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Phone: +1 646 783 7100 | reprints@portfoliomedia.com

Financial Reform 101: For Broker-Dealers

Law360, New York (July 27, 2010) -- The Dodd-Frank Wall Street Reform and Consumer Protection Act — passed by Congress on July 15, 2010, and signed into law by President Obama on July 21, 2010 — is the culmination of years of debate and negotiation over the scope of reform in the financial services industry.

One of the most contentious topics debated by Congress was whether to adopt a uniform and enhanced fiduciary standard to be applied to all relationships between broker-dealers and their retail clients. Despite immense pressure to adopt such a standard, the act falls well short of imposing a uniform standard.

Prior to passage of the act, U.S. Securities and Exchange Commission Chairwoman Mary Schapiro stated: “I have long advocated such a uniform fiduciary standard and I am pleased the legislation would provide us with the rulemaking authority necessary to implement it.”

The SEC is authorized by the Dodd-Frank Act to conduct a study that would permit the SEC to adopt rules to impose the same fiduciary standard of care on broker-dealers who provide “personalized investment advice” as is currently required of investment advisers under the Investment Advisers Act of 1940.

A close examination of the act reveals, however, that subsequent regulations will likely be limited in scope and primarily result in a strengthening of the suitability standards already applicable to solicited retail transactions.

The most probable long-term effect would be the imposition of a fiduciary duty on brokers when recommending transactions to customers that mirrors the current suitability framework of FINRA Rule 2310.

It is particularly notable that the act clearly states that any fiduciary duty ceases once a transaction is complete; thus, the law remains that a broker-dealer in a non-advisory relationship does not have a continuing duty of care and loyalty after personalized investment advice is provided to a customer.

Currently, any broker who receives fees, rather than commissions, for services is typically subject to the Advisers Act and its associated fiduciary duty, as is any broker who manages a discretionary account.

These duties require a broker or adviser to “manage the account in a manner comporting with the needs and objectives of the customer,” to “keep informed regarding the changes in the market which affect his customer’s interest and act responsibly to protect those interests,” to “keep his customer informed as to each completed transaction” and to “explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.”

Conversely, a broker-dealer owes more limited duties to a customer in a nondiscretionary account, and those duties cease “when the transaction is closed.”

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FINRA's Suitability Requirements for Recommended Transactions

Broker-dealers who are exempt from the Advisers Act are still subject to regulatory requirements in their dealings with customers. Under FINRA Rule 2310, any broker who recommends the purchase or sale of a security must have "reasonable grounds for believing that the recommendation is suitable for such customer."

The broker must make reasonable efforts to obtain information about the customer's financial status, tax status, investment objectives and other investments and must base the investment recommendation on the information obtained.

Practically, the suitability rule is both more concrete and more narrowly tailored than the fiduciary duty standard. It does not impose ongoing, post-recommendation duties, nor does it require the broker-dealer to place the client's interests above his/her own interest.

While FINRA rules do not explicitly impose a fiduciary duty on otherwise exempt brokers, common law may impose certain heightened duties on brokers. The common law duties imposed on exempt brokers, however, fall short of the general fiduciary duty imposed on investment advisers.

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

There was extensive debate on the scope of a fiduciary standard applicable to retail customers in the months leading up to passage of the act. Christopher Dodd, D-Conn., the chairman of the Senate Committee on Banking, Housing and Urban Affairs, initially proposed to simply abolish the broker-dealer exclusion provision of the Advisers Act.

As finally enacted, the act requires the SEC to conduct further study and acknowledges that, while the financial services industry is complicated, the SEC may impose a fiduciary duty on broker-dealers who make recommendations to customers—in essence an enhanced suitability standard.

The Dodd-Frank Act, in Section 913, amends Section 15 of the Securities Exchange Act of 1934 in order to provide the SEC with authority to enact rules which subject a broker or dealer who provides "personalized investment advice about securities" to the same standard of conduct required of an investment adviser under Section 211 of the Advisers Act.

This amendment, however, provides a crucial limitation: "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities." Furthermore, the amendment sets forth that the receipt of commission-based or fee-based compensation will not be considered a violation of the standard of care.

The act also amends Section 211 of the Advisers Act to authorize the SEC to create rules that require broker-dealers who provide personalized investment advice to act in "the best interest of the customer" without regard to their own financial interest.

The scope of the standard of care will be evaluated by the SEC after the six-month study provided for in Section 913 of the act of "the effectiveness of existing legal and regulatory standards of care for brokers dealers, and investment advisers ... for providing personalized investment advice and recommendations" and "whether there are legal or regulatory gaps, shortcomings, or overlaps" in these standards.

In addition to these general topics, the study will specifically address:

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1) whether customers understand the different standards of care;

2) whether different standards confuse customers about the quality of the advice they receive;

3) regulatory and enforcement resources devoted to enforcing the standards of care;

4) substantive differences in the regulation of brokers and investment advisers;

5) "specific instances" in which regulations for investment advisers provide greater protection for consumers than those for brokers, and vice versa;

6) existing state standards;

7) the impact to customers if Advisers Act requirements are imposed on broker-dealers;

8) the impact of eliminating the broker-dealer exclusion from the Advisers Act, which includes the impact on customers, the number of additional registrations and related costs to firms, and the impact on regulatory resources;

9) the different services provided by brokers and investment advisers and differences in customer relationships;

10) the impact of regulatory changes on customers, including fraud protection and access to personalized advice; and

11) potential additional expenses to customers, brokers and investment advisers.

