

11-20-2010

## The Quest for Financial Regulatory Reform: Will a Uniform Fiduciary Standard Guide the Way?

Bonnie M. Treichel

Follow this and additional works at: <https://digitalcommons.pepperdine.edu/jbel>



Part of the [Banking and Finance Law Commons](#), and the [Securities Law Commons](#)

---

### Recommended Citation

Bonnie M. Treichel, *The Quest for Financial Regulatory Reform: Will a Uniform Fiduciary Standard Guide the Way?*, 4 J. Bus. Entrepreneurship & L. Iss. 1 (2010)

Available at: <https://digitalcommons.pepperdine.edu/jbel/vol4/iss1/6>

This Article is brought to you for free and open access by the Caruso School of Law at Pepperdine Digital Commons. It has been accepted for inclusion in The Journal of Business, Entrepreneurship & the Law by an authorized editor of Pepperdine Digital Commons. For more information, please contact [bailey.berry@pepperdine.edu](mailto:bailey.berry@pepperdine.edu).

---

# THE QUEST FOR FINANCIAL REGULATORY REFORM: WILL A UNIFORM FIDUCIARY STANDARD GUIDE THE WAY?

BONNIE M. TREICHEL<sup>1</sup>

I. Introduction .....	152
II. Background: Current Regulatory Scheme of Governance .....	153
Regulation of IARs .....	155
Regulation of Registered Reps .....	156
Fiduciary or Suitability? Determining When the Registered Rep’s Duties Go Beyond “Suitability” .....	158
Comparing IARs and Registered Reps .....	159
III. Proposed Changes: Toward a Uniform Fiduciary Standard .....	159
The Call for a Uniform Fiduciary Standard .....	160
Registered Reps and IARs Engage in Increasingly More Similar Activities .....	160
A New Kind of Financial Professional: Financial Planners .....	161
Development of New Brokerage Accounts and Increased Popularity in Fee-Based Accounts .....	162
The Proposed Changes .....	164
The Proposal for a Uniform Fiduciary Standard .....	164
A Second, Implied Proposal: Self Regulation Under a Single SRO .....	165
The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 .....	167
IV. Impact: Implications of a Uniform Standard .....	168
The Stakeholders .....	168
Impact of the Uniform Fiduciary Standard .....	169
Standard of Care .....	169
Processes and Procedures for Putting Together Deals .....	169
Disclosure Requirements .....	170
Toward a Uniform Fiduciary Standard .....	171
Proponents of the Uniform Fiduciary Standard .....	171
Opponents of the Uniform Fiduciary Standard .....	172
Toward Uniform Governance Under a Single SRO .....	174
Proponents of a Single SRO .....	174
Opponents of a Single SRO .....	175

---

<sup>1</sup> Pepperdine University School of Law, *Juris Doctor* Candidate, 2011 and Fellow of the Geoffrey H. Palmer Center for Entrepreneurship & the Law at Pepperdine University School of Law.

V. Alternatives to the Uniform Fiduciary Standard .....	175
Heightened Standards for Registered Reps Providing Securities- Related Advice .....	176
Universal Standard of Care for Registered Reps and IARs, but Not a Fiduciary Standard .....	176
Brokerage Firms Should Not Be in the Advisory Business .....	177
Borrow from ERISA: Definition of Fiduciary under ERISA .....	177
VI. Conclusion .....	179

## I. INTRODUCTION

In 2008, the United States economy plummeted, catching the attention of every American, creating widespread distrust in the financial markets, generating long-lasting consequences in all industries, and threatening the retirement plans of grandparents, parents, and future generations. While the financial crisis of 2008 reminded older generations of the Great Depression during the 1930s, younger generations soon understood the turmoil and fear that was generated by financial crisis. Immediately charged with the quest of financial reform, the Obama Administration faced economic challenges long before the presidential term began. The administration understood that the United States financial markets created the underpinnings of capitalism as we know it. The administration saw that the United States economic system was the foundation for economic success, and likewise economic havoc, in markets around the world.<sup>2</sup>

Facing this horrendous economic crisis that was crippling the nation in all industries, the Obama Administration released a plan for financial reform on June 17, 2009. This plan, known as the “White Paper,”<sup>3</sup> sought to end the financial crisis and restore confidence in the integrity of the financial system.<sup>4</sup> The White Paper laid out five reforms, in which the administration sought to: (1) promote supervision and regulation of financial firms; (2) establish more comprehensive supervision of financial markets; (3) protect consumers and investors from financial abuse in a complex industry; (4) establish tools to be used by the government to manage financial crisis; and (5) raise international regulatory standards and improve international cooperation.<sup>5</sup> The focus of this article is on the third reform, the protection of consumers and investors from financial abuse.<sup>6</sup>

<sup>2</sup> See Dave Keating, *The 2008 Economic Crisis Explained*, CAFÉBABEL.COM, July 10, 2008, <http://www.cafebabel.co.uk/article/26545/analysis-financial-crisis-2008-explained.html> (asserting that if “the US sneezes, the world catches a cold. This adage of the twentieth century has never been more true than today, as European economies reel from an economic crisis created thousands of miles away. In today’s interconnected financial system, what began with some unwise lending decisions in the US has spread throughout the world, and threatens to sink the globe into another great depression.”).

<sup>3</sup> U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (June 17, 2009), [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> The White Paper lists three strategies for accomplishing the goal of consumer and investor protection from abuse: (1) the creation of a new consumer protection agency; (2) reform of consumer

Specifically, this article will explore strengthened investor protection in which the administration advocated that the United States Securities and Exchange Commission (“SEC”) be given new tools to ensure fairness for investors by establishing a fiduciary duty for Broker-Dealers offering investment advice and by harmonizing the regulation of Investment Advisers and Broker-Dealers.<sup>7</sup>

This article will explore the benefits and detriments that Broker-Dealers and the financial industry will face if the administration’s proposal for a uniform fiduciary standard is implemented by the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Legislation”).<sup>8</sup> This article will argue that despite the fears of regulators and investors facing the financial industry due to the current scheme of regulation and the recent economic crisis, the administration’s proposal will pose substantial consequences to Broker-Dealers and as such, alternative options should be considered.<sup>9</sup> Part II is an introduction to the regulation of the financial industry, particularly the regulation of Investment Advisers and Broker-Dealers.<sup>10</sup> Part III will examine the administration’s proposal and the Dodd-Frank Legislation.<sup>11</sup> Part IV will introduce the stakeholders to be affected by legislative success of the administration’s proposal and will explore the implications of the proposed regulatory reform.<sup>12</sup> Part V will propose alternative options to the proposed standard.<sup>13</sup> Finally, Part VI will conclude this article.<sup>14</sup>

## II. BACKGROUND: CURRENT REGULATORY SCHEME OF GOVERNANCE

Financial industry regulation is complex and varies upon the presence or absence of several factors, including the type of professional at issue,<sup>15</sup> the type of

---

protection; and (3) strengthened investor protection. *See id.*

<sup>7</sup> *Id.*

<sup>8</sup> *See* SEC.gov, Implementing the Consumer Protection Act, <http://www.sec.gov/spotlight/dodd-frank.shtml> (last visited Nov. 8, 2010). The Dodd-Frank legislation is broad financial regulatory reform, which only cover a minimal amount of the legislation’s broad-reaching reforms, including the following: whistleblower incentives and protection programs; shareholder voting on executive compensation; disclosure by institutional investment managers of votes on executive compensation; anti-manipulation rules for security-based swaps; mitigation of conflicts of interest involving security-based swaps; and many other rules and regulations. *Id.*

<sup>9</sup> The author’s opinion is formulated on extensive research, but of equal importance, many of the author’s opinions formulated in this article are based off of interviews with well-known professionals in the financial industry. Of notable importance, interviews were conducted with Mr. John Simmers, Mr. Lou Harvey, and Mr. Jason Roberts. Thank you to these individuals for their perspective and guidance in formulating this article.

<sup>10</sup> *See infra* notes 15-49 and accompanying text.

<sup>11</sup> *See infra* notes 50-101 and accompanying text.

<sup>12</sup> *See infra* notes 102-43 and accompanying text.

<sup>13</sup> *See infra* notes 144-64 and accompanying text.

<sup>14</sup> *See infra* notes 165-68 and accompanying text.

<sup>15</sup> *See generally* ANGELA HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008). As an initial point of confusion for many retail investors and even some members of the financial industry, there are several different kinds of financial professionals, including Registered Reps, IARs, and Financial Planners. *Id.* at xiv. Furthermore, these distinctions can be confusing based upon the various terminology used to refer to these professionals. For example, sometimes IARs are referred to as RIAs, the abbreviation for “Registered Investment

services provided by the financial professional,<sup>16</sup> and the state jurisdictional approach to financial industry regulation. The first two parts of this section will lay out the current scheme of regulation<sup>17</sup> for two kinds of organizations in the financial industry: (1) Investment Adviser firms, who refer to their representatives as Investment Adviser Representatives (“IARs”) and (2) Broker-Dealer firms, who refer to their representatives as Registered Representatives (“Registered Reps”).<sup>18</sup> The third part of this section will address the uncertainties that arise when determining what duty is owed to the client by the Registered Reps. Finally, the

---

Adviser.” *Id.* Because of the interchangeability of many of these terms and designations, many professionals use the terms incorrectly, which makes the retail customer entirely confused as to the type of professional in which the retail investor deals.

<sup>16</sup> See generally Paul Sullivan, *Broker? Adviser? And What’s the Difference?*, N.Y. TIMES, Feb. 17, 2010, available at <http://www.nytimes.com/2010/02/18/your-money/financialplanners/18TRUST.html?sq=broker?%20adviser?&st=cse&scp=1&pagewanted=print>. In the financial industry, there are many financial institutions that offer more than one service. For example, some institutions traditionally recognized as insurance providers also offer financial planning services. Further, many financial institutions have both an arm of business that serves as a Broker-Dealer, but also an arm of service that serves as an Investment Adviser. Hence, the average retail investor is easily confused by the type of service provided, and as such, the average retail customer lacks the ability to understand the regulatory supervision and regulatory standards governing the financial institution in which the retail customer deals.

<sup>17</sup> See DOL.gov, ERISA, <http://www.dol.gov/dol/topic/health-plans/erisa.htm> (last visited Nov. 8, 2010). One of the major sources of governance in the financial industry is the Employee Retirement Income Security Act of 1974 (“ERISA”), which is beyond the scope of this article. ERISA, however, is a federal law that sets minimum standards for most voluntarily established health care and pension plans in the private sector to provide protection for the individual investors in the plans. *Id.* The United States Department of Labor describes ERISA by explaining that:

ERISA requires plans to provide participants with plan information including important information about plan features and funding; provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; and gives participants the right to sue for benefits and breaches of fiduciary duty.

