not constitute a "recommendation."

The very broad definition of the term "recommendation" is also problematic as it applies to the distribution of research. When a broker-dealer produces research, it is axiomatic that the broker-dealer is under a duty to have a reasonable basis for the product description contained in the research. On the other hand, where a broker-dealer distributes research widely, it cannot be the case that the broker-dealer is undertaking to guarantee that any transaction described in the research is suitable for any possible recipient of the research. If NASAA believes that the distribution of impersonal research may be subject to suitability requirements (and we observe that outside of the context of preventing fraud by penny stock promoters, no federal regulator has ever suggested such a requirement), we believe that NASAA should also explicitly consider the negative effect that the imposition of such requirements would have on the ability of broker-dealers to provide research to individual investors.

B. Supervisory Issues

The Draft expands the term "recommendation" to include, among other things, "any affirmative act or statement that solicits, requests, commands, importunes, or intentionally aids" another person in giving a recommendation. Read literally, this definition seems vastly overbroad, and it is not clear what policy result is intended.**10** However, the Draft's section-by-section analysis states that this term is intended to achieve a reasonable result: to make clear that supervisory personnel employed by penny stock promoters bear responsibility where such supervisory personnel has recklessly "directed" the giving of a recommendation without any consideration of investors' individual circumstances. Unfortunately, none of the explanatory language in the section-by-section analysis has made its way into the operative language of the Draft.

C. The Consequences of a Sale

The Draft would require a broker-dealer that recommends the purchase of any security to determine the essential facts regarding, among other things, "the consequences associated with disposing of any existing customer assets." This would impose an unrealistic requirement, well beyond the capabilities of broker-dealers and, we believe, any investor's reasonable expectations. Even non-institutional investors may have hundreds of individual assets (institutional investors may have thousands of assets). Investors' assets may include not only securities and other similar financial assets but also homes and other real estate, businesses, jewelry, physical commodities, insurance products, and so on. Having determined that the purchase of a single security would be suitable for an investor, a broker-dealer cannot then be expected to determine the consequences of the sale of every asset that the investor may own. Leaving aside even the impossibly broad burdens that are expressly imposed by this requirement, the mmittees are also extremely concerned that this requirement is intended to imply that broker-dealers are responsible for providing investors with advice on the tax consequences of the sale of assets. NASAA should be aware that it is not appropriate to require that broker-dealers provide tax advice.**11**

D. Institutional Investors

1. The Institutional Suitability Interpretation. Since 1994, there has been extensive public debate as to the manner in which broker-dealer suitability obligations should be applied to recommendations made to institutional investors. The participants in this public discussion included individual firms in the securities industry and trade organizations such as SIA,

representatives of governmental investors such as the Government Finance Officers Association, and other investors, financial market participants, regulators, including the SEC, and members of Congress. The culmination of this discussion was the adoption by the NASD, with the approval of the SEC, of the "Institutional Suitability Interpretation."**12** Following the adoption of the NASD's Institutional Suitability Interpretation, the principal bank regulators adopted their own suitability rules.**13** The bank suitability rules, which were likewise adopted after an opportunity for broad public comment, were very closely modeled on the NASD's Suitability Rule, including the Institutional Suitability Interpretation. In adopting their suitability rules, the bank regulators indicated that one of their principal considerations was uniformity of law: that the sales of securities products by banks be similarly regulated to the sales of securities products by broker-dealers.

The Institutional Suitability Interpretation (and the generally identical rule adopted by the bank regulators) has two key aspects. First, it recognizes that there is a difference between institutional investors and retail investors.**14** Second, in the case of an institutional investor, the Interpretation provides that a broker-dealer's suitability obligation to the institution can be fulfilled with respect to any transaction by reasonably determining that the institution (a) is capable of independently evaluating the transaction and (b) is in fact exercising independent judgment, and not relying on the broker-dealer's recommendation with respect to the transaction. **15**

2. The Draft. The Draft assumes there is no difference between institutional investors and retail investors, and thus that there should be no difference in the application of broker-dealer suitability obligations to such investors. In making this assumption, the Draft appears to disregard the prolonged public discussion, which involved all the principal federal securities and banking regulators, and which reached a different conclusion. The Committees urges the NASAA Board of Directors to consider the views expressed by other regulators on this issue.

More substantively, the Draft appears to be based on a fundamental misunderstanding of the Institutional Suitability Interpretation. The Institutional Suitability Interpretation treats a customer's exercise of independent judgement as an **alternative method** for a broker-dealer to satisfy its suitability obligations; it is **not an additional obligation**. That is, the Institutional Suitability Interpretation provides that "[w]here a broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled" without a separate evaluation of consistency with the customer's investment objective.

