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What's in a Name: The Battle over a Uniform Fiduciary Standard for Investment Advisers and Broker-Dealers

Andrew Melnick

WHAT'S IN A NAME: THE BATTLE OVER A UNIFORM FIDUCIARY STANDARD FOR INVESTMENT ADVISERS AND BROKER-DEALERS

ANDREW MELNICK†

For generations, investors had clear choices when seeking assistance in investing their money. Investment advisers provided financial advice, either by exercising discretionary trading authority or providing financial planning, in exchange for a fee, typically based on the asset value of the account. Broker-dealers provided execution services for clients who wished to trade, occasionally made recommendations to customers on which they could choose to act or not act, and were compensated by commissions generated on transactions in the account. Investment advisers were regulated by the Investment Advisers Act of 1940 and had clear fiduciary duties. Brokers under the Financial Industry Regulatory Authority's ("FINRA") regulatory scheme did not have generalized fiduciary duties to their customers, but when making recommendations to customers, they had to act "fairly" and have a "reasonable basis" for making such recommendations.

The lines have blurred considerably over the past decades as broker-dealers expanded their offerings of products and services. Brokers—"registered representatives" with FINRA—now carry titles such as "Financial Adviser" or "Investment Consultant" and may have designations such as "Certified Financial Planner" and "Retirement Planning Specialist." They may now also charge a fee in a brokerage account. Broker-dealers themselves offer an array of advisory services and programs in which registered representatives, portfolio managers, or others within the firm act in an advisory capacity.

† Partner, Schindler Cohen & Hochman LLP in New York. The author would like to thank Francesca Celestre, Esq., his colleague at Schindler Cohen & Hochman LLP, for her invaluable insights and assistance in preparing this Article.

Multiple studies have shown that investors, while benefiting from having the choice of working with an investment adviser or broker, are confused by the differences between the two and are not familiar with the differences in the standard of care between them.[1] FINRA Rule 2111, the suitability standard for broker-dealers, requires that a FINRA member have a "reasonable basis" to believe that a recommended transaction or strategy is suitable for the customer based on the customer's investment profile.[2] Some commentators posit that the suitability standard of conduct fails to adequately protect investors.[3] Advocates and participants in securities litigations, arbitrations, and regulatory enforcement proceedings have spent hundreds of thousands of hours arguing over whether a particular registered representative and his or her firm owed a fiduciary duty to a particular client, and if so, what duties exactly were owed to the client as a result of this status.

Congress sought to address the issue of the proper standard of care applicable to investment advisers and broker-dealers in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank"),[4] which, among other things, required the Securities and Exchange Commission (the "SEC") to conduct a study to evaluate "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, [and] investment advisers."[5] Specifically, Dodd-Frank amends section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") to permit the SEC to

> promulgate rules to provide that, with respect to a broker or dealer, *when providing personalized investment advice* about securities to a retail customer . . . the standard of conduct for

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[1] *See* ANGELA A. HUNG ET AL., RAND INST. FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 112 (2008).

[2] FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1.

[3] David Serchuk, *Suitability: Where Brokers Fail*, FORBES.COM (June 24, 2009, 6:00 AM), http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html.

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-03, § 913(b), 124 Stat. 1376, 1824–25 (2010).

[5] *Id.*

> such broker or dealer with respect to such customer *shall be the same as the standard of conduct applicable to an investment adviser* . . . .[6]

On January 21, 2011, the SEC staff released its Dodd-Frank-mandated *Study on Investment Advisers and Broker-Dealers* (the "SEC Staff Study" or "Study").[7] In the Study, consistent with its legislative mandate, the SEC staff recommended rulemaking to establish a uniform fiduciary standard for investment advisers and broker-dealers that is "no less stringent" than the fiduciary standard applicable to investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").[8] Specifically, the Staff recommended that

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.[9]

The SEC Staff Study was issued in January 2011.[10] Although former SEC Chairman Schapiro stated that such rulemaking is "a priority" and there have been congressional hearings, no rules have been issued.[11] In the interim, a general consensus among industry participants and observers has emerged, perhaps recognizing the inevitability of the imposition of a uniform standard, in support of the concept of a uniform fiduciary standard for broker-dealers and investment advisers.[12] The Securities Industry Financial Markets Association ("SIFMA") lent its support to the concept of a uniform standard.[13]

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[6] Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 124 Stat. at 1828 (emphasis added) (codified as amended at 15 U.S.C. § 78o(k)(1) (2012)).

[7] U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011), *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf.

[8] *Id.* at v–vi.

[9] *Id.* at 109–10.

[10] *See generally id*.

