Symposium: Compensation of Plaintiffs in Mass Securities Litigation

Keynote Address

Regulating Broker–Dealers and Investment Advisers: Demarcation or Harmonization?

Elisse B. Walter*

I. INTRODUCTION 1
II. BACKGROUND 2
III. GENERAL PRINCIPLES 4
IV. COMMISSION RULEMAKING UNDER CURRENT AUTHORITY 5
V. LEGISLATIVE APPROACH 6
A. Registration Process 7
B. Licensing and Continuing Education Requirements 7
C. Disclosure Obligations 7
D. SRO Membership 7
E. Remedies 8
F. Uniform Standard of Conduct 9
VI. CONCLUSION 10

I. INTRODUCTION

This topic is actually not as far afield from your conference topic as it might appear at first blush. Successful litigation always depends on a party having violated some statute, rule, duty, or standard of conduct. I hope, therefore, that my remarks today, which lay out my evolving views on the regulation of financial professionals, will be of interest to you. Please keep in mind, however, that my remarks today represent my own views, and not necessarily those of the Commission, my fellow Commissioners, or members of

* Commissioner, U.S. Securities and Exchange Commission.

the staff.[1]

II. BACKGROUND

I would like first to take a step back and put the question of broker–dealer and investment adviser regulation into the broader context of recent discussions of regulatory reform, and also to provide some historical background. The current securities regulatory framework in the United States was enacted by Congress in the 1930s and '40s; it is now a patchwork quilt—and a badly worn one at that. Although I am continually amazed at how well our securities statutes have done their job over the decades, when you look closely at the full fabric of our regulatory system, it is apparent, although not shocking, that there are gaps and overlaps. Some of the decisions made more than a half century ago are no longer ideal. There are important products and market actors, such as hedge funds and much of the over-the-counter financial derivatives market, that are beyond effective oversight by regulators. Other products and market actors are subject to regulation by a myriad of federal and state bodies, whose divided and sometimes unnecessarily overlapping jurisdictions create inefficiencies. Addressing these gaps and overlaps is high on the Commission's agenda, both by working with Congress to draft appropriate legislation and through the exercise of its current rulemaking and interpretive authority.

The Balkanized structure of financial regulation in the United States is apparent in the regulation of financial professionals. I am going to focus my attention in this speech on broker–dealers and investment advisers because they are—with a few notable exceptions—subject to the Commission's jurisdiction. Of course, the gist of what I am going to say would apply equally well to other financial professionals, regardless of their primary regulator.

For the most part, broker–dealers and investment advisers are regulated under different statutes and at times by different regulatory bodies. Yet, they often provide practically indistinguishable services to retail investors and direct them to the same products. As Chairman Schapiro recently told Congress, "[The Commission is] studying whether to recommend legislation to break down the statutory barriers that require a different regulatory regime for investment advisers and broker–dealers, even though the services they provide often are virtually identical from the investor's perspective."[2]

Before I go too much further, let me review a little background. In the Investment Advisers Act of 1940 (Advisers Act), Congress defined an "investment adviser," in part, as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in . . . securities."[3] A variety of people and entities that provide investment advice as they carry out their other professional activities, such as banks, lawyers, and publishers, are excepted from this

1. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, other Commissioners, or the staff.

2. *Enhancing Investor Protection and Regulation of the Securities Markets—Part II: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2009/ts032609mls.htm.

3. Investment Advisers Act of 1940 § 202(a)(11) (codified at 15 U.S.C. § 80b-2 (2006)).

definition.[4]

Congress also included an exception for broker–dealers. Specifically, the Advisers Act excepts from the definition of an investment adviser any broker–dealer whose provision of investment advice is "solely incidental" to the conduct of its brokerage business and who receives "no special compensation," which refers to an asset-based or fixed fee rather than commissions, markups, or markdowns.[5] As former Commissioner Annette Nazareth noted: "This now longstanding exception to investment adviser regulation recognized both that broker–dealers were already comprehensively regulated and that there was a natural interrelationship between brokerage and providing information and advice about investments."[6]

Before 1975, broker–dealers charged fixed commissions in connection with their brokerage services. But things changed that year when Congress unfixed commissions. Broker–dealers began to face ever-tightening margins on commission rates, and naturally sought fee structures that would help stabilize revenues.

