



The Dodd-Frank Wall Street Reform and Consumer Protection Act: Standards of Conduct of Brokers, Dealers, and Investment Advisers

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Summary

Brokers and dealers and investment advisers have been held to different standards of conduct in their dealings with investors. In very general terms, a broker-dealer is held to a suitability standard, and an investment adviser is held to a fiduciary duty standard. With passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), which tasks the Securities and Exchange Commission (SEC) with issuing rules concerning the standards of conduct for brokers, dealers, and investment advisers, the current standards may be changed.

The Financial Industry Regulatory Authority, a self-regulatory organization that oversees securities firms doing business in the United States and issues rules that the Securities and Exchange Commission may oversee, enforces a suitability standard for brokers and dealers. The standard requires that brokers and dealers assess their customers' knowledge of securities and their financial situations and recommend securities that are suitable for their customers.

An individual investor wishing to pursue action against a broker-dealer for recommending an unsuitable investment will often have to allege the violation of the general anti-fraud provision of the Securities Exchange Act, section 10(b), and the SEC rule issued to implement the statute, Rule 10b-5. To pursue a section 10(b) violation, an individual plaintiff must allege that, in connection with the purchase or sale of securities, he relied on a misstatement or omission of a material fact made with scienter by the defendant and that this reliance caused his injury. Investors seeking to sue a broker-dealer for violation of the suitability rule may also have to comply with the requirements of the Private Securities Litigation Reform Act.

In contrast to the suitability standard, which is most often applied to broker-dealers, investment advisers usually have a fiduciary duty with respect to investors. An investment adviser comes within the requirements of the Investment Advisers Act. Although the Investment Advisers Act does not use the word "fiduciary" to apply to the standard of conduct to which an investment adviser is held in managing a client's account, court cases have interpreted that an investment adviser has a fiduciary duty.

Changes to the standards of conduct applied to broker-dealers and investment advisers were present in both the House and the Senate versions of financial regulatory reform. However, the House and the Senate had different approaches to this issue. The House approach was to harmonize the fiduciary standard for brokers, dealers, and investment advisers. The Senate approach was to have the SEC conduct a study to evaluate the effectiveness of existing standards of conduct for brokers, dealers, and investment advisers. The House and Senate conferees on Wall Street reform approved a financial regulatory reform bill, called the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank forged a kind of compromise between the House and Senate approaches. Section 913 of the legislation, titled "Study and Rulemaking regarding Obligations of Brokers, Dealers, and Investment Advisers," is the major provision setting out the new approach toward defining standards of conduct for these financial industry professionals. It requires the SEC to conduct a study to evaluate the effectiveness of the current legal or regulatory standards of care for brokers, dealers, and investment advisers and whether there are legal gaps, shortcomings, or overlaps in the standards. Criteria that the SEC must consider are set out. The SEC may issue new rules concerning the standards of conduct to be applied to brokers, dealers, and investment advisers. This report will be updated as warranted.

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Introduction

Brokers and dealers¹ and investment advisers² have been held to different standards of conduct in their dealings with investors. In very general terms, a broker-dealer is held to a suitability standard, and an investment adviser is held to a fiduciary duty standard.³ With passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act,⁴ which tasks the Securities and Exchange Commission (SEC) with issuing rules concerning the standards of conduct for brokers, dealers, and investment advisers, the current standards may be changed.

Standard of Conduct for Broker-Dealers

The Financial Industry Regulatory Authority (FINRA) was created in 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. FINRA is a self-regulatory organization, “the largest independent regulator for all securities firms doing business in the United States,”⁵ and issues rules that the SEC may oversee. With respect to the required standard of conduct to that brokers and dealers are held, FINRA, adopting NASD Rule 2310, enforces a “suitability” standard. The rule states:

- (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have 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 his other security holdings and as to his financial situation and needs.

- (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

¹ The Securities Exchange Act of 1934, 15 U.S.C. sections 78a *et seq.*, defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78c(4)(A). A “dealer” is defined as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.” However, a “dealer does not include a person that buys or sells securities for such person’s account, either individually or in a fiduciary capacity, but not as a part of a regular business.” 15 U.S.C. § 78c(5)(A) and (B). The term “broker-dealer” is often used because of the frequent overlap of their duties.

² The Investment Advisers Act, 15 U.S.C. sections 80b-1 *et seq.*, defines an “investment adviser” as:

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 ... ; (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.... 15 U.S.C. § 80b-2(11).

³ Fiduciary is defined as “a person or institution who manages money or property for another and who must exercise a standard of care in such management activity imposed by law or contract.” BLACK’S LAW DICTIONARY (5th ed. 1979).

⁴ P.L. 111-203.

⁵ <http://www.finra.org>.

