



Protecting Investors— Establishing the SEC Fiduciary Duty Standard

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Research Report

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AARP's Public Policy Institute informs and stimulates public debate on the issues we face as we age. Through research, analysis and dialogue with the nation's leading experts, PPI promotes development of sound, creative policies to address our common need for economic security, health care, and quality of life.

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INTRODUCTION

Many broker-dealers are not subject to a fiduciary duty when they provide personalized investment advice to their clients. Instead, they are only required to make suitable investment recommendations. While the duty to make suitable recommendations prohibits many abusive practices, it does not require, as a fiduciary duty would, broker-dealers or their representatives to give advice that is in the best interest of their clients. A fiduciary duty would also require broker-dealers and their representatives to disclose their conflicts of interest, including how they are compensated. The higher fiduciary standard of care could make a substantial difference in the retirement security of individual investors over the course of a lifetime of investing, because investors would receive better advice under the fiduciary standard.

The Dodd-Frank Wall Street Reform and Consumer Protection Act specifically authorizes the Securities and Exchange Commission to adopt a rule imposing a fiduciary duty on broker-dealers and their representatives when they provide personalized investment advice to certain investors. How such a rule is structured will determine whether investors receive an adequate level of protection. Factors that will affect the level of investor protection afforded by the rule include (1) the scope of investment advice covered by the rule; (2) how it regulates conflicts of interest, especially in connection with compensation arrangements; (3) what additional disclosure is required for broker-dealers; and (4) how the fiduciary duty will apply to principal transactions between broker-dealers and their clients.

The Fiduciary Duty at a Crossroad

This report comes at the crossroad of a long-standing public policy debate. Broker-dealers regularly provide investment advice, but not all broker-dealers who provide investment advice are subject to the federal fiduciary duty that applies under the Investment Advisers Act of 1940 (Advisers Act). This anomaly has led to calls to regulate broker-dealers under the Advisers Act, or at least to impose a fiduciary duty on broker-dealers when they provide investment advice. Historically, the brokerage industry has opposed imposing a fiduciary duty on broker-dealers that are not subject to the act.

In connection with broad legislative reform of financial services, Congress addressed this issue by granting the Securities and Exchange Commission (SEC or Commission) express authority under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or Dodd-Frank Act) to establish fiduciary standards of conduct for broker-dealers that provide personalized investment advice. Section 913 also required the SEC to conduct a study of broker-dealer and investment adviser regulation, which was released in January 2011 (Section 913 Study). Based on the SEC staff's recommendations in the study, the SEC is likely to engage in "fiduciary" rulemaking under Section 913 by imposing a fiduciary duty on broker-dealers when they provide personalized investment advice. This report discusses what form that rulemaking may take.

Fiduciary Duty Is Important to Investors

Perhaps the most pertinent question for fiduciary rulemaking is, What difference would a fiduciary duty make for consumers? The extent to which a federal fiduciary duty should be imposed on broker-dealers that provide investment advice should depend on the net benefits

that the duty would create for their customers. Many abuses in the financial services industry are already covered by broker-dealer regulation, which begs the question of what a federal fiduciary duty would accomplish that existing regulation does not. The ultimate measure of any fiduciary rulemaking will be the additional value that it creates for America's investors.

One answer to this question is that the law has long found that the fiduciary duty adds value in many business contexts. In particular, it is well established in the common law that persons who provide professional services (e.g., lawyers, accountants, and doctors) are required to act in the best interest of their clients. Professional relationships involve the kind of highly technical knowledge that makes it more difficult for consumers to evaluate the services they are receiving. They also engender the kind of relationships of trust and confidence in which customers are less likely to exercise the caution normally present in more impersonal relationships. By holding investment professionals to a higher standard of conduct than the that applied in arms-length transactions, the fiduciary duty increases the likelihood that advisory clients will receive advice that enhances their financial security and maximizes net social welfare.¹

The law has long held that investment advisory relationships involve the kind of technical knowledge and trust and confidence that warrant imposing a fiduciary duty, the importance of which is heightened for older investors.² People over 50 have less time to make up for losses, and retired investors are less likely to be able to find a paying job to offset financial reversals. As people age, their resistance to abusive sales practices may decline; conversely, their appeal to fraudsters as targets may increase.

Older investors therefore are at greater risk under fraud-based standards where a *caveat emptor* defense that the victim chose the inappropriate investment can be sufficient to defeat a claim. This defense often fails where the fiduciary duty affirmatively requires that the adviser act in the best interest of the client. It is therefore with respect to vulnerable investors that the fiduciary duty is likely to have the greatest effect, because it is designed to protect investors who may be less able to protect their own interests. This vulnerability is greatest when broker-dealers' and investment advisers' compensation depends not on the quality of their services or the performance of the products that they recommend, but on the product the client purchases. The fiduciary duty requires avoidance of such conflicts of interest and full disclosure of conflicts when avoidance is not practicable.

Antifraud rules may be sufficient to address most, but not all, misconduct. The value of the fiduciary duty lies in the conduct that should be prohibited and that only the fiduciary duty prohibits, that is, conduct that is not prohibited by antifraud rules. Imposing a fiduciary duty on persons who provide retail investment advice is no panacea,³ but it does not need to be. It is simply good policy that will enhance Americans' financial security.

¹ See, generally, Tamar Frankel, "Fiduciary Duties as Default Rules," *Oregon Law Review* 74 (1995): 1209.

² Some states have adopted rules that are specific to seniors regarding sales practices and professional designations.

³ See Arthur Postal, "What Did the Fiduciary Standard Do to Stop Madoff?" *National Underwriter* (Feb. 23, 2010), <http://www.lifeandhealthinsurancenews.com/News/2010/2/Pages/NAIFA-What-Did-The-Fiduciary-Standard-Do-To-Stop-Madoff.aspx?k=madoff>.

Fiduciary Duty: Historical Context

Many broker-dealers are not subject to the fiduciary duty under the Advisers Act because they are excluded from the act’s definition of “investment adviser.” The exclusion is available to broker-dealers whose investment advice is solely incidental to their brokerage services and who receive no special compensation for advice. Commissions are not considered to be “special compensation,” but asset-based fees are, which means that fee-based brokerage programs are subject to the act.

During the past decade, opposition to the inconsistent standards applied to investment advice provided by broker-dealers and investment advisers coalesced. Consumer and financial planner groups lobbied for a uniform fiduciary standard for all investment advisory relationships.⁴ SEC Chairman Mary Schapiro announced her support for a fiduciary standard for broker-dealers that provided investment advice, and the Financial Industry Regulatory Authority (FINRA) reversed its earlier opposition to the fiduciary standard.

In 2009, the Treasury Department released a report that endorsed “establishing a fiduciary duty for broker-dealers offering investment advice.”⁵ The department emphasized the need to—

empower [the SEC] to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in investors’ best interest.⁶

The report formed the basis of the broad-based legislative review of financial services regulation that culminated in the Dodd-Frank Act. Congress did not expressly establish a fiduciary duty for broker-dealers in the act, but required the SEC to study broker-dealer and investment adviser regulation and authorized it to adopt fiduciary rules based on its findings. Section 913(g) of the act also authorized the SEC to—

examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

The Section 913 Report specifically recommends that the SEC “prohibit certain conflicts,”⁷ which should be a central part of the SEC’s fiduciary rulemaking.

