The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) may have a significant impact on broker-dealers, though much of the impact will depend on how regulators, including the Securities and Exchange Commission (SEC), interpret its mandate and craft implementing rules. A significant possible impact is the potential shift from a suitability to a fiduciary duty standard when broker-dealers provide advice and recommendations to retail customers. In addition, the SEC will likely require that broker-dealers provide new disclosures to customers concerning conflicts of interest and the receipt of compensation. The Act also provides the SEC with broad new powers to prohibit or restrict sales practices, conflicts of interest, and compensation schemes that the SEC deems contrary to the public interest. In addition, the SEC now has the authority to alter the current system of mandatory arbitration by imposing conditions or limitations on its use. More broadly, an open question is whether the Act and its follow-on SEC rules will lead the SEC to focus more attention on rule-making, examinations, and enforcements involving the retail investor. This A Closer Look is our initial perspective on how Dodd-Frank and its implementing regulations could impact broker-dealers with respect to their obligations and interactions with retail investors.

Dodd-Frank could potentially impact all broker-dealers and their registered representatives that provide personalized investment advice and recommendations about securities to retail customers. This includes broker-dealers and their registered representatives who sell mutual funds, variable annuities, and other securities.
Will broker-dealers be subject to a fiduciary duty?

This may be the big question for retail broker-dealers with regard to the provisions of Dodd-Frank. The Act defines the fiduciary standard as acting “in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. . . . [A]ny material conflicts of interest shall be disclosed and may be consented to by the customer.” The fiduciary standard differs from the current suitability standard that requires that broker-dealers recommend products that are suitable for the customer in light of the customer’s investment objectives, risk tolerance, and other factors.

The SEC will conduct a (quick) study

Dodd-Frank directs the SEC to conduct a study and to report its findings, conclusions, and recommendations within six months of enactment. The SEC is to evaluate existing legal and regulatory standards of care for brokers, dealers, and advisers (and their associated persons) when providing personalized investment advice and recommendations about securities to retail customers (defined as an individual person who uses such advice primarily for personal, family, or household purposes).

The SEC will consider, among other things:

• Whether retail customers understand that there are different standards of care applicable to broker-dealers and investment advisers when they provide personalized investment advice to retail customers
• Whether the existence of different standards of care is a source of confusion to retail customers regarding the quality of personalized investment advice
• The regulatory, examination, and enforcement resources devoted by the SEC, the states, and the Financial Industry Regulatory Authority (FINRA) to enforce the standards of care for broker-dealers and investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including the effectiveness of examinations in determining compliance and the frequency of examinations
• The substantive differences in the regulation of broker-dealers and investment advisers when providing personalized investment advice and recommendations about securities to retail customers
• The specific instances in which the regulation and oversight of investment advisers provides greater protection to retail investors, and instances in which the regulation and oversight of broker-dealers provides greater protection to retail customers
• The existing legal or regulatory standards of state securities regulators and other regulators intended to protect retail customers
• The potential impact of the Investment Advisers Act of 1940 (Advisers Act) on retail customers and their access to the range of products offered by broker-dealers, particularly as regards the imposition of a fiduciary duty under the Advisers Act
• The potential impact of eliminating the broker-dealer exclusion from the definition of “investment adviser” under the Advisers Act
• The varying level of services provided by brokers, dealers, and advisers to retail investors and the varying scope and terms of their relationships with retail customers
• The potential impact on retail customers that could result from changes to the regulatory requirements or legal standards of care, including protection from fraud; access to personalized investment advice; the availability of such advice and recommendations; and potential costs and expenses to retail customers, broker-dealers, and advisers
The Act sets an aggressive timeframe for the study, though the SEC will likely call upon its existing knowledge of the issue, its experience in regulating advisers under the fiduciary standard, and other relevant studies (e.g., the Rand study commissioned several years ago). The SEC is also required to seek public comment as part of the study. The study should provide guidance to broker-dealer firms about how existing practices could result in problems under an enhanced liability standard. Some open questions for the study include, for example, (i) how a fiduciary standard would impact the current broker-dealer model with respect to commission-based compensation and other sales incentives, as well as product selection and product features; (ii) how frequently a broker-dealer would need to review the customer’s account; and (iii) how meaningful disclosure of conflicts of interest could be made. Existing law and interpretations of the duty as applied to advisers will likely guide the SEC in its study.

