

The Future of Financial Advice: Eliminating the False Distinction Between Brokers and Investment Advisers

Christine Lazaro

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

This Symposium is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact selbyc@stjohns.edu.

THE FUTURE OF FINANCIAL ADVICE: ELIMINATING THE FALSE DISTINCTION BETWEEN BROKERS AND INVESTMENT ADVISERS

CHRISTINE LAZARO[†]

The individuals who effectuate securities transactions and offer financial advice to the public are regulated at several levels—by federal statute, by state law, and by rules of federal regulators, including the Securities and Exchange Commission (“SEC”) and self-regulatory organizations. Following the stock market crash of 1929, Congress began to enact a federal framework of regulation of the securities markets and the individuals working within the securities markets. Initially, Congress focused on brokers, the individuals who were paid to effectuate securities transactions.¹ Next, Congress focused on investment advisers, the individuals who were paid for the advice they gave in connection with securities transactions.²

The SEC is responsible for implementing the regulatory schemes for both brokers and investment advisers. The SEC directly regulates investment advisers.³ Brokers are indirectly regulated by the SEC and primarily regulated by the Financial

[†] Acting Director of the Securities Arbitration Clinic at St. John’s University School of Law. I would like to thank Teresa Grogan and Mark Movsesian for their helpful comments and Adam Heckler, J.D., 2012, St. John’s University School of Law, for his research assistance and help editing this Article.

¹ See 15 U.S.C. § 78o (2012); Thomas Lee Hazen, *Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*, 15 N.C. BANKING INST. 47, 50 (2011).

² See 15 U.S.C. § 80b-1 (2012); Hazen, *supra* note 1.

³ See James T. Koebel, *Trust and the Investment Adviser Industry: Congress’ Failure To Realize FINRA’s Potential To Restore Investor Confidence*, 35 SETON HALL LEGIS. J. 61, 64–65 (2010); Ross Jordan, Note, *Thinking Before Rulemaking: Why the SEC Should Think Twice Before Imposing a Uniform Fiduciary Standard on Broker-Dealers and Investment Advisers*, 50 U. LOUISVILLE L. REV. 491, 494–95 (2012).

Industry Regulatory Authority ("FINRA"), one of the self-regulatory organizations for which the SEC has oversight responsibility.⁴

The regulatory schemes associated with the SEC and FINRA are separate and distinct. The standard of care applicable to brokers is limited in scope and time to the transaction they are effectuating.⁵ Pursuant to rules promulgated by FINRA, brokers must make suitable recommendations to their clients, execute orders promptly, disclose certain material information, charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest.⁶ Brokers are not fiduciaries of their clients and their duties to their clients end once the transaction is completed.⁷ Brokers have no obligation to provide any ongoing advice to their clients nor are they obligated to monitor their clients' accounts.⁸ Brokers are obligated to observe high standards of commercial honor and just and equitable principles of trade.⁹ On the other hand, investment advisers are held to a higher standard of care. Investment advisers are deemed fiduciaries and are expected to act in their clients' best interests at all times.¹⁰ The advice they give is ongoing and, accordingly, the standard of care applicable to their interactions with their clients is ongoing.¹¹ Investment advisers are expected to monitor their clients' accounts and provide advice as appropriate.¹²

Over time, the distinctions between brokers and investment advisers have blurred. Effectuating transactions and offering advice are no longer distinct activities conducted by different individuals. Brokers offer advice and seek compensation for the

⁴ See Koebel, *supra* note 3; Jordan, *supra* note 3.

⁵ See Jordan, *supra* note 3, at 501.

⁶ See *id.* at 501–02.

⁷ See Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 716, 719, 726–27 (2010) [hereinafter Laby, *Fiduciary Obligations*].

⁸ See *id.* at 728.

⁹ FINRA Rule 2010 (2008), available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=5504.

¹⁰ See Laby, *Fiduciary Obligations*, *supra* note 7, at 718; Jordan, *supra* note 3, at 502–03.

¹¹ See Laby, *Fiduciary Obligations*, *supra* note 7, at 728.

¹² *Id.*

advice they give to clients.¹³ Aware that brokers were beginning to conduct activities which might bring them under the purview of the regulations governing investment advisers, the SEC attempted to carve out exceptions to the regulations for brokers.¹⁴ However, the SEC has been unsuccessful in this regard when challenged in court.¹⁵ Now, an individual offering financial advice may be both a broker and an investment adviser and offer different levels of service to different clients. This individual will be governed by the regulations associated with brokers when acting in the capacity of a broker and will be governed by the regulations associated with investment advisers when acting in the capacity of an investment adviser.¹⁶ This has blurred the distinctions even further, as the same person may be both.¹⁷

Concerned that the distinctions between brokers and investment advisers have blurred too far, a number of studies, including several commissioned by the SEC, have examined an investor's comprehension of the distinctions. The studies have consistently demonstrated that investors do not understand the different roles of brokers and investment advisers.¹⁸ Investors do not understand that the conduct of brokers and investment advisers are governed by different regulatory schemes and by different standards of care.¹⁹ Investors do not always understand with whom they are doing business.²⁰

The SEC was not the only entity concerned that the investing public may not understand who is offering them advice and what responsibilities attach to such individuals. In 2010, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Congress decided to take a closer look at the legislation and regulations governing the relationships between brokers and investment advisers and their

¹³ See Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 400–01 (2009) [hereinafter Laby, *Reforming the Regulation*].

¹⁴ See *id.* at 403.

¹⁵ See *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 483 (D.C. Cir. 2007); Laby, *Reforming the Regulation*, *supra* note 13, at 410–12.

¹⁶ See Laby, *Fiduciary Obligations*, *supra* note 7, at 715.

¹⁷ See *id.*

¹⁸ See U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS i (2011), [hereinafter SEC STUDY], available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

¹⁹ See *id.*

²⁰ See *id.*

clients.²¹ As a result, it tasked the SEC with examining this relationship and determining if any action need be taken.²² The SEC completed a comprehensive study that examined these issues and made recommendations (the "Study").²³

The Study issued by the staff of the SEC recognized that there is widespread confusion among investors about both the differences between brokers and investment advisers and the differing standards of liability that are applicable to each.²⁴ As a result, the Study recommended harmonizing the standards applicable to brokers and investment advisers when providing personalized investment advice about securities.²⁵ However, the Study specifically did not advocate adopting a standard for brokers that would be ongoing.²⁶ The standard of care proposed would still be limited in time.²⁷ Accordingly, it would not mirror the scope of the standard applicable to investment advisers.

Rather than adopt the recommendations proposed by the SEC, this Article proposes that the best course of action at this point is to adopt new legislation—a Financial Advice Act. While the distinctions between brokers and investment advisers have blurred, there remain distinctions. A one-size-fits-all regulatory structure will disregard the realities of the marketplace. Different clients have different needs and expectations from their financial professionals and want different fee structures which reflect the different services. Accordingly, the Financial Advice Act would not harmonize the standards applicable to brokers and investment advisers. It would eliminate the artificial distinctions between brokers and investment advisers as they now exist, and replace them with new definitions more closely tied to the services actually offered by the financial professional. It would recognize that there are varying levels of financial advice with different compensation associated with them. It would create standards of care that are more closely related to the advice and the expectations created by the financial professional. Clients would have the option of choosing to do

²¹ Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1824 (2010).