⁴ See, e.g., Letter from Financial Planning Coalition to Conferees (June 23, 2010) (copy on file with author); *Statement of CFA Director of Investor Protection Barbara Roper In Support of House Fiduciary Duty Provision*, Consumer Federation of America (June 15, 2010), http://www.consumerfed.org/elements/www.consumerfed.org/file/Roper_Statement_fiduciary_duty_press_conference.pdf.

⁵ *Financial Regulatory Reform: A New Foundation*, Department of the Treasury, (June 17, 2009), p. 15, http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

⁶ *Ibid.*, p. 71.

⁷ Section 913 Study, p. vii.

THE FEDERAL REGULATION OF INVESTMENT ADVISERS

Investment Advisers Act of 1940

Investment advisers are regulated primarily under the Investment Advisers Act of 1940. The Advisers Act generally regulates persons who are “investment advisers” under the act, which are defined to include—

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.⁸

The SEC has interpreted the phrases “for compensation” and “advising others” so broadly⁹ that core services provided by most retail broker-dealers fall within the definition of investment advice under the act. The bulk of broker-dealers’ activities therefore would be subject to the act if they could not rely on the broker exclusion.¹⁰

The Broker Exclusion

The Advisers Act provides an exclusion from the act’s definition of “investment adviser” (and thereby a complete exemption from the Act) for 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.¹¹

The SEC takes the position that discretionary accounts are not “solely incidental” and that asset-based fees (i.e., a percentage of assets under management) constitute “special compensation.” Many broker-dealers and their affiliates are registered investment advisers because they charge asset-based fees, exercise discretion over customer accounts, or otherwise engage in activities that make the broker exclusion unavailable. They must register under the act and are subject to the act’s fiduciary duty. Broker-dealers that charge only commissions and do not exercise discretion of customer accounts generally can rely on the exclusion. This latter category would be the group most affected by fiduciary rulemaking under Section 913.

⁸ Advisers Act Section 202(a)(11).

⁹ See *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, SEC Release No. IA-1092 (Oct. 8, 1987).

¹⁰ Section 913 required that the SEC consider repeal of the broker exclusion as a means of applying the fiduciary duty to broker-dealers. The Section 913 Study recommended against repealing the exclusion, and this alternative is not discussed further in this report. See Section 913 Study, p. 140.

¹¹ Advisers Act Section 202(a)(11)(C).

Antifraud Provisions and the Fiduciary Duty

Many of the substantive conduct requirements under the Advisers Act arise from the antifraud provisions of Section 206 of the act. Sections 206(1) and (2) generally make it unlawful for an investment adviser—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client; [or]
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.¹²

A substantial body of law has developed under these provisions, including the fiduciary duty that the Supreme Court has found that they create.¹³

THE FEDERAL REGULATION OF BROKER-DEALERS

Although the focus of broker-dealer regulation is transactional services, rather than advisory services, its coverage of advisory services is considerable. The existing regulation of broker-dealers' advisory activities necessitates that any fiduciary rulemaking build on this existing structure of advisory regulation. This is not to say that fiduciary rulemaking must accommodate broker-dealers' existing business models. Rather, fiduciary rulemaking must accommodate the way in which broker-dealers' business models already incorporate existing, quasi-fiduciary regulation of their advisory activities.

The following discussion briefly sets forth the basic structure of broker-dealer regulation and addresses some of the ways in which it applies to broker-dealers' advisory activities.

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 is the primary source of regulation for broker-dealers in the United States. It generally requires that persons who act as “brokers” or dealers,”¹⁴ among other requirements, comply with net capital rules, market structure rules, and special trading restrictions; and register and file reports with SEC.

¹² See also Advisers Act Sections 206(3) (restricting transactions involving advisory clients in which the adviser is acting as a broker or principal on the other side of the transaction) and 206(4) (prohibiting fraud and deceit in violation of rules adopted by the SEC pursuant to Section 206(4)). Under its Section 206(4) rulemaking authority, the SEC has adopted rules relating to advertisements, custody, disclosure of financial and disciplinary information, and cash payments to solicitors.

¹³ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, *passim* (1963). In *Capital Gains*, the Court granted a preliminary injunction requiring an investment adviser to disclose its purchases of securities prior to recommending the same securities in an investment newsletter. The Court has held that there is no private right of action under Section 206; see *Transamerica Mortgage Advisors Inc. v. Lewis*, 444 U.S. 1 (1979), which has left much of the development of the law under Sections 206(1) and (2) to public enforcement proceedings.

¹⁴ The Exchange Act defines “brokers” as persons who are “engaged in the business of effecting transactions in securities for others,” and “dealers” as persons who are “engaged in the business of buying and selling securities for [their] own account[s].” Exchange Act Sections 3(a)(4) and (5).

Broker-dealers are also subject to the Exchange Act’s general antifraud provisions. Section 10(b) authorizes the SEC to adopt rules prohibiting fraudulent practices, and Rule 10b-5 under that provision prohibits such practices. Rule 10b-5 is very similar to the general antifraud provisions under the Advisers Act.¹⁵

FINRA Oversight and Rules

Virtually all broker-dealers are effectively required to become members of FINRA, which imposes its own set of rules. The Exchange Act requires that FINRA rules be “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,” and “to protect investors and the public interest”¹⁶ In addition, FINRA’s rules must provide for appropriate discipline of members who violate the Exchange Act or rules thereunder, or FINRA rules.

FINRA does not have the authority to enforce the provisions of the Advisers Act or rules thereunder,¹⁷ although it can and does engage in direct and indirect regulation of its members’ advisory activities through its Exchange Act authority. The clearest example of FINRA’s direct regulation of its members’ advisory activities is the suitability rule.

The Suitability Rule

Brokers are subject to a suitability obligation in National Association of Securities Dealers (NASD) Rule 2310, which provides that, when recommending a transaction, a broker must—

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.¹⁸

Before making the recommendation, a broker-dealer generally must have made “reasonable efforts to obtain information” concerning the customer’s financial and tax

¹⁵ One difference is that Rule 10b-5 expressly prohibits material misstatements and omissions, while Advisers Act Section 206 does not. In *Capital Gains*, the Supreme Court essentially held that the prohibition against material misstatements and omissions was incorporated into Section 206 by implication. A second difference is that a violation of Section 206 can be negligence-based, whereas Rule 10b-5 has a scienter (intent) requirement.

¹⁶ See Exchange Act Section 15A(b)(6).

¹⁷ See Letter from Office of the General Counsel, Securities and Exchange Commission to the Financial Planning Association (Aug. 27, 2009).

