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A Summary of the SEC Study on Investment Advisors and Broker-Dealers

Christine Lazaro
St. John's University School of Law

A SUMMARY OF THE SEC STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS

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I. Introduction[2]

For some time, there has been a debate over what the appropriate standards of care are and should be for both broker-dealers and investment advisers. The standards vary based on where the investment professional is, where the customer is, what types of services are being offered and what responsibilities are assumed. Across the country, there is a complete lack of uniformity. Congress considered this when drafting the Dodd-Frank Wall Street Reform and Consumer Protection Act[3]. Accordingly, pursuant to Dodd-Frank, Congress required the SEC (the "Commission") to conduct a study to examine the current standards of care for both brokers and investment advisers and determine if there were any gaps in the current system. On July 27, 2010, the Commission sought public comment to evaluate "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors; and whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries."[4] In response, the Commission received over 3,000 individual comments and over 500 form comments. The Commission also met with a number of groups, including PIABA.

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1. Christine Lazaro is a Supervising Attorney in the Securities Arbitration Clinic at St. John's University School of Law, where she supervises students who represent investors in arbitration claims against brokers. Ms. Lazaro also serves as chairwoman on PIABA's SRO/Legislation Committee and is a member of the New York State Bar Association's Securities Litigation and Arbitration Committee.

2. Members of PIABA's Dodd-Frank Fiduciary Standard Subcommittee contributed to the summary, specifically, Hugh Berkson, Glenn Gitomer, Christine Lazaro, Jeffrey Pederson, Howard Rosenfield, Henry Simpson, Mindy Steuer, Bill Young, and the Chairman of the subcommittee, Joe Peiffer.

3. P.L. 111-203.

4. *S.E.C. Release No. 34-62577; IA-3058*, "Study Regarding Obligations of Brokers, Dealer, and Investment Advisers", available at http://www.sec.gov/rules/other/2010/34-62577.pdf.

The Commission issued its report, the "Study on Investment Advisers and Broker-Dealers" (the "Study"), to Congress on January 21, 2011.[5] The Study examined fourteen different items, as directed by Dodd-Frank. The final product was 208 pages long. It examined the current landscape of regulation of both broker-dealers and investment advisers; it looked at the perceptions of investors; and made recommendations. The Study recommended enactment of a uniform fiduciary standard that would apply to both broker-dealers and investment advisers when providing personalized investment advice about securities to a retail customer. The intricacies and the details of this recommendation will be discussed in further detail below.

What follows is a summary of the Study, beginning with the substantive section of the Study, section II. To the extent practical, the headings below following the headings included within the Study. The recommendations referenced and the opinions discussed are those included within the Study, and are not necessarily shared by the contributors to this article.

II. Overview of the Current Business and Regulatory Landscape

A. Current Business Landscape for Investment Advisers and Broker-Dealers

The Study's description of the investment adviser regulatory framework reveals that every regulation stems from the fundamental concept that investment advisers maintain a fiduciary standard obligating them to put their clients' interests before their own. Accordingly, every possible conflict must be revealed so that the client is well informed before hiring the investment adviser, much less accepting the investment adviser's advice.

The Study's description of the broker-dealer framework is very different. The key in the difference in the Study's view of investment advisers and broker-dealers is encapsulated in the following quote from the Study: "Under the antifraud provisions of the federal securities laws and SRO rules, including SRO rules addressing just and equitable principles of trade, broker-dealers are required to deal fairly with their customers."[6] This statement, while at first blush innocuous, reveals the key. Per this statement, the Study presumes that broker-dealers are under no obligation to put their customers'

5. "Study on Investment Advisers and Broker-Dealers", available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

6. See, the Study, p. 50.

interests first. Rather, broker-dealers are simply obligated to treat their customers fairly. The Study notes that the duties and obligations have been developed through Commission and SRO pronouncements, rules, interpretive decisions, opinions, enforcement action orders and, finally, common law. The Study concedes that common law may impose a fiduciary duty under certain circumstances, depending on state law. The Commission and SRO structure does not itself impose or recognize a fiduciary duty for broker-dealers.