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.⁶

An individual investor wishing to pursue action against a broker-dealer for recommending an unsuitable investment will often have to allege the violation of the general anti-fraud provision of the Securities Exchange Act, section 10(b),⁷ and the SEC rule issued to implement the statute, Rule 10b-5.⁸ To pursue a section 10(b) violation, an individual plaintiff must allege that, in connection with the purchase or sale of securities, he relied on a misstatement or omission of a material fact made with scienter⁹ by the defendant and that this reliance caused his injury. Investors seeking to sue a broker-dealer for violation of the suitability rule may also have to comply with the requirements of the Private Securities Litigation Reform Act (PSLRA).¹⁰ The PSLRA is very specific about what the plaintiff must show concerning the defendant's state of mind when he committed an allegedly illegal act and requires that:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.¹¹

Although the fiduciary duty standard does not generally apply to broker-dealers, there are instances in which courts have in fact applied a fiduciary duty standard to actions by a broker-dealer. For example, a broker-dealer who handles a discretionary account¹² for a customer has often been held to a fiduciary duty standard.¹³

⁶ http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

⁷ 15 U.S.C. § 78j(b). The provision states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

⁸ 17 C.F.R. § 240.10b-5.

⁹ Scienter is defined as a "Latin term for a person's guilty knowledge; i.e., knowing that a person's actions are wrong." MODERN DICTIONARY FOR THE LEGAL PROFESSION (3d 2d. 2001).

¹⁰ 15 U.S.C. § 78u-4.

¹¹ 15 U.S.C. § 78u-4(b)(2).

¹² A discretionary account is one in which an investor allows the broker-dealer to purchase and sell securities without having to give his consent for each transaction. In a nondiscretionary account the broker-dealer buys and sells securities only as ordered by the investor.

¹³ See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F.Supp. 951 (E.D. Mich. 1978), in which at 953 [citations omitted] the court stated:

Unlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes (continued...)

Standard of Conduct for Investment Advisers

In contrast to the suitability standard, which is most often applied to broker-dealers, investment advisers usually have a fiduciary duty with respect to investors. As referenced in footnote 2, a person who for compensation advises others about purchasing securities (i.e., an investment adviser) comes within the requirements of the Investment Advisers Act. Unless registered with the SEC, an investment adviser may not make use of the mails or any means or instrumentality of interstate commerce in connection with his business as an investment adviser.¹⁴ An investment adviser may register by filing specified information with the SEC.¹⁵

Although the Investment Advisers Act does not use the word “fiduciary” to apply to the standard of conduct to which an investment adviser is held in managing a client’s account,¹⁶ court cases have interpreted that an investment adviser has a fiduciary duty. In 1963 a United States Supreme Court case, *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*,¹⁷ stated that an investment adviser owes a fiduciary duty to a client. The SEC brought suit in this case to obtain an injunction requiring a registered investment adviser to disclose to clients that he often

(...continued)

the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer’s investment and trading history; (2) keep informed regarding the changes in the market which affect his customer’s interest and act responsively to protect those interests; (3) keep his customer informed as to each completed transaction; and (5) [sic] explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.

¹⁴ 15 U.S.C. § 80b-3(a).

¹⁵ 15 U.S.C. § 80b-3(c).

¹⁶ The SEC has used the word “fiduciary” in describing the duties of an investment adviser to his clients. *Information for Newly-Registered Investment Advisers*, prepared by the staff of the SEC’s Division of Investment Management and Office of Compliance Inspections and Examinations, available at <http://www.sec.gov/divisions/investment/adooverview.htm>, states:

As an investment adviser, you are a “fiduciary” to your advisory clients. This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients’ best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfill your obligations. You must employ reasonable care to avoid misleading clients and you must provide full and fair disclosure of all material facts to your clients and prospective clients. Generally, facts are “material” if a reasonable investor would consider them to be important. You must eliminate, or at least disclose, all conflicts of interest that might incline you—consciously or unconsciously—to render advice that is not disinterested. If you do not avoid a conflict of interest that could impact the partiality of your advice, you must make full and frank disclosure of the conflict. You cannot use your clients’ assets for your own benefit or the benefit of other clients, at least without client consent. Departure from this fiduciary standard may constitute “fraud” upon your clients (under Section 206 of the Advisers Act).

It should be noted that section 206 of the Investment Advisers Act, 15 U.S.C. section 80b-6, states in part:

It shall be unlawful for any investment adviser, by the use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client....

¹⁷ 375 U.S. 180 (1963).

purchased securities for his own account before recommending those securities to his clients and then sold those securities at a profit when the market price rose after the recommendation. The Court held for the SEC and in its decision examined the legislative history, including congressional reports and hearings, of the Investment Advisers Act. From its examination of this legislative history, the Court concluded that an investment adviser has a fiduciary duty to a client that includes disclosing his practice of selling securities shortly after recommending them in order to make a profit. At the beginning of its analysis, the Court discussed the basic purpose behind the major federal securities laws.