²² *See id.* at 1824–27.

²³ *See generally* SEC STUDY, *supra* note 18.

²⁴ *See id.* at 101.

²⁵ *See id.* at 132.

²⁶ *Id.* at 165–66.

²⁷ *Id.*

business with a full range of financial professionals from discount to full service, and would receive a corresponding level of protection.

In order to set the stage for the discussion of this Article's proposal, this Article first examines the legislative history of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, and second, the judicial history of both. The circumstances in which each Act was formed explain why the Acts were initially distinct and inform the discussion of why those distinctions are no longer applicable. Next, this Article examines how the SEC has attempted to deal with the blurring of the distinctions in a way that would permit the financial professionals to offer various advice models to clients. By ensuring that there remain definable distinctions between brokers and investment advisers, the courts have further blurred the landscape.

Next this Article examines Congress's attempt to deal with this blurring of roles, and the effect Dodd-Frank has had on this landscape. It will explore the Study conducted by the SEC pursuant to Dodd-Frank and the recommendations made by the staff of the SEC. Lastly, this Article will describe a proposal for a new securities act, which would modify the existing legislation in such a way to eliminate the artificial distinctions between brokers and investment advisers.

I. LEGISLATIVE HISTORY OF THE SECURITIES ACTS FOR BROKERS AND INVESTMENT ADVISERS

In order to comprehensively evaluate the weaknesses in the current regulatory structure governing the provision of financial advice, it is important to understand the environment in which the applicable statutes were initially enacted. Prior to the enactment of federal securities laws, the offering of securities was governed by the states or by stock exchanges.²⁸ It was not until the early part of the twentieth century that investments in securities became widespread to the general public.²⁹

²⁸ Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 794-95 (2004).

²⁹ *Id.* at 778.

During World War I, the U.S. Government began offering Liberty Bonds, creating a broad public interest in securities.³⁰ Following the War, the 1920s were a boom period in the United States, during which time an “unhealthy volume of credit was sucked into securities markets to the deprivation of agriculture, commerce, and industry,” causing widespread securities inflation.³¹

The post-war boom in stocks also attracted . . . the attention of private individuals who up to that time had been more likely to put their funds in savings banks, mortgages, local investments, the managers of which they knew personally, or which were such a factor in their surroundings, their neighborhood, that they felt some confidence in them.³²

By 1934, “nearly one half of the entire national wealth of the country [was] represented by corporate stocks and corporate and Government bonds”; however, “nearly one half of that corporate wealth [was] vested in the 200 largest nonbanking corporations.”³³ Corporate ownership was now vested in the hands of a large number of investors, separating ownership of the corporations from control of the corporations. It was estimated that more than “10,000,000 individual men and women in the United States [were] the direct possessors of stocks and bonds.”³⁴

As more money went into the securities markets, the value of stocks increased, creating a bubble that inevitably burst in October 1929. “The market value of all stocks listed on the New York Stock Exchange slumped from \$89,000,000,000 on September 1, 1929, to \$15,000,000,000 on July 1, 1932,”³⁵ a drop of more than eighty percent. Throughout this time period, it was clear that securities markets were occupying a much more significant place in the day-to-day workings of the country, yet there was little to no oversight. This had to change.

Stock exchanges which handle the distribution and trading of a very substantial part of the entire national wealth and which have developed a technique of sucking funds from every corner of the country cannot operate under the same traditions and

³⁰ *Id.* at 796.

³¹ S. REP. NO. 73-792, at 3 (1934).

³² SEC. & EXCH. COMM'N, INV. TRUSTS AND INV. COS. 4 (1939).

³³ H.R. REP. NO. 73-1383, at 3 (1934).

³⁴ *Id.*

³⁵ S. REP. NO. 73-792, at 3.

practices as pre-war stock exchanges which handled substantially only the transactions of professional investors and speculators.³⁶

Following the crash of the stock market in 1929, Congress examined the lack of oversight of the securities industry. Initially, Congress enacted the Securities Act of 1933.³⁷ This statute has two primary goals: (1) to ensure that investors receive full disclosure in connection with securities being offered for public sale; and (2) to prohibit fraud in connection with the sale of securities.³⁸ The Act focuses primarily on the issuance of securities. Because the Act does not deal with the oversight of brokers or investment advisers, this Act will not be discussed in this Article. The Securities Exchange Act of 1934 would deal with the secondary markets in which securities trade.

A. *The Securities Exchange Act of 1934*

As the country delved further into the Great Depression, President Roosevelt tasked Congress with enacting legislation “providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and . . . for the elimination of unnecessary, unwise, and destructive speculation.”³⁹ In response, Congress adopted the Securities Exchange Act of 1934 (the “1934 Act”).⁴⁰

The 1934 Act was proposed to combat the issues coming out of the Great Depression. The cure had to be widespread if there was any possibility of it being effective. “Speculation, manipulation, faulty credit control, investors’ ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web. No one of these evils can be isolated for cure of itself alone.”⁴¹ The 1934 Act was meant to deal with three principal problems: (1) “the excessive use of credit for speculation,” (2) “the unfair practices

³⁶ H.R. REP. NO. 73-1383, at 4.

³⁷ See generally Securities Act of 1933, ch. 38, 48 Stat. 74.

³⁸ *The Laws That Govern the Securities Industry*, SEC. & EXCH. COMM’N, <http://www.sec.gov/about/laws.shtml> (last modified Oct. 1, 2013).

³⁹ S. REP. NO. 73-792, at 2 (1934).

⁴⁰ See generally 15 U.S.C. § 78a–78pp (2012).

⁴¹ H.R. REP. NO. 73-1383, at 6.

employed in speculation," and (3) "the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities."⁴²

Congress was concerned primarily with two practices of brokers. The first was the extension of margin credit.⁴³ Brokers were lending their clients' money, which they had borrowed from a bank or another broker, so that their clients could speculate in the market.

The ease and celerity with which such a transaction is arranged, and the absence of any scrutiny by the broker of the personal credit of the borrower, encourage the purchase of securities by persons with insufficient resources to protect their accounts in the event of a decline in the value of the securities purchased.⁴⁴

The second concern was the commingling of broker and dealer functions.⁴⁵

[A] broker who deals in securities for his own account finds it difficult to give disinterested advice to a customer with regard to the securities the customer seeks to buy. However honest the broker's intentions may be, it is argued that he should be placed beyond temptation, by a complete segregation of the broker and dealer functions.⁴⁶

However, the committee declined to take such action. Instead, the committee recommended that one situation in which broker and dealer functions were combined should be eliminated.⁴⁷ The committee recommended prohibiting a broker from effecting "any transaction involving the sale on margin, of a security in the distribution of which he has participated during the preceding 6 months."⁴⁸ Additionally, the proposed bill required brokers to disclose in writing to their customers any interest the broker had in the transaction.⁴⁹

⁴² S. REP. NO. 73-792, at 5.

