Broker-Dealers, Fiduciary Duties and Enhanced Conduct Standards Under the Financial Reform Act

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I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act")[1] passed by Congress on July 15, 2010 is the culmination of years of debate and negotiation over the scope of reform in the financial services industry. Among the most contentious topics debated in Congress was the call to adopt a uniform and enhanced fiduciary standard to be applied to all relationships between broker-dealers and their retail clients.

Section 913 of the Act authorizes the United States Securities and Exchange Commission ("SEC") to conduct a study that permits the SEC to adopt rules imposing the same fiduciary standard of care on broker-dealers who provide "personalized investment advice" as is currently required of investment advisers under the Investment Advisers Act of 1940.[2] The most likely long-term result will be the imposition of a fiduciary duty on brokers (who recommend transactions to customers) that mirrors the current suitability framework already in place. The Act is notable because it provides that this fiduciary duty ceases once the transaction is complete; thus, a broker-dealer in a non-advisory relationship does not have a continuing duty of care and loyalty after providing personalized investment advice to a customer. This paper will examine the current law governing broker-dealers, the likely impact the Act will have on future relationships with retail customers, and the potential compliance and supervisory issues that will arise from the new standards.

II. Current Fiduciary Standards for Broker-Dealers and Advisers

The current regulatory regime differentiates between investment advisers subject to fiduciary duties under the Investment Advisers Act of 1940 ("Advisers Act") and broker-dealers who do not receive fee-based compensation.[3] Investment advisers—those engaged in the primary

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business of providing investment advice, research, or analysis in exchange for compensation[4] —must comply with Section 206 of the Advisers Act, a general antifraud provision, which the Supreme Court has held creates a general fiduciary duty owed by investment advisers to their clients.[5] An investment adviser's fiduciary duty of "utmost good faith, and full and fair disclosure of all material facts"[6] includes a duty of loyalty "to act with the highest degree of honesty and loyalty toward another person, and in the best interests of the other person"[7] and to avoid potential conflicts of interest. Thus, investment advisers are prohibited from engaging in principal transactions without express consent[8] and from receiving capital gains-based compensation.[9] This is a public fiduciary duty whose violation may be prosecuted by the SEC but would not give rise to a private cause of action.[10]

Under SEC 202(a)(11)-1, known commonly as the "Merrill Rule," a broker-dealer who gives investment advice or recommendations is exempt from the Advisers Act requirements if the advice or recommendations are "solely incidental to the conduct of his business as a broker or dealer" and if the broker "receives no special compensation therefore."[11] As enacted, the exception was intended to encompass broker-dealers who were paid commissions on the products they sold, not on the advice they gave; thus, commission-based compensation was the key factor in analyzing of the exception. Determining who met the exception became more difficult in the 1990s, when more broker-dealers moved from commission-based compensation[12] to fee-based compensation.[13]

In an attempt to circumnavigate the confusion of a changing duty, based solely on the nature of the compensation received, the SEC proposed a rule to base the exception on the service provided, rather than on the compensation received, and to exempt only those brokers whose advice or recommendations were "solely incidental" to their brokerage sales services. The District of Columbia Court of Appeals in 2007 struck down part of Rule 202 when it held that the Advisers Act imposes a fiduciary relationship on most fee-based brokerage accounts.[14] Thus, under current regulations, any broker who receives fees, rather than commissions, for services will typically be subject to the Advisers Act and its associated fiduciary duty, as will any broker who manages a discretionary account.[15]

The broad fiduciary duties applicable to a broker who manages a discretionary account or to investment advisers were set out in *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978). These duties require a broker or adviser to "manage the account in a manner comporting with the needs and objectives of the customer," to "keep informed regarding the changes in the market which affect his customer's interest and act responsibly to protect those interests," to "keep his customer informed as to each completed transaction" and to "explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged." Conversely, a broker-dealer owes more limited duties to a customer in a non-discretionary account, and those duties cease "when the transaction is closed."[16]

III. FINRA's Suitability Requirements for Recommended Transactions

Broker-dealers who are exempt from the Advisers Act are still subject to regulatory requirements in their dealings with customers. Under FINRA Rule 2310, any broker who recommends the purchase or sale of a security must have "reasonable grounds for believing that the recommendation is suitable for such customer."[17] The broker must make reasonable efforts to obtain information about the customer's financial status, tax status, investment objectives, and other investments and must base the investment recommendation on the information obtained.[18] The suitability rule is less exacting than the general fiduciary duty standard; it does not explicitly require that the broker exhibit "the highest degree of honesty and loyalty" and act "in the best interests of the other person." [19] Practically, the suitability rule is both more concrete and more narrowly tailored than the fiduciary duty standard. It does not impose ongoing, post-recommendation duties, nor does it require the broker-dealer to place the client's interests above his/her own interest.

