

The Madoff “Opportunity” Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice

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Among the early fallout from the scandal involving Bernard Madoff's Ponzi scheme and the general turbulence in the financial markets is a general recognition that the current bifurcated approach to regulating financial professionals who give investment advice—specifically, broker-dealers and investment advisers—may not be serving the best interests of investors. In recent years, changes in the financial services industry have blurred the distinction between broker-dealers and investment advisers in the eyes of investors, regulators, and financial professionals. The industry's ever increasing complexity has strained regulators' ability to keep pace with developments.¹ Though both give investment advice to investors, broker-dealers and investment

advisers remain subject to regulatory requirements that differ in many respects, are

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administered by different regulatory bodies, and may leave investor protection gaps (as well as create “regulatory arbitrage” opportunities).²

Unfortunately, Madoff’s deception seems to have been skillfully designed to exploit these regulatory gaps. Madoff’s business was registered as a broker-dealer that was subject to regulatory oversight by the Financial Industry Regulatory Authority (FINRA) and certain units of the Securities and Exchange Commission (SEC) and, later in the game, as an investment adviser, which was subject to SEC oversight.³ Because each regulatory unit focused its oversight activities on its portion of Madoff’s business, neither regulatory “silo” seems to have been able to see the full picture of an admittedly well-concealed deception.⁴

For more than a decade, this “Balkanized” approach to regulating financial professionals who give investment advice has been questioned from time to time.⁵ A comprehensive 2008 SEC-sponsored survey—commonly known as the RAND Report—found that, in varying degrees, investors, investment professionals, and other affected parties either do not understand, or are confused by, the bifurcated approach.⁶ And this confusion is understandable because broker-dealers and investment advisers often do the very same thing: they give advice or recommendations and effect transactions in securities.⁷ According to the survey, investors struggle to understand the different standards of care currently required of broker-dealers and investment advisers, even though the survey used plain language in an effort to explain the differences. And even when investors were told that the standards were different, many still expressed doubts that, in fact, the standards have any practical difference.⁸ As one commentator observed, “The RAND Report makes clear that individual investors generally do not understand, appreciate, or care about such legal distinctions.”⁹

But on the positive side, the Madoff scandal’s devastating effects have clearly focused attention on the need for long-overdue reform of the regulation of investment professionals who give advice. The broker-dealer and investment adviser industries, as well as SEC Chairman Mary Schapiro, FINRA CEO Richard Ketchum, and many others,

have called for the existing regulatory schemes to be “harmonized.”¹⁰ As Chairman Schapiro has stated, “[i]t’s not fair for us to leave to investors to figure out what protections they’re entitled to depending on which regulatory regime just happens to capture the person they’re dealing with.”¹¹

Harmonization is long overdue, and this laudable effort’s overriding goal should be to ensure that investors receive a uniform level of professionalism and accountability from the financial professionals they deal with, whether they choose to use a broker-dealer or an investment adviser.¹² An additional benefit of harmonization would be the increased potential that future Madoff scandals could be prevented or, at least, identified and stopped sooner. Though the stars (finally) seem to be aligning for this much-needed reform, a question remains as to whether long-standing competitive distrust, jockeying over legalistic distinctions, and focusing on “labels” could derail the “opportunity” for reform that has been fostered by the Madoff scandal.¹³

The Current Challenge

While consensus for harmonization is gathering, a spirited debate has emerged about how best to achieve this goal. Initial discussion has focused on the fundamental question of identifying an overarching uniform standard of care that financial professionals would owe investors to whom they give investment advice. This vital first step will establish the philosophical framework for the process of harmonizing the existing regulatory schemes to address particular facts and circumstances. Not unexpectedly, the broker-dealer and investment adviser industries—who are keen competitors in the business world—seem split on the appropriate overarching standard of care, with rhetoric flowing freely from segments on both sides.¹⁴

The Standard of Care for Advisers

The investment adviser industry believes strongly that the fiduciary duty concept currently embedded in the Investment Advisers Act of 1940 (Advisers Act) should be the overarching standard of care to govern the activities of all financial pro-

professionals who give investment advice. Although the Advisers Act does not include the phrase “fiduciary duty,” the landmark 1963 Supreme Court decision in *SEC v. Capital Gains Research Bureau (Capital Gains)* recognized that, as a matter of law, investment advisers owe a fiduciary duty to investors by virtue of state common law.¹⁵ This duty, which is embedded in the Advisers Act, is designed to achieve a high standard of business ethics in the securities industry by substituting a philosophy of full disclosure for the philosophy of *caveat emptor*.¹⁶ As a fiduciary, an adviser must act in the best interest of its clients and make full and fair disclosure, particularly regarding conflicts between the adviser’s interests and those of its clients. The fiduciary relationship is the foundation of the adviser/client relationship.¹⁷ Many consider this standard to provide investors with the highest degree of legal protection, which is particularly apt for investors who have given their adviser complete investment discretion and rely on their adviser to manage their accounts in their best interests, given the investor’s stated circumstances, needs, and objectives.¹⁸

Based primarily on the *Capital Gains* decision, traditional common law “fiduciary duty” is the cornerstone of investment adviser regulation. The SEC and its staff regularly use this fiduciary duty obligation as the basis for regulating the activities of advisers.¹⁹ Premised on fiduciary duty, the SEC and its staff have effectively imposed substantive obligations on advisers (*e.g.*, to seek best execution, manage portfolios in the best interests of clients, allocate trades fairly, make suitable recommendations, vote proxies, and adopt a written compliance program)²⁰ and prohibited specific activities (*e.g.*, undisclosed market timing and placing personal interests ahead of those of clients). In addition, the SEC, through Form ADV, requires advisers to make extensive disclosure to investors about the services they offer, particularly about potential conflicts of interest.

