The Shape of Things to Come under a Uniform Fiduciary Standard for Brokers and Advisors

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The regulatory regimes for brokers and advisors providing retail advice almost certainly will converge. Under a uniform standard, brokers who give personalized investment advice to their retail clients will be accountable as fiduciaries for their advice and the existing fiduciary obligations of investment advisors will necessarily evolve in the alignment process. The imperative for a uniform fiduciary standard is driven by three decisive points:

1. Financial service representatives performing essentially the same services should be subject to the same regulatory strictures.
2. When personalized investment advice is provided to clients, fiduciary obligations arise and advice-providers should understand and be held accountable to fiduciary principles.
3. Existing regulatory regimes do not uphold the premises captured in points 1 and 2.

While change seems inevitable, the timing and details remain in question. This article provides an historic context for the regulatory standards of care imposed on brokers and advisors, and it describes the forces that are likely to shape the uniform fiduciary standard that will govern advice to retail investors in the future.

Definition of a Fiduciary

While there is no universally accepted definition of a fiduciary in the industry, the Securities and Exchange Commission (SEC) emphasizes the broad duties of loyalty and care owed by advisors to their clients as defining elements of what it means to be a fiduciary (SEC 2011, iii). The duty of loyalty requires the advisor to serve clients’ best interests. This includes the obligation to seek to avoid conflicts of interest and, at a minimum, to fully disclose all conflicts of interest that could impact the client-advisor relationship (SEC 2011, 22–23). A duty of care translates into forming recommendations based upon sound due diligence including “the use of methods and techniques that take into account principles, theories, customs and conventions generally accepted by the investment management community,” or, in other words, a duty of prudence in applying theory to real situations (SEC 2011, 23).

The Origin of the Fiduciary Debate

Investment advisors have been fiduciaries to their clients since Congress enacted the Investment Advisers Act of 1940, the last in a series of Depression-era securities laws. Two years earlier, broker-dealers providing investment recommendations and advice on securities transactions were subject to retail market regulation under an amendment to the Securities and Exchange Act of 1934 called the Maloney Act of 1938. The Maloney Act led to the creation of the National Association of Securities Dealers and other self-regulatory organizations (SROs) to establish market rules for customer transactions; NASD merged with the New York Stock Exchange in 2007 and was re-named the Financial Industry Regulatory Authority (FINRA).1

For more than half a century, investment advisors and broker–dealers operated as largely distinct segments of the financial services marketplace. Advisors provided advisory services with fiduciary accountability. Brokers facilitated securities transactions, often offering research and recommendations in the process.

In the early 1990s, with the advent of wrap-fee programs that offered one combined fee for portfolio management and transaction costs, brokerage and investment advisory services became inextricably intertwined, both in regulation and competition for assets (SEC 1994). Many broker-dealer sponsors of wrap-fee programs began to register as investment advisors and treated wrap-fee customers as advisory clients. However, other nondiscretionary wrap-fee programs began operating as “fee-in-lieu-of-commission” accounts on a nonfiduciary basis under the assumption that the advice rendered could be considered “solely incidental” to the transactions involved (SEC 1999).

In 1999, the SEC proposed and eventually adopted an exemption from the Advisers Act for the latter advice programs of broker–dealers, leading to vigorous opposition from advisor and consumer groups claiming an unlevel playing field in the accountability standards for investment advice. The rule was known in advisor quarters as the “Merrill Lynch Rule” due to the large amount of assets held at that firm, or “Rule 202” to the brokerage industry. In Financial Planning Association v. SEC (482 F.3d 481, 493), the association sued...
and the rule was vacated in 2007. Since then the debate has continued almost unabated, eventually being caught up in financial reform legislation.

**SEC “913 Study” on Regulatory Regimes Focuses the Fiduciary Debate**

In the wake of the 2008 financial crisis, the Obama administration called for a fiduciary standard for brokers to be added to legislation intended to reform Wall Street (Kim and Lucchetti 2009). The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted in 2010 and included a provision known as “Section 913” that required the SEC to conduct a study to, among other things, evaluate existing regulation covering investment advice to retail clients of broker–dealers and investment advisors, and identify any legal or regulatory gaps related to the standards of care (Dodd-Frank 2010, 449). The study has been commonly referred to as the 913 Study, and since its release on January 21, 2011, it has renewed the fiduciary debate.

In greatly understated fashion, the 913 Study describes the “regulatory schemes for investment advisers and broker–dealers [as] designed to protect investors through different approaches” (SEC 2011, iii). Investment advisers, the staff notes, are fiduciaries to their clients, and regulation under the Advisers Act is principles-based (SEC 2011, iii). As fiduciaries, investment advisers owe their clients a singular duty of loyalty. Broker–dealers, in contrast, generally are not subject to a fiduciary duty to their clients under federal securities laws (SEC 2011, 54). Brokers are agents of their firms and owe primary loyalty to their employers and are regulated according to SRO rules based on, among other things, principles of fairness and transparency (SEC 2011, iii). They are permitted to offer advice that is “solely incidental” to a securities transaction in a nonfiduciary capacity as long as they receive no “special compensation” for their advice (SEC 2011, 15). However, courts have held that broker–dealers with discretionary control over customer assets, or in a relationship of trust and confidence with customers, owe customers a fiduciary duty (SEC 2011, 54).

