

The Brave New World of Fiduciary Duty for Broker-Dealers and Investment Advisers*

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“The line it is drawn the curse it is cast
The slow one now will later be fast
As the present now will later be past
The order is rapidly fadin'.
And the first one now will later be last
For the times they are a-changin'.”

- Bob Dylan (1963)

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On December 11, 2009, the House of Representatives took a big step toward ushering in a new era in the regulation of financial intermediaries by passing the Wall Street Reform and Consumer Protection Act of 2009 (the "CPA").¹ This legislation, if passed by the Senate and signed into law by the President, would have significant and widespread effects on broker-dealers and investment advisers. This white paper explores some of these effects and how broker-dealers and investment advisers can prepare for a future in which they operate under a statutory fiduciary duty.

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The white paper begins with a review of the law of fiduciary duty. It discusses the rationale for fiduciary law and the primary duties that fiduciaries owe to those to whom they provide services (also known as "entrustors"). The white paper then considers these general principles in the context of the regulation of investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The white paper next addresses the legislative proposals from the Obama Administration and Congress (collectively, the "Legislative Proposals") and discusses the practical import, in terms of disclosure, conflicts of interest, suitability, compensation, advertising and documentation, of investment advisers and broker-dealers being subject to a statutory fiduciary duty. Finally, the white paper examines

some of the potential implications of a statutory fiduciary duty, the contours of which will be shaped by the Securities and Exchange Commission (“SEC”) via rulemaking authority granted under the Legislative Proposals.

What it Means to Be a Fiduciary. The principles defining and governing fiduciary duty arise out of the law of equity. Basic fiduciary relationships generally involve two parties: (i) entrustors (e.g., clients, in the context of investment advisory relationships), who grant certain powers and/or authority over their property to another party in order to receive certain services; and (ii) fiduciaries (e.g., investment advisers, in the context of investment advisory relationships), who agree to take and use such powers and/or property to perform the designated services for the entrustors’ benefit. By granting such powers and/or property to their fiduciaries, entrustors risk being harmed by the fiduciaries (through embezzlement, misuse of authority, negligence, etc.) This risk is increased by the high costs associated with monitoring the actions of fiduciaries. These costs arise, in part, from fiduciaries’ specialized skills and superior access to information as compared to entrustors, which may permit fiduciaries to effectively conceal activities from entrustors until after significant harm is inflicted. As a result of these risks, the common law evolved over time to impose certain substantive duties on fiduciaries that limit their freedoms. Specifically, courts have imposed two primary duties on fiduciaries: (i) the duty of loyalty; and (ii) the duty of care. Fiduciary law thus vests in entrustors the legal right to rely on the integrity and honesty of their fiduciaries and the quality of the services they provide. From these overarching duties, various obligations have been imposed on fiduciaries under the common law.

Investment Advisers Are Fiduciaries. Investment advisers have long been deemed to be fiduciaries to their clients. This reflects, in part, a recognition that clients entrust investment advisers with assets and investment authority. It also reflects the unique personal relationship that advisers have with their clients. In *SEC v. Capital Gains Research, Inc.*, the Supreme Court officially recognized that investment advisers serve as fiduciaries to their clients and held that they must therefore eliminate, or at least expose, all conflicts of interest that might cause them, consciously or not, to provide advice that is not disinterested. In enforcing this obligation, which is derived from the duty of loyalty, the SEC has interpreted the decision in *Capital Gains* as requiring advisers to, among other things: (i) manage portfolios in the best interest of clients; (ii) provide clients with “undivided loyalty”; (iii) make full and fair disclosure of all material conflicts of interest; (iv) seek best execution for client transactions; (v) ensure that investment advice is suitable for clients’ objectives, needs and circumstances; and (vi) refrain from effecting personal securities transactions inconsistent with client interests.

Broker-Dealers Generally Are Not Fiduciaries Under Current Law. In contrast to investment advisers, broker-dealers generally have been viewed as salesmen *vis-à-vis* the investing public.² This approach recognizes broker-dealers’ primary role of distributing and selling securities and executing securities transactions. Broker-dealers often are involved in underwriting securities offerings, serving as syndicate members or wholesalers, matching buyers and sellers of securities, acting as market makers, selling securities to the public from inventory, and clearing and settling trades. Given these roles, broker-dealers often facilitate the interests of multiple parties at the same time, including those of customers. In recognition of their intermediary role, the SEC created (and courts approved) the “shingle theory” to impose on broker-dealers a duty to deal fairly with customers. Based on this principle of fair dealing, self-regulatory organizations such as the Financial Industry Regulatory Authority (“FINRA”) have crafted detailed rules to govern the conduct of broker-dealers. Notwithstanding the adoption of such rules, however, there are significant differences between the obligations and limitations imposed on broker-dealers under the shingle theory and those imposed on investment advisers under fiduciary law with respect to such matters as disclosures of conflicts of interest, the nature and extent of advice that is provided, the obligation to monitor clients’ accounts and the ability to engage in principal transactions.

A Tectonic Shift in Regulation. The CPA and other Legislative Proposals discussed below would result in significant changes for broker-dealers and investment advisers providing investment advice to retail customers. For instance, broker-dealers that provide investment advice to retail customers would be fiduciaries under the law, and new obligations would be imposed on both broker-dealers and investment advisers alike. The white paper discusses what these changes might mean for

the operations of broker-dealers and investment advisers and how firms can prepare for the pending changes.

Disclosure. One result of being a fiduciary is the obligation to disclose all material conflicts of interest. If broker-dealers become fiduciaries, they should anticipate having to fully and fairly disclose the following to customers at the point of sale:

- The broker-dealer's role and relationship vis-à-vis the issuer, principal underwriter, wholesaler, dealer-manager, syndicate member or any other third party and the conflicts of interest created by these relationships;
- The broker-dealer's sources of compensation with respect to the transaction;
- Any compensation arrangement that creates a material conflict of interest between the broker-dealer or its associated persons and their customers (whether such arrangement involves compensation received from a third party or from the broker-dealer itself);
- Where applicable, other business relationships that create conflicts (e.g., payment for order flow or soft dollar arrangements); and
- All risks and costs involved in any securities advice or recommendations.

Conflicts of Interest. One of the most significant implications of being a fiduciary is the need to conduct *ongoing* monitoring and reviews of conflicts of interests. Broker-dealers' businesses typically are quite dynamic -- they continually enter new markets, sell new types of securities, form new customer relationships, sell in new geographic regions, add business lines and enter into new distribution, wholesaling or selling arrangements. Any of these changes have the potential to create or heighten conflicts of interest. So do compensation arrangements, principal transactions with customers and charging separate fees for providing investment advice and executing trades based on such advice. If broker-dealers become fiduciaries under the law, then they should consider enhancing and formalizing policies and procedures to continually monitor for conflicts of interest and adopt mechanisms to mitigate and disclose such conflicts.

Suitability of Advice and Recommendations. One important ramification of the Legislative Proposals would be increased scrutiny of the costs and expenses of securities that are recommended to customers. Securities regulators can be expected to review how firms come to recommend expensive securities to customers. As fiduciaries, firms would have to be able to justify why expensive securities are recommended to customers, particularly if less expensive alternatives are available. This justification may come to resemble the soft dollar analysis conducted by investment advisers under the safe harbor in Section 28(e) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), which, among other things, requires advisers to determine in good faith that the commissions charged are reasonable in relation to the value of the brokerage and research services provided. Firms should expect to be asked to justify why the beneficial features of a recommended security justify its costs and expenses. Documenting the rationale for the recommendation will be essential to being able to evidence the analysis that was conducted and demonstrating that the recommendation satisfied the firm's fiduciary duty and was in the best interests of the customer.

As fiduciaries, firms should avoid recommending securities with features customers neither need nor want, if feasible alternatives exist that provide similar benefits but do not contain the features that are not needed or desired. Similarly, where two securities fully meet a customer's needs but one is more expensive than the other, then, everything else being equal, the broker-dealer ought to recommend the less expensive option. Of course, this analysis is usually fairly complicated since securities rarely are equal. While cost/expense is one difference to be considered, other factors, such as the features, benefits, risks, and uniqueness of the securities, may be as, if not more, important in any given case. The key question is whether the documentation, viewed fairly and objectively, supports the conclusion that the advice or recommendation satisfies the goals, objectives and needs of the client as well as, or better than, other reasonably available alternatives.

The foregoing discussion denotes one of the most significant changes for broker-dealers under a fiduciary regime. If broker-dealers become fiduciaries under the law, then they would need to consider

how their advice and recommendations compare to reasonably available alternatives. Securities could not be viewed and considered in isolation. Such considerations are more difficult to manage if a broker-dealer has a conflict of interest in the recommended security (e.g., the security is issued by an affiliate of the broker-dealer or the broker-dealer receives higher gross dealer concessions for selling the security as compared to alternatives), and/or if the broker-dealer is limited in the types of securities it can offer customers.

Another ramification of being a fiduciary is increased regulatory scrutiny of the complexity of securities. Like the analysis above with respect to costs, such scrutiny would stem from firms' duty of care and the requirement to act in the best interests of customers. As fiduciaries, firms should expect to be asked to justify why the beneficial features of a recommended security justify its complexity. Documenting the rationale for the recommendation will be essential to being able to evidence the analysis that was conducted and demonstrating that the recommendation satisfied the firm's fiduciary duty and was in the best interests of the customer.

Ongoing Due Diligence and Know Your Customer Reviews. One of the fundamental characteristics of being a fiduciary is the need to conduct *ongoing* product due diligence and "know your customer" reviews. With respect to the obligation to "know your customer," the SEC has made clear in the context of investment advisers that fiduciaries are expected to ensure that the advice provided continues to be in the best interests of clients. For its part, FINRA recently proposed to adopt a standard that would require member firms to use due diligence in regard to opening *and* maintaining every account in order to know the essential facts concerning the customer. FINRA noted this information may be used to aid firms in all aspects of the customer/broker relationship and that the obligation does not depend on whether a recommendation has been made. Thus, if broker-dealers become fiduciaries, they will be expected to have policies and procedures in place to: periodically monitor the products that are offered and sold to customers and the market conditions for such securities and assess whether such securities continue to be in the best interests of customers; periodically meet with customers to determine whether there have been any changes in customers' financial situation or investment objectives; and promptly communicate with customers if assumptions or expectations concerning the operation or performance of a security materially changes.

Compensation. The Legislative Proposals can be expected to have a profound effect on the compensation practices of broker-dealers. Being subject to a fiduciary duty standard would increase regulatory scrutiny of commission, mark-up and mark-down practices that are "outside the norm," particularly if the compensation is beyond the five percent ceiling noted in FINRA's guidance. Accordingly, it would become even more important for broker-dealers to be aware of, and document, how their commission, mark-up and mark-down practices compare to the marketplace. In the context of securities offerings (e.g., corporate offerings and direct participation programs), broker-dealers would need to be sensitive to underwritings involving rich compensation packages, since FINRA will search for arrangements that are inconsistent with the best interests of customers or primarily benefit member firms. With respect to the internal compensation practices of broker-dealers, it is possible that the SEC could use its rulemaking authority under the Legislative Proposals to restrict, or perhaps even ban, the practices of: (i) paying out higher ratios for the sale of proprietary products; (ii) sales contests, bonuses and non-cash compensation that are based on sales of specific securities or types of securities; and (iii) revenue sharing, differential compensation, and other compensation arrangements. If such compensation practices are not banned, they are likely to be more closely scrutinized by the SEC and FINRA. Thus, broker-dealers should consider adopting the procedural safeguards detailed in the main portion of the white paper to ensure compliance with their fiduciary obligations.