Because traditional fiduciary duty principles are embedded in, but not defined by, the Advisers Act, the SEC and its staff have expansive leeway to identify and define new fiduciary obligations for advisers in light of ever-evolving circumstances, and they do this fairly regularly.²¹ In some

cases the SEC uses formal rulemaking to define fiduciary responsibilities or adopts rules to prevent breaches of fiduciary duty like fraud.²² But, more often the SEC and its staff provide guidance through informal means, such as no-action letters²³ and settled enforcement actions, which lacks the clarity, precision, and transparency of rulemaking and other more formal guidance.²⁴ Informal guidance frequently reflects positions based on a particular set of facts and circumstances, including egregious misconduct, rather than the broader and carefully-reasoned policy perspective used in rulemaking and other formal guidance.²⁵ The SEC, which always seems short on resources, gains many practical benefits by using informal means to set standards, but one noted commentator has pointed out that standards developed in this way frequently are “less clear and leave open significant questions of practical importance...” and impose unnecessary costs, complexity, and uncertainty on advisers trying to understand what is expected of them.²⁶

The Standard of Care for Broker-Dealers

The broker-dealer industry has a different perspective on the overarching standard of care for all financial professionals, including those who give investment advice. The industry trade association, the Securities Industry and Financial Markets Association (SIFMA), has recommended a new “universal standard of care.”²⁷ Though this standard has not yet been fleshed out fully, it seeks to avoid the use of legalistic labels—such as “fiduciary duty”—which the broker-dealer industry believes contributes to, rather than resolves, investor confusion.²⁸ Rather, the new standard will be designed to express, in plain English, the fundamental principles of fair dealing that investors should expect from all financial professionals who give investment advice, whether they are financial planners, investment advisers, securities broker-dealers, a banks, insurance agencies, or other types of financial services providers.²⁹ In this way, the new standard will focus largely on the common standards of conduct shared across those professions in a measured way that also reflects the differing roles they play and obligations

they have. Presumably, however, as this standard is defined, it will build on principles found in the existing broker-dealer regulatory scheme.³⁰

Unlike the approach of the Advisers Act, the current broker-dealer regulatory scheme does not have traditional fiduciary duty principles embedded in it (*i.e.*, the broker-dealer scheme has no corollary to the *Capital Gains* decision), but it nevertheless clearly reflects fiduciary principles.³¹ Particularly in the past decade, FINRA has issued a variety of rules and other formal guidance articulating the expected standard of care for all broker-dealers, including those who give investment advice.³² Among the areas FINRA has addressed are suitability of recommendations (Rule 2310 for retail-oriented customers and IM-2310-3 for institutional customers),³³ communications with the public (Rule 2210), obligations when selling securities in a high yield environment (Regulatory Notice 08-81), compensation limitations (Rule 2830(l) and 2820(g)), gifts (Rule 3220), outside business activities (Rule 3030), private securities transactions (Rule 3040), and oversight and supervision (Rules 3010, 3012, and 3130). Although this guidance is rarely couched in “fiduciary duty” nomenclature, there can be no doubt that its “DNA” flows from fiduciary principles and the policy rationales on which those principles are based.

When addressing the responsibilities of a broker-dealer who gives investment advice to investors, FINRA’s guidance frequently reflects the following core fiduciary or quasi-fiduciary principles:

- *Just and Equitable Practices*—A broker-dealer must observe high standards of commercial honor and just and equitable principles of trade.
- *Suitability of Recommendations*—A broker-dealer must have a reasonable basis to believe that any recommendation is “suitable,” *i.e.*, appropriate for that customer’s particular investment objectives and circumstances.
- *Best Execution of Transactions*—A broker-dealer must effect securities transactions in a manner consistent with best execution. The duty of best execution requires a broker-dealer to seek the most advantageous terms for its customers’ orders reasonably available under the circumstances.³⁴
- *Fair and Balanced Disclosure to Investors*—Sales materials and oral presentations must present a fair and balanced picture to investors regarding both the risks and the benefits of investing in a recommended product. Statements must not be misleading within the context in which they are made, and firms must consider the nature of the target audience. Firms also must take steps to ensure that any discussion between a registered person and an investor is balanced with a discussion of risks.
- *Supervision*—A broker-dealer must adequately supervise employees who give advice and implement adequate supervisory controls to reasonably ensure compliance with applicable regulatory requirements.
- *Training*—A broker-dealer must train its registered persons about the characteristics, risks, and rewards of each product before they allow such persons to recommend that product to investors.³⁵

Standard of Care—A Comparison

Despite the current rhetoric, any reasonable comparison of the current regulatory schemes for broker-dealers and investment advisers who give investment advice reveals that they are far more similar than they are different.³⁶ This is understandable, as both regulatory schemes share a common heritage—an affirmative obligation to act in investors’ best interests with full and fair disclosure, particularly regarding conflicts of interest.³⁷

