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SEC's Proposed Uniform Fiduciary Standard for Financial Advisers: An Update

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Introduction

It has been three years since the Securities and Exchange Commission, acting under the authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, released the results of its study recommending a uniform fiduciary standard for the conduct of registered representatives and investment advisers.[i] While SEC Chair Mary Jo White has proclaimed that adoption of a uniform fiduciary standard was a major regulatory priority, the SEC has yet to promulgate final regulations implementing the change.[ii] Additionally, the SEC's 2014 regulatory agenda listed "Personalized Investment Advice Standard of Conduct" as a "long term action" and as priority number 40 out of 43, suggesting that other initiatives were higher priorities.[iii]

Historically, registered representatives have not been held to a fiduciary standard unless they have written discretion to manage their customers' funds.[iv] On the other hand, investment advisers, who typically execute money management agreements with their clients, have been held to a fiduciary standard. Investment advisers have a fiduciary duty to act in their clients' best interests and to place the interests of their clients before their own. As part of this fiduciary responsibility, "an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to clients."[v]

The fiduciary standard also requires advisers to extend the duties of care and loyalty to their customers. The duty of loyalty is "to act in the best interests of clients and to avoid or disclose conflicts."[vi] In other words, advisers are prohibited from putting their own interests, or those of their firms, ahead of their clients. The duty of care requires an adviser to "make a reasonable investigation to determine that [the adviser] is not basing [his] recommendations on materially inaccurate or incomplete information."[vii] Investment advisers, as fiduciaries, must "seek best execution for their clients' securities transactions when they have the responsibility to select broker-dealers to execute client trades."[viii]

The Proposed Fiduciary Standard for Registered Representatives

Following passage of the Dodd-Frank Act in 2010, the SEC issued a report concerning: (1) the effectiveness of the existing legal and regulatory standards of care for brokers, investment advisers, and associated persons; (2) whether the existence of different standards of care causes confusion for retail customers; and (3) whether the SEC should develop rules to address existing legal and regulatory standards.[ix] The SEC report recommended adoption of a uniform fiduciary standard for both investment advisers (who are currently held to such a standard) and registered representatives (who currently are not). As of this writing, the Commission is considering whether or not to implement the proposed standard.

The SEC report noted that retail customers are confused by the roles of investment advisers and broker-dealers, and do not understand the differences in the standards of care applicable to investment advisers as compared to brokers.[x] This confusion is "compounded by the fact that retail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[xi] The report notes the importance of uniformly protecting retail investors "when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer." Therefore, the report recommends implementation of "a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers."[xii]

The concept of holding retail registered representatives to the same fiduciary standard as advisers has been debated for years. Investor advocates have long lobbied for a fiduciary standard. Seth Lipner, a claimants' lawyer and a founder of the Public Investors Arbitration Bar Association (PIABA), argues that the existing Financial Industry Regulatory Authority (FINRA) suitability rule "doesn't go far enough."[xiii] Holding brokers to a fiduciary standard would require them to act in the best interests of their clients, even when it conflicts with the brokers' own interests.[xiv] Other claimants' advocates have argued that the current FINRA suitability rule fails to regulate conflicts in which brokers' financial interests influences their recommendations to clients. As one critic argues, under the current rules, "[t]he broker is free to recommend inferior options that compensate the broker more generously, rather than what's best for the investor."[xv] Adoption of a fiduciary standard for registered representatives would "prevent securities firms from selling investment products that a firm created or for which it is receiving extra compensation."[xvi]

Securities industry professionals have weighed in with concerns about the proposed uniform fiduciary standard. According to *Financial Advisor* magazine, the Securities Industry and Financial Markets Association (SIFMA) does not oppose adoption of a fiduciary standard for brokers, but some broker-dealers urge that a fiduciary standard of care should be carefully crafted to account for the unique role of registered representatives.[xvii] A SIFMA spokesperson has written "that the federal fiduciary standard of care [should] preserve investor choice and investor access to a broad range of products and services."[xviii] According to *Investment News*, some brokers worry that "a fiduciary standard would force them to dump less profitable clients or adopt a fee-only business model."[xix] A fee-based compensation structure makes wealthy clients more lucrative than middle-class investors. Furthermore, broker-dealers are concerned that a fiduciary standard could diminish the promotion and sale of the firm's own products.