Additional questions for the study are whether the SEC would conclude that its own existing regulatory, examination, and enforcement resources, along with those devoted by the states and FINRA, are inadequate or too disparate to enforce the standards of care for broker-dealers and investment advisers, particularly if broker-dealers are subject to a fiduciary standard. Will this lead to requests for additional resources for the SEC or for renewed calls for a self-regulatory organization (SRO) for advisers? Would a common standard for brokers and advisers lead to a common rule-making and oversight approach for advisers and broker-dealers?

Following the study, the SEC is authorized to commence rule-making

The Act empowers the SEC to write rules addressing the legal and regulatory standards of care for brokers, dealers, and investment advisers (and their associated persons) when providing personalized investment advice about securities to retail customers “and such other customers as the Commission may by rule provide.” The SEC is specifically empowered to require broker-dealers to adhere to the same standard of conduct applicable to an investment adviser under the Advisers Act.

The SEC is authorized to adopt a fiduciary standard, though it is not mandated to do so, and there is no deadline for such rule-making. It is authorized to adopt the same fiduciary standard as is applicable to advisers; it does not seem to have discretion to define the duty by using another standard. Existing law and interpretations of the duty as applied to advisers will likely guide the SEC if it extends the duty to broker-dealers. With respect to the application of the duty, the SEC apparently is provided with authority to adopt a fiduciary standard for any type of customer, not just retail customers.

Some questions about the application of a fiduciary duty to brokers-dealers

The Act contemplates the application of a fiduciary standard to broker-dealers, and addresses some potentially thorny issues in the application of the standard, namely:

Compensation. The receipt of commission-based compensation or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of the fiduciary standard.

Ongoing duty. A broker-dealer or registered representative is not required to have a continuing duty of care or loyalty after providing personalized investment advice.

Proprietary products. The sale of only proprietary products or a limited range of products shall not, in and of itself, be considered a violation of the fiduciary standard. (The SEC is authorized to require disclosure to and consent from customers regarding the limited range of products offered by the broker-dealer.)

Method of disclosure. The SEC is directed to facilitate the provision of “simple and clear” disclosures to investors regarding the terms of their relationship with brokers, dealers, and investment advisers, and any material conflicts of interest.
If it adopts a fiduciary duty standard, the SEC will likely provide additional guidance with respect to these and other issues. A change in the legal standard for broker-dealers’ interactions with retail customers would likely require that broker-dealers take steps to examine their current practices in light of the enhanced standard. For example:

- To identify conflicts of interest and potential conflicts of interest for mitigation, elimination, and/or disclosure. This would include, for example, relationships with mutual fund and other asset management firms, including the payment and receipt of compensation, referral arrangements, and sales incentives, as well as trading and allocations, relationships with affiliates, and other possible areas of conflict.
- To review their broker compensation models and consider any conflicts of interest. While the receipt of commission-based compensation will not “in and of itself” be considered a violation of the fiduciary standard, what role will compensation play in incentivizing conduct consistent with a fiduciary role?
- To review the current product mix and determine whether particular products or product features should be dropped or altered. While the sale of only proprietary products or a limited range of products will not “in and of itself” be considered a violation of the fiduciary standard, what will a broker-dealer’s obligation be, if any, with respect to potentially superior products that the firm does not sell?
- To review current disclosures of conflicts of interest with a view toward enhancing disclosure of all conflicts and potential conflicts. Making new “simple and clear” disclosures about conflicts of interest and the terms of relationships would require significant care.
- To review the process around product creation and product selection and consider how it could be affected by a fiduciary model. This would likely require additional care in product creation and selection and careful consideration of product features.
- To create new training for supervisors and registered representatives concerning their new fiduciary obligations.
- To implement revised and new supervisory and compliance procedures, controls, and testing.