1. Investment Advisers

Investment advisers provide a wide range of advisory services to both individuals and institutions. According to the Study, there are more than 11,000 investment advisers registered with the Commission, and they manage more than $38 trillion for more than 14 million clients. There are an additional 275,000 investment adviser representatives registered with states, and more than 15,000 state-registered investment advisers. Of the Commission registered investment advisers, 75% manage individual and small business portfolios. Approximately 92% of the assets under management were in discretionary accounts.[7]

Investment advisers also manage portfolios of pooled investment vehicles. Investment advisers may provide financial planning and pension consulting services, sponsor or manage wrap fee programs, and publish periodicals or newsletters. Over 95% of the registered investment advisers charge fees to clients based on the percentage of assets under management.[8]

2. Broker-Dealers

Broker-dealers handle accounts for both retail and institutional investors. According to the Study, at the end of 2009 broker-dealers held approximately 110 million customer accounts. The Commission oversees approximately 5,100 broker-dealers with over 600,000 registered representatives. Of the 5,100 registered firms, 985 have indicated that they engage in, or expect to engage in, investment advisory services. [9]

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7. See, the Study, pp. 6 – 7.

8. See, the Study, p. 7.

9. See, the Study, p. 8.

The products and services offered by broker-dealers fall into two broad categories, brokerage services and dealer services. The Study defines a broker as one who acts as an agent for someone else, and a dealer as someone acting as principal for its own account. Broker-dealers may offer a variety of both brokerage services and dealer services. Broker-dealer compensation is generally transaction-based, earned through commissions, mark-ups and mark-downs, and sales loads. There is no charge for advice that is incidental to the transactions.

The Study recognizes that broker-dealers offer services to a broad range of retail customers, which may include inexperienced investors seeking basic brokerage services and recommendations as well as investors with aggressive investment objectives or unique situations seeking sophisticated investment strategies.

3. Dual Registrants

Many financial services firms offer both investment advisory and broker-dealer services. Approximately 5% of Commission registered investment advisers reported that they were also registered as a broker-dealer, and 22% reported that they had a related person that was a broker-dealer. Approximately 18% of FINRA registered broker-dealers were also registered as investment advisers. Approximately 37% of FINRA registered broker-dealers had an affiliate engaged in investment advisory activities. Approximately 88% of investment adviser representatives were also FINRA registered representatives.[10]

The Study indicates that a number of large financial services firms reported that some of their customers maintain multiple types of accounts and relationships with them. Some of these customers may receive advice from "dual-hatted" personnel that are subject to both investment adviser and broker-dealer regulations. This may provide some benefits for the customers, but may also raise conflicts for the dual registrants that need to be managed.

10. See, the Study, p. 12.

B. Commission and SRO Regulation of Investment Advisers and Broker-Dealers

1. Investment Advisers

a) Overview of Commission Regulation

The Advisers Act was the last in the series of federal statutes which were meant to eliminate the abuses that Congress believed led to the crash of 1929 and the Depression. The objective of the Advisers Act was to protect investors against wrongdoing by those paid to provide advice.

A person or firm who falls within the definition of "investment adviser" must register under the Advisers Act unless either it is exempt from registration or is prohibited from registering. Investment advisers register under the Advisers Act by completing a Form ADV.

Investment advisers may use persons to help solicit clients and prospective clients for advisory services. Because of the inherent conflicts of interest that exist in the investment adviser – solicitor relationship, they must enter into a written agreement requiring the solicitor to make certain disclosures to prospective clients.

b) Regulation Related to the Provision of Personalized Investment Advice to Advisory Clients

The Supreme Court has construed the Advisers Act as establishing a federal fiduciary standard which governs the conduct of investment advisers. According to the Study, the fiduciary standard applies to the entire relationship between the investment adviser and the client. Fundamental to the federal fiduciary standard are the duties of loyalty and care. The duty of loyalty requires an investment adviser to serve the best interests of his clients. The duty of care requires that an investment adviser make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.

The investment adviser must fully disclose to its clients all material information that is intended to eliminate, or at least expose, all conflicts of interest (or potential conflicts of interest) which might incline an investment adviser to offer advice that was not disinterested.

Investment advisers are restricted when entering into principal and agency-cross trades with their clients. If an investment adviser acts as principal on its own account, it must disclose to its client prior to the transaction being completed the capacity in which it is working, the compensation it is receiving and obtain the client's consent. With regard to agency-cross trades, the investment adviser need not receive transaction by transaction consent, but rather may obtain blanket consent which is renewed annually.

Investment advisers owe their clients the duty to provide suitable investment advice. The investment adviser must disclose its investment process to clients, including its methods of analysis and investment strategies. Investment advisers also have the duty to seek best execution for transactions where the investment adviser has the responsibility to select broker-dealers to execute trades, such as when the account is a discretionary account. Investment advisers are also prohibited from using any advertisement that contains any untrue statement of a material fact or is otherwise false and misleading.

Commission registered investment advisers are subject to record-keeping rules. Additionally, investment advisers must have established supervisory procedures which are designed to prevent violations of the federal securities laws and their rules and regulations. Investment advisers must also adopt a written code of ethics. On the Form ADV, investment advisers must disclose information about the disciplinary history of the firm and its personnel.

