MEMORANDUM

Fiduciary Duty Provisions in the
Dodd-Frank Wall Street Reform and Consumer Protection Act

July 21, 2010

On July 21, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law. This memorandum discusses and analyzes the fiduciary duty provisions in the Dodd-Frank Act. There are two main parts to the fiduciary duty provisions – one part mandates a study of the obligations of broker-dealers, investment advisers, and their associated persons and the second part grants the Securities and Exchange Commission (SEC) authority to adopt rules to address the standard of care for broker-dealers, investment advisers, and their associated persons.

Unlike many of the studies in the Dodd-Frank Act, the study provision of the standard of care for broker-dealers and investment advisers specifically requires the SEC to seek public and industry input. Given the short deadline (January 21, 2011) for the report of the study to be submitted to Congress, we expect the SEC to seek public input on the issues it must consider for the study shortly.

Mandatory Study Provision

Section 913 of the Dodd-Frank Act requires the SEC to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for broker-dealers, investment advisers, and their associated persons for providing personalized investment advice and recommendations about securities to retail customers. The SEC is required to evaluate its existing standards and those imposed by national securities associations as well as other federal and state standards. The SEC also must determine whether there are legal or regulatory gaps or overlaps in standards in the protection of retail customers that should be addressed by rule or statute.

In conducting this study, the Dodd-Frank Act requires the SEC to consider numerous factors. Specifically, the SEC must consider (1) the effectiveness and substantive differences of existing standards of care; (2) gaps, shortcomings or overlaps in regulatory standards; (3) the understanding and confusion of retail clients of differing standards; (4) potential impact on retail

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1 Retail customer is defined as a natural person or the legal representative of a natural person who receives personalized investment advice about securities from a broker-dealer and uses such advice primarily for personal, family, or household purposes.

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customers; (5) levels of services provided by broker-dealers, investment advisers, and their associated persons; and (6) resources devoted to regulation, examination and enforcement by the SEC, the states, and the national securities associations. In addition, the Dodd-Frank Act requires the SEC to consider specific instances in which regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of broker-dealers and visa-versa.  

Under this provision, the SEC also must consider factors that are intended to address some of the concerns expressed by broker-dealers and insurance agents during the legislative process. To this end, the SEC is required to consider the potential impact on retail customers, including their access to the range of products and services offered by broker-dealers and their associated persons of imposing the standard of care applied under the Advisers Act and other requirements of the Advisers Act. The SEC must consider the potential additional costs and expenses both to retail customers regarding, and the potential impact on, the profitability of their investment decisions and to broker-dealers and investment advisers.

The SEC also is specifically required to consider the potential impact of eliminating the broker-dealer exclusion from the definition of “investment adviser” under section 202(a)(11)(C) – an option that was first proposed in the original Senate bill. With respect to this consideration, the SEC is required to study the benefits and harm to retail customers that could result from such a change, the number of additional entities and individuals that would be required to register under, or become subject to, the Advisers Act, and the additional requirements to which broker-dealers and their associated persons would become subject, including additional associated person licensing, registration, and examination requirements and additional costs and the impact on SEC and state resources.

No later than six months after enactment (January 21, 2011), the SEC must submit its findings, conclusions, and recommendations from the study to Congress. In the report, the SEC must describe the considerations, analysis, and public and industry input that the SEC considered in making its recommendations. We expect that the SEC will shortly issue a release seeking input on all the issues that the SEC is required to consider in making its findings and recommendations for the report to Congress.

**Rulemaking Authority**

*Permissive Rulemaking for Standards of Conduct*

After conducting this six-month study comparing the effectiveness of broker-dealer and investment adviser regulation, the Dodd-Frank Act authorizes—but does not require—the SEC to conduct a rulemaking to address the legal or regulatory standards of care for broker dealers and investment advisers (and their associated persons), taking into account the findings of the study.

