Morgan Lewis | White Paper

# DEPARTMENT OF LABOR RETIREMENT INITIATIVE FAILS TO CONSIDER CURRENT REGULATORY REGIME, WHICH COMPREHENSIVELY PROTECTS INVESTORS, INCLUDING IRA INVESTORS, AND PRESERVES INVESTOR CHOICE

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## Executive Summary

- **Current Framework Governing Financial Professionals Protects Investors**
  - **Comprehensive Regime —** Aside from the Department of Labor, existing U.S. regulation of financial professionals who provide assistance to investors, including those saving for retirement through IRAs, is comprehensive and coordinated, and reflects a thoughtful approach to regulation that is based on over a century of learning and experience.
  - **Preserves Choice —** Existing regulation balances investor choice and investor protections in a manner that protects the investor's ability to choose the financial professional that he or she wants to work with, and the level (and costs) of the services provided.
  - **Scales Protection —** Investor protections increase as the financial professional's role and authority increase, and as the investor's reliance increases.
  - **Addresses Conflicts —** Current regulatory framework already provides investors, including IRA investors, with comprehensive and consistent core protections from conflicts of interest, no matter the type of financial professional the investor chooses, and no matter how the financial professional is compensated.
  - **Thoroughly Regulates Broker-Dealers —** Broker-dealers, and their registered representatives, are currently subject to extensive regulation, and are held to high professional standards through regulatory oversight and enforcement, and investors' private rights of action.
  - **Focuses on IRAs —** Recognizing the increasing importance of IRAs as sources of retirement income, the financial regulators, those with deep history and understandings of both the U.S. capital markets and investor protections, are continuously adapting their approaches under the existing regulatory framework to address changes in the retirement savings landscape, and to further protect IRA investors.
- **CEA Report Fails to Appreciate Key Aspects of Current Regulation of Financial Professionals**
  - **Fails to Appreciate Comprehensive Protections In Place —** No matter the type of financial professional providing guidance — be it a broker-dealer, investment adviser, or bank fiduciary — comprehensive and consistent protections are in place to protect investors, including against conflicts of interest and other concerns.
  - **Over-Simplifies Broker-Dealer Regulation —** The CEA Report fails to appreciate the comprehensive regulation of broker-dealers established in reticulated form via SEC and FINRA requirements, which both protects investors and is calibrated to reflect that broker-dealers and investment advisers play different roles.
  - **Does Not Acknowledge Capabilities of Established Financial Services Regulators —** Established financial services regulators are better positioned to establish and enforce investor protections given their vast experience, technical expertise, and understanding of the financial services industry.

## Department of Labor Retirement Initiative Fails to Consider Current Regulatory Regime, Which Comprehensively Protects Investors, Including IRA Investors, and Preserves Investor Choice

We have prepared this white paper to address errant claims made in the Council of Economic Advisers' (CEA) report, "The Effects of Conflicted Advice on Retirement Savings" (CEA Report), regarding perceived inadequacies in the existing regulation of investment advice provided to individual retirement account (IRA) investors, with a particular focus on U.S. federal securities laws. Specifically, the CEA Report claims that the different legal standards that apply to the provision of investment advice by broker-dealers and investment advisers, and the different ways in which broker-dealers and investment advisers are compensated, cause broker-dealers and some investment advisers to give advice that favors themselves over their customers.[1] But, the CEA Report fails to acknowledge and address key aspects of the comprehensive and multilayered regulatory framework that has developed in the United States over the past 100-plus years, and that protects all investors, including IRA investors, from conflicts of interest.[2] In particular, the CEA Report does not recognize that broker-dealers and the registered representatives that they employ to assist customers are subject to extensive regulation and oversight by the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and state securities regulators, and are also held to high professional standards through regulatory oversight and enforcement, and the arbitration process for private rights of action asserted by investors.

No thoughtful analysis can begin to frame the issues surrounding how Americans save and invest for retirement — or provide a sound foundation for policy judgments — without taking stock of the investor protections and key aspects of the robust regulatory framework currently in place. This regulatory framework requires all financial professionals, whether an investment adviser, broker-dealer, or other financial professional, to act consistently with the applicable

1. President's Council of Economic Advisers, The Effects of Conflicted Investment Advice on Retirement Savings at 6 (Feb. 2015) (CEA Report). For purposes of this memorandum, references to investors, customers, and clients are to non-institutional investors, customers, and clients. The term "investment advice" as used in this white paper is intended to be construed as that term is used under the federal securities and banking laws. The term "financial professional" is intended to refer broadly to any individual or entity who provides investment advice, including broker-dealers, investment advisers, and banks (and their representatives).

2. Investor protections in the United States are derived from British common law. The common law imposes a duty on agents and fiduciaries who act on behalf of their clients to act in the interest of their clients (the duty of loyalty), and to act with care and prudence in fulfilling their duties (duty of care). *See* Restatement (Third) of Agency (2014); Restatement (Third) of Trusts (2007); A. Scott, Law of Trusts (3d ed. 1967). These laws have long been enforced by the state courts and began to be codified under federal law in the 19th century. *See, e.g.,* The National Bank Act of 1864.

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standard of care and in their clients' best interests,[3] and to address and mitigate conflicts of interest when working with investors.[4]

This white paper describes the framework of regulatory protections currently in place for all investors, including those saving through IRAs, with a particular focus on the securities laws. It also highlights key aspects of the securities laws designed to address the concerns identified in the CEA Report, how the securities laws are calibrated to address particular advice models, and initiatives of the SEC and FINRA to address concerns specific to retirement savings.

## Pervasive Regulation of Investment Advice

Broker-dealers, investment advisers, banks, and other institutions that provide investment advice to investors operate within a comprehensive regulatory framework established and overseen by various federal and state agencies and self-regulatory organizations (SROs). At the federal level, investment advice is regulated primarily by the SEC and FINRA. The investment advice provided by banks is generally exempt from SEC regulation, but depending on whether the bank is nationally chartered or state chartered, is subject to regulation and supervision by one or more of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and state banking authorities.[5] Further regulation is overseen by the Municipal Securities Rulemaking Board (MSRB) (for advice with respect to municipal securities) and the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) (for advice with respect to commodity trading).

The states also have jurisdiction over investment advice provided by small and mid-sized investment advisers, broker-dealers, insurance providers (regulated by state insurance commissioners), and state-chartered banks (regulated by state agencies). Although federal law preempts much of the authority state regulators have over SEC-registered investment advisers because of the extensive federal regulatory framework, the states still retain the authority to

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3. *See infra* notes 14 and 25-28, and accompanying text.

4. The purpose of this white paper is to discuss the structures and investor protections currently in place that protect all investors, including IRA investors, in light of the CEA Report. Recognizing that retirement assets (and retirement account service providers) are generally subject to additional regulatory scrutiny and limitations (including under the provisions of the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code, and state law), a discussion of those retirement-centric provisions and limitations, in general, and potential changes to those rules, in particular, is beyond the scope of this memorandum.

5. National Bank Act, 12 U.S.C. § 92a; Federal Deposit Insurance Act, 12 U.S.C. § 1831a; Home Owners' Loan Act, 12 U.S.C. § 1464(n); Federal Reserve Act, 12 U.S.C. § 321. The OCC is the primary regulator for national banks, national trust banks, and federal savings associations; the FRB and state banking regulators are the primary regulators for state-chartered banks and trust companies that are Federal Reserve System members; and the FDIC and state banking regulators are the primary regulators for state-chartered banks that are not Federal Reserve System members. Note that investment advice provided by broker-dealers and registered investment advisers that are affiliated with banks is subject to SEC and FINRA regulation, as applicable.

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investigate and bring enforcement actions for fraud and deceit against SEC-registered investment advisers.[6] The Appendix to this white paper provides information regarding these regulators, including their respective regulatory authorities.

