



Insights: Alert

Industry Groups and State and Federal Securities Regulators Grapple with Fiduciary Standards for BDs and Private Fund Advisers

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Written by **Jeffrey T. Skinner** and **Alexandra M. Fenno**

Last April, the SEC released proposed rules¹ related to the standard of care that broker-dealers (“BDs”) owe their customers and issued proposed guidance² related to the standard of care that investment advisers (“IAs”) owe their clients. The SEC has yet to finalize either proposal, but indications are that the SEC is targeting the fourth quarter of 2019 for release of both proposals. During the delay, some state regulators have grown impatient and have sought to move ahead with their own fiduciary duty frameworks. However, those efforts may be hitting some road bumps.

This Legal Alert provides an overview of recent efforts by regulators and industry groups to enact stricter BD and IA fiduciary obligations, as well as a summary of the central arguments at issue in the BD-IA duty debate. As discussed below, the tension between regulators and the industry ultimately seems to stem from a disagreement regarding how much responsibility rests with investors to understand the services they are buying and the protections that are included therewith.

Recent Events

State Efforts in Nevada, Maryland, and New Jersey

Nevada, Maryland, and New Jersey were the front runners among states in taking steps to implement their own IA and BD fiduciary duty frameworks. However, their efforts may be slowing.

As we discussed in a previous Legal Alert, **Nevada** released its long-awaited proposed fiduciary duty rules last January.³ However, during its comment letter period that ended on March 1, the state received a number of letters that raise challenging questions for the state. For example, SIFMA explained in a comment letter that “the draft regulations have both pre-emption issues and legal deficiencies.”⁴ In particular, SIFMA cited conflicts with the National Securities Markets Improvements Act (“NSMIA”), the Investment Advisers Act of 1940 (the “Advisers Act”), the Employee Retirement Income Security Act of 1974, and the Federal Arbitration Act, among others.⁵ Morgan Stanley submitted a letter reportedly indicating that the rule as proposed would render the firm “unable to provide brokerage services to the residents of the state of Nevada.”⁶ It is unclear how Nevada regulators will respond to these comments.

The fate of Maryland's efforts is also unclear. On March 13, 2019, Committees in the **Maryland** State Legislature's House and Senate each held hearings on the state's proposed fiduciary legislation, but neither has moved forward since the hearings.⁷ This may mean that the bills are heading for summer study.

As we understand it, **New Jersey's** Securities Bureau and its Division of Consumer Affairs continue to work behind the scenes to draft a proposed fiduciary rule. Efforts in this regard seem to be proceeding slowly but deliberately, taking into account industry and regulatory discourse relating to the Nevada proposal and the status of the SEC's Regulation Best ("Reg BI").

Mounting Pressure on the SEC's Reg BI

Many state regulators and industry groups are shifting their focus from state-specific rules to Reg BI.

In its legislative agenda briefing on **Capitol Hill** earlier this month, the North American Securities Administrators Association ("NASAA") made clear that it has no plans to draft or put forward a model state-specific fiduciary rule. Instead, NASAA is focusing its efforts on pressing the SEC to strengthen and clarify BDs' obligations to investors under the proposed Reg BI. One tangible criteria identified by NASAA at the briefing for inclusion in Reg BI guidance is the total cost of the transaction.

Additionally, prior to the briefing, NASAA complained in a letter to the SEC that current interpretations of Reg BI enable BDs to use disclosure to minimize their duties to investors.⁸ It encouraged the SEC to clarify that BDs will not be compliant with Reg BI if they continue "business as usual."⁹

These views were supported at a recent hearing of the House Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (the "Subcommittee"). At the hearing, industry representatives testified¹⁰ and NASAA submitted a written statement¹¹ to the Subcommittee stating that Reg BI, among other things, fails to:

- clearly define what it means to act in a client's "best interest";
- explicitly prohibit certain conflicts of interest created by BD firms, including incentive based compensation such as sales quotas and sales contests;
- strengthen the current suitability standard for BDs so as to mirror the stronger fiduciary duty standard imposed on IAs; and
- provide Reg BI's protections to a greater number of investors.¹²

Institutional Investors Call for Heightened Standards for Private Fund IAs

Recent efforts have also been made to hold IAs to a higher standard. Last month, the Institutional Limited Partners Association ("ILPA")¹³ released a letter urging the SEC to implement stronger fiduciary protections for private fund investors.¹⁴ Despite the fact that such investors are generally considered more sophisticated and in less need of regulatory protection, ILPA urged the SEC to:

- require that private fund IAs “explicitly and clearly disclose” to investors the standard of care owed to them under both state laws and the Advisers Act;
- state that the standard of care owed to clients of private fund IAs is a “negligence” standard;
- limit private fund IAs’ “pre-clearance” of conflicts of interest, and require that such conflicts be presented to investors to receive “true ‘informed consent’”;
- state that it is best practice for private funds to have a Limited Partner Advisory Committee to resolve perceived conflicts; and
- limit the instances in which private fund IAs may use hedge clauses to limit their fiduciary obligations.¹⁵