While both regulatory schemes are based on fiduciary principles, they take quite different approaches in defining and adapting these principles to changing roles and times. Because fiduciary duty is embedded in the Advisers Act as a matter of law and covers all aspects of the client’s advisory relationship, the SEC and its staff have broad

authority to identify and define new fiduciary obligations for advisers, which they regularly do through formal and, more frequently, informal means. By contrast, fiduciary duty is not similarly embedded in FINRA's regulatory scheme, so new fiduciary or fiduciary-like obligations for broker-dealers must be developed primarily through rule-making and other more formal processes.³⁸ Despite these process differences, however, the SEC itself has acknowledged that regulatory rules and other formal regulatory guidance for broker-dealers who give investment advice provide a level of investor protection that in many cases exceeds that of the Advisers Act.³⁹ Indeed, broker-dealers are subject to a broad array of detailed, reticulated rules that reflect the varied and complicated roles they play, while investment advisers are subject to far fewer rules.⁴⁰ This is not to suggest that the substance of investment adviser regulation comes up short by comparison to broker-dealer regulation. Rather, the different approaches reflect the differences in business models and roles played by broker-dealers and investment advisers, respectively, and implicit policy judgments on whether their activities are best regulated by detailed, prescriptive rules or general "black and white" prohibitive regulation designed to prevent fraud.

A Proposed Uniform Standard

The appropriate uniform standard of care for financial professionals needs to be vigorously debated. The final result must balance a number of public policy, investor protection, political, and competitive considerations. This process will naturally and necessarily involve, at each step, vigorous advocacy by constituencies on all sides. Nevertheless, it is critical for the parties not to lose sight of the most crucial goal—clarity and uniform protection for investors. A clear consensus on the need for harmonization is emerging, and the first critical step in that process is to develop an overarching standard of care.⁴¹ An investor's relationship with his or her financial professional should be subject to an overarching standard of care that reflects high standards of business ethics—investors deserve no less. Such a uniform standard will ensure that investors receive the

same level of professionalism and accountability from any financial professional who gives them investment advice, regardless of professional designation.

Fortunately, developing such a standard might not be as difficult as might be expected. Despite the understandable skirmishing and rhetoric, the reality is that both current regulatory schemes are fundamentally designed to protect the best interests of investors through high standards of business ethics and full disclosure, particularly of conflicts, even though these regulatory schemes pursue these goals through different means. As discussed above, each regulatory scheme has strengths and weaknesses. The new uniform standard should seek to combine the best aspects of both.

First, the overarching uniform standard should be grounded in the traditional fiduciary duty concepts embedded in the Advisers Act. All financial professionals who give advice to investors should be subject to a broad fiduciary standard that governs all their advisory activities with investors, like that currently imposed on investment advisers.⁴²

Second, while fiduciary duty clearly should be the overarching standard of care, that standard must be defined and applied in particular cases with more specificity than is currently the case and in a way that recognizes the different roles financial professionals may play when giving investment advice. As SEC Commissioner Elisse Walter has wisely observed, this standard should be applied in a nuanced and measured manner that reflects the varied roles and responsibilities of the financial professional. As she said recently:

[W]hat a fiduciary duty requires depends on the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account. What a fiduciary duty requires may also depend, in certain respects, on the sophistication of the investor. What may be appropriate behavior toward large institutional investors, with knowledgeable counsel, may not be

appropriate behavior toward retail investors... who are not always going to understand the meaning of disclosures regarding certain conflicts of interest.⁴³

Following the approach FINRA has largely used for broker-dealers who give advice, the day-to-day application of “fiduciary duty” to particular circumstances needs to be spelled out with greater clarity, to the maximum extent possible through rulemaking or other more formal processes. Just as investors need to know what conduct they should expect from their financial professionals, financial professionals too should know what is expected of them.⁴⁴ In particular, regulators need to include the views of financial professionals in the harmonization process. A healthy “give and take” between the parties should result in guidance designed to serve the best interests of investors without creating unnecessary costs, complexity, or ambiguity for financial professionals.

Thoughts on the Harmonization Process

The actual harmonization process will not be an easy task. Once the overarching standard of care is confirmed, much work remains in determining how to define and apply it to different situations. Moreover, harmonization does not mean homogenization. Any new approach to regulation of financial professionals should recognize both the common principles that unite the current schemes and the different and changing roles financial professionals play. What should follow is a comprehensive review of SEC and FINRA rules and interpretations, with four goals in mind: (i) identifying gaps, deficiencies, and inconsistencies in existing rules and interpretations; (ii) considering and proposing revisions to existing rules; (iii) identifying positions that have outlived their usefulness; and (iv) establishing a federal scheme for the regulation of financial professionals who give advice that defines their client obligations and preempts varying and in some cases inconsistent state law.⁴⁵

This process will undoubtedly raise many challenges and questions for all involved. Among the

areas that need to be addressed and, in some cases, reconciled are the following:

- *Scope*—A basic issue is the scope of activities of financial professionals that should be subject to the uniform standard of care. In the case of investment advisers, the fiduciary duty standard generally is applied broadly but only to the firm’s advisory activities. Broker-dealers, on the other hand, typically engage in significant variety of activities in addition to giving investment advice – from accepting orders and assisting self-directed investors to acting as market makers to underwriting securities— many of which are subject to extensive regulation under other regulatory schemes.⁴⁶ As with advisers, the fiduciary duty standard should cover all advisory activities of broker-dealers. However, careful consideration, and a specific finding of the need for fiduciary protections, should be present before that standard is extended to broker-dealer activities beyond an investment advisory relationship.⁴⁷
- *Tailoring the Standard to Fit the Advisory Services*—As we have discussed, any standard must be applied in a nuanced and measured manner that both reflects the varied roles and responsibilities of the financial professional and recognizes that the responsibilities of a financial professional providing discretionary services are vastly different than the responsibilities of financial professionals providing other types of investment advice. While the Advisers Act’s fiduciary duty requirements apply (at least in theory) to all adviser/client relationships, virtually all substantive guidance in this area relates to discretionary advisory relationships. This focus is understandable, because fiduciary concerns are much greater for discretionary arrangements in which the investor relies fully on the adviser in managing his or her account.⁴⁸ Moreover, most large advisers provide their services primarily on a discretionary basis, and non-discretionary arrangements provide less opportunity for misconduct since the client, and not the adviser, makes all investment decisions. By

contrast, many broker-dealers (when acting as such) provide advisory services on a non-discretionary basis. Given the relatively few concerns historically associated with non-discretionary advice, investors who use financial professionals for non-discretionary advice seem adequately protected by the current approach. In addition, any rethinking in this area should include developing guidance that sets out and differentiates the fiduciary responsibilities a financial professional owes to discretionary clients as opposed to those owed to non-discretionary clients, including where the non-discretionary advice is provided through research reports or other impersonal advice, on a one-off or episodic nature at the client's request, through a model portfolio, through financial plans that take a snapshot of a client's assets at a given instant, and through non-discretionary services offered on a continuous basis.

- *Custody*—The Madoff scandal has highlighted the critical importance of custody arrangements for investor assets and the existing regulatory schemes approach this issue quite differently. Custody arrangements for broker-dealers that commonly have custody of client assets are already subject to extensive regulation and any additional regulation would seem largely unnecessary. Among other things, broker-dealers must control customer securities they hold, set aside money owed to customers, reconcile securities held quarterly, and send customers periodic account statement detailing transactions and securities held. Broker-dealers cannot borrow or pledge customer securities unless the customer owes it money. Broker-dealers also must maintain a blanket fidelity bond covering the loss, theft, forgery, alteration, and misplacement of securities by the firm's officers or employees. Broker-dealers must hire accountants who are members of the Public Company Accounting Oversight Board (PCAOB) to conduct audits and file financial statements with the SEC. Moreover, coverage provided by the Securities Investor Protection Corporation (SIPC) protects against misappropriated or missing funds and securities.⁴⁹ Investment advisers, on the other hand, are subject to much less regulation on custody, though these requirements are premised on client assets being held by a qualified custodian, such as a broker-dealer or a bank, and the SEC has recently proposed to add additional requirements in this area by incorporating, in part, requirements applicable to broker-dealers.⁵⁰
- *Principal Transactions*—Perhaps one of the most visible differences between financial professionals who give advice that will need to be addressed is the ability to engage in principal transactions with clients. Currently, broker-dealers (those that are not deemed acting as investment advisers) can engage in principal transactions with clients without client consent, but they must disclose their capacity in the transactions. By contrast, an investment adviser generally cannot engage in principal transactions except with disclosure and client consent for each transaction. This is a particularly controversial issue, but the current trade-by-trade consent requirement appears unnecessarily restrictive in certain cases and warrants review and reform (*e.g.*, for riskless principal transactions, transactions in liquid securities, and transactions where the broker-dealer has previously disclosed to the client the range of its possible markups and the actual markups fall within the stated range).
- *Solicitors/Finders*—Early reports show that solicitors or finders—perhaps unknowingly—played an important role in facilitating the Madoff scandal. The SEC has adopted a rule under the Advisers Act, Rule 206(4)-3, that seeks to address the role and status of solicitors primarily through disclosure, while the broker-dealer regulatory scheme focuses less on disclosure and generally restricts the use of finders that are not themselves registered broker-dealers. Neither approach may be totally satisfactory, though both provide elements for a possible harmonized approach.

- *Disclosure*—Another area that will need harmonization is the approach to disclosure under the two existing regulatory schemes. For investment advisers, Form ADV requires an adviser to provide or make available to clients an extensive amount of disclosure, generally at the outset of the relationship and annually, about the adviser, its services, and key personnel, whereas the current broker-dealer regulatory scheme relies primarily on transactional and periodic disclosure, with special disclosures for particular products or services (e.g., Margin Disclosure Documents for margin accounts) or types of investors (e.g., senior investors). However, FINRA’s Public Disclosure Program—commonly known as BrokerCheck—maintains a toll-free hot line for investors to learn about the professional background, business practices, and conduct of brokerage firms and their representatives, including information about pending and final disciplinary matters (which is also available on FINRA’s website).

