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A Work in Progress: Evolving Responsibilities in the Retail Broker-Dealer/Customer Relationship

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The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (Dodd-Frank Act or Act) has accelerated the process of erasing the distinction between a registered investment adviser and a "mere" broker whose advisory services have traditionally been considered only incidental to the brokerage relationship. The Act is audacious in its scope and embraces virtually all aspects of the financial services universe—from executive compensation to advertising and securities brokers to mortgage lenders. Indeed, it has been called the "most sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression."[2]

Broker-dealers and investment advisers are heavily regulated, but the regulatory regimes differ and the two groups have been subject to different standards under federal law when providing investment advice. Retail investors generally are not aware of these differences or their legal implications.[3] Many investors are also confused by the different standards of care that apply to investment advisers and broker-dealers. The experienced practitioner understands that jurors and many arbitrators often do not grasp the distinctions. Compared to a breach of fiduciary duty claim, assessing the merits of a breach of contract or fraud claim may seem like simplicity itself.

Section 913 of the Act requires the Securities and Exchange Commission (SEC) to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them in providing personalized investment advice or recommendations to retail customers[4], and determine whether any gaps or shortcomings should be addressed by rule or statute. The Act provides that the SEC's study must consider, among other things:

- Whether retail customers understand or are confused by the differences in the standards of care that apply to broker-dealers and investment advisers;
- The regulatory, examination, and enforcement resources required to enforce standards of care;
- The potential impact on retail customers if regulatory requirements change, including their access to the range of products and services offered by broker-dealers;
- The potential impact of eliminating the broker-dealer exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940 (Advisers Act); and

- The potential additional costs to retail customers, broker-dealers, and investment advisers from any changes in regulatory requirements.

Regardless of what the SEC ultimately does with the results of this study, one thing is now clear: broker-dealers will be held to the same fiduciary standard of conduct applicable to an investment adviser under Section 211 of the Advisers Act.

Evolution of the Duty of Care

With the demise of *caveat emptor* following the first great wave of regulatory legislation in the 1930s, a broker-dealer's responsibility to its customers was often referred to as the "know your customer" rule. This principle was embodied in NYSE Rule 405 and the suitability rule promulgated by the Financial Industry Regulatory Authority (FINRA), f/k/a the National Association of Securities Dealers, Inc.[5] [6]. Broker-dealers and their associated persons are also subject to requirements that are designed to protect customers from abuses that may not be fraudulent but are nonetheless viewed as unethical. These abuses are generally characterized as being inconsistent with "just and equitable principles of trade." Violating these principles may subject a firm and its registered employees to disciplinary sanctions by the applicable regulator, but they are not generally viewed as giving rise to a private right of action by an investor.

California Sets a Standard

Historically, regulators and the courts viewed the suitability obligation through a transactional prism and considered the broker to have no fiduciary obligation to a customer with a non-discretionary account. While the broker was required to have a reasonable basis to believe a recommendation was appropriate for a particular customer based upon information provided to it by the customer, the broker was not required to conclude that a given recommendation was the "best," nor did it have any obligation to monitor the investment subsequent to purchase to ensure that it remained in the customer's interest to continue to own it. A crack in the wall separating the "mere broker" from a fiduciary adviser first appeared in several decisions of the California courts.[7] It is likely that Section 913 of the Dodd-Frank Act will lead to the establishment of nationwide rules that will already be familiar to a California broker, lawyer or regulator.

The seminal California case to find that a broker could, in certain circumstances, be a fiduciary was *Twomey v. Mitchum, Jones & Templeton, Inc*.[8] The customer in *Twomey* was a widow with no previous securities experience who told her broker that she could not afford a loss of principal and was relying on her investments for income. The broker told her to sell her entire portfolio (at a loss) and proceeded to make investment recommendations over the next year, which the customer invariably followed. On the facts presented, the Court found that a confidential relationship existed between the stockbroker and the client.

The leading California case to address this question after *Twomey* was *Duffy v. Cavalier*.[9] Unlike the inexperienced widow plaintiff in *Twomey*, the customers in *Duffy* were the trustees of a corporate profit-sharing plan. The defendants argued that, under California law, brokers do not owe a fiduciary duty to a sophisticated customer. The Court disagreed, holding that a fiduciary duty exists in every broker-customer relationship. However, the scope or extent of that duty depends on the facts of the specific case. The *Duffy* Court ruled that, where a broker does not control the activity in the account, its fiduciary obligation is essentially satisfied if the broker can show that it complied with the NASD's suitability rule[10] and, if the customer gave an instruction that the broker concluded was unsuitable, warned the customer of the risks.

