

A Fiduciary Duty for Broker-Dealers?

(The Dodd-Frank Act)

August 2010

Disclaimer

- Regulatory reform legislation (the Dodd-Frank Act) will effect sweeping changes for financial institutions
- Many sections mandate that studies be conducted and that agencies undertake significant rule-making
- A full assessment of the impact will only be capable of being made as some of the rule making advances

Overview

- Implements changes to regulatory supervision
 - a new Consumer Financial Protection Bureau
 - a Financial Stability Oversight Council
 - abolishes the OTS
- Introduces a systemic risk and resolution process
 - Applicable to non-U.S. institutions that have organized their U.S. activities under a U.S. holding company
- Creates a new nomenclature
- Requires stricter regulatory capital requirements
- Regulates OTC derivatives

Overview (cont'd)

- Subjects many more private funds to SEC registration
- Requires or proposes that rules be implemented to strengthen investor protection
 - standard of care for broker-dealers
 - disclosures for retail products
- Implements the Volcker Rule
- Implements changes affecting the securitization market and interactions with, and the regulation of, credit rating agencies
- Requires a number of corporate governance changes

Background

- Broker-dealers have generally not been considered “fiduciaries”
- Investment advisers, on the other hand, are considered “fiduciaries” and have an obligation to act in their customers’ best interests
 - Investment advisers “have a fundamental obligation to act in the best interests of clients and to provide investment advice in the clients’ best interests”
- Broker-dealers are not required to comply with these “fiduciary” standards
 - While their duties and requirements provide some degree of investor protection, they fall short of the “fiduciary” standards described by the SEC

Provisions of the Act

- Section 913
 - Requires that the SEC undertake a study and issue a report to Congress within six months regarding the effectiveness of existing legal and regulatory standards of care for brokers, dealers, investment advisers, and associated persons that 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
 - require broker-dealers to notify retail customers and obtain their acknowledgement or consent when the broker-dealer provides only a limited range of investment products

Provisions of the Act (cont'd)

- 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

Potential Impact on Broker-Dealer Business Practices

- Trading with a retail customer on a principal basis
 - Broker-dealers 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
 - Will a new fiduciary standard require retail customers to provide a written consent before the broker-dealer may trade on a principal basis?
 - Will disclosure of mark-ups be required?
- 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
 - How much detail in this regard would be necessary to discharge a fiduciary obligation?

Potential Impact on Broker-Dealer Business Practices (cont'd)

- Making recommendations to retail customers
 - 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 client’s best interests?
 - Will more extensive background information and more frequent consultations be required to meet this standard?
- Initial public offerings
 - 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 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 Act on broker-dealers will remain unclear
- Any new rules by the SEC are likely to impact broker-dealers who have retail clients
- Rulemaking process should be closely monitored