¹⁸ FINRA is in the process of consolidating the rulebooks of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). Until the process is complete, some rules, like NASD 2310, are still referred to by their NASD or NYSE numbers. Sales of variable annuities are particularly prone to abusive practices. FINRA Rule 2330 accordingly imposes heightened suitability requirements on such sales.

status, investment objectives, and other information reasonably necessary for making the recommendation.¹⁹

The suitability rule is undeniably a form of regulation of investment advisory activities. The rule is, like the fiduciary duty, an inherently principles-based rule that is triggered by investment advice (“recommendations”).²⁰ However, the suitability standard is materially lower than a fiduciary standard. There is no obligation under the suitability rule to have reasonable grounds to believe that a recommendation is in the best interest of the customer. If a security recommended by a broker-dealer is suitable for a customer, but a different security would be a better choice for the customer, there is no obligation to recommend the other security. The broker-dealer is free to recommend the security that pays the broker-dealer the highest compensation, as long as it is suitable, and the broker-dealer is not necessarily obligated even to disclose the conflict of interest that the differential compensation represents.

Broker-Dealers’ Fiduciary Duties with Respect to Advisory Activities

The direct and indirect regulation of broker-dealers’ investment advisory activities under the Exchange Act and FINRA rules could not be said to rise to the level of a federal fiduciary duty, but broker-dealers can be subject to a fiduciary duty with respect to their advisory activities under other, nonfederal sources of law. In private claims, for example, courts have frequently found that a broker has a fiduciary duty under state law, depending on the particular facts and circumstances.²¹ The most common claim brought in FINRA arbitration is a violation of a fiduciary duty. In some cases, even the antifraud provisions of the Exchange Act have been deemed to create a fiduciary duty.²²

Broker-Dealer Compliance under a New Federal Fiduciary Duty

A number of factors indicate that, for many broker-dealers, the effect of a new federal fiduciary duty on their compliance systems will be small. Broker-dealers already are frequently held to a fiduciary duty with respect to their advisory activities; they are already subject to extensive, principles-based regulation of their broker-dealer and advisory activities; and many of them already are subject to the Advisers Act’s fiduciary duty. Effective broker-dealer compliance systems therefore must be designed to manage fiduciary responsibilities under the existing regulatory regime.

Thus, to a large extent broker-dealers’ compliance systems are already designed to manage precisely the compliance concerns that a federal fiduciary duty creates. The new fiduciary duty will bring an additional, limited set of activities—namely, nondiscretionary investment advice for which only commissions are charged—under existing compliance systems. Although these activities will incur short-term transition costs, the application

¹⁹ NASD Rule 2310(b). This requirement supplements a general rule regarding the maintaining of specified account information under NASD Rule 3110 and rules promulgated under the Exchange Act.

²⁰ See *E. F. Hutton & Co., Inc.*, Exchange Act Rel. No. 25887 (1988) (FINRA rules “embod[y] basic fiduciary responsibilities”).

²¹ See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981).

²² See, e.g., *Geman v. SEC*, 334 F.3d 1183 (10th Cir. 2003).

of a uniform fiduciary duty to many broker-dealers may be more likely to *reduce* compliance costs in the long term because the currently bifurcated regulatory approach to retail advice will be simplified under a single, federal fiduciary umbrella.

If fiduciary rulemaking is conducted as part of the broader harmonization of broker-dealer and investment adviser regulation recommended by the SEC staff, many broker-dealers should realize further net reductions in compliance costs. The harmonization of parallel requirements under the Exchange and Advisers Acts with respect to advertising, supervision, registration, arbitration, solicitors, customer communications, and books and records, for example, should reduce overall regulatory burdens to a far greater extent than the additional costs that may be associated with the narrow expansion of broker-dealers' substantive duties under a new uniform fiduciary standard.

DODD-FRANK SECTION 913

Fiduciary Rulemaking

Section 913 grants the SEC authority to adopt rules governing broker-dealers' conduct under three provisions. Paragraph (f) of Section 913 empowers the SEC to adopt rules to "address" the standards of care that apply to brokers, dealers and investment advisers in "providing personalized investment advice about securities to such retail customers." This open-ended authority is subject only to the condition that the SEC "consider the findings conclusions, and recommendations of the study" required under paragraph (b).

Paragraph (g) includes two provisions that authorize fiduciary rulemaking, respectively, under the Advisers Act and the Exchange Act. These provisions are subject to a number of conditions that will constrain the SEC's fiduciary rulemaking authority.

The Advisers Act authority provides that, with respect to personalized investment advice that brokers provide to retail customers (and nonretail customers as determined by the SEC)—

1. The standard of conduct for broker-dealers under the rules shall be to "act in the best interest of the customer."
2. The broker-dealer must act "without regard to the financial or other interest of the broker . . . providing the advice."
3. Under the rules, "any material conflicts of interest shall be disclosed and may be consented to by the customer."
4. The standard of conduct under the rules must be "no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of [the Advisers Act]."

The foregoing rulemaking conditions operate as a kind of floor below which fiduciary rules may not fall. Conversely, the Advisers Act authority also places a *ceiling* on the reach of the rules in two respects:

1. A "customer" under the rules may not include an investor in a "private fund."
2. "[T]he receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation" of the standard of conduct under the rules.

Section 913(g) Exchange Act authority provides that the fiduciary standard shall be the “same as the standard of conduct applicable to an investment adviser” under the Advisers Act rulemaking. This requirement effectively necessitates that Exchange Act rulemaking satisfy all of the provisos discussed immediately above. It also includes two additional provisos:

1. The “best interest” standard shall not, by itself, require a broker “to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.”
2. A broker’s “sale of only proprietary or other limited range of products . . . shall not, in and of itself, be considered a violation” of the “best interest” standard.

Harmonization

Section 913(h) includes a requirement that the SEC seek to “harmonize” the enforcement of rules applicable to broker-dealers and investment advisers when they provide personalized, retail investment advice. The harmonization provisions further evince Congress’s expectation that the same standard of conduct will be applied to broker-dealers and investment advisers with respect to personalized investment advice.

The SEC staff embraced this directive in its Section 913 Study. The study presents detailed recommendations regarding areas in which the SEC should consider harmonizing broker-dealer and investment adviser regulation. As discussed below, some recommendations contemplate raising the standards applicable to broker-dealers to reflect a higher adviser standard (e.g., more extensive disclosure in a brochure similar to that provided to clients by advisers). Other recommendations would extend more detailed, FINRA-like standards to advisers.²³

APPROACHES TO FIDUCIARY RULEMAKING

The question of how the SEC may approach fiduciary rulemaking under Dodd-Frank Section 913 can be usefully divided between two categories. First, the SEC is likely to establish some form of “best interest of the customer” standard that applies to personalized, retail investment advice and incorporates certain minimum terms that Section 913 requires fiduciary rulemaking to reflect. A draft of what such a rulemaking might comprise is provided in appendix A of this report. The draft rules in appendix A would provide a minimum “best interest” standard and formal basis for specific conduct rules.

Second, Section 913 at least implicitly authorizes rules that establish specific, substantive standards of conduct. The Section 913 Study identifies the conduct areas that are most likely to be subject to such rulemaking. These include the fiduciary duty as applied to the disclosure, restriction, and prohibition of conflicts of interest; principal transactions between broker-dealers and their advisory customers; and the requisite minimum basis for investment recommendations.

²³ See Section 913 Study, pp. 130–39.