Conclusion

The Madoff scandal has provided a unique opportunity for reform. Much work and thought will be needed to harmonize the existing broker-dealer and investment adviser regulatory schemes for financial professionals who give investment advice. However, the first—and probably most crucial—step is to acknowledge that the regulatory scheme must focus on the best interests of investors. Every investor deserves to expect that the financial professionals to whom he or she turns for investment advice are subject to a uniform standard of care, grounded on fiduciary principles, that is focused on what is in the investor’s best interests. Based on this fiduciary foundation, the existing investment adviser and broker-dealer regulatory schemes provide the building blocks for developing a uniform and comprehensive regulatory scheme for financial professionals who give investment advice that will truly be in the best interests of investors.

NOTES

1. See “Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,” RAND Institute for Civil Justice at xiii (2008) (the RAND Report) (“As the industry has become more complex, it has become increasingly difficult for regulators to design regulations that govern the different financial services available in the market.”).
2. While the Investment Advisers Act of 1940 regulates entities that, for compensation, are engaged in the business of providing advice, analyses, or reports about securities to others, it also includes an exception for broker-dealers who provide investment advice solely incidental to the conduct of their brokerage business and who receive no special compensation. See Investment Advisers Act of 1940 Section 202(a)(11)(C). This exception reflects the notion that, although a natural interrelationship exists between brokerage and providing information and advice about investments, broker-dealers are already comprehensively regulated under the Securities Exchange Act of 1934. See Speech by SEC Commissioner Elisse B. Walter, “Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?” (Mutual Fund Directors Forum, May 5, 2009) (Walter Speech). For a comprehensive discussion of the current dividing line between advisers and broker-dealers, see the RAND Report at 14-15.
3. The SEC is the primary regulator for investment advisers subject to the Investment Advisers Act of 1940 (Advisers Act). FINRA is a self-regulatory organization that is the primary regulator for broker-dealers subject to registration under the Securities Exchange Act of 1934. The SEC also has oversight responsibility over both broker-dealers and FINRA. There currently is no self-regulatory organization for investment advisers. Ironically, apparently Madoff’s business had to register as an investment adviser because of the SEC’s 2005 rule changes generally designating the exercise of brokerage discretion as advice requiring adviser registration because it was not incidental to brokerage.
4. See, e.g., “SEC Pick Pledges to Ratchet Up Oversight,” Washington Post (Jan. 16, 2009) (“One of the real lessons of this tragedy is that we have this stovepiped approach to

- regulation that allows misconduct to take place out of the sight of at least some of the regulators,' [Mary Schapiro] said. 'There are many reasons for this crisis, and one of them is that our regulatory system has not kept pace with the markets.'").
5. See, e.g., Walter Speech ("The Balkanized structure of financial regulation in the United States is apparent in the regulation of financial professionals."); Testimony of T. Timothy Ryan, Jr., President and CEO, Securities Industry and Financial Markets Ass'n, Before the U.S. Senate Comm. On Banking, Housing and Urban Affairs, Hearings on: "Enhanced Investor Protection and the Regulation of the Securities Markets" at 7 (March 10, 2009) (Ryan Testimony) ("SIFMA has long advocated the modernization and harmonization of the disparate regulatory schemes for investment advisory, brokerage and other financial services in order to promote investor protection."); Kaswell and Rose, "A New Paradigm for Federal Regulation of Financial Intermediaries" at 29, 38 (Federated Investors White Paper) (Kaswell Article) ("We also believe that years of squabbling and a lack of regulatory clarity over the regulatory treatment of basic financial services has harmed the competitive position of the U.S. in the global marketplace."); Selman, Price, and Kosciulek, "Regulating Mutual Fund Distribution: Is the Traditional Definition of 'Broker-Dealer' Obsolete?" *The Investment Lawyer* (Apr. 1998).
 6. See RAND Report at 117-18. See also Kaswell Article at 25 (noting that "if [the RAND Report's] assessment [about confusion over the current system] is accurate, it is a disappointing commentary on the existing framework."). Interestingly, whatever their understanding of the regulatory approach, most investors indicated they were happy with the service provided by their financial professional. See RAND Report at xix.
 7. Established means of distinguishing broker-dealers from investment advisers under the current regulatory approach— such as whether a broker-dealer's compensation is "special"—seem not to work amidst changing business practices and paradigms.
 8. See RAND Report at 118.
 9. See Ryan Testimony at 8.
 10. See, e.g., Walter Speech; IAA Newsletter, "Inside the Beltway" at 15 (April 2009) (in his first speech as the new FINRA CEO Richard Ketchum stated "It is time we make an honest effort to break this logjam— two different standards is simply untenable in this world"); "ICI Proposal Conjures Broker-Dealer Channel Ghosts," *Ignites.com* (March 11, 2009) (mutual fund trade association called specifically for an end to the different standard of care between broker-dealers and investment advisers); "Fiduciary Standards Could Restore Trust," *Financial Planning* (March 16, 2009) (two financial industry executives calling for uniform fiduciary standard); "Rules for Financial Pros Need Work: SEC Member," *Reuters* (Jan. 14, 2009) ([SEC Commissioner Kathleen] Casey... told *Reuters* she strongly believed that the rules [for broker-dealers and advisers] should be "harmonized.").
 11. See Waddell, "Coming Into Focus," *Investment Advisor* at 29 (April 2009). See also Walters Speech ("I also believe strongly that retail investors should not bear the burden of understanding distinctions between financial professionals that have become increasingly less relevant over the years.").
 12. See Kaswell Article at 25 ("Although in our view, investor protection is a more important goal than simplicity, these two objectives need not be mutually exclusive. It is our view that Congress, working with all interested parties, could develop a system that provides protections that are designed to address investor protection concerns and that also offer the benefit of greater simplicity."); Walters Speech ("When your Aunt Millie walks into her local financial professional to ask for advice, she does not need to know whether the person on the other side of the table is a registered representative of a broker-dealer or an investment adviser. She should not be placed at risk by the fact that application of those labels may lead to differing levels— or at least different kinds— of protection. Instead, she should know, or be able to assume— consciously or subconsciously— that regardless of the title held by the person sitting across the desk from her, she will receive an appropriate and comparable level of protection.").
 13. See generally "The SEC Reformation," *Investment Advisor* at 15 (May 2009) (commenting on harmonizing the rules for broker-dealers and investment advisers, SEC Chairman Schapiro stated that "[t]here's a lot

