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News Bulletin

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SEC Releases Study on Fiduciary Standard for Broker-Dealers

By Hillel T. Cohn

On January 21, 2011, the Securities and Exchange Commission ("SEC") released its Congressionally mandated study on the effectiveness of current legal and regulatory standards for broker-dealers and investment advisers (the "Study"). The Study was prepared by the SEC staff and does not necessarily reflect the views of the five SEC Commissioners who must ultimately decide what, if any, rules should be adopted. Two of the Commissioners dissented from the decision to release the Study based on their concern that the Study failed to adequately support its position with empirical data. Nonetheless, the Study should be viewed as another step towards the likely imposition of a fiduciary standard for broker-dealers.

Background

Historically, investment advisers are considered "fiduciaries" who must act in the best interest of their customers. Broker-dealers, on the other hand, are generally not deemed "fiduciaries" and are currently excluded from the definition of "investment adviser," unless they charge separately for their investment advice. While broker-dealers are generally not considered "fiduciaries," they do owe various duties to their customers, such as the duty to recommend "suitable" investments, obtain "best execution" when effecting trades and charge fair commissions or mark-ups for their services. However, these duties fall short of a fiduciary's requirement to act in the best interests of the client and to avoid placing the interests of the fiduciary ahead of those of the client.

The different legal standard applicable to broker-dealers and investment advisers is to a large extent a product of their historically different functions—investment advisers were hired to provide advice and were paid a fee that was generally based on the value of the assets in the client's account, whereas brokers were hired to execute trades and were paid on a transactional basis for their services. Over the last 30 years, the distinction between the role played by investment advisers and the role of broker-dealers has become blurred. Today, many brokerage firm representatives are called "financial advisers" and fee-based brokerage accounts have become common.

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in 2010, it required the SEC to undertake a number of studies, including one focused on the adequacy of current regulatory standards for broker-dealers and investment advisers who provide personalized investment advice to retail customers. The Study is only one part of a broader legislative mandate which empowers the SEC to adopt rules addressing perceived regulatory gaps and which directs the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers. While the Dodd-Frank Act did not impose a fiduciary standard on broker-dealers, it clearly paved the way towards such an outcome.

Principal Conclusion of the Study—Adopt a Uniform Fiduciary Standard

The principal conclusion of the Study is that the SEC should establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice to retail customers.

Under this standard:

- Both broker-dealers and investment advisers must act in the best interests of their customers.
- In doing so, they must act without regard for their own financial interests.
- Broker-dealers would be held to a fiduciary standard no less stringent than the existing fiduciary standard for investment advisers under Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act").

The Study contemplates that the uniform fiduciary standard would involve both a duty of loyalty and a duty of care. Under the duty of loyalty, a broker or adviser would be prohibited from putting its interests ahead of the interests of the customer and would be required to disclose any conflicts of interest. Under the duty of care, a broker or adviser would be held to minimum standards of review and analysis when making investment recommendations or otherwise providing personalized investment advice to retail customers. It is not clear how, if at all, the proposed duty of care would differ from the suitability requirements already imposed on broker-dealers.

The Study discusses a number of issues which would need to be addressed if the uniform fiduciary standard is adopted and recommends that the SEC clarify how the standard would be applied through rule-making and/or interpretive guidance. Unfortunately, the Study is short on specifics as to how the fiduciary standard would be implemented and how key terms should be defined. Nonetheless, a few principles emerge from the discussion:

- There would be a uniform approach to disclosure designed to ensure that retail customers of both broker-dealers and investment advisers receive adequate and clear disclosures about:
  - the services offered by the broker-dealer or investment adviser,
  - how they charge for their services, and
  - material conflicts of interest.
- While conflicts of interest must be disclosed, broker-dealers may not be required to adhere to the requirements of Section 206(3) of the Advisers Act which requires disclosure and customer consent on a transaction by transaction basis.
- Broker-dealers would continue to be permitted to trade in a principal capacity with their retail customers, notwithstanding the obvious conflict. The SEC would provide ground rules to govern how principal trading could take place under a new fiduciary standard. Specific disclosure of conflicts would be a possible remedy, although separate disclosure and consent for every principal trade might not be required.
- The new rules should be business-model neutral. No particular business model should be favored and a diverse range of business models should be preserved in order to maximize customer choice.

The Study also considers and rejects alternative approaches that would have resulted in broker-dealers being subjected to all or most provisions of the Investment Advisers Act. These alternatives were dismissed as both unnecessary and problematic because of the multiple layers of regulation which would result for broker-dealers.

Harmonization of Regulation

In addition to recommending a uniform fiduciary standard, the Study recommends that the SEC consider harmonizing the regulation of broker-dealers and investment advisers in other areas. The SEC staff notes that investment professionals performing the same or substantially similar functions should be subject to substantially similar regulations. Regulatory topics mentioned by the Study as potential areas for harmonization include:

- Advertising and other communications with customers,
- Use of finders or solicitors,
- Customer remedies,
- Supervisory requirements,
- Firm registration procedures,
- Licensing and continuing education requirements for associated persons, and
- Books and records requirements.

Once again, the Study identifies broad areas for potential action by the SEC without providing detailed or specific recommendations as to how harmonization should be effected.

Next Steps

While the Study continues the process initiated by the Dodd-Frank Act, there is still a long way to go before any new fiduciary standard is finalized. As noted, there appears to be a potential split among the SEC Commissioners regarding the Study which may portend lengthy and contentious debate before the SEC takes any action based on the Study. Moreover, there is a strong possibility that Congress will hold hearings to consider the results of the Study. Given the changes in the composition of Congress as a result of the 2010 elections, it would be hazardous to forecast how the Study will be received on Capitol Hill.

Nonetheless, there may be a consensus forming around the concept of a modified fiduciary duty along the lines suggested by the Study. It would be prudent for members of the brokerage industry to consider how any such standard will affect their business operations. Of course, detailed planning will not be possible until the SEC provides more specific rules or guidance addressing the many issues which were not answered by the Study.

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