*Id.* Over the past several years, there have many several amendments to ERISA, which have expanded protection for the plan participants. *Id.* Although ERISA is not the focus of this article, it is important to understand that ERISA requires the managers of the plans to act as a fiduciary, meaning that the needs of the plan participant come first and foremost, before any interests of the plan manager or his firm. *Id.* The reason that ERISA requires such a high standard of care of managers of the plans is that in most cases, the participants are so far removed from the plan management, that the participants must put their utmost reliance in the plan manager. *Id.* For example, as a full-time employee in a retail business, the employee is able to participate in the business’s ERISA plan. However, the employee does not have the opportunity to choose the manager of the ERISA plan and many times, the employee is so far removed from the ERISA management itself, that the employee must rely solely on the ERISA manager to act in the employee’s best interests. Hence, the government requires that the ERISA manager act as a fiduciary, putting the interests of the employee above all other interests. *Id.*

<sup>18</sup> Jason M. Kueser, *Caveat Consiliator – Let the Adviser Beware Imposing Fiduciary Duties on Fee-Based Financial Professionals*, 14 PUB. INVESTOR ARB. B. ASS’N B.J. 18, 26-27 (2007). Some scholars, as well as the SEC, also make clear the distinction between a third category of financial professionals – Financial Planners. Jason M. Kueser asserts that the term “Financial Planner” has become “main stream” over the past twenty years. *Id.* Kueser explains that “Financial Planners” refers to professionals who perform a variety of financial services. *Id.* The SEC, however, has explained that the typical Financial Planner is not involved in the direct management of the clients’ money and that generally the Financial Planner is only involved in the advisory services provided to individuals or families regarding the management of their financial resources on a case-by-case basis. *Id.* Thus, the Financial Planner is not subject to the regulations of the Investment Advisers Act of 1940 unless the planner provides advice directly related to the sale or purchase of a specific security; only then is the Financial Planner required to register with the SEC under the 1940 Act. *Id.*

fourth part of this section will summarize, compare, and contrast the major distinctions between IARs and Registered Reps.

### *Regulation of IARs*

IARs are subject to the Investment Advisers Act of 1940 (“1940 Act”)<sup>19</sup> and are regulated by the SEC.<sup>20</sup> Generally, a financial professional qualifies as an IAR when he meets two conditions. First, the adviser must be “in the business of advising others,”<sup>21</sup> and second, the adviser must be compensated for his advice.<sup>22</sup> If both conditions are met, then the financial professional is an IAR and is, therefore, subject to the 1940 Act.<sup>23</sup> Although not expressly stated in the 1940 Act, courts have interpreted the 1940 Act as requiring IARs to act as fiduciaries, such that IARs owe their clients a fiduciary duty.<sup>24</sup> As fiduciaries, IARs have an implicit duty of loyalty to their customers, which requires IARs to adopt a code of

---

<sup>19</sup> See 15 U.S.C. § 80b (2006). The 1940 Act defines an investment adviser as:

[a]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analysis or reports concerning securities.

*Id.* The 1940 Act further states that an investment adviser is not someone who buys or sells securities or “execute[s] trades as a part of that business.” *Id.*

<sup>20</sup> Nikhil Bhargava, *Broker-Dealers and Investment Advisers: The Administration’s Plans for the Future of Regulation*, 61 ADMIN. L. REV. 907, 909 (2009). The SEC is charged with the responsibility of regulating approximately 11,000 registered adviser firms. *Id.* Unlike regulation for Registered Reps, there is no corresponding Self Regulatory Organization (“SRO”) to regulate IARs. *Id.*

<sup>21</sup> The question of whether a professional is considered to be “in the business of advising others” varies by jurisdiction. See Kueser, *supra* note 18, at 25 (comparing *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977) (where a general partnership in a limited partnership that was formed to invest in securities and whose compensation was based on the performance of the securities is an investment adviser) with *Zinn v. Parrish*, 644 F.2d 360 (7th Cir. 1981) (where a sports agent who occasionally passed securities recommendations from others to his clients was not an investment adviser)).

<sup>22</sup> See Kueser, *supra* note 18, at 25. Qualification as an IAR under the 1940 Act requires that the financial professional be paid for the action of offering advice. *Id.* Further, IARs do not engage in the actual placing of transactions for the customer, but rather, the IAR’s role is to provide financial advice to the client as to the transactions in which the client should engage. *Id.* For example, Jason Kueser explains:

a person who meets with an individual, then gathers relevant personal and financial information, creates a report that illustrates a proposed financial plan, presents the plan to the individual, and is paid by the individual for the plan and does nothing more obviously meets the statutory definition of an investment adviser.

*Id.*

<sup>23</sup> See generally 15 U.S.C. § 80b (2006).

<sup>24</sup> *Id.*; see *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963) (stating that Congress intended the investment adviser to be a fiduciary and that courts have imposed on a fiduciary “an affirmative duty of ‘utmost good faith, and full and fair disclosure of all material facts,’ as well as an affirmative obligation ‘to employ reasonable care to avoid misleading his clients’”); see also *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17 (1979) (stating that “[i]ndeed, the [1940] Act’s legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations”); see also *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d 622, 644 (E.D. Va. 2003) (quoting *SEC v. Capital Gains* and asserting that the 1940 Act “creates a fiduciary duty on the part of investment advisers to exercise good faith and fully and fairly disclose all material facts”).

ethics,<sup>25</sup> always act in the best interests of the client, engage in full disclosure to clients, and always make the client's interests paramount to all other interests.<sup>26</sup> For example, SEC requirements mandate that IARs must disclose detailed information when completing their Form ADV<sup>27</sup> and likewise, IARs must provide similar disclosure to clients in the form of brochures that disclose information about the IAR's business practices, fees, and conflicts of interest.<sup>28</sup>

#### *Regulation of Registered Reps*

As described in the previous section, the standard for IARs is well established; IARs owe the highest duty to their clients under the 1940 Act – a fiduciary duty.<sup>29</sup> Regulation of Registered Reps, however, is not so clear. Registered Reps are regulated by the SEC and the Financial Industry Regulatory Authority (“FINRA”), a self-regulatory organization (“SRO”).<sup>30</sup> Registered Reps are subject to the Securities Exchange Act of 1934 (“1934 Act”).<sup>31</sup>

Registered Reps, who work for Broker-Dealers, generally serve two primary functions in the financial industry.<sup>32</sup> First, a “broker” is defined as “any person who, as an agent, ‘effect[s] transactions in securities for the account of others.’”<sup>33</sup> Second, the term “dealer” refers to “any person who, as a principal, transacts securities for his or her own account.”<sup>34</sup> Thus, traditionally a Registered Rep, as a professional working for a Broker-Dealer, is a financial professional who gives

---

<sup>25</sup> Kueser, *supra* note 18, at 25.

<sup>26</sup> Bhargava, *supra* note 20, at 909.

<sup>27</sup> See SEC.gov, Form ADV, <http://www.sec.gov/answers/formadv.htm> (last visited Jan. 17, 2010). Form ADV is the form of registration that an IAR must complete in order to register with the SEC. *Id.* In addition, some states also use the Form ADV for registration. *Id.* Form ADV has two parts. *Id.* The first part requires more personal information about the IAR's education as well as the adviser's business and disciplinary history. *Id.* The second part of the form includes more business-specific information including information about the IAR's fees, services and investment strategies. *Id.*

<sup>28</sup> Kueser, *supra* note 18, at 25-26. Although the IAR is required to provide brochures and detailed information disclosing the IAR's role and obligations to the customer, it is the opinion of this article that most of these brochures are not read by the average retail customer. *Id.* Furthermore, even when the retail customer does read the material, it is highly likely that the retail customer does not fully understand the materials and as such the customer gains no appreciation for the duty owed to him/her. *Id.* In addition, it is the contention of this article that when more than one service is provided by the financial institution, the retail investor becomes further confused by multiple brochures with potentially conflicting disclosures. *Id.*

<sup>29</sup> See *supra* notes 25-29 and accompanying text.

<sup>30</sup> IARs are not regulated by an SRO. See FINRA.org, About the Financial Industry Regulatory Authority, <http://www.finra.org/AboutFINRA/> (last visited Jan. 16, 2010). Registered Reps, however, are regulated by the Financial Industry Regulatory Authority (“FINRA”). *Id.* FINRA is an independent regulator for all securities firms doing business in the United States, overseeing nearly 4,750 brokerage firms at approximately 167,000 branch offices housing approximately 633,000 registered securities representatives. *Id.* FINRA is unique in that although it is not a taxpayer-funded government agency, it still has rulemaking and adjudicatory authority such that FINRA can “enforce federal securities laws as well as develop, implement, and enforce its own rules and regulations.” Bhargava, *supra* note 20, at 910.

<sup>31</sup> 15 U.S.C. § 70c (2004).

<sup>32</sup> Bhargava, *supra* note 20, at 909.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

advice to retail investors buying and selling securities, but the advice from the Registered Rep is such that the advice is only “incidental” to the business of the Broker-Dealer. Because of the type of services Registered Reps provide, Registered Reps fall under the “incidental” exception to the 1940 Act and are, therefore, governed by the 1934 Act,<sup>35</sup> meaning that Registered Reps are not generally subject to the heightened requirements of the 1940 Act.<sup>36</sup>

Working under an exemption from the 1940 Act, Registered Reps are subject to a “suitability” standard.<sup>37</sup> The suitability standard<sup>38</sup> requires that a Registered Rep make “reasonable efforts to assure that a recommendation is in accordance with a customer’s objectives and financial status.”<sup>39</sup> More specifically, before executing a transaction recommended to an investor, under the suitability standard, a Registered Rep must make “reasonable efforts” to discover the following information about their client: (1) the customer’s financial status, (2) the customer’s tax status, (3) the customer’s investment objectives, and (4) other information used or considered in determining a suitable recommendation to the client.<sup>40</sup> Thus, under the Registered Rep’s suitability standard, Registered Reps are commonly subject to liability for actions such as concealment of material facts, manipulation of the market, excessive trading on a client’s account, accepting funds or securities while insolvent, or delaying delivery of securities.<sup>41</sup>

---

<sup>35</sup> The 1940 Act requires any IAR who does not fall under a specific exception to register with the SEC. 15 U.S.C. § 80b (2006). However, there are several exemptions under the 1940 Act including “advisors who do all of their business within a state and not pertaining to securities sold on a national exchange, private advisers with fewer than 15 clients, hedge-fund advisers, commodity-trading advisers, and investment advisory firms that are themselves charitable organizations.” *Id.* However, as the report issued by RAND (“2008 Report”) explains, “some of these exceptions are not as clear as they first appear. For example, in assessing the number of clients maintained by the adviser, the SEC has had difficulty determining whether to treat corporate clients as a single client or to pierce through to the actual number of shareholders.” HUNG ET AL., *supra* note 15, at 12 n.12.