Principles-Based Fiduciary Rulemaking

The Uniform Fiduciary Standard

As discussed above, Section 913 of Dodd-Frank grants the SEC the authority to impose fiduciary rules on broker-dealers subject to the following conditions:

- Neutrality as to (*i.e.*, no bias regarding) the menu of options offered, the compensation structure applied, and the continuous nature of the advice;
- Uniformity in content and application to broker-dealers and investment advisers;
- A “best interest” standard that (a) is at least as stringent as that applied under Advisers Act Sections 206(1) and (2), (b) requires disclosure of material conflicts of interest and customer consent thereto, and (c) requires that advice be provided without regard to the broker-dealer’s interests; and
- Exemption of certain investors in private funds.

This baseline set of rulemaking guidelines would afford the SEC broad discretion in determining how to apply a fiduciary duty to broker-dealers that provide personalized, retail investment advice.

The Section 913 Study recommends that the SEC adopt principles-based rules along these lines.²⁴ This recommendation, while lacking specifics, supports stand-alone, principles-based rules, the promulgation of which would not depend on concurrent rulemaking regarding specific areas of conduct.²⁵ Initially, the SEC should adopt a rule similar to the draft rules in appendix A that incorporate the essential elements of such a principles-based approach and establish a foundation for further rulemaking.

Personalized Investment Advice

One potentially contentious issue regarding fiduciary rulemaking is how the SEC will define the “personalized investment advice” that would be subject to the uniform fiduciary duty. Section 913’s use of the term “personalized investment advice” normally would be interpreted consistently with the Advisers Act. The term has a long history and common usage under the Advisers Act and no history or common usage under the Exchange Act, as noted in the Section 913 Study.²⁶ The amendment to the Exchange Act that authorizes the imposition of a fiduciary duty is derivative; that is, it expressly adopts the standard applied under the Advisers Act, which further supports interpreting the term “personalized investment advice” under that act.

²⁴ *Ibid.*, p. 109.

²⁵ However, two SEC Commissioners objected that the study did not provide adequate empirical support for the recommended uniform fiduciary duty, an argument since echoed by some members of Congress. There is a significant risk that fiduciary rulemaking will be subject to a legal challenge on the ground that the SEC did not conduct an adequate cost-benefit analysis, especially in light of the recent, successful challenge to the SEC’s proxy access rule on this basis. *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir. July 22, 2011).

²⁶ See Section 913 Study, pp. 123–24.

Excluding some forms of retail investment advice provided by broker-dealers from the uniform fiduciary duty by limiting the scope of “personalized investment advice” would contradict Section 913’s harmonization purpose. As stated in the Section 913 Study, “[t]he implementation of a uniform standard of conduct would be most effective only if the standard is applied uniformly.”²⁷

However, the study states that “personalized investment advice” would not necessarily include all “actions or communications that would be investment advice about securities under the Advisers Act.”²⁸ Thus, the staff is receptive to arguments that some forms of personalized investment advice under the Advisers Act may nonetheless be excluded from personalized investment advice under Section 913 and therefore exempt from the uniform fiduciary duty.²⁹ Subjecting broker-dealers and investment advisers that provide identical advisory services to different legal standards because of a narrow interpretation of “personalized investment advice” would undermine Congress’s intent to harmonize the regulatory treatment of investment advice. The SEC should clearly establish that it will interpret the term “personalized investment advice” consistently with its long history and usage in the Advisers Act.

Continuous Duty of Care and Loyalty

The standard of conduct adopted under the Section 913(g)’s Exchange Act rulemaking authority cannot require that broker-dealer owe a “continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.”³⁰ This continuous duty proviso creates the risk that it will be interpreted to permit broker-dealers to remove their fiduciary mantle in the course of an ongoing advisory relationship. They may argue that the advisory relationship ceases at the moment, for example, that a financial plan has been delivered to a customer, at which time the broker-dealer would be relieved of any fiduciary duty arising from standards of conduct promulgated under Section 913.

Such an interpretation of the continuous duty proviso threatens the efficacy of any standard of conduct rules adopted under Section 913. As studies have repeatedly found, investors do not understand the different legal standards that apply to brokers and investment advisers.³¹ They expect those who provide professional services such as personalized

²⁷ *Ibid.*, p. 112.

²⁸ The Section 913 Study (p. 127) states that, at a minimum, “personalized investment advice” should include all “recommendations” under FINRA rules and exclude “impersonal” investment advice as that term is used under the Advisers Act.

²⁹ *Ibid.*, p. 127, “[t]he phrases ‘personalized investment advice’ and ‘recommendations’ relate to existing terms of art in both the broker-dealer and investment adviser regimes. This usage suggests that the phrase ‘personalized investment advice about securities’ in the uniform fiduciary standard could be read in a way that is consistent with the scope and interpretive history of both statutes.”

³⁰ It is well established that the “giving of advice triggers no ongoing duty to do so.” *de Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002).

³¹ See, e.g., *U.S. Investors and the Fiduciary Standard*, AARP, Consumer Federation of America and North American Association of Securities Administrators (Sept. 15, 2010); Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, and Farrukh Suvankulov, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (Rand Corporation, 2008).

investment advice to be required to act in their best interest. Allowing brokers to switch hats would facilitate the use of the fiduciary relationship to lull unsuspecting customers into a false sense of security, making them easier targets for fraud and abuse.

Although the Section 913 Study does not discuss the extent to which the uniform fiduciary duty applies with respect to services following the providing of investment recommendation, the staff has previously taken positions that appear to authorize misleading hat-switching.³² The SEC should expressly repudiate these positions and provide guidance narrowly circumscribing the circumstances in which broker-dealers can provide investment advice subject to a fiduciary duty and then implement that advice or provide other related services without being subject to the fiduciary duty.

Recommendations Made Without Regard to Broker-Dealers’ “Interests”

Fiduciary rules adopted under the Advisers Act, and therefore rules derivatively adopted under the Exchange Act, must require that broker-dealers act in the best interest of their customers “without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.” Although some commentators have suggested that this phrase could mean that broker-dealers must provide their services for free,³³ it more likely means that the broker-dealer cannot provide advisory services that are unduly motivated or influenced by the amount of the compensation the broker-dealer receives in connection with the advice.

This requirement may raise issues for broker-dealers when the nature of their advice affects their compensation. For example, broker-dealers that receive differential compensation, such as revenue-sharing payments from mutual funds, that varies depending on which investment they recommend, may be more vulnerable to claims that their advice was not given “without regard to the financial or other interests of the broker” than brokers that unbundle their fees and charge the same fee regardless of the investment selected.³⁴

The broker-dealer community also has expressed concern regarding the extension of the “without regard to” standard to what might be called “second-tier” differential compensation. This includes indirect benefits that may inure to broker-dealers when they recommend, for example, proprietary funds or investments in initial public offerings in which their firm is a syndicate member. Even if the individual registered representative who makes the recommendation receives no direct benefit therefrom, the representative may have an indirect incentive to recommend certain transactions. The Section 913 Study does not discuss this

³² See, e.g., *Securities Industry Association*, SEC No-Action Letter, 2005 WL 3526529 (Dec. 16, 2005), permitting hat switching.