- of lore that's grown up around both advisors and the broker-dealer side of the question, but just because it's tough doesn't mean we shouldn't tackle it.").
14. See, e.g., Veres, "A Conversation," *Financial Planning* (March 1, 2009) ("Moving everybody over to FINRA would allow the brokerage firms to continue with business as usual, but with less competition from advisors who provide objective recommendations. In fact, if FINRA gets its way, it would gleefully impose all sorts of difficult restrictions on the equivalent of doctors in the advisory profession and favor the drug companies whose executives sit on its board."); "Investor Advocates Blast Schapiro's Statements on Adviser Regulation," *ACAInsight.com* (April 20, 2009); "Fiduciary Fracas," *Financial Advisor* (April 2009) (David Bellaire, general counsel and director of government affairs at the Financial Services Institute, a membership group for independent broker-dealers and financial advisors, stated that "the issue is more about reviewing, examining and enforcement on the advisory side than it is about dealing with regulatory standards. He said the Bernard Madoff case is a lesson that investment advisors should be held to the same level of supervision and examination as broker-dealers are now.").
 15. *SEC v. Capital Gains Research Bureau*, 375 U.S. 18 (1963) (*Capital Gains*).
 16. See *Capital Gains* at 186. See also *Capital Gains* at 191-92 (citations omitted) (the Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser— consciously or unconsciously— to render advice which was not disinterested."); Barbash and Massari, "The Investment Advisers Act of 1940: Regulation by Accretion," 39 *Rutgers Law Journal* 627, 634 (2009) (Barbash Article) ("*Capital Gains* both expanded the scope of the duties owed by an investment adviser to its client as a fiduciary and, consistent with the Advisers Act approach, found disclosure an effective tool in curing conflicts of interest."); RAND Report at 13 ("In addition to registration requirements, and unlike broker-dealers, federally registered investment advisers owe fiduciary obligations to their clients as a *categorical* matter.").
 17. See Speech by SEC Commissioner Luis A. Aguilar, "Increasing Accountability and Transparency to Investors" (The SEC Speaks in 2009, Feb. 6, 2009).
 18. See, e.g., IAA Newsletter, "Inside the Beltway" at 15 (April 2009); "Tittsworth Urges Advisers to Join Policy Reform Fight," *ACAInsight.com* (March 16, 2009) (IAA President David Tittsworth stated that "fiduciary duty is 'a core fundamental cultural issue' for advisers, representing 'the highest standard' that advisers owe their clients. The fiduciary standard is one 'that we need to fight for....'").
 19. See Inv. Adv. Act Rel. No. 1406 at text accompany nn. 2-3 and n. 2 (March 16, 1994) ("Investment advisers are fiduciaries who owe their clients a series of duties.... These duties include the duty of full disclosure of conflicts of interest...; utmost and exclusive loyalty...; and the duty of best execution.") (footnotes omitted).
 20. See, e.g., Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003) (In adopting compliance program Rule 206(4)-7, the SEC stated that "[t]he rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.").
 21. See, e.g., RAND Report at 13 (citation omitted) ("Although the specific standards for fiduciary obligations are not laid out clearly in the statute, they are unambiguously a centerpiece of the [Advisers Act's]... differential treatment of investment advisers, and their categorical application has since been upheld in numerous specific circumstances.").
 22. See, e.g., Rule 206(4)-8 under the Advisers Act; Inv. Adv. Act Rel. No. 2628 (Aug. 3, 2007) ("Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law.").
 23. See, e.g., SMC Capital, Inc., SEC No-Action Letter (Sept. 5, 1995); Auchincloss & Lawrence, Inc., SEC No-Action Letters (April 5, 1074 and Feb. 8, 1974). A no-action letter is an expression of the SEC staff's enforcement attitude toward a proposed transaction based on the particular facts and circumstances presented by the request. See Lemke, "The SEC No-Action Letter Process," 42 *Bus. Law.* 1019 (1987).