In contrast, by treating "customer understanding" as an additional requirement of suitability, the Draft reaches the result that a broker-dealer is engaging in "unethical" conduct simply by recommending a transaction that a customer does not understand, even if the transaction is in fact suitable and the customer wishes to rely upon the broker-dealer. We are sure that the NASAA Board of Directors will agree that this aspect of the Draft is not only inconsistent with current legal requirements, it is also illogical and surely unintended.

E. Duty to Warn

The Draft proposes a new duty to warn of transactions that the broker-dealer did not

recommend to the customer if the broker "had reason to know" the transaction was unsuitable. The only support the Proposal provides for this requirement are (i) footnote 12, which merely cross-cites to footnote 8, which in turn cites to a case involving scienter, the direct relevance of which is questionable; (ii) a reference to the Certified Financial Planner Board of Standards rules concerning "recommendations"; and (iii) an article titled "The Outer Limits." The Draft says that this new requirement "stops short" of requiring the broker not to execute the transaction, leaving the implication that it does not stop very far short. This new requirement is unprecedented and unworkable, especially for discount brokers and those dealing with institutional customers. In these situations, the Committees urge NASAA to acknowledge that the broker-dealer's representative servicing the customer will often be doing nothing more thaacting as an "order-taker."

IV. Disclosure of Charges.

Sections 2(b)(4) and 2(c)(3) of the Draft would make it a "suitability violation" for a broker-dealer to fail to determine all commissions, charges or other fees associated with a transaction and for the broker-dealer to fail to determine the customer's understanding of the financial benefits to the person recommending the transaction. (This seems a disclosure-type obligation, rather than a suitability obligation. Certain of the cases cited by the Draft relate to disclosure; none seem to relate, except perhaps indirectly, to suitability. We are not certain, however, why the Draft has merged the concepts of suitability and disclosure.)

A. Current Law

At the completion of each securities transaction, a broker-dealer must send a confirmation disclosing not only the information specifically required by Rule 10b-10 under the Securities Exchange Act of 1934, but also any other information "material" to the transaction. Among the specific disclosures required by Rule 10b-10 are the capacity in which the broker-dealer acted (e.g., as principal or agent), commissions on agency transactions, mark-ups on riskless principal transactions in equity securities and transactions in national market system securities, and certain yield calculations with respect to debt securities. In addition, a broker-dealer that is also acting as an investment adviser must make the disclosures, and obtain any consent, required by Section 206(3) of the Investment Advisers Act of 1940.

B. The Proposal

The Proposal strongly suggests that something is wrong with current Rule 10b-10 disclosure requirements, but ultimately makes clear neither what is wrong nor what remedy is proposed. Rather, the Draft supports the implication that a problem exists by citing a large number of cases, drawn from both within and without the securities laws, that do not have any clear relationship either with each other or with the main text of the Draft. (As we stated in part I of this letter, we believe it incumbent upon the NASAA Board of Directors to consider whether the cases cited in the Draft actually stand for the proposition for which they are cited.**16**)

As the Draft does not propose specific disclosure requirements, we obviously cannot provide specific comments. Accordingly, we confine ourselves to three general comments and requests. First, the Draft neither identifies any problem with current Rule 10b-10 nor proposes any additional specific requirement. Second, before proposing individual State law

confirmation requirements, we ask NASAA to consider whether such requirements are operationally practical and what the costs of such requirements might be. Third, we urge NASAA to consider whether such individual requirements would be consistent with NSMIA and with State case law to the effect that SEC Rule 10b-10 is intended to preempt State regulation in this area.**17**

The Committees appreciate the opportunity to comment on the Draft. While we recognize that our comments on the Draft are generally critical, we hope that NASAA will recognize that the Committees could not react otherwise in light of a proposal that appears both unworkable and, in certain respects, adversarial. We hope that NASAA will also recognize SIA's strong desire to work with NASAA on issues such as the prevention of penny stock fraud and appropriate regulations governing investments by State authorities.

If you have any questions in regard to this letter, please do not hesitate to contact any of signatories or Steven Lofchie of Davis Polk & Wardwell (at 212-450-4075), our special counsel for this project.

Best regards.

Very truly yours,

C. Evan Stewart, Chairman
Federal Regulation Committee

R. Gerald Baker, Chairman
Self Regulation and Supervisory Practices Committee

John Wurth, Chairman
State Regulation and Legislation Committee

Footnotes

1 The Securities Industry Association is the trade association representing about 700 securities firms headquartered throughout North America. Its members include securities organizations of all types--investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are active in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities business conducted in the United States.