When an investment adviser has authority to vote a client's proxies, the investment adviser must cast the proxy votes in a manner consistent with the best interests of the client. Investment advisers must disclose to clients how they are compensated for their services. Moreover, investment advisers must charge fees that are fair and reasonable, and must disclose if the adviser's fee is higher than others. When an investment adviser enters into an advisory contract with a client, the contract may not be assigned without the client's consent. To the extent a contract contains a mandatory pre-dispute arbitration clause, the language in the contract must be clear that such clause does not constitute a waiver of any right provided in the Advisers Act.

Investment advisory clients generally do not have a private right of action for damages and other monetary relief against the investment adviser under the Advisers Act, however, clients have a limited private right of action to void the contract and obtain restitution of fees paid. Clients may seek to enforce claims against an investment adviser under the Securities Exchange Act of 1934 (the "Exchange Act") to the extent there is fraud in connection with the purchase or sale of a security. Clients may also pursue state common law or statutory claims against investment advisers.

2. Broker-Dealers

a) Overview of Commission and SRO Regulation

The Exchange Act generally requires broker-dealers to register with the Commission and an SRO. Associated persons must also, as a general rule, register. Finders, those intermediaries who "find" potential investors, must also register. Before approving the membership application, the SRO must consider the firm's ability to: adhere to the applicable rules and regulations, maintain sufficient capital to operate; maintain financial controls; put in place and effectuate a sufficient compliance and supervisory structure; keep proper records; and enforce continuing education standards. The SRO must also consider any other information it has that would lead to a conclusion that the applicant may fail to adhere to the rules and regulations. Broker-dealers, as opposed to investment advisers, need not maintain a stated ethical code.

b) Regulation Related to the Provision of Personalized Investment Advice and Recommendations to Retail Customers

Where the investment adviser framework is based on the fiduciary duty, the law and custom applicable to broker-dealers is based on fairness. The Study addresses the duty to treat clients fairly in some detail. The discussion serves to highlight the difference between such a duty and a fiduciary one. For example, the Study indicates that the antifraud provisions of federal securities law impose a duty for the broker-dealer to deal fairly with a client. The Study states: "Actions taken by the broker-dealer that are not fair to the customer must be disclosed in order to make this implied representation of fairness not misleading."[11]

SRO rules obligate broker-dealers to observe "high standards of commercial honor and just and equitable principles of trade." In practical terms, the broker-dealer must:

- have a reasonable basis for the recommendation in light of a customer's financial situation to the extent known to the broker (suitability);
- engage in fair and balanced communications with the public;
- provide timely and adequate confirmation of transactions;

11. See, the Study, p. 51.

- provide account statements;
- disclose conflicts of interest;
- receive fair compensation both in agency and principal transactions; and
- give customers the opportunity to arbitrate their claims.

FINRA is imbued with the power to enforce these "just and equitable principles of trade."

The Study addresses the antifraud provisions of the Exchange Act, noting that they broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. If there is to be a fiduciary duty imposed, it stems from common law. The Study describes the instances in which courts will find the existence of a fiduciary duty: "Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty."[12]

According to the Study, the extent of the broker-dealers' duties stems from the nature of the relationship with the customer. For example, addressing conflict of interest disclosures, the Study notes that if the broker-dealer processes orders but does not recommend securities or solicit customers, the material information to be disclosed is narrow and relates only to the consummation of the transaction. Such a broker-dealer would not have to disclose information about the security or its own economic self-interest in the transaction. But, if the broker-dealer recommends a security, it must "give honest and complete information," and must disclose "material adverse facts of which it is aware."[13] Generally speaking, when recommending a security, the broker-dealer must disclose its own economic interests in the trade, such as whether it will be acting as a principal; third-party compensation paid; whether there is revenue sharing for a mutual fund; and the expenses related to the class of security offered. The Study concludes that such disclosures "allows customers to verify the terms of their transactions and provides disclosure on potential conflicts of interest."[14]

Certain conflicts are acceptable if disclosed (i.e., third party compensation, broker-dealer control, interest or affiliation in the security offered, and conflicts arising from analyst recommendation of securities). However, there are also conflicts that cannot be disclosed away. Broker-

12. See, the Study, p. 54.

13. See, the Study, p. 55.

14. See, the Study, p. 57.

dealers cannot recommend securities they themselves issue, nor can they provide gifts or payment to gain securities business. Broker-dealers cannot borrow money from or loan money to a customer unless there are written procedures in place addressing such transactions. Regulation M generally prohibits those with an interest in an offering from engaging in certainly activities during the security's distribution (in order to avoid price manipulation). Broker-dealers are also prohibited from extending credit to allow customers to buy new issues – thereby discouraging the manufacture of a high demand for the offering.

