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Getting Ahead of the Curve: Enhancing Disclosures to Retail Investors

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Even casual observers of the financial markets were unlikely to miss the often heated debate that led to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] That provision requires the Securities and Exchange Commission ("SEC" or "Commission") to conduct a study to evaluate, among other things, the effectiveness of the existing standards of care for broker-dealers and investment advisers providing personalized investment advice and recommendations about securities to retail investors. Dodd-Frank further authorizes the Commission to make rules to address any shortcomings in the relevant standards of care, including authority to establish a fiduciary standard of care for broker-dealers providing personalized investment advice to retail investors that would be the same as that applicable to investment advisers under the Investment Advisers Act of 1940 ("Advisers Act").

While much of the debate about Section 913 has focused on the appropriate contours of a fiduciary standard of care, the Financial Industry Regulatory Authority ("FINRA") has gotten a head start on another important aspect of the legislation.[2] FINRA Regulatory Notice 10-54 requests comment on a Concept Proposal that would require FINRA members at or before commencing a business relationship with a retail customer to provide a

written statement to the customer describing (i) the types of accounts and services it provides, (ii) any conflicts associated with such accounts and services, and (iii) any limitations on the duties the firm otherwise owes to retail customers (the Concept Proposal).[3] Specifically, the disclosure document as conceived would address:

- The various products and services provided by a broker-dealer to its retail customers, including any limitations on the scope of such products and services (*e.g.*, limitations on the types of research coverage or the fact that products offered may be originated or sponsored by the broker-dealer's affiliates);
- All fees associated with specific brokerage accounts and services offered to retail investors, including whether such fees are negotiable;
- Financial incentives that the broker-dealer or its registered representatives have in recommending certain products over others, including, among other incentives, customer referral arrangements or payout rates to representatives that vary by product or service sold;
- General conflicts of interest that may arise between the broker-dealer and its customers, including conflicts associated with servicing multiple customers, and a description of how such conflicts are managed; and
- Limitations on the duties a firm owes to its customers (*e.g.*, the scope of any ongoing suitability or monitoring obligations).

The Concept Proposal is, in many respects, the continuation of a steady trend toward enhancing disclosure to investors regarding broker-dealer services and conflicts. For example, in 2003 the Commission staff urged every financial services firm to undertake a "top-to-bottom" review of its business with the goal of identifying and addressing conflicts of interest of every kind.[4] More recently, the SEC Chairman and Commissioners have commented on the importance of meaningful and understandable disclosures to clients of both broker-dealers and investment advisers.[5] In addition, Rule 202(a)(11)-1 under the Advisers Act which, before being vacated by the U.S. Court of Appeals for the District of Columbia Circuit for other reasons,[6] deemed financial planning and discretionary brokerage accounts to be investment advisory services, caused many broker-dealers to engage in the self-assessment contemplated by the Concept Proposal and Dodd-Frank. Indeed, some broker-dealers currently produce and provide investors with detailed disclosures about the nature of their relationships with customers (including distinctions between the broker-dealer's duties as an investment adviser versus as a broker-dealer), the pricing of and risks related to various products and services, and compensation to representatives.

In light of Dodd-Frank, the Concept Proposal represents an opportunity for member firms to have early input on what clearly will be new disclosure obligations for firms that service retail investors. In this regard, among other things, broker-dealers should consider the following in formulating comments:

- The scope of products and services offered to retail investors;
- The review of any conflicts related to the offering of retail products and services generally, and the assessment of how such conflicts are managed;
- The manner in which particular potential conflicts of interest should best be addressed, including, for example, appropriate mechanisms for engaging in principal transactions with retail customers;[7]
- The types of customers to which any new disclosure obligations would apply. Interestingly, while Dodd-Frank defines a "retail customer" as any natural person (or his or her legal representative) who receives personalized investment advice about securities from a broker-dealer or investment adviser and uses the advice primarily for personal, family, or household purposes, the Concept Proposal would use a narrower definition of this term. Under the Concept Proposal, a "retail customer" would mean any customer that does not qualify as an "institutional account" under NASD Rules, effectively excluding natural persons with total assets of at least $50 million;[8]
- The most effective manner by which disclosure materials could be provided to customers, including the use of electronic delivery;
- The timing and need for coordination of any new FINRA obligations in this area, particularly given the pending Commission study and likely follow-up rulemaking under Dodd-Frank; and
- The relative importance of promoting comparable disclosures across firms versus providing individual firms flexibility to meet any obligations under a new rule.

Broker-dealers providing services to retail customers that have not already done so should give serious thought to the likely consequences of Dodd-Frank and the pending Commission study on broker-dealer and investment adviser standards of care. This should include evaluating each segment of a firm's business in light of the regulatory changes likely to arise as a result of the legislation and regulatory review. The Concept Proposal raises a number of issues that will be of importance to firms and represents an excellent opportunity for broker-dealers to help craft a framework that will most effectively and efficiently provide useful disclosures to retail investors.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Dodd-Frank also directs the Commission to facilitate clear and better disclosures by broker-dealers and investment advisers to their customers about a host of items, including the nature of the customer's relationship with the broker-dealer or investment adviser. Dodd-Frank § 913(l).

[3] FINRA Regulatory Notice 10-54, Disclosure of Services, Conflicts and Duties (Oct. 2010), *available at*www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122361.pdf. To implement the disclosure items discussed in the Concept Proposal, FINRA would have to file a proposed rule change with the Commission, which would then publish the proposal for public comment in the Federal Register. The Commission would have to approve the proposed rule in order for it to become effective.

[4] Stephen M. Cutler, Director, SEC Division of Enforcement, Remarks Before The National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference (Sept. 9, 2003), *available at*www.sec.gov/news/speech/spch090903smc.htm.

[5]*See* Elisse B. Walter, Commissioner, SEC, Opening Statement at SEC Open Meeting: Amendments to Form ADV (Final Rule) (July 21, 2010), *available at*www.sec.gov/news/speech/2010/spch072110ebw-adv.htm; Mary L. Schapiro, Chairman, SEC, Speech at SEC: Looking Ahead and Moving Forward (Feb. 5, 2010), *available at*www.sec.gov/news/speech/2010/spch020510mls.htm.

[6]*Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

[7] Rule 206(3)-3T of the Advisers Act provides a temporary means by which a non-discretionary investment adviser also registered as a broker-dealer may engage in principal trades with its advisory clients after obtaining revocable prospective written consent from each client, subject to certain written or oral disclosures and trade-by-trade consent requirements. The rule is scheduled to expire on December 31, 2010, and it appears that the Commission will not act to prevent the expiration. Firms may want to consider the effectiveness of the temporary rule and other means to address principal trading in the event the Commission ultimately adopts a fiduciary standard of care pursuant to the authority granted in Dodd-Frank.

[8] "Institutional accounts" include accounts of (A) banks, savings and loan associations, insurance companies, or registered investment companies, (B) registered investment advisers, and (C) any other entity (including a natural person) with total assets of at least $50 million. NASD Rule 3110(c)(4).

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