<sup>36</sup> Bhargava, *supra* note 20, at 909.

<sup>37</sup> Registered Reps are traditionally only subject to a suitability standard, rather than a fiduciary duty standard, because “traditionally, when retail investors bought and sold securities through Registered Reps, any advice they received was only incidental to the business of the broker-dealer firm and was thus exempted from the requirements under the [1940 Act].” *Id.*

<sup>38</sup> The suitability standard is a more relaxed standard than the fiduciary duty, which is the highest form of responsibility to the client. *Id.* Under the suitability standard, it is implicit that the Registered Rep makes a living from the advice the Registered Rep provides to the client. *Id.* Registered Reps sell products, or investments, to their clients and through these sales to the client, the Registered Reps will earn a profit. The goal of the Registered Rep generally is to pair buyers with sellers such that the Registered Rep is able to earn a profit from his/her effort of pairing buyers and sellers in the industry.

<sup>39</sup> Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 545-46 (2002). More specifically, Registered Reps are subject to the rules created by the governing SRO, FINRA, which generally requires compliance in four areas that favor customers of the Registered Reps, rather than the Registered Reps themselves: (1) brokers must only make recommendations of securities to customers that are suitable in light of the customer’s investment objectives and capabilities; (2) brokers may not engage in churning, which precludes a broker from using control over a customer’s account to generate excessive trading activity; (3) brokers are charged with broad supervisory duties; and (4) brokers must observe general “high standards of commercial honor” and “just and equitable principles of trade.” *Id.* at 544.

<sup>40</sup> HUNG ET AL., *supra* note 15, at 9.

<sup>41</sup> Carol R. Goforth, *Stockbrokers’ Duties to their Customers*, 33 ST. LOUIS U. L.J. 407, 417 (1989).



*Fiduciary or Suitability? Determining When the Registered Rep's Duties Go Beyond "Suitability"*

As demonstrated in the previous sections, Registered Reps generally do not owe a fiduciary duty to their clients, but rather, Registered Reps owe their clients a lesser level of "suitability." However, there are certain situations and certain jurisdictions that have complicated this basic rule such that in some instances, Registered Reps are subject to the standards of a fiduciary. Under the current scheme of governance, the trouble is not in articulating the duties under the fiduciary standard, but rather, the trouble arises in determining when a fiduciary relationship has been formed. This issue is determined on a case-by-case basis as articulated by state law<sup>42</sup> and, therefore, the standard varies across the country.<sup>43</sup>

Although not the standard in every jurisdiction, most states articulate the duty owed to the client based upon the type of services provided by the financial professional, specifically whether the Registered Rep is managing a discretionary account or a nondiscretionary account. A discretionary account is an account in which "the [financial professional] determines which investments to make and carries out such transactions without prior authorization" from the client.<sup>44</sup> When a Registered Rep is actively making decisions on behalf of the client, without the client's consent on each individual transaction, then the Registered Rep generally owes the higher fiduciary duty in those transactions.<sup>45</sup> Under this standard, the Registered Rep has an elevated duty and is required to do the following:

- (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history;
- (2) keep informed regarding the changes in the market which affect his customer's investment interest and act responsively to protect those interests. . . ;
- (3) keep his customer informed as to each completed transaction; and
- (4) [sic] explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged. . .<sup>46</sup>

---

<sup>42</sup> "Several federal courts have indicated that the issue of whether a fiduciary relationship exists between a broker and his customer is one that must be resolved according to state law." Goforth, *supra* note 41, at 418. See, e.g., *Greenwood v. Dittmer*, 776 F.2d 785, 788 (8th Cir. 1985) (existence of a fiduciary duty is determined by state law); *McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1258 (8th Cir. 1984) (existence of a fiduciary duty between a broker-dealer and a customer is a matter to be determined by state law); *Corbey v. Grace*, 605 F. Supp. 247, 253 (D. Minn. 1985) (existence of a fiduciary duty between a broker-dealer and a customer is a state law determination).

<sup>43</sup> For example, in some jurisdictions, the court considers all relationships between a broker and a client to be a fiduciary relationship. See *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978). Conversely, states such as New York, say that there is no fiduciary duty imposed upon Broker-Dealers. See *Perl v. Smith Barney, Inc.*, 230 A.D.2d 664, 666 (N.Y. App. Div. 1996) (stating that a broker "does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities").

<sup>44</sup> *Kueser, supra* note 18, at 28 (quoting *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990)).

<sup>45</sup> See *Kueser, supra* note 18, at 28. See also *Leib v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 461 F. Supp. 951, 953-54 (E.D. Mich. 1978) (asserting that the Broker-Dealer has a fiduciary duty where the client's account is discretionary, which imposes upon the Broker-Dealer the affirmative duty to explain possible consequences of his actions to this customer).

<sup>46</sup> *Leib*, 461 F. Supp. at 953 (internal citations omitted). See David J. Libowsky, *Securities Law Alert: Congress Should Consider Legislation Establishing A Fiduciary Duty For Securities Broker-*

A nondiscretionary account, on the other hand, is an account in which the financial professional receives permission from the client prior to conducting any activities with the client's account.<sup>47</sup> Thus, when the Registered Rep is acting in a nondiscretionary capacity, the Registered Rep does not owe a fiduciary duty to the client and instead, the lower "suitability" requirements of the 1934 Act are imposed upon the Registered Rep.<sup>48</sup>

### *Comparing IARs and Registered Reps*

To summarize, the major distinction in the governance of financial professionals exists in the applicable Act under which the professional is governed. IARs are governed by the 1940 Act, while Registered Reps are governed by the 1934 Act, and enjoy an exemption from the 1940 Act. In addition, IARs are regulated by the SEC, while Registered Reps are governed by FINRA.

Equally important, the two groups differ in their form of compensation for the financial professional: IARs charge a general fee, whereas Registered Reps generally charge transaction-specific fees on a transaction-by-transaction basis.<sup>49</sup> Thus, when Registered Reps and IARs begin to receive compensation in methods outside of this traditional scope, it becomes increasingly difficult to determine whether the financial professional is acting as an IAR or a Registered Rep. The distinctions just summarized are imperative to understanding the financial industry and will continue to be important until successful legislative reform changes regulation of the financial industry.

### III. PROPOSED CHANGES: TOWARD A UNIFORM FIDUCIARY STANDARD

During recent years, there has been growing concern by some regulators and investors that the current scheme of governance poses problems<sup>50</sup> in the financial

---

*Dealers*, BRESSLER, AMERY & ROSS SEC. L. ALERT, Nov. 2009, [http://www.bressler.com/news/publications/Securities\\_November\\_3Page\\_CS2.pdf](http://www.bressler.com/news/publications/Securities_November_3Page_CS2.pdf).

<sup>47</sup> Kueser, *supra* note 18, at 28.

<sup>48</sup> See *Lieberman v. Worden*, 268 A.D.2d 337, 339 (N.Y. App. Div. 2000) (stating that the court properly dismissed a cause of action for a breach of fiduciary duty where the account was a standard, nondiscretionary account); see also *De Kwiatkowski v. Bear, Stearns, & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (asserting that a Registered Rep owes clients of nondiscretionary accounts the "duties of diligence and competence in executing the client's trade orders, and is obligated to give honest and complete information when recommending a purchase or sale." In addition, the court explained that these duties owed to nondiscretionary account holders "ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice or warnings concerning the customer's investments."). Thus, the higher, ongoing relationship between the client and the Registered Rep as a fiduciary is only formed when the customer's account is discretionary. Hence, the determination of a Registered Rep's duty is formed on a case-by-case analysis of each individual client's account.

<sup>49</sup> HUNG ET AL., *supra* note 15, at 14.

<sup>50</sup> As described in the subsequent sections, the problems in the financial industry encompass a broad scope of issues. From a philosophical perspective, the current regulatory scheme established a system that nearly collapsed and in the midst left retail investors fearful of the financial markets that at one time ran our economy and thrived in our nation. As a logistical matter, the current landscape is problematic because of a lack of oversight by regulatory bodies. For example, the SEC does not have the man power necessary to oversee the many Financial Advisers across America. This is merely the tip of the iceberg, but this example is important, as it demonstrates that the scope of regulatory

industry. The first part of this section will describe the reasons for, and the events that lead to, the administration's proposal in the June 2009 publication of the White Paper.<sup>51</sup> The second part of this section will address the proposed changes in greater detail, emphasizing two primary themes of the proposal: (1) a uniform fiduciary standard and (2) a single regulatory SRO. The final part of this section will explain the successful legislative initiative – H.R. 4173: The Dodd-Frank Legislation.

#### *The Call for a Uniform Fiduciary Standard*

Over the years, the once distinct line of duties and responsibilities for IARs and Registered Reps became blurred. With great concern about this evolutionary change in the financial industry, the SEC commissioned the RAND Institute for Civil Justice<sup>52</sup> to conduct a study of Registered Reps and IARs that was published in March 2008.<sup>53</sup> The report issued by RAND (the "2008 Report") revealed that because of the different regulatory standards and governing bodies for IARs and Registered Reps, it was important to distinguish between the two types of financial professionals.<sup>54</sup> However, the 2008 Report showed that despite this important distinction, the line between the two groups – IARs and Registered Reps – was often blurred and muddled.<sup>55</sup>

#### *Registered Reps and IARs Engage in Increasingly More Similar Activities*

First, the 2008 Report explained that over the past two decades, from a regulatory standpoint, the activities in which Registered Reps engage have become increasingly more similar to the activities of IARs.<sup>56</sup> Likewise, IARs have broadened their scope of services beyond their traditional form, thus blurring the lines between IARs and Registered Reps.<sup>57</sup> For example, from the perspective of

---

problems are very broad reaching. Thus, as a corollary matter, the changes advocated by the Obama Administration will have broad reaching effects on not only the logistics of regulation, but also on the perspectives of retail investors across the nation and the world.

<sup>51</sup> FINANCIAL REGULATORY REFORM, *supra* note 3.

<sup>52</sup> The RAND Institute for Civil Justice is a center committed to improving decision making on civil legal issues "by supplying policymakers with the results of objective, empirically based, analytic research." HUNG ET AL., *supra* note 15, at 12. Within the RAND Institute for Civil Justice, the LRN-RAND Center for Corporate Ethics, Law, and Governance conducted the research and compiled the report that was commissioned by the SEC. *Id.* The purpose of the report was:

[To] better understand the industry's dynamics and its effects on individual investors...from two perspectives: first, examine investment advisers' and broker-dealers' practices in marketing and providing financial products and services to individual investors; and second, evaluate investors' understanding of the differences between investment advisers' and broker-dealers' financial products and services, duties, and obligations.