The SEC is given new and unprecedented rule-making authority

Sales practices. The SEC is directed to examine and, where appropriate, issue rules “prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”

One question is how the SEC would use this new authority to prohibit certain sales practices, compensation schemes, and conflicts of interest. Typically, the SEC has relied on FINRA and the SROs to craft sales practices rules for broker-dealers. Will the SEC seek to regulate sales practices more directly? For example, would it seek to prohibit sales seminars that target senior citizens? The use of boiler rooms for cold calling? Compensation for shelf space? Payments for referrals?

Arbitration. The SEC is also authorized to prohibit or impose conditions on the use of mandatory arbitration agreements by broker-dealers and investment advisers.

While the existing arbitration process administered through FINRA continues to evolve, an open question is whether the SEC will ban or restrict the use of pre-dispute arbitration agreements that serve to keep customer disputes out of court.

Pre-sale disclosure. The bill also clarifies the SEC’s authority to require “clear and concise” pre-sale disclosure to retail investors regarding investment objectives, strategies, risks, and costs, and any compensation or other financial incentive received by a broker-dealer or other intermediary in connection with the purchase of the product.
The SEC is likely to move forward with point-of-sale disclosure requirements. The Act does not limit such disclosure to particular products.

**Enforcement against advisers and broker-dealers**

**Harmonization.** The Act requires “harmonization” of enforcement by the SEC with respect to violations of the broker-dealer and investment adviser standard of conduct. In seeking prosecutions and sanctions, the SEC is directed to apply equal rigor against broker-dealers and investment advisers who are in violation of standards of conduct.

For broker-dealers and advisers, there should be greater consistency in charging decisions, settlement terms, and sanctions. The “harmonization” of enforcement does not appear to be dependent on the SEC adopting a fiduciary standard for broker-dealers. An unknown element in the “harmonization” is how FINRA and its enforcement actions against broker-dealers are implicated. Currently, most enforcement actions involving violations of a broker-dealer’s suitability obligation are brought by FINRA, not by the SEC.

In particular, as the law directs that enforcement of the broker-dealer and adviser standards of care be consistent, will that mean more SEC enforcement actions in matters that may in the past have been referred to or handled by an SRO?

**Financial planners**

**Government Accountability Office to study need for regulation.** The Act requires that the Government Accountability Office (GAO) conduct a study within six months to evaluate current oversight of financial planners and the effectiveness of regulations to protect investors and consumers from individuals who hold themselves out to be financial planners through the use of misleading titles, designations, or marketing materials. The study will consider:

- The role of financial planners in providing financial, tax, education, retirement, and estate planning
- Whether current regulations provide adequate ethical and professional standards
- Possible risks to investors and consumers by individuals who hold themselves out as financial planners in connection with the sale of financial products, including insurance and securities
- Possible risks to investors and consumers by the use of misleading titles, designations, and marketing materials
- The ability of investors and consumers to understand licensing requirements and standards of care of financial planners
- The benefits of regulation and professional oversight of financial planners

The recommendations are to include an appropriate structure for regulation and establishing standards for financial planners.

Broker-dealers and others who provide financial planning could see additional calls for regulation, including regulation governing the use of designations and qualifications.

**Investor access to information about brokers and advisers**

**Easier access to pertinent information.** The SEC is directed to conduct a study, within six months, of ways to improve investors’ access to information about advisers and broker-dealers (and their associated persons) on the Central Registration Depository (CRD) and the Investment Adviser Registration Depository (IARD) systems. This information includes disciplinary, regulatory, judicial, and arbitration histories of advisers and broker-dealers, and other information. The study is to include an analysis of the advantages and disadvantages of centralizing the systems, identifying data that is pertinent to investors and specifying a
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method for displaying such data to enhance accessibility and utility to investors. The SEC is directed to implement any changes within 18 months.

Currently, information about broker-dealers is contained on the CRD, administered by FINRA. Similar information from advisers’ Form ADV is contained on the IARD, also administered by FINRA. Enhancing the accessibility of information about advisers and broker-dealers could help investors make informed decisions about a potential adviser or broker-dealer and associated individuals, and would underscore the need for fully accurate information in broker-dealer CRD records.
While Dodd-Frank will have significant impact on retail broker-dealers, many implementation issues are currently unclear and are subject to the SEC and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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