

# SEC Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers

January 24, 2011

## General Observations

**Background.** On January 21, 2011, the Securities and Exchange Commission (the “**SEC**” or “**Commission**”) released its much anticipated staff study on the effectiveness of the standards of care required of broker-dealers and investment advisers providing personalized investment advice about securities to retail customers (the “**Study**”). As required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”), the Study also considered whether there are regulatory gaps, shortcomings or overlaps that should be addressed by rulemaking.

**Conclusions of the Study.** After extensively discussing the regulatory framework applicable to broker-dealers and investment advisers, the Study 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, no less stringent than currently applied under Sections 206(1) and (2) of the Investment Advisers Act of 1940 (the “**Advisers Act**”). The Study explicitly rejects two other approaches that Section 913 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.

Importantly, the Study recognizes the distinctions between broker-dealer and investment adviser business models, and recommends that any future SEC rulemaking should “particularly focus on assisting broker-dealers with complying with the minimum requirements of the uniform fiduciary standard.” The Study recommends that the SEC address through guidance or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading. In addition, the Study recognizes that a fiduciary duty does not mandate “the absolute elimination of any particular conflicts,” nor does it mandate avoidance of conflicts; rather, the Study recommends that the SEC should facilitate disclosure of conflicts to retail customers. However, the Study states that under a new uniform standard, existing guidance and precedent under the Advisers Act regarding fiduciary duty would continue to apply to investment advisers and be extended to broker-dealers. It is not clear how SEC staff or courts would reconcile existing Advisers Act precedent with any guidance adopted under Section 913, to the extent there are inconsistencies.

**Harmonization of Regulation.** Aside from its core recommendations regarding a uniform fiduciary standard, the Study recommends that the SEC consider harmonizing other areas of broker-dealer and investment adviser regulation, including with respect to advertising, the use of finders and solicitors, supervisory requirements, licensing and registration of firms and associated persons, and books and records. It is not clear from the Study whether these ancillary matters will receive the same level of attention and priority as adopting the standard itself. A number of staff recommendations are extremely general, and in many cases are tempered with the observation that it would be difficult for the SEC to oversee new initiatives absent additional resources.

Section 914 of Dodd-Frank separately required the SEC to study the need for enhanced examination and enforcement resources for investment advisers, and in particular the extent to which having Congress

authorize the SEC to designate a self-regulatory organization (“**SRO**”) to augment the SEC’s efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers. This Section 914 study was released days before the fiduciary duty study. The SEC staff recommended presenting Congress with three options, authorizing: (1) the SEC to impose user fees on investment advisers to fund their examinations; (2) an SRO to examine investment advisers; or (3) FINRA to examine dual-registrants for compliance with the Advisers Act. The staff clearly favored the first option, as was pointed out and criticized in Commissioner Walter’s separate statement. Commenters note that the effectiveness of a uniform standard of care will ultimately depend on whether all financial services providers are subject to a comparable oversight, examination and enforcement program.

**Consequences of the Study.** The Study addresses many of the concerns previously identified by broker-dealers regarding the practical challenges of applying a uniform fiduciary standard to broker-dealers and investment advisers, and notes the importance of preserving investor access to investment products and choice among compensation schemes. Many critical recommendations, however, are vague, leaving for the future important details on issues such as disclosure and the definition of personalized investment advice. In addition, Commissioners Casey and Paredes jointly published a statement criticizing what they view as the Study’s analytical shortcomings, including a lack of economic analysis.

## Summary of Staff Recommendations to the Commission

### Disclosure

- The SEC should facilitate provision of uniform simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.
- **Timing of Disclosure.** The Commission should consider the disclosures that should be provided:
  - Account Opening. At or prior to account opening in a general relationship guide, which would be updated annually.
  - Point of Sale. In more specific disclosures at the time of providing investment advice, such as details of a product, its risks, compensation or any specific conflicts, e.g. for transactions that raise particular customer protection concerns.
- **Summary Disclosure.** The Commission should consider requiring broker-dealers and investment advisers to provide a summary disclosure document containing key information on a firm’s services, fees, and conflicts and the scope of its services (e.g., whether its advice and related duties are limited in time or ongoing).
- **Limits of Disclosure.** The Study suggests that disclosure may be inadequate to address certain conflicts (without specifying which conflicts might fall into this category), and notes that the SEC has the authority to prohibit conduct that may raise such conflicts.

### Principal Trading

- Notably, the Study does not make specific recommendations in the area of principal trading. However, the staff recommends that the SEC provide guidance on how broker-dealers should fulfill the uniform fiduciary standard especially when engaging in principal trading. While the Study notes that the uniform fiduciary standard would not import the standards of Section 206(3) of the Advisers Act or compel trade-by-trade disclosure by broker-dealers engaging in principal trading, the standard would require broker-dealers to provide sufficiently specific facts so that

investors are able to understand the conflicts of interest. Finally, the Study expresses a view that requests for consent embedded in voluminous boilerplate documents impede the provision of consent.

### Professional Standards for Making a Recommendation to Retail Customers

- The SEC should consider minimum baseline standards for what basis a broker-dealer or investment adviser should have in making a recommendation to a retail customer.

### Personalized Investment Advice About Securities

- **Personalized Advice Should at a Minimum Include “Recommendation”**
  - The SEC should adopt guidance to define what it means to provide “personalized investment advice.”
  - The definition *at a minimum* should encompass the making of a “recommendation” as defined under applicable broker-dealer regulation, and should not include “impersonal investment advice” as defined under the Advisers Act.

### Retail Customers

- The SEC should adopt guidance to further define the term “retail customer.”
- Personalized investment advice provided to retail customers should include both advice to a specific retail customer on a one-on-one basis and advice to a group of retail customers under circumstances in which members of the group reasonably would believe that the advice is intended for them.
- The SEC could consider whether the uniform fiduciary standard should also be extended to persons other than retail customers (which the SEC is authorized to do under Dodd-Frank).

### Harmonization of Regulation of Advisers and Broker-Dealers

- Harmonization of the regulation of investment advisers and broker-dealers should be considered where harmonization appears likely to add meaningful investor protection.
- **Advertising and Other Communications.** The SEC should consider consistent substantive advertising and customer communication rules for investment advisers, including internal pre-use review requirements.
- **Use of Finders and Solicitors.** The SEC should consider harmonizing existing regulatory requirements to address the status of finders and solicitors, and disclosure requirements to assure that retail customers better understand the conflicts associated with a solicitor’s and finder’s receipt of compensation for sending a retail customer to an adviser or broker-dealer.
- **Remedies.** The Study explicitly does *not* make a recommendation with respect to rules governing arbitration.
- **Supervision.** The SEC should consider whether to harmonize investment adviser supervisory requirements with broker-dealer standards, including whether detailed supervisory structures are not appropriate for a firm with a small number of employees.
- **Licensing and Registration of Firms.** The SEC should consider harmonizing the disclosure requirements in Forms ADV and BD where they address similar issues, and should consider whether investment advisers should be subject to a substantive review prior to registration.

- **Licensing and Continuing Education Requirements for Associated Persons.** The SEC should consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.
- **Books and Records.** The SEC should consider whether to modify the Advisers Act books and records requirements, including by adding a general requirement to retain all communications and agreements (including electronic communications) related to an advisor's "business as such."

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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