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Broker-dealers could be given a higher fiduciary standard

Brokers may hesitate when recommending transactions

Less than a week after President Obama signed the Dodd-Frank financial reform law, the U.S. Securities and Exchange Commission began soliciting comments from the public on one of the bill's more controversial topics: Whether securities brokers and dealers should be held to the same fiduciary standard that applies to registered investment advisers.

Broker-dealers are individuals engaged in the business of buying and selling securities, either for the accounts of others (brokers) or for their own accounts (dealers). Investment advisers, on the other hand, are in the business of providing advice to consumers regarding securities investments.

Investment advisers and their representatives are charged with higher duties toward those who receive their advice, as compared with broker-dealers and their representatives who simply effect transactions or trades for others.

Investment advisers have clients and they have the fiduciary duty to place their clients' interests above their own. Broker-dealers, in contrast, have customers, and they owe those customers a basic duty of fair dealing, and they must ensure the trades are suitable and are the best-executed trades available. Broker-dealers and their representatives have no obligation to place their customer's interests above their own.

The Dodd-Frank law, formally called the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires the SEC to conduct a study and evaluate whether to adopt a uniform fiduciary standard for broker-dealers and investment advisers.

The SEC must consider a dozen factors, including the potential added costs and expenses to both retail customers and broker-dealers that a common fiduciary duty would impose. The SEC could find that the costs of a uniform standard outweigh the benefits, and choose not to adopt a uniform standard.

Nevertheless, earlier comments by SEC Chairwoman Mary Schapiro favoring the uniform fiduciary standard suggest that the SEC is likely to formally adopt a fiduciary standard for brokers-dealers.

What are the likely implications of such a standard to retail consumers and purchasers of securities? Consumers will likely face at least

four developments.

First and foremost, the retail consumer's relationship to a broker-dealer will be far more tentative. A broker-dealer representative will be more hesitant to make recommendations that previously might have been considered suitable, for fear that even a suitable investment might not be in the best interests of the consumer.

The transaction could fall short of the new standard and result in liability to the broker-dealer for breach of fiduciary duty. Consumers should therefore expect that a broker-dealer will not as readily execute an order, but will take the time to ensure recommendations and trade executions have been vetted to the same degree as an investment adviser's recommendation to a client.

Second, a broker-dealer representative may actually lessen the degree to which he or she provides a consumer with personalized investment advice.

Dodd-Frank's authorization of a fiduciary standard would apply when a broker-dealer provides "personalized investment advice about securities to a retail customer" (or other such customers as the SEC designates). Broker-dealers therefore would try to refrain from giving such advice. What constitutes personalized investment advice is not totally clear, but will likely be clarified in further SEC rulemaking or by the courts. Some commentators have suggested that a broker-dealer representative doing something as basic as providing a brochure to a customer could constitute personalized investment advice.

Third, retail consumers should expect broker-dealers to advise them that their relationship is strictly limited to the specific trade or transaction. Dodd-Frank specifies that a fiduciary relationship would be limited to the instance of a particular trade, and that neither a broker, dealer nor registered representative would have a "continuing duty of care or loyalty to the customer after providing personalized investment advice."

Accordingly, broker-dealers will likely pro-



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vide disclaimers specifying that the relationship with the customer terminates after each and every trade.

Fourth, certain consumers will benefit from broker-dealers and their representatives having a heightened duty, especially in certain gray-area investments that are of marginal suitability for certain customers.

For example, variable annuities, which are often marketed to middle-market consumers, have

been called one of the worst retirement investments a person can make. They tend to have low flexibility and high costs in both fees and tax treatment. Broker-dealer representatives often receive higher commissions for selling variable annuities as compared to competing products.

Absent the fiduciary standard, a self-interested representative might more readily make the case that a variable annuity is suitable for a customer. However, if representatives have a duty to put their customers' interests before their own, they may be less likely to recommend such a product.

The majority of the initial responses to the SEC's request for public comments has come from registered brokers and are negative. The conscientious broker-dealers say that the existing safeguards are sufficient to protect investors.

Whether the SEC ultimately adopts a uniform standard among broker-dealers and financial advisers remains to be seen. Even if the common fiduciary standard is not adopted, consumers can expect for now a more guarded approach by broker-dealers as they effect transactions on behalf of their customers (and now quasi-clients) and await the SEC's final rule.

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