The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940. A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, "It requires but little appreciation ... of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail" in every facet of the securities industry [footnotes and citations omitted].¹⁸

After examining the history of the Act, the Court discussed Congress's philosophy concerning the investment adviser's relationship with a client.

The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients.¹⁹

The Court went on to emphasize the fiduciary nature of an investment adviser's relationship to his client.

Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.²⁰

¹⁸ *Capital Gains Research Bureau*, at 186-187.

¹⁹ *Capital Gains Research Bureau*, at 191-192.

²⁰ *Capital Gains Research Bureau*, at 194 [footnotes omitted].

Congressional Action on Standard of Conduct for Broker-Dealers and Investment Advisers

A broker-dealer, traditionally acting upon the orders of a client with respect to a non-discretionary account, is thereby excluded from the requirements of the Investment Advisers Act; an investment adviser, as defined by that Act, is one who is paid for giving investment advice concerning investments in securities. There has been criticism over the years that this traditional distinction has become blurred and that, because of this blurring, the same standard of conduct should be applied to both broker-dealers and investment advisers. Critics point, for example, to the increase of discretionary accounts in which a broker-dealer has at least some control over the buying and selling of securities without always informing the client of each action. Critics also point to other kinds of accounts that broker-dealers have come to offer in addition to the transaction-based account, such as fee-based accounts and wrap accounts.²¹

Changes to the standards of conduct applied to broker-dealers and investment advisers were present in both the House and the Senate versions of financial regulatory reform. However, the House and the Senate had different approaches to this issue. The House approach was to harmonize the fiduciary standard for brokers, dealers, and investment advisers.²² The Senate approach was to have the SEC conduct a study to evaluate the effectiveness of existing standards of conduct for brokers, dealers, and investment advisers; submit a report of the study, with conclusions and recommendations, to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services; and begin rulemaking concerning any gaps or overlaps found by the study.²³

The House and Senate conferees on Wall Street reform approved a financial regulatory reform bill. On June 30, 2010, the House agreed to the conference report²⁴ for H.R. 4173, now referred to as the Dodd-Frank Wall Street Reform and Consumer Protection Act. On July 15, 2010, the Senate agreed to the conference report. The President signed the bill into law as P.L. 111-203 on July 21, 2010.

Dodd-Frank forged a kind of compromise between the House and Senate approaches. Section 913 of the legislation, titled “Study and Rulemaking regarding Obligations of Brokers, Dealers, and Investment Advisers,” is the major provision setting out the new approach toward defining standards of conduct for these financial industry professionals.

Section 913 of Dodd-Frank

Subsection (a) sets out the definition of “retail customer” as:

²¹ A wrap account is one “in which a brokerage manages an investor’s portfolio for a flat quarterly or annual fee. This fee covers all administrative, commission, and management expenses. Sometimes this also includes funds of funds.” Available at <http://www.investopedia.com/terms/w/wrapaccount.asp>.

²² H.R. 4173, § 7103.

²³ S. 3217, as amended, § 913.

²⁴ H.Rept. 111-517.

a natural person, or the legal representative of such natural person, who—

- (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and
- (2) uses such advice primarily for personal, household, or family purposes.

Subsection (b) requires the SEC to conduct a study to evaluate the effectiveness of the current legal or regulatory standards of care for brokers, dealers, and investment advisers and those associated with them and whether there are legal gaps, shortcomings, or overlaps in the legal or regulatory standards for the protection of retail customers that should be addressed by rule or statute.

Subsection (c) sets out what the SEC is required to consider in conducting the study: (1) the effectiveness of current legal or regulatory standards of care which have been imposed by the SEC or a national securities association and other federal and state legal or regulatory standards; (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in the standards of conduct for protecting retail customers that should be addressed by rule or statute; (3) whether retail customers understand that there are different standards of care applicable to brokers, dealers, and investment advisers in the provision of personalized investment advice about securities to retail customers; (4) whether the existence of different standards of care concerning the quality of personalized investment advice that retail customers receive is confusing to them; (5) the resources and activities of the SEC, the states, and a national securities association to enforce the standards of care, including the effectiveness of examinations of brokers, dealers, and investment advisers in determining compliance with regulations, the frequency of examinations, and the length of time of the examinations; (6) the substantive differences in regulating brokers, dealers, and investment advisers in their providing personalized investment advice and recommendations about securities to retail customers; (7) specific instances concerning personalized investment advice about securities in which regulation and oversight of investment advisers provide greater protection than regulation and oversight of brokers and dealers and instances in which regulation and oversight of brokers and dealers provide greater protection than regulation and oversight of investment advisers; (8) existing legal or regulatory standards of state securities regulators and other regulators intended to protect retail customers; (9) the potential impact on retail customers of imposing upon brokers and dealers the standard of care applied under the Investment Advisers Act; (10) the potential impact of eliminating the broker and dealer exclusion from the definition of “investment adviser” in the Investment Advisers Act; (11) the varying level of services provided by brokers, dealers, and investment advisers to retail customers; (12) the potential impact on retail customers that could result from changing the regulatory requirements or legal standards of care affecting brokers, dealers, and investment advisers concerning their obligations to retail customers about investment advice; (13) the potential additional costs to retail customers concerning the potential impact on the profitability of their investment decisions and to brokers, dealers, and investment advisers resulting from changes to the regulatory requirements or legal standards affecting brokers, dealers, or investment advisers; and (14) any other consideration that the SEC considers necessary and appropriate in determining whether to conduct a rulemaking.