The regulatory oversight of the federal and state agencies form the primary protections afforded to investors in the United States, including IRAs and employer-sponsored plans. Federal and state regulators have long collaborated and coordinated their approaches to regulating investment advice to harmonize investor protections and to avoid regulatory redundancy.[7] The SEC and other authorities have established formal cooperation programs with the United States Department of Labor (DOL) and the Internal Revenue Service (IRS),[8] and routinely refer potential violations involving plans and IRAs to the DOL or IRS for additional review as appropriate. The agencies have entered into a number of joint settlements of alleged violations by financial services firms.[9]

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6. Advisers Act § 203A(b)(2), 15 U.S.C. § 80b-3a(b)(2).
7. *See, e.g.,* Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 56501 (Sept. 24, 2007), 72 Fed. Reg. 56514 (Oct. 3, 2007) (codified at 12 C.F.R. pt. 218, 17 C.F.R. pts. 240 and 247) (adopting Regulation R); U.S. COMMODITY FUTURES TRADING COMMISSION & U.S. SECURITIES AND EXCHANGE COMMISSION, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (October 16, 2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf. Regarding coordination among state and federal agencies, *see, e.g.,* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) (expressing views developed jointly by staff of the SEC's Division of Investment Management and the North American Securities Administrators Association, Inc. (NASAA)). In addition, the SEC and NASAA have collaborated on registration and disclosure issues related to investment advisers, including Form ADV and the Investment Adviser Public Disclosure website.
8. In February 2006, an interagency agreement was signed between the DOL and federal financial institution regulatory agencies, including the FRB, the FDIC, the National Credit Union Administration (NCUA), and the OCC, whereby those agencies agreed to notify the DOL of possible violations of ERISA discovered in the course of their supervision of the fiduciary activities of institutions subject to their respective jurisdictions. On July 25, 2013, the DOL and the SEC entered into a Memorandum of Understanding (MOU) to facilitate the exchange of information between the two agencies. Under the MOU, the SEC grants the DOL standing access to nonpublic examination information with respect to examinations that SEC staff determines are relevant to the DOL's mission. Similarly, the DOL and IRS have long coordinated examination efforts with respect to retirement plans and most recently entered into an MOU on June 3, 2003.
9. *See, e.g.*, Press Release, Department of Labor, Employee Benefits Security Administration, US Labor Department and Securities and Exchange Commission Reach Combined $21M in Settlements with Western Asset Management (Jan. 27, 2014); *Capital Consultants, LLC et al.*, Litigation Release No. 16720 (Sept. 21, 2000). The SEC and DOL also assist each other in investigating potential violations of the securities laws or ERISA by financial professionals. *See Worldwide Energy and Manufacturing USA, Inc. et al.*, Litigation Release No. 22475 (Sept. 10, 2012); *Peter O. Marion*, Litigation Release No. 18796 (July 27, 2004); *Michael Resnick et al.*, Litigation Release No. 18797 (July 27, 2004). In addition, at times, the SEC and DOL have coordinated in considering potential rulemaking. *See*, *e.g.*, Press Release, Securities and Exchange Commission, SEC, DOL to Hold Joint Hearing Examining Target Date Funds (May 12, 2009), *available at* http://www.sec.gov/news/press/2009/2009-107.htm.

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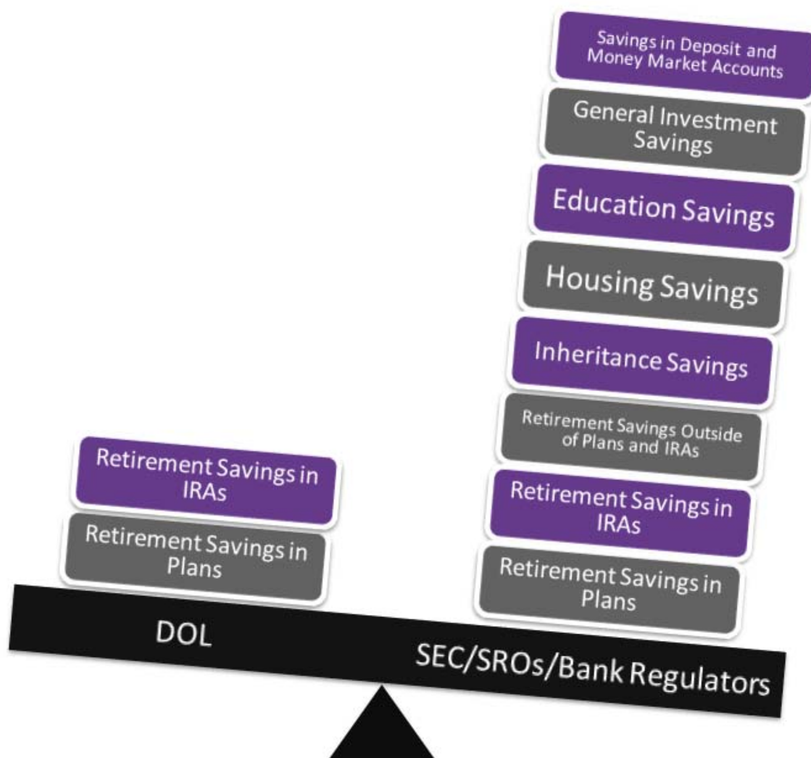
The figure below illustrates the range of investments to which the rules and oversight of the SEC, SROs, and banking regulators *already* apply.

## Protection of Investors' Retirement and Other Investments




Established financial services regulators are better positioned to establish standards of conduct for broker-dealers and investment advisers that protect investors given these regulators' vast experience, technical expertise, and understanding of the financial services industry.

## Uniform Core Protections Address Concerns Identified in the CEA Report

No matter the particular regulatory framework involved, comprehensive and consistent investor protections, including the core protections outlined below, are in place to address any conflicts of interest and other concerns identified in the CEA Report. This is so regardless of whether the advice is for retirement assets in IRAs or plans, or for personal assets in other accounts, and regardless of whether the advice would cause the financial professional to be viewed as a fiduciary under the DOL's regulations.

The Securities Exchange Act of 1934 (Exchange Act) and FINRA rules govern investment advice provided by broker-dealers, and the Investment Advisers Act of 1940 (Advisers Act) governs

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advice provided by federally registered investment advisers. Though broker-dealers and investment advisers are subject to different statutes, common standards apply to each. Specifically, both broker-dealers and investment advisers are subject to antifraud provisions (and other rules) that require them to seek information on customers' investment circumstances and objectives, consider customers' interests when giving investment advice, address conflicts of interest, and avoid unreasonable costs. The OCC and other banking regulators impose similarly stringent requirements when banks provide investment advice.[10]

The antifraud provisions of the Exchange Act prohibit fraud by broker-dealers in connection with the purchase or sale of securities.[11] In addition, under the antifraud provisions and FINRA rules, broker-dealers are required to deal fairly with their customers and to observe "high standards of commercial honor and just and equitable principles of trade."[12] Similarly, sections 206(1), 206(2), and 206(4) of the Advisers Act prohibit an investment adviser from committing fraud on any client or prospective client.[13] The antifraud provisions of the Exchange Act and Advisers Act, and, in the case of broker-dealers, FINRA rules, have been interpreted to require the following of both broker-dealers and registered investment advisers:

- **Investment recommendations and decisions must be based on a reasonable determination that the investment is suitable in light of the investor's financial situation and investment objectives.** Broker-dealers are subject to suitability obligations under the antifraud provisions and FINRA Rule 2111, which require a broker-dealer to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable for its customer based on the customer's investment profile. The SEC and FINRA have

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10. *See* Office of the Comptroller of the Currency, Comptroller's Handbook: Personal Fiduciary Activities (Feb. 2015), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/am-pfa.pdf; Office of the Comptroller of the Currency, Comptroller's Handbook: Conflicts of Interest (Jan. 2015), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/conflictofinterest.pdf; Federal Reserve Board, Commercial Bank Examination Manual, Section 4200, *available at* http://www.federalreserve.gov/boarddocs/supmanual/supervision_cbem.htm; Federal Deposit Insurance Corporation, Trust Examination Manual, Section 8 – Compliance/Conflicts of Interest, Self-Dealing and Contingent Liabilities (May 2005), *available at* https://www.fdic.gov/regulations/examinations/trustmanual/.
11. For example, section 15(c) of the Exchange Act prohibits a broker-dealer from inducing or attempting to induce the purchase or sale of a security using any manipulative, deceptive, or other fraudulent device or contrivance. Sections 9(a) and 10(b) of the Exchange Act and section 17(a) of the Securities Act of 1933 (Securities Act) also include antifraud provisions that are applicable to broker-dealers when dealing with retail customers.
12. *See* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).
13. Specifically, sections 206(1) and (2) prohibit an adviser from employing "any device, scheme, or artifice to defraud any client or prospective client" or from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Investment advisers may also face liability for violations of certain Exchange Act provisions, such as section 10(b) and Rule 10b-5 thereunder. Section 206(4) makes it unlawful for any investment adviser directly or indirectly "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and gives the SEC authority "for the purposes of [paragraph (4)] by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

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interpreted this standard to require that "[a] broker's recommendations . . . be consistent with his customer's *best interests*, and he or she . . . abstain from making recommendations that are inconsistent with the customer's financial situation."[14] Further, a customer's consent, even with complete disclosure, does not obviate a broker-dealer's suitability obligations.[15] Suitability requirements apply not only to the recommendation of particular investments, but also to the frequency of trading in a brokerage account. Thus, FINRA rules and the antifraud provisions have been interpreted to prohibit excessive trading, churning, or mutual fund switching.[16] In addition, FINRA has further elaborated upon suitability obligations with products that can create unique risks or conflicts of interest, such as variable annuities, direct participation programs, options, security futures, and index warrants, currency index warrants, and currency warrants.[17] Further, as discussed in more detail below, FINRA has provided specific guidance on suitability obligations related to IRA rollover recommendations.[18] The Exchange Act and FINRA rules further require firms to supervise their representatives vis-à-vis their recommendations.[19]