The fundamental difference that investment advisors generally are fiduciaries and most broker–dealers are not, is lost on most investors. In the 913 Study, the staff noted that “… retail customers do not understand and are confused by the different roles played by investment advisers and broker–dealers, and more importantly, the standards of care applicable to investment advisers and broker–dealers when providing personalized investment advice and recommendations about securities … Investors have a reasonable expectation that the advice that they are receiving is in their best interest” (SEC 2011, 101).

The core recommendation of the 913 Study is for “the Commission [to] engage in rulemaking specifying a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers under the Advisers Act Sections 206(1) and (2) that would apply to broker–dealers and investment advisers when they provide personalized investment advice about securities to retail investors” (SEC 2011, 101). The standard, according to SEC staff, should provide that both act “in the best interest of the customer without regard to the financial or other interest” of the firm providing the advice (SEC 2011, 109–110), and be accompanied by interpretive guidance regarding application of the duties of loyalty and care. The new standard also would rely on past SEC guidance and enforcement actions under the Advisers Act, and case law (SEC 2011, 112). Essentially, SEC staff would apply the current overlay of advisor regulation to personalized investment advice of brokers.

The 913 Study by no means ended the fiduciary debate. Two of the five-member Commission issued an unusual dissenting opinion opposing its release, although not necessarily its findings, stating that further empirical research on its costs and benefits was needed before making a recommendation (Casey and Paredes 2011).

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Given the lack of consensus among the SEC commissioners, and the highly publicized dissent, the staff recommendations must be viewed in that light, i.e., a useful starting point for framing the outlines of a uniform fiduciary standard, but not necessarily the likely outcome. The final rule may be substantially different, and indeed may even be challenged in court once it is adopted by the SEC (Protess 2011).

As late as March 2009, the main industry advocate for the brokerage industry, the Securities Industry and Financial Markets Association (SIFMA), had questioned the effectiveness of a fiduciary standard for brokerage advice. But soon thereafter, SIFMA and FINRA swung over to publicly support a uniform fiduciary standard. Although the insurance industry

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continues to question the need for a uniform fiduciary standard, the debate appears to have shifted to general support, with the current discussion over the boundaries and application of a fiduciary standard in practice.

It is therefore instructive, for purposes of assessing the potential impact of a standard on the wealth management profession, to review the staff analysis of a fiduciary standard in the 913 Study and the current exchange of industry comment letters regarding its application in practice.

The extent to which the duty of care applies to personalized investment advice no doubt will be debated intensively by the industry. The report provides only a few examples of what may and may not be deemed an investment recommendation under the fiduciary standard.

Duty of Loyalty–Disclosure

With regard to disclosure requirements, SEC staff recommended creation of uniform, clear disclosures, and a general “relationship guide akin to the new Form ADV Part 2A.” SEC staff also suggested consideration of a summary disclosure form outlining key information at the onset of the engagement, as well as guidance on specific disclosures made at the time of an investment recommendation. More importantly, staff suggested the commission should consider rules to prohibit or mitigate certain conflicts, or to impose specific disclosure and consent requirements, consistent with a duty of loyalty (SEC 2011, 117).

Of significant interest is the staff statement, as noted above, that the customer’s interest should come first, “without regard to the financial or other interest” of the party providing the advice. This would suggest a heightened duty of loyalty not unlike the requirement under the Employee Retirement Income Security Act of 1974 (ERISA) that a fiduciary shall discharge his duties with respect to a plan solely in the interest [emphasis added] of the participants and beneficiaries.3

Duty of Loyalty–Principal Trading

SEC staff also noted that the conflicts of interest inherent to principal trading by broker–dealers, i.e., distributing primary or secondary issues out of inventory to a firm’s customers, also would need to be addressed. Staff suggested that, at a minimum, brokers should disclose conflicts but not necessarily follow the specific notice and consent procedures for advisors under Sec. 206(3) of the Advisers Act (SEC 2011, 120). This would appear to follow the same requirements as Temporary Rule 3(T), which is scheduled to lapse at the end of 2012 (SEC 2007).

Duty of Care

The principal focus of SEC staff with respect to the duty of care appears to be the suitability of investment recommendations, such as “specifying what basis [the broker/advisor] should have in making a recommendation” (SEC 2011, 123). The report does not discuss in any detail interpretations of a duty to assure investment costs are reasonable, unlike the “exclusive purpose” rule under ERISA requiring fiduciaries to incur only reasonable expenses in the discharge of their duties. SEC staff has, however, traditionally stressed a requirement for advisors to seek best prices in trade execution, and not incur unnecessary brokerage costs and charges (SEC 2012). The extent to which the duty of care applies to personalized investment advice no doubt will be debated intensively by the industry. The report provides only a few examples of what may and may not be deemed an investment recommendation under the fiduciary standard (SEC 2011, 124–126).