Twenty years later, the SEC's Committee on Compensation Practices issued a report—usually referred to as the "Tully Report," after Daniel Tully—that lauded the benefits of fee-based programs principally because the Committee viewed that form of compensation as aligning the interests of registered representatives and brokerage firms with their customers' interests better than transaction-based compensation did.[7] Partly in response to the Committee's recommendation, the Commission adopted a rule in 2005 that permitted a broker–dealer to offer fee-based brokerage accounts, provided it made certain disclosures regarding the nature of its services.[8] The rulemaking also included an interpretation of the "solely incidental" prong of the broker–dealer exception from the definition of an investment adviser.[9] That interpretation focused on the provision of financial planning services, but also covered discretionary asset management. The United States Court of Appeals for the District of Columbia Circuit overturned the rule in 2007.[10]

Prior to the D.C. Circuit's decision, the SEC had announced its intention to commission a study to compare the regulatory regimes applicable to investment advisers and broker–dealers and the protections afforded to retail investors.[11] The RAND

4. § 202(a)(11)(A), (B), (D).

5. § 202(a)(11)(C).

6. Annette L. Nazareth, Comm'r, SEC, Remarks Before the IA Week Sixth Annual Fall Conference (Sep. 25, 2006), *available at* http://www.sec.gov/news/speech/2006/spch092506aln.htm.

7. *See generally* SEC, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES (1995), *available at* http://www.sec.gov/news/studies/bkrcomp.txt.

8. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Advisers Act Release No. 35-51523, 70 Fed. Reg. 20,424 (Apr. 19, 2005), *available at* http://www.sec.gov/rules/final/34-51523.pdf (allowing broker–dealers to charge a fixed fee "provided it makes certain disclosures").

9. *See* Investment Advisers Act of 1940, § 202(a)(11)(C) (codified at 15 U.S.C. § 80b-2(a)(11)(C) (2006)).

10. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481, 487 (D.C. Cir. 2007) (holding that the Commission exceeded its authority under the Advisers Act when it promulgated Rule 202(a)(11)-1 exempting certain broker–dealers providing fee-based brokerage accounts from registering as investment advisers).

11. *See* Notice of Broker-Dealer/Investment Adviser Study, Advisers Act Release No. 2492 (Mar. 3, 2006), *available at* http://www.sec.gov/rules/other/34-53406.pdf (announcing "that a study will be commenced to compare the levels of protection afforded [to] retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act").

Corporation conducted the study for the Commission and issued a report in 2008 detailing its findings (RAND Report).[12] The RAND Report did not make legislative or regulatory recommendations, but rather focused on fact-finding. It found, among other things, that "trends in the financial service[s] market since the early 1990s ha[d] blurred the boundaries between" investment advisers and broker–dealers and that firms were "constantly evolving and bundling diverse products and services in response to market demands and the regulatory environment."[13] The RAND Report also found that retail investors were confused about the differences between investment advisers and broker–dealers, including the legal duties owed to investors with respect to the services and functions those professionals performed.[14]

III. General Principles

With this background in mind, I would like to turn to the fundamental principle that I believe should guide any attempt to address the blurring of the lines between broker–dealers and investment advisers. I believe that the 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.

When your Aunt Millie walks into her local financial professional to ask for advice, she does not need to know whether the person on the other side of the table is a registered representative of a broker–dealer or an investment adviser. She should not be placed at risk by the fact that application of those labels may lead to differing levels—or at least different kinds—of protection. Instead, she should know, or be able to assume—consciously or subconsciously—that, regardless of the title held by the person sitting across the desk from her, she will receive an appropriate and comparable level of protection.

The result to which this philosophy guides us depends on whether Congress enacts legislation addressing the regulatory regimes governing broker–dealers and investment advisers, or whether, in the absence of legislation, the Commission must do what it can through rulemaking under its current statutory authority. In what follows, I will first spell out how the Commission could deal with the disparate regulatory treatment of financial professionals under its current authority, and then set forth, in more detail, what I hope any legislation in this area would encompass.

12. *See* ANGELA A. HUNG ET AL., RAND CORP., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf ("conduct[ing] a study of broker-dealers and investment advisers from two perspectives").

13. *Id*. at xiii.

14. *Id*. at 117–18.

IV. Commission Rulemaking under Current Authority

Even without legislation, the Commission could take some action in this area. Before proceeding with rulemaking, however, the Commission must make a decision regarding which of two paths it wishes to pursue. The first path would involve rulemaking to try to better distinguish broker–dealers and investment advisers—what I will call the "demarcation approach." The second path would involve rulemaking to harmonize, to the extent possible, the two regimes within the Commission's current authority—what I will call the "harmonization approach." Although to a certain extent both paths could be pursued simultaneously, I believe that the two approaches represent a fork in the road where the Commission should choose its route. And, if it is not already, it will become clear that I strongly favor the harmonization approach.