[11] Jesse Hamilton & Margaret Collins, *Tougher Dodd-Frank Fiduciary Standard for Brokers Stalled*, BLOOMBERG (Sept. 10, 2012, 10:48 AM), http://www.bloomberg.com/news/2012-09-10/tougher-dodd-frank-fiduciary-standard-for-u-s-brokers-stalled.html.

[12] *Id.*

[13] *SIFMA Statement on SEC Fiduciary Duty Study*, SIFMA (Jan. 22, 2011), http://www.sifma.org/news/news.aspx?id=23128.

A coalition of the Consumer Federation of America, AARP, and others has also publicly stated support.[14] Prominent academics and industry observers have voiced support for such a standard, citing concerns that "investors will be sold inappropriate products or [be] overcharged without the rule."[15]

What these broad statements of support for a uniform standard mask are the fierce differences in the competing visions of what precisely that uniform fiduciary standard should look like and how it should be implemented. While the SEC staff should be praised for their exhaustive and thoughtful analysis of the regulatory framework of investment advisers and broker-dealers, many of the recommendations in the SEC Staff Study are vague and need substantial clarification as part of the final rulemaking process. As these interested industry groups and individuals recognize, the devil is in the details. Simply imposing a "fiduciary" standard taken from, or based on, the Advisers Act—effectively labeling broker-dealers as fiduciaries under that regulatory regime—is both detrimental to the broker-dealer model and inconsistent with the SEC's mandate under Dodd-Frank.

The imposition of a uniform fiduciary standard covering broker-dealers has the potential to upend decades of case law and regulatory precedent regarding the existence of, and more importantly, the scope of a broker-dealer's fiduciary duty. The SEC and FINRA have long refrained from imposing a blanket fiduciary standard upon broker-dealers, instead following a transaction-based approach discussed in more detail in Part I.B below.[16] Courts have recognized that a broker-dealer does not owe fiduciary duties to its customers absent the existence of specific circumstances, such as the exercise of discretionary trading authority.[17] Broker-dealers have developed sophisticated supervisory and compliance regimes designed to help brokers

[14] *See* Letter from the Consumer Fed'n of Am. et al. to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n 1 (Mar. 28, 2012) [hereinafter CFA Letter], http://www.consumerfed.org/pdfs/SIFMA-FrameworkResponse3-29-12.pdf.

[15] Hamilton & Collins, *supra* note 11.

[16] *See infra* Part I.B.

[17] *See* Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 484 (2003).

meet their suitability obligations and protect investors.[18] Registered representatives have been trained and tested, for example through the Series 7 licensing exam, on their suitability obligations.[19] The SEC's final rules need to be clear and precise and need to provide ample illustrative guidance on the contours of any uniform fiduciary standard that will be applied to broker-dealers. In short, being labeled a "fiduciary" subject to a uniform fiduciary standard of care is just the start of the process.

This Article briefly traces the content and sources of the standards governing the conduct of investment advisers and broker-dealers. This Article then summarizes the key elements and recommendations of Dodd-Frank and the SEC Staff Study, and describes the competing visions offered by SIFMA and the Consumer Federation of America coalition in their respective letters to the SEC. This Article concludes with a few observations about particular areas—specifically on the meaning of "personalized investment advice" and the provision of ongoing advice and the duty to monitor—that the SEC should consider providing detailed guidance on. Depending on the final rules formulated by the SEC, the imposition of a uniform fiduciary standard applicable to broker-dealers can represent a sea change in how broker-dealers conduct their business, requiring an overhaul of the current model and a massive investment in technology, personnel, and training; or it can represent an incremental change, one that enhances investor protection and reduces investor confusion while allowing the broker-dealer model to continue to offer investors a wide array of choices of services and products at a range of pricing options.

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[18] *See* Graham Ravdin, Note, *One Step Forward, Two Steps Back: Arguing for a Transatlantic Investor Protection Regime*, 50 COLUM. J. TRANSNAT'L L. 490, 498 (2012).

[19] *See* Barbara Black, *Transforming Rhetoric into Reality: A Federal Remedy for Negligent Brokerage Advice*, 8 TRANSACTIONS: TENN. J. BUS. L. 101, 111–12 (2006); Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 137 (2010).

I. STANDARDS OF CONDUCT APPLICABLE TO INVESTMENT ADVISERS AND BROKER-DEALERS

A. *Registered Investment Advisers: The Fiduciary Standard*

Under the Advisers Act section 202(a)(11), an investment adviser is:

> 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.[20]

The SEC staff has generally concluded that a person is an investment adviser if that person: (i) provides advice, or issues reports or analyses, regarding securities; (ii) is in the business of providing such services; and (iii) receives compensation for such services.[21] "Many money managers, investment consultants, and financial planners are regulated as 'investment advisers' under the Advisers Act or similar state statutes."[22] Excluded from the definition of "investment adviser" under the Act are broker-dealers (i) whose performance of investment advisory services is "solely incidental" to the conduct of its business as a broker-dealer and (ii) who receive no "special compensation" for their advisory services.[23]

Under the Advisers Act, investment advisers are fiduciaries to their clients.[24] An investment adviser is duty-bound to serve the best interests of its clients, including an obligation to act solely in the client's best interests and thus subordinate its own interests to those of its clients.[25] This duty of loyalty requires an investment adviser that has a material conflict of interest to

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[20] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C § 80b-2(a)(11) (2012).