Advertising. If broker-dealers become fiduciaries they would need to be careful how they hold themselves out to the public. For instance, any advertising highlighting their fiduciary status would need to also fully and fairly disclose any and all conflicts of interest arising from their relationship with third parties (e.g., issuers, principal underwriters, dealer-managers and syndicate members), and any limitations on the securities and services they provide arising from such relationships or otherwise.

One contentious question raised by the Legislative Proposals is whether the “switching hat” construct that emerged in the financial planning landscape over thirty years ago will continue. This construct permits a dual registrant’s representative to switch from serving as an investment adviser representative to a registered representative as the dialogue with a customer transitions from presenting a financial plan to discussing specific investments for implementation. Under guidance issued by the SEC, to take advantage of this construct, full disclosure must be provided to the customer about the change in the relationship and any consequent change in the obligations assumed. In addition, the customer must be able to reasonably understand that the firm is removing itself from a position of trust and confidence. Based on the rationale underlying the Legislative Proposals, much of the reason for distinguishing between an investment advisory and broker-dealer relationship ought to disappear, since both advisers and broker-dealers would owe investors the same fiduciary duty. In this respect, one of the key principles underlying the CPA is to harmonize the regulatory framework governing investment advisers and broker-dealers. However, under an amendment inserted into the CPA during its debate on the House floor, broker-dealers and registered representatives would not have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.

The amendment thus raises the question of whether the “switching hat” construct will continue in the future. It also calls into question whether broker-dealers will be expected to periodically monitor the securities they offer and sell to customers and the market conditions for such securities and assess whether such securities continue to be in the best interests of customers. The continued viability of the amendment provision is not clear. Under the Restoring American Financial Stability Act of 2009 (the “RAFSA”), which is discussed below, the issue would be moot, since all investment advice would be subject to the Advisers Act. The future of the hat switching construct and the question of what kind of ongoing duty broker-dealers owe to customers after they recommend and/or sell a security will likely be determined in the Senate when it considers the RAFSA or takes up the Senate version of the CPA.

Documentation. Broker-dealers and investment advisers often find themselves unable to prove that they disclosed particular information, researched an issue, contacted a client, performed due diligence or otherwise conducted some activity. Being subject to a statutory fiduciary duty will make it even more important for broker-dealers and investment advisers to document the processes undertaken to satisfy their fiduciary obligations. Thus, as detailed in the main portion of the white paper, investment advisers and broker-dealers must ensure they meticulously document all of the steps taken to provide services to customers.

I. What it Means to be a Fiduciary

A. The Rationale for Fiduciary Law

The principles defining and governing fiduciary duty arises out of the law of equity. Basic fiduciary relationships generally involve two parties: (i) entrustors (e.g., clients, in the context of investment advisory relationships), who grant certain powers and/or authority over their property to another party in order to receive certain services; and (ii) fiduciaries (e.g., investment advisers, in the context of investment advisory relationships), who agree to take and use the powers and/or property they have been provided to perform the designated services for the entrustors' benefit. The sole purpose of the entrustment is to enable the fiduciary to serve the entrustor.³ Entrustors' costs of monitoring fiduciaries' use of the entrusted powers or property and the quality of fiduciary services are generally quite high and typically, such monitoring is very time-consuming and difficult. This is often due to the specialized skills possessed by the fiduciary or to the disparity in information possessed by the fiduciary as compared to the entrustor. In addition, the quality of the services provided often cannot be judged simply by the results at the time the services are provided. Properly monitoring the activities of fiduciaries (by hiring a third party, for example) in order to prevent misuse of the entrusted property, or to ensure the quality of services provided, would undermine the utility of entering into the fiduciary relationship.

Accordingly, entrustors in a fiduciary relationship are in a position of vulnerability and subject to various risks relating to the property they have entrusted to the fiduciary. In addition, they do not have the skills, knowledge, access to information or practical ability to protect their own interests. As recent headlines illustrate, unscrupulous fiduciaries sometimes misuse the assets and powers they are entrusted with and embezzle entrustors' property. Fiduciaries also can harm entrustors in a myriad of other ways, such as obtaining benefits from using entrustors' assets, overcharging for their services, acting imprudently or negligently or failing to follow entrustors' instructions.

As a result of these risks, the common law evolved over time to impose certain duties on fiduciaries that limit their freedoms but also increase their marketability by endowing them with a reputation for honesty backed by regulation.⁴ Imposing duties on fiduciaries provides entrustors with the necessary incentive and confidence to enter into relationships with fiduciaries, by reducing the risks and costs of misuse of the powers and property entrusted to fiduciaries and by ensuring quality services are provided. Fiduciary law thus vests in entrustors the legal right to rely on the integrity and honesty of their fiduciaries and the quality of the services they provide by imposing certain duties on fiduciaries. These duties are imposed when public policy encourages the provision of services that require the entrustment of property or assets and are prohibitively difficult and expensive to monitor.⁵

B. The Primary Fiduciary Duties

In crafting and interpreting the law, the courts have imposed two primary duties on fiduciaries:

- **the duty of loyalty; and**
- **the duty of care.**

From these overarching duties, various obligations have been imposed on fiduciaries under the common law. The duty of loyalty requires fiduciaries to refrain from converting or misappropriating the entrusted powers and assets and from using them for unauthorized purposes or for personal gain. The duty thus addresses the risk of misuse of entrusted powers and assets. Based on the duty of loyalty, courts and regulators have required fiduciaries to: (i) segregate and earmark entrusted assets; (ii) avoid conflicts of interest with entrustors; (iii) avoid competing with entrustors; and (iv) provide entrustors with information and accounting.⁶

The common law also imposes a duty of care on fiduciaries when performing their services. Thus, entrustors have a legal right to receive quality fiduciary services, commensurate with their reasonable expectations. This duty often is measured by the level of care fiduciaries use in managing their own affairs.⁷ Typically, this duty is thought to require fiduciaries to, among other things: (i) gather pertinent information; (ii) analyze and deliberate before making a decision; and (iii) apply their expertise and skills in the decision-making process.⁸ Inherent in the foregoing is the importance of having a prudent process for making decisions that impact entrustors' property.

While all fiduciary relationships share the characteristics noted above, the scope of a fiduciary's duty under the law varies depending on the scope of the fiduciary's authority, the ability of the entrustor to control and terminate the fiduciary, the ability of the entrustor to monitor the fiduciary, the extent of power and entrustment provided to the fiduciary, and the nature and extent of the services provided by the fiduciary, among other factors.⁹ The greater a fiduciary's authority, and the less able an entrustor is to protect himself (e.g., by terminating the fiduciary), the more protection the entrustor receives under the law.¹⁰

II. Being a Fiduciary Under the Advisers Act

Investment advisers have long been deemed to be fiduciaries to their clients. This is not surprising since clients entrust to advisers the power to act on their behalf and/or make investment decisions for their accounts. The fiduciary status of advisers also reflects the personal nature of their relationship with clients. When clients hire an adviser, they are buying the intellectual capital, judgment and expertise of the adviser. This view of advisers as commonly providing personalized services to clients is woven into the fabric of the Advisers Act,¹¹ but it was not until 1963 that the Supreme Court officially established that advisers are fiduciaries *vis-à-vis* their clients. In *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court pointed to the legislative history of the Advisers Act to hold that a fiduciary relationship arises between advisers and their clients under section 206 thereof.¹² The Court concluded that the intent of section 206 was "to eliminate, or at least expose, all conflicts of interest" that might cause, consciously or not, investment advisers to provide advice that is not disinterested.¹³ In enforcing this duty, the SEC has interpreted the decision in *Capital Gains* as requiring advisers to, among other things: manage portfolios in the best interest of clients;¹⁴ provide clients with undivided loyalty;¹⁵ make full and fair disclosure of all material conflicts of interest;¹⁶ seek best execution for client transactions;¹⁷ ensure that investment advice is suitable for clients' objectives, needs and circumstances;¹⁸ and refrain from effecting personal securities transactions inconsistent with client interests.¹⁹

Long before *Capital Gains*, however, the SEC and its staff were requiring investment advisers to make full and fair disclosure of all material facts, particularly when advisers had a conflict of interest. For instance, in 1945, the SEC's General Counsel took the position that, under Sections 206(1), (2) and (3) of the Advisers Act, an investment adviser must disclose to an advisory client any adverse interest that the adviser might have, "together with any other information in his possession which the client should possess" to facilitate an informed decision by the client whether to consent to a principal transaction.²⁰ In more recent years, the SEC has said "Sections 206(1) and 206(2) of the Advisers Act also impose on advisers an affirmative duty of good faith with respect to their clients and a duty of full and fair disclosure of all facts that are material to the advisory relationship with their clients."²¹

In sum, the antifraud provisions of Section 206 of the Advisers Act are understood to require an investment adviser to provide clients with full and fair disclosure regarding the adviser's services and any related actual or potential conflicts of interest.²² In recognition of the fiduciary standard, rules under the Advisers Act require an adviser to deliver to each client a written disclosure document (either Part II of its Form ADV registration statement or a brochure containing the information required by Part II) disclosing prescribed information about the adviser and its services.²³ Part II of Form ADV requires disclosure of a wide range of arrangements and relationships that could present conflicts of interest, including participating in or having an interest in, a client's transactions. **Additionally, an investment adviser**

must disclose when a related person engages in these transactions and what restrictions, internal procedures, or disclosures are used for conflicts of interest in such transactions.²⁴

III. The Legislative Proposals

A. A Bit of History

In contrast to investment advisers, broker-dealers generally have been viewed as salesmen *vis-à-vis* the investing public. This approach recognizes broker-dealers' role of distributing and selling securities and executing securities transactions. Broker-dealers often are involved in underwriting securities offerings, serving as syndicate members or wholesalers, matching buyers and sellers of securities, acting as market makers, selling securities to the public from inventory, and clearing and settling trades. Given these roles, broker-dealers often are facilitating the interests of multiple parties at the same time, including those of customers.

Broker-dealers frequently enter into agreements with issuers, principal underwriters, syndicate members or wholesalers in order to obtain rights to distribute and participate in securities offerings (as well as the right to be compensated for their distribution efforts). With respect to offerings, such broker-dealers serve as principals for their own accounts or as agents of those for whom they engage in distribution efforts. This structure is mandated by applicable SRO rules²⁵ and is the way securities offerings have long been distributed to the public. Thus, in the context of offerings, broker-dealers act for their own account or as agents of the issuer, principal underwriter, syndicate members or wholesaler at the same time they provide advice and recommend the purchase of securities to the public. These broker-dealers are contractually obligated (generally on a firm commitment or best efforts basis) to distribute the securities that they provide advice and recommendations on to investors.

The contractual arrangements underlying the distribution of securities offerings means that such broker-dealers have competing loyalties (on one hand to sell as much as possible and on the other hand to make suitable securities recommendations) whenever they recommend and sell securities in offerings.

As discussed below, the contractual arrangements entered into by such broker-dealers and the corresponding loyalties and duties created thereunder will present challenges for these firms under a fiduciary standard.