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2 The SEC also may consider “any other consideration” that the SEC considers “necessary and appropriate in determining whether to conduct rulemaking.”
Specifically, the Dodd-Frank Act adds section (k) (Standard of Conduct) to Section 15 of the Securities Exchange Act of 1934 (Exchange Act) permitting the SEC to adopt rules to prescribe a standard of conduct for broker-dealers providing personalized investment advice about securities to retail customers that would be the same standard applicable to investment advisers under the Advisers Act. At the same time, the Dodd-Frank Act adds new section (g) (Standard of Conduct) to section 211 of the Advisers Act, which permits the SEC to adopt rules to provide that the standard of conduct for all broker-dealers and investment advisers will be to act in the best interest of the customer without regard to the financial or other interests of the person providing investment advice. This provision states that “such rules shall be no less stringent than the standard applicable to investment advisers under… the Investment Advisers Act.” In accordance with any such rules, any material conflicts of interest must be disclosed and may be consented to by the customer.  

There are a number of additional provisos in the Dodd-Frank Act that attempt to address various concerns raised by the brokerage and insurance industries. First, the Dodd-Frank Act amends both the Exchange Act and the Advisers Act stating that the receipt of “compensation based on commission” would not in and of itself be considered a violation of the prescribed standard. Second, the Dodd-Frank Act also adds language to new Exchange Act Section 15(k) that broker-dealers and registered representatives would not have a “continuing duty of care or loyalty” to the customer after providing personalized investment advice about securities. Third, the Dodd-Frank Act adds a provision to the Exchange Act that permits the SEC to adopt a rule requiring broker-dealers to provide notice to each retail customer and obtain the consent or acknowledgement of the customer if the broker-dealer is selling only proprietary or limited range of products. The provision also states that the sale of only proprietary or other limited range of products by a broker-dealer shall not, in and of itself, be considered a violation of the standard of conduct.

Therefore, under these new provisions, the SEC would be permitted to adopt new rules of conduct to apply to broker-dealers, investment advisers, and their associated persons providing personalized investment advice about securities to retail customers to act in the best interest of the customer. Presumably, these rules must be no less stringent than the standard under the Advisers Act – fiduciary duty. There are, however, numerous questions. First, will the SEC adopt a broad rule that would simply require broker-dealers, investment advisers, and their associated persons to act in the best interest of their clients? Or will the SEC adopt more prescriptive set of rules that delineate what broker-dealers, investment advisers, and their associated persons must do to be considered to be acting in the best interest of their clients? If the second alternative is taken, there would be another set of rules with which investment advisers that provide investment advice to retail clients must comply.

Second, there is the question of whether the SEC will adopt a rule or rules that apply to more than natural person clients, such as pension plans. The Dodd-Frank Act specifically permits the SEC to adopt rules for the protection of “such other customers” as the SEC may by rule provide. There also is the question of whether the SEC will define the scope of

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3 New Section 211(g) provides that the SEC cannot ascribe a meaning to the term “customer” that would include an investor in a private fund managed by an investment adviser where such private fund has entered into an advisory contract with such adviser.
“personalized” investment advice. If the term was simply to refer to advice tailored to the objectives of a person seeking the advice, then it is arguable that the Dodd-Frank Act did not need to include a provision that prohibits the SEC from ascribing a meaning to the term “customer” that would include an investor in a private fund. The advice being provided by an investment adviser in such situations would be tailored to the investment objectives of the entity – the private fund – rather than the individual investors of the fund.

Moreover, there will be other open questions as the SEC and the courts gain experience with any rules that are adopted. For example, it is unclear whether the courts and the SEC will apply the new rules in the same way that they have enforced the fiduciary duty standard under the Advisers Act. It also remains to be seen whether the statutory “limitations” (such as no continuing duty after the provision of the advice) merely state the facts and circumstances application of fiduciary duty or will place substantive limitations on fiduciary duty that will result in the development of another body of law (separate from fiduciary duty).

**Mandatory Rulemaking or Other Measures**

Although the adoption of rules of standard of conduct is permissive, the Dodd-Frank Act requires the SEC to “facilitate” the provision of simple and clear disclosure to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest. It is unclear whether a requirement to “facilitate” means rulemaking or whether some other means to encourage the industry to provide these disclosures “voluntarily” would meet the statutory mandate.

Finally, the SEC is required to examine and adopt rules, where appropriate, prohibiting or restricting certain 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. This authority is quite broad, and the SEC can adopt various restrictions or prohibitions under this provision.