JULY / AUGUST 2010 Special Edition

NSCP CURRENTS

A Publication of the NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS

No Easy Road – Developing a Fiduciary Standard for Broker-Dealers

by Holly Smith

As everyone reading this article knows, we are embarking on a new era of securities regulation. When President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] on July 21, 2010, he proclaimed "These reforms represent the strongest consumer financial protections in history."[2] To achieve the legislation's goals, many decisions will need to be made in the coming months by the SEC regarding how best to achieve the legislation's purposes.

One of the most important decisions confronting the SEC as a result of the Dodd-Frank Act has to do with the legal standard that currently governs the relationship broker-dealers have with their customers. The suitability standard, which for decades has been the principal legal doctrine governing the broker-dealer/customer relationship, appears to have been overtaken by the fiduciary standard. What remains unclear and unwritten is how this fiduciary standard will be defined.

To help broker-dealers prepare for a new legal standard, this article reviews the duties to which broker-dealers are currently subject in their dealings with customers and the legislation that will form the basis for any new legal standard.

The Suitability Standard

Many years ago I worked for the SEC and spent a great deal of time thinking about the duties a registered representative owes his customers. I thought about the fact that a registered representative is a salesperson, someone who at the end of the day earns his living by introducing a product to potential customers and turning potential customers into real customers. I viewed suitability as inimical to the sales process and fundamentally two-sided because it depended upon the salesperson asking the customer the right questions, and the customer being forthcoming and honest in his responses. If the salesperson did not ask the right questions, or the customer did not disclose important information, in all likelihood there would be a mismatch between what the salesman understood about the customer's objectives and needs, and what the customer understood about the product being sold. I did not think customers were being shortchanged by not having a fiduciary standard govern their broker's conduct, probably because I viewed the suitability standard as creating a very high, and appropriate, threshold for that conduct, and because other industry rules and standards protected the customer's interests.

To review: the suitability standard is not codified in any SEC rule but it is made robust by having its own place in NASD and NYSE rules.[3] NASD Rule 2310 prohibits a salesman from making a recommendation to a customer if the salesman does not have "reasonable grounds for believing" that the recommendation is suitable for the customer.[4] The salesman's reasonable belief must be based on information disclosed by the customer regarding the customer's other security holdings, financial situation and needs. The salesman is not prohibited from making a recommendation to a customer who is not forthcoming about his financial situation, but the salesman is required to make reasonable efforts to obtain information regarding the customer's financial and tax status, investment objectives, and such other information as the salesman deems reasonable.[5] If this iterative process works as intended, the salesman understands the customer's financial needs and risk tolerance, and the customer has reason to believe that products recommended by the salesperson meet the customer's financial objectives.[6]

In applying Rule 2310 broker-dealers have been guided by FINRA interpretative material that sets forth particular types of conduct that are viewed as inherently suspect or per se fraudulent. For example, salespersons that excessively trade a customer's securities or recommend purchases beyond the financial means of the customer risk disciplinary action for conduct inconsistent with the suitability standard.[7]

In interpreting Rule 2310 FINRA has emphasized that broker-dealers and their registered representatives

(Continued on page 2)

Holly Smith *is a Partner at Sutherland Asbill & Brennan LLP in Washingon, DC, and is a former NSCP Director. She holds the CSCP designation.*

BD FIDUCIARY STANDARD
(Continued from page 1)

owe a duty of "fair dealing" to their customers.[8] Indeed, FINRA characterizes "fair dealing" as "implicit in all member and registered representative relationships with customers and others"[9] and has given fair dealing the status of a "fundamental responsibility" owed by the broker-dealer and its salesmen to their customers.[10] I believe it is fair to say that the suitability standard as codified in Rule 2310 recognizes an *ethical* obligation on the part of registered persons and their firms to treat all of their customers fairly,[11] thereby moving the suitability standard away from a "check the box" analysis toward an obligation on the part of the salesman to carefully probe and listen to his customer's concerns and objectives and act in a manner consistent with the best interests of the customer when making a recommendation. Like a seesaw balanced at the midpoint, a sale is suitable under current legal standards when the information the salesman knows about his customer matches the profile of the security being recommended.