2 That is, the Draft assumes (i) all investors, whether sophisticated institutions or unsophisticated individuals, should be treated as unsophisticated; (ii) all broker-dealers should be treated as penny stock promoters; (iii) all securities products (except money market mutual funds) should be treated like stock options; (iv) all relationships between a broker-dealer and a customer should be treated as if the broker-dealer were also the customer's investment adviser, tax adviser and estate planner; (v) all transactions should be treated as recommended by the broker-dealer; (vi) all recommendations to purchase also should be deemed recommendations to sell; and (vii) all obligations imposed on broker-dealers should be open-ended and not delimited.

3 See, e.g., Section 15(h)(1) of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires the Securities and Exchange Commission (the "SEC") to consult periodically with the State securities commissions concerning the adequacy of federal regulation.

4 See Section 15(h)(1) of the Exchange Act.

5 In the way of providing some background to our views on NSMIA, the Committees observe that prior to the adoption of NSMIA, a number of States had adopted individualized requirements as to the customer information that broker-dealers were required to obtain and maintain. The likelihood of individual record keeping requirements being adopted in all of the fifty States, and the operational problems that would have created, led to the enactment of NSMIA. Subsequently, the SEC proposed a books and records rule (the "Books and Records Release") that was intended to respond to the concerns, expressed by some State regulators, that federal record keeping requirements are insufficient for their purposes. See SEC Release No. 34-37850 (Oct. 22, 1996). (In particular, see the Summary, Part I and Part II.C.) The Committees thus urge the NASAA Board of Directors to examine the very considerable extent to which the Draft resembles both the state regulations that clearly were intended to be pre-empted by NSMIA and thSEC's Books and Records Release, which was intended to address the concerns raised by pre-emption.

6 See Part II of the Draft (Purpose of the Proposed Model Rule.)

7 For example, a report prepared at the direction of the California Legislature, and written by California State Senators, found that the highly publicized losses by Orange County resulted in large part from "a breakdown of established governmental procedures" in the County. See California Legislature, Report of the Senate Special Committee on Local Government Investments, "The Orange County Bankruptcy: Broad Repercussions, New Public Policy" (August 1995). Similarly, a report by the United States General Accounting Office ("GAO") found that "weak corporate governance system[s] that did not establish effective risk management and internal controls" contributed significantly to a number of the recent highly publicized investor losses. With respect to the losses suffered by Orange County, the GAO report found that the responsible government officials had "failed to carry out [their] public responsibilities to effectively supervise the county's investment activities." United States General Accounting Office,eport to Congressional Committees, "Financial Derivatives: Actions Taken or Proposed Since May 1994" (November 1996), at 120-3.

8 See also New York Stock Exchange ("NYSE") Rule 405 (the "Know Your Customer Rule") which requires, among other items of information, that an NYSE member have definite knowledge that a corporate client for which it carries a margin account has the right under its charter and by-laws to engage in margin transactions, and that persons acting for a corporate client are duly authorized.

9 The securities industry has long recognized that a broker-dealer who "recommends" an investment undertakes certain suitability obligations. These obligations, which are principally embodied in the rules of the self-regulatory organization, are specifically tailored to the circumstances of a transaction. The NASD's Suitability Rule prohibits a broker-dealer from recommending a transaction to a customer unless the broker-dealer has "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the

facts, if any, disclosed by such customer" as to the customer's other security holdings and financial situation and needs. Currently, this Rule applies to transactions by NASD members involving all securities other than municipals, which are subject to MSRB G-19. The NYSE's Know Your Customer Rule requires that every NYSE member broker-dealer use due diligence to learn the "essential facts" relative to every customer, order and account. The NASD's Suitability Rule d the NYSE's Know Your Customer Rule are supplemented by a number of other SRO rules that have application to specific products, such as options, speculative and low-priced securities, or collateralized mortgage obligations.

10 If one broker-dealer employee "requests" another broker-dealer employee to call an institutional customer and ask if the institution is interested in buying or selling a security, then the first broker-dealer employee has seemingly "recommended" the transaction to the institution.

11 Our concern in this regard is heightened because it is unclear whether the Draft has drawn this requirement from the guidelines applicable to personal financial planners who do provide tax planning and related services.

12 See SEC Release No. 34-37588 (Aug. 20 1996).

13 See 62 Fed. Reg. 13276 (Mar. 19, 1997) (sales practice rules adopted by the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation).

14 For example, institutional accounts typically will engage in transactions with a number of different dealers, and take an arms-length approach to their dealings with securities firms and their affiliates. SEC Release No. 34-37588 (August 20, 1996).