HUNG ET AL., *supra* note 15, at iii.

<sup>53</sup> *Id.* at iii.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 14.

<sup>57</sup> HUNG ET AL., *supra* note 15, at 14-15.

the retail client, when the IAR begins offering services that use computerized trading programs and when IARs, for example, simultaneously take an active, discretionary management role over customer accounts, then the retail client might not be able to distinguish between the role that the client's IAR plays and the role that the client's Registered Rep plays.<sup>58</sup>

In addition, the activities are increasingly more similar because in many cases, IARs offer both services – those traditionally provided by IARs and those traditionally provided by Registered Reps.<sup>59</sup> For example, Mr. Kelly Campbell is an independent adviser in Fairfax, Virginia, whose business model is comprised of sixty to seventy percent fee-based services, while the remaining thirty to forty percent of his business is derived from commissions from selling products.<sup>60</sup> Traditionally, Campbell's business of selling fee-based services would make Campbell an IAR, while the commission-based sales would make Campbell a Registered Rep. However, as Campbell sees it, "he has a foot in each camp, and there is no conflict."<sup>61</sup> The illustration of Campbell's business model is similar to the services provided by many other financial professionals who provide both services traditionally associated with IARs as well as services traditionally associated with Registered Reps. These sorts of business models lend themselves to the evolving problem articulated in this section that IARs and Registered Reps are providing increasingly more similar services, thus making it more difficult for the retail investor to determine the role of their financial professional and the regulations under which their financial professional is governed.

#### *A New Kind of Financial Professional: Financial Planners*

Second, the 2008 Report demonstrates that the lines between IARs and Registered Reps became blurred further by the fact that during the past two decades, a third form of financial professional came into existence – Financial Planners.<sup>62</sup> The 2008 Report argues that even though Financial Planners are independent of both IARs and Registered Reps, "offering generalized advice about a general financial plan for a client," it is widely acknowledged that Financial Planners typically offer a range of services, which do not always comply with the description of a Financial Planner.<sup>63</sup> Often times, the "range of services" offered by the Financial Planner includes both services that are traditionally under the umbrella of an IAR, while simultaneously offering traditional services of a Registered Rep. Thus, the development of the Financial Planner further blurs the traditional roles of both IARs and Registered Reps.

---

<sup>58</sup> *Id.* at 14.

<sup>59</sup> *See generally* Sullivan, *supra* note 16.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *See supra* note 18 and accompanying text.

<sup>63</sup> HUNG ET AL., *supra* note 15, at 15.

*Development of New Brokerage Accounts and Increased Popularity in Fee-Based Accounts*

Third, the 2008 Report goes on to assert that the line between the two kinds of professionals – IARs and Registered Reps – is blurred because of (1) the development of new types of brokerage accounts<sup>64</sup> and (2) the increase in popularity of fee-based accounts.<sup>65</sup> In response to these developments, the SEC tried to achieve clarity in the financial industry by adopting new rules including the “Certain Broker-Dealers Deemed Not to Be Investment Advisers” Rule.<sup>66</sup> This rule sought to provide an additional exemption under the 1940 Act for Registered Reps who were offering fee-based accounts.<sup>67</sup> Shortly after its issuance, the Rule was struck down in *Financial Planning Ass’n v. SEC*<sup>68</sup> because the Court found that the SEC lacked the power to craft new exemptions to the 1940 Act, and in May 2007, the SEC announced that they would not seek an appeal on the rule.<sup>69</sup>

<sup>64</sup> For example, “discount” brokerage accounts and “fee-based” accounts became popular, further blurring the distinctions between IARs and Registered Reps. The 2008 Report found that the reason for the increased popularity in “discount” accounts was the attractiveness to brokerage customers who wanted to “trade securities at a lower commission rate and who did not want assistance from a registered representative.” *Id.* Thus, Registered Reps began to introduce discount brokerage programs in order to compete with the new discount brokerage firms of the 1990s. *Id.* At the same time, however, Registered Reps continued to offer their full range of services, and as such, lines of the Registered Reps’ roles began to blur. *Id.*

<sup>65</sup> In 1995, the “Tully Report” was issued, defining the best practices as those “designed to align the interest of all three parties in the relationship – the client, the registered representative, and the brokerage firm,” and among the findings in the report, one of the best practices was “paying a portion of [registered representative] compensation based on client assets in an account, regardless of transaction activity, so the [registered representative] received some compensation even if they advise a client to do nothing.” *Id.* Thus, the committee went further to determine that fee-based accounts were particularly appropriate for investors “who prefer consistent and explicit monthly or annual charges for services received, and whose level of trading activity is moderate.” *Id.*

<sup>66</sup> SEC Certain Broker-Dealers Deemed Not to Be Investment Advisers Rule, 17 C.F.R. Pt. 275 (Apr. 12, 2005), <http://www.sec.gov/rules/final/34-51523.pdf>.

<sup>67</sup> HUNG ET AL., *supra* note 15, at 16.

<sup>68</sup> *Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). The 2008 Report explained that a core aspect of the [Financial Planning Association] challenge was that, by excluding from the definition of investment adviser any broker-dealers who offer fee-based accounts, the rule exceeded what the SEC, as an administrative agency, was empowered to do. Furthermore, it claimed, even if within the SEC’s power, the rule constituted unreasonable interpretation of the empowering statutes.

HUNG ET AL., *supra* note 15, at 16. Further, the 2008 Report explained:

[t]he court’s opinion revolved exclusively (or nearly so) around statutory interpretation...to conclude that § 202(a)(11)(C) made up the sole and exclusive exemption for broker-dealers and that § 202(a)(11)(F), which gives the SEC broad discretionary powers over future exemptions, could not be used to broaden that tailored and precise exemption for broker-dealers in § 202(a)(11)(C).

*Id.*

<sup>69</sup> HUNG ET AL., *supra* note 15, at 17. Following the SEC announcement that it would not appeal in *Financial Planning Ass’n v. SEC*, the SEC announced that it intended to review the regulation of IARs and Registered Reps. *Id.* Moreover, prior to the final vacating of the SEC Rule, the SEC adopted a temporary rule to expire in 2009, Rule 206(3)-3T, and proposed a new rule, 202(a)(11)-1. *Id.* The purpose of the temporary rule was to allow Registered Reps that are also registered as IARs to engage in principal trading on nondiscretionary advisory accounts under specified conditions. *Id.* Likewise, the proposed new rule reinstated the general principle from the vacated Rule – Certain Broker-Dealers

During the next year and a half, no major regulatory reforms occurred as the economy worsened and the administration changed hands. In 2009, however, at the peak of financial crisis, the new administration issued their White Paper, which contained sweeping regulatory reforms.<sup>70</sup> Of the many initiatives described in the introduction to this article,<sup>71</sup> this section will focus on the proposal striving to (1) increase fairness for investors by establishing a fiduciary duty for Registered Reps offering investment advice and (2) harmonize the regulation of IARs and Registered Reps.<sup>72</sup> The White Paper draws conclusions similar to those of the 2008 Report, asserting that

[r]etail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisers or broker-dealers – to help them manage their investments. However, investment advisers and broker-dealers are regulated under different statutory frameworks, even though the services they provide often are virtually identical from a retail investor’s perspective.<sup>73</sup>

Writing from the perspective of the retail investor, the administration went on to assert that

[r]etail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment adviser and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century . . . In the retail context, the legal distinction between the two is no longer

---

Deemed Not to Be Investment Advisers. *Id.*

<sup>70</sup> See *supra*, Part I. See generally FINANCIAL REGULATORY REFORM, *supra* note 3. Prior to the release of the White Paper in June, the SEC was already laying the ground work for the administration’s proposal. On May 5, 2009, SEC Commissioner Elisse B. Walter addressed those in attendance at the Mutual Fund Directors Forum Ninth Annual Policy Conference. Elisse B. Walter, Comm’r, U.S. Sec. & Exch. Comm’n, Speech at the Mutual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers; Demarcation or Harmonization? (May 5, 2009), [http://www.sec.gov/news/speech/2009/spch050509\\_ebw.htm](http://www.sec.gov/news/speech/2009/spch050509_ebw.htm). After laying out the background of the financial industry, particularly the regulation of IARs and Registered Reps, Walter addressed what she believed to be the “fundamental principle that [ ] should guide any attempt to address the blurring of the lines between broker-dealers and investment advisers.” *Id.* She asserted:

I believe that regulation of a financial professional should depend on what she does, not what she calls herself or how she is paid. As a corollary, 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. These opaque distinctions frequently lead to investor confusion and arguments about definitions that simply should not matter. This reasoning, I believe, leads to the fundamental principle that should guide our review of how to regulate financial professionals for the protection of the investing public: Investors should receive the same level of protection when they purchase comparable products and services, regardless of the financial professional involved.

*Id.* This foundation is important because this sets the tone for the administration’s proposal which is solely from the perspective of the retail investor. Walter’s assertion does not consider the affect that the changes to the standards will have on Registered Reps, nor the other players in the financial industry. See *id.*

<sup>71</sup> See *supra* note 5 and accompanying text.

<sup>72</sup> See FINANCIAL REGULATORY REFORM, *supra* note 3, at 71.

<sup>73</sup> *Id.*

meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.<sup>74</sup>

Thus, while writing from the standpoint of the retail investor, the administration did not acknowledge the proposed changes and their affect from the standpoint of the Registered Rep or the other players in the financial industry.<sup>75</sup>

### *The Proposed Changes*

To address these concerns, the administration developed an outline for new legislation, which the administration believed would “bolster investor protections and bring important consistency to the regulation of [IARs and Registered Reps].”<sup>76</sup> The theme of the first proposal is quite clear: the administration seeks a regulatory scheme that brings both IARs and Registered Reps under a universal fiduciary standard. Second, scholars and financial professionals argue that there is a second, implied theme in the administration’s proposal, which seeks to bring both IARs and Registered Reps under a single regulatory authority.<sup>77</sup> The next two parts of this section will address both themes of the administration’s proposal.

### *The Proposal for a Uniform Fiduciary Standard*

The administration asserts in the White Paper that the “SEC should be permitted to align duties for intermediaries across financial products.”<sup>78</sup> Moreover, the White Paper advocated to grant the SEC the power to “examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors’ best interest.”<sup>79</sup> Finally, the White Paper called for legislation

requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as [IARs];

providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and

prohibiting certain conflict of interests and sales practices that are contrary to the

---

<sup>74</sup> *Id.*

<sup>75</sup> The White Paper allocates less than two pages to this proposal, all of which is from the perspective of the needs of the retail investor. This style of presenting the information is in line with the goal of regulatory reform – the restoration of confidence and integrity in the financial system – but this approach fails to consider the affect that such reform may have on the industry, in turn affecting the retail investor in the long run. This potential consequence of the reform will be further discussed in Part IV of this article at 102-43.