The Limited Scope of the New Standard of Care

While the scope of broker-dealers' future fiduciary duties is uncertain, important language in the act limits the fiduciary duty of brokers to the provision of advice or recommendations in connection with a particular transaction.

Thus, the act distinguishes a broker-dealer's duty from an investment adviser's continuing duties of care and loyalty. Moreover, the act appears to exempt unsolicited transactions and self-directed investments from its fiduciary scope.

By its terms, the enhanced standards of care under the Act apply only to "personalized investment advice" in the form of recommendations. Many brokers, including online brokerage services, act only as order-takers, and therefore fall outside the scope of the act. The key issue will be the definition of "personalized investment advice" and "recommendations" required to trigger a fiduciary duty for unsolicited and self-directed transactions.

Currently, there is not an industrywide, bright-line definition of what constitutes a "solicited" transaction. Hopefully, new SEC rules will offer clarification; if not, firms may need to examine their definitions of "recommendation," "solicited" and "unsolicited" to ensure that they are clear, not overbroad, easily applied, and logically explained.

Another open question is whether a fiduciary duty would apply when a broker recommends that a customer retain a security or advises a customer not to sell the security.

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“Holder” claims against brokers are typically not valid under the Exchange Act, and the proposed amendment to the Exchange Act makes clear that there is no continuing duty of care after a broker provides an investment recommendation or advice.

However, if the same “best interests” standard applicable to investment advisers giving advice — which encompasses advice to hold — is applied to brokers giving advice, a fiduciary duty might be applied to “holder” claims against brokers.

While a broker would not have the duty to monitor an investment and would not have an affirmative duty to advise the client whether to hold, any advice the broker chose to give (in response to a client question or on the broker’s own initiative) might be subject to the requirement that any advice be in the client’s “best interests.”

Similarly, it is unclear if a fiduciary duty would attach to broker research. Many brokerage firms prepare research reports on products they offer. The reports are often intended as a general assessment of the securities offered and are not targeted at any particular customer.

Still, firms should consider including language in generalized research reports that explains that the reports are intended to be an overall assessment of the security and are not intended to be personal recommendations to customers. Financial advisers need to be aware that providing customers with research reports could be construed as providing investment advice.

Assuming the fiduciary duty is applied to a broker-dealer, what are the parameters of the duty? The Amendment in Section 913 of the Dodd-Frank Act to the Advisers Act creates a “no less stringent” standard of care on broker-dealers than that required of investment advisers.

The amendment states that “material conflicts of interest shall be disclosed and may be consented to” by the customer. Aside from stating that the receipt of fees or commissions will not violate conflict-of-interest provisions as a general matter, the amendment does not specify which of the broad conflict-of-interest prohibitions associated with the investment adviser fiduciary duty would apply to broker-dealers.

A fiduciary duty most likely would not change broker-dealer compensation. The conflict of interest provisions of the fiduciary duty may, however, require greater disclosure of compensation.

While the act provides that receipt of a commission or fee would not alone violate the fiduciary duty, it also requires disclosure of conflicts of interest to investors, and provides that the Advisers Act standards of conduct — requiring full disclosure of all material facts — should apply to brokers.

In accordance with the Advisers Act, the SEC requires that investment advisers provide clients a disclosure statement about services, fees and conflicts of interest. Brokers may be required to provide disclosures on all compensation similar to that required of investment advisors and to receive client consent to their compensation in order to meet new fiduciary duty requirements.

The Act’s Enhanced Standard of Conduct Creates the Need for Additional Supervisory Oversight

Until the SEC study is completed and specific rules are enacted, questions will remain about the scope and actual impact of the Dodd-Frank Act on broker-dealers’ duties to their customers. Given the act’s specific authorization for the SEC to create fiduciary duty rules and the SEC’s expressed interest in such rules, some form of fiduciary duty will likely be mandated.

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The act makes clear that any fiduciary duty imposed on broker-dealers will encompass greater disclosure and consent requirements. Broker-dealers should prepare for the changes by creating comprehensive disclosure and consent policies.

Brokers who provide investment advice should consider greater disclosure of compensation, interest as principals, proprietary or limited offerings, selling syndicate involvement, and anything else that could broadly be construed as creating a potential conflict with fiduciary duty. Customers should be asked to provide written consent to these practices before brokers provide any advice.

--By S. Lawrence Polk (pictured) and Aaron S. Furniss, Sutherland Asbill & Brennan LLP

Larry Polk (larry.polk@sutherland.com) is a partner in Sutherland's litigation practice group in the firm's Atlanta office and represents broker-dealers, banks and accountants, concentrating his practice in the areas of securities litigation, securities arbitration, professional liability litigation, commercial litigation and U.S. Securities and Exchange Commission enforcement actions. Aaron Furniss (aaron.furniss@sutherland.com) is an associate in the firm's litigation practice group in the Atlanta office and focuses his practice on securities and commercial litigation.

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