The Dodd-Frank Act and A Fiduciary Standard

Title IX of the Dodd-Frank Act – "Investor Protections and Improvements To The Regulation of Securities" – is intended to benefit retail securities customers.[12] Importantly, Section 913 of Title IX provides a new definition of "retail customer" in the federal securities laws and rules.[13] Under Section 913, a "retail customer" is a natural person, or the legal representative of a natural person, who (i) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (ii) uses such advice primarily for personal, family, or household purposes. Section 913 orders the SEC to conduct a study to evaluate whether existing retail customer standards of care applicable to brokers, dealers, investment advisers and their associated persons are "effective", and whether there are problems in the protection of retail customers that can be traced to the standard of care provided to them. In conducting this study, the SEC must take into account fourteen (14) factors enumerated in the Act, including whether retail customers "understand that there are different standards of care" applicable to broker-dealers and investment advisers.[14]

The SEC must finish its Duty of Care/Retail Customer Study by January 21, 2011. Thereafter, it may propose a new rule or rules to protect the interests of retail customers and such other customers as it deems necessary or appropriate. The rule making authority granted to the SEC in this regard is specifically intended to address legal or regulatory standards of care for broker-dealers, investment advisers and their associated persons for providing personalized investment advice about securities to retail customers.

The Dodd-Frank Act does not mandate a uniform standard of care for retail customers of broker-dealers and investment advisers but it points heavily in that direction by giving the SEC authority to establish a fiduciary duty for brokers and dealers. Section 913 amends the Exchange Act by adding a new "Standard of Conduct" provision to the Exchange Act. This Standard of Conduct provision permits (but does not force) the SEC to adopt rules that require broker-dealers to use the same "standard of conduct" in providing personalized investment advice about securities to retail customers as would be applicable to an investment adviser under Section 211 of the Advisers Act.[15]

Within the Standard of Conduct provision, three items are particularly noteworthy. First, the provision states that it does not require a broker, dealer or registered representative to have a continuing duty of care or loyalty to the customer *after* providing personalized investment advice about securities to a retail customer.[16] Second, it states that commission payments and other standard forms of compensation to broker-dealers for the sale of securities shall not in or of themselves be considered a violation of the new broker-dealer fiduciary duty.[17] Third, the provision authorizes the SEC to adopt a rule requiring brokers or dealers that sell only proprietary or a limited range of products to provide notice to each retail customer and obtain the consent or acknowledgement of the customer (oddly, the Standard of Conduct does not identify what the customer is acknowledging or consenting to but presumably it would be to some presumed, inherent conflict of interest created by selling one's own products).[18] With respect to this last point, the Standard of Conduct provision states that a broker-dealer's sale of proprietary or other limited range of products shall not by itself be considered a violation of the fiduciary standard.

Although the Standard of Conduct provision allows but does not require the SEC to impose a fiduciary duty on broker-dealers that is the same as the fiduciary standard for investment advisers, it directs the SEC to "facilitate" the provision of "simple and clear" disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest.[19] It also directs the SEC to examine certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers and investment advisers that the SEC believes are contrary to the public interest and the protection of investors.[20] Accordingly, even if the SEC declines to impose a fiduciary standard on broker-dealers, it must ensure that it meets Congress' vision of providing "simple and clear" disclosures to investors regarding material conflicts of interest that may exist between investors and their brokers, dealers and investment advisers. Moreover, the Act directs the SEC "where appropriate" to adopt rules prohibiting or restricting sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.[21]

Conflicts of Interest

Implicit in the Dodd-Frank Act is a conclusion that customers of broker-dealers are accorded a lesser standard of care than customers of investment advisers because the latter are beneficiaries of a "fiduciary" standard.[22] This is consistent with statements made by SEC Chairman Mary L. Schapiro, who has noted that investors may be treated differently depending on whether they receive advice from a broker-dealer or an investment adviser because the fiduciary standard means that investment advisers must put the interests of their clients before their own interests.[23]