A broker-dealer's duty to only recommend suitable securities stems from the antifraud provisions of the federal securities laws and the SRO rules. Suitability determinations are fact-specific. The Study seemingly distinguishes an offer from a recommendation: "The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a 'recommendation.'"[15] Reading between the lines, it seems that the Study would not find a suitability obligation for securities offered, but not recommended.

The Study addresses what it deems three approaches to suitability under common law: reasonable basis suitability, customer specific suitability and quantitative suitability. Under the first, the broker-dealer must have investigated the security and have adequate information concerning the security recommended. Under the second, the broker-dealer must make inquiry concerning the customer and make a recommendation based on the customer's response. The third requires a broker-dealer that maintains actual or de facto control over a customer account to have a basis to believe the amount of trading in a customer's account is suitable. In other words, churning is a quantitative suitability issue.

Broker-dealers must charge fair and reasonable prices, violations being deemed violations of the antifraud provisions. For example, undisclosed equity markups of more than 10% are deemed fraudulent. Lower markups can be considered fraudulent depending on the circumstances. Markups on debt securities in excess of 4 to 5% are probably fraudulent. "Unfair or unreasonable" underwriting compensation is fraudulent and broker-dealers are obligated to disclose all underwriting compensation in a prospectus. In essence, all aspects of a firm's compensation are subject to scrutiny – including non-cash compensation.

15. See, the Study, p. 60.

The broker-dealer's duty of fairness extends to best execution. While the security price is the dominant factor, other factors are considered in determining best execution, including the order size, speed of competing markets, trading characteristics of the security, availability of information regarding competing markets, availability of competing markets, and cost of access to competing markets.

In its communications with the public, broker-dealers must avoid misleading statements which would violate the antifraud provisions of the securities laws. Such communications must be "fair and balanced." [16] Communications must include material facts and qualifications, not predict or project performance, or make exaggerated claims. Certain broker-dealer communications must be filed with FINRA for approval. For example, a broker-dealer's first year of communications must be approved. Preapproval is also required for registered investment companies, CMOs, security futures and bond mutual funds including bond mutual fund volatility ratings. Other communications must simply be filed with FINRA, such as advertisements regarding registered investment companies, public direct participation programs and government securities. The Study notes that 99,000 communications were reviewed by FINRA in 2008. Of these, 476 investigations were performed regarding 2,378 separate communications.[17]

There are various administrative requirements applicable to broker-dealers, such as the records retention requirements. Broker-dealers must also maintain a certain amount of net capital. The purpose of net capital is described: "to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from SIPC."[18]

The administrative requirements described in the Study also include the broker-dealer's supervision and compliance systems. Broker-dealers must not only establish policies and procedures reasonably designed to detect and prevent violations of laws and regulations, but they must actually enforce those policies and procedures. The policies and procedures must be tested on an ongoing basis to ensure they work.

The supervision obligations must include supervision of outside business activities. Associated persons with outside business relationships must disclose them to the broker-dealer for approval. Such relationships are

16. See, the Study, p. 71.

17. See, the Study, p.72.

18. See, the Study, p. 73.

acceptable unless they interfere or compromise the associated person's responsibilities to the broker-dealer and its customers, or if it would be viewed by the public as part of the broker-dealer's business. Broker-dealers may prohibit outside business activities if circumstances so warrant. Additionally, there are testing and continuing education requirements for associated persons. Customer complaints must be maintained and reported under the requisite rules. Forms BD and U4 are used for the disclosure of certain disciplinary and complaint information.

The Exchange Act provides a private right of action, but violations of the act require proof of scienter. Under Section 17(a) and 10(b) and Rule 10b-5, a misrepresentation or material omission, made with scienter, must be demonstrated. The Study distinguishes violations of FINRA rules, which do not contain a scienter element. The Study explains the difference: "[W]hile the suitability obligation under the federal securities laws arises from the antifraud provisions, the SRO rules are grounded in concepts of ethics, professionalism, fair dealing and just and equitable principles of trade, which gives SROs more authority in dealing with the suitability issues."[19]

The Study properly concludes that arbitration is the *de facto* standard because of the opening account documents used by almost all firms. Arbitrations commonly are based on rule violations, without the scienter requirement. While the SRO rules don't provide a private cause of action in court, plaintiffs often use them to establish a standard of care in the negligence context. SRO rules require that awards be paid within 30 days, with the revocation or suspension of membership serving as a penalty for failure to make payment.