⁴³ *Id.* at 6-7.

⁴⁴ *Id.*

⁴⁵ *Id.* at 11-12.

⁴⁶ *Id.* at 11.

⁴⁷ *Id.* at 12.

⁴⁸ *Id.*

⁴⁹ *Id.*

The 1934 Act created the Securities and Exchange Commission.⁵⁰ The SEC was created so that there would be flexibility in the implementation of the statute. Congress recognized,

so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. Unless considerable latitude is allowed for the exercise of administrative discretion, it is impossible to avoid, on the one hand, unworkable ‘strait-jacket’ regulation and, on the other, loopholes which may be penetrated by slight variations in the method of doing business. Accordingly it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion.⁵¹

Throughout the 1934 Act, the SEC is empowered with the ability to create rules that would govern how the 1934 Act is implemented.⁵² The 1934 Act contains a broad antifraud provision, which provides the following:⁵³

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange[]

.....

(b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁵⁴

The wording of the statute is broad and leaves the SEC with the responsibility to develop rules and regulations defining the conduct it deems unacceptable. The SEC in turn promulgated Rule 10b-5, which broadly prohibits fraud in connection with the purchase or sale of securities.⁵⁵

⁵⁰ 15 U.S.C. § 78d(a) (2012).

⁵¹ S. REP. NO. 73-792, at 5 (1934).

⁵² See *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCH. COMM’N, <http://www.sec.gov/about/whatwedo.shtml> (last modified June 10, 2013) (“The Act empowers the SEC with broad authority over all aspects of the securities industry.”).

⁵³ See 15 U.S.C. § 78j.

⁵⁴ *Id.*

⁵⁵ See 17 C.F.R. § 240.10b-5 (2013). Rule 10b-5 states the following:

The 1934 Act also gave the SEC broad authority over the securities industry, including the power to “register, regulate, and oversee brokerage firms”⁵⁶ as well as brokers. Under the 1934 Act, a broker is defined as “any person engaged in the business of effecting transactions in securities for the account of others.”⁵⁷ In 1938, the Maloney Act amended the 1934 Act to provide for a system of self-regulation of brokerage firms.⁵⁸ The section permitted the registration of an association of brokers and dealers as a national securities association.⁵⁹ Only one such association has ever registered pursuant to this section—the National Association of Securities Dealers (“NASD”), which is today known as the Financial Industry Regulatory Authority.⁶⁰ Under the watch of the SEC, FINRA has the primary responsibility of regulating brokers and writing and enforcing rules for every broker in the United States.⁶¹

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) [t]o employ any device, scheme, or artifice to defraud,

(b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

⁵⁶ *The Laws That Govern the Securities Industry*, *supra* note 38.

⁵⁷ 15 U.S.C. § 78c(a)(4)(A).

⁵⁸ *See id.* § 78o-3.

⁵⁹ *Id.* § 78o-3(a).

⁶⁰ In 2007, FINRA was created through the consolidation of NASD and the member regulation, enforcement, and arbitration operations of the New York Stock Exchange. Press Release, NASD and NYSE Member Regulation Combine To Form the Financial Industry Regulatory Authority—FINRA, Fin. Indus. Regulatory Auth. (July 30, 2007), *available at* <http://www.finra.org/Newsroom/NewsReleases/2007/P036329>. Today, it is the largest independent regulator for all securities firms doing business in the United States, and it oversees over 4,000 brokerage firms and over 600,000 registered securities representatives. *About the Financial Industry Regulatory Authority*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/AboutFINRA/> (last visited Jan. 14, 2014).

⁶¹ GET TO KNOW US, FIN. INDUS. REGULATORY AUTH. (2012), *available at* <http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf>.

B. *The Investment Advisers Act of 1940*

Congress was not finished when it enacted the 1934 Act, however. It continued to evaluate the securities markets to determine whether additional legislation was necessary. In 1939, the SEC submitted a report to Congress on Investment Trusts and Investment Companies.⁶² As discussed above, following World War I, stock ownership had become more widespread. Consequentially, a need for investment counsel arose.⁶³ Very few investment counselor firms existed prior to 1919. Investors had other sources of advice available to them, and a number were

completely satisfied with the fact that they were being given competent and sound advice by the investment banking houses. The brokers were more of a secondary source of advice, while the banking houses knew quite a bit about bonds and not so much as a rule about stocks, the brokers knew more about stocks and very little about bonds insofar as their function was concerned. Their attention was centered on the more active stocks, per se, to some extent.⁶⁴

It was recognized that although many different sources of advice existed, there was “no one to whom [an investor] could turn and retain professionally the way he would retain a lawyer on a technical problem where he was up against technical men on the other side who knew more than he did.”⁶⁵

Issues arose, because at this point, investment counselors were not regulated broadly. There were a handful of small organizations that investment counselors could join; however, there was no requirement that an investment counselor be a member of any organization.⁶⁶ The standards were disparate, “[a]lthough in the majority of cases the personnel of investment counsel firms had had some experience in the security brokerage business or in the financial field, definite or uniform standards of

⁶² See generally SEC. & EXCH. COMM’N, INVESTMENT TRUSTS AND INVESTMENT COMPANIES: REPORT OF THE SECURITIES AND EXCHANGE COMMISSION PURSUANT TO SECTION 30 OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 (1939).

⁶³ Throughout the SEC’s report, the term “investment counselor” was used. However, in the Act, this term was replaced with “investment adviser.” For clarity purposes, this Article will use the term “investment counselor” when referring to the SEC’s report.

⁶⁴ SEC. & EXCH. COMM’N, *supra* note 62, at 3.

⁶⁵ *Id.* at 4–5.

⁶⁶ *Id.* at 4.

training for employees were almost never laid down.⁶⁷ As a result, “individuals without the requisite qualifications and financial responsibility who indulged in exaggerated claims constituted a menace not only to the investor but to the counselors.”⁶⁸

Representatives of investment counselors recognized that their function was the “furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments” and they could not do this “unless all conflicts of interest between the investment counsel and the client were removed.”⁶⁹ One such conflict arose from the intermingling of functions between investment counselors and brokers. Investment counselors were concerned that affiliations between investment counselor firms and brokers

fostered undesirable and irreconcilable conflicts of interest, for “the broker receives his income principally or entirely from the commissions received on transactions—the larger the number of transactions the larger his gross income” and “the broker’s interest in turnover might be a temptation to advise clients to trade more than might be to their advantage or than might be necessary in their interest.”⁷⁰

The report provided by the SEC demonstrated the need for the adoption of legislation aimed at regulating investment counselors. Accordingly, in 1940, Congress adopted the Investment Advisers Act (the “Advisers Act”).⁷¹ “The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale.”⁷²

The Advisers Act requires that firms or individuals who provide investment advice must register with the SEC.⁷³ The Advisers Act defines an investment adviser as

⁶⁷ *Id.* at 16.