Gary Sanders, vice president of securities and state government relations for the National Association of Insurance and Financial Advisors (NAIFA), suggests that adoption of a uniform standard could lead to increased costs. He warns that "applying the fiduciary standard to broker-dealers as it is now applied to investment advisers would add to brokers' compliance and liability costs, with no certainty of additional protection for investors."[xx] Higher costs could incentivize some brokers to cease offering commission-based accounts in favor of more lucrative accounts that compensate brokers based on a percentage of the investors assets, leaving "many lower- and middle-income investors without anyone to turn to for investment advice."[xxi] In the words of one financial advisor: "If you impose a fiduciary standard on agents like myself, you'll take us out of the market and make our services unavailable to middle America. . . . I'm sure my E&O coverage would go up substantially, and I can't afford to talk to my clients without them helping to cover that overhead."[xxii]

The SEC report acknowledges the potential increased costs to broker-dealers in order to comply with a new standard. Costs of compliance would include amending disclosures, training, policies, and monitoring procedures, as well as developing new account documentation.[xxiii]

Some broker-dealers might potentially opt to reregister as registered investment advisers, whereby brokerage accounts could be converted into advisory accounts subject to advisory fees. Alternatively, broker-dealers could unbundle their services and instead offer them through affiliates or third parties, also resulting in increased costs.[xxiv] These increased costs, according to the SEC report, would likely be passed on to the firms' customers.[xxv]

Implementation of the Fiduciary Standard

Another question is how a fiduciary standard would be implemented, and whether it would impact current FINRA suitability rules. Would imposition of a fiduciary standard upon registered representatives affect suitability analysis? Would a fiduciary standard result in a two-step analysis consisting of, first, an analysis of suitability and, second, a determination of whether the broker breached a fiduciary duty? A fiduciary standard for registered representatives could potentially heighten the scrutiny at an arbitration or disciplinary hearing beyond "Was the recommendation reasonable?" to "Was it the best recommendation for the customer?"

An additional issue is that registered representatives are bound and regulated by FINRA suitability requirements, but investment advisers are not. This raises concerns in light of the SEC's suggestion that a universal standard is necessary to provide clarity to the current confusion as to the difference in standards for brokers and investment advisers.[xxvi] This confusion, in the public's view, may depend on the changing roles of registered representatives and investment advisers -- and which investment professionals are actually making recommendations to buy, sell or hold securities. A uniform standard, however, may not be the solution that the SEC is looking for. To the extent that investment advisers and registered representatives have different roles and serve different functions, it may not alleviate confusion to apply the same legal standard to their conduct, as investment advisors may, in some circumstances, be called upon to answer for FINRA suitability requirements.

One possible solution to investor confusion would be to task FINRA with the responsibility of providing oversight of investment advisers currently regulated by the SEC and the states. This concept, currently under consideration by the SEC, is causing concern among investments advisers, accountants, and state securities regulators, who oppose the move. According to former SEC Commissioner Luis Aguilar, such a move would "amount to outsourcing the SEC's regulatory mission and would be more costly than increasing the SEC's resources to oversee advisers."[xxvii] The American Institute of Certified Public Accountants further warns that FINRA has a "perfunctory approach to enforcement" and that the agency might be biased against investment advisers during compliance exams.[xxviii] FINRA, naturally, is confident that oversight would be improved under its jurisdiction.

Conclusion

It is unclear whether or when a universal fiduciary standard will be adopted. Adoption of a uniform fiduciary standard could lead to the expansion of arguments available to claimants' counsels in FINRA arbitrations. Arbitration hearings could become more complex in order to adjudicate and determine multi-leveled claims for suitability and breach of fiduciary duty.