With respect to hedge clauses, ILPA specifically asked that the SEC: (i) rescind the Heitman Capital No-Action Letter,¹⁶ which IAs have relied on to reduce their fiduciary obligations to investors by including hedge clauses in limited partnership agreements (“LPAs”); (ii) state that any settlement of an enforcement action with a private fund IA must be conditioned on the IA itself assuming those costs, rather than receiving indemnification from clients; and (iii) conduct an examination sweep of hedge clauses in private fund LPAs.¹⁷

The Underlying Debate

It is unclear whether the SEC will strengthen obligations owed by BDs and IAs in future rules and guidance. Just as state regulators and investor groups have heavily advocated for stronger protections, others have heavily advocated for the converse. For example, at the Subcommittee hearing discussed above, former SEC chairman Harvey L. Pitt called Reg BI a “well-planned effort” that provides greater investor protections than current standards. Several members of the Subcommittee seconded this view, and expressed worries that a stronger standard would limit investment choices for main street investors.

It’s worthwhile to spend some time considering the central arguments at issue in this debate. Ultimately, the tension seems to largely relate to a disagreement between regulators and the industry regarding how much responsibility rests with investors to understand the services they are buying and the protections that are included therewith. Central to this disagreement is how each side believes regulators should resolve investor confusion about the differing roles of BDs and IAs.

Current IA and BD Obligations

IAs are in the business of providing advice and/or issuing reports or analyses to others concerning investments in securities for compensation. Notably, no federal statute or rule states that investment advisers owe investors a fiduciary duty in delivering this advice. However, a fiduciary duty has been implied by courts and the SEC.¹⁸

Fiduciary duty standards are typical of trustee-beneficiary relationships. The term “fiduciary” is defined by Merriam-Webster as a relationship “founded in trust and confidence.”¹⁹ The IA fiduciary standard has evolved (and continues to evolve) through court and SEC interpretations into an ever increasing, heightened obligation for IAs—individuals entrusted to provide their clients with investment advice—to fully disclose all actual or perceived conflicts of interest and to act with care, loyalty, honesty, and good faith to further the client’s best interests.²⁰

In contrast, BDs facilitate sales of securities, either between two parties (“brokering”), or for their own accounts

(“dealing”). While BDs often provide investment advice in the course of their broker-dealer business, they are not required to register as an IA if that advice is solely incidental to their business of offering and selling securities to customers. Thus, BDs are not subject to ongoing fiduciary obligations (e.g., to monitor the performance of securities held in an account). Instead, BDs have rigorous suitability obligations (generally, obligations to ensure that securities transactions that they facilitate are “suitable” for their customers).²¹ Pursuant to these suitability obligations, BDs are required to deal fairly and maintain high standards of commercial honor and just and equitable principles of trade when conducting their broker-dealer business.²²

The Higher-Standard Debate

Since 1996, state enforcement authority has generally been limited to regulation under anti-fraud laws because NSMIA forced states to cede much of their regulatory authority to the SEC. Federal BD and IA standards were traditionally grounded in anti-fraud, but have evolved over the last century from anti-fraud (for BDs and public companies) toward a fiduciary standard (for IAs). States are now pushing for a similar trajectory, apparently based on their experience with examinations and enforcement proceedings against BDs in which the states' have felt constrained in achieving their investor protection goals.

As access to securities markets has improved through the Internet and electronic trading platforms, increased competition has led to a substantial reduction in commissions earned by BDs for executing trades, thus encouraging many BDs to increasingly move toward IA-like models. This has led many state regulators and investor groups to believe that BDs should now be subject to an IA-like fiduciary standard. While this sentiment sounds positive (aren't higher standards always better?), higher standards correlate to higher costs and would further exacerbate industry and market confusion about the difference in the services offered and roles played by IAs and BDs. The industry argues that permitting a range of options with varying levels of protections (i.e., an IA option versus a BD option) enhances the range of options available to customers, whereas conflating the standards of care raises costs for everyone with little benefit, ultimately reducing options for investors.

Where the SEC falls in this debate will remain unclear until it finalizes Reg BI. It is similarly uncertain what steps, if any, the SEC will take with respect to IAs of private funds. We encourage BDs and IAs to follow developments closely.

If you have any questions about the standards to which BDs and IAs are held, or about the regulation of BDs and IAs generally, please feel free to contact us.

By the *[Investment Management and Broker-Dealer Team at Kilpatrick Townsend & Stockton](#)*

Footnotes

¹ Regulation Best Interest, Securities Exchange Act Release No. 83062 (Apr. 18, 2018), 83 Fed. Reg. 21574 (May 9, 2018), <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>. For more information regarding Regulation Best Interest, please [click here](#) for our previous blog post.

² Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889 (Apr. 18,

2018), 83 Fed. Reg. 21203 (May 9, 2018), <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

³ John I. Sanders et. al, *State Regulators Begin Imposing Fiduciary Standards on BDs and IAs*, KILPATRICK TOWNSEND & STOCKTON (Jan. 28, 2019), <https://www.kilpatricktownsend.com/Insights/Alert/2019/1/State-Regulators-Move-Forward-with-Imposing-State-Specific-Fiduciary-Standards-on-BDs-and-IAs>.

⁴ Letter from SIFMA et. al. to Diana Foley, Nevada Secretary of State's Office, Securities Division (March 1, 2019), <https://www.sifma.org/wp-content/uploads/2019/03/Nevada-Joint-Trades-Letter-March-1-2019.pdf>.

⁵ *Id.* at 2.

⁶ See, e.g., Bruce Kelly, *Morgan Stanley Threatens to Pull Out of Nevada Over State's Fiduciary Rule*, Investment News (Mar. 13, 2019), <https://www.investmentnews.com/article/20190313/FREE/190319968/morgan-stanley-threatens-to-pull-out-of-nevada-over-states-fiduciary>; Melanie Waddel, *Nevada Fiduciary Rule Would Scare Off Morgan Stanley, TD Ameritrade*, ThinkAdvisor (Mar. 18, 2019), <https://www.thinkadvisor.com/2019/03/18/nevada-fiduciary-rule-would-scare-off-morgan-stanley-td-ameritrade/?slreturn=20190222140910>.

⁷ Maryland H.B. 1127 and Maryland S.B. 786.

⁸ Letter from NASAA to Brent Fields, SEC Secretary (Feb. 19, 2019), <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Reg-BI-Supplemental-Comment-Letter-021919.pdf> (hereinafter, "NASAA Letter"). NASAA released a similar letter last August. Letter from NASAA to Brent Fields, SEC Secretary (Aug. 23, 2018), <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Reg-BI-Comment-Letter-8-23-2018.pdf>.

⁹ *Id.* at 3-4.

¹⁰ *Putting Investors First? Examining the SEC's Best Interest Rule: Hearing Before the Subcomm. on Investor Protection, Entrepreneurship, and Capital Markets of the H. Comm. on Financial Services* (2019), available at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402388#Wbcast03222017>.

¹¹ Written Statement of Michael S. Pieciak, President of NASAA and Commissioner of Vermont Department of Financial Regulation, to the U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (March 14, 2019), <http://www.nasaa.org/47410/putting-investors-first-examining-the-secs-best-interest-rule/> (hereinafter, "NASAA Written Statement").

¹² NASAA letter, at 9; NASAA Written Statement, at 3.

¹³ ILPA represents various institutional investors in the private equity market, such as private and public pension funds, charitable groups, and university endowments.

¹⁴ Letter from ILPA to Brent Fields, SEC Secretary (Feb. 12, 2019), <https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf> (hereinafter, "ILPA Letter"). ILPA released similar letters last August and November. Letter from ILPA to Brent Fields, SEC Secretary (Aug. 6, 2018), <https://www.sec.gov/comments/s7-09-18/s70918-4173955-172347.pdf>; Letter from ILPA to Brent Fields, SEC Secretary (Nov. 21, 2018), <https://www.sec.gov/comments/s7-09-18/s70918-4766054-176835.pdf>.

¹⁵ ILPA Letter at 2-3.

¹⁶ Heitman Capital Management, LLC, SEC No-Action Letter (February 12, 2007).

¹⁷ ILPA Letter at 2-3.

¹⁸ In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); Lori A. Richards, Speech by SEC Staff, *Fiduciary Duty: Return to First Principles*, Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), <https://www.sec.gov/news/speech/spch022706lar.htm>.

¹⁹ Fiduciary, Merriam-Webster, <https://www.merriam-webster.com/dictionary/fiduciary>.

²⁰ See Richards, *supra* note 18.

²¹ See, e.g., FINRA Rules 2111 and 2090.

²² FINRA Rule 2010.

Related People



F. Daniel Bell, III

t 919.420.1834

dbell@ktslaw.com



Jeffrey T. Skinner

t 336.607.7512

jskinner@ktslaw.com



Thomas W. Steed, III

t 919.420.1832

tsteed@ktslaw.com



Regan K. Adamson

t 336.607.7450

radamson@ktslaw.com



Katherine A. McCurry

t 336.607.7359

kmccurry@ktslaw.com



Alexandra M. Fenno

t 336.607.7426

afenno@ktslaw.com



Lauren B. Emanuel

t 336.607.7305

lemanuel@ktslaw.com