³³ See, e.g., Clifford Kirsch, *Broker-Dealer Advisory Services*, SR029 ALI-ABA 193 (Oct. 8–9, 2009), “Is the standard of acting ‘without regard to’ the financial interest of the broker-dealer so broad that it effectively requires no compensation . . .?”

³⁴ This unbundling incentive is also reflected in the SEC’s proposed 12b-1 fee reforms. See *Mutual Fund Distribution Fees; Confirmations*, Exchange Act Rel. No. 62544 (July 21, 2010), pp. 244–45. The issue is analogous to the debate regarding proposed rules that implement the Employee Retirement Income Security Act of 1974 (ERISA) requirement that certain advisers’ fees not be affected by the recommendations that they make to plan beneficiaries. See, generally, *Investment Advice—Participants and Beneficiaries*, 75 F.R. 9360 (Mar. 2, 2010).

issue, but it should be the central feature of fiduciary rulemaking. The SEC should identify the circumstances in which a financial professional's receipt of compensation or other second-tier benefits that vary depending on the advice provided to a customer create a conflict of interest and therefore could cause the advice to be deemed to have been provided "with regard" to the broker-dealer's financial interest for purposes of Section 913. The SEC also should consider banning certain of these practices, as specifically authorized by Section 913(g).

Nonretail Investors

Section 913's rulemaking grant of authority extends to retail customers "and such other persons as the Commission may by rule provide." It is unlikely that any fiduciary rulemaking regarding nonretail investors will occur in the near term. The SEC's workload will be dominated by Dodd-Frank requirements for most or all of 2011; merely promulgating standards for retail investors in the near term will tax the SEC's resources. The Section 913 Study does not recommend extending (or not extending) the fiduciary duty to nonretail clients.³⁵ Recent congressional questioning regarding the fiduciary standard as applied to retail investors makes the near-term possibility of applying the standard to nonretail investors less likely.

However, the retail/nonretail distinction in Section 913 creates significant tensions in the regulation of investment advice that should not be left unaddressed in the long term. Many "nonretail" advisory clients manage assets for retail investors, which militates for extending fiduciary standards to at least some types of nonretail customers. For example, public pension plans manage billions of dollars in public assets on which the quality of life of millions of natural (retail) persons depends, and many of these pension plans are the kind of unsophisticated investors for which a fiduciary duty would be appropriate. In light of the growing problems of public financial mismanagement,³⁶ the SEC should not delay considering the application of the fiduciary duty to certain nonretail investors.³⁷ Indeed, the potential societal costs of failing to do so may exceed a failure to apply the fiduciary duty to retail investors.

Implementation of the Uniform Fiduciary Standard

The promulgation of a uniform fiduciary standard is likely to be followed, if not accompanied, by rulemaking and interpretive guidance regarding specific elements of the fiduciary duty. The Section 913 Study discusses these elements as set forth below.

³⁵ Section 913 Study, p. 913, "The Commission could consider whether the uniform fiduciary standard should also be extended to persons other than retail customers that may also benefit from the additional investor protections that would be provided by the standard."

³⁶ See Meredith Whitney, "The Hidden State Financial Crisis," *Wall Street Journal* (May 18, 2011).

³⁷ Cf. Dodd-Frank Sections 731 (generally providing that swap dealers and major swap participants acting as advisers "shall have a duty to act in the best interests" of certain nonretail customers, including states, municipalities, public and private pension plans and endowments) and 975 (establishing a fiduciary duty for "municipal advisors").

Disclosure of Conflicts of Interest

Disclosure of conflicts of interest is arguably the core requirement of the fiduciary duty. As stated in the Section 913 Study, “for the uniform fiduciary standard to be effective, investors need to understand any material conflicts of interest of their investment adviser or broker-dealer.”³⁸ Section 913 provides that, under fiduciary rulemaking, “any material conflicts shall be disclosed and may be consented to by the customer.” Broker-dealers and investment advisers currently disclose conflicts of interest under a variety of rules, in different formats, and at different times.

Unlike the discretionary authority granted to the SEC to adopt fiduciary rules, Section 913 of Dodd-Frank *requires* that the SEC “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.” The mandatory nature of this directive makes it likely that the promulgation of a uniform fiduciary standard will be accompanied or soon followed by new disclosure rules.

The Section 913 Study notes that broker-dealers are not required to provide a specific disclosure document to a customer at the inception of the relationship. In contrast, investment advisers are required to deliver part of their registration form (Form ADV), which is known as the “brochure,” at the time that they enter into a relationship with a client. Broker-dealers are not subject to the same level of disclosure as required in Form ADV.

Broker-dealers are subject to certain disclosure requirements at the time an investment recommendation is made and must provide post-transaction information to customers on the trade confirmation required by Exchange Act Rule 10b-10. However, these disclosures do not necessarily precede the customer’s investment decision, much less the decision to retain the broker-dealer.

The staff recommends that SEC consider three approaches to facilitate the disclosure of conflicts of interest, along with other information, that is “uniform, simple and clear.”³⁹ The staff recommends that the SEC—

- consider requiring broker-dealers to deliver a disclosure document similar to an adviser’s brochure at or before the time the customer opens an account;
- “explore the utility and feasibility of a summary disclosure document that would describe in clear, summary form, a firm’s services (including the extent to which its advice is limited in time or is continuous and ongoing), charges, and conflicts of interest;” and

³⁸ *Ibid.*, p. 116.

³⁹ *Ibid.*, p. 117. Pursuant to Section 919B of Dodd-Frank, the SEC conducted a study of “ways to improve the access of investors to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information)” about broker-dealers and investment advisers. See *Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers* (SEC Office of Investor Education and Advocacy, Jan. 2011). The study’s near-term recommendations, which must be implemented by August 2012, relate to the consolidation of BrokerCheck and the Investment Advisor Public Disclosure (IAPD) system to improve the usability of the information for investors. See Section 913 Study, pp. 5–6.

- consider developing uniform disclosure requirements that apply at the time the investment advice is provided on, for example, information regarding products, risks, and compensation that is more specific to a particular transaction.

It appears that the summary document might be made available on a firm’s website, with the brochure being delivered to each client. Notably, the staff does not recommend that the broker-dealer registration form (Form BD) and Form ADV be consolidated.

It is likely that the SEC will propose rules that substantially revise the framework in which broker-dealers provide disclosure to their clients. This may entail the delivery of a brochure, such as that proposed by FINRA in 2010,⁴⁰ as well as more specific disclosure delivered at the time of a transaction and/or investment recommendation, such as the point-of-sale disclosure originally proposed by the SEC in 2004.⁴¹ As noted, the mandatory nature of Dodd-Frank’s instructions regarding disclosure makes it likely that this rulemaking will accompany or follow closely on the promulgation of a uniform fiduciary standard. The SEC should adopt rules that require broker-dealers to provide a brochure prior to the time of the engagement in order to allow clients an opportunity to evaluate the broker-dealer’s services and compensation structure before opening an account. Additional, transaction-specific disclosure should be required as appropriate.