Although the SEC will need to write a rule to create a uniform fiduciary standard, the Dodd-Frank Act provides the roadmap for that rule by amending the Advisers Act in a way that makes clear that any fiduciary rule written by the SEC must require broker-dealers and investment advisers to "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[24] Dodd-Frank also requires that any new standard of conduct rule requires brokers, dealers and investment advisers to disclose material conflicts of interest to their customers and importantly, provides that such material conflicts of interest "may be consented to by the customer."[25] Thus, in the future, the suitability standard (assuming that it survives in some form) may become one leg of an "act in the best interest of the customer" standard, with legs two and three consisting of disclosure and consent standards.

What Will Change

I said at the outset of this article that in the past I did not believe customers of broker-dealers were shortchanged by the suitability standard in part because the suitability standard is augmented by other industry rules. Broker-dealer compliance professionals are well versed in existing SEC and FINRA rules that speak to many broker-dealer conflicts of interest by addressing, for example, the prices customers receive or pay in transactions;[26] the relationship between issuers and product distributors;[27] and the segregation of customer funds and securities.[28] These rules have been supplemented in recent years by SEC and FINRA enforcement actions that encouraged (some might say required) broker-dealers to provide more disclosure to customers regarding their conflicts of interest.[29]

So, let's assume that broker-dealers are accustomed to prohibiting certain conduct altogether and to disclosing information about material conflicts. What changes should we expect a new fiduciary standard to bring about for broker-dealers?

Consent Consent Consent

First and foremost may be changes to the way in which customers consent to conflicts of interest. Currently, retail customers of broker-dealers evidence their consent to the establishment of a securities account (and thus a relationship with a broker-dealer) by entering into written agreements with their broker-dealers. Although many account opening documents used in the industry are similar, there is relatively little standardized disclosure of conflicts within these documents. Customers are informed of the uses of personal information (in compliance with privacy and money laundering statutes and rules) and are informed that by signing the application they are consenting to mandatory arbitration.[30] Once having signed an account opening document, broker-dealer customers are not typically asked to provide any additional evidence of consent to specific broker-dealer practices (e.g., revenue sharing) or specific securities transactions.[31]

If the SEC adopts a fiduciary standard for broker-dealers, it will need to deal with the issue of customer consent to conflicts of interest, and the best way to obtain customer consent. What form of consent will meet the needs of both broker-dealers and their customers? Will broker-dealers be able to use account opening documents to provide notice to their customers of potential conflicts and obtain customer consent to those conflicts? Or would that type of consent not be necessary if customers received "point of sale" disclosures about conflicts of interest? The SEC and FINRA have been advocates of point of sale documents in the past, so this may be a favored approach, but it does involve timing and content issues. For example, would point of sale documents have to be generated for each specific type of conflict, and would customer consent be required on those documents, before the transaction discussed in the document is executed? As a practical matter that approach would not seem to be in the best interests of customers; a trading opportunity could be gone by the time the document was delivered, executed by the customer, and returned to the member firm. The Dodd-Frank Act does not provide the answer but specifically authorizes the SEC to issue rules identifying documents or information that a broker-dealer would be required to provide to a retail investor before the purchase of an investment product or service by the retail customer.[32]

As important as the timing of consent is the issue of what exactly the customer is consenting *to.* As noted above, current SEC and FINRA rules address numerous broker-dealer conflicts by requiring the broker-dealer to act in a certain way (*e.g.*, to provide best execution to the customer, display customer orders in broker-dealer quotations, disclose affiliations with issuers) or abstain from certain conduct altogether (*e.g.*, frontrunning). If we assume that these rules are not going to be re-written as part of the adoption of a fiduciary standard for broker-dealers, then the universe of information that must be disclosed to a customer – and consented to by the customer – should be fairly narrow. In this regard, broker-dealers may want to consider requesting that the SEC identify the items that must be included in any disclosure and customer consent forms. Without this guidance from the SEC, broker-dealers