While FINRA rules do not explicitly impose a fiduciary duty on otherwise exempt brokers, common law may impose certain heightened duties on brokers. In Leib, the federal court held that brokers

in a non-discretionary account are obligated: 1) to recommend a security "only after studying it sufficiently to become informed as to its nature, price, and financial prognosis," 2) "to carry out the customer's orders promptly in a manner best suited to serve the customer's interests," 3) "to inform the customer of the risks involved in purchasing or selling a particular security," 4) "to refrain from self-dealing or refusing to disclose any personal interest," 5) "not to misrepresent any fact material to the transaction," and 6) "to transact business only after receiving prior authorization from the customer."[20] Recently, the Georgia Supreme Court held that brokers for non-discretionary accounts owe "limited fiduciary duties" to their customers, including a "heightened" duty when recommending an investment for which the broker may have a conflict of interest.[21] The common law duties imposed on exempt brokers, however, still do not rise to the level of general fiduciary duty imposed on investment advisers.

IV. The Call for a Uniform Fiduciary Standard

Proposals for a uniform fiduciary duty standard stemmed from increased concern by consumer advocates that many broker-dealers provide services similar to investment advisers without being held to the same standard of care. The clear division between investment advisers and brokers began to blur when brokers moved away from the commission-based system and began providing fee-based services. Consumer advocates have argued that firms that offer both advisory services and retail brokerage services cause confusion because customers are unaware of which "hat" their investment professionals wear in connection with a particular transaction.

In 2007, in response to a perceived lack of clarity in the standard, the SEC commissioned a study of the financial services industry's practices and investors' perceptions. The Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (the "RAND Report") found that "investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define."[22] The study included a survey in which customers were asked to match job descriptions with "investment adviser" or "broker-dealer." The clearest distinction participants could make was that brokers were paid on commission; they otherwise found substantial overlap.[23] When presented with the definitions of broker and investment adviser, which included job titles, legal duties, and compensation, most focus group participants were confused by the differences between the two and could not distinguish whether their financial professionals were investment brokers or advisers. Some focus group participants did not understand the differences between fiduciary duty and the suitability standard, while others believed neither standard was high or clear enough, and most did not understand the meaning of suitability. [24]

Given the Act's specific authorization for the SEC to create fiduciary duty rules and the SEC's previous recommendations, some form of fiduciary duty will most likely be mandated.

The RAND Report led to calls for regulatory reform. SEC Commissioner Elisse Walter stated in a February 2010 speech that "retail investors should not bear the burden of understanding distinctions between financial professionals that have become less relevant over the years" and that "[t]hese opaque distinctions frequently lead to investor confusion."[25] If the services are no longer distinct, it is argued, neither should the regulatory regimes be. "Investors should receive the same level of protection when they purchase comparable products and services, regardless of the financial professional involved."[26] Organizations, including the North American Securities Administrators Association, the Consumer Federation of America, and the Investment Adviser Association, lobbied for the imposition of a uniform fiduciary duty.

V. The Financial Reform Act and Its Limited Adoption of a Fiduciary Standard

In the months leading to the adoption of the Act, debate centered on the scope of a fiduciary standard applicable to retail customers. Chairman Christopher Dodd initially proposed to simply abolish the

broker-dealer exclusion provision of the Advisers Act.[27] As finally enacted, the Act requires further study and acknowledges that while the financial services industry is complicated the SEC may impose a form of fiduciary duty on broker-dealers who make recommendations to customers—in essence an enhanced suitability standard.

The Act amends Section 15 of the Securities Exchange Act of 1934[28] to provide the SEC with authority to enact rules subjecting a broker or dealer who provides "personalized investment advice about securities" to the same standard of conduct required of an investment adviser under Section 211 of the Advisers Act.[29] This amendment provides a crucial limitation: "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities," and that the receipt of commission-based or fee-based compensation will not be considered a violation of the standard of care.[30] The Act also amends Section 211 of the Advisers Act to authorize the SEC to create rules that require broker-dealers who provide personalized investment advice to act in "the best interest of the customer" without regard to their own financial interest. This "standard of conduct shall be no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of this Act when providing personalized investment advice about securities."[31] The scope of the standard of care is to be evaluated by the SEC after a six-month study of "the effectiveness of existing legal and regulatory standards of care for brokers dealers, and investment advisers . . .for providing personalized investment advice and recommendations" and "whether there are legal or regulatory gaps, shortcomings, or overlaps" in these standards.[32]

The Act is notable because it provides that this fiduciary duty ceases once the transaction is complete; thus, a broker-dealer in a non-advisory relationship does not have a continuing duty of care and loyalty after providing personalized investment advice to a customer.