[21] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 15; *see* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092, 39 SEC Docket 494, 1987 WL 112702, at *3 (Oct. 8, 1987).

[22] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 15.

[23] *See* Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C).

[24] *See id.* § 206, 15 U.S.C. § 80b-6; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

[25] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 22.

either eliminate that conflict or fully disclose to the customer all material facts relating to the conflict and obtain his or her written consent.[26] With respect to compensation, investment advisers typically charge an asset-based fee, thereby avoiding the incentive to execute trades that might not be in the client's best interest.[27] Further to this duty to eliminate or disclose material conflicts of interest, the Advisers Act explicitly prohibits an adviser, when acting as a principal for its own account, from effecting any sale or purchase of any security for the account of a client without first disclosing certain information to the client in writing and obtaining the client's consent.[28]

The duty of care ascribed to an investment adviser requires it to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[29] The Advisers Act demonstrates "a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as [sic] investment adviser—consciously or unconsciously—to render advice which was not disinterested."[30] Thus, in practice, "the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients."[31]

B. *Broker-Dealers: The Suitability Standard*

A "broker" is defined by the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others."[32] A "dealer" is similarly defined as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or

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[26] *Id.* at 22, 26.

[27] *See id.* at 41–42.

[28] Investment Advisers Act of 1940 § 206(3), 15 U.S.C. § 80b-6(3); U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 25.

[29] Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052, 98 SEC Docket 3027, 2010 WL 2779423, at *52 (July 14, 2010); U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 22.

[30] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963).

[31] SEC v. Moran, 922 F. Supp. 867, 895–96 (S.D.N.Y. 1996).

[32] Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2012).

otherwise."[33] Broker-dealers must generally register with the SEC and are required to become members of at least one self-regulatory organization ("SRO"), such as FINRA.[34] Unless broker-dealers charge separately for their advice, they are excluded from the definition of "investment adviser" and are not subjected to a fiduciary standard.[35] Broker-dealers traditionally receive transaction-based compensation, for example, in the form of commissions.[36]

Pursuant to the antifraud provisions of the securities laws and SRO rules—including FINRA Rule 2010, which relates to the "just and equitable principles of trade"—broker-dealers are required to deal fairly with customers.[37] However, the federal securities laws, SEC rules, and SRO regulations do not impose a blanket fiduciary duty upon broker-dealers in dealing with their customers.[38] Rather, courts have generally held that broker-dealers, absent the exercise of discretionary trading authority or control over customer assets—the hallmark of a non-discretionary account—or the existence of a relationship of trust and confidence with a customer, do not owe customers a fiduciary duty.[39] Thus, in the typical non-discretionary brokerage account, absent special factors and circumstances, a broker-dealer does not owe its customer a fiduciary duty.[40] Rather, the duty is

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[33] *Id.* § 3(a)(5)(A), 15 U.S.C. § 78c(a)(5)(A).

[34] *Id.* § 15(a)(1), (b)(11)(a)(i), 15 U.S.C. § 78o(a)(1), (b)(11)(a)(i); 17 C.F.R. § 240.15b9-1 (2013).

[35] *See* Investment Advisers Act of 1940 § 202(a)(11)(c), 15 U.S.C. § 80b-2(a)(11)(c) (2012); Nicholas S. Di Lorenzo, Note, *Defining a New Punctilio of an Honor: The Best Interest Standard for Broker-Dealers*, 92 B.U. L. REV. 291, 299 n.44 (2012).

[36] *See* Cable, *supra* note 19, at 139.

[37] FINRA Rule 2010, *available at* http://finra.complinet.com/en/display/display_content.html?rbid=2403&element_id=5504; *see* Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 540–41, 546–47 (2002).

[38] *See* Di Lorenzo, *supra* note 35, at 305 (discussing the Merrill Lynch Rule which was designed "to exempt broker-dealers from fiduciary duties").

[39] *See* De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1308–09 (2d Cir. 2002); Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc., 767 F. Supp. 1220, 1231 (S.D.N.Y. 1991) ("Although the existence of fiduciary relationships under New York law cannot be determined by recourse to rigid formulas, New York courts typically focus on whether one person has reposed trust or confidence in another who thereby gains a resulting superiority or influence over the first."), *rev'd*, 967 F.2d 742 (2d Cir. 1992).