⁶⁸ *Id.* at 28.

⁶⁹ *Id.*

⁷⁰ *Id.* at 29 (footnote omitted).

⁷¹ 15 U.S.C. § 80b-1 (2012).

⁷² S. REP. NO. 76-1775, at 21 (1940).

⁷³ 15 U.S.C. § 80b-3.

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.⁷⁴

Specifically exempted from the definition of investment adviser is “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.”⁷⁵

Like the 1934 Act, the Advisers Act prohibits fraud and deceptive practices on the part of an investment adviser. Unlike the 1934 Act, the Advisers Act is more explicit in the conduct it prohibits:⁷⁶

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.⁷⁷

⁷⁴ *Id.* § 80b-2(a)(11).

⁷⁵ *Id.* § 80b-2(a)(11)(C).

⁷⁶ *Id.* § 80b-6.

⁷⁷ *Id.*

Unlike the 1934 Act, the Advisers Act does not leave it to the SEC to define the conduct it deems unacceptable.⁷⁸ The SEC, however, does have the authority to enact rules governing investment advisers and has the primary responsibility for regulating the conduct of investment advisers.⁷⁹

II. THE JUDICIAL HISTORY OF THE SECURITIES ACTS FOR BROKERS AND INVESTMENT ADVISERS

The standards of care, which were set forth by both the 1934 Act and the Advisers Act, were not clear. Although both statutes contain separate antifraud provisions, the courts have interpreted each provision differently. This has led to disparities in the obligations of brokers and investment advisers, even though both statutes aimed to prevent fraudulent conduct. Over time, courts interpreted the antifraud section of the Advisers Act to establish a federal fiduciary duty on the part of investment advisers, while the antifraud section of the 1934 Act was said to have established no such duty on the part of brokers.⁸⁰

To determine the standard of care associated with each Act, the courts considered the level of scienter necessary to find a violation of each Act's antifraud provision.⁸¹ In 1963, the Supreme Court considered the relationship between an investment adviser and a client, and concluded that the relationship was fiduciary in nature.⁸² Justice Goldberg, writing for the majority, stated,

And the Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment

⁷⁸ *See id.*

⁷⁹ *Id.* § 80b-11.

⁸⁰ *Compare* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (holding that under the Advisers Act, a relationship between an investment advisor and a client is fiduciary in nature), *with* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (holding that scienter is a necessary element of the antifraud section of the 1934 Act and therefore it does not confer a fiduciary duty on brokers).

⁸¹ *See* Ernst & Ernst, 425 U.S. at 193; *Capital Gains Research Bureau*, 375 U.S. at 191-92.

⁸² *Capital Gains Research Bureau*, 375 U.S. at 191.

advisory relationship,’ as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser—consciously or unconsciously—to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates ‘as a fraud or deceit,’ intended to require proof of intent to injure and actual injury to clients.⁸³

In considering a breach of this fiduciary duty, the Court determined that the motivation of the investment adviser was not relevant.⁸⁴ “It misconceives the purpose of the statute to confine its application to ‘dishonest’ as opposed to ‘honest’ motives.”⁸⁵

With respect to section 10(b) of the 1934 Act, the courts have determined that, because scienter is a necessary element to find a violation of the section, the section does not confer a fiduciary duty on brokers.⁸⁶ As explained by the Supreme Court, “Section 10(b) makes unlawful the use or employment of ‘any manipulative or deceptive device or contrivance’ in contravention of Commission rules. The words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggest that [section] 10(b) was intended to proscribe knowing or intentional conduct.”⁸⁷

The Court also considered whether or not Rule 10b-5 may cover negligent acts, determining that it could not.⁸⁸ The Court recognized that Rule 10b-5 was enacted by the SEC pursuant to authority granted to it by section 10(b) of the 1934 Act.⁸⁹ “Thus despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under [section] 10(b).”⁹⁰ Accordingly, both section 10(b), and Rule 10b-5 require a finding of scienter, foreclosing liability for negligent violation of either.

⁸³ *Id.* at 191–92.

⁸⁴ *Id.* at 192.

⁸⁵ *Id.* at 201 (footnotes omitted).

⁸⁶ *See Ernst & Ernst*, 425 U.S. at 201.

⁸⁷ *Id.* at 197.

⁸⁸ *Id.* at 201.

⁸⁹ *Id.* at 212–13.

⁹⁰ *Id.* at 214.

In addition to the scope of the standard of care an investment adviser owes a client, the recourse available to clients for a violation of the standard is also an important consideration. In 1979, the Court revisited the issues regarding the standards of care applicable to investment advisers when it determined whether or not Congress intended investors to have a private right of action for violations of the Advisers Act.⁹¹ The Court recognized that section 206 of the Advisers Act “establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers.”⁹² Notwithstanding the broad purposes of investor protection which were behind each of the securities acts enacted following the Great Depression, the Court determined that investors did not have the right to pursue monetary damages under the statute beyond that contemplated by section 215.⁹³ The Court held “that when Congress declared in § 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution.”⁹⁴ However, the Court found that Congress had failed to clearly express an intended private right of action for violations of section 206.⁹⁵ Accordingly, the Court held that “there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable.”⁹⁶

The courts have found, however, that investors do have a private right of action for violations of section 10(b), notwithstanding that it contains no explicit assertion of such a right. The Court has recognized that

[a]lthough [section] 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.⁹⁷

⁹¹ *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 12–13 (1979).

⁹² *Id.* at 17 (citations omitted).

⁹³ *Id.* at 18.

⁹⁴ *Id.* at 19.

⁹⁵ *Id.* at 19–20.

⁹⁶ *Id.* at 24.

⁹⁷ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (footnotes omitted).

In a later case, the Court explained further that “[j]udicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”⁹⁸ With respect to section 10(b), the Court was more concerned with the intent of the wrongdoer than it was when dealing with investment advisers, even though the legislative history of the 1934 Act barely discussed the scope of 10(b). The Court reasoned,

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress’ intent, we think the relevant portions of that history support our conclusion that [section] 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.⁹⁹

III. REGULATORY CHANGES TO THE SECURITIES ACTS

The differing standards of care applicable to brokers and investment advisers took on greater significance over time. When the Advisers Act was enacted, it was accepted that brokers would not be covered by the Act, even though they did offer some advice to customers. At the time, the SEC’s General Counsel offered his opinion on the topic:

Clause (C) of Section 202(a)(11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to ‘special compensation’ amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.¹⁰⁰

⁹⁸ *Basic Inc. v. Levinson*, 485 U.S. 224, 230–31 (1988).

⁹⁹ *Ernst & Ernst*, 425 U.S. at 201.