VI. The Limited Scope of the New Standard of Care

While the scope of future fiduciary duty for broker-dealers is uncertain, important language in the Act limits the fiduciary duty of brokers to the provision of advice or recommendations in connection with a particular transaction and thus distinguishes this duty from an investment adviser's continuing duties of care and loyalty.[33] The Act appears to exempt unsolicited transactions and self-directed investments from its fiduciary scope.

By its terms, the enhanced standards of care under the Act apply only to "personalized investment advice," in the form of recommendations.[34] Many brokers, including online brokerage services, simply act as order-takers, and thus will be outside the scope of the Act's reach. The key issue in the future will be the definition of "personalized investment advice" and "recommendations" required to trigger a fiduciary duty for unsolicited and self-directed transactions. How much information could a broker provide before such a transaction is deemed a recommendation, thus triggering the duty? Would the duty to act in the client's best interests require the broker to advise the client against making an unsolicited transaction if the broker believes it is not in the client's interests?

Currently, there is not an industry-wide, bright-line definition of what constitutes a "solicited" transaction, and the definitions vary among brokers and brokerage firms. Hopefully, the SEC rules will offer greater clarification; but if not, firms may want to examine their definitions of "recommendation," "solicited," and "unsolicited" to ensure that they are clear, not overbroad, easily applied, and logically explained. Care should also be taken to educate brokers on uniform standards in order to counteract the temptation to mark a trade "unsolicited" to avoid the imposition of a fiduciary duty. Compliance review of "unsolicited" transactions should be heightened particularly with this motive in mind.

Another open question is whether a fiduciary duty would apply when a broker recommends that a customer retain a security or advises a customer

not to sell the security. "Holder" claims against brokers are typically not valid under the Exchange Act,[35] and the proposed amendment to Section 15 of the Exchange Act makes clear that there is no continuing duty of care after the broker has provided an investment recommendation or advice.[36] If the same "best interests" standard applicable to investment advisers giving advice—which encompasses advice to hold[37] — is applied to brokers giving advice, the fiduciary duty might be held to apply to "holder" claims against brokers. While a broker would not have the duty to monitor a customer account and would not have an affirmative duty to advise the client to hold, any advice the broker chose to give (in response to a client question or on the broker's own initiative) might be subject to the requirement that the advice be in the client's "best interests."[38]

Similarly, it is unclear whether and when a fiduciary duty would attach to broker research. Many brokerage firms prepare general research reports on products they offer. The reports are most often intended to be a general assessment of the securities offered and are not targeted at any particular customer. Plaintiffs likely will argue that such reports should be considered "personalized investment advice" or a "recommendation" of the securities. Until this issue is clarified, firms should consider including language in generalized research reports that explains that the reports are intended to be an overall assessment of the security and are not intended to be personal recommendations to customers. Financial advisors should be aware that providing their customers with research reports could be construed as providing investment advice.

Assuming the fiduciary duty is applied to a broker-dealer, what are the parameters of the duty? The Advisers Act Amendment creates a "no less stringent" standard of care on broker-dealers than that required of investment advisers.[39] The Amendment states that "material conflicts of interest shall be disclosed and may be consented to" by the customer.[40] Aside from stating that the receipt of fees or commissions will not violate conflict-of-interest provisions as a general matter, the Amendment does not specify which of the broad conflict-of-interest prohibitions associated with the investment adviser fiduciary duty would apply to broker-dealers.

Many brokers-dealers offer limited and/or proprietary products. The Amendment to the Exchange Act clarifies that offering only proprietary products or offering only a limited selection of products will not in itself violate the fiduciary duty, but the broker may be required to disclose to customers that his/her offerings are proprietary or limited and to obtain written customer acknowledgement.[41]

While a fiduciary duty most likely would not change broker-dealer compensation, the conflict of interest provisions of the fiduciary duty may require greater disclosure of compensation. The Amendments to the Advisers Act and to the Exchange Act provide that receipt of a commission or fee would not alone violate the fiduciary duty.[42] The Amendments also require disclosures of conflicts of interest to investors, and the Advisers Act Amendment provides that the Section 206(1) and 206(2) standards of conduct—requiring full disclosure of all material facts — should apply to brokers.[43] In accordance with Sections 206(1) and 206(2), the SEC requires investment advisers to provide clients with a disclosure statement about services, fees, and conflicts of interest that meets the requirement of Form ADV.[44] Brokers may be required to provide disclosures of compensation, including commissions and 12b-1 fees, similar to that required by Form ADV, and to receive client consent to their compensation, in order to meet new fiduciary duty requirements.

