

# NSCP CURRENTS

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## White House Proposes Harmonization of Duties for Broker-Dealers and Investment Advisers

by Scott N. Sherman and Trey Haire

### Introduction

Broker-dealers could soon be subject to a tougher standard of care under legislation proposed by the Obama Administration. The White House, in an effort to “harmonize” the regulation of investment advisers and broker-dealers, has proposed subjecting both categories to the tougher “fiduciary” standard that is already applied to investment advisers. While both broker-dealers and investment advisers believe that some standard should apply for investment advice, serious concerns exist from the industry about a possible one-size-fits-all approach by the government, and instead the need to provide a broader spectrum of duties imposed by any legislation in light of the different factual situations that exist between broker-dealers and investment advisers.

### Current Standards

According to the White House, investors cannot be blamed for confusion over the differences between investment advisers and

brokers.<sup>1</sup> As it becomes more common for brokers to give “incidental advice” in addition to their more traditional securities trading services, the roles served by the two categories becomes less distinguishable. The legal distinction between an investment adviser and broker, however, currently determines the standard that will be applied to what is often the same service.

The fiduciary duty investment advisers are subject to is widely recognized in case law and statutes. Courts have consistently held investment advisers to the heightened fiduciary duty of care with their customers.<sup>2</sup> The fiduciary standard has been honed by decades of legal precedent, beginning with the 1963 Supreme Court case *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*<sup>3</sup> Additionally, the Investment Advisers Act of 1940 (the “Investment Advisers Act”) codifies the fiduciary duty standard applied to investment advisers.<sup>4</sup> In a letter to Congress, representatives of investment advisers defined the fiduciary duty

as the following:

In simplest terms, the fiduciary duty is the obligation at all times to place the client’s interests first and to eliminate or mitigate any conflicts of interest. As fiduciaries, investment advisers have an affirmative duty to act in the best interests of their clients and to make full and fair disclosure to clients regarding conflicts of interest.<sup>5</sup>

Despite a long history of commentary and litigation, the requirements of the fiduciary standard avoid definition. The duty owed is dependent on the client’s particular facts and circumstances, but can include, for example, an obligation to monitor the performance of the client’s account and recommend, and if authorized, make, appropriate changes to the customer’s investment portfolio.<sup>6</sup> Other examples of the investment adviser’s duties are to:

- Disclose commission arrangements for selling one fund over another.
- Disclose information about how the adviser is compensated, and whether he or she has been subject

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(Continued on page 2)

**HARMONIZATION***(Continued from page 1)*

to any disciplinary actions.

- Make reasonable investment recommendations independent of outside influences, and based on the client's investment objectives, financial situation and other factors.
- If authorized, select broker-dealers based on their ability to provide the best execution of trades.
- Always place client interests ahead of its own.<sup>7</sup>

The duties owed by broker-dealers are generally more lenient in light of its more traditional history of handling non-discretionary accounts with incidental investment advice. A broker owes duties of diligence and competence in executing a client's trade orders and should give honest and complete information when recommending the purchase or sale of securities.<sup>8</sup> Brokers giving investment advice are not subject to the same type of fiduciary duty as investment advisers if the advice is "solely incidental" to their brokerage services.<sup>9</sup> Rather, brokers must ensure that an investment is "suitable" for a particular investor. Other duties that have been applied to brokers include: (1) refraining from self-dealing; (2) recommending an investment after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (3) transacting business only after receiving customer authorization; (4) not misrepresenting material facts, including facts about the securities recommended, the risks involved or the ability of the customer or the broker to limit these risks, the broker's commissions, and the broker's claimed possession of

inside information; (5) observing all industry rules, regulations, customs, and practices, including internal policies and procedures intended to protect the customer; and (6) carrying out the customer's orders promptly, in a manner best suited to serve the customer's interests, and at the best reasonably available price.<sup>10</sup> As with investment advisers, the broker's duty depends largely on the sophistication of the client, the relationship the broker has with the client, and the type of account the broker holds for the client.

**Reform Efforts**

According to reform proponents, differing standards would not be problematic if investment advisers and broker-dealers remained separate, with clearly distinct roles in serving their clients. The difference between the two intermediaries, however, is increasingly unclear, especially to clients looking simply for help managing their investments. The Obama administration has defined the issue as follows:

From the vantage point of the retail customer . . . an investment adviser and a broker-dealer providing "incidental advice" appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.<sup>11</sup>

The solution, according to the Treasury Department, is to empower the SEC to "align duties for intermediaries across financial products."<sup>12</sup> The Investor

Protection Act of 2009, proposed legislation sent to Congress in July 2009 by the Treasury Department, would amend the Securities Exchange Act of 1934 and Investment Advisers Act to allow 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 Commission 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 providing the advice.<sup>13</sup>

The Act also gives the SEC the authority to simplify disclosures regarding the relationship between investors and investment advisers and to promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes that the SEC deems contrary to public interest.<sup>14</sup>