C. State and Other Regulation of Investment Advisers and Broker-Dealers

1. Investment Advisers

a) Overview of State Regulation Intended to Protect Clients

Most small investment advisers are prohibited from registering with the Commission and, instead, are registered and regulated by state regulators. States also retain authority over Commission registered investment advisers under state investment adviser statutes.

19. See, the Study, p. 62.

States generally impose requirements upon state-registered investment advisers that are similar to those imposed by the Advisers Act, however, the requirements do vary by state. States also generally impose registration, licensing or qualification requirements on the investment adviser representatives who are doing business within the state.

b) Other Federal and State Regulation Intended to Protect Advisory Clients

Certain investment advisers are subject to ERISA if they exercise authority or control over the management or disposition of employee benefit plans which are subject to ERISA, provide investment advice for a fee with respect to the plan assets, or have discretionary responsibility or authority to administer a plan.

2. Broker-Dealers

a) Overview of State Regulation Intended to Protect Retail Customers

The Commission has non-exclusive jurisdiction over broker-dealers. Every state requires broker-dealers and their agents to be registered with or licensed by the securities regulators of the states in which they conduct business. If an existing customer is temporarily in another state, the broker-dealer need not register with that state. States may also impose bonding, net capital, custody, financial statement reporting, and recordkeeping requirements on broker-dealers, however, they must conform to federal law.

b) Other Federal and State Regulation Intended to Protect Retail Customers

Broker-dealers are generally not considered fiduciaries for ERISA purposes, as traditional recommendations would not be considered investment advice under ERISA. A broker-dealer may be considered a fiduciary under ERISA if it exercises discretion beyond that permitted under the regulations.

III. Retail Investor Perceptions and Confusion Regarding Financial Service Provider Obligations and Standard of Conduct

The Commission had been studying retail investor perceptions of the standards of care applicable to investment advisers and broker-dealers and their representatives through survey evidence and focus groups for a number of years.

The Study notes that baby boomers control roughly $13 trillion in household investable assets, over 50% of US household investment assets, and nearly one in every six Americans will be 65 or older by the year 2020.[20] The Study points out that many retail investors do not understand or are confused by the different standards of care applicable to investment advisers and broker-dealers and their respective associated persons.

A. Investor and Investor Advocate Comments

Through publicly solicited comments, many investors stated that they did not understand the standards of care applicable to investment advisers and broker-dealers, found the standards of care confusing, and were uncertain about the meaning of the multiple titles used by investment advisers and broker-dealers.

B. Commission-sponsored Studies

1. Siegel & Gale, LLC and Gelb Consulting Group, Inc. Study

Siegel & Gale, LLC and Gelb Consulting Group, Inc. were retained by the Commission in 2004 to conduct focus group testing. The focus group participants had the same issues as those raised by investors in the publicly solicited comments, namely that they did not understand that the roles and legal obligations of investment advisers and broker-dealers are different, and that the different titles used are confusing. The participants also did not understand terms such as "fiduciary".

20. See, the Study, pp. 93 – 94.

2. RAND Report

The Commission retained RAND in 2006 to conduct a study of broker-dealers and investment advisers.

a) Firm Analysis

RAND found it difficult to identify with certainty the business practices of investment advisers and broker-dealers. RAND noted that it could be difficult for investors to understand the differences in the services provided by financial firms as the information was not presented uniformly, with some firms providing so much information it would be difficult to process and others providing scant information. RAND found that the firms believed investors tend to trust a particular firm without necessarily understanding the firm's services and responsibilities.

b) Investor Survey

Survey respondents and focus group participants reported that they did not understand the differences between investment advisers and broker-dealers, and found the titles used confusing. Focus group participants noted that "the interchangeable titles and 'we do it all' advertisements made it difficult to discern broker-dealers from investment advisers."[21] Participants also did not understand the legal duties owed to investors by investment advisers and broker-dealers. "The primary view of investors was that the financial professional – regardless of whether the person was an investment adviser or a broker-dealer – was acting in the investor's best interest."[22]

c) RAND's Conclusion

RAND came to the conclusion that the "financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment."[23]

21. See, the Study, p. 98.

22. See, the Study, p. 98.

23. See, the Study, p. 99.

Therefore, there has been a blurring of the distinctions between investment advisers and broker-dealers.

C. CFA Survey

Industry advocates and certain industry groups also conducted a survey. The results of the survey again suggest that investors do not understand the differences between investment advisers and broker-dealers, nor do they understand that there are differing standards of conduct related to each.