Similarly, an investment adviser may provide only suitable investment advice, which includes an obligation on the part of an adviser to make a reasonable determination that the advice is suitable based on the client's financial situation and investment

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14. *In the Matter of the Application of Dane S. Faber*, Exchange Act Release No. 49216 (Feb. 10, 2004) (emphasis added); *see also* FINRA Regulatory Notice 12-25 (Suitability – Additional Guidance on FINRA's New Suitability Rule) at 3, 19 n.15 (May 2012) (citing, among others, *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'"); *Wendell D. Belden*, 56 S.E.C. 496, 503, 2003 SEC LEXIS 1154, at *11 (2003) ("As we have frequently pointed out, a broker's recommendations must be consistent with his customer's best interests."); *Daniel R. Howard*, 55 S.E.C. 1096, 1100, 2002 SEC LEXIS 1909, at *5–6 (2002) (same), *aff'd*, 11 F. App'x 2 (1st Cir. 2003); *Powell & McGowan, Inc.*, 41 S.E.C. 933, 935, 1964 SEC LEXIS 497, at *3–4 (1964) (same); *Dep't of Enforcement v. Evans*, No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (NAC Oct. 3, 2011) (same); *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *19 (NAC May 10, 2010) (same), *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); *Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests, and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs.").
15. *See* Exchange Act § 29(a), 15 U.S.C. § 78cc; FINRA Rule 2111 (Suitability), Supplementary Material .02. Only institutional accounts may opt out of applicable suitability obligations under FINRA rules.
16. *See, e.g.*, STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS at 64–65 (January 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (IA-BD STUDY) (discussing excessive trading, churning, and mutual fund switching under the antifraud provisions and FINRA rules).
17. *See* FINRA Rule 2310(b)(2) (Direct Participation Programs); FINRA Rule 2330(b) (Members' Responsibilities Regarding Deferred Variable Annuities); FINRA Rule 2353 (Suitability) (regarding trading in index warrants, currency index warrants, and currency warrants); FINRA Rule 2360(b)(19) (Options); FINRA Rule 2370(b)(19) (Security Futures).
18. FINRA, Regulatory Notice 13-45, Rollovers to Individual Retirement Accounts: FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers (Dec. 2013), *available at* http://www.finra.org/sites/default/files/NoticeDocument/p418695.pdf.
19. *See* Exchange Act § 15(b)(4)(E), (b)(6)(A), 15 U.S.C. § 78o(b)(4)(E), (b)(6)(A); FINRA Rule 3110 (Supervision).

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objectives, and to have a reasonable basis for its recommendation.[20] Notably, interpretations of the suitability requirements under the Advisers Act generally align with interpretations of broker-dealers' suitability obligations under the Exchange Act.[21] Again, as for broker-dealers, disclosure and consent generally do not relieve an adviser from its duty to make suitable investment recommendations to, and decisions for, clients. Further, the Supreme Court has interpreted the Advisers Act antifraud provisions to impose a broad federal fiduciary standard on investment advisers.[22] (Note that, similarly to registered investment advisers, when a bank provides investment advice, the bank has an obligation to review the client's investment objectives and policy, and to administer the client's account in a prudent manner and in the best interests of the client.)[23]

The CEA report asserts that the differences between the standards that apply under the Advisers Act and those that apply under the Exchange Act result in investor harm,[24] but that assertion fails to address the significant protections offered under the broker-dealer regulatory regime, including antifraud provisions of the federal securities laws, suitability obligations, and other requirements under SEC and FINRA rules. In particular, according to the SEC and FINRA, a broker-dealer's suitability obligation generally requires that recommended investments be consistent with the

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20. *See* Status of Investment Advisory Programs Under the Investment Company Act of 1940, Investment Company Act Release No. 22579, Investment Advisers Act Release No. 1623 (Mar. 24, 1997), 62 Fed. Reg. 15098, 15102 (Mar. 31, 1997) ("Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice, whether or not the advice is provided to clients through an investment advisory program. To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.") (citation omitted); *see also Bullmore v. Ernst & Young Cayman Islands*, 45 A.D.3d 461, 463 (N.Y. App. Div. 2007) ("Professionals such as investment advisors, who owe fiduciary duties to their clients, 'may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties,' since in 'these instances, it is policy, not the parties' contract, that gives rise to a duty of care.'" (citations omitted)).

21 For example, in considering a proposed suitability rule for investment advisers, the SEC "looked to interpretations of the scope of broker-dealers' suitability obligations under the antifraud provisions of the" Exchange Act in interpreting the suitability obligations that apply to investment advisers and developing a proposed suitability rule for investment advisers. Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406 (Mar. 16, 1994), 59 Fed. Reg. 13464, 13465 n.6 (Mar. 22, 1994). Though the SEC never adopted the rule, the Staff of the Division of Investment Management has taken the position that "the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act." Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. Securities and Exchange Commission, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission at 24 n.134 (Mar. 2013).

22. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

23. *See, e.g.*, Comptroller's Handbook: Personal Fiduciary Activities, *supra* note 10, at 35; Comptroller of the Currency, Comptroller's Handbook: Conflicts of Interest (Jan. 2015), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/conflictofinterest.pdf; FDIC, Trust Examination Manual, Section 8 – Compliance/Conflicts of Interest, Self-Dealing and Contingent Liabilities (May 2005) *available at* https://www.fdic.gov/regulations/examinations/trustmanual/; FRB Supervisory Letter SR 96-10, Risk-Focused Fiduciary Examinations (April 24, 1996), *available at* http://www.federalreserve.gov/boarddocs/srletters/1996/sr9610.htm.

24. CEA REPORT, *supra* note 1, at 6.

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customer's *best interests*.[25] In addition, a broker-dealer's suitability obligation does not stand alone. It is bolstered by the antifraud provisions and standards of professional conduct under the securities laws and FINRA rules discussed above, and the additional prophylactic rules and regulations and other protections discussed in more detail below.[26] Further, under common law in many if not most states, a broker-dealer may be considered a fiduciary to its customers in various circumstances, such as when the broker-dealer exercises discretion or control over its customer's assets.[27] Similarly, broker-dealers may be held to a fiduciary standard in arbitrations; in fact, breach of fiduciary duty has been the most common claim in FINRA arbitration for at least the last five years.[28]

- **Broker-dealers and registered investment advisers must take steps to address conflicts of interest.** Investment advisers and broker-dealers are both required to address conflicts of interest that could affect their advice to investors.[29] Consistent with long-standing principles under common law, an investor may consent to a conflict of interest if the financial professional provides full and fair disclosure of the conflict of interest. In particular, the antifraud provisions under the Exchange Act require a broker-dealer that recommends a security to "give honest and complete information" and to disclose "material adverse facts of which it is

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25. *See supra* note 14 and accompanying text; *see also* Financial Industry Regulatory Authority, 2015 Regulatory and Examination Priorities Letter at 2 (Jan. 6, 2015), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf (reminding firms that they are subject to a de facto best interests standard). Though a broker-dealer's suitability obligation is not the legal equivalent of a fiduciary standard under either the Advisers Act or ERISA, it should not be viewed or considered in isolation. Rather, a more reasoned analysis should consider the investor protections provided by the entirety of the broker-dealer regulatory framework. *See, e.g.*, Elisse B. Walter, Commissioner, U.S. Securities and Exchange Commission, Speech at the Mutual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009) ("As you probably know, the standard of conduct issue has been discussed a great deal lately. Some have characterized the different standards applicable today in a very simple way: Investment advisers are subject to a fiduciary duty, and broker-dealers are not—end of story. I find that explanation unsatisfactory. As Einstein once said, 'Everything should be made as simple as possible, but not simpler.'").

26. The broker-dealer regulatory model includes investor protections that are well considered and, in many ways, more extensive than those applicable to fiduciaries like investment advisers and banks. These include, among other requirements, qualification and registration requirements, continuing education requirements, more transparent systems for reporting of disciplinary information of all kinds, specific supervision requirements, pre-use review and approval of communications with the public, and formal rules governing outside business activity and "selling away" by broker-dealers. Moreover, a broker-dealer's customers may pursue remedies through private rights of action in arbitration and through class action litigation, while an investment adviser's clients cannot pursue damages and other monetary relief under the Advisers Act, and instead are limited to voiding the advisory contract and obtaining restitution of fees paid. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

27. *See U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *U.S. v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002).

28. *See* FINRA Arbitration & Mediation, Dispute Resolution Statistics, *available at* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

29. Similar standards apply to advice provided by banks. *See* Comptroller's Handbook: Conflicts of Interest, *supra* note 10; Federal Reserve Board, Commercial Bank Examination Manual, *supra* note 10; FDIC, Trust Examination Manual, *supra* note 10.

