

Executive Summary

January 2011 SEC Report to Congress: Study on Investment Advisers and Broker-Dealers¹

I. Background

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)² required the Securities and Exchange Commission (“SEC” or “Commission”) to, among other things, conduct a study evaluating:

- a. The effectiveness of existing laws and rules of the SEC, self-regulatory organizations (“SROs”) and state regulators covering investment advice to retail clients of broker-dealers (“BDs”) and investment advisers (“IAs”);
- b. Whether there are legal or regulatory gaps or other problems in the protection of retail investors related to the standards of care for providing personalized investment advice.

Two of the five-member Commission issued a dissenting opinion upon release of the report stating their opposition to its release, although not necessarily its findings, due to the need for further study.³

Among the 14 items considered in the study:

- Whether investors understand the differences in standards of care between brokers and advisers;
- Resources available to enforce standards of care;
- Potential impact on investors if rules change, including access to products and services offered by broker-dealers; and
- Potential new costs to investors and industry resulting from changes to regulation.

II. Overview of Securities Industry

- a. Investment Advisers.

¹ See Staff of the U.S. Securities and Exchange Commission, “Study on Investment Advisers and Broker-Dealers,” January 2011, at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

² See Sec. 913, “Study and Rulemaking Regarding Obligations of Brokers, Dealers and Investment Advisers,” Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>, at 449.

³ See SEC Commissioners Kathleen L. Casey and Troy A. Paredes, “Statement Regarding Study on Investment Advisers And Broker-Dealers,” January 2011, at <http://www.sec.gov/news/speech/2011/spch012211klctap.htm>.

- i. More than 11,000 IA firms are registered with the SEC, managing more than \$38 trillion for 14 million clients.
 - ii. Another 15,000 smaller IA firms, in terms of assets under management, are state-registered.
 - iii. Combined, there are more than 275,000 IA representatives of both SEC and state-registered IA firms.
 - iv. Approximately 88 percent of IA representatives are affiliated with dually registered BDs.
- b. Broker-Dealers.
- i. 5,100 BD firms with 109 million retail and institutional accounts.
 - ii. Some 18 percent of BDs are registered with SEC or state as IAs.

III. Regulation of Investment Advisers and Broker-Dealers.

- a. IAs are fiduciaries with twin duties of loyalty and care, as well as suitability obligations; regulation is ‘principles-based.’
- b. IAs must fully eliminate conflicts and/or disclose all material facts.
- c. Nearly all BDs are overseen by the Financial Industry Regulatory Authority (“FINRA”), an SRO.
- d. Central to SRO rules governing the conduct of BD representatives are suitability obligations and, under certain circumstances, a fiduciary duty to customers.

IV. Examination and Enforcement Resources.

- a. Office of Compliance Inspections and Examinations (“OCIE”) examines IAs under a ‘risk-based’ approach.
- b. FINRA has primary responsibility for inspecting BDs; SEC has additional authority but generally does not examine firms on a routine basis.
- c. States examine smaller IAs and coordinate BD examinations with SEC and FINRA.
- d. Both SEC and state securities commissioners have shared authority to investigate fraud.

V. Retail Investor Perceptions.

- a. Many investors find the standards of care confusing.

- b. Many are uncertain about the meaning of various titles and designations used by IAs and BDs.

VI. SEC Staff Recommendations.

- a. Commission should adopt a ‘uniform fiduciary standard’ for brokers and advisers, consistent with requirements under Dodd-Frank Act, when providing personalized investment advice about securities to retail customers.
- b. Uniform fiduciary standard should be “no less stringent than currently applied to IAs under sections 206(1) and (2) of the Investment Advisers Act of 1940 (“Advisers Act”)
- c. Notes fiduciary standard for BDs under Dodd-Frank does not necessarily:
 - i. Preclude receipt of commission-based compensation;
 - ii. Preclude the sale of proprietary products; or
 - iii. Require a continuing duty of care or loyalty by BDs after providing advice.
- d. Standard of Conduct.
 - i. All BDs and IAs, when providing personalized investment advice to retail customers, shall act in the best interest of the customer without regard to the financial or other interest of the firm.
- e. Implementation. Rulemakings or Interpretive guidance should:
 - i. Address the principal components of a fiduciary standard, i.e., duties of loyalty and care;
 - ii. Consider the new standard to be an overlay of existing regulation;
 - iii. Continue to apply previous interpretations established under the Advisers Act and through enforcement actions; and
 - iv. Provide specific examples of ‘potentially relevant and common material conflicts of interest’ through rulemaking and interpretations.
- f. Duty of Loyalty.
 - i. SEC should facilitate disclosure of ‘uniform, simple and clear disclosures about terms of relationships and material conflicts; and
 - ii. Certain conflicts should be prohibited.

- g. Duty of Care.
 - i. SEC should specify uniform standards;
 - ii. Minimum ‘baseline standards’ could include specifying the basis for making a recommendation.
- h. Principal Trading.
 - i. SEC should provide guidance on how BDs should act as fiduciaries when engaged in principal trading.
- i. Personalized Investment Advice.
 - i. SEC should explain what it means by ‘personalized investment advice about securities.’
- j. Investor Education.
 - i. SEC should consider additional investor education outreach to complement regulation.

VII. Harmonization of BD/IA Regulation.

SEC should harmonize regulations covering BDs and IAs in the areas of:

- Advertising and other communications;
- Use of solicitors;
- Supervisory requirements;
- Licensing and registration of firms;
- Licensing and CE requirements for IA or BD reps; and
- Books and records.

VIII. Alternatives to a Uniform Fiduciary Standard.

- a. Repeal of BD exclusion from Advisers Act.
- b. Impose Advisers Act standards and rules on BD firms.

IX. Cost Analysis

- a. Study concludes that projecting costs from regulatory changes would be difficult to quantify.
- b. Report provides different scenarios with general commentary on how changes in standards or regulation may affect consumer choice and compliance costs.

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For more information and commentary on the SEC's study, visit the fi360 blog: http://blog.fi360.com/fi360_blog/2011/01/fi360-comments-on-the-sec-fiduciary-study.html