15 The Institutional Suitability Interpretation sets out relevant, but not exclusive, factors that may be taken into consideration in connection with any transaction. Factors relevant to the customer's "ability to evaluate" investment risk include: (i) the customer's use of consultants or advisers; (ii) the complexity of the security in question and the customer's experience with, and ability to understand, the security; and (iii) the customer's ability to understand how market developments would affect the security. Factors relevant to whether the customer is "exercising independent judgment" include: (i) the existence of written or oral agreements between the parties regarding the nature of their relationship; (ii) any pattern of acceptance of the broker-dealer's recommendations; (iii) the customer's use of suggestions from other market professionals; and (iv) whether the broker-dealer has been provided with information about the customer's portfolio or investment objectives. The Interpretation providethat where an institutional customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the "factors analysis" applies to the agent.

16 For example, *McCoy v. Goldberg* , 748 F.Supp. 146 (S.D.N.Y. 1990), cited as the only authority for the proposition that "existing antifraud law" "commands" that the broker make reasonable efforts to determine the customer's understanding of the "essential financial benefits" to the person recommending the transaction, in fact involved an investor claim based on misrepresentation of the risks and nature of a series of investments. The benefits to the broker were discussed only in connection with the issue of *scienter*.

Similarly, footnote 10 of the Draft cites two Supreme Court cases, *Basic v. Levinson and TSC Industries v. Northway*, which stand for the proposition that a seller of securities must disclose material nonpublic information concerning the securities being sold to the investor. The Committees fully agrees with these cases, but notes that they have no clear relationship to suitability issues or to conflict of interest.

Cases cited as "arising from over-the-counter transactions" are similarly either unsupportive or lead us to question what problem the Draft is trying to address. Chasins v. Smith Barney & Co., Inc., 438 F.2d 1167 (2d Cir. 1970) held that a broker-dealer may be required to disclose on its confirmation that it was acting as a market maker if this disclosure is material to the transaction. This conclusion was subsequently specifically incorporated into Rule 10b-10. *Magnum Corp. v. Lehman Brothers Kuhn Loeb, Inc.*,794 F.2d 198 (5th Cir. 1986), held that a broker had a duty to disclose to its customer that the large volume of orders would necessarily drive up the price for the purchased security. Unusual "financial or economic incentives" did not play a part in the decision. *SEC v. Hasho*, 784 F.Supp. 1059 (S.D.N.Y. 1992), involved a "boiler room" operation in which a raft of misrepresentations and omissions concerning the securities sold to investors were found. As in most situations involving "boiler rooms," the case discusses the obligation of a broker-dealer to have a reasonable basis for its research, but it seems to have only a limited relationship to the other cases cited in the Draft footnotes. *Claughton v. Bear Stearns & Co.*, 156 A.2d 314 (Pa. 1959) involved a broker acting as agent for both the buyer and seller of securities, and receiving commissions from both. Here again, disclosure would be required by Rule 10b-10, leaving us to wonder what issue the Draft is attempting to address. *SEC v. Capital Gains Research Bureau* is generally understood not as a disclosure case at all, but as prohibiting "front-running" by investment advisers. Similar prohibitions apply to broker-dealers, but these prohibitions do not seem very germane to the suitability issues raised by the Draft. *E.F. Hutton & Co.*, Fed. Sec. L. Rep. (CCH) [1988-1989 Transfer Binder] ¶ 84,303, relates to the obligation of a broker-dealer to disclose its procedures for handling limit orders to customers. This case is no longer good law, as it has since been superseded by the adoption of Rule 11Ac1-4 under the Exchange Act. *Jerlyn Yacht Sales v. Wayne Roman Yacht Brokerage*, 950 F.2d 60 (1st Cir. 1991) does not even involve the securities industry (it involves yacht sales); if the case had involved securities rather than yachts, the conduct at issue would have violated Rule 10b-10. Similarly *Store of Happiness v. Carmona & Allen*, 312 P.2d 1104 (Ca. Dist. Ct. of Appeal, 1957) involves an agent buying television advertising time.

17 The highest courts in at least two States have ruled that Rule 10b-10 impliedly preempts state fiduciary and agency law with respect to brokers' receipt of payment for "order flow" from wholesale securities dealers, in addition to the commissions received from customers on the transactions. Dahl v. Charles Schwab & Co. Inc., 545 N.W.2d 918 (Minn. 1996); Guice v. Charles Schwab & Co. Inc., 89 N.Y.2d 31, 674 N.E.2d 282 (N.Y. 1996).