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aware."[30] Courts have interpreted this provision to require broker-dealers to disclose information in a number of situations involving conflicts of interest, including where the broker-dealer may receive compensation from providers of investment products it recommends.[31] Similarly, under the Advisers Act, where an adviser provides full disclosure of a conflict of interest, clients may generally consent to a conflict that would otherwise raise issues under the investment adviser's duty of loyalty.[32]

The CEA Report asserts that certain financial professionals receive undisclosed "conflicted payments" (*e.g.*, revenue sharing, sales loads, sales targets and payouts, and variable commissions) that induce them to recommend investments that generate better returns for the financial professional at the expense of investors.[33] As Richard G. Ketchum, the Chairman and CEO of FINRA, recently said, "that impression [articulated in the CEA Report] is false."[34] Many financial professionals do not receive any compensation from third-parties in connection with client dealings, and if they do, the third-party compensation may directly or indirectly offset or reduce the fees that clients might otherwise pay. Even without such fee offsets or reductions, as discussed above, broker-dealers and investment advisers generally

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30. *See In the Matter of Richmark Capital Corp.*, Securities Act Release No. 8333, Exchange Act Release No. 48758 (Nov. 7, 2003) ("When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of 'adverse interests' such as 'economic self interest' that could have influenced its recommendation.") (citations omitted); *see also Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 459-61 (9th Cir. 1986).

31. *See In re AIG Advisory Group*, No. 06 CV 1625(JG), 2007 WL 1213395, at *7–9 (E.D.N.Y. Apr. 25, 2007) (regarding revenue sharing payments from mutual funds); *see also* NASD Notice to Members 95-80 (NASD Further Explains Members Obligations And Responsibilities Regarding Mutual Funds Sales Practices) (regarding disclosure obligations with respect to the differences in expenses and fees between share classes of a recommended mutual fund and how those differences will impact returns). In addition, broker-dealers must disclose any compensation they will receive from underwriters when selling the underwriter's mutual funds unless that information is disclosed in the mutual fund prospectus. *See* NASD Notice to Members 94-14 (NASD Clarifies Compensation Disclosure Requirements For Mutual Funds In Article III, Section 26 Of The NASD Rules Of Fair Practice). Further, FINRA has established restrictions on the use by broker-dealers of non-cash compensation in connection with the sale or purchase of certain securities, including, among others, mutual funds and variable annuities. *See* FINRA Rule 2320 (Variable Contracts of an Insurance Company); NASD Rule 2830 (Investment Company Securities); *see also* FINRA Rule 2310 (Direct Participation Programs); FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements). In October 2013, FINRA issued a report identifying effective practices that FINRA has observed firms using or that FINRA believed, based on its experience and analysis, could help firms better manage conflicts of interest. *See* Financial Industry Regulatory Authority, Report on Conflicts of Interest (Oct. 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.

32. *See* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), 75 Fed. Reg. 49234, 49234 (Aug. 12, 2010) ("A prospective client may seek modifications to an investment advisory agreement to better protect the client against an investment adviser's potential conflict of interest, either by better aligning the adviser's interest with that of the client or by prohibiting a particular practice in the client's account. If an adviser is unwilling to make such modifications, a prospective client may select a different adviser.").

33. CEA REPORT, *supra* note 1, at 2, 7; *see also President* Barack H. Obama, Remarks by the President at the AARP (Feb. 23, 2015).

34. *See* Melanie Waddell, *All Eyes on SEC Chief to Move Fiduciary Forward, FINRA's Ketchum Says*, THINKADVISOR, Mar. 16, 2015, *available at* http://www.thinkadvisor.com/2015/03/16/all-eyes-on-sec-chief-to-move-fiduciary-forward-fi (quoting Mr. Ketchum as stating "'if there's an impression in America that undisclosed backdoor payments are the driver of what goes on in the securities industry, that impression is false.'").

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must disclose compensation received from providers of investment products they recommend.[35] These disclosures are often supplemented by additional disclosures from the third parties making the payments.

For example, when broker-dealers and investment advisers recommend a mutual fund, they generally are required to disclose any compensation they will receive from the mutual fund or its service providers. As another example, many dually registered broker-dealer investment advisers provide clients with helpful information about their compensation and other arrangements they have with mutual fund organizations, including through website disclosures and new account information.

Thus, an investor working with a financial professional associated with a dual registrant may receive a number of disclosures, including the following:

## Disclosures that Inform Investors

These disclosures both inform investors, and deter improper conduct. Further, receipt of undisclosed compensation is a key focus of SEC examination and enforcement efforts.[36]

Recognizing the role of effective disclosures, the SEC has taken steps to modernize disclosure with a focus on providing investors with information and disclosures that are clear and accessible, including establishing plain-English disclosure requirements,[37] adopting the Summary Prospectus Rule,[38] and amending Part 2A of

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35. *See supra* notes 29–32 and accompanying text. Investment advisers are required to disclose any compensation they receive from a non-client as part of the comprehensive disclosures on Part 2A of Form ADV. *See* Item 14 of Part 2A of Form ADV. Similarly, broker-dealers that effect transactions in securities are required to disclose, at or before the completion of the transaction, the source and amount of any remuneration from a third party, or provide a written notification that the information is available upon request. Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10. Further, if an investment adviser engages a third party to solicit or refer prospective clients for compensation, both the solicitor and the adviser are required to disclose the compensation arrangement. Advisers Act Rule 206(4)-3; 17 C.F.R. § 275.206(4)-3.

36. *See, e.g.*, Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks to the IA Watch 17 Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015) (discussing the SEC Division of Enforcement's focus on disclosure of conflicts of interest, its Undisclosed Adviser Revenue risk-analytic initiative, and recent enforcement actions).

37. *See, e.g.*, SECURITIES AND EXCHANGE COMMISSION, OFFICE OF INVESTOR EDUCATION AND ASSISTANCE, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS (Aug. 1998), *available at* https://www.sec.gov/pdf/handbook.pdf (providing guidance in drafting plain English disclosures); Plain English Disclosure, Securities Act Release No. 7497, Exchange Act Release No. 39593, Investment Company Act Release No. 23011, International Series No. 1113 (Jan. 28, 1998), 63 Fed. Reg. 6370 (Feb. 6, 1998) (adopting the Plain English Disclosure Rule requiring "issuers to write the cover page, summary, and risk factors section of prospectuses in plain English").

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Form ADV to provide a narrative disclosure that better enables clients to compare fees, conflicts of interest, and other information from different advisers.[39] For example, in adopting the Summary Prospectus Rule, the SEC indicated that this disclosure is intended to help ensure that mutual fund investors have adequate information about payments that may create conflicts of interest for financial professionals.[40]

In addition to actions taken by the SEC, many financial services firms have long supported, and continue to support, efforts to educate investors about financial decisions and initiatives to develop more effective disclosures.[41]

The CEA Report questions the effectiveness of disclosure to address conflicts of interest, and specifically notes that disclosure may "lack salience," face "design challenges," or "backfire" by making financial professionals more willing to pursue their own interests, or causing advisees to trust their financial professional and thus to be "more likely to follow their advisers' biased advice."[42] But, the studies on which the CEA Report relies to support these assertions do not provide an adequate foundation on which to assess the merits of disclosure in the financial services industry. For example, the studies by Cain, Lowenstein, and Moore, which claim that

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38. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28584 (Jan. 13, 2009), 74 Fed. Reg. 4546 (Jan. 26, 2009) (adopting the Summary Prospectus Rule requiring "key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus").

39. Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), 75 Fed. Reg. 49234, 49234 (Aug. 12, 2010) (adopting amendments to Form ADV "to provide new and prospective advisory clients with clearly written, meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser"). The SEC also recently undertook a study required by section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding financial literacy among investors "to identify the existing level of financial literacy among retail investors as well as methods and efforts to increase the financial literacy of investors." STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS (Aug. 2012), available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

40. 74 Fed. Reg. at 4557. We note that the DOL has historically relied heavily on disclosure and informed consent, when coupled with other conditions, in its rule making and in granting class and individual prohibited transaction exemptions. *See, e.g.,* ERISA § 408(b)(2) (for service provider relationships with ERISA plans), Prohibited Transaction Exemption 77-4 (for fiduciary investments in propriety mutual funds), Prohibited Transaction Exemption 84-24 (fiduciary selling or recommending certain insurance products and mutual funds), Prohibited Transaction Exemption 86-128 (fiduciary effecting plan transactions through an affiliated broker).

41. *See, e.g.*, Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated May 16, 2008 (recommending, among other things, ways to enhance the readability of investment adviser brochures, Part 2A of Form ADV); Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated Feb. 28, 2008 (providing comments on the SEC's proposed summary prospectus rule); Letter from Ira D. Hammerman, Senior Vice President and General Counsel, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Apr. 4, 2005 (providing comments on the SEC's proposed point-of-sale disclosure rule); SIFMA Foundation, http://www.sifma.org/education/sifma-foundation/about-the-sifma-foundation/ ("The SIFMA Foundation is dedicated to fostering knowledge and understanding of the financial markets for individuals of all backgrounds").

