

SEC Requests Additional Information on Conduct Standards for Broker-Dealers and Investment Advisers

In 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) gave the Securities and Exchange Commission (the “SEC”) the power to adopt rules providing for a “harmonized” standard of conduct for broker-dealers and investment advisers when they provide advice to retail customers. Since that time the SEC has taken public comments and published a study on this issue and in January 2012 announced that it would seek additional input before proposing any rules. The SEC recently followed up on this promise by issuing another request for information on possible rules. Highlights of the SEC release include:

- Requests for information on the current market for investment advice to establish a baseline for consideration of regulatory changes
- An outline of, and requests for comment on, possible regulatory approaches for a uniform fiduciary standard and alternatives
- Requests for comment on other potential areas for regulatory harmonization for broker-dealers and investment advisers

Contrary to the prior request, the current request places significant emphasis on receiving quantitative and empirical data on the effects of a uniform fiduciary duty standard. The SEC release is available at <http://www.sec.gov/rules/other/2013/34-69013.pdf>. For more information regarding broker-dealer and investment adviser conduct standards, please see the following publications:

- “SEC to Seek Further Input on Broker-Dealer Fiduciary Duty Rule” available at http://www.chapman.com/media/publication/89_media.11140.pdf
- “Broker-Dealer and Investment Adviser Fiduciary Duties Under the Dodd-Frank Wall Street Reform and Consumer Protection Act; SEC Request for Comments” available at http://www.chapman.com/media/site_files/140_Fiduciary%20Duties-1.pdf
- “Fiduciary Duty—Investment Advisers and Broker-Dealers” in our publication entitled “Dodd-Frank: Impact on Asset Management” available at http://www.chapman.com/media/publication/97_media.901.pdf

Where Are We and How Did We Get Here?

As Congress discussed what would become the Dodd-Frank Act, the possibility of a uniform statutory standard of conduct for broker-dealers and investment advisers was a hotly debated topic. In the end, the House and Senate did not agree on setting a statutory duty

standard and the Dodd-Frank Act ultimately punted the issue to the SEC. The Dodd-Frank Act did this by amending the Securities Exchange Act of 1934 (the “Exchange Act”) and Investment Advisers Act of 1940 (the “Advisers Act”) to expressly permit the SEC to adopt rules that provide a standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice to retail customers. The Dodd-Frank Act

also required the SEC staff to conduct a study (the “Study”) of the legal and regulatory requirements applicable to broker-dealers, investment advisers, and associated persons who provide personalized investment advice and recommendations about securities to retail customers. For these purposes, the term “retail customer” means “a natural person, or the legal representative of such natural person, who (1) receives personalized investment advice about securities from a broker or dealer or investment adviser, and (2) uses such advice primarily for personal, family, or household purposes.”

The SEC initially published a request for public comment related to these issues in July 2010 in a release available at <http://www.sec.gov/rules/other/2010/34-62577.pdf>. The SEC used that information in connection with the Study, which the SEC released in January 2011. The Study is available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>. The SEC staff made two basic recommendations in the Study. The first was for the SEC to exercise its discretionary powers under the Dodd-Frank Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The second recommendation was for the SEC to consider harmonizing the regulatory requirements of broker-dealers and investment advisers if the staff finds, after additional inquiry, that such harmonization would provide additional investor protection.

The Dodd-Frank Act does not require the SEC to engage in rulemaking in this area, and the SEC has not formally indicated whether it intends to adopt rules, although the SEC has generally indicated that it intends at least to propose rules. After concern about a possible timetable for a rule proposal was expressed by some industry participants, former SEC Chairman Mary Schapiro suggested in January 2012 that the SEC would seek additional public comment before proposing such a rule. The SEC’s online plan of Dodd-Frank implementation had originally indicated that the SEC would propose rules implementing recommendations contained in the Study in the April to July 2011 range.

The SEC is now soliciting additional public comment before taking further action. Highlights of the SEC request summarized in this Client Alert include (1) requests for information on the current market for investment advice to establish a baseline for consideration of regulatory changes, (2) an outline of, and requests for comment on, possible regulatory approaches for a uniform fiduciary standard and alternatives, and (3) requests for comment

on other potential areas for regulatory harmonization for broker-dealers and investment advisers. We discuss at the end of this Client Alert how you can submit comments to the SEC.

SEC Seeks Information on the Current Market for Investment Advice

In order to establish a baseline for comparison for any proposed regulatory changes, the SEC is requesting information regarding the current regulatory structure of broker-dealers and investment advisers. The SEC has requested data and information comparing broker-dealer and investment adviser capacities regarding the following topics:

- characteristics and perceptions of retail customers who invest using firms in each capacity;
- types and availability of services provided to retail customers under each capacity;
- the extent to which different rules apply to the same or similar activities and the impact on retail customers;
- types of securities offered or recommended, security selections, principal trading with retail customers, analysis of customer returns, and nature, magnitude, and disclosure of conflicts of interest;
- costs to firms and to customers associated with providing/receiving investment advice;
- ability of retail customers to bring claims against firms as well as the costs and results;
- differences in state laws contributing to differences in advice to customers; and
- the extent to which retail customers are confused about the regulatory status of the two capacities.