In recognition of their intermediary role, the SEC created (and courts approved) the "shingle theory" to impose on broker-dealers a duty to deal fairly with customers.²⁶ The shingle theory posits that by hanging out a shingle and holding itself out to the public as providing brokerage services, a broker-dealer implicitly represents that it will deal fairly with the public.²⁷ Based on this principle of fair dealing, self-regulatory organizations such as FINRA have crafted detailed rules to govern the conduct of broker-dealers, such as NASD Conduct Rule 2310, which addresses the suitability of broker-dealer recommendations.²⁸ **Where a transaction is recommended by a broker-dealer, rule 2310 requires the firm, among other things, to have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by such customer as to his/her financial situation and needs.**

Notwithstanding the various rules adopted by FINRA to govern the activities of broker-dealers, there are significant differences between the obligations and limitations imposed on broker-dealers under the shingle theory and those imposed on investment advisers under fiduciary law with respect to such matters as disclosures of conflicts of interest, the nature and extent of advice that is provided, the obligation to monitor clients' accounts on an ongoing basis, and the ability to engage in principal transactions. In recent years, these differences have led to calls from Capitol Hill, the SEC, FINRA, and

various industry trade groups to “harmonize” the regulatory framework governing broker-dealers and investment advisers. In the words of the SEC’s Chairman, “consumers of financial products and services must receive the same level of protection regardless of the product or service that they purchase.”²⁹

B. Obama Administration Proposal

The calls to harmonize the regulatory regime governing broker-dealers and investment advisers received impetus from the financial crisis in 2008 and 2009 and the resulting calls to reform the overall regulation of the financial services industry. Additional motivation was provided by the collapse of the largest ponzi scheme in history, since Bernie Madoff’s firm was dually registered as both an investment adviser and a broker-dealer. In response, on June 17, 2009, the Obama Administration (the “Administration”) published its proposal for financial regulatory reform entitled *A New Foundation: Rebuilding Financial Supervision and Regulation* (the “Administration Proposal”). Among other things, the Administration Proposal proposed to (1) establish a fiduciary duty for broker-dealers offering investment advice about securities to investors and (2) harmonize the regulation of investment advisers and broker-dealers. These proposals were based on the following conclusions:

- **The services provided by broker-dealers and investment advisers often are virtually identical from a retail investor’s perspective. In this respect, investors often are confused about the differences between broker-dealers and investment advisers;**
- **In the retail context, the legal distinction between the two is no longer meaningful;**
- **Retail investors rely on a trusted relationship with a broker-dealer that is often not matched by the legal responsibility of a broker-dealer; and**
- **Retail customers repose the same degree of trust in their brokers as in investment advisers -- so the standards should be equal.**

The Administration Proposal also suggested empowering the SEC to ban forms of compensation that encourage intermediaries to put investors in products that are profitable to the intermediaries but are not in investors’ best interests. The Administration Proposal further recommended new legislation that would require disclosure to investors regarding the scope of the terms of their relationship with their investment professionals and prohibit certain conflicts of interest and sales practices that are contrary to the interests of investors. Finally, the Administration Proposal recommended legislation that would give the SEC authority to prohibit mandatory arbitration clauses in broker-dealer and investment adviser agreements with retail clients.

C. The Investor Protection Act of 2009

1. Obama Draft Legislation. After releasing the Administration Proposal, the Administration submitted proposed legislation to Congress entitled the “Investor Protection Act of 2009” (the “Obama IPA”) on July 10, 2009. The Obama IPA sought to impose fiduciary duties on both advisers and broker-dealers. Specifically, it proposed to add a new sub-section to the 1934 Act that would authorize the SEC to promulgate rules “to provide, in substance, that the standards of conduct for all [brokers-dealers] and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the SEC may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the [broker-dealer] or investment adviser.” The Obama IPA proposed adding similar language to the Advisers Act. Notably, the term “retail customer” was not defined and there was no guidance as to when a broker-dealer would be deemed to be providing investment advice.

The Obama IPA also directed the SEC to (1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals, and (2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors. Finally, the Obama IPA would have permitted (but not required) the SEC to prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of broker-dealers or investment advisers to arbitrate disputes, if it finds that such prohibition, imposition of conditions or limitations are in the public interest and for the protection of investors.

2. House Proposal. On November 4, 2009, the House Financial Services Committee approved its own version of the Investor Protection Act as H.R. 3817, which was included as part of the CPA that the House of Representatives passed on December 11, 2009 (the “House IPA”) as H.R. 4173.³⁰ Among other things, the House IPA would impose a fiduciary standard on broker-dealers and investment advisers. Specifically, the House IPA would require the SEC to promulgate rules requiring broker-dealers and investment advisers “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” when broker-dealers and investment advisers are “providing personalized investment advice about securities to retail customers (and such other customers as the [SEC] may by rule provide).” The language also provides that “[i]n accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer.”

Importantly, the House IPA contains language providing that “[t]he receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such [fiduciary] standard applied to a broker or dealer.” However, the House IPA would require special disclosure when a broker-dealer sells only proprietary products: “Where a broker or dealer sells only proprietary or other limited range of products, as determined by the [SEC], the [SEC] shall by rule require that such broker or dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer.” While the sale of only proprietary products or other limited range of products would give rise to a disclosure requirement, “[t]he sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the [fiduciary] standard set forth” above.

The House IPA defines “retail customer” as a natural person who “receives personalized investment advice about securities” from a broker, dealer or investment adviser and “uses such advice primarily for personal, family, or household purposes.” Similar to the Obama IPA, the House IPA directs the SEC to (1) to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest and (2) examine and, where appropriate, promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that it deems contrary to the public interest and the protection of investors.

D. Senate Banking Committee Proposal

On November 10, 2009, Senator Chris Dodd of the Senate Banking Committee unveiled his own financial reform bill package, the RAFSA.³¹ In contrast to the approach taken by the Obama IPA and House IPA, the RAFSA would delete the exclusion from the definition of “investment adviser” in Section 202(a)(11)(C) of the Advisers Act. This provision excludes from the definition of investment adviser any broker or dealer whose provision of investment advice is solely incidental to the conduct of its business as a broker or dealer and who receives no special compensation therefore. This approach would effectively require broker-dealers providing advice on securities to clients to register as investment advisers under the Advisers Act. All investment advice regarding securities provided by broker-dealers would then be subject to the requirements of the Advisers Act and the rules and interpretive guidance thereunder, including those pertaining to fiduciary duty. In recognition of the fact that broker-dealers commonly act as dealers and buy and sell securities from and to clients, the RAFSA would grant the SEC authority to exempt any person or transaction, or any class of persons or transactions, from the provisions on

principal transactions in Section 206(3) of the Advisers Act (requiring disclosure to and consent from clients for principal transactions), if the SEC determines that the exemption is in the public interest and for the protection of investors and the adviser provides investors with adequate protection against principal transactions that are not in the best interests of the investors. The RAFSA was heavily criticized by a wide range of groups and it remains to be seen how the Senate might move forward on financial services regulatory reform.

IV. Implications of Legislative Proposals

The Legislative Proposals would result in significant changes for broker-dealers and investment advisers providing securities advice to retail customers. Regardless of the particular course chartered by Congress and the Obama Administration in coming months, it is clear that financial intermediaries will soon face a tectonic shift in the way they are regulated. This section of the white paper explores what this shift might mean for broker-dealers and investment advisers in conducting their business and how they might prepare for the coming regulatory changes.

A. Disclosure

One result of being a fiduciary is the need to disclose all material conflicts of interest. In this respect, both FINRA and the SEC have proposed enhancing the point of sale disclosures broker-dealer provide to customers. If some of the Legislative Proposals are adopted, broker-dealers can expect to see rulemaking initiatives that echo proposals in 2003 and 2004 from FINRA and the SEC discussed below³² and more recent initiatives.³³ Broker-dealers would be wise to consider the guidance provided by the SEC to investment advisers in Release 1092 concerning their duty to disclose conflicts of interest:³⁴

The type of disclosure required by an investment adviser who has a potential conflict of interest with a client will depend upon all the facts and circumstances. As a general matter, an adviser must disclose to clients all material facts regarding the potential conflict of interest so that the client can make an informed decision as to whether to enter into or continue an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved. . . .

The advisers' duty to disclose material facts includes the duty to disclose the various capacities in which he might act when dealing with any particular client. For example, an adviser who intends to implement the financial plans he prepares for clients, in whole or part, through the broker or dealer or insurance company with whom the adviser is associated, should inform a client that in implementing the plan the adviser will also act as agent for the broker or dealer or the insurance company.

An investment adviser who is also a registered representative of a broker or dealer and provides investment advisory services outside the scope of his employment with the broker or dealer must disclose to his advisory clients that his advisory activities are independent from his employment with the broker or dealer. Additional disclosures would be required, depending on the circumstances, if the investment adviser recommends that his clients execute securities transactions through the broker or dealer with which the investment adviser is associated. For example, the investment adviser would be required to disclose fully the nature and extent of any interest the investment adviser has in such recommendation, including any compensation the investment adviser would receive from his employer in connection with the transaction.³⁵ In addition, the investment adviser would be required to inform his clients of their ability to execute recommended transactions through other brokers or dealers. A financial planner who will recommend or use only the financial products offered by his broker or dealer employer when implementing financial plans for clients should disclose this practice to clients and inform clients that the plan may be limited by the products offered by the broker or dealer. Finally, the [SEC] has stated that 'an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients.' . . .

An investment adviser generally also must disclose if his personal securities transactions are inconsistent with the advice given to clients.³⁶ Finally, an investment adviser must disclose compensation received from the issuer of a security being recommended . . .

[T]he [SEC] has applied Sections 206(1) and (2) in circumstances in which the fraudulent conduct arose out of the investment advisory relationship between an investment adviser and its clients, even though the conduct does not involve a securities transaction. . . . Moreover, the staff has taken the position that an investment adviser who sells non-securities investments to clients must, under Sections 206(1) and (2), disclose to clients and prospective clients all its interests in the sale to them of such non-securities investments. [footnote omitted]

In order to meet these standards, if broker-dealers become fiduciaries they should anticipate having to fully and fairly disclose the following to customers at the point of sale:

- The broker-dealer's role and relationship vis-à-vis the issuer, principal underwriter, wholesaler, dealer-manager, syndicate member or any other third party and the conflicts of interest created by these relationships;
- The broker-dealer's sources of compensation with respect to the transaction. This is even more important if the broker-dealer serves in multiple roles or receives multiple forms of compensation;
- Any compensation arrangement that creates a material conflict of interest for the broker-dealer or its associated persons, whether such arrangement involves compensation received from a third party (such as revenue sharing payments from an issuer) or from the broker-dealer itself (such as an internal sales contest operated by the broker-dealer, higher payout ratios for certain securities or non-cash compensation arrangements);³⁷
- Where applicable, other business relationships that create conflicts, such as payment for order flow arrangements, soft dollar arrangements, providing other services for an issuer (such as merger and acquisition advisory services, underwriting services, fairness opinions, research or making a market in a security); and
- All risks and costs involved in any securities advice or recommendations.