(Continued on page 4)

BD FIDUCIARY STANDARD
(Continued from page 3)

could have no surety that they have focused on the items that conform to their fiduciary role.[33]

Clarity of Roles

Broker-dealers and investment advisers don't perform the same jobs.[34] If a uniform fiduciary standard is applied to both industries, however, will investors be any more certain about the differences between investment advisers and broker-dealers? SEC officials have cited investor confusion as being a primary driver of the need for a uniform standard of care for broker-dealers and investment advisers. I'm not certain a uniform standard of conduct will lessen this confusion. Maybe the better point to make – or to strive for in regulation – is a comprehensive set of *investor protections* that apply regardless of the regulatory status of the person with whom the customer deals. It should not be necessary to re-write several decades-worth of broker-dealer rules that currently protect broker-dealer customers from conflicts of interest.

There is no easy road here – broker-dealers, investment advisers, the SEC and FINRA will all need to engage in an earnest debate about what is in the best interests of retail investors but it will be broker-dealer customers, whom the Dodd-Frank Act almost presumes to be confused and disadvantaged by the lack of a fiduciary standard for broker-dealers, who will have to judge for themselves whether the cost of imposing a uniform standard of care is worth the candle.[35] In the near term, broker-dealers may want to weigh in with their views as the SEC considers just how much the suitability standard and other existing fair dealing rules need to be supplemented.

1. P.L. 111-203 (July 21, 2010). Throughout this article, the legislation is referred to as the "Dodd-Frank Act" or the "Act".
2. Reported by The New York Times on July 21, 2010 at http://www.nytimes.com/2010/07/22/business/22regulate.html?_r=1&hpw.
3. *See* NASD Rule 2310 and NYSE Rule 405. Although the SEC has no suitability rule *per se*, it can discipline inappropriate conduct in the salesman/customer relationship by making a finding of fraud under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act").
4. On July 30, 2010, FINRA submitted a proposed rule change to the SEC to adopt FINRA Rule 2111 (Suitability) and FINRA Rule 2090 (Know Your Customer) as part of the Consolidated FINRA rulebook. These proposed new rules would replace current NASD Rule 2310 and its related interpretative materials and NYSE Rule 405(1).
5. *See also* NASD Rule 3110, which requires FINRA members to make reasonable efforts to collect certain customer information prior to settlement of initial transactions in a customer account.
6. A 1996 NASD interpretation to Rule 2310 recognized important differences between retail and institutional customers and created a different legal standard with respect to a salesman's obligations to institutional customers. *See* NASD IM-2310-3 (Suitability Obligations to Institutional Customers); s*ee also* In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr. 50 SEC 164 (1989), reminding broker-dealers of their due diligence obligation with respect to products they distribute.
7. *See* NASD IM-2310-2 (Fair Dealing with Customers). Persons engaging in such activity may also be sanctioned for violating NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade).
8. *Id.*
9. *Id.*
10. *Id.*
11. IM-2310-2 refers to the NASD rules as creating "ethical standards".
12. One aspect of the focus on retail customers involves the establishment of a new, federally-funded committee to advise the SEC on matters of importance to retail customers. *See* Section 911 of Title IX, authorizing the establishment of an Investors Advisory Committee.
13. Under current federal securities laws and rules, retail customers are generally assumed to be all customers that do not meet an applicable "institutional" or similar customer definition and are not a broker-dealer. *See, e.g.,* SEC Rules 501 and 502 and SEC Rule 15c3-3.
14. The SEC is required to consider: (i) the effectiveness of existing legal and regulatory standards of care; (ii) legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards that protect retail customers, which should be addressed by rule or statute; (iii) whether retail customers understand that different standards of care apply to broker-dealers and investment advisers; (iv) whether the existence of different standards of care confuses retail customers with respect to the quality of personalized investment advice they receive; (v) the effectiveness of examination programs and resources for examinations and enforcement; (vi) substantive differences in the regulation of broker-dealers and investment advisers when providing personalized investment advice and recommendations about securities to retail customers; (vii) specific instances in which broker-dealer regulation and oversight provides better protection to retail customers with respect to the provision of personalized investment advice than the regulation and oversight of investment advisers and visa versa; (viii) existing legal and regulatory standards of state securities regulators and other regulators, which protect retail customers; (ix) the potential impact on retail customers of imposing on broker-dealers the standard of care applied under the Investment Advisers Act of 1940 (the "Advisers Act"), and other requirements of the Advisers Act; (x) the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" in the Adviser's Act; (xi) the varying level of services provided by broker-dealers and investment advisers to retail customers and the varying scope and terms of retail customer relationships; (xii) the potential impact upon retail customers that could result from changes in legal or regulatory standards of care; (xiii) potential additional costs and expenses to retail customers, including the potential impact on the profitability of their investment decisions and potential additional costs and expenses to broker-dealers and investment advisers as a result of new legal and regulatory standards, including the duty of care to retail customers, and (xiv) such additional factors as the SEC deems appropriate in furtherance of a rulemaking. Hereafter, the study required by Section 913 is referred to as the "Duty of Care/Retail Customer Study". On July 27, 2010 the SEC requested public comment on the Duty of Care/Retail Customer Study. *See* SEC Rel. No. 34-62577, available at http://www.sec.gov/news/press/2010/2010-134.htm.