42. CEA REPORT, *supra* note 1, at 24.

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conflicts of interest can increase bias in advice and that disclosure may make matters worse, examine only whether disclosure, standing alone without other regulatory deterrents, is sufficient to address conflicts of interest.[43]

Specifically, these studies do not factor in whether the potential for civil or criminal liability, regulatory sanctions, or other penalties may mitigate the potential harmful effects of biased advice.[44] This omission is significant because the broker-dealer and investment adviser regulatory regimes are not founded on disclosure alone, and are buttressed by fraud-based conduct obligations, regulatory examinations for fraudulent or abusive conduct, regulatory enforcement, and other protections outlined in this paper.[45]

The CEA Report notably fails to address other research findings that disclosure, when combined with the possibility of sanctions for providing biased advice, "can provide an efficient deterrent to financial advisers' opportunistic behavior."[46] One study, which was not cited in the CEA Report, recognized certain limitations in extending the research by Cain, Lowenstein, and Moore to the financial services industry, including that it failed to analyze whether the possibility of sanctions, in addition to disclosure, could alter advisers' behavior and reduce biased advice. Using an experimental investigation, the study found that "disclosure in combination with the availability of sanctions (certain penalties for bad advice) dampens advisers' bias

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43. Daylian Cain et al., *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101 AM. ECON. REVIEW 423 (2011); Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005).

44. The other studies cited address the efficacy of disclosure in situations that are not relevant in considering the appropriate standards of conduct for financial professionals or in situations that have since been addressed by the SEC. *See* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011) (discussing disclosure generally and in certain instances, acknowledging positive views of disclosure under securities regulation); John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685 (2007) (recommending, prior to the time the SEC adopted a Summary Prospectus in 2009, that the SEC adopt a "Profile Plus" disclosure document for mutual funds); Ulrike Malmendier & Devin Shanthikumar, *Are Small Investors Naïve About Incentive*, 85 J. FIN. ECON. 457 (2007) (examining investor reliance on security analysts' reports); Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 Wis. L. Rev. 1059 (2011) (discussing the merits of broker-dealers providing explicit disclosure that they do not owe a customer a fiduciary duty).

45. Further, as under common law, using disclosure and informed client consent is a long-standing practice that balances a rigid approach of outright prohibiting conflicts against preserving efficiency and other client interests, such as investor choice and the ability of investors to define their relationships with financial professionals. *See* RESTATEMENT (THIRD) OF TRUSTS § 78C.

46. See Bryan K. Church & Xi (Jason) Kuang, *Conflicts of Interest, Disclosure, and (Costly) Sanctions: Experimental Evidence*, 38 J. LEGAL STUD. 505, 509 (2009).

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markedly."[47] The authors' finding that disclosure plus sanctions provides meaningful protections should be acknowledged and addressed.[48]

- **Broker-dealers and investment advisers may not charge excessive fees and must consider investment expenses in making suitability decisions.** Though the federal securities laws do not generally fix the amount of fees an investment adviser or broker-dealer can charge investors, they do require that any charges be fair and reasonable.[49] The SEC staff has interpreted an investment adviser's fiduciary duties as requiring an investment adviser to charge fees that are fair and reasonable, and has stated that, if an investment adviser charges fees that substantially exceed fees charged by other investment advisers providing similar services, it must disclose that fact to clients and potential clients.[50] Similarly, broker-dealers are required under the antifraud provisions and the federal securities laws to charge fair prices and commissions.[51] Further, the suitability requirements discussed above require both broker-dealers and investment advisers to consider the fees and expenses associated with a recommended investment.[52]

  The CEA Report claims that "conflicted payments" generate incentives for financial professionals to "steer savers into products or investment strategies that provide larger payments to the adviser," but that may underperform, in part, because of allegedly higher fees associated with such payments. But, the CEA Report fails to address the investor protections that prohibit broker-dealers and advisers from receiving excessive compensation and that prohibit recommendations of investments at unfair or unreasonable prices.

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47. *See id.* at 527. The authors noted that this result occurred even though the structure of the study provided that sanctions would be costly for the investor to initiate and the investor would have nothing to gain by pursuing sanctions (other than penalizing the adviser). *Id.* It is possible that in the real world, where broker-dealer customers have access to arbitration, a less costly way to resolve disputes, this dampening effect may prove to be even greater. The authors also recognized that the sanctioning mechanism used in the study (sanctions were certain in the instance of bad advice and bad advice was clearly defined) "may present a greater threat than in many naturally occurring markets." *Id.* at 528.

48. In fact, even Cain, Lowenstein, and Moore acknowledged in a 2011 study that "[i]t would be a mistake, however, to conclude that disclosure is always counterproductive." Daylian Cain et al., *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836, 850–51 (2011) ("However, even when advisees pay little attention to disclosed information, it can have a 'telltale heart' effect and cause advisors to exercise restraint. . . . As long as disclosure is not viewed as equal substitute for elimination of conflict, and as long as disclosed information is interpretable by those who receive it (and not written in fine-print legalese), the benefits of disclosure may outweigh the risks delineated in this paper.").

49. Likewise, fees that banks charge must be reasonable and permitted under applicable law (*e.g.,* state law).

50. *See, e.g.*, IA-BD STUDY, *supra* note 16, at 40 ("The Commission staff has taken the view that as part of their fiduciary duties, advisers must charge fees that are fair and reasonable, and when an adviser's fee is higher than others, an adviser must disclose this").

51. *See* FINRA Rule 2121 (Fair Prices and Commissions).

52. *See, e.g.*, *In the Matter of IFG Network Securities Inc. et al.*, Exchange Act Release No. 54127, Investment Advisers Release No. 2533 (July 11, 2006) (finding that failure to disclose differences in cost structures between Class A and Class B shares was misleading); FINRA Regulatory Notice 12-25, *supra* note 14, at 4 ("The cost associated with a recommendation . . . ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.").

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The SEC and FINRA actively enforce the core requirements noted above to protect investors from potential harm that may result from investment recommendations that are not in the investors' interests. The table below summarizes these core protections.

## Core Protections Across Financial Professionals Giving Advice

| Regulatory Protections | Broker (SEC, FINRA, MSRB & States) | Investment Adviser (SEC & States) | Bank (OCC, FRB, FDIC & States) | Commodity Trading Advisor (CFTC & NFA) | Insurance Producers (States) |
|---|---|---|---|---|---|
| **Know your customer when giving advice** | ✔ | ✔ | ✔ | ✔ (at account opening) | ✔ |
| **Obligation to give suitable advice in client best interest** | ✔ | ✔ | ✔ | ✔ (at account opening) | ✔ |
| **Obligation to disclose material conflicts** | ✔ | ✔ | ✔ | ✔ | ✔ |
| **Obligation to charge reasonable prices** | ✔ | ✔ | ✔ | | ✔ |
| **Restrictions on self-dealing, such as principal trades, especially when acting as fiduciary** | ✔ (through disclosure) | ✔ | ✔ | | ✔ |

## Broker-Dealers Are Subject to Comprehensive Regulation

In addition to the core protections discussed above that apply regardless of the type of financial professional an investor chooses for investment advice, the current regulatory framework imposes specific requirements on broker-dealers that provide a high level of investor protection. Specifically, the broker-dealer regulatory framework provides:

- Comprehensive rules designed to protect customers;
- Oversight and enforcement by the SEC, FINRA, and state securities regulators; and
- The ability for investors to seek redress through arbitration and class action litigation.

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SEC and FINRA rules governing the conduct of a broker-dealer's business include, among other things, rigorous registration, testing, and continuing education requirements.[53] Further, rules applicable to broker-dealers require them to disclose information about registered representatives' background and conduct, which is publicly available through FINRA BrokerCheck,[54] impose robust recordkeeping requirements,[55] set standards for best execution and order handling,[56] and establish other customer protection obligations.[57] Broker-dealers are further required to supervise for compliance with the federal securities laws.[58]

Additionally, the SEC, FINRA, and state securities regulators conduct periodic examinations and have developed comprehensive and targeted enforcement programs to identify and correct compliance issues. Both broker-dealers and investment advisers are subject to extensive risk-based examinations. Though the examination cycles differ between broker-dealers and investment advisers for various reasons (with broker-dealers examined more frequently), firms employing the greatest number of financial professionals are closely monitored and subject to annual, if not more frequent, examinations.[59] The SEC and FINRA complement their broker-dealer examination programs with active enforcement.

Further, customers of broker-dealers are able to seek redress through class action litigation and arbitration, including FINRA arbitration, for certain alleged violations of the federal securities laws (*e.g.*, matters alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder related to disclosure, customer communications, and suitability violations) as well as

53. Section 15(a) of the Exchange Act requires broker-dealers that effect securities transactions, or that induce or attempt to induce the purchase or sale of securities, to register with the SEC. In addition, broker-dealers that conduct business with the public, such as retail customers, must become members of FINRA. Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8); Exchange Act Rule 15b9-1, 17 C.F.R. § 240.15b9-1. FINRA has also adopted rules requiring registration of principals and registered representatives, as well as testing and continuing education requirements. *See, e.g.*, NASD Rule 1021 (Registration Requirements); NASD Rule 1022 (Categories of Principal Registration); NASD Rule 1031 (Registration Requirements); NASD Rule 1032 (Categories of Representative Registration).