Broker-dealers' role in distributing and selling securities creates conflicts of interest that need to be fully disclosed to customers if broker-dealers become fiduciaries. Customers must be fully informed of broker-dealer's roles and corresponding conflicts of interest and the risks and costs associated with securities advice and recommendations. In certain circumstances, broker-dealers may be expected to obtain customers' acknowledgement of, or consent to, such conflicts. Firms should thus review the documentation they use with customers (such as account opening documentation and point of sale disclosures) to ensure all material information is clearly and fully disclosed.

B. Conflicts of Interest

One of the most significant implications of being a fiduciary is the need to conduct *ongoing* monitoring and reviews of conflicts of interest. Broker-dealers' businesses typically are quite dynamic -- they continually enter new markets, sell new types of securities, form new customer relationships, sell in

new geographic regions, add business lines, enter into new distribution, wholesaling or selling arrangements, etc. Any of these types of changes have the potential to create or heighten conflicts of interest. In this respect, on October 27, 2009, the Chairman and CEO of FINRA stated: "In a fiduciary world, the regular examination of conflict of interest becomes even more fundamental. Institutions should make reviewing their conflicts a part of their standard operating procedure. It is not enough to do a conflict review once every few years and put it in a drawer. It should be a continuous, evolving process that's just as real-time as the changes in a firm's business and the financial products it manufactures and sells."³⁸

If broker-dealers become fiduciaries under the law, then they should consider enhancing and formalizing policies and procedures to continually monitor for conflicts of interest created by new business relationships with customers, issuers, distributors, underwriters, wholesalers, and other third parties and adopt mechanisms to mitigate and disclose such conflicts.

The foregoing section on compensation illustrates that compensation arrangements often create conflicts of interest for broker-dealers and investment advisers. Conflicts of interest, of course, can arise from a number of activities. As noted above, in the context of offerings, broker-dealers act for their own account or as agent of the issuer or other broker-dealers at the same time they provide advice and recommend the purchase of securities to customers. The contractual arrangements underlying the distribution of securities offerings mean that such broker-dealers have competing loyalties whenever they recommend and sell securities in offerings. The Legislative Proposals acknowledge the conflicts created by the contractual arrangements entered into by such broker-dealers. For instance, the RAFSA would grant the SEC authority to exempt any person or transaction, or any class of persons or transactions, from the provisions on principal transactions in Section 206(3) of the Advisers Act, if the SEC determines that an exemption is in the public interest and for the protection of investors and the adviser provides investors with adequate protection against principal transactions that are not in the best interests of investors.

Broker-dealers that make markets in securities or hold positions via proprietary accounts regularly engage in principal transactions with customers. Such transactions can benefit customers by allowing them to buy or sell securities without exposing the orders to the open market, thereby enabling the transaction to be effected without market impact. The concern with such transactions, of course, is the potential for self-dealing by dumping unwanted securities on customers (or buying undervalued securities from customers) or engaging in price manipulation.³⁹ This concern is why Section 206(3) of the Advisers Act prohibits an adviser from entering into a principal transaction with a client unless the adviser has notified the client in writing *and* obtained the client's informed consent to the transaction. These notice and consent requirements generally must be met *prior to each* principal transaction.⁴⁰

If the RAFSA is adopted, the SEC can be expected to use its exemptive authority to set forth conditions to protect customers against the possibility of dumping or price manipulation in connection with principal transactions. After all, there is perhaps no greater conflict of interest for a fiduciary than being on the opposite side of a transaction from an entrustor. Broker-dealers should thus anticipate the need to institute enhanced policies and procedures relating to principal transactions, such as enhanced disclosures of the conflicts created by principal transactions, providing clients with the ability to opt out of principal transactions and periodically reviewing the principal transactions that are conducted to ensure the prices in such transactions are those that would be obtained in an arm's-length transaction between two equal parties.

Broker-dealers that engage in principal transactions with customers would do well to take heed of the SEC staff's view that fiduciaries participating in principal transactions must ensure such transactions are truly in the interests of customers. In this respect, the SEC staff has asserted:

We do not agree that 'an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest.' While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest. The facts concerning the adviser's interest, including its level, may bear upon the reasonableness of any belief that he may have that a transaction is in a client's interest or his capacity to make such a judgment.⁴¹

Beyond principal transactions, conflicts arise where a broker-dealer and affiliated adviser each charge separate fees for their services (e.g., the adviser charges for its advice and the broker-dealer charges for trade execution). This same conflict also arises where one entity is dually registered as both a broker-dealer and investment adviser, and charges separate fees for providing investment advice and executing trades based on its advice. Both circumstances implicate self-dealing and "double-dipping" concerns, because fees for advisory and execution services are charged with respect to the same assets. However, such practices should be acceptable so long as distinct services are provided for each fee that is charged, the amount of fees is reasonably related to the services provided and full and fair disclosure of the services and fees is provided.⁴² Firms should consider carefully documenting the services provided, the analysis of fees and the disclosures made to customers.

Broker-dealers should consider adopting policies and procedures to manage the competing loyalties they face when recommending securities in offerings by fully and fairly disclosing their dual loyalties. Because the nature of such conflicts will vary depending on the broker-dealer's role in the offering, broker-dealers should consider "inventorying" their practices and roles that create conflicts. Where it is impossible to avoid conflicts, broker-dealers should fully and fairly disclose such conflicts and seek customers' consent or acknowledgement to the conflicts of interest. Accordingly, broker-dealers should consider reviewing their account opening documentation, including brokerage agreements, as well as notices, reports and confirmations sent to customers to ensure that conflicts of interest are appropriately disclosed.

C. Suitability of Advice and Recommendations

1. In General. Both advisers and broker-dealers have suitability obligations. NASD Conduct Rule 2310 requires a broker-dealer, in recommending to a customer the purchase, sale or exchange of any security, to have reasonable grounds for believing that the recommendation is suitable for the customer based upon the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. Prior to the execution of a transaction recommended to a non-institutional customer, a broker-dealer must make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, and such other information used or considered reasonable by the firm or registered representative in making the recommendation.

While the Advisers Act does not expressly impose a suitability requirement on advisers, such a requirement is implicit in the antifraud provisions of Section 206 and has been enforced by the SEC.⁴³ Discharging this duty requires an adviser to make a reasonable inquiry into the financial situation, investment experience, and investment objectives of the client and reasonably to determine that the investment advice is suitable for the client. Advisers must thus implement procedures to timely and

accurately gather, maintain and analyze client financial information in connection with their investment recommendations. **In establishing these procedures, guidance may be drawn from a rule that was proposed by the SEC, but not adopted, that would have imposed an express suitability requirement on advisers. In 1994, the SEC proposed a rule that would have expressly set forth that an adviser is prohibited from making unsuitable recommendations to clients.**⁴⁴

The proposed rule would have prohibited an adviser from giving advice to a client unless the adviser reasonably determined that the advice was suitable to the client's financial situation, investment experience and investment objectives. Suitability of the advice would be evaluated in the context of the client's entire portfolio. The proposed rule also would have required advisers to "know the client." In this respect, the rule would have required an adviser, before providing any investment advice, and as appropriate thereafter, to make a reasonable inquiry into a client's financial situation, investment experience and investment objectives. The proposing release noted that the extent of the inquiry would turn on what is reasonable under the circumstances. The proposal also would have required advisers to make inquiries to update the client's information. The frequency of such updates would have turned on what is appropriate under the circumstances. In determining when to update client information, the proposal would have required advisers to consider, among other things, the passage of time since the information was last updated and whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the information on which it currently bases its advice. For example, a change in the tax law or knowledge that the client has retired or experienced a change in marital status might trigger an obligation to make a new inquiry under the proposal.

2. Impact of Costs and Expenses on Securities Recommendations. The proposed suitability rule, interpretive guidance provided by the SEC staff and statements made in the course of examinations shed light on the suitability obligations imposed on investment advisers. Should broker-dealers become fiduciaries under the Legislative Proposals, there will be a number of important ramifications relating to their suitability obligations. One important ramification will be increased scrutiny of the costs and expenses of recommended securities.

One can expect increased regulatory focus on the costs and expenses of securities recommended by broker-dealers to customers. This focus would stem from firms' duty of care and the requirement to act in the best interests of customers. Thus, the SEC and FINRA can be expected to review how broker-dealers come to recommend expensive securities to customers. As fiduciaries, broker-dealers would have to be able to justify why expensive products are recommended to customers, particularly if less expensive alternatives are available. This justification may come to resemble the soft dollar analysis conducted by investment advisers under the safe harbor in Section 28(e) of the 1934 Act, which requires, among other things, advisers to determine in good faith that the commissions charged are reasonable in relation to the value of the brokerage and research services provided. Thus, broker-dealers should expect to be asked to justify why the beneficial features of a recommended security justify its costs and expenses. Documenting the rationale for the recommendation will be essential to being able to evidence the analysis that was conducted and demonstrating that the recommendation satisfied the broker-dealer's fiduciary duty and was in the best interests of the customer.

Being subject to a fiduciary duty should not mean there will be a "race to the cheap" in which broker-dealers can only recommend the cheapest product available. Recommending the cheapest product available may *not* be in the best interests of a customer. The key for broker-dealers will be ensuring that they can evidence that the benefits of a recommended product justifies its cost and expense and any other negative attributes, which requires, among other things: obtaining and documenting the customer's financial circumstances (*e.g.*, objectives, needs, time horizon, risk tolerance, tax status, income, liabilities, *etc.*); recommending products that match the customer's needs; and evaluating whether there are reasonably available less expensive alternatives that meet the customer's needs.

Inherent in the fiduciary duty is the importance of not recommending products that have features customers do not need or want where there is an increased cost for such features (whether such costs are explicit or implicit and built into the overall cost of the product) if there are feasible alternatives available that provide similar benefits but do not contain the features that are not needed or desired. Thus, where two products fully meet a customer's needs but one is more expensive than the other, then, everything else being equal, the broker-dealer ought to recommend the less expensive option.

Of course, different products are rarely equal and typically there are a number of differences between them. In such circumstances, one has to weigh and judge the value attributed to such differences. Cost/expense is one, but not necessarily the most important, factor. How much of a factor cost/expense should be depends on the facts and circumstances. How much more expensive is the product sought to be recommended? How similar is it to other alternatives? What are the benefits of the product? Are they unique? What are the disadvantages and risks associated with the product? Are they unique? How important are any unique features of the product to the customer? Can the customer get the benefits sought to be obtained from an alternative product that is lower in cost? These and other factors may all be material to the analysis. Many of the differences may be qualitative in nature and thus difficult to quantify. Others may be quantitative and thus easy to measure. In most cases, comparing two similar, but different, securities involves judging a host of qualitative and quantitative factors and is as much art as it is science. The key is to analyze the differences and to document the reasoning underlying the analysis. The question to be asked is whether the documentation, viewed fairly and objectively, supports the conclusion that the advice or recommendation satisfies the goals, objectives and needs of the customer as well as, or better than, other reasonably available alternatives.

The foregoing discussion denotes one of the most significant changes for broker-dealers under a fiduciary regime: the need to compare the recommended product or investment advice against alternatives.

If broker-dealers become fiduciaries under the law, then they would need to consider how their advice and recommendations compare to reasonably available alternatives. Securities could not be viewed and considered in isolation.

The above considerations become more difficult when a broker-dealer has a conflict of interest in the product that is recommended. Such a conflict might arise because the product is issued by an affiliate, because the registered representative earns more compensation from the recommended product than alternatives or because of some other reason. Broker-dealers should consider ways to neutralize and mitigate these conflicts by implementing the measures discussed below (e.g., having persons not subject to such conflicts review and analyze the advice and recommendations provided by registered representatives and reviewing data to see if there is any evidence that compensation or other financial incentives skewed the advice provided).

