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ResearchReport

Broker-Dealers' Standard of Care

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Issue

Describe laws that impose a fiduciary duty on broker-dealers.

Summary

Unlike investment advisers (see side bar), who are subject to a fiduciary standard (i.e., a duty to act in the client's best interest), broker-dealers have traditionally been subject to a less stringent federal "suitability standard." The suitability standard requires broker-dealers to provide suitable investments to customers but does not require the broker-dealer to act in the client's best interest.

However, broker-dealers have been held to a fiduciary standard under some states' common-law and more recently under the federal Department of Labor's (DOL) Conflict of Interest Rule. Also, the Securities and Exchange Commission (SEC) has submitted a staff study to Congress recommending a uniform fiduciary standard of conduct for both broker-dealers and investment advisers.

Courts in at least four states (California, Missouri, South Carolina, and South Dakota) have explicitly imposed a fiduciary standard on broker-dealers (see Table 1). On the other hand, courts in 14 states have expressly held that a fiduciary duty does not exist between a client and a broker-dealer (Arizona, Arkansas, Colorado, Hawaii, Massachusetts, Minnesota,

The Investment Advisers Act *defines an "investment adviser" as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, about the value of securities or about the advisability of investing in, purchasing, or selling securities, or who, for compensation as part of a regular business, issues or promulgates analyses or reports about securities (15 U.S.C. § 80b-2(a)(11)).*

The act excludes broker-dealers from the definition of an investment adviser (15 U.S.C. § 80b-2(a)(11)(C)).

The Exchange Act *defines a "broker-dealer" as any person engaged in the business of effecting transactions in securities for the account of others (15 U.S.C. § 78c(a)(4)).*

Mississippi, Montana, New York, North Carolina, North Dakota, Oregon, Washington, and Wisconsin). (Minnesota and Wisconsin laws provide that a broker does not owe a fiduciary duty to clients unless there is a special agreement between the parties (Minn. Rules § 2876.5023 and Wis. Stat. § 881.02).)

Connecticut is among 32 states that do not impose a fiduciary duty on broker-dealers but impose a standard that exceeds the federal "suitability standard."

States' Common-Law

Table 1 summarizes the fiduciary standard to which broker-dealers have been held by courts in California, Missouri, South Carolina, and South Dakota.

Table 1: States that Explicitly Apply Fiduciary Standards to Broker-Dealers

State *(Authority)*	***Fiduciary Standard for Broker***
California (*Hobbs v. Bateman Eichler, Hill Richards Inc.*, 164 Cal.App.3d 174 (1985))	"A broker's fiduciary duty requires that he or she act in the highest good faith toward the customer."
Missouri (*State ex rel Paine Webber v. Voorhees,* 891 S.W.2d 126 (1995))	"Stockbrokers owe customers a fiduciary duty," which includes, at a minimum, managing the account as directed by the customer's needs and objectives, informing of risks in particular investments, refraining from self-dealing, following order instructions, disclosing any self-interest, staying abreast of market changes, and explaining strategies.
South Carolina (*Cowburn v. Leventis, 366 S.C. 20 (*2005))	State courts have imposed duties similar to those required when a fiduciary duty applies, such as a duty to refrain from acting contrary to a customer's best interest, avoid fraud, and communicate information to the customer that would be in the customer's advantage.
South Dakota *(Dismore v. Piper Jaffray Inc.,* 593 N.W.2d 41 (1999))	"Securities brokers owe the same fiduciary duties to customers as those owed by real estate brokers, including a duty of utmost good faith, integrity, and loyalty, and a duty to act primarily for the benefit of another."

DOL Conflict of Interest Rule

Under the DOL's new Conflict of Interest Rule, anyone that provides "investment advice" to plans, plan sponsors, fiduciaries, plan participants and beneficiaries, or IRA owners must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption issued by the department. Under new exemptions adopted with the rule, firms must acknowledge their status and the status of their individual advisers as fiduciaries.

The rule requires firms and advisers to:

1. make prudent investment recommendations without regard to their own interests or the interests of anyone other than the customer,

2. charge only reasonable compensation, and

3. make no misrepresentations to their customers regarding recommended investments.

Covered Investment Advice

The rule describes the kinds of communications that would constitute investment advice and the types of relationships in which those communications would give rise to fiduciary investment advice responsibilities.

To establish the existence of fiduciary investment advice, it must be determined whether a recommendation occurred. A "recommendation" is a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the person receiving the advice engage in or refrain from taking a particular course of action. The more individually tailored the communication is to a specific recipient, the more likely the communication will be viewed as a recommendation.

In order for a recommendation to constitute fiduciary investment advice, it must be rendered for a fee or other compensation.

Exemptions

If the communications do not meet the definition of recommendations as described above, the communications are considered non-fiduciary. The final rule also includes some specific examples of other communications that would not constitute a fiduciary investment advice, these include:

1. education about retirement savings and general financial and investment information,

2. general communications that a reasonable person would not view as an investment recommendation,

3. provision of a selection of investment alternatives by a platform provider,

4. transactions with investment plan fiduciaries with financial expertise, and

5. reports and recommendations by a company's employees.

SEC Study - Uniform Fiduciary Standard

Pursuant to requirements under the Dodd-Frank Act, the Securities and Exchange Commission (SEC) submitted to Congress a staff study recommending a uniform fiduciary standard of conduct for broker-dealers and investment advisers, no less stringent than currently applied to investment advisers under the Advisers Act, when those financial professionals provide personalized investment advice about securities to retail investors.

> *"The Investor Advisory Committee believes that personalized investment advice to retail customers should be governed by a fiduciary duty, regardless of whether that advice is provided by an investment adviser or a broker-dealer.*
>
> *The Committee further believes that the fiduciary duty for investment advice should include, first and foremost, an enforceable, principles-based obligation to act in the best interest of the customer. In approaching this issue, the SEC's goal should be to eliminate the regulatory gap that allows broker-dealers to offer investment advice without being subject to the same fiduciary duty as other investment advisers but not to eliminate the ability of broker-dealers to offer transaction-specific advice compensated through transaction-based payments." - SEC Staff Study*

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