

Broker-Dealer and Investment Adviser Fiduciary Duties Under the Dodd-Frank Wall Street Reform and Consumer Protection Act; SEC Request for Comments

Title IX of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) requires, among other things, the Securities and Exchange Commission (“SEC”) to conduct studies and evaluations of the effectiveness of existing 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. The Act also amends Section 15 of the Securities Exchange Act of 1934 (the “Exchange Act”) and Section 211 of the 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 Act defines “retail customer” for these purposes as a natural person (or such person’s legal representative) who receives personalized investment advice about securities from a broker-dealer or investment adviser and uses that advice primarily for personal, family or household purposes.

On July 27, 2010, the SEC published a request for public comment related to these issues and the comment period will remain open for 30 days following publication in the Federal Register. The SEC release is available at <http://www.sec.gov/rules/other/2010/34-62577.pdf>

Background

While investment advisers are generally considered to owe fiduciary duties to their advisory clients, broker-dealers have generally not been considered “fiduciaries” with respect to brokerage clients. The SEC has generally held the position that investment advisers have a fundamental obligation to act in the best interests of their advisory clients and to provide investment advice in a client’s best interests, among other things. On the other hand, broker-dealers not acting in an investment adviser capacity generally have more limited obligations with respect to brokerage clients. For example, a broker-dealer generally has a duty of fair dealing, duty of best execution, suitability requirements and certain disclosure requirements. The basic broker-dealer suitability obligation generally requires that a broker-dealer, in recommending to a customer the purchase, sale or exchange of any security, must have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of any facts disclosed by the customer as to other security holdings and the customer’s financial situation and needs. This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations and to keep such information current, however, contrary to the fiduciary obligations of an investment adviser, the broker-dealer suitability obligation generally applies only to solicited transactions and is not an ongoing obligation that applies after the recommendation of the purchase or sale transaction for a particular security. Broker-dealers are also often excluded from the definition of “investment adviser” under the Advisers Act if performance of

investment advisory services is solely incidental to the conduct of business as a broker-dealer and the broker-dealer receives no special compensation for such services. Accordingly, the current broker-dealer standards of conduct with respect to brokerage clients differ significantly from the fiduciary duties typically owed by investment advisers to advisory clients.

Required SEC Study

Section 913 of the Act requires the SEC to evaluate the effectiveness of existing standards of care for broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers and whether there are legal or regulatory gaps, shortcomings or overlaps in existing standards of care that should be addressed by rule or statute. In conducting the study, the SEC is required to examine several specific issues, including:

- Whether retail customers understand that different standards of care currently apply to broker-dealers and investment advisers, and whether such differences cause confusion;
- What substantive differences exist between such standards of care, and whether existing broker-dealer regulations and oversight provide greater or weaker protection to retail customers than regulations and oversight applicable to investment advisers;
- Whether the regulatory, examination and enforcement resources currently allocated to oversight of the standards of care applicable to broker-dealers, investment advisers and associated persons who provide personalized investment advice to retail customers are effective and sufficient;
- What standards are currently imposed by state regulators;
- What impact imposing the Advisers Act standard of care on broker-dealers potentially may have on retail customers, including access to the range of products and services offered by broker-dealers;
- What impact eliminating the broker-dealer exclusion from the definition of “investment advisor” under the Advisers Act potentially may have on the number of persons required to register under or become subject to the Advisers Act, including additional costs to broker-dealers and the applicable regulatory entities;
- What level and scope of services are currently provided by broker-dealers, investment advisers and associated persons to retail customers;
- What potential impact upon retail customers could result from changes to the standards of care with respect to protection from fraud, access to and availability of personalized investment advice and recommendations, and profitability of investment decisions; and
- Whether any other considerations are necessary and appropriate.

The SEC has six months from the date of the Act’s enactment to complete its study and deliver its report to Congress. The report is required to include input and data from public and industry sources.

Rulemaking Authority

Section 913 of the Act amends Section 15 of the Exchange Act to provide that the SEC may adopt rules to provide that when a broker-dealer provides personalized investment advice about securities to a retail customer (and such other customers as the SEC may determine), the standard of conduct for such broker-dealer with respect to the customer shall be the same as the standard of conduct applicable to an investment adviser under amended Section 211 of the Advisers Act (described below). The amendment to Section 15 of the Exchange Act further provides that the 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 standard applied to a broker-dealer. Notably, the amendment to Section 15 of the Exchange Act also specifies that nothing in amended Section 15 will require a broker-dealer or registered representative to have a continuing duty of care or loyalty to a customer after providing personalized investment advice about securities. The Act also amends Section 15 to provide that where a broker-dealer sells only proprietary products or another limited range of products, the SEC may adopt rules that require that the broker-dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer, provided that the sale of only proprietary or other limited range of products by a broker-dealer will not, in and of itself, be considered a violation of any standard of conduct adopted under amended Section 15.

Section 913 of the Act also amends Section 211 of the Advisers Act to permit the SEC to adopt rules that would provide that the standard of care applicable to broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers (and such other customers as the SEC may determine) shall be to act in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser providing the advice. Amended Section 211 also requires that in accordance with such rules any material conflicts of interest must be disclosed and may be consented to by the customer. The amended provision also requires that such rules provide that such standard of conduct be no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of the Advisers Act when providing personalized investment advice about securities, provided that the SEC may not ascribe a meaning to the term "customer" that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. Similar to amended Section 15 of the Exchange Act, amended Section 211 provides that the receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker-dealer or investment adviser.

Section 913 of the Act permits, but does not require, the SEC to adopt rules setting forth the standard of care applicable to broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. However, SEC Chairman Mary Shapiro and certain other SEC Commissioners have stated their support for such standards on several occasions.

Amended Section 15 and Section 211 both also require that the SEC (a) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers-dealers and investment advisers, including any material conflicts of interest; and (b) examine and, where appropriate, adopt rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.

SEC Requests Public Comments

As required by Section 913 of the Act, on July 27, 2010, the SEC published a request for public comment to inform its study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors. The public comment period will remain open for 30 days, following publication of the comment request in the Federal Register. The SEC release is available at <http://www.sec.gov/rules/other/2010/34-62577.pdf>

If you would like to discuss any of the issues 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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