Restricted/Prohibited Conflicts of Interest

In addition to enhancing the disclosure of conflicts of interest, the SEC is likely to consider outright prohibitions of certain practices. Section 913(g) of Dodd-Frank requires that the SEC—

examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

The Section 913 Study does not indicate what practices should be examined pursuant to this mandate. The most likely candidates for prohibition may be compensation practices that create financial incentives for financial professionals to favor one course of action or investment product over another, regardless of which is in the client’s best interests. This would be consistent with Section 913’s mandate that the fiduciary standard require a broker-dealer or investment adviser to act in the customer’s best interest “without regard to [its] financial or other interest.” For example, the SEC should require disclosure of the dollar amount of all fees received by broker-dealers and investment advisers and that such disclosure be accompanied by a statement of the conflict of interest created by differential compensation and/or the offering of a limited menu of proprietary products (as subparagraph (d)(2) in the draft rules in appendix A should be interpreted

⁴⁰ *Disclosure of Services, Conflicts and Duties*, FINRA Regulatory Notice 10-54 (Oct. 2010). The Section 913 Study briefly discusses this proposal in footnote 517 on page 114.

⁴¹ See *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, Investment Company Act Rel. No. 26341 (Jan. 29, 2004).

to require). Alternatively, the SEC should consider an outright ban on revenue-sharing payments that vary depending on the fund that a broker-dealer recommends.

Principal Transactions

Section 206(3) of the Advisers Act generally requires investment advisers to obtain client consent prior to any transaction in which the adviser acts as principal. Fiduciary rulemaking would not make Section 206(3) directly applicable to broker-dealers, but it would raise the question as to what a uniform fiduciary standard requires with respect to principal transactions. The staff's position on this issue is unclear. On the one hand, the Section 913 study recognizes that “[p]rincipal trades by broker-dealers raise the same potential conflicts of interest as such trades by investment advisers and thus implicate the duty of loyalty included in the uniform fiduciary standard.”⁴² Section 913 provides that, under fiduciary rulemaking, “any material conflicts shall be disclosed and *may be consented to by the customer*” (emphasis added). These positions would support requiring broker-dealers to obtain client consent to at least some transactions to which Section 206(3) applies.

On the other hand, the staff takes the position that Congress's incorporation of only Sections 206(1) and (2) in the uniform fiduciary standard “appears to reflect a Congressional intent” that Section 206(3) not be included.⁴³ The staff provides no support for this position. Nor does it explain why, in Section 913, Congress required that the fiduciary standard be “no less stringent” than Sections 206(1) and (2) unless it contemplated the possibility that requirements in excess of those established by those sections might be imposed, or why it required that the uniform fiduciary standard mandate disclosure of material conflicts of interest that “may be consented to by the customer,” unless it contemplated client consent requirements similar to, if not specifically entailing Section 206(3)'s consent requirement.

In addition, the study notes that the SEC could “consider whether any changes should be made to the principal trading requirements that apply to investment advisers.”⁴⁴ This statement implies that investment advisers might be relieved of Section 206(3)'s provisions, presumably on the same terms as broker-dealers, with respect to certain types of transactions.⁴⁵

In summary, the SEC staff has artificially excluded principal trades from the reach of the fiduciary duty under Section 913, which would result in broker-dealers engaging in principal transactions with advisory clients without obtaining transaction-specific client consent—even when such consent is in the best interests of investors and would be required under a true fiduciary standard. The staff's position also undermines the harmonization goal of Section 913, because whether broker-dealers providing personalized retail advice were required to obtain transaction-specific consent for principal trades with clients would depend on whether the broker-dealer was paid only commissions or received asset-based fees. The SEC should, pursuant to fiduciary rulemaking, ensure that transaction-specific client consent is required for all transactions where the fiduciary duty would require such consent.

⁴² Section 913 Study, p. 120.

⁴³ *Ibid.*, p. 119.

⁴⁴ *Ibid.*, p. 120.

⁴⁵ See, e.g., *Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act*, Advisers Act Release No. 2653 (Sep. 24, 2007).

Basis of Investment Recommendations

The Section 913 Study recommends that the SEC “consider specifying uniform standards for the duty of care owed to retail customers, through rulemaking and/or interpretive guidance.”⁴⁶ For example, under FINRA rules, broker-dealers are subject to detailed requirements regarding their basis for making investment recommendations. In contrast, “[d]etailed guidance in this area has not been a traditional focus of the investment adviser regulatory regime.”⁴⁷ The SEC may seek to harmonize broker-dealer and investment adviser requirements regarding the basis for the investment recommendations made to retail customers.⁴⁸ The SEC should subject all providers of retail investment advice to minimum standards of care and require documentation of their investment recommendation processes. These standards should be heightened when investment recommendations may be subject to a conflict of interest, such as when a broker-dealer or adviser receives differential compensation depending on the recommendation or offers only a narrow range of proprietary products.

FINRA’S ROLE IN THE PROMULGATION OF FIDUCIARY STANDARDS OF CONDUCT

As discussed above, if the SEC promulgates fiduciary rules under Dodd-Frank Section 913, it is likely to do so under the Exchange Act. FINRA not only is *permitted* to enforce Exchange Act rules, but also is *required* to do so. Therefore, assuming broad, principles-based fiduciary rulemaking under the Exchange Act, FINRA will become the primary regulator for the interpretation and enforcement of the uniform fiduciary standard as to FINRA members and will have rulemaking authority thereunder.⁴⁹

Indeed, FINRA may effectively become the predominant source of fiduciary law under the Advisers Act as well. It is likely that FINRA’s regulatory output would make it the primary driver of the development of the law under Sections 206(1) and (2). It brings more retail sales practices enforcement actions and can promulgate rules more easily than the SEC, and it oversees thousands of private claims each year in arbitration.

⁴⁶ Section 913 Study, p. 123.

⁴⁷ *Ibid.*

⁴⁸ The SEC may seek to harmonize other regulatory areas relating to the duty of care, such as best execution obligations, the suitability standards as to specific products, and fair pricing and compensation, but the Section 913 Study does not make specific recommendations in these areas. See *Ibid.*, p. 122 and note 555, citing commentators that, “[i]n considering whether and how to develop investment advisers’ duty of care, . . . have pointed to the detailed rules imposed on broker-dealers as a useful framework.” For the most part, these duties of broker-dealers address concerns that generally arise in connection with the providing of brokerage services as opposed to only advisory services. It is the fiduciary duty under the Advisers Act to which many broker-dealers are not subject that should be the SEC’s first priority.

⁴⁹ Most associated persons of investment advisers are dually registered as registered representatives of broker-dealers. FINRA reports that, as of October 2010, there were 275,873 registered investment adviser representatives, of which whom 241,586 (87.6 percent) were also registered representatives of a broker-dealer. See Letter from FINRA to SEC, pp. 1–2 (Nov. 3, 2010), <http://www.sec.gov/comments/4-606/4606-2836.pdf>.

FINRA implementation and enforcement of fiduciary standards therefore is likely to affect standards that apply to nonmembers under the Advisers Act. The Dodd-Frank Act evinces Congress's intent that these standards be harmonized, and this is formally accomplished by making the Exchange Act fiduciary standard derive from the Advisers Act standard. As fiduciary law develops under the Exchange Act, this law therefore will contribute to, if not substantially determine, the developing contours of the Advisers Act fiduciary duty that is its source. In short, Exchange Act precedent will travel upstream and become part of the fiduciary law under the Advisers Act.

