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FOR: The Institute for the Fiduciary Standard

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SUBJECT: A Discussion of Some of the Differences Between the Regulatory Requirements of Brokers and RIAs

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SUMMARY

Relatively little discussion has occurred to help investment advisors, policy makers and investors understand the differences and similarities, as currently required in law, between a fiduciary relationship and an arm's length transaction.

An arm's length relationship requires a minimum level of care in the free market, where *caveat emptor* generally rules. The firm or broker has no duty to further a customer's interests. Requirements of "fair dealing" and "good faith" do apply and generally prohibit dishonest conduct by both parties.

In contrast, the authentic fiduciary standard requires the RIA to always put the best interest of the client first, fully disclose all important facts and conflicts, and then manage any unavoidable conflicts in the investor's interest.

While both brokers and RIAs are required to follow certain practices (best execution, supervision, etc.) in the main, the standards are more different than similar. It is not only that these standards impose different duties, but they represent opposing sides of the transaction. In the commercial contractual transaction, the broker is generally obligated to represent the interests of a manufacturer; in the fiduciary relationship the advisor is always obligated to put the client's best interest first. (1)

These differences reflect requirements established in law. While it is clear that many brokers voluntarily exceed the minimum legal requirements of registered reps, the fact remains that the magnitude of the difference between what is required of a broker in contrast to what is required of an investment adviser is substantial and is pertinent to investors.

So much so that FINRA CEO Richard Ketchum has publically expressed concerns about firms' products and services that, he suggests, seemed designed to only meet "a minimum standard of acceptability" as opposed to the "best interest of the customer." (2) It is this precise difference between the minimum standard of acceptability and the fiduciary standard best interest that needs to be fleshed out more clearly.

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INTRODUCTION

A discussion of the differences in the standards of investment advisers and brokers is essential amidst the calls for "harmonizing" the two. This paper seeks to highlight how these two standards differ in terms of the legal requirements and duties imposed on advisers and brokers.

REGULATORY REQUIREMENTS OF A BD

Suitability

The suitability standard is based on a broker having "reasonable grounds for believing that the recommendation is suitable" based on the facts, "if any", of the customers situation. (3) In addition, brokers are prohibited from sales activity involving "any manipulative, deceptive, or other fraudulent device or contrivance." They must "deal fairly with the public". (4) The SEC has reinforced the importance of a fair dealing standard by applying the "shingle theory," a contractual theory. Shingle theory simply notes that "even a dealer at arm's length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public". (5)

Arm's Length Transactions

The suitability standard and the general regulatory requirements of a BD draw immediate and apparent similarities to an arm's length transaction. The arm's length transaction binds most commercial transactions between a customer and a company, and it is fundamentally different from a fiduciary relationship. *Registered Rep* magazine notes this difference, "Reps are required only to select investments for their clients that are suitable, while [investment advisers] must act as fiduciaries, putting the interests of their clients before their own when selecting investments. The fiduciary standard is a tougher standard to meet...." (6) For example, the "suitability" standard generally lets brokers recommend products that pay the broker far higher commissions or fees – as compared to a lower cost product of equivalent quality – and the broker is not required to disclose the two products price differences to the customer.

This lower suitability standard has prompted FINRA Chief Richard Ketchum to express concern, " In recent years, business practices have evolved to a point where for some firms products and services were being offered not on the basis of whether they were in the best interest of the customer, but whether they met a minimum standard of acceptability. We have seen this with a variety of structured products, in which there was no change in the business model, despite a dramatic change in the business climate." (7)

Ketchum recommends BDs should 'think fiduciary,' when he states, "Product committees need to be institutionalized. And the committees need to broaden their focus to look at not just whether a product is acceptable…(but also) I urge you to view your responsibilities in a true fiduciary spirit."