15. The reference to a fiduciary standard in Section 211 is presumptively a reference to a new fiduciary rule that the SEC would adopt for investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers.
16. *See* Dodd-Frank Act at Section 913(g)(1).
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. The Advisers Act does not define the fiduciary standard but makes it unlawful (in Section 206) for investment advisers to engage in any fraud or deceit.
23. Speech by SEC Chairman Mary L. Schapiro, "Moving Forward: The Next Phase in Financial Regulatory Reform", available at http://www.sec.gov/news/speech/2010/spch072710mls.htm.
24. *See* Dodd-Frank Act at Section 913(g)(2).
25. *Id.*
26. *See, e.g.,* NASD Rules 2320 and 2440, FINRA Rule 2264, and SEC Regulation NMS.
27. *See, e.g.,* FINRA Rules 2262, 2269, and 5250.
28. See Exchange Act Rule 15c3-3.
29. *In the Matter of Morgan Stanley DW Inc.,* Admin. Proc. File No. 3-11335, Exchange Act Release No. 48789 (Nov. 17, 2003).
30. Note that the Dodd-Frank Act in Section 921 authorizez the SEC to prohibit or condition the use of mandatory arbitration by investment advisers and broker-dealers.
31. Depending upon the type of security at issue, customers may enter into subscription agreements in addition to account opening agreements, but retail broker-dealer customers generally are not required to separately consent to broker-dealer transactions effected for the customer on either an agency or principal basis. Contrast this practice with the requirements of Section 206(3) of the Advisers Act.
32. *See* Section 919 of the Dodd-Frank Act.
33. Section 919 identifies any compensation or other financial incentive received by a broker-dealer or other intermediary in connection with the purchase of retail investment products, as an item that would need to be disclosed if the SEC adopts a point-of-sale type rule under Section 919.
34. For an analysis of differences between investment advisers and broker-dealers, *see* "Six Degrees of Separation: Principles to Guide The Regulation of Broker-Dealers and Investment Advisers", by Michael B. Koffler, Securities Regulation & Law Report, 41 SRLR 776 (April 27, 2009).
35. Expression from medieval times when the value of any night time activity was considered against the cost of the candles that would need to be lit in order to conduct the activity.

NSCP CURRENTS

is published by the
National Society of Compliance Professionals, Inc.
22 Kent Road, Cornwall Bridge, CT 06754
(860) 672-0843 / info@nscp.org

Editor & Layout
Frederick D. Vorck, Jr.

Editor
Joan Hinchman