SIFMA
Securities Industry and Financial Markets Association

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SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:
CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE

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Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee: My name is John Taft. I am Head of U.S. Wealth Management, RBC Wealth Management, and Chairman of the Private Client Group Steering Committee of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for the opportunity to testify at this important hearing. I will present SIFMA's views on the discussion draft of the Investor Protection Act of 2009 ("Investor Protection Discussion Draft"),[2] particularly

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C. and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org.

[2] Discussion draft released by Congressman Kanjorski on October 1, 2009, available at http://www.house.gov/apps/list/press/financialsvcs_dem/investor_protection_act_draft.pdf.

with respect to Section 103 (establishment of a fiduciary duty for brokers, dealers and investment advisers) and Section 201 (predispute arbitration agreements in the securities industry).

SIFMA and its members support the Committee's efforts to reform our financial regulatory system in order to create a new foundation for investor confidence and stability in our financial markets. We are also committed to being a constructive participant in the process as Congress considers important changes in our financial regulatory system.

We have the ability – and the responsibility – to both enhance investor protection and improve the efficiency and effectiveness of regulatory oversight. This guiding principal underpins the testimony we present today on fiduciary duty and securities arbitration. It also distinguishes SIFMA's views in terms of our support for strong and consistent safeguards that both protect individual investors, and preserve their choice of the widest range of products, services and advice offered by their financial services providers – which is part of putting clients first.

A. Fiduciary Duty for Brokers, Dealers, and Investment Advisers

On July 17, 2009, SIFMA testified before this Committee in support of a harmonized fiduciary standard for broker-dealers and investment advisers, established and applied at the federal level.[3] Under our proposed formulation, when broker-dealers

[3] Testimony of Randolph C. Snook before the U.S. House of Representatives Committee on Financial Services in the July 17, 2009 hearing on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" ("Snook Testimony"), available at http://www.sifma.org/legislative/testimony/pdf/Snook-testimony-7-17-09.pdf.

and investment advisers engage in the identical service of providing *personalized investment advice* about securities to individual investors, they should be held to a uniform, federal fiduciary standard of care. We further testified that the federal fiduciary standard should be applied exclusively, and should supersede existing state common law-based fiduciary standards. We also agreed with the U.S. Treasury's proposal to delegate to the SEC broad authority to create the rules that would govern the federal fiduciary standard.

Today, we will expand upon these and other important points from our earlier testimony.

1. Personalized Investment Advice

One of our primary concerns with the proposed legislation is ensuring that it clearly and appropriately defines the circumstances under which a federal fiduciary duty would apply. As we testified in July 2009, we believe the term *personalized investment advice* is perfectly suited for this purpose.[4]

This term was coined nearly 25 years ago in a U.S. Supreme Court case that sought to define the business of investment advisers.[5] Since that time, the term has been

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[4] As illuminated by Supreme Court caselaw and the federal securities regulations, the term *personalized investment advice* means investment advice services which purport to meet the objectives or needs of specific individuals or accounts.

[5] *Lowe v. Securities and Exchange Commission*, 472 U.S. 181, 204 (1985) (legislative history of Investment Advisers Act of 1940 "plainly demonstrates that Congress was primarily interested in regulating the business of rendering *personalized investment advice* (emphasis added)").

further clarified under various federal securities regulations.[6] In recent months, SEC Chairman Mary Schapiro invoked the term to define the circumstances under which a fiduciary duty should apply to both brokers and investment advisers alike – when they are performing the same important service of providing personalized investment advice to individual investors.[7]

SIFMA agrees with the SEC Chairman that the term *personalized investment advice* appropriately identifies the common business activity that both broker-dealers and investment advisers provide to individual investors, and that should be subject to a federal standard of care. Although broker-dealers and investment advisers provide some of the same services to individual investors,[8] they are disparately regulated, contributing to investor confusion.[9] This area of overlap, thus, is at the crux of this particular harmonizing legislation and addressing it should deliver the most meaningful benefit to

[6] *See, e.g.*, Investment Advisers Act Rules 203A-3(a)(3), 204-3(g)(1), and 206(4)-3(d)(3).

[7] Speech by SEC Chairman Mary L. Schapiro, Address before the New York Financial Writers' Association Annual Awards Dinner, New York, NY (June 19, 2009), available at http://sec.gov/news/speech/2009/spch061809mls-2.htm.

[8] Section 103 uses the term "retail customers," as opposed to "individual investors," but defines the term to mean an individual who receives from a broker, dealer or investment adviser personalized investment advice which is to be used primarily for personal, family, or household purposes, and also the legal representative of such an individual. We believe this lends valuable clarity and focus to the legislation. The federal fiduciary standard that SIFMA supports should apply to individual investors only based on our view that institutional clients are better able to – and in practice do in fact – appreciate and appropriately define the terms of their relationships with investment advisory service providers.