Caveat Emptor

In an arm's length relationship, the principle of *caveat emptor* ("let the buyer beware") generally governs. This age-old principle describes the essence of the rules of a free market. Parties are presumed knowledgeable and capable. The nondisclosure of material facts may be permitted. This means that the customer's burden to be vigilant in examining the product or service before buying is imperative. Further, neither party is legally obliged to further or consider the commercial or financial interests of the other. Still, both parties have basic duties. All conduct must be conducted in "good faith" and entail "fair dealing". Fraud is prohibited and dishonesty is prohibited. (8)

Commercial in Nature

Generally, characterizing the fundamental legal obligation of brokers as parallel to the legal obligations established in law in an arm's length relationship is not in dispute. As Scholar Tamar Frankel notes, "B/ds are regulated as contract parties subject to fairness treatment of customers, although under some circumstances they were held liable as fiduciaries..." (9) Further, a staff member from the National Conference of Commissioners on Uniform State Laws put it succinctly when he noted, "A contract between a financial advisor or consultant and a client is a service contract that is commercial in nature. This is its fundamental nature." (10)

FIDUCIARY RELATIONSHIPS

The fundamental nature and unique importance of a fiduciary relationship has been described often. Judge Benjamin Cardozo may have stated it most eloquently:

> *Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior [for fiduciaries]… Uncompromising rigidity has been the attitude of the courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions…* (11)

While the Investment Adviser Act did not in its text use the term "fiduciary duty"; the Supreme Court did in 1963. (12) Here the court explained:

> *A fundamental purpose common to these statutes [securities legislation enacted in the 1930s and 1940] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.(186) ... investment advisers could not completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless all conflicts of interest between the investment counsel and the client were removed.(187)*

The court concluded, simply:

> *The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship."* **38** *(189)*

FDR and Wall Street – A Moral Issue?

President Roosevelt inspired the moral purpose of the Advisers Act. The context for this opinion by the Court is even better appreciated when bearing in mind President Roosevelt's views on the need for regulating the markets after the stock market crash. In fact, from the outset FDR viewed reforming Wall Street as much a moral issue as a regulatory issue. The importance of applying "social values more noble than mere monetary profit" and restoring "honesty", "honor" and the "sacredness of obligations" to business and Wall Street were part of the new president's call to action in his first inaugural address. As one researcher pointed out, a major objective of FDR had been his 'purpose to aid the honest businessman and to assist him in bringing higher standards to this particular corner of the business community...' (13)

The authentic fiduciary standard currently established in law reflects the views noted above and comprises the legal duties essential to maintaining the "Punctilio of an honor" called for by Cardozo. This standard recognizes the inherently unlevel playing field between the investment adviser and client, one in which the client has far greater reliance on the investment adviser "expert" than does a customer in a typical commercial transaction. In its essence, fiduciary status exists to mitigate the information asymmetry between providers of socially important services that require a high level of expertise, such as law and medicine, and consumers of these services.

The fiduciary relationship is thus based on trust and confidence and premised on the fiduciary discharging duties of care, utmost good faith and loyalty. While far-reaching in its scope, six key duties have been crafted that seek to embody the most important elements of an investment fiduciary's duties. These principles are: (14)

- Serve the client's best interest
- Act in utmost good faith
- Act prudently -- with the care, skill and judgment of a professional
- Avoid conflicts of interest
- Disclose all material facts
- Control investment expenses

THE DIFFERENCES BETWEEN ARM'S LENGTH AND FIDUCIARY RELATIONSHIPS

Some industry representatives stress "similarities" between the two standards are important. One paper suggests that the "broker-dealer regulatory scheme…clearly reflects fiduciary principles" and that, from recent FINRA "guidance", there can be no doubt that (this guidance's) DNA flows from fiduciary principles and the policy rationales on which those principles are based." (15) The paper says that the guidance "frequently reflects the following core fiduciary or quasi-fiduciary principles". (16) They note six "principles":

- Just and Equitable Practices
- Suitability of Recommendations
- Best Execution of Transactions
- Fair and Balanced Disclosures to Investors
- Supervision
- Training

Are These Tasks Fiduciary Principles?

In light of the nature of a fiduciary relationship and six key principles reflecting fiduciary duties, it should be readily apparent that five of these six practices (17) are either not directly relevant to true fiduciary conduct, or inconsistent with fiduciary conduct. (Best execution practices may, arguably, be quasi fiduciary in that it exceeds a fair dealing standard.)