<sup>76</sup> FINANCIAL REGULATORY REFORM, *supra* note 3, at 72.

<sup>77</sup> See Bhargava, *supra* note 20, at 915 (quoting posting of David Gaffen to Market-Beat, <http://blogs.wsj.com/marketbeat> (Jan. 28, 2009) (describing industry indicators that denote self-regulation are increasingly likely)).

<sup>78</sup> FINANCIAL REGULATORY REFORM, *supra* note 3, at 71.

<sup>79</sup> *Id.* at 71-72.

interests of investors.<sup>80</sup>

In addition to the White Paper, the administration's government agencies followed suit. Following the announcement of the regulatory reforms, on June 18, 2009, SEC Chairman Mary L. Schapiro<sup>81</sup> addressed the New York Financial Writers' Association at their annual dinner.<sup>82</sup> Schapiro furthered the administration's call for action by considering the plight of the retail investor. Schapiro said,

[t]he market gyrations of 2008 and the first half of 2009 have befuddled even the most seasoned investors, let alone Mom and Pop seeking to plan for retirement and invest for their children's educations. Increasingly these Mom and Pop investors are turning to financial intermediaries to help them navigate the sometimes treacherous securities market.<sup>83</sup>

To combat this problem, Schapiro announced that the SEC would review the current regulatory scheme in order to respond to these concerns and provide protection for retail investors.<sup>84</sup>

*A Second, Implied Proposal: Self Regulation Under a Single SRO*

The administration's proposal, and the SEC's support for that proposal, focused on bringing Registered Reps under a single, uniform fiduciary standard in line with the fiduciary standard of IARs. Some scholars, however, believe that there is a second, implied reform under consideration: harmonization of regulation under a single SRO.<sup>85</sup> Recall that Registered Reps are regulated under an SRO

---

<sup>80</sup> *Id.* at 72.

<sup>81</sup> Mary L. Schapiro was appointed by President Obama on January 20, 2009, and she was sworn in on January 27, 2009. SEC.gov, SEC Biography: Chairman Mary L. Schapiro, <http://www.sec.gov/about/commissioner/schapiro.htm> (last visited Jan. 16, 2010). Taking the reins in the middle of the financial crisis, Schapiro's priorities at the SEC include: "reinvigorating a financial regulatory system that must protect investors and vigorously enforce the rules; and working to deepen the SEC's commitment to transparency, accountability, and disclosure while always keeping the needs and concerns of investors front and center." *Id.*

<sup>82</sup> Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman: Address Before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009), <http://www.sec.gov/news/speech/2009/spch061809mls-2.htm>.

<sup>83</sup> *Id.*; see also Chris Carosa, *Broker or Registered Investment Adviser? What's the Best for the ERISA/401(k) Fiduciary?*, FIDUCIARY NEWS, Oct. 7, 2009, <http://fiduciarynews.com/2009/10/broker-or-registered-investment-adviser-what%e2%80%99s-best-for-the-erisa401k-fiduciary/>. "Here's an issue that can perplex even the most experienced ERISA/401k fiduciary," said Chris Carosa in October of 2009: "[w]hat's the difference between a [Registered Rep] and a Registered Investment Adviser?" *Id.* More importantly, Carosa asked whether distinguishing between these two groups – Registered Reps and IARs – "significantly raise[s] the fiduciary liability for the typical fiduciary?" *Id.* As demonstrated in this article, the answer is yes, for liability purposes under the current regulatory scheme, it is imperative to distinguish between Registered Reps and IARs. The problem, however, as articulated in this article is that financial professionals, regulators in the financial industry, and customers in the financial industry are frequently unable to distinguish between Registered Reps and IARs and their corresponding governance.

<sup>84</sup> Schapiro Address, *supra* note 82.

<sup>85</sup> See Bhargava, *supra* note 20, at 915 (quoting posting of David Gaffen to Market-Beat, <http://blogs.wsj.com/marketbeat> (Jan. 28, 2009) (describing industry indicators that denote self-regulation are increasingly likely)).



known as FINRA.<sup>86</sup> IARs, however, are currently regulated under the sole jurisdiction of the SEC.<sup>87</sup> This scheme of regulation poses concerns in cases where a financial institution houses both IARs and Registered Reps. In these cases, the SEC possesses the jurisdiction to investigate and regulate both IARs and Registered Reps.<sup>88</sup> FINRA, however, has a jurisdictional reach limited only to Registered Reps; thus, FINRA does not have the authority to engage in any investigations or regulations of IARs.<sup>89</sup>

Although not explicitly addressed in the White Paper,<sup>90</sup> the SEC has expressed concern about their lack of manpower.<sup>91</sup> An example illustrates the SEC's concern: Registered Reps are examined by either FINRA or the SEC at least once a year.<sup>92</sup> IARs, however, are generally only examined by the SEC once every decade.<sup>93</sup> Some scholars argue that if there was a single SRO, funded by the financial member firms themselves, then examinations of financial institutions, including Investment Adviser firms, Broker-Dealers, and firms housing both IARs and Registered Reps, would take place more frequently because of the increased manpower and resources available to conduct examinations and investigations.<sup>94</sup>

---

<sup>86</sup> See FINRA.org, *supra* note 30.

<sup>87</sup> See *supra* note 30 and accompanying text.

<sup>88</sup> See Bhargava, *supra* note 20, at 915.

<sup>89</sup> A notable example will demonstrate the problem that is posed by the current jurisdictional scheme. See Bhargava, *supra* note 20, at 910-12. Bernie Madoff had a \$50 million scheme that eventually wiped out thousands of investors and charitable organizations. *Id.* How did he do it? Madoff took advantage in the jurisdictional loopholes of the current scheme. Madoff registered his asset management business as an Investment Adviser with the SEC. *Id.* As a result, the SEC then had the sole jurisdictional power to investigate that portion of Madoff's operation under the 1940 Act. *Id.* The SEC, however, due to an organizational defect never investigated Madoff. *Id.* Meanwhile, Madoff had another business as a Registered Rep. *Id.* FINRA, being the regulator of Registered Reps, did investigate Madoff, but because FINRA was only authorized to investigate the Registered Rep portion of the business, the FINRA investigators never became aware of the massive scheme that was taking place on the exact same premises. *Id.* Although FINRA was later criticized for not uncovering this scheme, FINRA maintains that statutorily, FINRA did not have the authority to investigate the advisory side of Madoff's business. *Id.* Thus, this example is illustrative proof that before a single standard will really be able to be enforced, there is an initial problem to be addressed: who will regulate and enforce whatever rules are enacted in the coming days.

<sup>90</sup> See FINANCIAL REGULATORY REFORM, *supra* note 3.

<sup>91</sup> See Bhargava, *supra* note 20, at 910-12 (citing Rick Ketchum, Chairman and Chief Executive Officer, Fin. Indus. Regulatory Auth., Speech at the National Association for Variable Annuities Government & Regulatory Affairs Conference (June 8, 2009), <http://www.finra.org/Newsroom/speeches/Ketchum/P118889> (noting the thirty percent increase in investment-adviser registrations since 2005 and the lack of SEC resources to regulate investment advisers)). Also, recall that an SRO is not a taxpayer-funded organization. See FINRA.org, *supra* note 30. FINRA, for example, is the largest independent regulator for all securities firms. *Id.* The SEC, on the other hand, is not an independent agency. *Id.* Thus, funding and manpower among the two regulation structures is vastly different. *Id.*

<sup>92</sup> See Bhargava, *supra* note 20, at 915.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* This article agrees with the argument asserted by Bhargava. The frequent regulation by FINRA is proof that there is the potential for regular audits and examination for firms when those examinations are privately-funded by the member firms themselves. *Id.* The SEC, however, is a taxpayer-funded organization and, therefore, the SEC does not possess the sufficient manpower for conducting the extensive, frequent examinations and audits that the financial markets require. *Id.* This article advocates that if the administration truly seeks to restore integrity in the financial markets, then a key step is not a single fiduciary duty, but rather, the first key step is a single SRO to govern these financial institutions in their entirety, including both the Broker-Dealer side of the firm and the

Thus, although not explicitly stated in the White Paper, there is arguably an implied call for action by the SEC, and likely supported by the administration, to bring regulation of financial professionals – both IARs and Registered Reps – under a single umbrella.<sup>95</sup>

*The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*

In response to the call for action by both the administration and the SEC, members of both the House of Representatives and the Senate began to take action. Although there were several proposed ideas, the prevailing legislation was the H.R. 4173, the Dodd-Frank Legislation.<sup>96</sup> Among the many provisions in the Dodd-Frank Legislation, the new law directed the SEC to study the effectiveness of existing regulatory standards for Registered Reps and IARs, the gaps in the current regulation, and overlaps in the standard of care for Registered Reps and IARs.<sup>97</sup> The Dodd-Frank Legislation required a report on the study's finding to be submitted to Congress in January 2011.<sup>98</sup>

One component of the study included a request for comments to the SEC regarding the obligations of Registered Reps and IARs.<sup>99</sup> The comment period, which ended on August 30, 2010, garnered approximately 2,700 responses.<sup>100</sup> The compilation of such responses, coupled with other efforts by the SEC to study the current regulatory scheme, will in effect determine the fate of the regulatory regime in the financial industry to the extent that Registered Reps will, or will not,

---

Advisory side of the firm. *Id.*

<sup>95</sup> *Id.* See discussion *infra* notes 137-43 (regarding the advantages and disadvantages of a single standard under one governing SRO).

<sup>96</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H.R. 4173, 111th Cong. (2010). Sponsored by Democratic Representative Barney Frank of Massachusetts, the legislation passed the House of Representatives on December 11, 2009 and it passed the Senate on May 20, 2010. Govtrack.us, *H.R.4173: Dodd-Frank Wall Street Reform and Consumer Protection Act*, <http://www.govtrack.us/congress/bill.xpd?bill=h111-4173> (last visited Sep. 20, 2010). By June 30, 2010, the committee met to resolve the differences between the House Bill and the Senate Bill, and the legislation was signed into law by President Obama on July 21, 2010. *Id.*

<sup>97</sup> Dodd-Frank Legislation, *supra* note 96; see also Ed Mahaffy, *Regulating the Givers of Advice*, BARRON'S OTHER VOICES (Aug. 14, 2010), available at <http://online.barrons.com/article/SB500014240529702032960045753107818766759> 98.html; see also Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, SEC Release No. 34-62577 (July 27, 2010), <http://www.sec.gov/rules/other/2010/34-62577.pdf>.