Finally, to the extent a broker-dealer is materially limited in the number or types of appropriate products they can offer because, for instance, they have a limited number of selling agreements with issuers of a certain type of security or only sell proprietary products with respect to a particular type of security, this limitation should be disclosed. In this respect, the SEC has said that a financial planner who will recommend or use only the financial products offered by his broker-dealer when implementing financial plans for clients should disclose this practice to clients and inform clients that the plan may be limited by the products offered by the broker or dealer.⁴⁵ In addition, the House IPA would require special disclosure and customer consent or acknowledgment when a broker-dealer sells only proprietary or any other limited range of products.

3. Impact of Complexity on Securities Recommendations. Another ramification of being a fiduciary is increased regulatory scrutiny on the complexity of products. In this respect, regulators

have often associated complexity with increased risk and with an amplified chance of customer confusion.⁴⁶ Accordingly, broker-dealers that regularly sell complex products to retail customers should expect a healthy dose of regulatory skepticism in reviewing recommendations, particularly where such products also are expensive or present conflicts of interest. Like the analysis above with respect to costs, this focus would stem from firms' duty of care and the requirement to act in the best interests of customers. Thus, the SEC and FINRA can be expected to review how broker-dealers come to recommend complex securities to customers. As fiduciaries, broker-dealers should expect to be asked to justify why complex products are recommended to customers, particularly if less complex alternatives are available. As with the consideration of costs, this analysis may come to resemble the soft dollar analysis conducted by investment advisers under the safe harbor in section 28(e) of the 1934 Act.

Broker-dealers should expect to be asked to justify why the beneficial features of a recommended product justify its complexity. Documenting the rationale for the recommendation will be essential to being able to evidence the analysis that was conducted and demonstrating that the recommendation satisfied the broker-dealer's fiduciary duty and was in the best interests of the customer.

This is not to say that the complexity of a product means recommending it is inconsistent with a broker-dealer's fiduciary duty. Some products are naturally complex because of what they seek to achieve or because of the interplay of various market, tax or other variables. Accordingly, being subject to a fiduciary duty does not mean the SEC and FINRA will expect broker-dealers to only recommend simple products. In certain cases, recommending a simple product may not be in the best interests of the customer. Whether that is the case depends on the facts and circumstances. The key for broker-dealers will be ensuring that they can evidence that the benefits of a recommended security justifies its complexity and any other negative attributes, which requires, among other things: obtaining and documenting the customer's financial circumstances (e.g., objectives, needs, time horizon, risk tolerance, tax status, income, liabilities, etc.); recommending securities that match the customer's needs; and evaluating whether there are reasonably available, less complex alternatives that meet the customer's needs. As with the question of cost, the key is to analyze the differences and to document the reasoning underlying the analysis. The question to be asked is whether the documentation, viewed fairly and objectively, supports the conclusion that the advice or recommendation satisfies the goals, objectives and needs of the client as well as, or better than, other reasonably available alternatives.

4. Ongoing Due Diligence and Know Your Customer Reviews. One of the fundamental characteristics of being a fiduciary is the need to conduct *ongoing* product due diligence and "know your customer" reviews. In this respect, the views expressed by the Chairman and CEO of FINRA on product due diligence are telling. In a recent speech, Chairman Ketchum asserted the following:

What is clear from the recent experience with auction rate securities is that every broker-dealer must understand the risk-reward quotient of products and that understanding must extend from the product originator to the furthest down-line firm marketing the product. Product review cannot be a static process and firms must understand when market forces render a change in the risks of a product at the earliest reasonable time. . . .

What I'm suggesting is an ongoing new products process. Firms need to look at their list of products and make fairly difficult assessments as to whether they are still right for their customers. That requires an in-depth understanding of the components of the products. It demands a sophisticated analysis of which external forces could influence their behavior, and how. . . .

As investors find what are perceived to be safer places to put their money, firms need to be able to communicate to them not just the risks of those products now, but anticipate and communicate the risks if conditions change. . . .

For example, we will see even greater retail participation in the muni market, and given the increased financial exposure of some state and local governments, what bonds remain appropriate and what changes in disclosure are necessary to reflect new risks? What controls do you have in place to identify municipalities entering into financial distress and to make sure that information flows to your retail customers?⁴⁷

With respect to the obligation to “know your customer,” the SEC has made clear in the context of investment advisers that fiduciaries are expected to ensure that the advice provided continues to be in the best interests of clients. For its part, FINRA recently proposed to adopt a standard that would require member firms to use due diligence in regard to opening *and* maintaining every account in order to know the essential facts concerning the customer (including the customer’s financial profile and investment objectives or policy). FINRA noted “this information may be used to aid the firm in all aspects of the customer/broker relationship” and that “[t]he obligation arises at the beginning of the customer/broker relationship and does not depend on whether a recommendation has been made.”

If broker-dealers become fiduciaries, they will be expected to have policies and procedures in place to: (i) periodically monitor the products that are offered and sold to customers and the market conditions for such securities and assess whether such securities continue to be in the best interests of customers; (ii) periodically meet with customers to determine whether there have been any changes in customers’ financial situation or investment objectives; and (iii) promptly communicate with customers if assumptions or expectations concerning the operation or performance of a security materially changes.

Mr. Ketchum’s statements and the duty of care inherent in the fiduciary duty mean there will be circumstances under which a security that was recommended by a broker-dealer and was in the best interests of the customer at a given point of time ceases to be in the best interests of the customer and should be liquidated. Such a situation might make broker-dealers wary of performing the ongoing monitoring and review required of a fiduciary because of concerns that a recommendation to sell a security that was originally recommended to a customer will increase the risk of private litigation and “Monday morning quarterbacking” by regulators. Broker-dealers might be concerned that a subsequent “sell” recommendation might be viewed as evidence that the original “buy” recommendation was defective, unsuitable or inconsistent with the best interests of the customer. While there is no guarantee that plaintiff counsel would not seek to make such an argument, the words of economist John Maynard Keynes come to mind: “When the facts change, I change my mind. What do you do, sir?” As the language from the Chairman and CEO of FINRA make clear, broker-dealers will be expected to review, *and where appropriate*, revise the advice they originally provided in the past.

In fact, the fiduciary duty will, from time to time, *mandate* this result. As the events of the past eighteen months amply demonstrate, the financial markets are incredibly dynamic and in times of stress, relationships and correlations among various economic variables (as well as long-standing practices) can suddenly terminate or change. It would be a violation of fiduciary duty not to take changed facts and circumstances into consideration when providing advice to customers. The regulators have *already* indicated they expect broker-dealers to do so. Common sense requires broker-dealers to do so. And most importantly, a broker-dealer’s fiduciary duty would require it to do so. Accordingly, not recommending the sale of a security that was originally recommended for purchase by a broker-dealer could constitute, in certain circumstances, a violation of the broker-dealer’s fiduciary duty. A broker-dealer could risk regulatory action and private litigation for failing to recommend the sale of a security that was originally recommended, but is no longer in the interests of a customer. The foregoing simply reflects the reality that economic events or the customer’s financial or personal situation could materially change over time such that what was once in the best interests of the customer becomes adverse to such interests. To protect themselves, broker-dealers should ensure they carefully document the rationale provided for the original and subsequent recommendations. Where each recommendation is well

documented by evidence that the advice, at the applicable time, was in the best interests of the customer, then no liability should attach.⁴⁸

D. Compensation

Broker-dealers are subject to various policies and rules that impose restrictions on the compensation they may receive for providing brokerage services. Certain rules apply to transactions in traded securities, while other rules apply various types of offerings. In addition, FINRA has rules that govern sales contests, bonuses, revenue sharing, and differential compensation. This section of the white paper discusses the impact that a fiduciary duty standard might have on these compensation practices.

1. Transactions in Traded Securities.

Most customer transactions in exchange traded securities are effected by broker-dealers in an agency capacity, with broker-dealers charging a commission for their brokerage services. Transactions in non-exchange traded securities generally are traded on a principal basis in a dealer market, with broker-dealers charging a mark-up or mark-down for their services. Since the deregulation of fixed commission rates in the 1970s, broker-dealers have been permitted to set their commissions and offer discounts, subject to certain fairness standards. NASD Rule 2440 requires member firms to charge fair prices and commissions for traded securities transactions. IM-2440-1 sets forth FINRA's mark-up policy and explains that, in determining the fairness of a mark-up or mark-down, member firms should take into account such factors as the type of security, the security's availability in the market, the security's price, the amount of money involved in the transaction, market conditions at the time of the transaction, the expense involved, the member firm's pattern of mark-ups, and the nature of the member firm's business. IM-2440-1 reiterates prior guidance setting five percent as a general ceiling on the amount of mark-ups and commissions. In 2007, FINRA adopted IM-2440-2, which provides supplemental guidance for determining fair mark-ups for transactions in debt securities. IM-2440-2 states that, in a debt security transaction for a customer, a broker-dealer must calculate its fair mark-up or mark-down, as applicable, with reference to the prevailing market price of the security, which is presumptively equal to the broker-dealer's contemporaneous cost or proceeds. IM-2440-2 also describes procedures for determining the fair mark-up or mark-down when there is no contemporaneous cost or proceeds.⁴⁹

Being subject to a fiduciary duty standard will increase regulatory scrutiny of commission, mark-up and mark-down practices that are "outside the norm," particularly if the compensation is beyond the five percent ceiling noted in FINRA's guidance. Accordingly, it will become even more important for broker-dealers to be aware of, and document, how their commission, mark-up and mark-down practices compare to the marketplace. They also should have tools to carefully document the rationale for the commissions, mark-ups and mark-downs charged to customers. In this respect, the fiduciary standard will give the SEC and FINRA an additional instrument to combat compensation practices that are deemed to be inconsistent with the best interests of brokerage customers. The higher the compensation, the greater the scrutiny broker-dealers can expect of the rationale provided.

2. Corporate Financings. FINRA Rule 5110 generally governs member participation in SEC-registered public offerings (generally referred to as corporate financings) unless the securities involved are subject to regulation under FINRA Rule 2310 (for registered direct participation programs), Rule 2320 (for registered variable insurance contracts) or Rule 2830 (for mutual funds and certain other registered investment companies). FINRA Rule 5110 sets forth limits and conditions on underwriting compensation and arrangements for offerings subject to the rule. The key limitation is a fairness standard: the rule prohibits a member from receiving an amount of underwriting compensation in connection with a public offering that is "unfair or unreasonable" or from participating in a public offering of securities if the underwriting compensation is unfair or unreasonable. The rule lists factors that must be considered when determining whether the compensation is unfair or unreasonable. They include: (1) the offering proceeds; (2) the amount of risk assumed by the underwriter; and (3) the type of security offered. Further, the rule states that the amount of compensation (stated as a percentage of the proceeds) should vary directly with the amount of risk assumed by the underwriter, and inversely with the dollar amount of

the offering proceeds. FINRA generally enforces the “fair and reasonable” standard through its review of filings for offerings.