[40] *See* Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996), *aff'd*, 157 F.3d 138 (2d Cir. 1998); *see also* Caravan Mobile Home Sales, Inc. v.

limited to the specific matter entrusted to the broker-dealer—namely, the "narrow task of consummating the transaction requested."[41]

Moreover, it is well-settled that a broker ordinarily does not have a duty to give ongoing advice in between transactions in a non-discretionary account, even if the broker had volunteered such advice on previous occasions.[42] As the Second Circuit held in *De Kwiatkowski v. Bear, Stearns & Co.*:

> It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention.[43]

Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 563, 567 (9th Cir. 1985) (holding no continuing fiduciary relationship existed where the customer had a non-discretionary account with broker); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 952–53 (E.D. Mich. 1978) (finding that broker owed only limited, transactional duties to customer who maintained non-discretionary account), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

[41] Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999).

[42] *See De Kwiatkowski*, 306 F.3d at 1302.

[43] *Id.*; *see also* BNP Paribas Mortg. Corp. v. Bank of Am., N.A., 866 F. Supp. 2d 257, 265 (S.D.N.Y. 2012) ("A broker or dealer that lacks discretionary control over investment decision usually has no duty of care that extends beyond the execution of transactions."); DeBlasio v. Merrill Lynch & Co., No. 07 Civ. 318(RJS), 2009 WL 2242605, at *32 (S.D.N.Y. July 27, 2009) ("[T]he Court agrees with Plaintiffs that cases such as *Kwiatkowski* do not demonstrate as a matter of law that every brokerage relationship lacks fiduciary characteristics, Plaintiffs have not alleged facts or circumstances that, if proven, would establish that the Brokerage Defendants breached the limited duties that they owed to Plaintiffs in regard to their brokerage accounts."); Welch v. TD Ameritrade Holding Corp., No. 07 Civ. 6904(RJS), 2009 WL 2356131, at *43 (S.D.N.Y. July 27, 2009) ("Brokerage Defendants were not required to notify Plaintiffs of opportunities to improve their earnings on uninvested funds."); Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 113 (N.D. Ala. 1971) ("[A]bsent an express investment advisory contract there is no fiduciary duty [to monitor] unless the customer is infirm or ignorant of business affairs."), *aff'd*, 453 F.2d 417 (5th Cir. 1972).

But broker-dealers remain subject to a suitability obligation, which generally requires a broker-dealer to make recommendations that the broker reasonably believes are suitable for the client.[44] Thus, new FINRA Rule 2111 requires that a broker-dealer and registered representative "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[45] As described in FINRA's guidance in connection with issuance of the new suitability rule, there are three main obligations comprising a broker-dealer's suitability obligation: (i) reasonable-basis suitability; (ii) customer-specific suitability; and (iii) quantitative suitability.[46] For reasonable-basis suitability, the broker-dealer must have a reasonable basis, based on reasonable diligence, to believe that the recommendation is suitable for at least some investors.[47] FINRA guidance makes clear that the scope and breadth of "reasonable diligence" is dependent upon the complexity and risks associated with the security or strategy and the member firm's familiarity with the security or investment strategy.[48] The customer-specific obligation requires that the member firm have a reasonable basis to believe that the recommendation is suitable for the particular customer based on the customer-specific information obtained by the member firm.[49] The third component, quantitative suitability, evaluates whether a broker-dealer who has actual or de facto control over a customer account has a reasonable basis for believing that a series of recommendations is suitable and not excessive in light of the customer's investment profile.[50]

[44] *See* FINRA, Regulatory Notice 11-25: Know Your Customer and Suitablity 2 (2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf; FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (replacing NASD Rule 2230 with FINRA Rule 2111).

[45] FINRA Rule 2111.

[46] *See id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

A broker-dealer's suitability obligation is largely transaction-based and is keyed to a recommendation.[51] Absent a recommendation, under the FINRA rules, a broker-dealer has no suitability obligation.[52] There is no ongoing duty to monitor the account or provide advice between transactions.[53] This principle was affirmed in *De Kwiatkowski v. Bear, Stearns & Co.* and more recent cases.[54]

II. THE SEC'S STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS

The SEC Staff Study starts from the premise that retail investors are often confused about the roles played by investment advisers and broker-dealers and are not familiar with the standard of care that applies to their dealings with them.[55] At the same time, investors wanted to preserve their investment choices and maintain access to the fee structures and services offered by both investment advisers and broker-dealers.[56]

The SEC Staff Study, after an exhaustive discussion of the regulatory framework applicable to broker-dealers and investment advisers, recommends that the SEC establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers; this standard should be "no less stringent" than currently applied under sections 206(1) and (2) of the Advisers Act,[57] which require an adviser to eliminate, or at least disclose, all material conflicts of interest.[58] More specifically, the SEC Staff Study recommends adopting a uniform fiduciary standard that requires investment advisers and broker-dealers, when providing such personalized investment advice about securities to retail customers, to "act in the best interest of

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51 *See id.*

52 *See id.*; *see also* BNP Paribas Mortg. Corp. v. Bank of Am., N.A., 866 F. Supp. 2d 257, 268 (S.D.N.Y. 2012).