D. Conclusion

The Study indicates that, based on the comments, studies and surveys, investors do not understand the differences between investment advisers and broker-dealers. This is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[24] The Study concludes that "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[25]

IV. Analysis and Recommendations

A. General Differences in Investment Adviser and Broker-Dealer Regulation

As discussed above, investment advisers and broker-dealers are subject to different regulations. Investment Advisers are fiduciaries to their clients and are regulated under the Advisers Act. There is generally a principles-based approach to regulating investment advisers. An investment adviser

24. See, the Study, p. 101.

25. See, the Study, p. 101.

must eliminate, or at least disclose, all conflicts of interest that might incline an investment adviser to render advice that is not disinterested.

Broker-dealers are typically not fiduciaries to their clients except in rare instances. Broker-dealers are governed through the Commission's antifraud authority in the Securities Act of 1933 and the Exchange Act as well as SRO rules based on Exchange principles. Theirs is characterized as a predominantly rules-based approach that focuses on rules embodying principles of fairness and transparency to relationships between broker-dealers and their customers. Federal securities laws and SRO rules address broker-dealer conflicts in three ways: express prohibition, mitigation, and disclosure.

B. Standards of Conduct

The main difference in the standard of conduct between the two is that investment advisers are held to a fiduciary duty and broker-dealers generally are not. The fiduciary duty of an investment adviser includes both the duty of loyalty as well as the duty of care. On the other hand, a broker-dealer's standard of conduct is primarily characterized as an obligation to deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade. Broker-dealers are also subject to a number of specific obligations including a duty of suitability, as well as requirements to disclose certain conflicts.

The Commission Staff believes the differences are significant and not well understood by retail customers. Investors generally expect that an investment professional is acting in their best interests. With this background in mind, the Commission Staff made the following recommendation[26]:

> The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should 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 interests

26. See, the Study, pp. 109 – 110.

> of the customer without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice.

The Study states that such a standard would not have any direct bearing on other persons who may be characterized as fiduciaries other than investment advisers and broker-dealers. In addition, the uniform fiduciary standard would overlay on top of the existing investment adviser and broker-dealer regimes and would supplement, and not supplant them. It balances concerns about the impact of regulatory change on investor access to low-cost products and services by not per se eliminating particular products, services, or compensation schemes.

C. Implementing the Uniform Fiduciary Standard

The uniform fiduciary standard should contain, at a minimum, the duties of loyalty and care that are encompassed in the duty as it is applied to investment advisers. The Commission Staff recommends that the Commission provide guidance on the components of the uniform fiduciary standard through both rule making and interpretive guidance.

1. Duty of Loyalty

The duty of loyalty is a fundamental aspect of the fiduciary standard under the Advisers Act. To comply with the duty of loyalty, broker-dealers would have to eliminate or disclose material conflicts of interest. Commission-based compensation does not violate the fiduciary standard. Nor does the fiduciary standard require that a broker-dealer have a continuing duty of care or loyalty after providing personalized investment advice.

a) Disclosure

The Staff recognizes that there are various disclosures currently made by both investment advisers and broker-dealers at different times throughout the relationship with the customer. The Staff also recognizes that the disclosures need to be clear and consistent. The Staff recommends a uniform approach to disclosure that would provide the customers of both investment advisers and broker-dealers key information at the outset of the relationship and at appropriate times thereafter.

The Staff also recommends that the Commission explore the utility and feasibility of a summary disclosure document that would describe in clear, summary form, a firm's services, charges, and conflicts of interest. The Staff believes it is the firm's obligation, and not the customers', to ensure that material conflicts of interest are fully, fairly and clearly disclosed so that they are understood. The Staff recommends that the Commission consider whether certain conflicts should be prohibited, and when it may be appropriate to impose specific disclosure and consent requirements.

b) Principal Trading

Dodd-Frank section 913 (g) required the Commission to consider a fiduciary standard no less stringent than Advisers Act Sections 206 (1) and (2), however, it omitted 206 (3), which refers to principal trading. The Staff interprets this as a Congressional intent not to mandate the restrictions regarding principal trading against broker-dealers, although the Commission has the authority to do so.

The Staff recognizes that principal trading has the potential for raising conflicts of interest. The Staff recommends that, at a minimum, under a uniform fiduciary standard, a broker-dealer should disclose its conflicts of interest, but it would not necessarily need to follow the same specific notice and consent requirements of the Advisers Act. The Staff does recognize that broker-dealers would remain subject to the obligations related to suitability, best execution, and fair and reasonable pricing and compensation when engaging in principal trading.

The Staff recommends that the Commission offer specific rulemaking and/or guidance as to how a broker-dealer may engage in principal trading and fulfill its fiduciary duty. The Staff also recommends that the Commission revisit the principal trading rules as they apply to investment advisers and determine if those rules should be changed.