54. *See* FINRA By-Laws Art. V, Sec. 2.

55. *See* Exchange Act Rules 17a-3, 17a-4, 17 C.F.R. § 240.17a-3, 17a-4 (regarding broker-dealers' recordkeeping obligations).

56. *See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269 (3d Cir. 1998), *cert. denied* 525 U.S. 811 (1998); FINRA Rule 5310 (Best Execution and Interpositioning); MSRB Rule G-18 (Best Execution) (effective Dec. 7, 2015); *see also* Regulation NMS, Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004).

57. *See* Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (establishing net capital requirements); Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (establishing customer protection requirements related to reserves and custody of securities).

58. *See* Exchange Act § 15(b)(4)(E), (b)(6)(A), 15 U.S.C. § 78o(b)(4)(E), (b)(6)(A); FINRA Rule 3110 (Supervision).

59. Broker-dealers are generally examined once every one to four years. *See* IA-BD STUDY, *supra* note 16, at A-2 through A-16.

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alleged violations of FINRA rules.[60] In many cases, pursuing matters through arbitration can be faster and less costly than court-based litigation. Additionally, arbitration forums, including the FINRA arbitration forum, offer procedural safeguards to protect customers.[61] All FINRA arbitration awards are public, unredacted, and available on FINRA's website.[62]

## Regulation of Investment Advice Under the Securities Laws Is Calibrated to Protect Investors Appropriately, While Preserving Investor Choice

Though the securities laws include core protections applicable across both investment advisers and broker-dealers, as well as other rules specific to each, the laws recognize that advice is provided under different business models that provide investors, including those saving for retirement through IRAs, with a range of choices and the ability to define and control their relationships with their chosen financial professionals and how the financial professional will be compensated for his or her services. In light of the differences between how investment advisers and broker-dealers operate, the regulations that apply to each are tailored to address the risks and potential conflicts that are unique to each model.

In general, the more influence or authority a financial professional has over the investor's investment decisions, the greater the regulatory scrutiny and compliance requirements become. So, for example, if an investor merely requests that a broker-dealer execute an unsolicited securities transaction, the broker-dealer's duties are generally limited to seeking best execution (*i.e.*, where and how to effect the trade) and satisfying certain disclosure requirements, and there is no obligation to investigate the suitability of the investor's security transaction. At the other end of the spectrum, if an investor hires an investment adviser to make and carry out investment decisions for the investor without first consulting the investor (*i.e.*, discretionary investment advice), the adviser is subject to more fulsome obligations, including the Advisers Act suitability and disclosure requirements, the federal fiduciary standards noted above, and restrictions on principal trading. Importantly, while broker-dealers are governed by SEC and FINRA requirements when they provide advice incidental to their role as broker-dealers, if their advice goes beyond that threshold (including by offering advisory services for separate compensation or on a discretionary basis), the added fiduciary safeguards under the Advisers Act swing into force. The illustration below shows how the regulatory requirements increase at different advisory service levels.

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60. With over 3,500 arbitration cases filed with FINRA in 2014, customers actively use arbitration as a means to address complaints against broker-dealers.

61. *See, e.g.*, IA-BD Study, *supra* note 16 at 80–81; SIFMA, White Paper on Arbitration in the Securities Industry (Oct. 2007), *available at* http://www.sifma.org/issues/legal,-compliance-and-administration/pre-dispute-arbitration/resources/. Note that the SEC is authorized to oversee the FINRA's arbitration programs.

62. *See* FINRA Arbitration & Mediation, FINRA Arbitration Awards Online, *available at* http://finraawardsonline.finra.org/.

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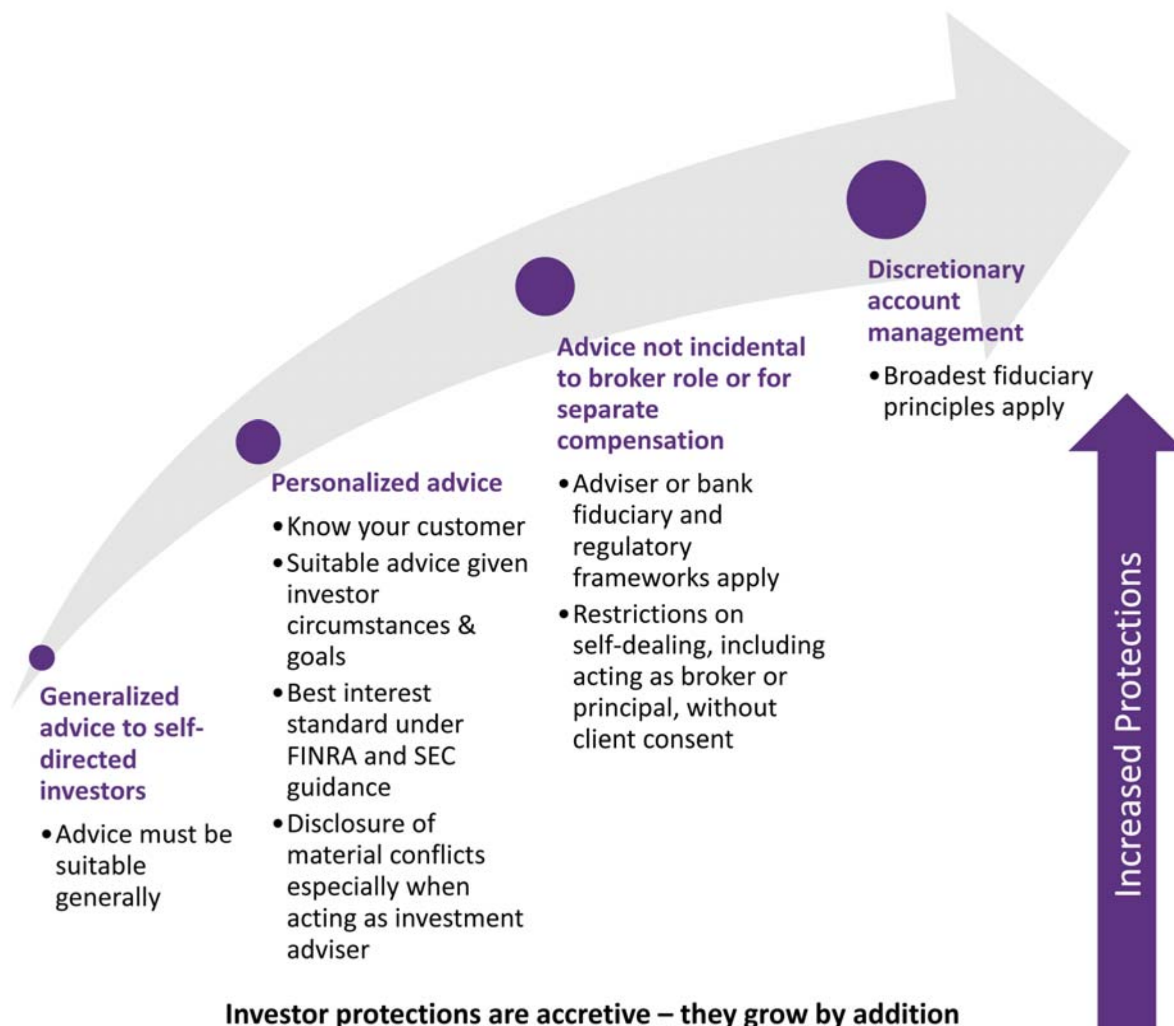
## Graduated Investor Protections when Receiving Advice

Protections Increase as Financial Professional's Role and Authority – and Investor's Reliance – Increase




As so structured, the securities laws increase investor protections as the investor's reliance on the financial professional increases. This calibrated regulatory framework recognizes that investors and their financial professionals should be able to control the extent and the contours of their relationship, and that the laws governing that relationship should follow accordingly. Further, because service level and regulatory compliance costs are inevitably passed on to investors, graduated regulation may facilitate investor access and choice, particularly for investors who do not want to pay for ongoing advice. The current regulatory framework enables such investors to access guidance and assistance from investment professionals with a range of

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options and choices regarding the type of relationship and related costs, while still benefiting from an appropriate level of investor protection and regulatory oversight.

The CEA Report suggests that the fiduciary standard that applies to investment advisers offers better consumer protections than the suitability standard that applies to broker-dealers.[63] This over-simplifies a complex regulatory framework, fails to appreciate that the regulatory framework is calibrated to reflect that broker-dealers and investment advisers play different roles, and fails to address broker-dealers' obligations that are established in reticulated form via SEC and FINRA requirements. The CEA Report further claims that preserving the current system is not necessary to maintain access to professional advice for savers with lower account balances because change will not increase the cost of advice and financial professionals will still have incentives to provide services to savers with low balances.[64] Though the merits of these claims are better addressed through economic analyses that are beyond the scope of this white paper,[65] we note that these claims dismiss the value the current regulatory framework provides to investors, including low-balance investors, by enabling them to choose and define their relationships with their chosen financial professionals.