53 *See* De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002).

54 *See id.*; *see also* In re Merrill Lynch Auction Rate Sec. Litig., 765 F. Supp. 2d 375, 387–88 (S.D.N.Y. 2011), *aff'd sub nom.* Anschutz Corp. v. Merril Lynch & Co., 690 F.3d 98 (2d Cir. 2012).

55 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 101.

56 *See id.*

57 *Id.* at v–vi.

58 Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2012).

the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[59] The SEC Staff Study further recommends that the SEC consider harmonizing laws and regulations to provide protection to retail investors who receive the same or substantially similar services from investments advisers and broker-dealers.[60]

The broad outline of the proposed uniform fiduciary standard set out by the SEC staff contains a duty of loyalty and a duty of care.[61] The SEC Staff Study notes that the duty of loyalty under the Advisers Act prohibits an adviser from putting its own interests ahead of its clients' and requires broker-dealers to disclose or eliminate material conflicts of interest.[62] However, consistent with section 913 of Dodd-Frank, the SEC Staff Study explains that the receipt of commissions or other transaction-based compensation for the sale of securities does not, in and of itself, necessarily violate the duty of loyalty component of the proposed uniform fiduciary standard.[63]

The Staff recommended that the SEC promulgate rules to facilitate "uniform, simple and clear disclosures to retail [investors] about the terms of their relationships with broker-dealers and investment advisers."[64] These disclosures would be similar to the Form ADV that investment advisers are required to provide at the outset of the relationship and would include more specific disclosures at the time that personalized investment advice is provided.[65]

Under the Staff's proposal, a broker or adviser would be held to minimum standards of review and analysis when providing personalized investment advice to retail investors.[66] The Staff

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[59] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 109. The study explicitly rejects two other approaches that section 913 of Dodd-Frank required the SEC to consider: eliminating the broker-dealer exclusion from the definition of "investment adviser" under the Advisers Act and applying the duty of care and other requirements of the Advisers Act to broker-dealers. *Id.* at 139–40.

[60] *See id.* at 129.

[61] *See id.* at 112, 120.

[62] *Id.* at 112–13; Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 SEC Docket 3502, 2010 WL 2957506, at *2 (Aug. 12, 2010).

[63] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 113; *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828–29 (2010) (codified as amended at 15 U.S.C § 80b-11(g) (2012)).

[64] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 117.

[65] *Id.*

[66] *See id.* at 122.

recognized the need for sufficient flexibility to cover a large and dynamic marketplace.[67] As the Staff noted, "Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to a retail customer."[68]

The SEC Staff Study also recommends that the SEC adopt guidance to define what it means to provide "personalized investment advice."[69] At a minimum, the Study recommends that the definition should encompass the making of a "recommendation" as that concept has developed under applicable broker-dealer regulation[70] and should not include "impersonal investment advice" as defined under the Advisers Act.[71]

The SEC Staff Study recognizes that whether a recommendation has been made is an intensely fact-specific inquiry, generally dependent upon the content, context, and presentation of a particular set of communications.[72] Generally, an important consideration is whether the communication—given its content, context, and manner of presentation—reasonably would be viewed as a "call to action" or a suggestion that the customer engage in a particular transaction.[73] The SEC Staff Study provided the following as a non-exhaustive list of communications generally viewed as constituting a recommendation: (1) customer-specific communications to a targeted customer or group of customers encouraging a transaction in a particular security or a particular strategy; (2) communications stating that customers should invest in a particular sector and providing a "recommended" list or "buy" list of stocks; (3) portfolio analysis tools that generate a specific list

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[67] *Id.* at 123.

[68] *Id.*

[69] *Id.* at 127.

[70] *Id.*; FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

[71] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 127.

[72] *Id.* at 124; NAT'L ASS'N OF SEC. DEALERS, INC., NOTICE TO MEMBERS 01-23, ONLINE SUITABILITY: SUITABILITY RULE AND ONLINE COMMUNICATIONS 2 (2001), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf.