FINRA aspires to assume this lawmaking role,⁵⁰ which may generate certain benefits for investors. FINRA already has principal rulemaking, inspection, and enforcement authority over broker-dealers, and some argue that its inspections are far more frequent⁵¹ (although arguably less independent) than the SEC's. FINRA operates under lighter administrative law requirements than the SEC, which allows it to shepherd rules through to final approval more easily. In practice, FINRA's rules have been less susceptible to Administrative Procedures Act (APA) challenges by industry members. Its enforcement actions also are less vulnerable to legal challenges, and its examinations less constrained by limits on government action.

The delegation of responsibility for promulgating fiduciary standards to FINRA also would create certain risks. The SEC and the states would surrender some control over the substance and enforcement of the standards, while the financial services industry (FINRA members) would gain additional control over the content of the rules. FINRA, which for years took the position that broker-dealer regulation set standards that were as high or higher than those applied to investment advisers,⁵² might not apply sufficiently stringent standards. Indeed, FINRA recently proposed a rule relating to the disclosure of revenue sharing that falls demonstrably short of what the fiduciary duty would require.⁵³ To the extent that fiduciary rulemaking is delegated to FINRA, the SEC must exercise diligent oversight to prevent or at least minimize the dilution of the existing standard under the Advisers Act.⁵⁴

⁵⁰ In anticipation of fiduciary rulemaking under Section 913, FINRA already has proposed a rule that would require its members to deliver a document to noninstitutional customers that is "similar in purpose to Form ADV." FINRA Notice 10-54 (Oct. 2010).

⁵¹ See Hearing before the Committee on Financial Services, House of Representatives (Oct. 6, 2009) (testimony of Richard Ketchum, President, FINRA). The SEC and FINRA examine 55 percent of registered broker-dealers; the SEC examines 9 percent of registered investment advisers.

⁵² See, e.g., Barbara Black, "Brokers and Advisers: What's in a Name?" *Fordham Journal of Corporate and Financial Law* 31 (2005): 52–53, discussing FINRA claim that its advertising rules are the "highest" in the industry.

⁵³ See FINRA Notice of Filing of Proposed Rule Change (May 3, 2011), <http://www.sec.gov/rules/sro/finra/2011/34-64386.pdf>.

⁵⁴ See *Organizational Study and Reform* (Boston Consulting Group, Mar. 10, 2011), discussing the adequacy of SEC oversight of FINRA, <http://www.sec.gov/news/studies/2011/967study.pdf>.

CONCLUSION AND RECOMMENDATIONS

Fiduciary rulemaking under Dodd-Frank Section 913 could substantially mitigate the disparate regulation problem of broker-dealers and investment advisers being held to different standards of conduct when providing personalized investment advice. Any fiduciary rules under the Exchange Act will be linked to the standard applied under Advisers Act rules, and both will be effectively linked to the standard under Sections 206(1) and (2) of the Advisers Act. This linkage should generally ensure that the fiduciary duty under the Exchange and Advisers Acts ultimately derives from the same source of law: judicial and administrative interpretation and application of Advisers Act Sections 206(1) and (2).

The fiduciary duty is likely to take the form of a combination of principles-based rules, such as the draft rules in appendix A, and specific conduct rules in certain areas. The SEC staff's recent study of broker-dealer and investment adviser regulation recommended rulemaking in a number of areas, including harmonization of the information disclosure requirements for broker-dealers and investment advisers. The study also recommended that the SEC issue guidance on the application of a uniform fiduciary standard to principal transactions with clients and consider rulemaking regarding the minimum basis necessary for a financial professional to make investment recommendations. In addition to recommendations related directly to the uniform fiduciary standard, the staff outlined a broad harmonization initiative that would generally extend FINRA-style regulation in many areas to investment advisers.

Fiduciary rulemaking under Section 913 generally should improve the protection of investors who receive investment advice from broker-dealers who are not subject to the fiduciary duty under the Advisers Act. However, the reconciling of long-standing broker-dealer practices with the fiduciary duty and FINRA's likely role in determining the substance of that duty under the Advisers Act combine to create a significant risk that the current fiduciary standard under the Advisers Act will be diluted. Nonetheless, the net effect may be positive for investors as a whole if the additional protection gained by raising the lowest (suitability) standard exceeds the protection lost by diluting the highest (fiduciary) standard.

The SEC can mitigate the potential dilution of the fiduciary standard by adopting a principles-based base rule similar to the draft rules in appendix A and then promulgating detailed rules that follow these recommendations (or ensuring that FINRA does so):

- Interpret the term “personalized investment advice” consistent with its long history and usage in the Advisers Act.
- Provide guidance narrowly circumscribing the circumstances in which broker-dealers can provide investment advice subject to a fiduciary duty and then implement that advice or provide other related services without being subject to the fiduciary duty.
- Identify the circumstances in which a financial professional's receipt of compensation or other second-tier benefits that vary depending on the advice provided to a customer create a conflict of interest and therefore could cause the advice to be deemed to have been provided “with regard” to the broker-dealer's financial interest for purposes of Section 913.
- Consider banning certain of compensation practices, such as revenue sharing, as authorized by Dodd-Frank Section 913(g).
- Promptly consider the application of the fiduciary duty to certain nonretail investors.

- Require broker-dealers to provide a brochure prior to the time of the engagement in order to allow clients an opportunity to evaluate the broker-dealer’s services and compensation structure before opening an account and require additional, transaction-specific disclosure as appropriate.
- Require disclosure of the dollar amount of all fees received by broker-dealers and investment advisers and that such disclosure be accompanied by a statement of the conflict of interest created by differential compensation and/or the offering of a limited menu of proprietary products (as subparagraph (d)(2) in the draft rules in appendix A should be interpreted to require).
- Ensure that transaction-specific client consent is required for all transactions where the fiduciary duty would require such consent.
- Subject all providers of retail investment advice to minimum standards of care and require documentation of their investment recommendation processes, with heightened standards when investment recommendations may be subject to a conflict of interest.

APPENDIX A: DRAFT FIDUCIARY RULES

This appendix provides draft rules under the Exchange and Advisers Acts pursuant to Dodd-Frank Section 913. They are principles-based rules that would, in effect, provide the umbrella authority for the SEC and/or FINRA to establish specific conduct rules, as appropriate, with respect to particular business practices.