The pliable nature of the fairness standard embedded in rule 5110 could present a challenge to broker-dealers if they are deemed to be fiduciaries. Broker-dealers will need to be sensitive to underwritings involving rich compensation arrangements, including arrangements involving tail fees, ongoing placements or financings, options, warrants or convertible securities and over-allotment options. FINRA will search for compensation arrangements that are inconsistent with the best interests of customers or primarily benefit member firms. Any arrangements that create conflicts of interest will be scrutinized closely. Broker-dealers should be aware of how their compensation arrangements compare to those paid to other firms for similar offerings. The underwriting agreements and other documentation should carefully specify the various services provided, the risks incurred by the broker-dealer, and any characteristics of the securities that support the nature and amount of compensation that is paid.

3. Direct Participation Programs and Other Securities. FINRA Rule 2310 imposes a “fair and reasonable” standard on sales compensation for member participation in public offerings of direct participation programs. This standard is applied to the organization and offering expenses for the program. The rule provides that arrangements for organization and offering expenses will be presumed to be unfair and unreasonable if the total amount of all items of compensation from whatever source payable to underwriters, broker-dealers or affiliates thereof, which are deemed to be in connection with or related to the distribution of the public offering, exceeds the currently effective compensation guidelines for direct participation programs published by FINRA. In 1982, FINRA published a guideline of 10% of proceeds received, plus a maximum of 0.5% for reimbursement of bona fide due diligence expenses.⁵⁰ In 2008, FINRA Rule 2310 was amended to codify the long-standing practice of subjecting certain real estate investment trust offerings to the rule’s compensation limits.⁵¹ The same considerations noted above for corporate financings generally should apply to offerings of direct participation programs since the standards (except for the 10% cap) are similar.⁵²

4. Proprietary/Non-Proprietary Compensation Practices. While broker-dealers should expect to face increased scrutiny of any compensation arrangements that are greater than normal or otherwise outside industry practice, it is clear from the history of the Legislative Proposals that there are certain compensation practices that will be particularly vulnerable to being deemed to be inconsistent with a firm’s fiduciary duty. Chief among them are the incentives that broker-dealers or an affiliate receive or provide for the sale of proprietary products. This has long been an area of focus for FINRA. For example, in 1999, FINRA’s predecessor, the NASD, sought to amend NASD Conduct Rule 2830 to prohibit the payment of a higher percentage of gross dealer concessions to registered representatives for the sale of proprietary investment company securities than the percentage provided on the same dollar amount of non-proprietary investment company securities with similar investment objectives.⁵³ While the NASD limited its proposal to investment company securities, it solicited comment on the extent to which the proposed amendment should be extended to other kinds of securities as well.

The NASD proposed the amendment because of its view that the payment of higher compensation to registered representatives for the sale of proprietary products creates incentives to inappropriately favor such products over non-proprietary products. It considered a disclosure-based approach to this problem but rejected it for a number of reasons, including its conclusion that customers are rarely in a position to evaluate the impact of a compensation arrangement on the recommendation. The proposed amendment was never adopted. If broker-dealers were to become fiduciaries under the law, it is not clear whether the practice of paying registered representatives higher payout ratios for the sale of proprietary products could continue. In this respect, the House IPA instructs the SEC to:

- Promulgate rules requiring broker-dealers and investment advisers to act in the best interest of the customer without regard to their financial or other interest; and
- Examine and, where appropriate, promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that it deems contrary to the public interest and the protection of investors.

It is possible that the SEC would use its rulemaking authority under the legislation to restrict, or perhaps even ban, the practice of paying out higher ratios for the sale of proprietary products and thereby accomplish what FINRA sought to do with respect to investment company securities in 1999. Such rulemaking would rest on the conclusion that paying registered representatives more for selling securities issued by an affiliate than those issued by an issuer that is unaffiliated with the broker-dealer breaches firms' fiduciary duty (particularly the duty of loyalty). The language in the House IPA requiring special disclosure where a broker-dealer sells only proprietary or other limited range of securities reflects a Congressional acknowledgment that the sale of proprietary products has fiduciary duty implications.

If the SEC does not prohibit broker-dealers from paying a higher payout ratio for sales of proprietary products as compared to non-proprietary products, then broker-dealers should consider adopting procedural safeguards to ensure compliance with their fiduciary obligations. Such safeguards might include one or more of the following:

- Fully and fairly disclosing the nature and extent of the conflict, including the ranges of differential compensation earned for selling proprietary products, to the customer before the customer makes an investment decision;
- Adopting and implementing policies and procedures to ensure adequate supervision of the recommendation of proprietary products by a principal;
- Requiring a written explanation by the registered representative of why the proprietary product is in the best interest of the customer and a review of the explanation by a principal;
- Preparing and reviewing exception reports indicating the ratio of a registered representative's sale of proprietary products as compared to non-proprietary products and comparison of this ratio against other registered representatives; and
- Preparing and reviewing exception reports indicating spikes in the sale of proprietary products and proper follow-up to determine the reason for such spikes.

5. Sales Contests, Bonuses and Non-Cash Compensation. Conflicts of interest arise when broker-dealers hold sales contests for certain types of securities, pay bonuses for sales of certain types of security or offer non-cash compensation benefits for the sale of certain types of securities. Such contests, bonuses and arrangements can cause registered representatives to recommend securities to increase their chances of earning a cash or non-cash award, without proper consideration being given to whether they are suitable for customers. Concern with such incentives led the NASD to propose to ban the use of single security sales contests.⁵⁴ The NASD subsequently sought to prohibit all sales contests, even those that conform to the total production and equal weighting requirements embedded in the current non-cash compensation rules.⁵⁵ The NASD proposal rested on its view that "any sales contest that favors one security (e.g., a proprietary investment company) or one type of security (e.g., investment companies or stocks) [has] the potential to create an incentive to engage in sales conduct unrelated to the best interests of customers." The proposed ban on sales contests would have prohibited "stock of the day" and similar promotions. It also would have prohibited increased bonuses or memberships that are awarded for the sale of specific securities or types of securities.

If any of the Legislative Proposals are adopted, then it is possible that the SEC would seek to reintroduce the NASD's proposed ban on sales contests and the payment of bonuses that are awarded for the sale of specific securities or types of securities. Likewise, the SEC could prohibit or restrict the payment of non-cash compensation that is based on the sale of only certain securities or types of securities. Such an approach could be undertaken pursuant to the directive to the SEC to promulgate rules requiring broker-dealers to act in the best interest of the customer without regard to their financial or other interest and to examine and, where appropriate, promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for broker-dealers that it deems contrary to the public interest and the protection of investors. If the SEC does not prohibit sales contests or the payment of bonuses or non-cash compensation that is awarded for the sale of specific securities or types of

securities, then broker-dealers should consider adopting procedural safeguards to ensure compliance with their fiduciary obligations. Such safeguards might include one or more of the following:

- Fully and fairly disclosing the nature and extent of the conflict, including descriptions of the qualification criteria for the sales contests, bonuses and arrangements and the nature of the cash and non-cash prizes and bonuses, to the customer before the customer makes an investment decision;
- Adopting and implementing policies and procedures to ensure adequate supervision of the recommendation of securities that qualify for sales contests or the payment of bonuses or non-cash compensation by a principal;
- Requiring a written explanation by the registered representative of why the recommendation of products that help the representative qualify for sales contests or the payment of bonuses or non-cash compensation is in the best interest of the customer and a review of the explanation by a principal;
- Preparing and reviewing exception reports indicating the ratio of the registered representative's sale of products that help the representative qualify for sales contests or the payment of bonuses or non-cash compensation as compared to products that do not help the representative qualify for such benefits and comparison of this ratio against other registered representatives; and
- Preparing and reviewing exception reports indicating spikes in the sale of products that help the representative qualify for sales contests or the payment of bonuses or non-cash compensation, particularly spikes that occur toward the end of the qualifying time period, and proper follow-up to determine the reason for such spikes.

6. Revenue Sharing, Differential Compensation and Other Compensation Arrangements. Revenue sharing payments from issuers, investment advisers or principal underwriters for the sale of certain securities represent another form of compensation that can influence the recommendations made by broker-dealers and registered representatives. In this respect, many revenue sharing payments are based on the amount of assets already in a product due to the sales efforts of a broker-dealer and/or current sales of the product. Accordingly, everything else being equal, broker-dealers have an incentive to sell securities for which they receive revenue sharing payments over securities for which they do not. The same is true for differential compensation arrangements under which a broker-dealer pays its registered representatives higher payouts for the sale of certain (not necessarily proprietary) securities than others. Due to the conflicts of interest raised by such arrangements, in 2003 the NASD proposed amendments to Rule 2830 to require disclosure of revenue sharing and differential compensation arrangements to customers.⁵⁶ In the NASD's words:

These compensation arrangements can create conflicts of interest by encouraging members and their registered representatives to recommend certain funds to maximize their compensation, rather than to best meet their customers' needs. They may provide point-of-sale incentives that could compromise proper customer suitability considerations and may present a situation in which the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers.

In the NASD's view, disclosure of revenue sharing and differential cash compensation arrangements would enable investors to evaluate whether a registered representative's particular product recommendation was inappropriately influenced by such arrangements. Accordingly, disclosure of these arrangements could help ensure that there is a match between the needs of an investor and the security that is recommended. Under the NASD's proposal, broker-dealers receiving revenue sharing or maintaining differential cash compensation practices would have had to disclose, in writing, at the time the customer establishes an account with the member or first purchases shares:

- If applicable, that the broker-dealer receives cash payments from fund offerors other than the sales charges and service fees disclosed in the prospectus;
- The names of the offerors that made these payments in descending order based upon the total amount of compensation received from each offeror; and
- If applicable, that registered persons receive different rates of compensation depending upon which investment company shares are purchased by a customer, the nature of these arrangements, and the names of the investment companies favored by these arrangements.⁵⁷

The NASD's proposal was never adopted. If broker-dealers were to become fiduciaries then, as with the compensation arrangements discussed above, the SEC could prohibit or restrict revenue sharing and differential compensation practices (or other compensation practices) if it finds such practices are contrary to the public interest and the protection of investors. If the SEC permits such arrangements, then broker-dealers should consider adopting procedural safeguards to ensure compliance with their fiduciary obligations. Such safeguards might include one or more of the following:

- Fully and fairly disclosing the nature and extent of the conflict, including the details of the revenue sharing or differential compensation arrangement, to the customer before the customer makes an investment decision;
- Adopting and implementing policies and procedures to ensure adequate supervision of the recommendation of securities that are subject to revenue sharing or differential compensation arrangements by a principal;
- Requiring a written explanation by the registered representative of why the recommendation of securities subject to revenue sharing or differential compensation arrangements is in the best interest of the customer and a review of the explanation by a principal;
- Preparing and reviewing exception reports indicating the ratio of the registered representative's sale of products that are subject to revenue sharing or differential compensation arrangements as compared to products that are not subject to such arrangements and comparison of this ratio against other registered representatives; and
- Preparing and reviewing exception reports indicating spikes in the sale of products that are subject to revenue sharing or differential compensation arrangements, particularly spikes that occur toward the end of any qualifying time period, and proper follow-up to determine the reason for such spikes.

The foregoing safeguards also should be considered with respect to other compensation practices that create conflicts of interest, such as paying registered representatives accelerated payouts or making loans when they first join a brokerage firm from another broker-dealer.

