

Duty Calls

Editorial

To start off 2012, we pick up where we left off with another article on financial reform. Last month's regulation round-up briefly addressed the tightening of **fiduciary duty standards**. Investment advisers and broker-dealers oftentimes serve in similar capacities when it comes to providing investment advice to customers, yet the two groups are governed by different sets of rules pertaining to the duties owed their clients. Not only does this leave room for confusion regarding the legal responsibilities they must uphold, but it also leads to different standards of disclosure on issues such as conflicts of interest.

While the new rule has yet to be written, in this article we recapitulate the intended objective under Title IX of the Dodd-Frank Act, reveal the conclusions of the mandated study carried out by the SEC, and explore its remaining uncertainties. As always, we suggest that while much may change in the next year, the topic demands attention and analysis.

We hope you find this article informative, and appreciate your feedback!

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>> **Dodd-Frank and the Broker-Dealer: The Call for a Uniform Fiduciary Standard Under Section 913**

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A quick look at the numbers—page numbers that is. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") is a hefty document at 2,319 pages. Compare that to the Securities Exchange Act of 1934 at 364 pages, and the Investment Advisers Act of 1940 at 40 pages, and it becomes resoundingly clear why the Act is the recipient of so much attention. For the purposes of this article, we narrow the scope to Title IX (out of 16 total titles) and more specifically, to the 16 pages which mandate the reform of the broker-dealer industry with regard to its fiduciary standards.

The impetus for the overhaul stemmed from the Bernie Madoff scandal and other conflicts of interest that were exposed during the financial crisis related to broker-dealers betting against products they were promoting to clients. With the proposed introduction of strong and consolidated new fiduciary standards, the Dodd-Frank Act strives to achieve a single paradigm of client care to protect retail investors, to which both broker-dealers and registered investment advisers must adhere. This, by extension, engenders enhanced transparency, fairness, and ethics founded upon good governance.

The Dodd-Frank Act on Fiduciary Duty

This notion of fiduciary duty, which is a relationship existing between two persons in which one party is extended the power to act or give advice on behalf of another, is embedded in Section 913 of the Dodd-Frank Act. It grants the Securities and Exchange Commission (SEC) the authority to enact rules pertaining to fiduciary standards for broker-dealers and investment advisers. It entitles the SEC to require that professionals who provide investment advice must act in the financial best interest of the client, independent of the adviser's own incentives.

In addition, it suggests that broker-dealers should potentially be subject to the same law, the Investment Advisers Act of 1940 ("Advisers Act"), to which investment advisers have been bound. The Investment Advisers Act contains rather stringent standards of fiduciary duty, particularly pertaining to conflicts of interest, but explicitly excludes broker-dealers from its jurisdiction.¹

In order to fully understand the implications and weigh the merits of such reform, the Act required that the SEC sponsor a study on the effectiveness of existing fiduciary standards regulating the conduct of broker-dealers and investment advisers who provide personalized advice to retail customers. Furthermore, the mandated study was charged with ascertaining if the case law suitability rules which currently guide broker-dealers satisfy the interpretive "best interest" determination, or if a robust, dedicated standard should instead be established.

Results of the SEC Study

On January 21, 2011, the SEC published its 208-page assessment entitled the 913 Study on Investment Advisers and Broker-Dealers ("the Study"), which was issued to Congress.

¹ Currently, broker-dealers are bound by separate legislation, the Securities Exchange Act of 1934, which does not contain the same notion of fiduciary requirements.

With regard to personalized investment and securities selection advice, the Study examined:

- > If the current regulations pertaining to standards of care are sufficiently vigorous;
- > If gaps, deficiencies or overlaps in current regulation exist that should be remediated through the creation of a new rule;
- > If current differences in standards of care between broker-dealers and investment advisers lead to confusion for retail clients;
- > The implications for retail clients if a uniform fiduciary standard were to be implemented, particularly in relation to product and service selection and availability;
- > The cost burden to broker-dealers, investment advisers and/or retail clients as a result of the introduction of new regulatory requirements;
- > The ability to monitor and enforce a rule that addresses any identified issues.

The Study's Prescriptions

The main conclusion emanating from the Study was the recommendation to adopt a new "uniform fiduciary standard" that would apply to both broker-dealers and investment advisers and would read as follows: "The standard of conduct for all brokers, dealers and investment advisers, when providing personalized investment advice about securities to retail customers...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." For example, investors would need to be made aware of all quotes received for market-maker inventory to evaluate (along with their broker-dealer) if the asset is at a fair price and in their best interest. The Study, which recommended a new and separate rule rather than merely subsuming broker-dealers under the Advisers Act, arrived at additional prescriptions with regard to the harmonization of law regulating investment advisers and broker-dealers:

- > Establishing consistent advertising and customer communication rules including pre-use advertising review requirements;
- > Duty of loyalty: prohibiting (in some cases) and divulging material conflicts of interest in a clear, transparent manner to customers at the beginning of the relationship or a transaction. The definition of what conflicts are considered "material" and therefore require disclosure would be left to the SEC rulemaking process;
- > Duty of care: promulgating a basis from which to provide investment advice to a customer;
- > Putting into place set rules that establish how broker-dealers can comply with the fiduciary standard when conducting proprietary trading;
- > Requiring internal supervisory bodies to oversee investment advice activities;
- > Giving retail customers access to the same disclosures to which regulators are privy, subjecting advisers to review before registration, and mandating continuing education and licensing requirements;
- > Maintaining records of all communications and agreements pertaining to an adviser's investment-related business.

Remaining Questions

The Study leaves many questions and areas open to interpretation. For example, how does one precisely define a "fiduciary standard" in regard to what exact standards broker-dealers should uphold during the course of realistic transactions? In addition, the notion of the "best interest of the customer," which lies at the core of the new fiduciary model, is highly subjective for broker-dealers and therefore leads to the need for clarification regarding who is to decide what is in a retail investor's best interest.

Furthermore, the kind of information that broker-dealers and investment advisers should be required to disclose is unclear. This is particularly relevant in light of the SEC's acknowledgment that investor education and knowledge tends to be inadequate—in other words, how are retail customers supposed to understand the true nature of "material" conflicts?

Now What?

A year after the SEC delivered the report recommending a regulation to impose a universal fiduciary duty for retail investment advice, the fate of any such standard rests in suspense. Although the Study overwhelmingly advocates for conforming standards of fiduciary duty, a recently released timetable of various components of the Dodd-Frank Act excludes a target date for a published draft of the proposed rule. In lieu of making an immediate decision regarding whether to pursue such a rule, the SEC is inviting additional commentary as well as collecting more data.

If the decision is eventually made to proceed with the rule-making process, it will most likely consume all of 2012. Once public comments are in, the next step will require that the SEC gather data specific to the provision of retail financial advice and the possible regulatory alternatives. After the SEC compiles the data, it will prepare the cost-benefit analysis of the impact of a standard-of-care regulation, which, while delaying the process, is fundamental to the development of the regulation.

In reality, the advancement of the final rule will depend on how the five SEC Commissioners vote, which is somewhat intertwined with the outcome of the presidential election.

Whatever to Do?

Even though the fate of a rule establishing a harmonized fiduciary standard remains to be seen, broker-dealers and investment advisers should embark on preparations to understand the potential impact on their respective businesses. The internal supervisory bodies and reporting and recordkeeping requirements alone will need analysis and structural adjustments which would best be examined as soon as possible.

Just as with many areas of the Dodd-Frank Act that are still undefined, internal studies geared to ascertain impacts and their potential consequences will go a long way when it comes time for the implementation of compliance standards ●