¹⁰⁰ Opinion of General Counsel Relating to Section 202(a)(11)(c), Investment Advisers Act Release No. 2, 1940 WL 975 (Oct. 28, 1940).

Usually, a broker is paid a fee for each transaction placed and an investment adviser is paid a management fee, which is a percentage of the assets managed.¹⁰¹ The investment adviser's fee is related to the advice and management provided whereas the broker's fee is related to the costs of transacting the trades.¹⁰² The distinctions in the fee structures made it clear that one fee structure was directly related to advice and the other was related to transaction costs. Over time, brokers expanded the services and fee structures they offered their clients, offering fee-based programs and self-directed accounts which had discounted fees.¹⁰³ Through the fee-based programs, brokers offered investors "a package of brokerage services—including execution, investment advice, custodial and recordkeeping services—for a fixed fee or a fee based on the amount of assets on account with the broker-dealer."¹⁰⁴ The self-directed accounts allowed investors to

purchas[e] execution-only services at a reduced commission rate. These execution-only programs often give customers the ability to trade securities over the Internet without the assistance of a registered representative. These programs offer customers who do not want or need investment advice the ability to trade securities at a lower commission rate.¹⁰⁵

Therefore, brokers were offering their clients fee-based programs, transaction-based fee structures in which the client received personalized investment advice, and self-directed account services where the client paid discounted transaction-based fees.

The new fee-based programs offered by brokers blurred the correlation between fees and advice. It was no longer clear what brokers were charging for when they charged clients an asset-based fee. The SEC was concerned that the new fee structures offered would bring brokers under the purview of the Advisers Act. The SEC recognized that fees earned in fee-based accounts might constitute "special compensation" for advice under the

¹⁰¹ See Laby, *Fiduciary Obligations*, *supra* note 7, at 702 ("Advisory firms . . . typically charge asset-based fees . . ."); Barbara Black, *Brokers and Dealers—What's in a Name?*, 11 *FORDHAM J. CORP. & FIN. L.* 31, 35–38 (2005).

¹⁰² See Black, *supra* note 101.

¹⁰³ See *id.* at 31–32.

¹⁰⁴ Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-42099, Investment Advisers Act Release No. 1845, 64 *Fed. Reg.* 61,226-01, at 61,228 (proposed Nov. 10, 1999).

¹⁰⁵ *Id.* (footnote omitted).

Advisers Act.¹⁰⁶ Further, offering discount services might make the fees received in connection with full service accounts “special compensation.”¹⁰⁷ “This is because the difference between full service and execution-only commission rates represents a clearly definable portion of a brokerage commission that is attributable, at least in part, to investment advice.”¹⁰⁸ However, the SEC did not believe

that Congress intended these programs, which are not substantially different from traditional brokerage arrangements, to be subject to the Act. While in 1940 the form of compensation a broker-dealer received may have been a reliable distinction between brokerage and advisory services, development of the new brokerage programs suggest strongly that it is no longer.¹⁰⁹

The SEC saw the various fee structures as flexibility in the way brokers did business—not necessarily as a change in the type of advice brokers offered their clients.

If brought under the Advisers Act, brokers would be held to the federal fiduciary duty of investment advisers and would be subject to certain other restrictions that the Act imposes. Specifically, section 206(3) of the Advisers Act prohibits an investment adviser from acting as a principal for his own account “without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”¹¹⁰ The practice of acting as a principal on his own account is commonplace for brokers and may be disclosed at the completion of the trade.¹¹¹ There is no requirement to disclose such information before the completion of the transaction, nor is there any requirement to obtain the consent of the client.¹¹² Restricting brokers in this way would impact the services they traditionally offered their clients.

Fearing that brokers would be subject to the obligations and the restrictions set forth in the Advisers Act, the SEC proposed retaining the exemption for brokers from the definition of

¹⁰⁶ *Id.* at 61,227.

¹⁰⁷ *Id.* at 61,228.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ 15 U.S.C. § 80b-6 (2012).

¹¹¹ 17 C.F.R. § 240.10b-10(a)(2) (2013).

¹¹² *See id.*

investment adviser, notwithstanding that the broker was now receiving what might otherwise be considered special compensation for advice.¹¹³ The SEC focused on the services provided by the broker rather than the form of the broker's compensation. In 2005, the SEC adopted Rule 202(a)(11)-1(a), which stated that brokers would not be required to treat customers as advisory customers provided the firm met the following conditions:

- (i) Any investment advice it provides to an account must be solely incidental to the brokerage services provided to the account (and thus must be provided on a non-discretionary basis); and (ii) advertisements for and contracts, agreements, applications and other forms governing its accounts must include a prominent statement that the account is a brokerage account and not an advisory account, and that the broker-dealer's interests may not always be the same as the customer's.¹¹⁴

Under Rule 202(a)(11)-1(b), "a broker-dealer will not be considered to have received special compensation solely because the broker-dealer charges one customer a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer."¹¹⁵

Not long after Rule 202(a)(11)-1 was adopted, it was challenged in court. In 2007, the Court of Appeals for the D.C. Circuit rejected the SEC's power to adopt such a rule.¹¹⁶ As discussed above, the Advisers Act already exempted brokers from the definition of investment adviser so long as the broker did not receive special compensation for giving advice.¹¹⁷ However, the Advisers Act contained a broader provision, which vested the SEC with power to exempt "other persons" from the definition of investment adviser.¹¹⁸ The court found that the adoption of Rule

¹¹³ Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-42099, Investment Advisers Act Release No. 1845, 64 Fed. Reg. 61,226-01, at 61,229 (proposed Nov. 10, 1999).

¹¹⁴ Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 20,424-01, at 20,434 (Apr. 19, 2005).

¹¹⁵ *Id.* at 20,436.

¹¹⁶ *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 487 (D.C. Cir. 2007).

¹¹⁷ 15 U.S.C. § 80b-2(a)(11) (2012).

¹¹⁸ At the time, § 202(a)(11)(F) of the Advisers Act exempted from the definition of investment adviser "such other persons not within the intent of this paragraph, as

202(a)(11)-1 was the SEC's attempt to expand the exemption for brokers by utilizing its broad power to exempt "other persons."¹¹⁹ Because Congress had already provided for an express exemption for brokers, the SEC could not also exempt them as "other persons." Therefore, the rule was inconsistent with the legislative intent behind the Advisers Act.¹²⁰

Once the rule was invalidated, brokers would not be able to continue to offer clients a variety of fee structures unless they also registered as investment advisers. At the time of the court decision, the SEC estimated that investors held \$300 billion in one million fee-based brokerage accounts with brokers.¹²¹ The brokers and the customers had to decide if they wanted to change the fee structure of the account so that the broker could continue to manage it. If the client wanted to continue to maintain a fee-based account, the brokers would have to register as investment advisers. Accordingly, the SEC sought some time, before the court's decision would become effective, "to protect the interests of those customers and to provide sufficient time for them and their brokers to discuss, make, and implement informed decisions about the assets in the affected accounts."¹²²

As a result of the court's decision, a number of brokers registered as investment advisers. As of late 2010, approximately eighteen percent of all brokerage firms registered with FINRA were also registered as investment advisers, and approximately thirty-seven percent of FINRA registered

the Commission may designate by rules and regulations or order." 15 U.S.C. § 80b-2(a)(11)(H) (originally 15 U.S.C. § 80b-2(a)(11)(F)).