Let me start with the demarcation approach, however. This approach could be pursued in a couple of ways. One possibility would be for the Commission to mandate enhanced disclosure of the duties and obligations of broker–dealers and investment advisers to give an investor more information to inform his decision to hire a financial professional. The Commission did just this in its 2005 rulemaking, when it required broker–dealers to include the following prominent statement in all contracts and agreements for fee-based brokerage accounts:

> Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time.[15]

Although disclosure generally serves a critical purpose and is a central form of regulation under the federal securities laws, it has its limitations. I have been a securities regulator for over 30 years, and I have to confess that I do not completely understand the disclosure I just quoted. Does it suggest that a brokerage firm does not have to do what is right for its customer? I hope not (and that was certainly not the Commission's intent). Are the interests of any financial professional and an investor ever exactly the same? They may be generally aligned, but they will never be the same, which is the rationale for requiring the disclosure of material conflicts of interest. And, in addition to questioning fee-based brokerage, should not investors also be encouraged to ask whether the compensation of investment advisers and commission-based broker–dealers varies by product and over time? I would think so. If I am this confused, can we possibly expect small investors to understand this statement or financial professionals to explain it?

Do not misunderstand. I believe improving the quality and timeliness of disclosure to investors is quite important, especially with respect to fees, compensation, and conflicts. But disclosure alone cannot solve the problem I see. Today, the burden is on investors to try to understand the differences between financial professionals, but the average retail investor and even some (at least supposedly) sophisticated institutional

15. 17 C.F.R. § 275.202(a)(11)-1(a)(1)(ii) (2009) (as adopted).

investors will not understand an explanation of those differences. To lift the burden we have placed on investors, we must, in addition to disclosure, have consistent regulation.

Another way of pursuing the demarcation approach would be to attempt to draw the regulatory lines more sharply to distinguish broker–dealers from investment advisers. The Commission also used this approach in the 2005 rulemaking, when it offered an interpretation of what constitutes "solely incidental" advice, particularly with respect to the provision of financial planning services. It is extremely difficult, however, to define in a rule where the line should be drawn between the advice offered by a broker–dealer and an investment adviser. In addition, limiting the type of advice that a broker–dealer may provide may have the unintended and harmful consequence of encouraging brokers to focus too narrowly on individual securities and discouraging them from looking at their customers' financial needs more holistically.

Rather than pursuing a demarcation approach, I believe that the Commission should instead pursue a harmonization approach. Specifically, using current statutory authority, I believe the Commission should try to harmonize, among other things, the registration process, disclosure obligations, supervisory responsibilities, and recordkeeping requirements of broker–dealers and investment advisers. The Commission should also consider imposing a uniform standard of conduct on all broker–dealers and investment advisers, which is something I will discuss more fully in just a moment. Although such rulemaking may not be the complete solution to the problem, it would be a good start.

V. LEGISLATIVE APPROACH

To harmonize the regulation of broker–dealers and investment advisers fully, legislative action appears to be necessary. Investment advisers and broker–dealers are primarily regulated under different statutes—the Advisers Act and the Securities Exchange Act of 1934, respectively. As former Commissioner Nazareth put it, "both statutes provide a significant amount of protection for investors, albeit from different angles. Put more simply, they are two different means of arriving at the same end of investor protection. And that's the point."[16]

In formulating new legislation, I believe Congress should take a "soup to nuts" approach. As I like to say, Congress should throw both statutes on the floor, select what is best in each, and cover any holes through which the floor boards show. In doing so, Congress should look at every aspect of a financial professional's business, from the moment of its inception until its dissolution. My thoughts on this are still evolving, but right now I think that, among other things, the following should be considered by Congress in vetting enabling legislation and by the Commission in implementing that law.

16. Nazareth, *supra* note 6.

A. Registration Process

Currently, there are different processes and different forms for broker–dealers and investment adviser registration.[17] I believe there should be a unitary system for registration. Every financial professional should be required to provide the information appropriate to the services and products it provides—in other words, its functions. I would also like to see a vetting process in which a new registrant would be required to demonstrate that it has the operational capacity to carry on its proposed business.

B. Licensing and Continuing Education Requirements

There should be licensing requirements for all associated persons, including the requirement to pass a proficiency test and appropriate continuing education requirements.

C. Disclosure Obligations

Although both broker–dealers and investment advisers are currently required to disclose conflicts of interest to an investor, they do so in different ways, to different extents, and sometimes at different times.[18] I believe that all financial professionals should provide investors with a uniform disclosure document explaining their material conflicts of interest at account opening (as currently is the case with investment advisers). We should also consider periodic updating of that disclosure for all financial professionals. In addition, in an area where much progress has already been made, investors should have access to a centralized database containing the disciplinary and employment history of all financial firms and their personnel.