Other Jurisdictions Reluctant to Follow California's Lead

Courts in other jurisdictions have been less ready to pin the fiduciary label on a broker who does not exercise discretion or control over the account. *De Kwiatkowski v. Bear Stearns & Co., Inc.*[11] is a prominent example of the majority view. In that case, De Kwiatkowski, a wealthy investor, sued his broker for negligence and breach of fiduciary duty relating to futures trading in his account. After a trial, a jury awarded De Kwiatkowski $111.5 million in damages. The Court of Appeals reversed, finding that there were no "special circumstances" that would justify holding the broker liable under either theory of liability, even though the broker provided substantial advisory services with respect to the size, timing, and placement of multiple complex transactions.

It may be useful to note that, notwithstanding the California courts' willingness to embrace the notion that every brokerage relationship is fiduciary in nature. while most other courts have rejected such a sweeping rule, virtually every court to have considered the question agrees that the inquiry is highly fact specific. In California, the onus may be on the broker to narrow the scope of its responsibility, whereas the Second Circuit seems to say that it is incumbent on the complaining customer to demonstrate "special circumstances" that might give rise to a fiduciary claim. In any event, to allege that someone is a fiduciary is only the beginning of the inquiry.

Effect of Dodd-Frank

At first blush, attorneys representing retail customers may view the enactment of the Dodd-Frank Act as a significant leg-up in establishing liability where a claim that a defendant broker has breached a duty of trust and confidence to the customer has been adequately pleaded. However, at least in the context of an arbitration claim, where motions to dismiss are not favored, fact finders may already be holding brokerage defendants to a higher standard than the law requires, particularly where the customer is not sophisticated or the investment is complex. The RAND study (*see* footnote 3, *supra*) suggests that juries may be inclined to do the same, notwithstanding instructions to the contrary.

Conversely, counsel for the broker-dealer must acknowledge that the stakes have increased since the legal issue is no longer whether a fiduciary duty exists but the scope of that duty in light of the specific facts of the case. Until the SEC proposes and adopts the rules called for by the Act, and the courts have an opportunity to flesh out the proper application of the statute and the related rules, counsel will have increased challenges as it evaluates and applies the new standards. Clearly, the practical implications of the Act are unclear in this area.

During calendar year 2010, FINRA reported that approximately one-fifth of all securities arbitration claims were disposed of after a hearing. The balance were either settled or withdrawn. The increased uncertainty created by the Act suggests that pressure to resolve claims by settlement will only increase. Although arbitration remains less costly and faster than litigation in court, it is nonetheless expensive and time consuming.[12] Increased uncertainty and the reality that nearly 80 percent of cases settle should cause litigants to make every effort to develop their cases, exchange discovery, and consider settlement as early in the process as possible. A skilled and knowledgeable mediator can often be a valuable aide as parties seek to value and resolve complex or high-dollar value cases.

Next Steps

Section 913(g) of the Dodd-Frank Act contains numerous carve-outs to the fiduciary obligations it establishes, which appear to be a legislative recognition that customer sophistication,

experience, and explicit understandings with a broker should inform the degree, but perhaps not the nature, of the duty owed by the broker to the customer. Furthermore, the statutory mandate that the SEC evaluate the effectiveness of existing legal or regulatory standards of care, and whether any gaps or shortcomings should be addressed by rule or statute, underscores that we are in uncharted territory.

Section 913(g) makes clear that the SEC has broad authority to establish the scope of the duty owed and the means by which the duty may be discharged. For example, the statute permits, but does not require, the SEC to promulgate rules to provide that the standard of conduct with respect to a retail customer be the same as the standard of conduct applicable to an investment adviser under section 211 of the Advisers Act.

In January 2011, the SEC Staff issued a study to evaluate and make recommendations to the SEC regarding whether it should adopt a uniform standard of care for providing personalized investment advice and recommendations about securities to retail customers (Study). The Study recommended that the SEC establish a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers—i.e., 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. As with most sweeping pronouncements of overarching policy, the devil is in the details.[13]

The Study explicitly recognizes that SEC rulemaking should be flexible and accommodate different existing business models and fee structures, preserve investor choice, and not decrease investors' access to existing products or services or existing service providers. Significantly, the Study expresses the Staffs' belief that eliminating the broker-dealer exclusion from the definition of "investment adviser" in the Advisers Act and applying the duty of care and other requirements of the Advisers Act to broker-dealers would not provide the SEC with a flexible, practical approach to addressing which standard should apply to broker-dealers and investment advisers when they are performing the same functions for retail investors.