[9] Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, December 31, 2007, available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

individual investors.[10] Thus, when broker-dealers and investment advisers engage in the identical service of providing *personalized investment advice* about securities to individual investors, SIFMA agrees they should be held to the same standard of care.

We appreciate that the Investor Protection Discussion Draft embraces the term *personalized investment advice* by incorporating it into the definition of *retail customer*. It does not, however, use the same term to specify when the fiduciary standard applies. Rather than invoke the concept of personalized investment advice to define the customers who are protected by this new standard, we believe it should be used to define the type of advice to which the standard will apply. Specifically, the proposed legislation should clarify that *personalized investment advice – about securities*[11] – triggers the fiduciary standard, and should direct the SEC to explicitly incorporate this harmonized standard into its rules under the federal securities laws.

2. Authentic Fiduciary Standard

Some have suggested that SIFMA's proposed fiduciary standard is somehow inferior to the genuine article – something less than what some refer to as the

[10] SIFMA also supports much further reaching harmonization and rationalization of the financial regulatory system in a wide variety of contexts. *See, e.g.*, Snook Testimony, available at http://www.sifma.org/legislative/testimony/pdf/Snook-testimony-7-17-09.pdf.

[11] The language in the Treasury's version of the Investor Protection Act wisely limited application of the fiduciary duty to advice *about securities*. Treasury's approach is consistent with the federal securities laws which broadly prohibit fraudulent activity "in connection with the offer, purchase, or sale of securities." It also avoids unnecessary and unintended over-breadth, and potentially abusive application, of the standard.

"authentic"[12] or bona fide or true fiduciary standard. Nothing could be further from the truth.

SIFMA's vision of a harmonized fiduciary standard is even stronger, and more pro-investor, than any other alternative we have heard advanced. As we previously testified, the central imperative of a fiduciary is putting investors' interests first. A fiduciary should also act with good professional judgment, and avoid conflicts of interest, if possible, or otherwise effectively manage conflicts through clear disclosure and, as appropriate, investor consent.[13] These decidedly pro-investor, core principles lie at the heart of what it truly means to be a fiduciary. This is the formulation of fiduciary that SIFMA endorses – and that individual investors deserve.[14]

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[12] *See, e.g.*, *New trade group wants 'authentic fiduciary standard,'* Sara Hansard, InvestmentNews (June 29, 2009) (reporting on a self-interested media campaign by a group of eleven fee-only advisers and consultants).

[13] Conflicts are inherent to the business of investment advisers and broker-dealers. As one SEC official has observed: "When you are *paid* to act as an intermediary, like a broker, or as another's fiduciary, like an investment adviser, the groundwork for conflict between investment professional and customer is laid. The historical success of the financial services industry has been in properly managing these conflicts, either by eliminating them when possible, or disclosing them. In the long run, treating customers fairly has proven to be good business." Remarks of Stephen M. Cutler, Director, SEC, Division of Enforcement, (Sept. 9, 2003), available at www.sec.gov/news/speech/spch090903smc.htm. We agree that the proposed legislation should encourage the SEC to review conflicts of interests facing investment advisers and broker-dealers alike and the adequacy of their measures to manage them, including through disclosure and investor consent as appropriate.

[14] We note that broker-dealers are already subject to and operate under many core fiduciary principles, including the following which are memorialized under current FINRA rules: just and equitable principles of trade; suitability of recommendations; best execution of transactions; fair and balanced disclosure to investors; supervision; and training.

3. Federal Fiduciary Standard

Our recommendation is based on traditional and well-recognized aspects of fiduciary law, and is also highly distinguishable from what others are proposing. SIFMA calls for the creation of a federal fiduciary standard that is *exclusive* and that supersedes and improves upon the current state common law-based fiduciary standards applicable to investment advisers for the benefit of *individual investors*.[15] SIFMA does not propose to modify the current state common law-based standards applicable to the delivery of investment advice to the institutional clients of investment advisers.[16]

The current state common law-based fiduciary standards are inadequate to serve as a harmonized standard for individual investors. Under state common law, which is court-made and often varies from court to court and jurisdiction to jurisdiction, the nature of a person's fiduciary duty depends on the relationship between the parties and the particular circumstances.[17] So, when you ask the seemingly simple question, "How do you define fiduciary?," the answer is, "It depends."

Courts across the country have reached decidedly different outcomes in determining whether a fiduciary duty exists, and if so, whether a financial services

[15] Currently, neither the Securities Exchange Act of 1934, which governs broker-dealers, nor the Investment Advisers Act of 1940, which governs advisers, expressly imposes a fiduciary standard. With respect to investment advisers, however, a 1963 Supreme Court case declared advisers to be fiduciaries by virtue of state common law. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). Although the broker-dealer regulatory scheme has no corollary to the *Capital Gains* decision, it clearly reflects fiduciary principles, as described immediately above.