[73] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 124.

of "buy" or "sell" recommendations based on customer-specific information; (4) securities that are bought, sold, or traded in a discretionary account.[74]

Similarly, the SEC Staff Study lists certain activities that fall outside the definition of a "recommendation":

> General financial and investment information such as (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes . . . (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;[75]
>
> Descriptive information about an employer-sponsored retirement or benefit plan . . . and the investment options [thereunder];[76]
>
> Asset allocation models that: (i) are based on generally accepted investment theory; (ii) be accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the . . . model . . . and (iii) comply with applicable FINRA interpretive material allowing investment analysis tools.[77]

While the SEC has been drafting a rule for nearly two years, no action on the measure is currently scheduled.[78] The SEC has held conferences and met with various interested parties regarding the proposed changes, and Congressional hearings have discussed the uniform fiduciary duty.[79] The SEC plans to put out a request for public comments on the potential costs of implementing a uniform fiduciary standard,[80] after which the

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[74] *Id.*

[75] *Id.* at 125; *see also* NASD Rule IM-2210-6, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3623 (superseded by FINRA Rule 2214, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=10651).

[76] U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 125.

[77] *Id.*

[78] Hamilton & Collins, *supra* note 11.

[79] *See* Joshua Horn, *Broker-Dealers May End Up with 'Hybrid' Fiduciary Standard*, THOMSON REUTERS (Oct. 3, 2011), http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/09_-_September/Broker-dealers_may_end_up_with_%E2%80%98hybrid%E2%80%99_fiduciary_standard/.

[80] Hamilton & Collins, *supra* note 11.

SEC would issue a proposal, again seeking public comment.[81] It is estimated that even if this process begins today, the process could continue into 2013.[82]

III. THE POSITIONS OF INTERESTED INDUSTRY GROUPS

A. *SIFMA's Position*

SIFMA submitted a letter dated July 14, 2011 (the "SIFMA Letter") to the SEC stating its support for the development of a uniform fiduciary standard of conduct for broker-dealers and investment advisers, when providing personalized investment advice to retail customers, and offering a proposed framework and principles for rulemaking under section 213.[83] While SIFMA supports the development of a uniform fiduciary standard, it opposes efforts by the SEC to simply impose on broker-dealers the fiduciary obligations of investment advisers under the Advisers Act and related case law and regulations.[84] SIFMA asserts that the broker-dealer business model, with its broad array of product and service offerings, is fundamentally different than the investment adviser model and that the "general fiduciary duty implied under section 206 of the Advisers Act, as developed through case law, guidance and other legal precedent, . . . provides incompatible and insufficient guidance for broker-dealers on how to manage, disclose, or obtain consents to these conflicts."[85]

The SIFMA Letter explains how an extension of the case law, guidance, and other precedent under the Advisers Act would lead to undesired effects for both broker-dealers and investors. In particular, SIFMA explains that it would adversely impact choice, product access, and affordability of customer services.[86] It would also upend the existing supervisory and compliance regime of broker-dealers, thereby requiring massive investments in

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81 *Id.*

82 *Id.*

83 Letter from Ira D. Hammerman, Senior Managing Dir. & Gen. Counsel, SIFMA, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n 1–2 (July 14, 2011) [hereinafter SIFMA Letter], *available at* http://www.sec.gov/comments/4-606/4606-2952.pdf.

84 *Id.* at 4.

85 *Id.* at 5.

86 *Id.* at 14.

supervisory protocols, technology, and training that would make the proposal incompatible with the "business model neutral" approach espoused by the SEC in the Study.

The SIFMA Letter further outlines a proposed framework and principles for the SEC to consider in promulgating rules establishing a uniform standard.[87] As formulated by SIFMA, the uniform standard would begin with the core principle mandated by Dodd Frank—that all broker-dealers and investment advisers, when providing personalized advice about securities to customers, shall "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*."[88] From there, SIFMA seeks a clear and detailed articulation of the scope of a broker-dealer fiduciary obligation under a uniform standard.[89] For example, SIFMA suggests that the standard of conduct should commence when the customer agreement is signed and should not apply to discussions about the "nature of the relationship."[90] Broker-dealers should also be permitted to shape the standard of conduct in the customer agreement and have the standard applied on an account-by-account basis.[91] SIFMA also seeks explicit rulemaking that traditional forms of broker-dealer products, sales, or compensation arrangements—including commissions, revenue sharing, distribution fees on mutual funds—are not violative of the uniform standard of conduct.[92] SIFMA seeks clear guidance from the rulemaking process that such language does require broker-dealers to run a completely conflict-free business[93]—specifically, language permitting transaction-based compensation.[94]

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[87] *Id.* at 15.

[88] *Id.* at 6 (internal quotation marks omitted).

[89] *See id.* at 16.

[90] *Id.*

[91] *See id.* at 16–17.

[92] *Id.* at 17.

[93] *See id.* at 18.

[94] *See id.* at 17.