VII. Conclusion: The Act's Enhanced Standard of Conduct Will Create the Need for Additional Supervisory and Compliance Oversight

Until the SEC study is completed and specific rules are enacted, many questions remain about the scope and the actual impact of a fiduciary duty on broker-dealers. Given the Act's specific authorization for the SEC to create fiduciary duty rules and the SEC's previous recommendations, some form of fiduciary duty will most likely be mandated. The Amendments to the Exchange Act and the Advisers Act make clear that any fiduciary duty imposed will encompass greater disclosure and consent requirements for broker-dealers.[45] Broker-dealers would be well-advised to prepare for the changes by creating comprehensive disclosure and consent policies. Brokers who provide investment advice

should consider greater disclosure of compensation, interest as principals, proprietary or limited offerings, selling syndicate involvement, and anything else that could broadly be construed as creating a potential conflict with fiduciary duty. Brokers may want customers to provide written consent to these practices before providing any advice. Firms and compliance departments should consider the open fiduciary duty issues and how they may impact their particular business practices.

ENDNOTES

1 The full title of the Act is "An act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."
2 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. H.R. 4173, 111th Cong. (2009-2010).
3 15 U.S.C.A. § 80b-2 et. seq. (2006).
4 15 U.S.C.A. § 80b-2(a)(11).
5 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
6 *Id.* at 194.
7 Black's Law Dictionary 581 (9th ed. 2009).
8 Advisers Act Section 206(3).
9 Advisers Act Section 206(2).
10 *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 14 (1979).
11 15 U.S.C. A. § 80b-2(a)(11).
12 *Id. See also* Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, Broker-Dealer Compliance Report (April 29, 2009) at 2-3 for an in-depth discussion of the history behind the move to fee-based compensation.
13 *Id.*
14 *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).
15 Investor as Purchaser Subcommittee Memorandum at 6.
16 This limited duty is commonly referred to as the suitability rule when the transaction is based upon the broker's recommendation.
17 FINRA Rule 2310.
18 Id.
19 Black's Law Dictionary 581 (9th ed. 2009).
20 *Lieb*, 461 F. Supp. at 953.
21 *Id.*
22 Angela Hung, et. al, RAND Corp., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2007) (available at http://www.sec.gov/news/press/2008/2008-1_randriabdreport.pdf), at xiv.
23 *Id.* at 89.
24 *Id.* at 111.
25 SEC Commissioner Elisse Walter, Remarks at 2010 Investment Adviser Compliance Forum (February 25, 2010) (available at http://www.sec.gov/news/speech /2010/spch022510ebw.htm) at 5.
26 *Id.*
27 H.R. 4173, 111th Congress, 2009.
28 15 U.S.C.A. § 78(a) *et. seq.*
29 H.R. 4173 § 913(g)(1)(k)(1).
30 H.R. 4173 § 913(g)(1)(k)(1).
31 H.R. 4173 § 913(g)(1)(B)(g)(1).
32 H.R. 4173 § 913(b). In addition to these general topics, the study will specifically address: 1) whether customers understand the different standards of care; 2) whether the different standards confuse customers about the quality of the advice they are receiving—both seemingly already addressed by the RAND report; 3) regulatory and enforcement resources devoted to enforcing the standards of care; 4) substantive differences in the regulation of brokers, dealers, and investment advisers; 5) "specific instances" in which regulations for investment advisers provide greater protection for consumers than those for brokers, and vice versa; 6) existing state legal and regulatory standards; 7) the potential impact to customers of imposing the Advisers Act requirements on broker-dealers, including access to broker-dealer products; 8) the potential impact of eliminating the broker-dealer exclusion from Section 202(a)(11)(C) of the Advisers Act, including the impact on customers, the number of additional registrations and related costs to firms, and the impact on regulatory resources; 9) the different services provided by brokers, dealers, and investment advisers and differences in customer relationships; 10) the impact of regulatory changes on retail customers, including fraud protection and access to and availability of personalized advice and recommendations; and 11) potential additional expenses of these changes to customers, brokers, dealers, and investment advisers. H.R. 4173 § 913(c)
33 H.R. 4173 § 913(g)(1)(k)(1).
34 H.R. 4173 §§ 913(g)(1)-(2).
35 *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-38 (1975).
36 H.R. 4173 § 913(g)(1)(k)(1).
37 15 U.S.C.A. § 80b-2(a)(11).
38 H.R. 4173 §§ 913(g)(1)-(2).
39 H.R. 4173 § 913(g)(2)(g)(1).
40 H.R. 4173 §§ 913(g)(1)-(2).
41 H.R. 4173 §§ 913(g)(1)(k)(2).
42 H.R. 4173 §§ 913(g)(1)-(2).
43 H.R. 4173 § 913(g)(2)(g)(1).
44 Amendments to Form ADV, Advisers Act Release No. 2711 (March 3, 2008).
45 H.R. 4173 §§ 913(g)(1)-(2).

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