## Proactive Oversight and Examination Focus on Retirement Assets and Senior Investors

Recognizing the increasingly important role IRAs play as one means of saving for retirement, the SEC and FINRA have undertaken special initiatives directed at IRAs, as well as employer-sponsored plans and senior investor issues.[66] These initiatives include the following:

- **Guidance on communications regarding fees in IRA advertisements.** In July 2013, FINRA issued Regulatory Notice 13-23 to provide guidance regarding fair and balanced advertisements with respect to IRA fees.[67]

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63. CEA REPORT, *supra* note 1, at 6-7.
64. *Id.* at 21.
65. *See* DR. JEREMY BERKOWITZ ET AL., NERA ECONOMIC CONSULTING, REVIEW OF THE WHITE HOUSE REPORT TITLED "THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS" (Mar. 2015) (discussing these and other claims in the CEA Report).
66. The OCC has also undertaken a particular focus on advice provided with respect to retirement assets and has published guidance on asset management services for retirement plans. Comptroller of the Currency, Comptroller's Handbook: Retirement Plan Products and Services (Feb. 2014) *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/file-pub-employee-benefits-retirement-plan.pdf.
67. FINRA, Regulatory Notice 13-23, Brokerage and Individual Retirement Account Fees: FINRA Provides Guidance on Disclosure of Fees in Communications Concerning Retail Brokerage Accounts and Individual Retirement Accounts (Jul.. 2013), *available at* http://www.finra.org/sites/default/files/NoticeDocument/p304670.pdf.

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- **Guidance to clarify the standards and requirements that apply to broker-dealers making recommendations and providing education to investors eligible for distributions from employer-sponsored plans.** Recognizing the complexity and importance of the decision to roll over assets to an IRA, or to keep them in an employer-sponsored plan, FINRA issued Regulatory Notice 13-45 in December 2013 to provide guidance on broker-dealers' responsibilities when making recommendations, providing education, and engaging in other activities with respect to such assets.[68] The notice includes a nonexclusive list of considerations broker-dealers must take into account when making a rollover recommendation to satisfy FINRA Rule 2111. These considerations include fees, available services and investments, distribution options, and tax considerations, among others.

  The notice further requires broker-dealers to review and assess conflicts of interest and to supervise "to reasonably ensure that conflicts of interest do not impair the judgment of a registered representative . . . about what is in the customer's interest." Additionally, the notice provides guidance on investor education and imposes further requirements on communications with the public.
- **Examination priorities focused on rollover practices.** Both the SEC and FINRA added practices with respect to rollovers from employer plans to IRAs to their examination priorities in 2014,[69] maintained them as priorities in 2015,[70] and have been active in examining rollover practices.
- **Examination priorities focused on other issues relevant to retirement investors.** The SEC's and FINRA's 2015 examination priorities particularly focus on retirement-related issues, noting that "investors are more dependent than ever on their own investments for retirement" and that "the financial services industry is offering a broad array of information, advice, products, and services to retail investors to help them plan for, and live in, their retirement years."[71] Among the items the SEC is examining is the suitability of recommendations of particular investment products and accounts.

  In addition to its focus on IRA rollovers, FINRA is examining communications to senior investors, suitability of recommendations made to seniors, training to address senior-specific issues (*e.g.*, elder abuse and diminished capacity), and supervision to protect senior investors.[72]

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68. Regulatory Notice 13-45, *supra* note 18.
69. SEC Office of Compliance Inspections and Examinations (OCIE), National Examination Priorities for 2014 (Jan. 2014), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf; FINRA, 2014 Regulatory and Examination Priorities Letter (Jan. 2014) *available at* https://www.finra.org/sites/default/files/Industry/p419710.pdf.
70. OCIE, National Examination Priorities for 2015 (Jan. 2015), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; FINRA, 2015 Regulatory and Examination Priorities Letter (Jan. 2015) *available at* https://www.finra.org/sites/default/files/p602239.pdf.
71. OCIE, National Examination Priorities for 2015, *supra* note 70, at 2.
72. FINRA, 2015 Regulatory and Examination Priorities Letter, *supra* note 70, at 10.

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FINRA's and the SEC's guidance and examination activities noted above represent an increased focus on protecting retirement investors and on retirement-specific issues. In suggesting that the current legal standards that apply to investment advisers and broker-dealers are inadequate to address potential harm to IRA investors, the CEA Report fails to address these developments and their potential over time to ameliorate any perceived gaps in the current system.

## Conclusion

The regulatory framework that applies to investment advisers and broker-dealers is extensive and reflects the complexity and variety of relationships that advisers and broker-dealers have with their clients, as well as the complexity and variety of investment products and strategies available to investors in the marketplace today. This framework is informed by over 100 years of learning and experience regarding how to best protect investors from potential harm that may result when their financial professional has a conflict of interest, while balancing the benefits of investor choice and autonomy.

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## Appendix – Regulators That Oversee the Provision of Investment Advice

| Name | Statutes | Authority |
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| **Board of Governors of the Federal Reserve System (FRB)** | Federal Reserve Act of 1913 | Regulates, supervises, and examines state-chartered banks and trust companies that are members of the Federal Reserve System, including activities with respect to investment advice. The FRB has established examination guidelines and guidance with respect to fiduciary services provided by banks and trust companies regulated by the FRB.[73] |
| **Commodity Futures Trading Commission (CFTC)** | Commodity Exchange Act of 1936 | Regulates advice related to commodity interests, which includes futures, options on futures, and swaps.[74] Intermediaries such as CTAs and commodity pool operators (CPOs) must be registered with the CFTC and be members of the NFA.[75] Associated persons (*i.e.*, persons engaged in the solicitation of customer accounts or funds and supervisors of such persons) must be individually registered and pass a test.[76] Associated persons and principals of CTAs and CPOs are subject to a background check and must not be subject to a statutory disqualification.[77]<br><br>CTAs and CPOs are subject to the antifraud provisions in the Commodity Exchange Act.[78] Registered CTAs and CPOs must provide risk disclosures to their clients, describing their background, trading program, risk factors, conflicts of interest, past performance |

73. FRB Supervisory Letter SR 96-10, Risk-Focused Fiduciary Examinations (April 24, 1996); Federal Reserve Board, Commercial Bank Examination Manual, *supra* note 10.
74. Section 4n of the Commodity Exchange Act; 7 U.S.C. § 6n.
75. *Id.*; NFA Bylaw 1101 states that no member of NFA may "carry an account, accept an order or handle a transaction" in commodity futures contracts for, or on behalf of, any nonmember of NFA that is required to be registered with the Commission as, *inter alia*, an IB, CPO, or CTA. Accordingly, any CTA or CPO required to be registered with the CFTC that desires to conduct business directly with an FCM must become a member of NFA.
76. Section 4k of the Commodity Exchange Act; 7 U.S.C. § 6k; NFA Registration Rule 206; NFA Compliance Rule 2-24.
77. NFA Registration Rules 206, 208.
78. Section 4o of the Commodity Exchange Act; 7 U.S.C. § 6o.

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| | | results, fees and expenses, and any information material to an investor's decision to invest.[79] CTAs and CPOs must make periodic filings with the CFTC and their clients and are subject to recordkeeping requirements.[80] |
| **Department of Labor – Employee Benefits Security Administration** | Employee Retirement Income Security Act of 1974 (ERISA)<br><br>Internal Revenue Code of 1986 (Code) | Interprets, regulates, and enforces the provisions of Title I of ERISA as they apply to fiduciaries and other service providers to ERISA-covered plans.<br><br>Interprets the prohibited transaction rules under section 4975 of the Code as they apply to fiduciaries and other service providers to plans, IRAs, and certain other accounts. |
| **Federal Deposit Insurance Corporation (FDIC)** | Banking Act of 1933<br><br>Federal Deposit Insurance Act of 1950 | Regulates, supervises, and examines state banks that are not members of the Federal Reserve System. State non-member banks must apply to, and receive the approval of, the FDIC in order to exercise trust powers in accordance with applicable state law. The FDIC has established examination guidelines related to banks' fiduciary duties with respect to investment advice.[81] The FDIC refers to applicable state and common law fiduciary standards when a bank provides fiduciary investment advice services to a client. |
| **Financial Industry Regulatory Authority (FINRA)** | Securities Exchange Act of 1934 | An SRO that is responsible for writing and enforcing rules governing registered broker-dealers and examining firms for compliance with those rules.<br><br>FINRA rules require broker-dealers to |

79. 17 C.F.R. §§ 4.24-25, 4.34-35; NFA Compliance Rules 2-13, 2-46.
80. 17 C.F.R. §§ 4.22-23, 4.33; NFA Compliance Rules 2-10, 2-13, 2-46.
81. FDIC, Trust Examination Manual, § 3.A.