D. SRO Membership

I also believe that all financial professionals should be required to be members of one or more self-regulatory organizations (SROs) that are empowered with both enforcement and standard-setting authority and are subject to the oversight of the Commission. Now, you are free to take my remarks with more than one grain of salt (and some, who shall remain nameless, have already done so) because I worked at FINRA (the primary SRO for broker–dealers) and one of its predecessor organizations, NASD, for over a decade. Nonetheless, I sincerely believe that use of the SRO model would bring a number of significant benefits to the regulatory framework. For example, the presence of SROs would allow the Commission to leverage resources available outside its four walls and provide a more flexible funding model. The SROs could handle routine examinations of financial professionals while the Commission devoted its examination resources primarily to SRO oversight and risk-based analysis, inspection, and oversight of the industry. This would allow the Commission to take a more targeted inspection approach

---

17. *See* SEC, GUIDE TO BROKER-DEALER REGISTRATION (2008), *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm [hereinafter BROKER-DEALER REGISTRATION]; SEC, Electronic Filing for Investment Advisers on IARD: How To Register With the SEC as an Investment Adviser, http://www.sec.gov/divisions/investment/iard/register.shtml (last modified Jan. 13, 2005).

18. *See* BROKER-DEALER REGISTRATION, *supra* note 17; SEC, INFORMATION FOR NEWLY-REGISTERED INVESTMENT ADVISERS, *available at* http://www.sec.gov/divisions/investment/advoverview.htm (last modified Feb. 22, 2008).

by concentrating on those firms perceived to be the greatest comparative risk to investors. And, SROs traditionally have authority to establish ethical as well as legal standards.

Let me dwell for a moment on the resources question. The securities industry has grown to the point where we must look outside the Commission for additional resources. The Commission is currently responsible for regulating approximately 5500 broker–dealers and over 11,000 investment advisers.[19] The number of SEC registered advisers has increased over 45% since the beginning of 2003.[20] Given the Commission's limited resources, it is simply not possible for the agency to examine all of these entities regularly. Requiring all financial professionals to be SRO members could help considerably to fill this oversight gap.

Now, I understand that some oppose the idea of expanding the use of SROs. Various reasons are usually given. Some argue that SROs are inherently subject to conflicts of interest. It is like asking the wolf to guard the chickens, some have claimed. Others are particularly concerned that expanding the current SRO model to other financial professionals would mean forcing square pegs into round holes.

Let me start with the conflict of interest objection. That conflict can be managed through mechanisms like a proper system of governance—for example, a completely public board of governors or a majority public board. In addition, SRO independence must be bolstered by close Commission oversight over the SROs' activities, including their rulemaking, examination, and enforcement functions. And, any SRO would have to be staffed with people who have the relevant expertise. In my view, rather than a fully public board, it is preferable to have that expertise represented on the board level as well. Structured correctly, there is no reason I can see why the SRO model would not work. If SROs do not emerge, I think that the Commission will still have to place greater reliance on private gatekeepers, such as accounting firms, in order to have a viable regulatory program, particularly if the advisory business continues to grow.

E. Remedies

Regulation without enforcement lacks teeth. It is certainly important to hold financial professionals to a high standard of conduct, but the Commission must also be able to aggressively enforce failures to live up to that standard and injured investors must be able to get redress. Although we should hope that financial professionals act with the highest integrity and honor, we unfortunately have to expect that some will not. Simply put, investors will be adequately protected only if there are effective ways to sanction misbehavior and to make investors whole. Another advantage of SROs is the potential for arbitration forums tailored to the business conducted by their members. Arbitration is generally faster and more cost-effective than litigation. I should note parenthetically, however, that today investors are required to bring their complaints against broker–

19. *See Hearing on the FY 2010 Funding Requests and Budget Justifications of the Securities and Exchange Commission and the Commodity Futures Trading Commission Before the Subcomm. on Financial Servs. and General Government of the S. Comm. on Appropriations*, 111th Cong. (June 2, 2009) (statement of Mary L. Schapiro, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2009/ts060209mls.htm (including Appendix: SEC Staff Levels Have Not Kept Pace with Industry Growth, *available at* http://www.sec.gov/news/testimony/2009/ts060209mls-app.pdf).