¹¹⁹ *Fin. Planning Ass'n*, 482 F.3d at 487–90.

¹²⁰ The court held that the final rule adopted by the SEC was inconsistent with the Advisers Act

because it fail[ed] to meet either of the two requirements for an exemption under subsection (F). First, the legislative "intent" [did] not support an exemption for broker-dealers broader than the exemption set forth in the text of subsection (C); therefore, the final rule [did] not meet the statutory requirement that exemptions under subsection (F) be consistent with the "intent" of paragraph 11 of section 202(a). Second, because broker-dealers [were] already expressly addressed in subsection (C), they [were] not "other persons" under subsection (F); therefore the SEC [could] use its authority under subsection (F) to establish new, broader exemptions for broker-dealers.

Id. at 488.

¹²¹ Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisors Act Release No. 2653, 91 SEC Docket 1915, 2007 WL 2778648, at *5 (Sept. 24, 2007).

¹²² *Id.* at *2.

brokerage firms had an investment adviser affiliate.¹²³ These firms offer clients a variety of services. As a result, clients may end up having several different types of accounts with the firm and may receive advice from “dual-hatted” personnel who are both brokers and investment advisers.¹²⁴ The individual will be subject to either brokerage firm regulation or investment adviser regulation based on the services offered.¹²⁵

The SEC remained concerned that dual registration would impact brokers' ability to offer a full range of investment options to their clients because of the restrictions on principal trading. The SEC adopted temporary rule 206(3)-3T, which offered an alternative means for investment advisers who were also brokers to meet the disclosure and consent requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients.¹²⁶ The rule allows investment advisers to orally disclose the fact that they are acting in a principal capacity, rather than in writing, so long as certain other conditions are met.¹²⁷ Theoretically, this rule provides more flexibility to investment advisers who are also brokers in terms of the way they do business with their clients.

¹²³ SEC STUDY, *supra* note 18, at 12.

¹²⁴ *Id.* at 13.

¹²⁵ *Id.*

¹²⁶ Temporary Rule Regarding Principal Trades with Certain Advisory Clients, 2007 WL 2778648, at *5–6.

¹²⁷ *Id.* at *5.

IV. LEGISLATIVE PROGRESS

Between 2007 and 2009, there was significant upheaval in the financial services industry¹²⁸ and the market declined considerably.¹²⁹ The country was embroiled in a financial crisis that was deemed the worst crisis since the Great Depression.¹³⁰ As a result, Congress considered necessary changes to the regulations governing the financial services industry. The Dodd-Frank Wall Street Reform and Consumer Protection Act¹³¹ was signed into law by President Obama on July 21, 2010. The purpose of Dodd-Frank was “[t]o promote the financial stability

¹²⁸ In June 2007, two major Bear Stearns hedge funds collapsed. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Two Former Bear Stearns Hedge Fund Managers with Fraud (June 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-115.htm>. In February 2008, the auction rate securities markets failed. See *Auction Rate Securities Market: A Review of Problems and Potential Resolutions Before the H. Comm. on Fin. Servs.*, 110th Cong. 9 (2008) (statement of Linda Chatman Thomsen, Director, Division of Enforcement, United States Securities and Exchange Commission). In March 2008, J.P. Morgan Chase & Co. acquired The Bear Stearns Companies Inc. See Press Release, J.P. Morgan Chase & Co., J.P. Morgan Chase to Acquire Bear Stearns (Mar. 16, 2008), available at <http://investor.shareholder.com/jpmorganchase/releasedetail.cfm?ReleaseID=299805>. In September 2008, Bank of America Corp. acquired Merrill Lynch & Co., Inc., AIG was bailed out by the U.S. government, and Lehman Bros. Inc. filed bankruptcy. See Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Bd. (Sept. 16, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>; Press Release, Bank of Am., Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm (Sept. 15, 2008), available at <http://newsroom.bankofamerica.com/press-release/corporate-and-financial-news/bank-america-buys-merrill-lynch-creating-unique-financial>; Press Release, U.S. Sec. & Exch. Comm’n, Statement Regarding Recent Market Events and Lehman Brothers (Sept. 15, 2008), available at <http://www.sec.gov/news/press/2008/2008-198.htm>. In December 2008, the SEC charged Bernard L. Madoff with a multi-million dollar ponzi scheme, and Wells Fargo & Co. merged with Wachovia Corp. See News Release, Wells Fargo & Co., Wells Fargo and Wachovia Merger Completed (Jan. 1, 2009), available at https://www.wellsfargo.com/press/2009/20090101_Wachovia_Merger; Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), available at <http://sec.gov/news/press/2008/2008-293.htm>.

¹²⁹ Between October 2007 and March 2009, the DOW Jones Industrial Average dropped by more than fifty percent of its value. See Peter A. McKay, *Dow Is Off 7,401.24 Points From Its Record High in '07*, WALL ST. J. (March 3, 2009), <http://online.wsj.com/article/SB123599406229708501.html>.

¹³⁰ THE FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xv (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

¹³¹ See generally Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."¹³²

The law as enacted was a compromise between the House and the Senate versions. Both the House and the Senate versions addressed changes to the standards of conduct applicable to brokers and investment advisers.¹³³ "The House approach was to harmonize the fiduciary standard for brokers, dealers, and investment advisers. The Senate approach was to have the SEC conduct a study to evaluate the effectiveness of existing standards of conduct for brokers, dealers, and investment advisers"¹³⁴

Section 913 of Dodd-Frank is entitled, "Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers."¹³⁵ Pursuant to subsection (b), the SEC is required to 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.¹³⁶

¹³² *Id.* at pmb1.

¹³³ MICHAEL V. SEITZINGER, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: STANDARDS OF CONDUCT OF BROKERS, DEALERS, AND INVESTMENT ADVISERS 5 (2010), available at <http://www.fas.org/sgp/crs/misc/R41381.pdf>.

¹³⁴ *Id.* (footnote omitted).

¹³⁵ Dodd-Frank Wall Street Reform And Consumer Protection Act § 913.

¹³⁶ *Id.* § 913(b).