<sup>98</sup> Dodd-Frank Legislation, *supra* note 96; see also Alexis Leondis, *Insurance Agents Oppose Fiduciary Standard in Comments to SEC*, BLOOMBERG, Sep. 2, 2010, available at <http://www.bloomberg.com/news/2010-09-02/insurance-agents-oppose-common-fiduciary-standard-in-comments-given-to-sec.html>; see also SEC Release No. 34-62577, *supra* note 97.

<sup>99</sup> SEC Release No. 34-62577, *supra* note 97. The SEC summarized their request by saying:

[t]he Securities and Exchange Commission is requesting public comment for a study to evaluate: the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors; and whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries.

*Id.*

<sup>100</sup> Leondis, *supra* note 98.

be governed by a uniform fiduciary standard.<sup>101</sup>

#### IV. IMPACT: IMPLICATIONS OF A UNIFORM STANDARD

The implementation of a uniform fiduciary standard will have broad reaching effects. First, this section will introduce the relevant stakeholders to be affected by the Dodd-Frank Legislation. Second, this section will evaluate the impact of the Obama Administration's proposal and the changes that will occur if the SEC and Congress agree in the January 2011 report that a universal fiduciary standard is warranted. Finally, this section will explore the proponents and opponents of (1) the proposed universal fiduciary standard and (2) the implied, second reform toward a single SRO.

##### *The Stakeholders*

The Obama Administration set out to restore integrity and confidence in the financial markets at a time where Main Street customers became frustrated with Wall Street executives. Meanwhile, the administration sought to fix this negative image of the financial industry through bailouts and implementation of substantial regulatory reform. Most of the proposed changes, therefore, seem to be written solely from the perspective of the fearful retail investors.

There are other stakeholders besides the retail investor who will be affected by the proposed changes and the new legislation. Obviously, Registered Reps are a major stakeholder. In addition, other financial professionals also hold a stake in the outcome of the proposed legislation, including but not limited to, IARs, Financial Planners, Compliance Officers, legal consultants, and insurance professionals.<sup>102</sup>

Moreover, there could, and most likely would, be unexpected consequences

---

<sup>101</sup> Mahaffy, *supra* note 97. Mahaffy stated:

Americans in need of investment advice may benefit from the new financial-reform act. But much depends on what the Securities and Exchange Commission will require of financial-services professionals. Will the commission force all advisors to follow the strictest standard of care, or will it continue to hold some to a lesser standard?

*Id.*

<sup>102</sup> Fred Reish, *Reish and Reicher Bulletin: Fiduciary Status for Broker-Dealers*, July 8, 2009, <http://www.reish.com/publications/pdf/fidstatbrkrdlr.pdf>. While it is quite obvious that IARs, Financial Planners, Compliance Officers, and legal consultants will be affected by the regulatory reform, it might not be quite as obvious that the insurance industry could also be subject to these sweeping regulatory changes. Another type of financial planner is known as a "benefit broker." *Id.* This type of broker is nearly always licensed under state insurance laws, which do not subject the brokers to a fiduciary duty standard. *Id.* In addition, benefit brokers might also be licensed under the securities laws as registered representatives of Broker-Dealers, although benefit brokers generally are not registered as IARs, and as such, benefit brokers are only subject to the suitability standard under which Registered Reps operate, rather than the fiduciary standard under which IARs operate. *Id.* Although the Obama Administration's proposal does not directly address benefit brokers, arguably benefit brokers would be subject to the Broker-Dealers laws, which under the administration's plan, would then be regulated under a fiduciary standard. *Id.* Thus, insurance industries likely would be affected in their benefit broker arm of business if the Obama Administration's proposal is ultimately implemented. *See also infra* Part IV.C.2.

that will indirectly affect retail investors. For example, if Registered Reps are forced to change their current organizational structure in order to comply with substantial regulatory reforms, the Broker-Dealers will incur substantial costs that will either be (1) expenses passed on to the investor, or alternatively, (2) some Broker-Dealers might go out of business and leave investors to find new institutions to handle their financial needs. Hence, in the long-run, if the retail investor is indirectly affected, then the administration's proposal potentially loses its primary purpose.

#### *Impact of the Uniform Fiduciary Standard*

All parties, both proponents and opponents of the universal fiduciary standard, can largely agree that a uniform fiduciary standard will change the industry in at least three ways. Although both sides likely foresee differences in the way these changes will affect the financial industry, it is clear that there are certain outcomes that will undoubtedly result.

#### *Standard of Care*

First, it is clear that the standard of care will change. Recall that under the current standard, Registered Reps are held to a suitability standard where the Registered Rep only needs to determine that an investment is "suitable" for a client based on an understanding of the client's characteristics and objectives.<sup>103</sup> Raised to the fiduciary standard, however, the Registered Rep would be required to rise to the level of a fiduciary, taking into account additional considerations including "whether the fees are reasonable, whether the investments are adequately diversified, whether there are conflicts of interest, whether the investments are consistent with the provisions of the trust or other governing document, and so on."<sup>104</sup>

Though the standards appear to operate under very similar considerations, one vastly different consideration is the determination of conflicts of interests. The very essence of the Registered Reps' business involves a conflict of interest. Registered Reps are in the business of pairing buyers and sellers; the transactions derived from a Registered Rep's efforts, yield profits for the Registered Rep. Thus, although the considerations appear to be similar, the requirement to consider conflicts of interest under the fiduciary standard creates a heightened standard of care for Registered Reps and a highly probable loss in profits, under the proposed changes.

#### *Processes and Procedures for Putting Together Deals*

Second, in order to accommodate the change in the standard of care, the process by which Registered Reps develop recommendations will change. Under the current scheme, Registered Reps develop recommendations that are suitable for

---

<sup>103</sup> See *supra* Part II.B. See also Reish, *supra* note 102.

<sup>104</sup> Reish, *supra* note 102.

the customer based on facts specific to the customer's objectives.<sup>105</sup> Under the heightened standard of the fiduciary, however, the development of recommendations is based on the "prudent and reasonable hypothetical person who is knowledgeable about investments, about portfolio concepts and about the purpose of the investments."<sup>106</sup> Although the two standards – the suitability standard and the fiduciary standard – might result in the same outcome, often times, it is the case that the specific customer considered under the suitability standard would not be the same as the hypothetical person with a knowledge of investments and portfolios.<sup>107</sup> Hence, under the elevated standard, Registered Reps would need to reevaluate their processes and procedures for putting together deals and as such, Registered Reps would be required to hold the customer to a much higher level of investment knowledge.

#### *Disclosure Requirements*

Third, it is the contention of this article that disclosure requirements, specifically in the area of management conflicts of interest, would be vastly different under a uniform fiduciary standard. Currently, Registered Reps recommend "suitable" investments to clients, but Registered Reps are not required to specifically disclose that certain recommended investments also provide the greatest benefit to the Registered Rep by yielding higher compensation levels to the Registered Rep.<sup>108</sup> Under the fiduciary standard, Registered Reps would be required to put the customer's interests ahead of the Registered Rep's interests.<sup>109</sup> Thus, in instances where there are any conflicts of interest, which there presumably would be due to the nature of the Registered Reps' business,<sup>110</sup> Registered Reps would be required to avoid such conflicts of interest. Where conflicts of interest did arise, Registered Reps would be required to disclose to the investor both "the nature and scope of the conflict."<sup>111</sup> Furthermore, disclosure might not always be enough under the heightened standard of the fiduciary.<sup>112</sup> In some instances, where the conflict would be so great as to materially affect the advice to the investor, Registered Reps would be entirely precluded from making both the recommendation and the transaction.<sup>113</sup> The three changes outlined in this section

---

<sup>105</sup> See *supra* Part II.B.

<sup>106</sup> Reish, *supra* note 102.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* See also *supra* Part II.B.

<sup>109</sup> See *supra* Part II.A.

<sup>110</sup> See *supra* note 36 and accompanying text. The way in which the Registered Rep makes money is through the pairing of buyers to sellers in the financial market. See also Sullivan, *supra* note 16 (explaining that "when a broker tells a client to buy or sell something, the suitability rule does not mean the broker has to be free of conflicts of interest. After all, the broker's salary is ultimately paid by the brokerage firm, which has various products to sell." However, Sullivan continues on by acknowledging that "brokerage firms say they are trying to eradicate [the] appearance of conflict."). Hence, it is inherent in the work of the Registered Rep that there will nearly always be a conflict of interest requiring disclosure.

<sup>111</sup> Reish, *supra* note 102.

<sup>112</sup> *Id.*

<sup>113</sup> See *id.*

will undoubtedly change the scope and practice of the Registered Reps' role and the means by which Registered Reps make a profit.<sup>114</sup>

### *Toward a Uniform Fiduciary Standard*

This article uses the Obama Administration's proposal in the White Paper as a starting point to discuss the proposals for regulatory reform. Though the Dodd-Frank Legislation was enacted in July 2010, the outcome of the legislation is still yet to be determined; the fate of the uniform fiduciary standard is now in the hands of the SEC, as its constituents study the industry and review the comments submitted during the comment period. During this time, interest groups set out on a quest to influence the legislation. Proponents of the uniform fiduciary standard include retail investors, the SEC, and some members of the financial industry. Opponents of the uniform fiduciary standard include Registered Reps, some IARs, and insurance agents.

### *Proponents of the Uniform Fiduciary Standard*

Beginning with investors, a uniform fiduciary standard will provide a more understandable system in which investors who seek to impose liability on their financial providers will not be confused as to the applicable standard.<sup>115</sup> For example, if a retail investor receives financial planning and investment services from his bank, the retail investor will know under the proposed standard, that no matter which branch (or arm) of the financial institution is providing the service, the service provider will be working as a fiduciary with the investor's interests reigning paramount to all other interests.<sup>116</sup> Furthermore, for investors, the fiduciary standard will provide greater protection from conflicts of interest that are inherent in the Registered Rep's work;<sup>117</sup> a Registered Rep under a fiduciary standard would be required to disclose that by choosing some specific investments, the Registered Rep will be able to earn a higher commission on those specific sales at the expense of the investor. Therefore, the investor under the fiduciary standard will be afforded greater protection against investments that might be more expensive to the investor, while yielding a higher return for the Registered Rep.

The SEC also supports a uniform fiduciary standard.<sup>118</sup> The SEC maintains

---

<sup>114</sup> See Reish, *supra* note 102 (explaining their experience as lawyers providing support in the financial industry: "[i]n our experience, many broker-dealers and financial advisers operate at a standard that equals or exceeds the fiduciary standard, even though they do not affirmatively embrace fiduciary status. As a result, while a comparison of the two standards from the perspective of the investor obviously favors fiduciary status, many broker-dealers and advisers have been loyal to their customers and have avoided the potential negative effects of conflicts of interest.").