As discussed above, the SEC's initial push for a universal fiduciary standard has met some resistance. Investment News reported in September 2014 that SEC Commissioner Michael Piwowar was "leaning against a rule that would require all financial advisers to adhere to the 'best interests' fiduciary standard, and instead favors strengthening disclosure."[xxix] According to Piwowar, "[I]t is not clear that changes in the regulations applicable to broker-dealers and investment advisers are necessary, including the adoption of a uniform fiduciary standard."[xxx]

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[i] Jessica Holzer, SEC Study Lifts Bar for Brokers, Wall St. J., Jan. 24, 2011, at C4; Study on Investment Advisers and Broker-Dealers (Jan. 2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf [hereinafter SEC Report].

[ii] Mark Schoeff Jr., SEC's Mary Jo White's Top Priority: Uniform Fiduciary Standard, Investment News, Feb. 21, 2014, http://www.investmentnews.com/article/20140221/FREE/140229975/secs-mary-jo-whites-top-priority-uniform-fiduciary-standard.

[iii] Stephanie Quiñones, Uniform Fiduciary Standard for Broker-Dealers: An Update, The Securities Edge, Mar. 4, 2014, http://www.thesecuritiesedge.com/2014/03/uniform-fiduciary-standard-for-broker-dealers-an-update/.

[iv] See DeKwiatkowsky v. Bear Sterns & Co., 306 F.3d 1293 (2d Cir. 2002); Barbara Black and Jill Gross, Making it Up as They Go Along: The Role of Law in Securities Arbitrations, 23 Cardozo L. R. 991(2002).

[v] SEC Letter from the Office of Compliance Inspections and Examinations, May 1, 2000, *available at* http://www.sec.gov/divisions/ocie/advltr.htm.

[vi] SEC Report, supra note 1, at 106.

[vii] SEC Report, at 121.

[viii] SEC Report

[ix] SEC Report, at 1-4.

[x] SEC Report, at 101.

[xi] SEC Report

[xii] SEC Report

[xiii] Seth Lipner, FINRA's New Suitability Rule Doesn't Go Far Enough, Forbes.com, Oct. 26, 2010, http://www.forbes.com/2010/10/26/suitability-rule-sec-intelligent-investing-finra.html.

[xiv] Holzer, supra note 1.

[xv] Suzanne Barlyn, What's No. 1 for Brokers? Wall St. J. Online, Dec. 6, 2010, http://www.wsj.com/articles/SB10001424052748704658204575610790180711052.

[xvi] Lipner, supra note 18.

[xvii] Brokers, Advisors Spar Over Fiduciary Standard, Financial Advisor, Aug. 17, 2010, http://www.fa-mag.com/news/brokers-advisors-spar-over-fiduciary-standard-5805.html.

[xviii] Id.

[xix] Mark Schoeff Jr., Battle Lines Drawn After SEC Backs Fiduciary Standard, Investment News, Jan. 22, 2011, http://www.investmentnews.com/article/20110122/FREE/110129976.

[xx] Daisy Maxey, Ruling Near on Fiduciary Duty for Brokers, Wall St. J., Apr. 13, 2014, *available at* http://www.wsj.com/articles/SB10001424052702304679404579459831342132534.

[xxi] Maxey, supra.

[xxii] Mark Schoeff Jr., Fiduciary Duty Rule: No Way Out, Investment News, Jul. 13, 2014, http://www.investmentnews.com/article/20140713/REG/307139999/fiduciary-duty-rule-no-way-out.

[xxiii] SEC Report, supra note 1, at 156.

[xxiv] SEC Report at 159.

[xxv] SEC Report at 162.

[xxvi] Holzer, supra note 1.

[xxvii] Jessica Holzer, Adviser Deal Eludes SEC, Wall St. J., Jan. 11, 2011, at C7.

[xxviii] Id.

[xxix] Mark Schoeff Jr., SEC Commissioner Piwowar Leans Against Fiduciary-Duty Rule, Investment News, Sep. 30, 2014, http://www.investmentnews.com/article/20140930/FREE/140939989/sec-commissioner-piwowar-leans-against-fiduciary-duty-rule.

[xxx] Id.