**Conflicting Reform Goals**

While both groups agree that the same standard should apply when giving investment advice, brokers and investment advisers disagree on what that standard should be. The Securities Industry and Financial Markets Association, or "SIFMA," the brokerage industry's lobbying group, has asked Congress to define a duty of care that supersedes existing fiduciary duty standards.<sup>15</sup> SIFMA believes that Congress should "start anew" with broker and adviser regulation, and create a federal standard that will be "clearly and equally applied."<sup>16</sup> A coalition representing investment advisers,

however, has dismissed SIFMA's statements as an attempt on the part of the brokerage industry to avoid being subject to the high fiduciary standard that investment advisers have operated under for decades. In a letter to Congress, the North American Securities Administrators Association Inc., the Investment Adviser Association and the Consumer Federation of America asked Congress to ignore SIFMA's request for a new standard and instead apply the fiduciary standard required of investment advisers under existing laws and regulations.<sup>17</sup> Barbara Roper, director of investor protection at the CFA described SIFMA's motives more bluntly: "For years, they've opposed the fiduciary duty. Now they've embraced it to gut it."<sup>18</sup>

### Conclusion

Brokers and advisers agree that the time has come for regulation that provides clarity and some standardization of the duties owed by broker-dealers and investment advisers. How stringent those standards should be and how those standards should be defined is certainly up for debate depending on whom you ask. Many brokers will look forward to some kind of reform to provide more clarity in this area. According to one commentator, many investment advisers employed by brokerage houses already operate under fiduciary standards but are required to deny the fiduciary relationship with their broker-dealer clients, putting them at a competitive disadvantage compared to independent advisers.<sup>19</sup> Other broker-dealers are highly concerned about a regulation that will in essence create a fiduciary duty for all of the

industry, potentially dramatically raising the bar of obligations and corresponding liability owed by brokers to their clients.

While the health care debate subsumes Congress' attention, the financial services industry will continue lobbying Congress for reform with the different players suggesting different ways of achieving such reform. The stakes are high. If brokers become subject to a fiduciary duty standard similar to the one governing investment advisers today, brokers would potentially be forced to change the products they sell and how they sell them. Investment advisers, on the other hand, are comfortable with the standards they have operated under for many years. Standardization of some kind is the likely outcome, but the impact is yet to be determined.

1. United States Dept. of Treasury, *Financial Regulatory Reform: A New Foundation*, at 71, available at <http://www.financialstability.gov/roadtostability/regulatoryreform.html>.
2. *Norman v. Salomon Smith Barney, Inc.*, 283 F. Supp. 2d 382, 392 (S.D.N.Y. 2004).
3. 375 U.S. 180 (1963).
4. Investment Advisers Act of 1940 § 206, 15 U.S.C. 80b-9.
5. Fred Joseph, President, North American Securities Administrators Association, Barbara Roper, Director of Investor Protection, Consumer Federation of America, & David G. Tittsworth, Executive Director, Investment Advisers Association, *Letter to the Honorable Christopher J. Dodd and the Honorable Richard C. Shelby*, March 23, 2009, available at [http://www.nasaa.org/issues\\_\\_\\_answers/legislative\\_activity/correspondence/952.cfm](http://www.nasaa.org/issues___answers/legislative_activity/correspondence/952.cfm).
6. *Norman*, 283 F. Supp. 2d at 235-38.
7. North American Securities Administrators Association, *Investment Adviser Guide*, available at [http://www.nasaa.org/industry\\_\\_\\_regulatory\\_resources/investment\\_advisers/456.cfm](http://www.nasaa.org/industry___regulatory_resources/investment_advisers/456.cfm).

8. *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002).
9. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. 80b-9.
10. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 952-53 (E.D. Mich. 1978), *aff'd* 647 F.2d 165 (6th Cir. 1981); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 f.3d 266, 270 (3d Cir. 1998); Jeanne Crandall, *Establishing A Reasonable Standard of Responsibility for Broker-Customer Relationships in Securities Arbitration 2006: Taking Responsibility*, 323, 328-30 (2006); Nat'l Ass'n of Sec. Dealers Rule 2310; N.Y. Stock Exch. Rule 405.
11. United States Dept. of Treasury, *supra* note 1, at 71.
12. *Id.*
13. Investor Protection Act of 2009 §§ 913, available at <http://www.financialstability.gov/roadtostability/regulatoryreform.html>.
14. *Id.*
15. Jane J. Kim, *Fiduciary Duty Hits the Street - Sort Of*, WALL STREET JOURNAL, August 31, 2009, at A23.
16. Press Release, *SIFMA Unveils New Pro-Consumer Reforms*, Securities Industry and Financial Markets Association, July 17, 2009, available at <http://www.sifma.org/news/news.aspx?id=12442>.
17. NASAA, CFA, IAA Letter, *supra* note 5.
18. Kim, *supra* note 15.
19. See Blaine F. Akin, *B-D Reps Will Reap Benefits of Reform*, INVESTMENT NEWS, September 13, 2009, available at <http://www.investmentnews.com/article/20090913/REG/309139985>.

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