[16] See discussion in footnote 9.

[17] Restatement (Third) Agency § 8.07 comment b.

professional satisfied that duty towards his or her individual client.[18] Not surprisingly, as a result, fiduciary law has developed haphazardly and often inconsistently among the 50 states.[19] Consequently, investor protection can actually grow or diminish as an individual investor moves from state to state.

In sum, the existing state common law-based standards for individual investors are imprecise and indeterminate, and have been developed unevenly over time. Thus, individual investors would benefit from the clarity, consistency, and uniformity of a national standard.

The Investor Protection Discussion Draft is silent as to the prospective interaction or interplay between the proposed harmonized fiduciary standard and common law-based fiduciary standards. Given this issue's potentially profound implications for both

[18] Among the dozens of cases that address this issue, there are few unifying principles or rules of thumb than can be drawn from them. *Compare Farmland Indus. v. Frazier-Parrott Commodities, Inc.*, 871 F.2d 1402, 1411 (8th Cir. 1989) (In Missouri, fiduciary duties may arise out of a financial professional-customer relationship); *with Lefkowitz v. Smith Barney, Harris Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986) (stating that "a simple [financial professional]-customer relationship does not constitute a fiduciary relationship in Massachusetts."); *and with Brown v. California Pension Administrators & Consultants, Inc.*, 52 Cal. Rptr. 2d 788, 796-97 (Cal. App. 1996) (stating that where a financial professional provided investment advice to his customer, the relationship was one of principal-agent, and therefore, fiduciary duties applied). *See Robinson v. Merrill Lynch*, 337 F. Supp. 107, 111 (N.D. Ala. 1971) ("The [fiduciary] relationship of agent and principal only existed between [broker and customer] when an order to buy or sell was placed, and terminated when the transaction was complete"), and *Baker v. Wheat First Securities*, 643 F. Supp. 1420 (S.D. W.Va. 1986) (stockbroker does owe a fiduciary duty to his client, but the scope of the broker's duties owed depends on a detailed consideration of other factors). *See also Int'l Order of Foresters v. Donaldson, Lufkin & Jenrette*, 157 F.3d 933, 940-41 (2d. Cir. 1998); *Davis v. Merrill Lynch*, 906 F.2d 1206 (8th Cir. 1990); *Romano v. Merrill Lynch, et al*, 834 F.2d 523, 530 (5th Cir. 1987); *Leib v. Merrill Lynch*, 461 F.Supp. 951, 953 (E.D. Mich. 1978); and *Paine, Webber*, 718 P.2d 508, 517-518 (Colo. 1986).

[19] As a result of the inconsistent, seemingly haphazard approach among the states, some commentators have suggested that fiduciary duties for broker-dealers should be developed primarily through rulemaking. *See The Madoff "Opportunity": Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice* (T. Lemke & S. Stone), 13 Wall Street Lawyer 6, n. 38 (June 2009).

investor protection and investor choice, however, we strongly recommend that Congress provide the clarity and consistency that only an exclusive fiduciary standard that is uniformly and even-handedly applied at the federal level can deliver.

We recognize and support the important role that States play in protecting individual investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions to the extent consistent with the federal fiduciary standard. We also recommend that the SEC confer with state regulators on how the SEC should define this federal fiduciary standard.

The federal fiduciary standard would best harmonize the regulatory regime for broker-dealers and investment advisers by avoiding other fiduciary regimes. It should also retain sufficient flexibility to adapt to: the wide range and variety of investment products and services that individual investors may choose; the personalized investment advice that individual investors may elect to receive and follow, or not, in the exercise of their own discretion; and their choice as to how they pay for their advice, whether on a commission-basis,[20] or fee-basis, or otherwise.

We agree that the SEC is best positioned to ensure that a federal fiduciary standard is clear, well-defined, and equally applied, so that all individual investors receive the same protections when receiving the same kinds of personalized investment

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[20] The Investor Protection Discussion Draft explicitly states that a broker-dealer's receipt of commission-based compensation would not violate the fiduciary duty. SIFMA agrees, but suggests that the proposed legislation should contemplate and allow for other forms of compensation as well.

advice about securities. But we are concerned about two aspects of the draft legislation that we think threaten to hinder attainment of its objectives.

First, we are concerned that the proposed legislation omits the concept of disclosure from its framing of the federal fiduciary duty – and thereby paints an adviser's obligations as absolute, without any ability to address conflicts through disclosure and client consent. This approach threatens to unhinge the disclosure-based approach that has been read into the Act ever since the Supreme Court decided *Capital Gains* and that has been the foundation of the SEC's framework of regulation under that statute. In essence, the Supreme Court ruled that an investment adviser's fiduciary duty was to act in the client's best interest or to disclose any material conflicts of interests that could impede the adviser in so doing. We expect that this proposed change will be of concern to both investment advisers and broker-dealers alike, and would be a setback to investors if it leads to them receiving less information from their financial professionals.