In comments to the press after addressing the Practicing Law Institute's "SEC Speaks" conference, SEC Chairman Mary Schapiro acknowledged that "[w]e have a lot of work to do ahead of us before we actually take a pen to paper and figure out what we might do in terms of writing any specific rule." Chairman Schapiro stated that the Study "was really very much the first step in what will be a process."[14]

On January 21, 2011, SEC Commissioners Kathleen Casey and Troy Paredes issued a statement opposing the Study, stating that the Study "fails to adequately justify its recommendation that the Commission embark on fundamentally changing the regulatory regime." They also stated that they did "not believe the Study fulfills the statutory mandate of Section 913 . . . to evaluate the 'effectiveness of existing legal or regulatory standards of care' applicable to broker-dealers and investment advisers.'" They expressed their view that the Study "should be viewed as a starting point for further research and consideration, rather than as forming the primary basis for rulemaking. Before the Commission proposes rules in this area, more rigorous analysis—rooted in economics and data—is needed to avoid unintended consequences."[15]

In remarks prepared for presentation at the Practicing Law Institute's SEC Speaks conference in Washington, D.C. in February 2011, Commissioner Casey expressed her view that the SEC may not have enough time to do a thorough job writing the rules required by the Act. She stated that "[t]he real threat here is that we are not able to fully consider the rules we are adopting." She went on to say that

the burden on the SEC is six times that imposed by Sarbanes-Oxley, making that law seem "almost quaint in comparison."[16]

In comments at the OneVision FSI Broker-Dealer conference in Phoenix in January 2011, FINRA President and CEO Rick Ketchum agreed that creating and enforcing a uniform fiduciary standard will not come quickly or easily. Ketchum predicted that whatever new legislation and enforcement rules are eventually rolled out will take place in pieces. "It's difficult for me to imagine a legislative process playing out any time before September or October and that's extremely ambitious," he said.

It is also an open question how the new standards will be monitored, defined, and enforced. Clearly, the securities industry and the self-regulatory organizations will want a seat at the table as regulators consider issues such as what constitutes "personalized investment advice" and the types of conflicts and other disclosures that may be required.

In the meantime, issues relating to fiduciary obligations, conflicts of interest, and disclosure are likely to move front and center as civil litigants begin to chart these largely untested waters. Until the rulemaking and the legislative process plays out and the courts formulate their view of this new regime, the rights and obligations of broker-dealers and their customers are subject to increased uncertainty. The risks of litigation have clearly increased for both sides. The thoughtful client and the nuanced litigator have much to think about.

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[1] Pub. L. 111-203, H.R. 4173.

[2] Obama's Financial Reform Plan: The Condensed Version, Wall Street Journal, June 17, 2009.

[3] In 2008, the RAND Institute for Civil Justice released a study commissioned by the SEC: http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf. One of the more interesting findings of the RAND study was that most retail customers did not understand the distinction between a non-fiduciary broker-dealer and a registered investment adviser, even after the difference was explained to them.

[4] For purposes of the Act, a "retail customer" is defined as "a natural person, or the legal representative of such natural person, who—(1) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes."

[5] These rules are generally based on the SEC's antifraud authority under the Securities Act of 1933 and the antifraud provisions of the Securities Exchange Act of 1934.

[6] FINRA has recently amended its Rules, effective October 1, 2011, to combine the FINRA and NYSE suitability and know your customer requirements. New Rule 2111 requires member firms and their associated persons to have "a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer…." This assessment must be "based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile, including, but not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." Perhaps the most dramatic change in the Rule is that it moves beyond a recommendation to buy or sell to include the requirement that the broker have a reasonable basis for recommending an overall investment strategy or a recommendation to continue to hold a position.

[7] *See, e.g.*, *Twomey v. Mitchum, Jones & Templeton, Inc., infra.*

[8] 262 Cal. App.2d 690, 69 Cal. Rptr. 222 (1968).

[9] 215 Cal. App.3d 1517, 264 Cal. Rptr. 740 (1989).

[10] NASD Rules of Fair Practice, Article III, Section 2. Effective October 7, 2011, the "suitability rule" has been amended and designated as Rule 2111.

[11] 306 F.3d 1293 (2d Cir. 2002).

[12] The average FINRA arbitration that was resolved after a hearing took 15 months from filing the Statement of Claim until the rendering of an award by the arbitrators. Larger, more complex cases probably took longer than average to obtain an award, while small, relatively straightforward matters probably moved more quickly.

[13] For example, the Act provides that the receipt of commission or other standard compensation shall not be a violation of the broker's obligations to its customer and that the broker has no continuing duty of care or loyalty to the customer after providing personalized investment advice. The statute explicitly recognizes that the broker may have interests that are in conflict with its customer's interests, and directs the SEC to facilitate the provision of simple and clear disclosures regarding the terms of the relationship, including material conflicts of interest.

[14] "SEC In No Great Rush To Write Fiduciary Rule," InvestmentNews.com/article/20110204/FREE/110209928.

[15] Statement Regarding Study on Investment Advisers and Broker-Dealers by Commissioners Kathleen L. Casey and Troy A. Paredes, *U.S. Securities and Exchange Commission,* January 21, 2011.

[16] Address to Practicing Law Institute's Sec Speaks in 2011 Program by Commissioner Kathleen L. Casey, *U.S. Securities and Exchange Commission,* February 4, 2011.