Subsection (d) requires the SEC not later than six months after the date of enactment of Dodd-Frank to submit a report on the study to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services. The report must describe the findings, conclusions, and recommendations of the SEC from the study.

Subsection (e) requires the SEC to seek public comments in preparing the report.

Subsection (f) allows the SEC to begin rulemaking to address the legal or regulatory standards of care for brokers, dealers, and investment advisers for providing personalized investment advice about securities to retail customers.

Subsection (g) amends section 15 of the Securities Exchange Act²⁵ to add a provision allowing the SEC to issue rules to provide that, with respect to a broker's or dealer's providing personalized investment advice about securities to a retail customer, the standard of conduct for the broker or dealer shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act.²⁶ The broker or dealer shall not be required to have a continuing duty or loyalty to the customer after providing personalized investment advice about securities. If a broker or dealer sells only a limited range of products, the SEC may require by rule that the broker or dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer. The SEC is required to facilitate providing simple and clear disclosures to investors concerning the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest and issue appropriate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers.

Subsection (g) also amends section 211 of the Investment Advisers Act to allow the SEC to issue rules to provide that the standard of conduct for all brokers, dealers, and investment advisers shall be to act in the best interests of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. Any material conflicts of interest must be disclosed and may be consented to by the customer. The rules must provide that the standard of conduct shall be no less stringent than the antifraud standard applied to investment advisers under section 206(1) and (2) of the Investment Advisers Act.²⁷ As with the amendment to section 15 of the Securities Exchange Act, the SEC must with respect to the Investment Advisers Act facilitate providing simple and clear disclosures to investors concerning the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest. The SEC shall issue rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC has decided to be contrary to the public interest and the protection of investors.

Subsection (h) amends section 15 of the Securities Exchange Act and section 211 of the Investment Advisers Act to provide for harmonization of enforcement by the SEC with respect to violations by brokers, dealers, and investment advisers in their providing personalized investment advice about securities to retail customers.

At this time any statements as to what the SEC study might find and whether there will be new rules concerning the standards of conduct for brokers, dealers, and investment advisers are completely speculative. Nevertheless, it is interesting to note what the Chair of the SEC, Mary Schapiro, stated in 2009:

²⁵ 15 U.S.C. § 78o.

²⁶ 15 U.S.C. § 80b-11. This section gives the SEC rulemaking authority over investment advisers.

²⁷ 15 U.S.C. § 80b-6(1) and (2).

When a retail investor turns to a financial professional for investment advice or assistance in accessing the securities markets, there is an array of choices. There are broker-dealers, investment advisers, financial advisors, financial consultants and financial planners to name just a few.

When assessing these financial service providers, there is a commonality of names in certain cases—and an apparent commonality of function and service provided.

However, the types of financial service providers I just mentioned are subject to very different regulatory regimes. And the standards of conduct and legal duties owed to investors under those regimes are not consistent.

I believe that, when investors receive similar services from similar financial service providers, they should be subject to the same standard of conduct—regardless of the label applied to that financial service provider. I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients.

The fiduciary duty means that the financial service provider must at all times act in the best interest of customers or clients. In addition, a fiduciary must avoid conflicts of interest that impair its capacity to act for the benefit of its customers or clients. And if such conflicts cannot be avoided, a fiduciary must provide full and fair disclosure of the conflicts and obtain informed consent to the conflict.

A fiduciary owes its customers and clients more than mere honesty and good faith alone. A fiduciary must put its clients' and customers' interests before its own, absent disclosure of, and consent to, conflicts of interest.²⁸

Congress may closely examine the report which the SEC must issue and any rules and regulations which the SEC issues concerning the standards of conduct for brokers, dealers, and investment advisers.

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²⁸ Speech by SEC Chairman: Address before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009), available at <http://www.sec.gov/news/speech/2009/spch061809mls-2.htm>.