Section 913 sets forth fourteen items that the SEC was to consider when conducting the study and includes a catchall of anything not explicitly set forth that the SEC deems necessary and appropriate.¹³⁷

A. *The SEC Study on Investment Advisers and Broker-Dealers*

Over the next several months, the SEC conducted the study as required by Dodd-Frank. The SEC issued its report, the “Study on Investment Advisers and Broker-Dealers” (the “Study”), to Congress in January 2011.¹³⁸ The Study examined the fourteen different items, as directed by Dodd-Frank.¹³⁹ It examined the current landscape of regulation of both brokers and investment advisers and the perceptions of investors.¹⁴⁰ It made a number of recommendations, most notably to harmonize the standards of care applicable to brokers and investment advisers.¹⁴¹ As discussed in further detail below, this recommendation is inadequate to address investors’ confusion over the responsibilities and obligations of the person with whom they are investing because it does not create an ongoing fiduciary duty on the part of brokers.

The Study recognized the differences in the regulatory framework for investment advisers and brokers. As discussed above, the main difference in the standard of conduct between the two is that investment advisers are held to a fiduciary duty and brokers 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, the law and custom applicable to brokers is based on fairness. “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.”¹⁴² The Study described the limited instances in which courts will find that brokers are subject to the fiduciary duty: “Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a

¹³⁷ *Id.* § 913(c).

¹³⁸ *See generally* SEC STUDY, *supra* note 18.

¹³⁹ *Id.* at 1.

¹⁴⁰ *See id.* at 5–101.

¹⁴¹ *See id.* at 108–10.

¹⁴² *Id.* at 51.

relationship of trust and confidence with their customers, owe customers a fiduciary duty."¹⁴³ However, there is no federal fiduciary duty created by the 1934 Act.

According to the Study, the extent of the broker's duties stems from the nature of the relationship with the investor. For example, addressing conflict of interest disclosures, the Study noted that if the broker 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.¹⁴⁴ Such a broker would not have to disclose information about the security or its own economic self-interest in the transaction.¹⁴⁵ But, if the broker recommends a security, it must "give honest and complete information" and must disclose "material adverse facts of which it is aware."¹⁴⁶ Generally speaking, when recommending a security, the broker 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.¹⁴⁷ The Study concluded that such disclosure "allows customers to verify the terms of their transactions and provides disclosure on potential conflicts of interest."¹⁴⁸

In addition to making certain disclosures when completing transactions, a broker also has a duty to ensure that any recommendation he makes to a client is suitable. The Study addressed what it deems three approaches to suitability under common law: reasonable basis suitability, customer specific suitability, and quantitative suitability.¹⁴⁹ Under the first, the broker must have investigated the security and have adequate information concerning the security recommended.¹⁵⁰ Under the second, the broker must make inquiry concerning the investor and make a recommendation based on the investor's response.¹⁵¹ Under the third, a broker that maintains actual or de facto

¹⁴³ *Id.* at 54.

¹⁴⁴ *Id.* at 55.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *See id.* at 55–56.

¹⁴⁸ *See id.* at 57.

¹⁴⁹ *See id.* at 63.

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 63–64.

control over an investor's account is required to have a basis to believe the amount of trading in the investor's account is suitable.¹⁵² This obligation to ensure that a recommendation is suitable for the investor is explicit in the FINRA Rules.¹⁵³

The Study also examined several sources of information regarding investor perception of a broker's duties, concluding that investors were confused about the distinctions between brokers and investment advisers.¹⁵⁴ Through comments the SEC publicly solicited, many investors stated that they did not understand the standards of care applicable to investment advisers and brokers, found the standards of care confusing, and were uncertain about the meaning of the multiple titles used by investment advisers and brokers.¹⁵⁵ Siegel & Gale, LLC and Gelb Consulting Group, Inc. were retained by the SEC in 2004 to conduct focus group testing.¹⁵⁶ The focus group participants raised 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 brokers are different and that the different titles used are confusing.¹⁵⁷ The participants also did not understand terms such as "fiduciary."¹⁵⁸

In 2006, the SEC retained RAND Corporation ("RAND") to conduct a study of brokers and investment advisers.¹⁵⁹ 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.¹⁶⁰ For example, some firms provided so much information to investors that it would be difficult for the investors to process it all, and other firms provided scant information to investors.¹⁶¹ RAND also found that the firms believed investors tend to trust a particular firm without necessarily understanding the firm's services and

¹⁵² *Id.* at 64.

¹⁵³ *See* FINRA Rule 2111 (2011).

¹⁵⁴ SEC STUDY, *supra* note 18, at 94.

¹⁵⁵ *See id.*

¹⁵⁶ *Id.* at 95.

¹⁵⁷ *Id.* at 96.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 97.

¹⁶¹ *See id.*

responsibilities.¹⁶² 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.”¹⁶³

The SEC also considered a survey conducted by industry advocates and certain industry groups.¹⁶⁴ The results of that survey again suggested that investors do not understand the differences between investment advisers and brokers, nor do they understand that there are differing standards of conduct related to each.¹⁶⁵

Overall, the Study found that, based on these comments, studies, and surveys, investors do not understand the differences between investment advisers and brokers. This lack of understanding is compounded by the fact that many investors may not have the “sophistication, information, or access needed to represent themselves effectively in today’s market and to pursue their financial goals.”¹⁶⁶ The Study concluded 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 also is 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.¹⁶⁷

As discussed above, the purpose of conducting the Study was to determine whether there were inadequacies within the standards of care applicable to brokers and investment advisers. Based on the information gathered in the Study, the SEC staff made the following key recommendation with respect to standardizing the conduct of brokers and investment advisers:

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

¹⁶² *Id.*

¹⁶³ *Id.* at 99.

¹⁶⁴ *See id.*

¹⁶⁵ *Id.* at 99–100.

¹⁶⁶ *Id.* at 101.

¹⁶⁷ *Id.*

Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that: [T]he 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.¹⁶⁸

The Study explained that the duties of loyalty and care that are encompassed in the standard of care owed by investment advisers must be included in this uniform fiduciary duty.¹⁶⁹ The duty of loyalty is a fundamental aspect of the fiduciary standard under the Advisers Act.¹⁷⁰ To comply with the duty of loyalty, brokers would have to eliminate or disclose material conflicts of interest.¹⁷¹ Commission-based compensation does not violate the fiduciary standard.¹⁷² Nor does the fiduciary standard require that a broker have a continuing duty of care or loyalty after the investment advice has been given.¹⁷³ This is a key departure from the standard of care applicable to investment advisers. The fiduciary duty described by the case law discussed above presumes that the investment adviser will provide advice on an ongoing basis. However, the recommendation made within the Study specifically states that it would not require brokers to provide ongoing advice.¹⁷⁴

The Study expected that the uniform fiduciary standard would overlay the existing investment adviser and broker regimes to supplement, not supplant, them.¹⁷⁵ It balanced 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.¹⁷⁶ The Study did not discuss how the absence of an ongoing duty to provide advice would address the confusion on the part of investors over the differences between brokers and investment

¹⁶⁸ *Id.* at 109–10.

¹⁶⁹ *See id.* at 106–07, 110–11.

¹⁷⁰ *Id.* at 112.

¹⁷¹ *Id.* at 113.

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *See id.*

¹⁷⁵ *Id.* at 109.