24. See, e.g., Putnam Inv. Mgmt., L.L.C., Inv. Adv. Act Rel. No. 2192 (Nov. 13, 2003). Chancellor Capital Mgmt., Inc., Inv. Adv. Act Rel. No. 1447 (Oct. 18, 1994); Jamison, Eaton & Wood, Inc., Inv. Adv. Act Rel. No. 2129 (May 15, 2003).
25. See Barbash Article at 653-54.
26. Barbash Article at 655.
27. See Ryan Testimony at 8. *But see* "FINRA Official: Fiduciary Duty Coming," Compliance Reporter (April 21, 2009) ("Broker/dealers should expect to be subjected to a form of fiduciary duty, Marc Menchel, executive v.p. and general counsel of the Financial Industry Regulatory Authority, said today.").
28. Ryan Testimony.
29. Ryan Testimony at 7. Both the North American Securities Administrators Association and the Consumer Federation of America oppose SIFMA's proposed universal standard of care because they believe its "principles of fair dealing" approach provides less protection to investors than fiduciary duty. See IAA Newsletter, "Inside the Beltway" at 15 (April 2009).
30. See "Brokers Versus Advisers—SIFMA Wants 'Universal,' Not Fiduciary Standard," *Registered Rep* (March 11, 2009) (According to Kevin Carroll, SIFMA managing director and associate general counsel of SIFMA, the new universal standard would combine the suitability requirement with the ideas in FINRA Rule 2110 (Standards of Commercial Honor and Principles of Trade), which requires FINRA-registered firms to observe high standards of commercial honor and just and equitable principles of trade).
31. In certain cases where a broker-dealer exercises investment discretion or control over client assets, courts have fairly consistently concluded that the broker-dealer owes its clients a broad fiduciary duty similar to that imposed on advisers. See, e.g., *Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd* 647 F.2d 165 (6th Cir. 1981); *O'Malley v. Boris*, in A.2d, 1999 WL 39548 Del.Ch., 1999. (Jan. 19, 1999), *rev'd* 742 A.2d 845 (Sup. Ct. Del. 1999) (broker had authority to select sweep account option for customer and held to be accountable under fiduciary standards). See also *Farm King Supply Inc. Integrated Profit Sharing Plan v. Edward D. Jones*, 884 F.2d 288 (7th Cir. 1989) (a broker-dealer is not a fiduciary under ERISA if it does not exercise discretion over client assets). However, as Prof. Louis Loss has observed, "There is no specific touchstone for determining when a broker-dealer assumes the obligations of a fiduciary." See L. Loss, *Fundamentals of Securities Regulation* at 966 (1983 ed.).
32. The SEC also has issued rules and other guidance that apply to broker-dealers, but they are much less significant in the overall regulatory scheme, particularly regarding the requirements applicable to broker-dealers who give investment advice. In many cases FINRA's guidance reflects principles previously articulated by the SEC.
33. The approach to suitability under the two regulatory schemes is a prime example of the practical differences in how guidance is provided under each scheme. As noted, on a number of occasions FINRA has provided formal guidance on a broker-dealer's suitability obligations to retail-oriented and institutional investors. The SEC believes that an adviser's fiduciary duty requires it to make suitable recommendations to investors, but it has not provided significant guidance on the nature of this obligation. See Cozzolino, "The Institutional Suitability Dilemma for Investment Advisers: What is the Legal Standard?" *The Investment Lawyer* 3 (July 1999). In 1994 the SEC proposed, but never adopted, a rule that would have codified the SEC's position regarding an adviser's suitability obligations. When formulating the proposed rule, the SEC looked primarily to interpretations of the scope of broker-dealer suitability obligations under applicable SEC and FINRA requirements. Accordingly, the proposed standard was not materially different from FINRA's suitability rule. See Inv. Adv. Rel. No. 1406 (March 6, 1994). However, consistent with the current "silo-ed" approach to the regulation of financial professionals, the SEC's proposal, while acknowledging that FINRA's rules incorporate suitability requirements for broker-dealers that were first developed by the SEC, specifically disclaimed that compliance with FINRA's rule would constitute compliance with its proposed rule, and vice versa. See Inv. Adv. Rel. No. 1406 at n.6.
34. See, e.g., NASD Rule 2320 (providing that broker-dealers must use reasonable diligence to ascertain the best market for a security, and buy or sell the security in such market so

