

Client Alert.

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One Step Closer to a Fiduciary Duty for Broker-Dealers?

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More than two years after an SEC Staff study recommended adoption of a uniform fiduciary standard for broker-dealers and investment advisers, the SEC has taken its first significant step towards possible implementation of the recommendation. On March 1, 2013, the SEC issued a public release seeking quantitative data and economic analysis relating to the benefits and costs that could result from adoption of a uniform fiduciary standard governing personalized investment advice provided to retail customers. In the release, while not committing to any specific actions, the SEC laid out a number of “assumptions” that may well presage the ultimate contours of any fiduciary duty imposed on broker-dealers.

BACKGROUND

Over the last decade, a number of studies have noted the convergence of services provided by broker-dealers and investment advisers to retail customers, and raised concerns about investor confusion regarding the different standards governing advisers and brokers. These studies were cited by Congress when it included in the Dodd-Frank Act a provision empowering the SEC to adopt a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice to retail customers.

The Dodd-Frank Act also directed the SEC to conduct a study regarding the effectiveness of existing standards of conduct, and whether there are any gaps in such standards that should be addressed by rule or statute. The SEC Staff study was approved for release by the Commission in January 2011. The study recommended that the SEC propose rules implementing a uniform fiduciary standard of conduct and harmonizing certain regulatory requirements applicable to broker-dealers and investment advisers. However, two SEC Commissioners dissented from the decision to release the Staff study, arguing that it was not adequately supported by empirical data regarding the costs and benefits of implementing a uniform fiduciary standard. Subsequently, a number of members of Congress expressed their concerns about the lack of data to support a decision to implement a new standard for broker-dealers, and the SEC has seen other rulemaking decisions reversed by the courts based on findings that the rules were not supported by an appropriate analysis of their benefits and costs.

It appears that the SEC wants to ensure it has adequate information enabling it to analyze the costs and benefits of any proposed rulemaking involving new standards of conduct for broker-dealers. This approach seems prudent not only to support any rulemaking by the SEC, but also to help navigate through the debate that has continued for the last several years between supporters and critics of a uniform fiduciary standard. The depth and breadth of the SEC’s information request has been praised by various partisans in the on-going debate, including the Securities Industry and Futures Markets Association (“SIFMA”) and the Investment Advisers Association.

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The SEC requests not only information related to the effects of potential rulemaking, but also information designed to provide it with a “baseline” understanding of current practices. The SEC is requesting information principally in the following three areas:

- the benefits and costs of the current standards of conduct applicable to broker-dealers and investment advisers when providing personalized advice to retail customers;
- the benefits and costs of implementing a uniform fiduciary standard of conduct; and
- the benefits and costs of harmonizing existing regulatory regimes applicable to investment advisers and broker-dealers.

Current Standards of Conduct. The SEC requests information regarding the costs and benefits of the current regulatory regime, including:

- the characteristics of retail customers that invest through broker-dealers versus those that invest through investment advisers;
- the types of services currently available to retail customers;
- perspective on whether current rules are beneficial or harmful to retail customers;
- information about the types of securities offered to retail customers;
- information about principal trading with retail customers;
- data regarding the returns earned by retail customers;
- information regarding the ability of retail customers to bring claims against financial professionals under the current regulatory structure;
- information regarding the conflicts of interest faced by broker-dealers and investment advisers;
- information about the costs and effectiveness of mandatory disclosure provided to retail investors; and
- information describing the extent to which retail customers are confused about the regulatory status of the person from whom they receive financial services.

Uniform Fiduciary Standard of Care. Although the SEC has not yet determined whether to exercise its Dodd-Frank Act authority to implement a uniform fiduciary standard of care, the release provides some insight as to how the SEC might design a uniform fiduciary standard that would include both a duty of loyalty and a duty of care.

In addressing the duty of loyalty, the SEC asks commenters to assume that any rule under consideration would be designed to accommodate different business models and fee structures, and that any rule would permit brokers to trade on a principal basis with their customers. Moreover, recommending only proprietary or a limited range of products to retail customers would not, in and of itself, violate a new fiduciary standard. However, any rule would at a minimum require disclosure of material conflicts of interest, and such disclosure might be made through a general “relationship guide” similar to Form ADV Part 2.

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Commenters should also assume that any rule would not impose a continuing duty to customers unless the agreement with the customer specifies that the broker or adviser will provide on-going investment management or similar services. Furthermore commenters should assume that certain fiduciary principles related to the allocation of investment opportunities and aggregation of orders currently applicable to investment advisers would be applicable to broker-dealers.

With respect to the duty of care, the SEC asks commenters to assume that general suitability standards would apply to recommendations made to customers, and that specific suitability and due diligence obligations would apply if recommendations involve certain types of securities such as structured products, options and bond funds. In addition, the SEC suggests that existing standards of best execution and reasonable mark-ups are likely to be included within the duty of care due to retail customers.

The SEC also asks commenters to consider the costs and benefits of alternative approaches to the uniform fiduciary standard:

- broker-dealers and investment advisers could be required to provide disclosure about the services they provide and the conflicts they may have with retail customers, without imposing a uniform fiduciary standard;
- the SEC could apply the uniform standard of care without extending to broker-dealers the existing guidance and precedent regarding fiduciary duty under the Investment Advisers Act;
- the SEC could maintain the status quo with respect to investment advisers and apply the fiduciary standard discussed in the release to broker-dealers only;
- the SEC could maintain the status quo with respect to the duties imposed on broker-dealers and impose certain minimum professional obligations consistent with the duty of care currently applicable to investment advisers; or
- the SEC could follow precedent set by regulators in other countries.

Regulatory Harmonization. The SEC also requests that commenters address whether and to the extent it should consider other adjustments to the regulatory obligations of broker-dealers and investment advisers, beyond a uniform fiduciary standard, particularly in situations when broker-dealers and investment advisers perform similar functions.

The SEC seeks specific comment regarding regulatory harmonization relating to:

- advertising and communications with the public;
- supervision;
- licensing and registration of firms and individuals;
- continuing education requirements;
- books and records; and
- the use of finders or solicitors.

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The March 1, 2013 release appears to be a serious effort by the SEC to build a base of empirical data on which to support eventual rulemaking. While the data has yet to be assembled and the details of any rules have yet to be determined, the release likely sets the SEC on a course to adopt some form of fiduciary standard to govern broker-dealers when they furnish personalized advice to retail customers.

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