¹⁷⁶ *Id.*

advisers. Although the Study termed it a “uniform” duty, there remain clear distinctions between the duty as it will apply to brokers and investment advisers.

In its guidance, Congress directed the SEC as to which sections of the Advisers Act the SEC should look to incorporate when considering the standards of care applicable to brokers and investment advisers. Section 913(g) of Dodd-Frank required the SEC to consider a fiduciary standard no less stringent than sections 206(1) and (2) of the Advisers Act; however, it omitted 206(3), which refers to principal trading.¹⁷⁷ This is the same section of the Advisers Act that the SEC modified through the temporary rule adoption. The Study recognized that principal trading has the potential for raising conflicts of interest.¹⁷⁸ The Study recommended that, at a minimum, under a uniform fiduciary standard, a broker 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.¹⁷⁹ This would allow brokers to continue to engage in principal trading without having to go through the same disclosure and consent requirements to which an investment adviser must adhere. The Study recognized that brokers would remain subject to the obligations which are set forth through the FINRA rules, including those related to suitability, best execution, and fair and reasonable pricing and compensation when engaging in principal trading.¹⁸⁰

Notwithstanding the recommendations made by the SEC staff, it has not yet issued any new rules or regulations on this topic.

V. MOVING FORWARD

In 1934, Congress recognized that it could not remain inactive while the securities markets changed around it. In 2010, following the second major financial crisis, Congress once again attempted to address concerns regarding the regulation of

¹⁷⁷ Compare Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376 (2010) with Investment Advisers Act of 1940, ch.686, § 206(3), 54 Stat. 847, 852 (codified as amended 15 U.S.C. § 80b-6(3) (2012)).

¹⁷⁸ See SEC STUDY, *supra* note 18, at 118.

¹⁷⁹ *Id.* at 120.

¹⁸⁰ *Id.*

the financial services industry. It is clear that the brokers and investment advisers of today are not the brokers and investment counselors of the 1920s and 1930s. The legislation coming out of the Great Depression was aimed at addressing the concerns of the time. With respect to brokers, these concerns were focused on firms extending credit in an imprudent manner. There was some recognition of the need for disclosure, especially when brokers were acting for their own accounts in addition to their customers' accounts. However, a broker was not the person to whom an investor went for broad advice. That role was played by investment counselors. Congress recognized at the time that investment counselors were primarily used by individuals with larger accounts, who were looking for personalized investment advice. Investment counselors themselves expected that they should be acting at all times in their clients' best interest. They expected that they should be segregated from incentives that might put their own interests ahead of their clients.

Over time, the relationship between investors and financial professionals has changed. More and more investors do not even realize that there is a distinction between brokers and investment advisers. While some may assert that this is an issue of investor education, it is more of an issue of how brokers and investment advisers are holding themselves out to the public. The SEC recognized the increase in overlap between brokers and investment advisers when it sought to exempt brokers who offered fee-based accounts from the Advisers Act's coverage. Although the exemption was overturned by the D.C. Circuit Court, the result was not clarity for investors. Instead, many brokers registered as investment advisers so that they could continue to offer flexible fee structures for their clients.

As the studies have shown, investors do not understand the different roles brokers and investment advisers play, nor do they understand the different regulatory structures governing each. As explained by the Treasury Department:

Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give "incidental advice" in the course of their

business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.

From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing "incidental advice" appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.¹⁸¹

Brokers have infiltrated the investment adviser world. The same individual may act as both a broker and an investment adviser for the same client, albeit with respect to different accounts. At the time the SEC conducted its Study in 2010, approximately eighty-eight percent of investment adviser representatives were also registered as brokers with FINRA.¹⁸² The benefit they offer to clients is most clearly evidenced by the flexibility in compensation structures they are able to offer their clients. If a client just wants trade execution, he can use a discount broker, which may involve the client placing trades himself through an online account. This tends to be the cheapest means of utilizing the services of a broker. If a client wants more advice, he can utilize the services of full-service broker, who will be bound by FINRA's suitability rules and offer advice as appropriate on a transaction-by-transaction basis. If the client wants full service, including monitoring of his accounts between transactions, he can utilize the advisory services of the firm and be charged an annual fee which is based on the net assets in the account. Theoretically, a larger account would need more oversight, justifying higher fees. It is unrealistic to expect that brokers will give up these options to once again fit into the role envisioned when the 1934 Act was adopted. It is unlikely that investors would want this as well. One must believe that, at least on some level, the supply of various levels of service flowed from an expressed demand for such variety.

¹⁸¹ DEPT OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 71 (2009), available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

¹⁸² SEC STUDY, *supra* note 18, at 12.

However, simply because the services offered by brokers now overlap with the role of investment advisers in some circumstances does not mean the Advisers Act should apply to brokers. There are certainly situations in which it would be appropriate to subject brokers to the obligations set forth in the Advisers Act. However, without a private right of action, the added protection to investors would be minimal.

What is needed is a new regulatory scheme, which recognizes the differing levels of services offered to clients by brokers and investment advisers, namely, a Financial Advice Act. The proposed legislation would apply to both investment advisers and brokers, thereby eliminating the false distinction between the two. The duties applicable to the financial professional would vary based on the services being offered and the prices being paid by the investors, not on the fee structure of the account. The proposed legislation must include both a duty of loyalty and a duty of care, which apply to all accounts, regardless of the fees paid. The duties may be limited in time when the account is a trading account, where the investor seeks no advice, but the duties should be ongoing when the investor does seek advice about investing. It seems counterintuitive that an investor would seek advice concerning what to purchase and when, but should not expect advice about when to sell the investment. The proposed legislation should recognize the position of trust financial professionals hold and should cover acts of negligence as well as fraud, as the Advisers Act has done.

Investors should retain the ability to choose how they want to interact with their financial professionals. The proposed legislation should aim at providing investors protection against unscrupulous investment “professionals” who seek to earn a profit at the detriment of their clients. However, the proposed legislation must allow legitimate financial professionals to do business. Investors should be provided with disclosures that outline the legislative protections they will receive with each level of service. However, if a financial professional acts as if the investor belongs to a higher category of service, the investor should be provided the heightened protections afforded to investors in that higher category. There should be explicit guidance within the proposed legislation about which sorts of conflicts must be avoided and which may be disclosed. The

proposed legislation should contain an express private right of action, firmly establishing a federal scheme of investor protection.

While investor education is an important component to an effective regulatory scheme, it should not be the key component. Investors should not be relegated to the atmosphere of caveat emptor that existed prior to the enactment of federal securities legislation.

CONCLUSION

The current regulatory scheme governing brokers and investment advisers has not accounted for the changes in the professions over the past ninety years. At the time the 1934 Act and the Advisers Act were enacted, there were clear distinctions between brokers and investment advisers. Those distinctions no longer exist. Accordingly, the regulations governing each must be truly harmonized. The most effective way to create a harmonized standard of care is to create new legislation that recognizes that the existing distinctions are false. To do otherwise will perpetuate the false distinctions to the disservice of the investing public.