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News Bulletin

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A Fiduciary Duty for Broker-Dealers? How Dodd-Frank May Change the Way Broker-Dealers Conduct Business

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Although much attention has been focused on how the Dodd-Frank Act will affect banks, it also has significant implications for broker-dealers. In particular, the Dodd-Frank Act takes a giant step towards imposing a fiduciary duty upon broker-dealers when they conduct business with retail customers. While the Dodd-Frank Act does not immediately impose a fiduciary standard on broker-dealers, it empowers the SEC to do so. SEC Chairman Mary Schapiro stated in a speech on July 9 that "I have long advocated such a uniform fiduciary standard and I am pleased the legislation would provide us with the rulemaking authority necessary to implement it."[1]

Background

Historically, broker-dealers have generally not been considered "fiduciaries," even when dealing with retail customers. Investment advisers, on the other hand, are considered "fiduciaries" and already have an obligation to act in their customers' best interests. The SEC has notified investment advisers that they:

> "have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients' best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client…"[2]

Because broker-dealers are excluded from the definition of "investment adviser" unless they charge separately for their advice, broker-dealers are not required to comply with these "fiduciary" standards. The standards of conduct currently applicable to broker-dealers derive from many sources, including agency law, the "shingle" theory, antifraud provisions of the securities laws and the rules and regulations of the SEC and self-regulatory organizations such as FINRA. Broker-dealers have a duty of fair dealing, duty of best execution, suitability requirements and various disclosure requirements. While such duties and requirements provide some degree of investor protection, they fall short of the "fiduciary" standards described by the SEC.

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[1] Chairman Mary L. Schapiro, "Remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals" (July 9, 2010), available at http://www.sec.gov/news/speech/2010/spch070910mls.htm.

[2] See "Information for Newly-Registered Investment Advisers" (Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations) available at http://www.sec.gov/divisions/investment/advoverview.htm.

Provisions in the Dodd-Frank Act

The Dodd-Frank Act represents a compromise between the House bill, which would have eliminated the exclusion for broker-dealers from the definition of investment advisers, and the Senate bill, which called for further study of the issue. While the Dodd-Frank Act does not impose a fiduciary duty, it includes a number of measures that will likely hasten the day when some form of fiduciary duty will be imposed upon broker-dealers. Section 913 of the Dodd-Frank Act:

- Requires the SEC to undertake a study and issue a report to Congress within six (6) months regarding the effectiveness of existing legal and regulatory standards of care for brokers, dealers, investment advisers, and associated persons who provide personalized investment advice to and recommendations about securities to retail customers.
- Authorizes the SEC to commence rulemaking based on the findings of its study.
- Empowers the SEC to adopt rules now that would require broker-dealers to comply with the standards of conduct applicable to investment advisers when providing personalized investment advice about securities to retail customers.
- Empowers the SEC to adopt rules now requiring broker-dealers to notify retail customers and obtain their acknowledgement or consent when the broker-dealer provides only a limited range of investment products.
- Directs the SEC 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.
- Directs the SEC to promulgate rules prohibiting or restricting 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.
- Amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to provide the SEC with authority to bring enforcement actions against broker-dealers or investment advisers in respect of personalized investment advice provided to retail customers using the standards of conduct applicable under either Act.

The Dodd-Frank Act defines "retail customer" as a natural person, or the legal representative of such a person, who receives personalized investment advice about securities from a broker or dealer or investment advisor and who uses such advice primarily for personal, family, or household purposes.

While the Dodd-Frank Act stopped short of delineating a "fiduciary" standard for broker-dealers, it clearly points in the direction of imposing such a duty, albeit one which may be modified from common law concepts of fiduciary duty. In that regard, the Dodd-Frank Act appears to contemplate that at least some conflicts of interest between broker-dealers and their clients may be resolved through disclosure and consent. Moreover, the Dodd-Frank Act specifically states that commission-based compensation and offering a limited range of products will not, in and of themselves, be deemed a breach of a broker-dealer's duty of care to retail customers. In addition, the Dodd-Frank Act provides that broker-dealers will not be deemed to have a continuing duty of care or loyalty to the retail customer after providing personalized investment advice about securities.

Potential Impact on Broker-Dealer Business Practices

As the SEC undertakes its study and considers potential new rules and standards, it may be prudent to consider how imposition of a "fiduciary" standard on broker-dealers could impact certain practices.

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Trading with a Retail Customer on a Principal Basis

Broker-dealers may act as agents or principals in their dealings with customers. While they currently must disclose the capacity in which they are acting, when trading as a principal they are generally not required to disclose their mark-up (except for riskless principal transactions and situations where the broker has a fiduciary relationship with the client). Will a new fiduciary standard require retail customers to provide a written consent before the broker-dealer may trade on a principal basis (as is currently the case with investment advisers)? Will disclosure of mark-ups be required? Will the broker-dealer have to provide other disclosures regarding its economic "stake" in the securities to be purchased or sold on a principal basis in order to discharge its duty?

Offering Proprietary Products

Broker-dealers offering proprietary products of the firm or its affiliates might be required to provide notice to each retail customer and obtain the consent or the acknowledgement of the retail customer. Will such notice need to explain to the retail customer any additional incentives that the broker-dealer's registered representatives may have to sell proprietary products? How much detail in this regard would be necessary to discharge a fiduciary obligation?

Making Recommendations to Retail Customers

While broker-dealers currently must ensure that any recommendations they make are suitable for the customer, there is a potential gap between what is "suitable" and what is "in the best interests" of the client. How will a broker-dealer determine what is in the best interests of the client? Will more extensive background information and more frequent consultations be required to meet this standard? Is a "best interests" standard realistic where the broker-dealer has a limited mandate and is one of many securities professionals working with the client?

Initial Public Offerings

When pricing an initial public offering, underwriters generally try to establish a price that balances the interests of the issuer and the purchasers in the IPO. In undertaking this process, investment bankers are traditionally viewed as independent actors who are not operating under any fiduciary duty. In fact, underwriting agreements typically include a disclaimer of any fiduciary duty to the issuer, in part to address the decision of the New York Court of Appeal in the eToys case. Imposition of a fiduciary duty for dealings with retail customers may complicate an underwriter's ability to strike a fair balance between the issuer and the purchasers, perhaps leading to the exclusion of retail customers from participating in IPOs.

Preference of Certain Customers over Others

If a broker-dealer makes an attractive investment opportunity available to certain customers, but not to others who might have an interest, would the broker be violating a duty of loyalty to the excluded clients?

Conclusions

Unless and until the SEC exercises its rulemaking authority, the impact of the Dodd-Frank Act on broker-dealers will remain unclear. Any new rules promulgated by the SEC are likely to have a significant effect on broker-dealers who have retail clients and the rulemaking process should be closely monitored.

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