Second, we are concerned that the Investor Protection Discussion Draft fails to provide the SEC with adequate leeway to accomplish the important purpose of the legislation. The Investor Protection Discussion Draft appears to unnecessarily constrain the SEC by entirely subjugating broker-dealer regulation under the Securities Exchange Act of 1934 to investment adviser regulation under the Investment Advisers Act of 1940.

The SEC, however, should retain sufficient flexibility to craft broker-dealer regulations – consistent with a uniform federal fiduciary standard – without being limited or constrained by investment adviser rules and in a manner that makes sense within its framework for regulating broker-dealers under the Securities Exchange Act of 1934. In certain respects, such flexibility would be necessary in recognition of the numerous, diverse, and investor-beneficial products and services offered by broker-dealers that differ from, and are more numerous than, those offered by today's investment advisers. Such flexibility would also necessarily protect investors by appropriately respecting and preserving investor choice – an often neglected, but necessary, component of putting individual investors' interests first.

B. Pre-Dispute Arbitration Clauses

The U.S. Treasury White Paper released in June 2009 proposed giving the SEC authority to prohibit pre-dispute arbitration agreements in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors.[21] Similarly, the proposed Consumer Financial Protection Agency[22] would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.[23]

Although the Treasury White Paper states that the SEC is required to study the use of predispute arbitration clauses to determine whether they harm investors,[24] the

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[21] U.S. Treasury White Paper, *A New Foundation: Rebuilding Financial Supervision and Regulation* at p.72 (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[22] Consumer Financial Protection Agency Act (CFPAA) of 2009, H.R. 3126, available at http://www.opencongress.org/bill/111-h3126/text.

[23] See Section 127 of the CFPAA discussion draft released on September 25, 2009.

[24] U.S. Treasury White Paper at p.72.

Investor Protection Discussion Draft omits this important requirement. We strongly support its restoration. We support continuous study of the fairness and efficiency of the securities arbitration system.

We recognize that Congress is taking a fresh and broad look at arbitration practices generally. An SEC study could help inform Congress's consideration of these issues with respect to securities arbitration in particular. In this context, it would be inappropriate and unfair to investors and securities firms alike to allow the SEC to ban predispute arbitration agreements by fiat without the benefit of study.

For nearly four decades, the SEC has upheld and enforced securities rules that require securities firms to arbitrate at the election of the investor.[25] Securities firms have gained the same right in return by entering into predispute arbitration agreements with their new customers. Such contracts ensure that both sides are treated fairly and effectuate the public policy in favor of predispute arbitration agreements that has been recognized by both Congress and the U.S. Supreme Court.[26] The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency.

Accordingly, the SEC should be required to study arbitration clauses and submit to Congress a report on the findings of any such studies, including any legislative

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[25] *See* § 12200 of the Financial Industry Regulatory Authority (FINRA) Code of Arbitration Procedure ("Code of Arbitration Procedure") and Rule 600A(a)(ii) New York Stock Exchange Arbitration Rules (directing that members of the securities industry must arbitrate upon demand of the customer). FINRA's rules have required member firms to arbitrate at the investor's demand since March 1972. *See* FINRA Manual (July 1, 1974) (noting that former Code of Arbitration Procedure ¶ 3702, § 2(a)(2) took effect on March 9, 1972).

[26] *See* Federal Arbitration Act, 9 U.S.C. Section 1 *et seq.*, available at http://www.law.cornell.edu/uscode/html/uscode09/usc_sup_01_9_10_1.html; *Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220, 225-226 (1987).

recommendations that the SEC finds are in the public interest and for the protection of investors. Frankly, we do not believe that any such study would ever lead to the conclusion that predispute arbitration agreements do not benefit investors.

We base this assertion in part on our own study of arbitration concluded in October 2007.[27] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them to pursue claims that they could not afford to litigate or that would be dismissed in court.

Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system. In fact, prohibiting such clauses would be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater

[27] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of the proposed legislation. We urge Congress to consider these factors in its deliberation over the securities arbitration proposal. We also urge further study of predispute arbitration clauses in the securities industry to determine whether there is any basis whatsoever for concern that these clauses may harm investors.

Conclusion

Thank you, Chairman Frank, Ranking Member Bachus, and members of the Committee, for allowing me to present SIFMA's views. Again, we support your efforts to improve upon our financial regulatory system. SIFMA and its members remain committed to being a constructive participant in the process, and we stand ready to assist the Committee on this historically important initiative.