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SEC Study on Investment Advisers and Broker-Dealers

The Securities and Exchange Commission (the “SEC”) has released the results of its study of the regulatory obligations of brokers, dealers and investment advisers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

Existing Regulatory Regime

- Investment advisers are subject to regulation under the Investment Advisers Act of 1940 (the “Advisers Act”); broker-dealers are subject to regulation (i) by the SEC under its antifraud authority pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, and (ii) by the Financial Industry Regulatory Authority (“FINRA”).
- Investment advisers are subject to a principles-based fiduciary duty standard, which includes a duty of loyalty and a duty of care. Broker-dealers must adhere to FINRA rules, which include the requirement that their recommendations be suitable for a customer’s financial situation, but are generally not subject to a fiduciary duty standard.

Recommendations

Summarized below are the key elements of the study’s recommendations. However, given the level of disagreement at the Commission level with the study and the fact that implementation of any of the recommendations will require detailed rulemaking and public comment, the ultimate ramifications in practice remain to be seen.

Uniform Fiduciary Standard

- The study recommends that the SEC engage in rulemaking to implement a uniform fiduciary standard of conduct that would cover both investment advisers and broker-dealers when they provide *personalized investment advice* about securities to *retail customers*. The standard would be at least as high as the fiduciary duty standard currently applied to investment advisers under the Advisers Act and, notably, would provide for violations of the standard not involving scienter to the same extent as is currently the case for antifraud violations involving breach of fiduciary duty under the Advisers Act.
 - *Personalized Investment Advice*. The study recommends that the SEC define “personalized investment advice” to include, at a minimum, “recommendation” as defined in existing broker-dealer regulations, and exclude “impersonal investment advice” as used under the Advisers Act.

- *Retail Customers.* The study recommends that the SEC define “retail customers” to include individual retail customers and groups of retail customers. It also notes that the SEC could consider extending the uniform fiduciary standard to cover persons other than retail customers.
- Existing guidance under the Advisers Act regarding fiduciary duty would apply to investment advisers and broker-dealers.
- The duty of loyalty would require that an investment adviser or broker-dealer provide full and fair disclosure about material conflicts of interest.
 - The study recommends that the SEC develop a uniform approach to disclosure, which may include requiring broker-dealers to provide a general relationship guide at the outset of the relationship. Investment advisers currently have a similar requirement for their firm brochures.
 - The study recommends that the SEC identify specific examples of potentially material conflicts of interest and consider whether it might be appropriate to impose an outright prohibition on certain conflicts of interest.
 - The study recommends that broker-dealers be required to disclose their conflicts of interest from principal trades, but notes specifically that they should not be subject to the same notice and consent procedures to which investment advisers are subject. In that connection, the study notes that some types of securities such as municipal and corporate bonds, new issues and proprietary products are typically traded and initially offered on a principal basis.
- The duty of care would require that investment advisers and broker-dealers meet specified professional standards. The study recommends that the SEC provide detailed guidance that delineates minimum expectations for the appropriate standard of conduct, which would include specifying the basis for a recommendation to a retail customer. The study emphasizes that these would only be minimum standards and would not establish a safe harbor or prevent the SEC from imposing a higher standard based on specific facts or circumstances.
- Section 913(g) of Dodd-Frank expressly provides that the receipt of compensation based on commission or other standard compensation would not, in and of itself, violate the uniform fiduciary standard. The study recommends that any proposed rulemaking or guidance preserve investor choice among services, products and fee structures.

Harmonization of Regulation

The study suggests that the regulatory requirements that investment advisers and broker-dealers face be harmonized. Recommendations for harmonization include:

- *Advertising.* Consider articulating consistent substantive advertising and customer communication rules, and specifically consider requiring that investment advisers, like broker-dealers, designate employees to review and approve advertisements.
- *Finders and Solicitors.* Review existing rules governing the use of finders and solicitors and disclosure of the conflict of interest associated with their compensation structure.
- *Supervision.* Review supervisory requirements, in particular consider creating a single set of universally applicable rules, and consider, in the alternative, creating different supervisory requirements based on size.
- *Licensing and Registration of Firms.* Consider harmonizing the disclosure requirements of Form ADV and Form BD, and consider subjecting investment advisers to a substantive review prior to registration (similar to FINRA membership requirements for broker-dealers).
- *Licensing and Continuing Education Requirements.* Consider subjecting investment adviser representatives to federal licensing and continuing education requirements, similar to broker-dealer associated persons registering with FINRA.
- *Books and Records.* Consider requiring investment advisers to retain all communications (including e-mail) and agreements related to an adviser's business as such, similar to broker-dealers.

Retain Broker-Dealer Exclusion from Registration under the Advisers Act

Under current law, broker-dealers need not register as Investment Advisers under the Advisers Act, provided that the investment advice they offer is solely incidental to the conduct of their business as a broker or dealer, and that they receive no special compensation for such advice. The study considers eliminating this exclusion, but concludes that the costs of doing so would exceed the benefits.

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