In a similar vein, SIFMA seeks clear guidance from the SEC on what business conduct constitutes personalized investment advice about securities.[95] SIFMA's suggested governing principles are drawn largely from the Study's analysis of what constitutes "personalized investment advice."[96]

Finally, SIFMA proposes that the SEC provide clear guidance on what disclosures would satisfy the uniform fiduciary standard of conduct.[97]

B. The Consumer Federation of America ("CFA") Letter

On March 28, 2012, a coalition of organizations and groups—the Consumer Federation of America, the Fund Democracy, AARP, the Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, and National Association of Personal Financial Advisors—issued a letter (the "CFA Letter") strongly supporting the extension of the fiduciary duty under the Advisers Act to all broker-dealers when they offer personalized investment advice, and responding to the framework proposed by SIFMA.[98]

In contrast to the SIFMA Letter, the CFA Letter advocates that the new uniform fiduciary standard should extend the existing Advisers Act standard, which currently applies to investment advisers, to broker-dealers while "clarifying its applicability in the context of broker-dealer conduct."[99] The CFA Letter suggests that the imposition of a uniform fiduciary standard on broker-dealers would not have the "catastrophic consequences" envisioned by SIFMA.[100] In particular, the CFA Letter concedes that Dodd-Frank permits broker-dealers to charge commissions, offer transaction-based recommendations, and sell proprietary products without any of these activities being violative of the fiduciary duty.[101]

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[95] *Id.* at 18.
[96] *See id.*
[97] *Id.* at 20.
[98] CFA Letter, *supra* note 14, at 1–2.
[99] *Id.* at 2.
[100] *Id.* at 1–2.
[101] *Id.* at 3; *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010) (codified as amended at 15 U.S.C. § 78o(k) (2012)).

Moreover, the CFA Letter agrees that "the fiduciary duty should permit advice regarding a discrete transaction without necessarily triggering a continuing duty of care."[102] However, the CFA Letter opposes SIFMA's proposal that a "continuing duty of care" be exclusively addressed by the written customer agreement.[103] The CFA Letter further notes that while section 913 allows for significant changes to current broker-dealer duties in the provision of investment advice,[104] the section rejects the imposition of an ongoing fiduciary duty, stating, "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."[105] The CFA Letter posits that whether a continuing duty of care exists should be determined by the facts and circumstances of the particular broker-dealer's relationship with the customer, and not the customer agreement.[106]

Finally, while the CFA agrees with SIFMA that the SEC needs to define "personalized investment advice,"[107] it advocates for a more general principles-based approach rather than a specific list of examples of conduct that would or would not constitute "personalized investment advice."[108] The CFA Letter agrees with SIFMA's list of four items that should be included within "personalized investment advice" and would also include advice on a decision to not purchase or sell a security on the list.[109] With respect to SIFMA's fifteen items that should not be considered "personalized investment advice,"[110] the CFA Letter agrees with some points on the list and disagrees with others.[111]

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102 CFA Letter, *supra* note 14, at 8.

103 *Id.*

104 *See id.*

105 Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 124 Stat. at 1828.

106 CFA Letter, *supra* note 14, at 9.

107 *Id.* at 1.

108 *Id.* at 11.

109 *Id.*

110 SIFMA Letter, *supra* note 83, at 19–20.

111 CFA Letter, *supra* note 14, at 12–14.

IV. THE CHALLENGES AHEAD

It appears likely that, absent a change in the administration, the SEC will be promulgating rules announcing a uniform fiduciary standard covering broker-dealers and investment advisers.[112] The SEC's challenge under Dodd-Frank is to shape the rules in such a way as to provide for enhanced investor protection and education, while not causing wholesale changes in the existing broker-dealer model or exposing broker-dealers to substantial litigation and regulatory exposure.[113]

There are several areas in particular where the SEC would do well to provide clear and explicit guidance. First, the SEC's rules should include an express acknowledgment that the receipt of a commission does not create a violation of the proposed fiduciary standard in and of itself.[114] While Dodd-Frank provides for this,[115] clarification in the SEC's rules would be highly beneficial. And then, perhaps the SEC can go a step further and, as guidance, make clear that, while compensation can be a factor in determining whether a broker-dealer acted in the best interest of its clients, it cannot and should not be the *sole* determinative factor. Without such clarification, in the litigation, arbitration, and regulatory enforcement process, broker-dealers and associated persons might be vulnerable to arguments that the "best interests" of their client were not served by putting the client in a particular product, account, or strategy when there was a lower-cost alternative available.[116] Given the wide range of securities and products, firms and registered representatives

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[112] Two of the five SEC commissioners dissented from the SEC Staff Study, citing an insufficient analytical or empirical basis for the recommendations made in the study. Kathleen L. Casey & Troy A. Paredes, Sec. & Exch. Comm'n, Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011), *available at* http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

[113] *See* Steven L. Schwarcz, Remarks, *The 2011 Diane Sanger Memorial Lecture, Protecting Investors in Securitization Transactions: Does Dodd-Frank Help, or Hurt?*, 72 LA. L. REV. 591, 597 (2012).