The remaining practices, while shared with RIAs, are not fiducial in nature. For example, *product sales training and supervision*, on their face, are more akin to management practices aimed to prevent fair dealing violations than fiduciary principles. (16) The remaining three principles, as they are widely understood, are far more illustrative of an arm's length relationship than a fiduciary relationship. The issue of *suitability* was discussed above. *Just and equitable practices* and *disclosures* merit comment.

Just and Equitable Practices

This practice refers to the duty to observe "high standards of commercial honor and just and equitable principles of trade." What is a high standard of commercial honor? It's not defined, but it appears to parallel an arm's length transaction and equate to fair dealing.

Fair dealing, as noted above, is mainly defined by the conduct that it prohibits: lying, stealing, and cheating. In the absence of this prohibited conduct, a party will generally meet the requirements of fair dealing and "high standards of commercial honor." Hence, violations of suitability, churning, and various fraudulent activities will constitute violations of this principle. For example, in May, 2009 FINRA charged six former brokers with fraud, unsuitable recom-mendations, and exercising discretion without authorization in connection with selling CMOs. The FINRA complaint also charged a violation of "high standards of commercial honor." (18)

Disclosures

The level of disclosures required of brokers and RIAs differs in kind, not degree. Brokers' disclosure obligations are focused on providing a "fair and balanced" portrayal of risks and benefits of products in oral presentation and sales materials, while RIAs' disclosure requirements are focused on written disclosures of potential and real conflicts of interest, fees, and expenses. The larger point, however, is that the role of disclosure in the two regimes differs materially. The focus of broker disclosure on product characteristics allows customers to make informed product choices; the focus of RIA disclosure on conflicts allows clients to make better advisor choices.

WHY THE LEGAL REQUIREMENTS OF BROKERS AND RIAs ARE NOT "MORE SIMILAR THAN THEY ARE DIFFERENT"

Suggesting that the legal requirements of brokers and RIAs are "more similar than they are different" is only accurate in a relatively narrow sense. As mentioned above, some practices are required of both brokers and RIAs, and in certain instances a broker's exercise of discretion or control over assets is deemed fiduciary.(19)

More broadly, the differences are clear and material. As was noted in the "Rand Report", "Unlike a contractual duty (which allows a party relatively broad discretion to pursue its own self interest, subject to a loose 'good faith' constraint) fiduciary duties require a heightened duty to act on another's behalf, in good faith, with honesty, with trust, with care, and with candor." (20)

The meaning of *loyalty* for the client in fiduciary law and the meaning of *caveat emptor* and 'fair dealing' for the customer in commercial contract law place these principles (and the standards) in their clearest possible focus. Their differences are in their "fundamental natures." In the commercial transaction, the broker may generally put his own best interest first; in a fiduciary relationship, the adviser must put the client's best interest first. In essence, the broker and adviser fill opposing roles.

These opposing roles have practical consequences for investors. The RIA is required to put investors' best interests first, act in a prudent manner; disclose conflicts and all important facts; avoid or manage in the investor's interest all material conflicts; disclose fees and control expenses; follow and document a due diligence process; and diversify investments. A broker, meeting the minimum legal requirements, is generally not bound by these requirements. (21)

THE "OPPOSING" ROLES OF BROKERS AND RIAS AS DESCRIBED IN THE PUBLIC DISCUSSION

The opposing roles of brokers and RIAs are not well articulated in the public discussion. While the fiduciary standard is typically – and not effectively – characterized as 'putting investors best interests first', the suitability standard is typically – and also not effectively – characterized as 'requiring brokers to make suitable recommendations. This brief explanation of the fiduciary standard is accurate; the explanation of the suitability standard is inaccurate on its face, and arguably misleading. Putting investors best interest first, while a fair characterization, fails to

communicate to most investors the significance of the standard, for numerous reasons. The most relevant reason may simply be that most investors are so distrusting of both Washington and Wall Street that words such as “clients best interest” are essentially “tuned out” by investors. They are not heard. (22)

Suitability or *suitable* in their common usage mean “proper”, “able” or “qualified.” Synonyms for “suitable” include “capable” “fit” and “good”, for example. (23) It is very difficult to square this common usage meaning with the wide range of products that “meet” the suitability standard.

