Unlike investment advisers, broker-dealers are not held to a fiduciary duty when they make recommendations concerning investments. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 authorizes the Securities and Exchange Commission (SEC) to adopt a rule imposing a fiduciary duty on broker-dealers when they provide investment advice. This paper recommends that the SEC adopt a broadly worded fiduciary rule and makes recommendations on how to clarify issues raised by such a rule as it is implemented.

This In Brief summarizes a new Public Policy Institute report on the form of a federal fiduciary duty rule for broker-dealers for consideration by the Securities and Exchange Commission (SEC).

The report discusses the law governing investment advice by investment advisers and broker-dealers, explores approaches to a fiduciary duty for investment advice, and makes policy recommendations for the SEC as it considers a rule imposing a fiduciary duty on broker-dealers when they provide investment advice.

Federal Regulation of Broker-Dealers

Investment advisers and broker-dealers are regulated under different federal statutes. Investment advisers have a fiduciary duty to act in the best interest of their clients when providing investment advice. Broker-dealers are, for the most part, exempt from the Investment Advisers Act and the fiduciary duty it imposes.

The Securities Exchange Act of 1934 is the primary source of law for broker-dealer activities. Under this act, broker-dealers are required to register and file reports with the SEC. The Exchange Act’s antifraud provisions authorize the SEC to adopt rules that are similar to the antifraud rules under the Advisers Act. However, there is no fiduciary duty for advisory activities under the Exchange Act or its rules.

FINRA’s suitability rule is not the same as a fiduciary duty.

Virtually all broker-dealers are required to become members of the Financial Industry Regulatory Authority (FINRA), which imposes its own rules on members and their representatives. Under FINRA rules, when broker-dealers make recommendations about investments (essentially giving investment advice), the recommendations must be suitable to meet their client’s needs.

FINRA’s suitability rule, like the fiduciary duty that applies to investment advisers, is principles-based. That is, the rule is a broadly stated principle of conduct, as opposed to a prescription-based rule, under which the person subject to the rule must
follow prescribed actions or refrain from specifically proscribed acts.

The suitability requirement is not as strong as a fiduciary duty. There is no requirement under the suitability rule to recommend the best product for the customer or to act in the best interest of the customer. A broker-dealer making a suitable recommendation that pays a higher commission than another recommendation that is better for the customer is under no obligation to disclose that conflict of interest.

**Dodd-Frank Authority to Adopt Fiduciary Rule**

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 specifically authorizes the SEC to establish a fiduciary duty for broker-dealers when they provide investment advice. Section 913 also requires the SEC to conduct a study of broker-dealer and investment adviser regulation. The study, conducted by SEC staff, was released in January 2011. It recommended that the SEC adopt a rule imposing a fiduciary duty on broker-dealers when they provide personalized investment advice to retail investors.

Fiduciary rulemaking by the SEC will, in all likelihood, build on the existing regulation of broker-dealers’ advisory activities to accommodate the way broker-dealer business models already incorporate existing regulation of their advisory activities.

**Recommendations for SEC Action**

The report recommends that the SEC adopt a broad principles-based rule that requires brokers to act in the best interest of their clients when giving investment advice, without regard to the interests of the broker. Appendix A of the report contains a model of such a rule. The report also makes the following nine recommendations to clarify the broad rule to be adopted either by the SEC or FINRA:

- Interpret “personalized investment advice” consistently with its usage under the Advisers Act.
- Narrowly define the circumstances under which a broker can give advice about investments without being subject to the fiduciary duty.
- Identify circumstances under which a financial professional’s compensation or other benefits create a conflict of interest and could cause the advice to be deemed to have been provided “with regard” to the professional’s interest.
- Consider banning certain compensation practices, such as revenue sharing.
- Consider applying the fiduciary rule to certain nonretail investors.
- Require broker-dealers to provide a brochure prior to engagement, as well as appropriate transaction-specific disclosures.
- Require broker-dealers and investment advisers to disclose fees, in dollars, and include a conflict-of-interest statement.
- Require transaction-specific client consent for all transactions where the fiduciary duty would require it.
- Subject all providers of retail investment advice to minimum care standards and require documentation of their recommendation processes, with heightened standards when investment recommendations may be subject to a conflict of interest.

In Brief 191, September, 2011

This In Brief is a synopsis of the AARP Public Policy Institute Research Report of the same title, number 2011-02. AARP Public Policy Institute, 601 E Street, NW, Washington, DC 20049 www.aarp.org/ppi 202-434-3910, ppi@aarp.org © 2011, AARP. Reprinting with permission only.