- that the resulting price to the customer is as favorable as possible under prevailing market conditions); see also NYSE Rules 123A.41 and 123A.42 (providing that broker-dealers handling market and limit orders must use due diligence to execute the orders at the best price or prices available on the exchange).
35. See, e.g., Regulatory Notice 08-82; Regulatory Notice 08-81.
 36. Confusion exists as to the degree of difference in the current regulatory schemes. See, e.g., "ICI Proposal Conjures Broker-Dealer Channel Ghosts," *Ignites.com* (March 11, 2009) ("Adhering to a fiduciary standard does not preclude advisors from selling in-house products [as some others seem to believe], says Jack Murphy, partner at Dechert.").
 37. See, e.g., Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Before the United States Senate Committee on Banking, Housing and Urban Affairs (March 26, 2009) ("The SEC's regulatory role, along with its oversight of the various self-regulatory organizations with respect to financial intermediaries and market professionals, focuses on helping to ensure that investors are treated fairly and that the institutions managing and processing their investments are subject to meaningful controls to protect investor assets. Our statutes and rules require that brokers and advisers tell investors the truth, that brokers recommend to their customers only those products that are suitable for them to buy, and that advisers act in accordance with their fiduciary duties. In the same way, we require that investment advisers manage any potential conflicts of interests and fully disclose them to investors."). Note, however, that a fiduciary relationship does not preclude the fiduciary from benefiting from the relationship, e.g., earning a fee or other compensation that is fully disclosed.
 38. The evolution of "fiduciary duty" under the broker-dealer and investment adviser regulatory schemes mirrors the broader development of fiduciary duty under common law. There is no *per se* law of fiduciary obligations because the nature of a person's fiduciary duty depends generally on the relationship between the parties and the circumstances involved. Rather, the "law of fiduciaries" has developed somewhat haphazardly and, in some cases, inconsistently under particular areas of the law, such as agency, trusts, corporations, wills, and restitution, and not as a specific area of the law.
 39. See Inv. Adv. Act Rel. No. 2340 (Jan. 6, 2005) ("The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder.").
 40. Simplistically, although the stacked volumes of statutes and SEC and SRO rules to which a broker-dealer is subject might span three feet in height, investment advisers are subject to statutes and rules that probably span less than three inches.
 41. Of course, many broker-dealers have different business models from investment advisers and may engage in a variety of activities other than giving investment advice. Harmonization should focus on broker-dealers who give investment advice.
 42. See Speech by SEC Commissioner Luis A. Aguilar, "SEC's Oversight of the Adviser Industry Bolsters Investor Protection" (IAA Annual Conf., May 7, 2009) ("I have been listening to the current debate about what the standard should be for those that provide investment advice. I have heard a lot of 'standards' offered including the following: (1) Professional Standard for All Financial Intermediaries; (2) A Universal Standard of Care; (3) A Fiduciary-like Standard. It is not clear to me that any of these standards measures up to the fiduciary standard that currently exists, and there is great concern that these proposed standards may have the effect of diluting the existing high fiduciary standard that serves as an important investor protection.").
 43. See Walter Speech.
 44. See, e.g., Walter Speech ("This is why I believe that it is important that the Commission explain what a fiduciary standard requires. Both investors and the industry deserve the clarity that formal Commission guidance would provide.").
 45. Cf. Section 514(a) of the Employee Retirement Income Security Act of 1974 (ERISA) (establishing federal preemption of state law for plans covered by this Act). See also Barbash Article at 655. The comprehensive

review could be conducted by the SEC or by a self-regulatory organization for financial professionals who give advice, should one be organized.

46. The manner in which the standard of care is applied to different financial professionals should recognize the different roles they play across the spectrum of financial services, including: (1) accepting orders; (2) referring customers to other providers of financial or financial related services; (3) answering investor questions and providing investor education; (4) providing research or other impersonal advice or recommendations; (5) giving investment recommendations; (6) providing financial plans; (7) providing investment supervisory services; and (8) managing accounts on a discretionary basis. The application of a uniform standard of care should not distort the roles played by financial professionals or prevent them from limiting their responsibilities in reasonable ways that reflect the tasks they have been hired to undertake. For example, the application of a uniform standard of care should not prevent an adviser from limiting its obligations to just those assets for which it has been given discretionary authority, as opposed to other client assets or the overall diversification of those assets. By the same token, the application of a uniform standard of care should not prevent a broker-dealer from limiting its recommendations to securities or financial products or services that are available through it. Similarly, the application of a uniform standard of care for advice should not interfere with a broker-dealer's ability to issue margin calls, effect buy-ins or otherwise to protect itself from customers that may default on their obligations. *Cf.* Goldman, Sachs & Co., SEC No-Action Letter (Feb. 22, 1999) (pertaining to the applicability of Advisers Act restrictions on principal trades to transactions effected for clients of the broker-dealer's prime brokerage services). While fiduciary principles may favor disclosure of these matters, they should not override them. Finally, any standard that is developed should explicitly recite that the fact a financial professional may owe a duty of care under the standard does not mean that the financial professional is providing investment advice or is otherwise a fiduciary for purposes of ERISA.

47. See Walter Speech.
48. Intuitively, an adviser should be regarded as having a higher responsibility to its discretionary clients over non-discretionary clients if only based on the notion that an adviser's fiduciary responsibility is a function of the breadth of its authority and responsibility and the reliance clients place on the adviser. *Cf.* 29 C.F.R. § 2510.3-21(c) (DOL regulation specifying that a person shall be deemed providing "investment advice" (and therefore a "fiduciary") for purposes of ERISA if such person "[r]enders any advice ... on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding ... that such services will serve as a *primary basis* for investment decisions with respect to plan assets") (emphasis added).
49. See, e.g., Exchange Act Rule 15c3-3(b); FINRA Rule 2330; IM-2330; NYSE Rule 402; Exchange Act Rule 17a-13; Exchange Act Rules 8c-1 and 15c2-1; NYSE Rule 402; Exchange Act Rule 15c3-3(e); Exchange Act Rule 15c3-2; NASD Rule 2340; NYSE Rule 409; CBOE Rule 9.12; Exchange Act Rule 17a-5(d)-(e); NASD Rule 2270; NYSE Rule 418; Exchange Act Rule 17a-5(f); Securities Investor Protection Act of 1970.
50. See Custody of Funds or Securities of Clients by Investment Advisers, Inv. Adv. Act Rel. No. 2876 (May 20, 2009).