CONCLUSION

In this memo I have reviewed the key characteristics and differences between the two standards that form the basis of investor protections. These differences are generally clear and material. If investor protections are to be strengthened in rule-making within the Securities and Exchange Commission and the Department of Labor, the differences between the two standards must be understood. The principles of the authentic fiduciary standard must be protected and reinforced.

The imperative to ensure the future integrity of the fiduciary standard in investor/adviser relations is far more important than much public discussion regarding fiduciary duties suggests. This imperative is hardly captured in the generally articulated “difference” between a standard that requires a “best interest” recommendation as opposed to a standard that requires the equivalent of a “good” recommendation. Nor is the gravity of the future of retirement savings in clear enough focus when so much attention is on whether there will be sufficient access and choice of products for brokerage customers under a uniform fiduciary standard (even when no reliable data has been offered to suggest access and choice will be limited to the detriment of investors.)

The question of whether a strong uniform *standard*, one based on the clients best interest and the *trust* and *confidence* that flows from unwavering loyalty, can help reduce conflicts and investment expenses, restore investor participation in capital markets, market integrity, and capital formation needs far more attention. It should be the investor protection regulatory issue of 2012.

NOTES

1. Attorney Michael Koffler stresses the competing loyalties of brokers, how many BDs “serve as principals of their own account or as agents” of others. “These broker-dealers are contractually obligated to distribute the very securities that they provide advice and recommendations on to investors… (they) have competing loyalties” between obligations and incentives to distribute product and obligations to – if in a fiduciary relationship – to put the investors’ best interest first. For further discussion, see: “Six Degrees of Separation: Principles to Guide the Regulation of Broker-dealers and Investment Advisers, M. Koffler, 4.

2. Speech at SIFMA Annual Meeting, October 27, 2009.

3. FINRA Rule 2310.

4. FINRA Rule 2020.

5. See Louis Loss, Joe Seligman, Securities Regulation 3814, 3rd Ed.

6. June 17, 2009

7. Op cit.

8. See, forthcoming, Financial Planners: Fiduciary Duties and Compliance, R. Rhoades.

9. Fiduciary Duties of Broker-Advisers-Financial Planners And Money Managers, Tamar Frankel, Boston University, July 2009.

10. John M. McCabe, National Conference of Commissioners on Uniform State Laws, letter to Knut A. Rostad, April 16, 1998.

11. Meinhard v Salmon, 249 N. Y. 458, 164 N.E. 545, 546 (128)

12. SEC v Capital Gains Research Bureau.

13. FDR's first inaugural address, March 4, 1933. For an in depth discussion, see: A Simple Code of Ethics: A History of the Morale Purpose Inspiring Federal Regulation of the Securities Industry, John Walsh, 2001.

14. The Institute for the Fiduciary Standard introduced the six key fiduciary duties in January, 2012

15. Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice, Wall Street Lawyer, Thomas P. Lemke and Steven W. Stone, June 2009.

16. id. at 6. The authors specifically discus *training* to mean *sales training*, as they reference the "characteristics, risks and rewards of each product."

17. These tasks appear misnamed as "principles." They seem more "the usual way of doing something" (a practice) than a "comprehensive and fundamental law, doctrine" (a principle), per Websters dictionary.

18. See: http://www.finra.org/Newsroom/NewsReleases/2009/P118787

19. This point is acknowledged in both the Frankel and Lemke articles.

20. Investor and Industry Perspectives on Investment Advisers and Broker Dealers, Rand, page 11.

21. It is fully recognized (as also noted above) that many brokers voluntarily seek to meet a fiduciary standard and exceed these minimum requirements.

22. There is much data suggesting most voters / consumers no longer listen to either Wall Street or Washington, generally. One quarterly survey that keeps its fingers on the pulse regarding Wall Street is the Financial Trust Index. http://www.financialtrustindex.org.

23. Webster's Dictionary.