2. Duty of Care

Both investment advisers and broker-dealers have duties of care, which incorporate among other things, a duty to investigate, a duty of best execution, and a duty to charge reasonable prices. The Staff recommends that the Commission specify the minimum professional obligations of investment advisers and broker-dealers under the duty of care, either through rulemaking and/or guidance.

The Staff recommends that the Commission develop professional standards regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice. The Staff also recommends that the Commission explicitly provide that any rulemaking or guidance is meant to provide a minimum expectation for the appropriate standard of conduct and would not establish a safe harbor or otherwise prevent the Commission from applying a higher standard of conduct based on specific facts and circumstances.

3. Personalized Investment Advice About Securities

The Staff recommends that the Commission define "investment advice" through rulemaking and/or interpretive guidance. While the Advisers Act focuses on investment advice, the broker-dealer regulatory regime focuses on recommendations. Under the uniform fiduciary standard, the term "personalized investment advice about securities" could be interpreted in a way that is consistent with the scope and interpretive history of both regulatory regimes.

At a minimum, the definition should encompass the making of a recommendation, as developed under the broker-dealer regulation, but should not include "impersonal investment advice" as developed under the Advisers Act. Additionally, other actions or communications which would be considered advice under the Advisers Act should be included in the definition.

a) Retail Customers

The Staff recommends that the Commission define "retail customer". The Staff recommends that the Commission also specify that advice provided to a group of retail customers under circumstances in which members of the group reasonably would believe that the advice is intended for them should be covered by a uniform fiduciary standard. Additionally, the Staff recommends that the Commission consider whether the standard should be extended to persons other than retail customers.

4. Investor Education

The Staff recommends that the Commission continue its investor education initiatives. The Staff suggests that the Commission design improved curriculum materials to assist retail investors, sponsor investor education workshops, and work in partnership with non-profit and community organizations to implement financial literacy programs designed to help investors understand the uniform fiduciary standard.

D. Harmonization of Regulations

This section addresses additional areas of differences between current investment adviser and broker-dealer regulations.

1. Advertising and the Use of Finders and Solicitors

a) Advertising and Other Communications

The Staff has reviewed the differences between investment adviser and broker-dealer regulations relating to advertising. Current differences include the following:

- Under certain circumstances, a registered principal of a broker-dealer must approve a communication before distributing it to the public, and certain communications must be filed with FINRA for approval. No such requirements exist for investment adviser communications.
- Specific content restrictions may differ. For example, investment advisers are prohibited from using testimonials in advertisements and restricted in using past specific recommendations. Broker-dealers are not prohibited from using testimonials. As another example, there is less detailed and extensive guidance regarding the use of performance information and the circumstances under which performance information is considered misleading for broker-dealers, than there is for investment advisers.

The Staff recommends that advertising and customer communication rules and guidance should be made consistent for broker-dealers and investment advisers. At a minimum, internal pre-use review requirements should be consistent and/or investment advisers should be required to designate employees to review and approve advertisements.

b) Use of Finders and Solicitors

The Staff has reviewed differences in regulations regarding the use of finders and solicitors. Currently, a solicitor/finder who causes an investor to retain the services of a broker-dealer must itself register as a broker-dealer. A solicitor/finder who causes an investor to retain the services of an investment advisory firm is not required to register as an investment adviser. However, the solicitor must disclose material conflicts, the adviser has an obligation to supervise the solicitor, and the adviser must treat the solicitor as an associated person to the extent the solicitor acts as such. The Staff recommends that the Commission should consider whether to provide additional guidance or harmonize existing requirements so as to ensure that retail customers understand the conflicts associated with solicitors/finders.

2. Remedies

The Staff has looked at the differences in remedies under current law. Current differences include the following:

- Broker-dealer customers typically are required to arbitrate before FINRA and FINRA rules require broker-dealers to arbitrate with customers, and prescribe the content and form of pre-dispute arbitration clauses in customer agreements. No such requirements exist for clients of investment advisers.
- Broker-dealer customers have private rights of action under certain provisions of the Exchange Act; investment adviser clients have a very limited private right of action under the Advisers Act.
- Broker-dealers are required by FINRA rules to pay awards within 30 days of receipt or face suspension or cancellation of membership. Investment advisers do not face such sanctions.

While the above differences are noted, the Staff does not recommend any action in this regard because Dodd-Frank section 921 (relating to ending or limiting agreements which require customers to arbitrate disputes) provides the Commission with the opportunity to review these issues in greater detail.