<sup>115</sup> See Sara Hansard, *A Uniform Fiduciary Standard a Good Bet, One Way or Another*, INVESTMENT NEWS, Jan 3, 2010, <http://www.investmentnews.com/article/20100103/REG/301039981>; see also Sullivan, *supra* note 16 (quoting Susan Fulton, President of FBB Capital Partners, "I don't know if more than 10 to 20 percent of my clients understand the difference . . . [T]he investment advisory and brokerage businesses don't make it clear.").

<sup>116</sup> See Carosa, *supra* note 83.

<sup>117</sup> See Hansard, *A Uniform Fiduciary Standard*, *supra* note 115.

<sup>118</sup> See Sara Hansard, *Schapiro, Blankenfein Back Single Fiduciary Standard for B-Ds, Advisers*,

that when providing the same services,<sup>119</sup> both IARs and Registered Reps should be subject to the same fiduciary standard as a matter of fairness.<sup>120</sup> The SEC asserts that simple logic dictates that the same services should be subject to the same regulations.<sup>121</sup> The SEC's argument, however, hinges on the notion that IARs and Registered Reps do in fact provide the same services. Although many reports, including the 2008 Report, do indicate increasingly similar services among IARs and Registered Reps, this issue remains one of the greatest areas of contention in the current debate of whether a uniform fiduciary standard is appropriate.<sup>122</sup>

In addition, members of the financial community have also weighed in with support for the administration's proposal. For example, Lloyd Blankfein, Chief Executive Officer and Chairman of Goldman Sachs, supported the administration's proposal in his testimony before the Financial Crisis Inquiry Commission.<sup>123</sup> Arguing that the "fiduciary standard puts the interest of the client first," Blankfein supported his opinion with the rationale that investors might not understand that IARs may be subjected to different rules and regulations than other financial professionals, such as Registered Reps.<sup>124</sup>

#### *Opponents of the Uniform Fiduciary Standard*

Conversely, the most obvious opponents of the Obama Administration's proposal are the Registered Reps themselves. Registered Reps fear that the administration's proposal, if enacted, would make it difficult for Registered Reps

---

INVESTMENT NEWS, Jan. 14, 2010, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20100114/FREE/100119947>.

<sup>119</sup> This argument, however, is based on the assumption that Registered Reps and IARs do in fact provide the same services. Although reports such as the 2008 Report from RAND assert that in some instances IARs and Registered Reps do provide the same or similar services, it is not entirely true that the two financial professionals actually provide the exact same service. See generally HUNG ET AL., *supra* note 15. In fact, this article does not support the contention that the two kinds of financial professionals – IARs and Registered Reps – do provide the exact same services. *Id.* Rather, this article advocates that the services are quite similar and many times from the standpoint of the retail investor, the services are the same, but in reality, the services and the form of compensation for Registered Reps and IARs are different in nature and should most likely remain as two distinct types of financial professionals.

<sup>120</sup> See Hansard, *Shapiro, Blankenfein*, *supra* note 118.

<sup>121</sup> See *id.* Hansard goes on to quote SEC Chairman Mary Schapiro who "reiterate[d] her call for bringing regulation of broker and adviser into line." *Id.* Shapiro said:

[w]hen investors receive similar services from similar financial service providers, it is critical that the service providers be subject to a uniform fiduciary standard of conduct that is at least as strong as exists under the Investment Advisers Act [of 1940], and equivalent regulatory requirements, regardless of the label attached to the service providers.

*Id.*

<sup>122</sup> See generally *Fiduciary Standard Part of Sweeping Regulatory Reforms*, FA NEWS, June 18, 2009, available at <http://www.fa-mag.com/fa-news/4252-fiduciary-standard-part-of-sweeping-regulatory-reforms.html>. "Groups representing broker-dealers don't buy the argument that differing standards on the investment advisor and broker-dealer sides need to be reconciled. They say there are legitimate reasons why the suitability standard is appropriate for broker-dealers." *Id.*

<sup>123</sup> See Hansard, *Shapiro, Blankenfein*, *supra* note 118.

<sup>124</sup> *Id.*

to conduct business as they have traditionally done business in the past.<sup>125</sup> Traditionally, Registered Reps earned commissions based on sales and selling products that are owned by their own firms.<sup>126</sup> Thus, if required to perform under a universal fiduciary standard, Registered Reps assert that the fiduciary standard might make it impossible for Registered Reps to conduct business in their traditional line of work, which is selling their own products to investors.<sup>127</sup>

This article foresees two major consequences for Registered Reps under a heightened fiduciary standard. First, if Registered Reps are forced to work outside of their traditional line of work, Broker-Dealers firms will likely incur great expenses in changing their line of work to comply with the new fiduciary standards. The additional expenses incurred by the Registered Rep likely will be passed along to the retail investor in some form or another.<sup>128</sup> In the end, therefore, the retail customers that the legislation is seeking to protect, might face the consequence of additional fees for their financial services from their Registered Reps.

Second, if Registered Reps are forced to work outside of their traditional line of work, it is possible that some Broker-Dealer firms will shut down due to (1) the additional expense to comply with the new standards and (2) the absence of income that was once made in the Registered Reps' traditional line of work. Again, the retail customer would be affected by this second consequence because if Registered Reps shut down, the retail investor will be forced to seek new financial institutions to handle the retail investor's needs, which presumably would be a burdensome and inconvenient process for the retail investor.<sup>129</sup> It is the contention of this article that, in the end, the Registered Reps are advocating against the fiduciary standard for their own business purposes, but, inadvertently, the effect on the Registered Reps' business will ultimately be passed along to the retail investor as well.

In addition to Registered Reps, some IARs also have expressed concern that by including Registered Reps under the fiduciary standard, there will be dilution and possibly elimination of the fiduciary obligations that IARs owe all of their clients.<sup>130</sup> Currently, IARs tout their independence and lack of conflicts as one of the advantages to being an IAR, as opposed to a Registered Rep.<sup>131</sup> However, if Registered Reps become subject to the fiduciary duty and, hence, eliminate conflicts of interest, then IARs fear that they may lose their purported edge over Registered Reps.<sup>132</sup>

Insurance professionals also oppose the uniform fiduciary standard primarily

---

<sup>125</sup> Sara Hansard, *Fighting FINRA's Grab for Advisers*, INVESTMENT NEWS, Dec. 13, 2009, <http://www.investmentnews.com/article/20091213/REG/312139989>.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*; see also Hansard, *A Uniform Fiduciary Standard*, *supra* note 115.

<sup>128</sup> See Hansard, *A Uniform Fiduciary Standard*, *supra* note 115.

<sup>129</sup> *Id.*

<sup>130</sup> *Industry Groups Differ on Fiduciary Standard*, FA NEWS, Oct. 6, 2009, available at <http://www.fa-mag.com/fa-news/4532-industry-groups-differ-on-fiduciary-standard-.html>.

<sup>131</sup> Sullivan, *supra* note 16.

<sup>132</sup> See generally FA NEWS, *Sweeping Regulatory Reforms*, *supra* note 122.



because insurance agents do not want to disclose conflicts of interest.<sup>133</sup> Insurance agents are permitted to sell variable insurance products in addition to traditional insurance that is commonly associated with insurance agents; included in the variable products sold by insurance agencies are variable annuities, which are considered to be securities.<sup>134</sup> If insurance agents are also required to live up to a universal fiduciary standard, the insurance industry will likely increase the cost of insurance services for consumers in order to account for the cost of compliance and the increase in lawsuits that will inevitably occur under a fiduciary standard for insurance agents.<sup>135</sup> Thus, insurance agents would likely argue that although the uniform fiduciary standard set out to assist retail investors, the short-sightedness of the plan could ultimately result in harm to the retail investor.

#### *Toward Uniform Governance Under a Single SRO*

Some scholars argue that in addition to the proposal for a uniform fiduciary standard, there is also implicitly a proposal for a single SRO to govern both IARs and Registered Reps. There are both proponents and opponents of this proposal as well.<sup>136</sup>

#### *Proponents of a Single SRO*

Some scholars argue that the presence of a single SRO to govern both IARs and Registered Reps is attractive.<sup>137</sup> Proponents of a single SRO argue that this structure would work in a similar fashion to FINRA.<sup>138</sup> For example, like under FINRA, IARs would pay into a regulatory program that would be self-sufficiently run, independent of tax revenue.<sup>139</sup> In addition, proponents of this plan argue that the SEC would still maintain overriding jurisdiction of the agency SRO to inspect IARs.<sup>140</sup> However, the SEC would maintain this jurisdiction from a more

---

<sup>133</sup> Leondis, *supra* note 98.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> Although this article has not identified sources to this effect, there are likely scholars who would argue that the advocates of a single SRO are off base because this proposal is not yet in the attention of regulators and legislators. However, this article argues that the issue of a single SRO is ripe and awaiting discussion because without a single governing body to enforce the legislation, no legislative reform will be necessary. For example, Part II of this article described the lack of manpower in the SEC for conducting investigations. *See supra* Part II. Thus, even if the regulation is changed such that there is an easily followed uniform standard for both Registered Reps and IARs, this uniform standard will be useless without the appropriate means of enforcement.

<sup>137</sup> *See* Bhargava, *supra* note 20, at 916.

<sup>138</sup> *Id.*

<sup>139</sup> *See id.* Also note that in addition to lifting the burden from the taxpayers, this proposal would be beneficial because it would allow for better planning and allocation of resources. For example, in a taxpayer-funded organization, the budget depends on the taxes that are charged, the payment of those taxes, and the mechanism for which the government collects those taxes and funnels the funds to the appropriate agency. *See id.* Many times, one of the three factors mentioned breaks down and leaves the budget of the government agency up to chance. *Id.* Through a single, independently-funded SRO, however, the SRO will better be able to allocate resources and determine the budget from one year to the next. *Id.*

<sup>140</sup> *See id.*

supervisory position, allowing the independent SRO to do most of the expensive and timely legwork that taxpayers often cannot afford.

#### *Opponents of a Single SRO*

The Financial Planning Coalition and the Investment Advisers Association (“IAA”) argue against regulation of IARs by a single SRO.<sup>141</sup> The Financial Planning Coalition argues that instead of an SRO, the SEC should “maintain its role as the sole federal regulator working in conjunction with state regulatory agencies.”<sup>142</sup> Further, the Financial Planning Coalition argues that the SEC is capable of regulating IARs and the addition of an SRO, introducing a rule-based regulatory system, would be “inappropriate” for IARs who are expected to live up to a fiduciary standard.<sup>143</sup>

#### V. ALTERNATIVES TO THE UNIFORM FIDUCIARY STANDARD

It is clear that there are problems with the current scheme of governance. First and foremost, the current scheme of governance in the financial industry is complex and difficult to understand. This problem creates two primary consequences: (1) financial professionals and regulators do not understand the scheme under which they are working and (2) investors are afforded little, or no, protection in a scheme of governance in which the investors do not understand the protection available to them.<sup>144</sup> Second, there are clear gaps in the supervision and regulation of the financial industry.<sup>145</sup> This lack of supervision and lack of manpower to conduct inspections of financial institutions must be addressed in order to restore confidence in the financial market and prevent economic meltdowns and future schemes such as Madoff’s Ponzi scheme.