SEC Seeks Information about Uniform Fiduciary Standard and Alternatives

As mentioned above, the SEC staff has recommended that the SEC should adopt rules that provide for a uniform standard of conduct for all broker-dealers and investment advisers. In the primary area of focus of the SEC release, the SEC is requesting information about the effects of an

adoption of a uniform fiduciary standard to both broker-dealers and investment advisers that provide personalized investment advice. The SEC outlines potential approaches to take in establishing this uniform fiduciary standard as well as alternative approaches that the SEC might take (including taking no action).

The SEC release notes that a uniform fiduciary standard of conduct has come to be understood differently by various parties. For example, some parties have assumed that such a standard would require a firm to provide the lowest cost alternative, refrain from offering proprietary products, charge only asset-based fees, and provide continuous monitoring of accounts. To address some of these issues and to establish a baseline for commenters, the SEC release sets forth certain assumptions for commenters to use in developing their responses.

Assumptions about a Possible Uniform Fiduciary Standard

Commenters using the SEC's baseline assumptions should develop their responses assuming:

- "personalized investment advice about securities" would include a "recommendation" as interpreted under existing broker-dealer regulation and any actions or communications that would be considered investment advice about securities under the Advisers Act (i.e., generally not "impersonal investment advice" or general educational tools);
- the term "retail customer" would have the same meaning as in the Dodd-Frank Act;
- any action would apply to all SEC-registered broker-dealers and SEC-registered investment advisers;
- the uniform standard would accommodate different business models and fee structures (e.g., brokers could receive commissions, no asset-based fee requirement, principal trades allowed with disclosure);
- the uniform standard would generally *not* require *either* broker-dealers or investment advisers to (1) have a continuing duty of care or loyalty after providing advice about securities or (2) provide services beyond those contractually agreed upon with the retail customer;
- offering or recommending only proprietary products or a limited range of products would not by itself constitute a violation of the fiduciary standard;
- Advisers Act Sections 206(3) and 206(4) and related rules would continue to apply to investment advisers but not to broker-dealers; and
- existing law and guidance would continue to apply to broker-dealers.

While these assumptions might shed some light on possible future SEC rulemaking, the SEC repeatedly made the point in its release that these assumptions do not suggest the SEC's policy view or the ultimate direction of possible SEC action. The SEC also noted that commenters are free to provide information using alternatives or assumptions that are different from these assumptions.

Possible Uniform Fiduciary Standard

The SEC staff recommended that the uniform fiduciary standard should provide that, when providing personalized investment advice about securities to retail customers, a broker-dealer or investment adviser must act in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser. The SEC staff further recommended that these rules (or related interpretive guidance) should address the two key components of a uniform fiduciary standard: the duty of loyalty and the duty of care.

For purposes of considering these recommendations, the SEC is seeking information on the costs and benefits of implementing a uniform fiduciary standard that would include a duty of loyalty element and a duty of care element. The SEC release states that commenters should assume that the SEC would provide detail or guidance that the duty of loyalty element would:

- require disclosure of all material conflicts of interest;
- require disclosure in a "general relationship guide" (similar to Form ADV Part 2A) to be delivered at the beginning of a retail customer relationship;
- require oral or written disclosure at the time advice is given of any material changes to existing conflicts of interest or new conflicts of interest;
- not require broker-dealers to conduct transaction-by-transaction disclosure and consent for principal trading as required of investment advisers under Advisers Act Section 206(3); and

- prohibit the receipt or payment of non-cash compensation in connection with the provision of personalized advice about the purchase of securities (no trips, prizes, sales contests).

In addition to the requirements of the duty of loyalty, the SEC stated that commenters should assume that the duty of care would impose certain minimum professional obligations upon broker-dealers and investment advisers. Commenters should assume that the duty of care would include:

- suitability requirements, including having a reasonable basis to believe that securities and investment strategy recommendations are suitable for (1) at least some customers and (2) the specific customer to whom the recommendation was made;
- product-specific disclosure, due diligence, and suitability requirements for certain product recommendations, such as penny stocks, options, debt securities and bond funds, municipal securities, mutual fund share classes, hedge funds, and structured products;
- a best execution duty; and
- a requirement that compensation must be fair and reasonable, taking into consideration all relevant circumstances.

Once again, the SEC stated that these assumptions do not suggest the SEC's policy view or the ultimate direction of possible SEC action.