3. Supervision

The Staff has reviewed differences in supervisory requirements between broker-dealers and investment advisers. Broker-dealers have more specific supervisory requirements than investment advisers under current law. The Staff recommends that the Commission should consider adopting a single set of universally applicable requirements for supervision. Alternatively, the Commission should consider whether supervisory structure requirements should be scaled based on the size and nature of the broker-dealer/investment adviser.

4. Licensing and Registration of Firms

The Staff has reviewed differences in requirements for the licensing and registration of firms. Currently, investment advisers register on Form ADV part 1 and broker-dealers register on Form BD. Broker-dealers must also satisfy FINRA's membership requirements, which include presenting a business plan and description of the nature and source of capital, the financial controls to be employed, the supervisory system and copies of certain procedures, a membership interview, compliance with applicable state licensing, establishment of a supervisory system and a membership agreement. Investment advisers are not subject to this level of review.

The Staff does not believe that requiring a uniform form for both broker-dealers and investment advisers would help to protect investors. The Staff believes a uniform form would create confusion and be burdensome for firms who are not already dual registrants. However, in instances where the forms ask for the same or similar information, they should be made as uniform as feasible. The Staff believes a more substantive review of investment adviser registration applications could improve investor protection but it is not feasible for the Commission to undertake this responsibility without additional resources. Nonetheless, it recommends that the Commission consider requiring a more substantive review.

5. Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers

The Staff has reviewed the differences between licensing and continuing education requirements for persons associated with broker-dealers and investment advisers. Associated persons of broker-dealers must be registered with FINRA, disclose their employment and disciplinary histories and keep such disclosures current, meet qualification requirements to effect securities transactions and fulfill continuing education requirements. No comparable requirements exist for investment adviser personnel.

The lack of uniform federal licensing and continuing education requirements for investment adviser personnel may be a gap in regulation, but the Staff recognizes that the Commission does not have the infrastructure, nor the resources to administer an education and testing program. However a private organization could develop such a program. The Staff therefore recommends that the Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

7. Books and Records[27]

There are currently differences in books and records requirements. Broker-dealers must retain all communications received and sent and all written agreements relating to a firm's business as such. Investment adviser retention rules are more limited. The Staff recommends that investment advisers should be required to retain the same books and records as broker-dealers.

E. Alternatives to the Uniform Fiduciary Standard

This section considers the options of repealing the broker-dealer exclusion and/or imposing the standard of care applied under the Advisers Act for providing personalized investment advice about securities and other requirements of the Advisers Act upon broker-dealers.

The Staff recognizes that while the foregoing options could have certain benefits (i.e. dividing financial services into two categories, simplifying regulation, helping to reduce investor confusion), any such benefits would be outweighed by the potential negative outcomes. Such potential drawbacks include: 1)they could prevent the Commission from evaluating the existing regulatory regimes and applying the best elements of each to investment advisers and broker-dealers; 2) they might result in fewer investor choices; and 3) they would likely be more costly for investors and the industry (see Section V). The Staff also believes the uniform fiduciary standard would provide investor protection and be a better approach in achieving uniform regulation.

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27. There is no number 6 in the Study.

V. Cost Analysis

This section discusses the costs that could be incurred by investors, broker-dealers, investment advisers, and their associated persons as a result of the Commission's adoption of the uniform fiduciary standard. The Costs Analysis essentially makes the following observations based upon comments, academic sources, and reports the Commission received:

- Commentators expressed a view that adoption of the uniform fiduciary standard would generally increase administrative and compliance costs to broker-dealers.
- Commentators have expressed a concern about the potential increase in litigation expenses, which may result from the adoption of the uniform fiduciary standard.
- Commentators have indicated that adoption of the uniform fiduciary standard would increase insurance costs for broker-dealers.
- The Study noted that application of the uniform fiduciary standard to broker-dealers might cause them to register as investment advisers and possibly de-register as broker-dealers. This may result in brokerage accounts being converted into investment advisory accounts subject to advisory fees. This conversion may involve certain upfront fees to the converting customers.
- The Study noted that the industry's increased compliance and administrative costs might be passed along to the retail investors and result in reduced services and products, which may no longer be profitably provided.
- As a result of these increased costs, broker-dealers might decide not to sell securities and bonds as a principal, resulting in a lower quality of execution.
- Custodial fees may be imposed on accounts which are not subject to an investment advisory fee or accounts may be subject to investment advisory fees regardless of the level of trading in those accounts, leading to the potential of "reverse churning."
- Any additional costs which may be passed on to the retail customer would negatively impact the profitability of their investments.

Notwithstanding these additional costs and burdens, the Staff recommends the adoption of the uniform fiduciary standard.