Dodd-Frank Limitations

The Dodd-Frank Act preserves several key activities of the broker-dealer business model under a uniform fiduciary standard that otherwise may come into conflict with the dictum that the broker serves the client’s best interest. These provisions note that the standard would not necessarily preclude receipt of commission-based compensation and the sale of proprietary products, nor would the standard necessarily require a continuing duty of care or loyalty after providing personalized investment advice.

Opposing Perspectives That Likely Will Shape the Uniform Fiduciary Standard

SIFMA renewed the debate over a uniform fiduciary standard in a comment letter from Ira Hammerman submitted to the SEC on July 14, 2011 (Hammerman 2011, 2012). The letter suggested a framework for a “newly articulated standard” that would not apply existing SEC staff guidance, legal precedent, or case law under the Advisers Act to broker–dealers, but instead would provide a set of principles and a series of specific rules that SIFMA contends would be “no less stringent” than the legislative requirements set forth under Dodd-Frank when providing personalized advice. SIFMA also noted the need for a definition of personalized investment advice and preserving principal transactions under the broker-dealer model.

A coalition of investment advisor, financial planning, and consumer groups submitted a detailed rejoinder eight
Prospects for a New Standard

The proposed fiduciary rule, or perhaps a concept release by the SEC, which now appears more likely, no doubt will lead to additional debate on the boundaries of a fiduciary standard. Currently, the trajectory of this discussion appears to be toward the application of a best-interest standard to broad areas of investment advice by brokers.

The timing, however, is anything but certain, given the political pressure by the House of Representatives and industry groups questioning the pace and costs versus benefits of rulemakings at the SEC and other agencies amid a heated presidential contest. It is uncertain at this point whether the commission will even proceed with a rulemaking in 2012. Regardless, the imperative for reform presented at the outset of this article, in combination with competitive forces, practical realities, and industry posturing, has created enough momentum that it would be virtually impossible for a complete reversal in course—even in the case of a complete repeal of the Dodd-Frank Act, as pledged by presidential candidate Mitt Romney (2012).

months later (Consumer Federation of America et al. 2012). While agreeing generally with the core principles spelled out by SIFMA, the group strongly opposed bypassing application of existing standards under the Advisers Act to brokers and strongly supported the need for a fiduciary standard flexible enough to address unanticipated conflicts. The letter also decried what it called “scenario planning” that was requested by SIFMA in the form of “bulky, complex and rigid rules that would be vulnerable to gamesmanship” (Consumer Federation of America et al. 2012, 11).

Finally, the opponents’ letter reviewed the list of activities that SIFMA recommended as nonfiduciary activities of a broker-dealer and strongly disagreed with, or qualified, the conditions under which activities would be subject to a fiduciary standard. Figure 1 shows activities that would and would not be covered under the fiduciary standard as defined by SIFMA versus those that would be covered if the standard established under the Advisers Act would be extended to cover all advisory activities.

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**FIGURE 1: CONTRASTING VIEWS OF A UNIFORM FIDUCIARY STANDARD FOR RETAIL ADVICE**

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<th>SIFMA PROPOSED UNIFORM STANDARD*</th>
<th>ALTERNATIVE MODEL**</th>
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<td>Advice on debit card, cash sweep, margin lending services</td>
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<td>Market making, absent buy/sell recommendations</td>
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<td>Underwriting, absent security recommendation</td>
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<tr>
<td>Referring customers to affiliated service providers</td>
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<td>Executing unsolicited customer orders</td>
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<td>Firm website used for self-directed trades</td>
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* Detailed descriptions of SIFMA recommendations may be found on page 18 of July 14, 2011, letter to SEC Chairman Mary Schapiro, at http://www.sec.gov/comments/4-606/4606-2952.pdf.

** Based on the author’s interpretation of investment advisory activities that would generally be subject to a fiduciary standard under current regulation (Investment Advisers Act of 1940).
Wealth managers would be well-advised to follow ensuing developments. Already accustomed to a fiduciary duty under the Advisers Act, wealth managers holding discretionary authority of client accounts should assume that the fundamental requirement of acting in the client’s best interest will not change significantly, even if they are dually registered as broker-dealer affiliates. However, dual-registrants should keep in mind that any new SEC regulation is likely to clarify that incidental investment advice as a registered representative will be subject to a fiduciary standard.

Conversely, the compliance requirements for independent advisors (those not affiliated with a broker–dealer) may change significantly, depending upon whether the SEC takes a detailed rules-based approach in defining fiduciary duties, maintains the traditional principles-based approach that leaves certain conflicts up to the professional discretion of the adviser to resolve, or seeks compromise through a mix of rules and interpretive guidance.

Nothing will better prepare wealth managers for the future, no matter their regulatory affiliations, than establishing procedures that comply with the highest standards possible. By following a consistent, prudent process across the board for all clients, and carefully documenting the fiduciary decision-making process, wealth managers will ensure constancy in the midst of a sea-change in regulation.

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References


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