7. Adviser Compensation. The Advisers Act does not explicitly address or regulate the kinds or amounts of fees an investment adviser may charge clients for advisory services, except with regard to performance-based fees. However, the SEC staff has interpreted the Advisers Act's general antifraud provision as requiring fair and full disclosure to clients of the fees an adviser charges clients, including, where relevant, whether the fees charged are excessive in relation to fees charged by other advisers for comparable services.⁵⁸ In addition, an investment adviser might violate Section 206's antifraud provisions by charging a fee that is simply too high. In the view of SEC staff, a fee that is not reasonable in relation to the services provided would violate the adviser's fiduciary duties.

Like broker-dealers, investment adviser compensation arrangements could involve conflicts of interest. For instance, advisers can negotiate different fee arrangements with different clients or charge more for managing one type of portfolio than another type of portfolio. Such differences in fee arrangements can create an incentive for an adviser to favor certain clients (e.g., those subject to a

higher fee schedule) over other clients. In addition, investment advisers may invest in, or recommend that clients invest in, pooled investment vehicles managed by the adviser. Such practices may be acceptable if the adviser provides distinct services for each fee that is charged and makes full and fair disclosure of the services it provides and the fees it receives.⁵⁹

The SEC staff has explained that as part of its fiduciary duty an adviser must disclose to clients any compensation it receives (regardless of source) that may affect its recommendations, so that clients can evaluate the adviser's motivation in recommending the particular transaction.⁶⁰ More generally, the SEC has asserted that an "adviser's duty to disclose material facts is particularly pertinent whenever the adviser is in a situation involving a conflict, or potential conflict, of interest with a client."⁶¹

The Advisers Act and its rules permit resolution of most potential and actual conflicts of interest with advance disclosure to, and consent of, the client. The following lists a few examples of arrangements and situations presenting conflicts that can be resolved through sufficient disclosure and client consent:

- receipt of commissions and Rule 12b-1 fees or services fees from client investments;⁶²
- commission splitting arrangements;⁶³
- receipt of compensation from a source other than the client for recommending a security;
- dual registration as, or an ownership or other affiliation relationship with, a broker-dealer through which transactions are effected;
- referral to a related broker-dealer for securities transactions; and
- referral arrangements where compensation is paid for referring clients to the adviser.

However, in a few cases, the SEC staff has taken the position that some conflicts are *per se* fraudulent and cannot be cured by disclosure and consent.⁶⁴ If broker-dealers are made fiduciaries under the law, they can expect to see similar regulatory scrutiny of conflicts of interest created by compensation practices.

E. Advertising

1. In General. If broker-dealers become fiduciaries they would need to be careful how they hold themselves out to the public. For instance, any advertising highlighting their fiduciary status would need to also fully and fairly disclose any and all conflicts of interest arising from their relationship with third parties such as issuers, principal underwriters, wholesalers, dealer-managers and syndicate members and any limitations on the securities and services they provide arising from such relationships or otherwise. Customers should therefore understand, if applicable, that while a broker-dealer is a fiduciary, it can only offer those securities offerings for which it has entered into a selling agreement. A broker-dealer also should disclose, if applicable, that it has only entered into selling agreements for a certain type of security if it receives revenue sharing from the issuer of the security or a certain level of gross dealer concession.

Broker-dealers need to ensure that advertisements touting their fiduciary status do not suggest that their advice is not conflicted or limited, if that is not the case.

2. Switching Hats. One question arising from the Legislative Proposals is whether the "switching hat" construct that emerged in the financial planning landscape over thirty years ago will continue. A few no-action letters for firms dually registered as broker-dealers and investment advisers outline a business model under which firms, through their representatives, provide generic recommendations in connection with financial planning services in their role as investment advisers, but provide specific recommendations and transaction execution in their role as broker-dealers.⁶⁵ Under this construct, the firm's representatives switch from serving as an investment adviser representative to a

registered representative as the dialogue with a customer transitions from presenting a financial plan to discussing specific investments for implementation. Firms asserted that, so long as there was effective disclosure of the transition, the representative's recommendations of specific investments should be subject to rules applicable to broker-dealers and not those applicable to investment advisers.

In early no-action letters outlining the business model, the SEC staff observed that "[w]hether or not such a distinction can be effectively implemented and adequately disclosed are questions of fact which would depend on the actual operation" of the services in question.⁶⁶ In an SEC administrative decision published in 2005, an administrative law judge recognized the practice, noting:

There is no case precedent that holds that an associated person of an investment adviser cannot change hats, to use [the defendant's] metaphor, and act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser. In light of the . . . [defendant's] efforts to differentiate between his roles as investment adviser and as salesman, it is concluded that no violation of [Advisers Act anti-fraud provisions] occurred.⁶⁷

More recently, the SEC staff acknowledged the "switching hats" construct in a letter issued to the Securities Industry Association.⁶⁸ This letter addressed the mechanics for switching between an advisory relationship and brokerage relationship with a customer receiving a financial plan as part of the advisory relationship and implementing securities transactions as part of the brokerage relationship. The letter acknowledged that the switch can be made, with an effective change in the applicable regulatory scheme, if "the broker-dealer/investment adviser has provided the client full disclosure about the change in the relationship and any consequent change in the obligations assumed by the broker-dealer." The letter also indicated that the disclosure "should be sufficient to enable the client to reasonably understand" that the firm "is removing itself from a position of trust and confidence with its client."⁶⁹

Based on the rationale underlying the House IPA and other Legislative Proposals, much of the reason for distinguishing between an investment advisory and broker-dealer relationship should disappear, since both advisers and broker-dealers would owe the same level of fiduciary duty to investors. Arguably, it should not matter to a dually registered firm which regulatory construct governed the provision of advice to an investor. In this respect, one of the key principles underlying the CPA is to harmonize the regulatory framework governing investment advisers and broker-dealers. However, it is possible that dual registrants could still seek to have a given transaction deemed subject to the 1934 Act, as opposed to the Advisers Act, depending on how certain issues, such as principal transactions, are resolved in the legislative process.

An amendment inserted into the House IPA immediately before it was passed adds impetus to this debate. The amendment provides: "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." This language could be read to endorse the hat switching construct and thus permit dual registrants to provide generic recommendations in connection with financial planning services in their role as investment advisers, and to sell securities and provide transaction execution in their role as broker-dealers. Even more importantly, the amendment calls into question whether broker-dealers will be expected to periodically monitor the products they offer and sell to and the market conditions for such securities and assess whether such securities continue to be in the best interests of customers. The amendment thus has the potential to significantly curtail the scope and impact of the Legislative Proposals. The continued viability of the amendment is not clear. Under the RAFSA, the issue would be moot, since all investment advice would be subject to the Advisers Act. The future of the hat switching construct and, perhaps, the question of what kind of ongoing duty broker-dealers have to customers after they recommend and/or sell a security, will likely be determined in the Senate when it considers the RAFSA.

3. Account Reporting. It is common practice for investment advisers to provide quarterly performance reports to clients depicting, among other things, clients' securities positions, beginning and ending account balances, contributions and withdrawals, dividend and interest payments, purchases and sales of securities, and account performance, which usually is benchmarked against an

index, over the quarter.⁷⁰ Such performance information often is accompanied by a review of the performance of various market sectors, a discussion of the drivers of performance for the quarter, a breakdown of clients' asset allocation, and an in-depth analysis of clients' account performance. As advice takes on an increasingly important role for broker-dealers, they may face increasing customer expectations and demands to demonstrate the value of their advice and recommendations. Robust performance reporting may be an important tool that broker-dealers use to prove the value of their services.⁷¹ In this respect, investors naturally wish to know how their fiduciaries are performing and fiduciaries generally are obligated to provide entrustors with information and an accounting concerning the services that are provided.

F. The Importance of Documentation

All too often, satisfying a standard of care is one thing and proving the standard was satisfied is something else entirely. Whether the context is a regulatory examination, arbitration hearing or lawsuit, broker-dealers and investment advisers often find themselves unable to prove that they disclosed particular information, researched an issue, contacted the client, performed due diligence or otherwise conducted some activity. After all, for years FINRA and SEC examiners have indicated that their working assumption is that if something cannot be proved, then it did not happen. Being subject to a statutory fiduciary duty will make it even more important for broker-dealers and investment advisers to document the processes undertaken to satisfy their fiduciary obligations. Thus, investment advisers and broker-dealers need to ensure they meticulously document, among other things, the following:

- Client information obtained and considered, including client's goals and objectives, account restrictions, risk tolerance questionnaires, investment policy statements, *etc*;
- Asset allocation creation, suitability, risk assessment and mitigation, and customization of customer advice;
- Research and due diligence conducted, including the factors considered and analyzed, and conclusions reached;
- Communications and disclosures made to clients, including account reports and oral conversations;
- Portfolio construction process, including the variables reviewed, and conclusions reached;
- Asset management decisions, including supporting analytics;
- Billing of client accounts, including how fees and charges were calculated;
- Account funding and opening mechanics;
- Account and portfolio reviews and monitoring, including drift alerts and trade alerts; and
- Reconciliation, data aggregation and performance reporting.

V. Conclusion

The pending changes under the Legislative Proposals will significantly impact broker-dealers and investment advisers. A statutory fiduciary duty will create opportunities and challenges for firms providing retail investment advice. Among the challenges will be increased regulatory scrutiny of disclosure practices, conflicts of interest, and the suitability of investment advice and recommendations. As fiduciaries, firms will be expected to analyze and consider the impact of compensation practices on recommendations and take into account product fees, charges and complexity in their product due diligence and suitability reviews. Firms should thus analyze the risks presented by their particular distribution and sales arrangements and consider how a statutory fiduciary duty will impact such arrangements under the principles discussed herein. Documenting such analysis and crafting policies and procedures to mitigate the risks that are identified will go a long way in ensuring firms satisfy their fiduciary obligations in the brave new world that is to come.

*** This White Paper does not constitute legal advice and should not be considered as such. Readers should seek the advice of counsel in determining their legal obligations. The views expressed herein reflect only those of the author.**

¹ See the “Wall Street Reform and Consumer Protection Act of 2009,” reported as H.R. 4173 on December 11, 2009.

² In certain discreet circumstances broker-dealers have been held to be fiduciaries, such as when they act pursuant to a grant of discretionary authority from the customer.

³ See Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (May 1983) (hereinafter, “Fiduciary Law”); Tamar Frankel, *Fiduciary Duties*, The New Palgrave Dictionary of Economics and the Law, vol. 2, at 127 (Peter Newman ed., 1998) (hereinafter, “Palgrave Dictionary”).

⁴ See Palgrave Dictionary, *supra* note 2 at 127.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ See *Fiduciary Law*, *supra* note 2, at 795.

¹⁰ See Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209 (Winter 1995).

¹¹ For instance, Advisers Act Section 205(a)(2) implicitly acknowledges the personal nature of the advisory relationship by providing that a registered investment adviser may not enter into an advisory contract unless the contract provides that it cannot be assigned by the adviser without the consent of the client. The term “assignment” is defined in section 202(a)(1) of the Advisers Act to include, among other things, any transfer of an investment advisory contract. The SEC has noted that the Advisers Act’s “legislative history mentions concern about fiduciaries assigning personal contracts and demonstrates that this provision is directed against persons who would otherwise ‘traffic’ in investment advisory contracts.” See, e.g., *Certain Transactions Not Deemed Assignments*, Advisers Act Release No. 1013 (Feb. 21, 1986). In addition, the SEC has stated that, “[u]nlike the sale of a single security or other products and services, the service provided by an investment adviser typically involves an ongoing personal relationship . . .” *Telemarketing And Consumer Fraud And Abuse Prevention Act; Determination That No Additional Rulemaking Required*, Exchange Act Release No. 38480 (Apr. 7, 1997).