Possible Alternatives to a Uniform Standard

The SEC makes clear in its release that the Dodd-Frank Act provisions do not mandate rulemaking and that the SEC has not yet determined whether to engage in any rulemaking or other action on the subject of a uniform fiduciary standard. Accordingly, the SEC is also requesting comment on several alternatives to a uniform fiduciary standard. The SEC is requesting comment on the following alternatives:

- establish a uniform requirement for broker-dealers and investment advisers to disclose (a) key facets of the services and types of products they offer and (b) material conflicts, without applying a uniform fiduciary standard;

- set a uniform fiduciary standard of conduct, as discussed above, but without extending the existing guidance and precedent under the Advisers Act regarding fiduciary duty to broker-dealers;
- establish a uniform fiduciary standard of conduct, as discussed above, but applicable only to broker-dealers;
- specify certain minimum professional obligations under an investment adviser's duty of care, without modifying the regulation of broker-dealers;
- consider models in use in other countries; and
- take no action and let existing standards continue to apply.

Key Industry Concerns

As the discussion of a possible uniform fiduciary standard has progressed since adoption of the Dodd-Frank Act, market participants have identified a number of key areas that could be significantly impacted by a uniform standard. As a result, the SEC is also seeking additional information about several of these activities, including:

- recommending proprietary products and products of affiliates;
- engaging in principal trades with respect to a recommended security;
- recommending a limited range of products and services;
- recommending a security underwritten by the firm or a broker-dealer affiliate;
- allocating investment opportunities among retail customers (e.g., IPO allocation);
- advising on a trading strategy involving concentrated positions;
- receiving third-party compensation in connection with securities transactions or distributions; and
- providing ongoing, episodic, or onetime advice.

Information about Changes Made in Response to 2007 Wrap Fee Account Rule Case

In the 2007 *Financial Planning Association v. SEC* (“FPA”) decision, the D.C. Circuit Court vacated an Advisers Act rule that excepted broker-dealers from being “investment advisers” based solely on their receipt of asset-based fees. The rule had allowed broker-dealers to offer wrap-fee and similar fee-based brokerage accounts without the accounts being treated as “advisory” accounts under the Advisers Act. Overnight, the FPA decision essentially caused broker-dealers offering fee-based brokerage accounts to treat those accounts as being subject to the Advisers Act (and the broker-dealers to be acting as investment advisers rather than merely broker-dealers). This also meant that those broker-dealers became subject to investment adviser fiduciary duties under the Advisers Act with respect to those accounts.

In its recent release, the SEC stated that the conversion of fee-based brokerage accounts to the Advisers Act’s coverage following the FPA decision presents similar issues to the imposition of a uniform fiduciary standard on broker-dealers. Accordingly, the SEC has requested information about broker-dealers that converted fee-based brokerage accounts to advisory accounts as a result of FPA; firms that independently determined to convert retail brokerage accounts to advisory accounts outside of the context of FPA; and retail customers whose accounts were converted under either of the two preceding scenarios.

SEC Seeks Information about Further Regulatory Harmonization

The second primary recommendation of the SEC staff’s Dodd-Frank Act Study is that the SEC should consider harmonizing regulatory requirements of broker-dealers and investment advisers where it could enhance investor protection. As a result, the SEC is seeking information regarding potential areas for harmonization. In particular, the SEC is seeking information on harmonization of areas such as the following:

- *Advertisements/ Customer Communications*—development of similar content standards for both broker-dealers and investment advisers, consistent internal pre-use requirements, and consistent filing requirements;
- *Use of “Finders” and “Solicitors”*—establishment of similar disclosure requirements regarding conflicts

associated with receipt of compensation for referring a retail customers;

- *Supervisory Requirements*—establishment of a single set of universally applicable requirements;
- *Licensing and Registration Requirements*—harmonizing broker-dealer and investment adviser requirements and Form ADV and Form BD disclosures, and imposition of substantive review on investment advisers prior to registration similar to broker-dealers;
- *Continuing Education Requirements*—requiring investment adviser personnel to be subject to qualification examination and continuing education requirements similar to broker-dealers; and
- *Recordkeeping Requirements*—harmonizing requirements applicable to investment advisers and broker-dealers.

What Happens Next?

Submitting Comments—You may submit comments in response to the SEC’s requests on or before July 7, 2013. You can submit comments by (1) using the SEC’s online form available [here](#), (2) email to rule-comments@sec.gov with “File Number 4-606” in the subject line, or (3) regular mail in triplicate referencing File Number 4-606 to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Before commenting, you should review the Appendix of the SEC release, because it contains special instructions on submitting data and other information that are unique to this request for comment.

Future SEC Action—After considering any information received in response to the current request, the SEC can propose specific rules under its Dodd-Frank Act rulemaking authority, take no action, or request additional information for further consideration. In her recent statement to the Senate Banking Committee on her nomination to be SEC Chairman, Mary Jo White stated that among her areas of focus would be “appropriate standards and regulations governing the conduct of broker-dealers and investment advisers when providing investment advice to retail customers.” However, the SEC has not set a timetable for consideration of any rulemaking or indicated whether it will move forward with any rulemaking.

Any rulemaking that the SEC does engage in should follow the normal SEC rulemaking process. This process would involve the SEC publishing specific proposed rules for public review and comment. Accordingly, if the SEC does move forward with rules in this area, you should have another opportunity to submit comments before the SEC takes any final action.

For more information on any of the topics discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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