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FOR: The Committee 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 policy makers and investors compare the differences and similarities, as currently required in law, between a fiduciary relationship and an arms length relationship.

An arms 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 fulfill certain practices in common (best execution, supervision, etc.) and certain circumstances exist where fiduciary duties are imposed on brokers, in the main, the two standards contain far more differences than similarities.

Not only do these standards impose very different duties, but they also structure the role of the intermediary (broker or RIA) differently. In the commercial contractual relationship, the broker is not generally prohibited to put his or her own best interest first; in a fiduciary relationship the adviser must put the client's best interest first.

Though these differences reflect legal requirements, it is clear that some brokers exceed these legal requirements and conduct themselves as fiduciaries, while some RIAs fail to meet the requirements of a fiduciary relationship.

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.[1] 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".[2] 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 arms length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public".[3]

Arms Length Relationships

The suitability standard and the general regulatory requirements of a BD draw immediate and apparent similarities to an arm's length relationship. The arm's length relationship is the legal relationship that binds most commercial relations between a customer and a company, and it is fundamentally different from a fiduciary relationship. *Registered Rep* magazine has taken note of this difference, saying, "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...." (June 17, 2009).

Caveat Emptor

In an arms 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 in "good faith" and "fair dealing". Fraud is prohibited. In essence, in the formation and performance of an arms length contractual relationship, dishonest conduct is prohibited.[4]

Commercial in Nature

Generally, simply 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..."[5] Further, a staff member from the National Conference of Commissioners on Uniform State Laws put it succinctly when he said, "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." [6]

FIDUCIARY RELATIONSHIPS

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

> *Many forms of conduct permissible in a workaday world for those acting at arms 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…*[7]

While the Investment Adviser Act did not in its text use the term "fiduciary duty"; the Supreme Court did in 1963.[8] 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)*

And further

> *… 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)*

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. The importance of a "high standard of business ethics" was uppermost in FDR's mind. In fact, from the outset FDR viewed reforming Wall Street as much a moral issue as a regulatory issue. He meant to "ensure the character of the people who composed the

securities industry." "When FDR signed the Advisers Act, he recognized his legacy. Since 1933, he said it 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...'"[9]

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. This standard, in the view of the Committee for the Fiduciary Standard, must include the following principles:

- Put the client's best interest first.
- Act with prudence—that is, with the skill, care, diligence, and good judgment of a professional.
- Do not mislead clients. Provide conspicuous, full, and fair disclosure of all important facts.
- Avoid conflicts of interest.
- Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.

THE DIFFERENCES BETWEEN THE ARMS LENGTH AND FIDUCIARY RELATIONSHIPS

Recent discussion in some quarters has focused on the "similarities" between the two standards. One paper suggested 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." As evidence, the paper stated that the guidance "frequently reflects the following core fiduciary or quasi-fiduciary principles".[10]

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 Fiduciary Principles?

Clearly, two of these six principles (they would more accurately be characterized as either policies or practices) are shared by RIAs: best execution and supervision. The remaining principles are not shared with RIAs; they are not fiducial in nature. For example, *product sales training*, on its face, would seem to be more a management

practice aimed to prevent fair dealing violations than it is a quasi fiduciary principle. The remaining three principles, as they are widely understood, are far more illustrative of an arms 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 may be easier to determine the practices that violate this principle than it is to define the principle itself. Consistent with its arms length relationship core, it is essentially 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 generally will 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 FINRA charged six former brokers with fraud, unsuitable recommendations, and exercising discretion without authorization in connection with selling CMOs. The FINRA complaint also charged a violation of "high standards of commercial honor." [11]

Disclosures

The level of disclosures required of brokers and RIAs differs in kind, not degree. Brokers' disclosure obligations are most focused on providing a "fair and balanced" portrayal of risks and benefits of products in oral presentation and sales materials. In contrast, RIAs disclosure requirements are focused on written disclosures of potential and real conflicts of interest, fees, and expenses.

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.[12]

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." [13]

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 difference is of their "fundamental natures." In the commercial contractual relationship, the broker may put his own best interest first; in a fiduciary relationship, the adviser must put the client's best interest first. From the investor's perspective, they put the broker and adviser in 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 in making decisions; and diversify investments. A broker, meeting the minimum legal requirements, is not bound by those requirements. [14]

CONCLUSION

In this memo I have reviewed the different requirements of the two standards that form the basis of investor protections. Their differences are clear and material. If investor protections are to be strengthened, the principles of the authentic fiduciary standard must be protected, if not reinforced, in any new legislation and rulemaking.

The imperative to ensure the future integrity of fiducial investor/adviser relations is far greater than the public attention it draws. It parallels the importance of the broader policy strategies that are intended to address systemic regulatory weaknesses. The need to restore investor's trust in capital markets is clear. The calls for greater transparency and regulatory enforcement and to restore a culture of strong business ethics are loud. President Obama made the return to certain values a cornerstone of his inaugural address:

> *Those values upon which our success depends - hard work and honesty, courage and fair play, tolerance and curiosity, loyalty and patriotism - these things are old. These things are true. They have been the quiet force of progress throughout our history. What is demanded then is a return to these truths.*

The Economist, perhaps one of the most respected and harsh critics of American political and business leaders, recently reminded its readers that, amidst all our problems, it continues to rate America a *buy*. Why? Over time, "America has succeeded brilliantly" in repairing its various faults. Reinforcing and reaffirming old and true fiduciary principles at this historic time, just as President Roosevelt did 75 years ago, would indeed be true to this heritage.

NOTES

1. FINRA Rule 2310.
2. FINRA Rule 2020.
3. See Louis Loss, Joe Seligman, Securities Regulation 3814, 3rd Ed.
4. See, forthcoming, Financial Planners: Fiduciary Duties and Compliance, R. Rhoades.
5. Fiduciary Duties of Broker-Advisers-Financial Planners And Money Managers, Tamar Frankel, Boston University, July 2009.
6. John M. McCabe, National Conference of Commissioners on Uniform State Laws, letter to Knut A. Rostad, April 16, 1998.
7. Meinhard v Salmon, 249 N. Y. 458, 164 N.E. 545, 546 (128)
8. SEC v Capital Gains Research Bureau.
9. A Simple Code of Ethics: A History of the Morale Purpose Inspiring Federal Regulation of the Securities Industry, John Walsh, 2001.
10. 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.
11. See: http://www.finra.org/Newsroom/NewsReleases/2009/P118787
12. This point is acknowledged in both the Frankel and Lemke articles.
13. Investor and Industry Perspectives on Investment Advisers and Broker Dealers, Rand, page 11.
14. It is fully recognized that many brokers voluntarily seek to meet a fiduciary standard and exceed these minimum requirements.