20. *Id.*

dealers to arbitration.[21] I do not favor the mandated pre-dispute approach.[22]

F. Uniform Standard of Conduct

Finally, I believe that every financial professional should be subject to a uniform standard of conduct. In my view, that standard should require all financial professionals to act as fiduciaries at all times. My statement that all financial professionals should be subject to a fiduciary duty needs some elaboration. As you probably know, the standard of conduct issue has been discussed a great deal lately. Some have characterized the different standards applicable today in a very simple way: Investment advisers are subject to a fiduciary duty, and broker–dealers are not—end of story. I find that explanation unsatisfactory. As Einstein once said: "Everything should be made as simple as possible, but not simpler." However, I do not want to dwell on current standards because I am here to talk about the future. And, in the future, a fiduciary standard should apply uniformly to all financial professionals.

Now, before I explain, I suspect that some may be thinking, "here is where she is going to start watering down what the fiduciary standard really requires, perhaps to make it more palatable to broker–dealers."[23] I assure you nothing could be further from the truth. In fact, in some respects I think that we actually need to strengthen the current standard, not dilute it. If I recommend anything that will compromise the protection that investors receive, I surely hope that you will let me know, loudly and clearly.

So let me tell you what I currently believe. First, saying that someone is a fiduciary who is required to act in the best interests of investors is the beginning of the analysis, not the end. As Lori Richards, the Director of the SEC's Office of Compliance, Inspections and Examinations, has noted, "[t]his is a simple statement to make, but one that is more difficult to apply."[24] To appreciate fully what a fiduciary standard means, and what it really means to act in the best interest of an investor, it is absolutely necessary to drill down and determine what duties and obligations flow from a fiduciary standard. This is why I believe that it is important that the Commission explain what a fiduciary standard requires. Both investors and the industry deserve the clarity that formal Commission guidance would provide.

Second, I believe that a fiduciary standard is not a substitute for business practice rules. Rather, the two are complementary. For one thing, business practice rules can help to flesh out the parameters of the fiduciary duty. They can also buttress the disclosure obligations of financial professionals with respect to conflicts of interest. For instance,

21. *See* Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220 (1987).

22. *See* Letter from Patrick Leahy, Chairman, Senate Judiciary Comm., & Russell D. Feingold, U.S. Senator, to The Honorable Christopher Cox, Chairman, SEC (May 4, 2007), *available at* http://feingold.senate.gov/pdf/ltr_050407_mandarb.pdf.

23. *But see* Louis Loss, Chief Counsel, Trading & Exch. Div., SEC, Remarks Before the Stock Brokers' Associates of Chicago: The SEC and the Broker-Dealer (Mar. 16, 1948), *available at* http://www.sec.gov/news/speech/1948/031648loss.pdf (discussing the history of the SEC's development of broker–dealer regulation); *see also* Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65 (1997).

24. Lori A. Richards, Dir., Office of Compliance, Inspections & Examinations, SEC, Remarks Before the Eighth Annual Investment Advisor Compliance Summit: Fiduciary Duty: Return to First Principles (Feb. 27, 2006), *available at* http://www.sec.gov/news/speech/spch022706lar.htm.

where appropriate, the Commission can use business practice rules to prohibit certain conflicted behavior or to require mitigation or management of the conflict. This is important when you consider that investors often do not read the disclosure and too often fail to fully understand its significance when they do.

Third, what a fiduciary duty requires depends upon the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account. What a fiduciary duty requires may also depend, in certain respects, on the sophistication of the investor. What may be appropriate behavior toward large institutional investors with knowledgeable counsel may not be appropriate behavior toward retail investors like Aunt Millie who are not always going to understand the meaning of disclosures regarding certain conflicts of interest.

Most important, whatever gloss and guidance the Commission provides, it should not deviate from the basic principle that financial professionals should always act in the best interests of investors, both large and small.

That, in sum, is my high-level approach to legislation harmonizing the regulation of financial professionals. I believe that there are numerous advantages to harmonizing legislation. First and foremost, it would provide a clear congressional statement that all financial professionals should be held to the same high standard of conduct. It would also address investor confusion by providing a unified system of regulation for all financial professionals offering comparable securities products and services. The Commission would no longer be responsible for overseeing duplicative sets of rules and regulations. Finally, it would preempt, hopefully once and for all, the stale arguments over the merits and demerits of the current state of the law.

VI. CONCLUSION

In closing, I appreciate the opportunity that I have had to share with you some of my evolving views on the regulation of financial professionals. I recognize that my views may be controversial. If so, I will feel that I have accomplished my objective. What I really want to do is assure that we have a robust dialogue about the best way to protect investors. These are certainly difficult waters to navigate, full of many rocks and shoals. But, I hope that we can engage in a frank discussion. I believe that we owe it to the Aunt Millies of the world to do all that we can to create a more rational, effective regulatory system. If any of you would like to discuss these issues or any other matters with me, please remember that my door and telephone lines are always open.