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STANDARD OF CARE FOR BROKER-DEALERS, FIDUCIARY DUTY AND OTHER COMPLIANCE ISSUES

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Standard of care for broker-dealers, fiduciary duty and other compliance issues

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BROKER-DEALERS ARE CONFRONTING numerous regulatory challenges, some brought about by the Dodd-Frank Act ('Dodd-Frank'), and others arising from new FINRA regulations and proposed ERISA regulations.

Dodd-Frank implemented a number of investor protection provisions. Most are familiar with Section 913 of Dodd-Frank, which mandated an SEC study concerning the effectiveness of current legal and regulatory standards of care for broker-dealers, investment advisers and their associated persons when providing personalised investment advice to retail investors. Broker-dealers generally are not subject to a fiduciary standard of care. By contrast, investment advisers are considered 'fiduciaries'. Although not considered 'fiduciaries', broker-dealers owe various duties to their customers, such as the duty to recommend 'suitable' investments, obtain 'best execution' when effecting trades and charge fair commissions or mark-ups.

On 21 January 2011, the SEC released its study. This study is another step towards the likely imposition of a fiduciary standard as it concludes that the SEC should establish a uniform fiduciary standard for broker-dealers and investment advisers pursuant to which both groups must act in their customers' best interest, without regard for their own financial interest. Broker-dealers would be held to a standard no less stringent than the existing fiduciary standard for investment advisers. This uniform standard would involve both a duty of loyalty and a duty of care. The study is short on specifics regarding implementation of the standard. The study also recommends harmonisation of the regulation of broker-dealers and investment advisers in other areas.

As broker-dealers await additional guidance, they must address FINRA's revisions to its 'know your customer' and suitability rules. The know your customer rule (Rule 2090) requires broker-dealers to use 'reasonable diligence' with respect to the opening and maintenance of a customer account in order to know and retain the essential facts concerning every customer. 'Essential facts' are those required to: (i) effectively service the customer's account; (ii) act in accordance with any special handling instructions for the account; (iii) understand the authority of each person acting on behalf of the customer; and (iv) comply with applicable laws, regulations, and rules. The final suitability rules (Rule 2111) implement a number of changes, including applying determinations to recommended investment strategies, and not only to recommendations relating to specific securities.

The rule identifies three elements of suitability: reasonable basis suitability, customer specific suitability and quantitative suitability. The list of items included as part of a retail investor's profile is expanded to include a number of new factors. The rule also clarifies the means by which the customer suitability obligation may be discharged in respect of recommendations made to institutional accounts. This duty would be discharged if the broker-dealer has a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation. An 'institutional account' includes an institutional investor with $50m in assets under management.

Broker-dealers also should consider their relationships with employee benefit plans in light of proposed changes to an ERISA regulation. On 21 October 2010, the Department of Labor issued a proposed regulation that may expand significantly the categories of persons considered fiduciaries as a result of their providing investment advice to plans subject to ERISA or to participants or beneficiaries of such plans. Under the proposed regulation, a person is treated as a fiduciary if the advice is considered investment advice, the arrangement is one in which the person is considered to be rendering the investment advice to a plan, and the person receives a fee for such advice. A person is considered to be rendering investment advice to a plan if the person provides investment advice pursuant to an agreement, arrangement, or understanding (written or not) between such person and the plan or plan fiduciary, and such advice may be considered in connection with making investment or management decisions with respect to plan assets and will be individualised to the needs of the plan, participant, or beneficiary.

Finally, Dodd-Frank also directs the SEC to facilitate the provision of simple and clear disclosures to retail investors regarding the terms of their relationships with broker-dealers and investment advisers. In the fall, FINRA separately published a regulatory notice requesting comments on a concept proposal to require member firms to provide retail customers with a written disclosure statement at the commencement of the relationship. We anticipate that a disclosure statement requirement will be implemented during the year. Broker-dealers will be required to devote substantial resources to all of the regulatory developments that follow from Dodd-Frank, as well as related initiatives that focus on investor protection. ■

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