This article advocates that other options, besides the administration’s proposal, should be considered by the SEC as they craft the report due to Congress in January 2011. Specifically, this article advocates that the SEC should borrow from the legislative scheme defining fiduciary in ERISA law. During this formative process, lawmakers should keep in mind that the retail investor is not the only stakeholder under consideration. In formulating legislation and new rules, lawmakers and the SEC should consider the perspective of the Broker-Dealer, the IAR, the regulator, the investor, the insurance agent, the other parties in the financial industry, and the effects of the financial industry upon other industries and other global market participants.

---

<sup>141</sup> *See id.*

<sup>142</sup> *See Bhargava, supra* note 20, at 916.

<sup>143</sup> *See id.*

<sup>144</sup> *See supra* Part III.A.

<sup>145</sup> *See supra* Part III.B.ii.

*Heightened Standards for Registered Reps Providing Securities-Related Advice*

Several industry players have suggested alternatives to the Obama Administration's proposal. For example, the IAA "strongly supports the Obama [A]dministration's proposal to require broker-dealers who provide securities-related investment advice to have the same fiduciary obligations as registered investment advisers."<sup>146</sup> However, the IAA is not in support of a "universal standard of care,"<sup>147</sup> which the Obama Administration proposed to harmonize the legal standards governing IARs and Registered Reps.<sup>148</sup> David Tittsworth, the Executive Director of IAA, expressed concern that a single standard might dilute or eliminate the fiduciary obligations that advisers owe to all of their clients.<sup>149</sup> "One of the greatest strengths of a fiduciary standard," Tittsworth said, "is precisely its breadth – the standard has allowed the regulation of advisers to remain dynamic and relevant in changing business and market conditions."<sup>150</sup> Thus, groups and individuals such as the IAA support heightened standards for Registered Reps providing securities-related investment advice, but advocates such as the IAA do not foresee the uniform fiduciary standard to be the correct way to heighten the Registered Rep's duties.<sup>151</sup>

*Universal Standard of Care for Registered Reps and IARs, but Not a Fiduciary Standard*

The Financial Services Institute ("FSI") proposes yet another alternative to the Obama Administration's proposal. During testimony before the House Financial Services Committee, Dale Brown, the President and Chief Executive Officer of FSI, suggested that a "new universal standard of care" should apply to both Registered Reps and IARs.<sup>152</sup> This new standard, however, would not involve any sort of fiduciary standard on Registered Reps.<sup>153</sup> Brown reasoned that:

applying the fiduciary standard to all financial advisors, regardless of their business model, will neither clear up the confusion nor lead to true reform. Instead, he supports a new universal standard of care that would close the regulatory gap between examination and supervision of RIAs and broker-dealers. He said that would benefit investors by contributing to the transparency, effectiveness and efficiency of the financial services regulatory structure.<sup>154</sup>

---

<sup>146</sup> FA NEWS, *Industry Groups Differ*, *supra* note 130.

<sup>147</sup> "Universal standard of care" is another way of referring to the single, uniform fiduciary standard proposed by the Obama Administration.

<sup>148</sup> FA NEWS, *Industry Groups Differ*, *supra* note 130.

<sup>149</sup> *Id.*

<sup>150</sup> *See id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> FA NEWS, *Industry Groups Differ*, *supra* note 130.

Brown goes on to point out the flaws of the fiduciary standard:

[w]e emphasize that it is critical for middle class retail investors that the lack of an efficient and effective regulatory examination and enforcement program for registered investment advisers be addressed as part of these reform efforts . . . Many of the financial advisors involved in recent high-profile fraud cases, such as Bernard Madoff, were subject to a ‘fiduciary standard,’ and yet were able to engage in fraudulent activities for years, due to the lack of effective, regular and vigorous oversight of their activities.<sup>155</sup>

Thus, groups such as FSI advocate for a new universal standard that focuses on the regulatory gaps that exist in the current scheme of governance.

*Brokerage Firms Should Not Be in the Advisory Business*

A third alternative is the elimination of brokerage firms altogether in the advisory industry. Though this measure seems quite extreme, Mark Matson, adviser and chief executive of Matson Money, advocates that “brokerage firms should get out of the advisory business altogether.”<sup>156</sup> Matson explains, “[t]he problem is that [Registered Reps] hold themselves out as offering advice and value-added services.”<sup>157</sup> However, Matson continues, Registered Reps should just tell clients, “I work for a brokerage and I’m going to suggest some things, and you have to make the decision if they’re right for you.”<sup>158</sup> While this appears to be a drastic measure, this proposal would eliminate the need for increased standards, and it would likely be a more clear-cut process for the retail investor.

*Borrow from ERISA: Definition of Fiduciary under ERISA*

Finally, some financial industry representatives have suggested that the crafting of a fiduciary standard for Registered Reps should look similar to the fiduciary standard imposed under ERISA.<sup>159</sup> Fred Reish argues that ERISA is the “best-developed body of law concerning fiduciary status and conflicts of interest . . . by far.”<sup>160</sup> Thus, Reish argues that in the short-term, as Congress seeks to craft a universal fiduciary standard for IARs and Registered Reps, ERISA should be used for guidance, and in the long-term, courts should look to ERISA decisions to determine the practical application of liability under a universal fiduciary standard.<sup>161</sup>

Specifically, this article agrees with Reish and advocates that the best opportunity for effective financial reform is to borrow from ERISA law in determining when a fiduciary relationship is established. Under ERISA, § 3(21)A lays out three ways in which a financial professional will be considered a

---

<sup>155</sup> *Id.*

<sup>156</sup> Sullivan, *supra* note 16.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> See, e.g., Reish, *supra* note 102.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

fiduciary: (1) when the financial professional offers any discretionary authority or control over the plan or when the financial professional exercises any authority or control over the disposition of assets, (2) when the financial professional renders “investment advice” or has authority or responsibility to offer investment advice, for a fee or for compensation, or (3) when the financial professional has any discretionary responsibility or authority over the administration of the plan.<sup>162</sup>

Thus, similar to the 1940 Act, ERISA, in-part, bases the determination of a fiduciary relationship on the presence of the adviser’s discretionary or nondiscretionary control over the account.<sup>163</sup> ERISA, however, goes one step further than the 1940 Act. Under ERISA’s definition of fiduciary, if the advice rendered by the adviser meets the following four elements, then the adviser is considered a fiduciary for purposes of ERISA: (1) advice is rendered on a regular basis, (2) the advice is rendered as a part of a mutual agreement between the customer and the adviser, (3) the investment advice serves as the primary basis for the customer’s investment decisions, and (4) advice rendered to the customer is individualized investment advice based on the particular needs of the customer and the plan.<sup>164</sup> However, as long as one of the four above elements is not met, then the adviser does not qualify as a fiduciary and, hence, the adviser will not be subject to heightened fiduciary duties under ERISA.

Put another way, under ERISA, the determination of whether an adviser is a fiduciary rests on whether the adviser is providing guidance as to the *availability* of funds or, alternatively, whether the adviser is advising the retail investor by providing “investment advice” meant to assist the retail investor in choosing funds. Under ERISA, when an adviser provides only a list of available funds, the four criteria above will not be met and the adviser will not be a fiduciary. However, when the adviser is providing investment advice, or advising the client as to what

---

<sup>162</sup> See generally ERISA, 29 C.F.R. § 2510.3-21 (2010). Further, under § 2510.3-21(c)(1), an advisor is considered to provide “investment advice” if the advisor:

(i) renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; and

(ii) such person either directly or indirectly (e.g., through or together with any affiliate)

A. has discretionary authority or control, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or

B. renders any such advice on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

*Id.* (emphasis added); see also United States Department of Labor, Advisory Opinion (Dec. 7, 2005), available at <http://www.dol.gov/ebsa/regs/aos/ao2005-23a.html>.

<sup>163</sup> See *supra* Part II.C.

<sup>164</sup> See ERISA, *supra* note 162; see also United States Department of Labor, Advisory Opinion, *supra* note 162.

funds to choose from the list of available funds, then the four criteria should be examined; if the four criteria are met, which is likely, the adviser will be considered a fiduciary under ERISA. Under this framework, ERISA providers, regulators, and legal counsel have been able to discern more clearly the presence of a fiduciary relationship and provide services accordingly.

## VI. CONCLUSION

Dating back to the first major financial reform act in 1934, the financial system has struggled over the years to stay within the confines of the 1934 Act and 1940 Act, while at the same time evolving to meet the ever-increasing needs of the financial world. Particularly during the last two decades, the legal distinctions and definitions that once applied to IARs and Registered Reps have lost their functional differences, calling into question the entire regulatory scheme's validity.<sup>165</sup>

Recognizing this issue, in June 2009, the Obama Administration proposed changes in the White Paper<sup>166</sup> and Congress followed suit by enacting the Dodd-Frank Legislation.<sup>167</sup> Though it is clear that a change is needed in the regulatory scheme, the question still remains: what course should Congress and the SEC take on the quest to restore the financial markets and increase investor confidence in the integrity of the system?

The Obama Administration's universal fiduciary standard, which applies to both IARs and Registered Reps is not the best course of action. President Obama and lawmakers have been short-sighted in their evaluation of the problem. In an effort to find a "quick-fix" end to investors' fears of the market, the administration has forgotten to consider the indirect consequences that a universal fiduciary standard imposes upon Registered Reps and the entire financial market. Most importantly, the administration has neglected to consider the effects on the retail investor. If Broker-Dealers are forced to make substantial changes to their business models, retail investors will likely incur additional expenses passed on from Broker-Dealers as they change their business model, or alternatively, some Broker-Dealers will close and force investors to seek out other institutions for their financial services.<sup>168</sup>

Legislators and the SEC should borrow from ERISA when crafting legislation in the coming days. Not only should legislators and the SEC use the ERISA framework for crafting a new understanding of the fiduciary standard, but also, in subsequent days, the judicial system should look to ERISA cases to guide the outcome of litigation that will occur after regulatory reform is enacted. This article supports changes in the regulatory structure of the financial system, but this article cautions against short-sighted decisions that fail to consider all relevant stakeholders in the financial industry, including retail investors, Registered Reps, IARs, insurance companies, regulators, and all other members of the financial

---

<sup>165</sup> HUNG ET AL., *supra* note 15.

<sup>166</sup> See *supra* note 5 and accompanying text.

<sup>167</sup> See *supra* note 96 and accompanying text.

<sup>168</sup> See *supra* Part IV.A.

industry.