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| | | "observe high standards of commercial honor and just and equitable principles of trade,"[82] and to have a reasonable basis to believe a recommendation is suitable for an investor, based on reasonable diligence of the investor's profile, and further to believe that a recommended number of transactions within a certain period is not excessive.[83]<br><br>FINRA rules further require fair and balanced communications with the public, disclosure of conflicts of interest, and receipt of fair compensation, as well as various other substantive requirements.[84] |
| **Internal Revenue Service** | Internal Revenue Code of 1986 (Code) | Enforces the prohibited transaction rules under section 4975 of the Code as they apply to fiduciaries and other service providers to plans, IRAs, and certain other accounts. |
| **Municipal Securities Rulemaking Board (MSRB)** | Securities Exchange Act of 1934 | Regulates broker-dealers that engage in municipal securities activities.[85]<br><br>Writes and enforces disclosure, due diligence, suitability, and other rules that apply to the sale of municipal securities.[86] |
| **National Futures Association (NFA)** | Commodity Exchange Act of 1936 | An SRO that regulates the derivatives industry, including futures, swaps, and foreign currencies.<br><br>NFA rules require CTAs and CPOs to "observe high standards of commercial honor and just and equitable principles of trade in |

82. *See* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).
83. FINRA Rule 2111 (Suitability).
84. *See, e.g.*, FINRA Rule 2210 (Communications with the Public); FINRA Rule 5121 (Public Offerings of Securities with Conflicts of Interest); FINRA Rule 2121 (Fair Prices and Commissions).
85. MSRB Rule A-12.
86. *See, e.g.,* MSRB Rule G-19.

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| | | the conduct of their commodity futures business and swaps business."[87]<br><br>Pursuant to NFA rules, CTAs and CPOs must obtain written authorization from a customer before exercising discretion over the customer's commodity futures account.[88] CTAs, CPOs, and associates with supervisory duties must diligently supervise their employees and agents in the conduct of their commodity futures activities for, or on behalf of, the CTA and CPO.<br><br>NFA rules further require fair and balanced communications with the public, a disclosure document using plain English principles with a break-even analysis that includes fees and expenses, performance reporting, and recordkeeping obligations, as well as various other substantive requirements.[89] |
| **Office of the Comptroller of the Currency (OCC)** | The National Bank Act | Charters, regulates, supervises, and examines national banks, national trust banks, and federal savings associations, including any investment advisory services they provide. National banks, national trust banks, and federal savings associations must apply to, and receive the approval of, the OCC in order to engage in fiduciary activities. OCC regulations and examination guidelines establish a number of requirements for national banks, national trust banks, and federal savings associations that provide fiduciary services.[90] The OCC refers to state laws as well as common law principles that |

87. NFA Compliance Rule 2-4.
88. NFA Compliance Rule 2-8.
89. *See, e.g.*, NFA Compliance Rule 2-10 (Recordkeeping), NFA Compliance Rule 2-13 (CPO/CTA Regulations); NFA Compliance Rule 2-29 (Communications With the Public and Promotional Material), NFA Compliance Rule 2-30 (Customer Information and Risk Disclosure), NFA Compliance Rule 2-34 (CTA Performance Reporting and Disclosures), NFA Compliance Rule 2-35 (CPO/CTA Disclosure Documents).
90. *See, e.g.*, 12 C.F.R. Part 9; Comptroller of the Currency, Comptroller's Handbook: Investment Management Services (Aug. 2001).

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| | | are applicable to the provision of fiduciary services. OCC regulations and guidance establish detailed requirements and expectations with respect to fiduciary activities, including avoidance of conflicts of interest.[91] |
| **Securities and Exchange Commission (SEC)** | Securities Exchange Act of 1934<br><br>Investment Advisers Act of 1940 | Power to register, regulate, oversee, and take disciplinary actions against large investment advisers (*i.e.*, those with at least $100 million of assets under management), certain mid-size advisers, and broker-dealers.[92]<br><br>With respect to broker-dealers, authority over Exchange Act antifraud provisions, and the implied duties of fair dealing, disclosure of material information and conflicts of interest, suitability of recommendations, fair and reasonable pricing, best execution, and to avoid misleading communications with the public.[93]<br><br>With respect to investment advisers, authority over compliance with the Advisers |

91. *See, e.g.,* Comptroller of the Currency, Comptroller's Handbook: Personal Fiduciary Activities (Feb. 2015); Comptroller of the Currency, Comptroller's Handbook: Conflicts of Interest (Jan. 2015); Comptroller of the Currency, Comptroller's Handbook: Retirement Plan Products and Services (Feb. 2014); Comptroller of the Currency, Comptroller's Handbook: Asset Management Operations and Controls (Jan. 2011).

92. Section 15(a) of the Exchange Act requires broker-dealers that effect securities transactions, or that induce or attempt to induce the purchase or sale of securities, to register with the SEC. Section 203 of the Advisers Act requires investment advisers to register with the SEC unless an exception applies; Section 203A of the Advisers Act (as amended by section 410 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) generally prohibits state-regulated investment advisers with less than $100 million of assets under management from registering with the SEC.

93. Section 15(c) of the Exchange Act prohibits a broker-dealer from inducing or attempting to induce the purchase or sale of a security using any manipulative, deceptive, or other fraudulent device or contrivance. Section 9(a) of the Exchange Act prohibits manipulation of security prices through various types of trading activities. Section 10(b) of the Exchange Act makes it unlawful to use any manipulative or deceptive device or contrivance, in connection with the purchase or sale of any security, in contravention of rules prescribed by the SEC. Section 17(a) of the Securities Act makes it unlawful "(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact . . . , or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" in connection with the offer or sale of any securities.

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| | | Act, including the antifraud provisions and registration requirements.[94]<br><br>Further authority to regulate and enforce substantive requirements applicable to broker-dealers and investment advisers, including recordkeeping, custody and safekeeping of client assets, supervision and compliance, advertising, and, with respect to broker-dealers, financial responsibility requirements.[95] |
| **State broker-dealer regulators** | State laws vary; majority of states have adopted Uniform Securities Act | Generally require registration and licensing, and enforce rules and regulations with respect to broker-dealer's business conduct within the state.<br><br>Generally prohibit making unsuitable recommendations, churning, excessive mark-ups and mark-downs, and manipulative and deceptive practices. |
| **State banking regulators** | State laws vary | Charters, regulates, supervises, and examines state-chartered banks and nondepository trust companies and their activities, including investment advice. State laws generally refer to common-law fiduciary duties as well as the regulations of the OCC, the FDIC, and the FRB; for example, some state laws establish that a bank or trust company chartered in that state can engage in fiduciary activities only if such activities are permissible for national banks. State regulators frequently apply OCC fiduciary requirements and guidance as a matter of |

94. Advisers Act § 203, 15 U.S.C. § 80b-3; Advisers Act § 206, 15 U.S.C. § 80b-6.

95. *See, e.g.*, Advisers Act Rule 204-2, 17 C.F.R. § 275.204-2 (regarding books and records); Advisers Act Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1 (regarding advertising); Advisers Act Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2 (regarding custody); Advisers Act Rule 206(4)-7, 17 C.F.R. § 275.206(4)-7 (regarding supervision); Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (regarding customer protection—reserves and custody of securities); Exchange Act Rules 17a-3, 17a-4, 17 C.F.R. §§ 240.17a-3, 17a-4 (regarding books and records); FINRA Rule 2210 (Communications with the Public); FINRA Rule 3110 (Supervision).

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| | | regulation or "best practices." Similar to the OCC and the FDIC, state laws typically require that a state bank or trust company wishing to engage in fiduciary activities apply to and receive the approval of the state banking regulator. |
| **State insurance regulators** | State laws vary, but many have adopted National Association of Insurance Commissioners (NAIC) model rules | State insurance commissions require licensing of agents and insurance companies selling insurance within the state and develop sales and marketing rules. Further, state common law generally imposes fiduciary duties on investment advice provided by insurance agents and companies.<br><br>Agents and companies selling insurance products considered to be securities, such as variable annuities, must also register with FINRA and the SEC.<br><br>Trade practices of insurance companies and insurances producers in the sale of fixed and variable annuity products and variable life insurance products are regulated pursuant to a number of model acts developed by the NAIC including the following: *Unfair Trade Practices Act* (NAIC 880-1), *Suitability in Annuity Transactions Model Regulation* (NAIC 275-1), *Variable Life Insurance Model Regulation* (NAIC 270-1), and *Annuity Disclosure Model Regulation*. |

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| **State investment adviser regulators** | State laws vary; many have adopted model rules of the North American Securities Administrators Association (NASAA) | Generally require registration and licensing, and enforce rules and regulations with respect to adviser's business conduct within the state.<br><br>Rules may specifically prohibit unsuitable investments, excessive trading, and certain conflicts of interest.<br><br>State law imposes common-law duties of care and loyalty on adviser's investment recommendations and discretionary management. |

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