¹² *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). (hereinafter “Capital Gains”) (noting that “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”).

¹³ *Id.*

¹⁴ See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (the “Hedge Fund Registration Release”) (citing *Capital Gains*; *Transamerica Mortgage Advisors, Inc., (TAMA) v. Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471, n. 11 (1977)).

¹⁵ See Advisers Act Release No. 2209 (Jan. 20, 2004).

¹⁶ See Advisers Act Release No. 470 (Aug. 20, 1975).

¹⁷ See *In Re Michael L. Smirlock*, Investment Advisers Act Release No. 1393 (Nov. 29, 1993).

¹⁸ See Advisers Act Release No. 1406 (Mar. 16, 1994); *In Re John G. Kinnard and Co.*, (pub. avail. Nov. 30, 1973).

¹⁹ See *Investment Advisers Act Release No. 203* (Aug. 11, 1966).

²⁰ See Advisers Act Release No. 40 (Jan. 5, 1945).

²¹ See Advisers Act Release No. 1732 (July 17, 1998); Advisers Act Release No. 1092 (Oct. 8, 1987) (hereinafter, “Release 1092”).

²² See, e.g., Release 1092, *supra* note 21.

²³ See Advisers Act Rule 204-3.

²⁴ See Item 9, Part II of Form ADV; Item 8, Part 1A of Form ADV.

²⁵ See, e.g., NASD Conduct Rule 2770 applicable to selling syndicate agreements; FINRA Rule 2320 (“No member who is a principal underwriter as defined in the Investment Company Act of 1940 may sell variable contracts through another broker/dealer unless . . . (2) there is a sales agreement in effect

between the parties.”); see also NASD Conduct Rule 3040, which prohibits “selling away” by registered representatives.

²⁶ See, e.g., *Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434 (2d Cir. 1943).

²⁷ See *Duker & Duker* 6 SEC 386 (1939).

²⁸ See also FINRA Rule 2010 (requiring broker-dealers to observe high standards of commercial honor and just and equitable principles of trade).

²⁹ Mary L. Schapiro, Remarks before the FINRA Fall Securities Conference (Oct. 23, 2008). See also Richard G. Ketchum, Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs (Mar. 26, 2009).

³⁰ The House IPA constitutes Title V, Subtitle C of the CPA. The engrossed language of the CPA was not available at the time of this White Paper. The House IPA provisions discussed herein therefore are from the version of the Investor Protection Act approved by the House Financial Services Committee and the amendments introduced on the House floor and approved by the House of Representatives during debate of the CPA.

³¹ See Senate Banking Committee Press Release, *Dodd, Banking Committee Democrats Unveil Comprehensive Financial Reform* (Nov. 10, 2009).

³² See *infra* notes 56-57.

³³ For instance, in Regulatory Notice 09-34 FINRA proposed requiring broker-dealers to disclose to customers the receipt of revenue sharing payments or higher sales commissions or service fees, in addition to the standard sales charges and services fees paid in connection with the sale or distribution of investment company securities. Under the proposal, broker-dealers would have to disclose, if applicable: that the firm receives cash payments from offerors, in addition to the standard sales charges and service fees disclosed in the prospectus; the nature of such payments received in the last 12 months; a list of offerors making such payments listed in descending order of payments received; and a web page or toll-free number containing updated information, which must be updated at least every six months.

³⁴ See also Advisers Act Release No. 470 (Aug. 20, 1975) (Whether Sections 206(1) and (2) require disclosure of specific facts about a transaction depends on the “materiality of such facts in each situation and upon the degree of the client’s trust and confidence in and reliance on the adviser with respect to the transaction.”)

³⁵ *Id.*

³⁶ In the Matter of Dow Theory Letters et al., Advisers Act Rel. No. 571 (Feb. 22, 1977).

³⁷ In this respect, investment advisers must disclose to clients if their fees are higher than usual market fees. See Charles Meyer (pub. avail. Sept. 4, 1975)

³⁸ See Richard G. Ketchum, Speech to SIFMA Annual Meeting (Oct. 27, 2009) publicly available at <http://www.finra.org/Newsroom/Speeches/Ketchum/P120289>.

³⁹ See Investment Trusts and Investment Companies: Hearings Before the Subcomm. of the H. Comm. on Banking and Currency, 76th Cong., 3d Sess. 320-22 (1940) (discussing the dangers presented by principal transactions conducted by investment advisers).

⁴⁰ See Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732 (July 17, 1998). Section 206(3) applies equally to advisers that themselves act as principals in such trades as to advisers affiliated with other parties acting as principals in such trades. See *Interplan Asset Management*, (pub. avail. Feb. 24, 1978). Section 206(3) also applies to certain transactions effected for advisory clients by an adviser on an agency basis where the adviser also is acting as an agent of another person (referred to as an agency cross transaction). However, in the case of agency cross transactions, an adviser can obtain “blanket consent” to such transactions if the adviser discloses in writing to the client the capacity in which it will act and its possible conflicts of loyalty and responsibility, the client executes a written consent prospectively authorizing agency cross transactions, the adviser sends the client a written confirmation of each such transaction as well as an annual statement disclosing agency cross transactions, and all documents sent to the client pertaining to agency cross transactions conspicuously state that the client may revoke the authority at any time. See Advisers Act Rule 206(3)-2.

⁴¹ *Rocky Mountain Financial Planning, Inc.* (pub. avail. Mar. 28, 1983).

⁴² See *Neuberger & Berman*, (pub. avail. Mar. 30, 1987).

⁴³ See, e.g., In re Bing Sung, Investment Advisers Act Release No. 1814 (Aug. 12, 1999) (chief investment officer of adviser entered into certain risky trades on behalf of two advisory clients in contravention of the investment guidelines established by the two clients); In re George Sein Lin,

Investment Advisers Act Release No. 1174 (June 19, 1989) (investment adviser found to have defrauded its advisory clients by misrepresenting the nature of their investments, making investments which were contrary to the clients' stated investment desires, failing to disclose the risks their investments involved, and recommending investments which were unsuitable in light of its clients' assets, income and degree of sophistication).

⁴⁴ Advisers Act Release No. 1406 (Mar. 16, 1994).

⁴⁵ See Release 1092, *supra* note 21.

⁴⁶ See Richard G. Ketchum, Speech to SIFMA Annual Meeting (Oct. 27, 2009) *available at* <http://www.finra.org/Newsroom/Speeches/Ketchum/P120289>.

⁴⁷ See Richard G. Ketchum, Remarks From the SIFMA Compliance & Legal Division's Annual Seminar (Mar. 23, 2009) *available at* <http://www.finra.org/Newsroom/Speeches/Ketchum/P118256>.

⁴⁸ One result of the foregoing considerations and Mr. Ketchum's statements is that imposing a fiduciary duty on broker-dealers would make it extremely difficult, if not impossible, to differentiate broker-dealers from investment advisers. A discussion of this issue and the role of Section 202(a)(11)(C) of the Advisers Act is beyond the scope of this white paper.

⁴⁹ NASD Rule 2430 mandates that administrative fees and charges imposed by member firms be reasonable and not unfairly discriminatory between customers. NASD Notice to Members 92-11, which discusses Article III Section 3 of the NASD Rules of Fair Practice, the precursor to NASD Rule 2430, states that customers must be given written notification of changes in fees and charges.

⁵⁰ See NASD Notice to Members 82-51 (Oct. 1982).

⁵¹ See FINRA Regulatory Notice 08-35 (July 2008).

⁵² Similar standards exist with respect to variable insurance products. Section 26(f) of the Investment Company Act of 1940, as amended, prohibits insurers from selling variable insurance products unless, among other things, the fees and charges deducted under the contracts, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurer. Accordingly, FINRA Rule 2320, which governs compensation paid with respect to variable insurance products, does not impose limits on the amount of compensation for variable insurance products sales by member firms. NASD Rule 2830 prohibits a member firm from offering or selling shares of mutual funds or certain other investment companies if the sales charges described in the prospectus are "excessive." The rule sets forth limits on the amount of charges and asset-based fees that may be charged. While the rule does not mandate quantity or cumulative discounts (also known as breakpoints), the rule's maximum limits are lowered if such discounts are not offered. Accordingly, broker-dealers selling mutual funds need to diligence the funds they wish to sell, analyze the amount of the sales charges and determine if the charges are reasonable in relation to the services provided to mutual fund shareholders. These steps should be carefully documented and maintained by the broker-dealer.

⁵³ See Notice to Members 99-81 (Sept. 1999).

⁵⁴ *Id.*

⁵⁵ See Notice to Members 05-40 (June 2005). The proposal would have permitted broker-dealers to hold contests that were based on registered representatives' total production of the sale of all securities.

⁵⁶ See Notice to Members 03-54 (Sept. 2003).

⁵⁷ In 2004, the SEC also proposed extensive point of sale and confirmation rules that would have likewise required disclosure of revenue sharing and differential compensation practices. See 1934 Act Release No. 34-49148 (Jan. 29, 2004).

⁵⁸ See Advisers Act Release 996 (Nov. 25, 1985).

⁵⁹ *Neuberger & Berman*, (pub. avail. Mar. 30, 1987).

⁶⁰ *Hornor Townsend & Kent*, (pub. avail. Apr. 4, 1995).

⁶¹ See Release 1092, *supra* note 21.

⁶² See *In re Michael C. Robertson, et al.*, Inv. Adv. Act Release No. 1581 (Sept. 26, 1996).

⁶³ See *In Re Thomas J. Bowes*, Inv. Adv. Act Release No. 1468 (Feb. 10, 1995).

⁶⁴ See, e.g., *Reinholdt & Gardner*, (pub. avail. March 25, 1971) (denial of no-action relief on the grounds that the entire proposal raised such serious questions under the anti-fraud provisions of the federal securities laws as to render doubtful the possibility that meaningful disclosure could be made).

⁶⁵ See, e.g., *American General Capital Planning, Inc.*, (pub. avail. Sept. 18, 1976); and *American General Capital Planning, Inc.*, (pub. avail. Mar. 21, 1977).

⁶⁶ See American General Capital Planning, Inc., (pub. avail. Mar. 21, 1977).

⁶⁷ *In re* IFG Network Securities, Inc., et al., Adm. Proc. 273 (File No. 3-11179) (Feb. 10, 2005), text accompanying notes 91-92.

⁶⁸ See Securities Industry Association, (pub. avail. Dec. 16, 2005).

⁶⁹ *Id.* at discussion of the third question.

⁷⁰ Investment Company Act of 1940 Rule 3a-4 provides a safe harbor from investment company registration for programs in which discretionary investment advisory services are provided to clients, if certain conditions are satisfied. One of these conditions requires the sponsor (or designee) to provide each client with a statement, at least quarterly, containing a description of all activity in the client's account during the preceding period, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period. Advisers Act Rule 206(4)-2 requires clients to receive an account statement, at least quarterly, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period, if the adviser has custody of client funds or securities.

⁷¹ Broker-dealers that depict or otherwise advertise the value of their advice need to be sensitive to the regulatory implications raised by such advertising under the registration provisions of the Advisers Act.