[114] SIFMA Letter, *supra* note 83, at 9 n.16.

[115] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010) (codified as amended at 15 U.S.C. § 78o(k) (2012)).

[116] *Cf.* Davantzis v. PaineWebber Inc., No. 20032/2000, 2001 WL 1423519, at *1–2 (Sup. Ct. Nassau Cnty. July 21, 2001) (dismissing breach of fiduciary duty claim alleging that defendant broker-dealer failed to put plaintiff in least expensive account structure).

should be allowed sufficient flexibility to recommend products and services based on multiple factors including, but not limited to, cost to the investor.

Perhaps more importantly, the SEC would be wise to provide precise rules and guidance establishing that there is no ongoing duty to provide advice between transactions unless specifically agreed to.[117] While section 913 of Dodd-Frank does not "require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities,"[118] the SEC should make clear that the final rules do not include or imply such a duty. Generally, a broker in a nondiscretionary account does not have a fiduciary duty to its client[119] and, more specifically, does not have a duty to monitor the client's accounts between transactions.[120] That fundamental principle lies at the heart of the broker-dealer model and the relationship between client and registered representatives.[121] The suitability rule that governs broker-dealers' conduct with their customers has traditionally been transaction-based.[122] The new suitability rules that recently became effective expand the concept by discussing suitability in terms of specific recommended trades *and*

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[117] Under New York law, a party to a contract—whether a fiduciary or otherwise—cannot be held liable for failing to perform duties beyond the scope of those required in the governing contract. *See, e.g.*, Chase Manhattan Bank, N.A. v. Remington Prods., Inc., 865 F. Supp. 194, 200 (S.D.N.Y. 1994) (granting summary judgment and rejecting breach of fiduciary duty claim where such claim was based on duties beyond the scope of relevant contract), *aff'd*, 71 F.3d 407 (2d Cir. 1995); *see also* BNY Capital Mkts., Inc. v. Moltech Corp., No. 99 Civ. 11754(GEL), 2001 WL 262675, at *8 (S.D.N.Y. Mar. 14, 2001) (stating that a fiduciary is only responsible for "matters *within the scope of the relation*"); Sonet v. Timber Co., L.P., 722 A.2d 319, 323 (Del. Ch. 1998) (dismissing breach of fiduciary duty claim where limited partnership agreement, not common law fiduciary principles, outlined governance process over setting and approving terms of transactions). The SEC should provide firms with the flexibility to clarify the scope of the customer agreement.

[118] Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 124 Stat. at 1828.

[119] *See* Unreported Cases, O'Malley v. Boris, 24 DEL. J. CORP. L. 1189, 1189 (1999).

[120] *See supra* note 43 and accompanying text.

[121] *See* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 719 (2010).

[122] *See* Steven D. Irwin et al., *Wasn't My Broker Always Looking Out for My Best Interests? The Road To Become a Fiduciary*, 12 DUQ. BUS. L.J. 41, 43–44 (2009).

recommended strategies, as well as recommendations to hold a security;[123] but, essentially, suitability remains a transaction-based inquiry.[124]

Currently, however, broker-dealers are simply not equipped to provide ongoing monitoring of their customers' accounts and positions between specific trades.[125] Indeed, a particular registered representative might have hundreds of accounts with hundreds of positions, some recommended, some unsolicited, and some transferred to the broker-dealer from other firms.[126] Imposing an ongoing duty of care and loyalty between transactions would require a wholesale change to broker-dealers' technology and systems, from client intake and "know your customer" to portfolio monitoring and reporting systems. It also would fundamentally alter the relationship between registered representative and broker-dealer and customer and potentially lead to substantially increased exposure for broker-dealers in the litigation, arbitration, and regulatory contexts.

CONCLUSION

In light of the SEC Staff Study and the various positions espoused by industry organizations and academics, it appears likely that a uniform fiduciary standard applicable to broker-dealers and investment advisers will be announced and implemented in the future. The impact on broker-dealers will depend on the details of the actual rules. If there is a wholesale grafting of the Advisers Act's fiduciary regime onto the rules governing broker-dealers, the uniform fiduciary standard will likely have a significant impact on how broker-dealers structure their relationships with their customers and on their potential legal exposure. If the rules are sufficiently flexible to account for the broker-dealer business model, the standard will enhance investor protection and education and reduce investor confusion, while maintaining the products and services investors currently enjoy from broker-dealers.

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[123] *See* FINRA, Regulatory Notice 11-25: Know Your Customer and Suitablity 2 (2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf.

[124] *See id.* at 2.

[125] *See* Gary A. Varnavides, Note, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 FORDHAM J. CORP. & FIN. L. 203, 203 (2011).

[126] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 7, at 8–11.