[Exchange Act Rule 15k-1] [Advisers Act Rule 211g-1]⁵⁵

- (a) The standard of conduct for a [broker or dealer] [investment adviser] when providing investment advice about securities to retail [customers] [clients] shall be 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.
- (b) For purposes of paragraph (a), the term “retail [customer] [client]” means any natural person and any legal representative of a natural person acting on behalf of such person who receives personalized investment advice about securities from a [broker or dealer] [investment adviser] that is used primarily for personal, family, or household purposes.
- (c) The term “retail [customer] [client]” does not include a natural person solely by reason of that person’s investment in a private fund, as defined in [cross-reference], where the fund has entered into an advisory contract with the investment adviser that manages the fund.
- (d) The standard set forth in paragraph (a) shall—
- (1) be no less stringent than the standard set forth in paragraphs (1) and (2) of Section 206 of [the Investment Advisers Act of 1940] [this title];
 - (2) require that all material conflicts of interest of the [broker or dealer] [investment adviser] providing the investment advice be disclosed and consented to by the [customer] [client], including but not limited to conflicts of interest related to:
 - (A) any compensation received by the [broker or dealer] [investment adviser] in connection with investment advice or
 - (B) the sale of only proprietary or limited range of products; and
 - (3) not limit in any way any rulemaking authority exercised under any other provision of the federal securities laws or other authorizing statute.
- (e) The receipt of compensation based on a commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of the standard set forth in paragraph (a).
- (f) The sale of only proprietary or limited range of products shall not,

⁵⁵ These illustrative draft rules do not attempt to resolve all of the technical issues raised by Section 913’s grant of rulemaking authority.

in and of itself, be considered a violation of the standard set forth in paragraph (a).

(g) A single instance in which a [broker or dealer] [investment adviser] provides investment advice shall not, in and of itself, create a continuing obligation to provide investment advice in the future.

APPENDIX B: DODD-FRANK ACT SECTION 913

SEC. 913. STUDY AND RULEMAKING REGARDING OBLIGATIONS OF BROKERS, DEALERS, AND INVESTMENT ADVISERS.

(a) Definition- For purposes of this section, the term ‘retail customer’ means 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, family, or household purposes.

(b) Study- The Commission shall conduct a study to evaluate—

(1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards; and

(2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.

(c) Considerations- In conducting the study required under subsection (b), the Commission shall consider—

(1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and 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 legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to 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, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers in the provision of personalized investment advice about securities to retail customers;
- (4) whether the existence of different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive;
- (5) the regulatory, examination, and enforcement resources devoted to, and activities of, the Commission, the States, and a national securities association to enforce the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including—
 - (A) the effectiveness of the examinations of brokers, dealers, and investment advisers in determining compliance with regulations;
 - (B) the frequency of the examinations; and
 - (C) the length of time of the examinations;
- (6) the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers;
- (7) the specific instances related to the provision of personalized investment advice about securities in which—
 - (A) the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers; and
 - (B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers;
- (8) the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail customers;
- (9) the potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers, and persons associated with brokers or dealers—
 - (A) the standard of care applied under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the Commission and the courts; and

(B) other requirements of the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.);

(10) the potential impact of eliminating the broker and dealer exclusion from the definition of ‘investment adviser’ under section 202(a)(11)(C) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)(C)), in terms of—

(A) the impact and potential benefits and harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;

(B) the number of additional entities and individuals that would be required to register under, or become subject to, the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), and the additional requirements to which brokers, dealers, and persons associated with brokers and dealers would become subject, including—

(i) any potential additional associated person licensing, registration, and examination requirements; and

(ii) the additional costs, if any, to the additional entities and individuals; and

(C) the impact on Commission and State resources to—

(i) conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and

(ii) enforce the standard of care and other applicable requirements imposed under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.);

(11) the varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers;

(12) the potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations to retail customers regarding the provision of investment advice, including any potential impact on—

- (A) protection from fraud;
 - (B) access to personalized investment advice, and recommendations about securities to retail customers; or
 - (C) the availability of such advice and recommendations;
- (13) the potential additional costs and expenses to—
- (A) retail customers regarding and the potential impact on the profitability of their investment decisions; and
 - (B) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations, including duty of care, to retail customers; and
- (14) any other consideration that the Commission considers necessary and appropriate in determining whether to conduct a rulemaking under subsection (f).
- (d) Report-
- (1) IN GENERAL- Not later than 6 months after the date of enactment of this Act, the Commission shall submit a report on the study required under subsection (b) to—
- (A) the Committee on Banking, Housing, and Urban Affairs of the Senate; and
 - (B) the Committee on Financial Services of the House of Representatives.
- (2) CONTENT REQUIREMENTS- The report required under paragraph (1) shall describe the findings, conclusions, and recommendations of the Commission from the study required under subsection (b), including--
- (A) a description of the considerations, analysis, and public and industry input that the Commission considered, as required under subsection (b), to make such findings, conclusions, and policy recommendations; and
 - (B) an analysis of whether any identified legal or regulatory gaps, shortcomings, or overlap in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers.
- (e) Public Comment- The Commission shall seek and consider public input, comments, and data in order to prepare the report required under subsection (d).

(f) Rulemaking- The Commission may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers. The Commission shall consider the findings conclusions, and recommendations of the study required under subsection (b).

(g) Authority to Establish a Fiduciary Duty for Brokers and Dealers-

(1) SECURITIES EXCHANGE ACT OF 1934- Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended by adding at the end the following:

‘(k) Standard of Conduct-

‘(1) IN GENERAL- Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940. The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer. 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.

‘(2) DISCLOSURE OF RANGE OF PRODUCTS OFFERED- Where a broker or dealer sells only proprietary or other limited range of products, as determined by the Commission, the Commission may by rule require that such broker or dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer. The sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the standard set forth in paragraph (1).

‘(l) Other Matters- The Commission shall—

‘(1) 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; and

‘(2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.’

(2) INVESTMENT ADVISERS ACT OF 1940- Section 211 of the Investment Advisers Act of 1940, is further amended by adding at the end the following new subsections:

‘(g) Standard of Conduct-

‘(1) IN GENERAL- The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be 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. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such 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, except the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.

‘(2) RETAIL CUSTOMER DEFINED- For purposes of this subsection, the term ‘retail customer’ means a natural person, or the legal representative of such natural person, who—

‘(A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and

‘(B) uses such advice primarily for personal, family, or household purposes.

‘(h) Other Matters- The Commission shall—

‘(1) 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; and

‘(2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and

investment advisers that the Commission deems contrary to the public interest and the protection of investors.’

(h) Harmonization of Enforcement-

(1) SECURITIES EXCHANGE ACT OF 1934- Section 15 of the Securities Exchange Act of 1934, as amended by subsection (g)(1), is further amended by adding at the end the following new subsection:

‘(m) Harmonization of Enforcement- The enforcement authority of the Commission with respect to violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer shall include—

‘(1) the enforcement authority of the Commission with respect to such violations provided under this Act; and

‘(2) the enforcement authority of the Commission with respect to violations of the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940, including the authority to impose sanctions for such violations, and

the Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under this Act to same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to an investment advisor under the Investment Advisers Act of 1940.’

(2) INVESTMENT ADVISERS ACT OF 1940- Section 211 of the Investment Advisers Act of 1940, as amended by subsection (g)(2), is further amended by adding at the end the following new subsection:

‘(i) Harmonization of Enforcement- The enforcement authority of the Commission with respect to violations of the standard of conduct applicable to an investment adviser shall include—

‘(1) the enforcement authority of the Commission with respect to such violations provided under this Act; and

‘(2) the enforcement authority of the Commission with respect to violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under the Securities Exchange Act of 1934, including the authority to impose sanctions for such violations, and

the Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to an investment adviser under this Act to same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under the Securities Exchange Act of 1934.’