How do you approach conflicts of interest in your practice?

Please select all that apply.

- [ ] I disclose conflicts of interest and allow the client to decide if they want to proceed with any recommendation(s).
- [ ] I avoid conflicts of interest by not recommending/using products for which I would receive a commission or similar compensation.
- [ ] Other, please specify... ________________________

Approximately how frequently do you have a conflict of interest?

- Never
- Occasionally (with 24% or fewer clients annually)
- Frequently (with 25%-74% of clients annually)
- Often (74%-99% of clients annually)
- All the time

On a weekly basis, approximately how much staff time is spent on compliance related activities? Please include your time and the time of all other staff members.

- 2 hours or less/week
- 3-4 hours/week
- 5-9 hours/week
- 10-19 hours/week
- 20-39 hours/week
- 40-59 hours/week (1 FTE)
- 60-79 hours/week
- 80-99 hours/week (2 FTE)
- 100-119 hours/week
- 120-129 hours/week (3 FTE)
- 130 hours or more/week

On an annual basis, how much do you spend on compliance related costs as a percentage of your total revenue?

- 1% or less
- 2-4%
- 5-9%
- 10-14%
- 15-19%
- 20-24%
- 25% or more

In your opinion, does a fiduciary standard protect consumers?

- Yes
- No
- Not sure

Do you believe a uniform fiduciary standard would change the costs of services provided to consumers?☐

- Yes, the cost would increase.☐
- Yes, the cost would decrease.☐
- No.☐
- Other, please specify... ________________________☐

Assume that a harmonized fiduciary standard increased the cost of services to the consumer. In that case, do you believe the benefits to the consumer of working with a fiduciary outweigh the downside of consumers being priced out of the advice market?

- Yes
- No
- Don’t know/not sure

(optional) Is there anything else you would like to share in regard to the SEC's evaluation of harmonizing the fiduciary standard?

____
____
____

Exhibit B

to

fi360, Inc. Comment Letter

File No. 4-606

The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice

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Texas Tech University

Thomas Langdon
Roger Williams University

March 9, 2012

Abstract: Consumers who rely on the financial advice of experts are at an information disadvantage that may be exploited by advisers who are not required to make recommendations that are in the best interest of the customer. Registered representatives of broker-dealers are subject to a suitability standard under the Securities Exchange Act of 1934, while investment advisers are regulated as fiduciaries under the Investment Advisers Act of 1940. An early legislative version of the 2010 Dodd-Frank Act would have eliminated the broker-dealer exception from the definition of investment adviser under the Advisers Act. If enacted, this change would have subjected brokers to a common-law fiduciary standard (like investment advisers), but was postponed to examine the consequences of this policy change. It has been suggested that the imposition of a fiduciary standard on registered representatives would result in significant changes in how broker-dealers conduct business by limiting a representative's ability to recommend commission investments, provide advice to middle-market clients, and offer a broad range of financial products. We take advantage of differences in state broker-dealer common law standards of care to test whether a relatively stricter fiduciary standard of care impacts the ability to provide services to consumers. We find that the number of registered representatives doing business within a state as a percentage of total households does not vary significantly among states with stricter fiduciary standards. A sample of advisers in states that have either a strict fiduciary standard or no fiduciary standard are asked whether they are constrained in their ability to recommend products or serve lower-wealth clients. We find no statistical differences between the two groups in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance.

Keywords: Fiduciary regulation, broker dealer exemption, financial advice, household finance, investment advising, brokerage industry

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I. **Introduction**

Financial advisers provide expert assistance selecting financial instruments for retail customers. Registered representatives of broker-dealers facilitate the sale of securities and often provide financial advice to clients who are less knowledgeable about the product. This imbalance of information has led to the imposition of a legal fiduciary standard when an informed agent is hired to make decisions on behalf of a less informed client (Frankel, 1983). In the absence of an informational imbalance between registered representatives (or brokers) and their customers, the primary service provided through broker-dealers is to sell retail financial products demanded by the customer. However, many broker-dealers have suggested through advertising and by referring to registered representatives with terms such as "financial planner" or "financial consultant" that their services include planning or consulting services that involve the provision of expert advice (Hung, Clancy, Dominitz, Talley, Berrebi and Suvankulov, 2008). Most consumers assume that advising services are provided by registered representatives of broker-dealers (Hung et al., 2008).

While consumers are generally unable to distinguish between investment advisers whose primary purpose is to provide investment advice and registered representatives whose advice is considered incidental to the sale of financial products, they are regulated by two different entities that apply different market conduct standards. Investment advisers are regulated by the Securities and Exchange Commission (SEC or Commission) under the Investment Advisers Act of 1940 (Advisers Act) as fiduciaries and a fiduciary standard of care is applied to the advice given to their clients. Registered representatives of broker-dealers are regulated under the Securities Exchange Act of 1934 through the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization. Registered representatives must meet a standard of suitability when providing information about financial products, and are not assumed to have a fiduciary responsibility toward customers.

The difference in regulation between investment advisers and brokers impacts the market for financial advice. The sale of professional advisory services to a less-informed client involves significant potential agency costs that exist when the interests of the client and broker/adviser are not perfectly aligned (Jensen and Meckling, 1976). These costs occur when the broker recommends products that benefit the broker to the disadvantage of the customer. Examples of agency costs include recommending products that have higher commissions or not taking the time to consider alternative financial strategies for a customer. It is possible that the application of a suitability standard to investment advice will lead to greater agency costs. A suitability constraint allows brokers to recommend products that are not necessarily in the best interest of the client but may be considered potentially suitable given the customer's characteristics and needs. This latitude in product recommendation among registered representatives provides a greater opportunity to extract customer rents than would be possible under the constraints of a fiduciary standard (Cummings and Finke, 2010). If the suitability standard provides greater opportunities to extract rents from clients, we would expect the broker-dealer industry to defend its ability to maintain this advantage by continuing the existing regulatory regime.

If, however, a fiduciary standard was applied to registered representatives whose sole purpose is to facilitate the sale of financial instruments within a competitive marketplace, the imposition of a fiduciary standard to these sales activities may have a negative impact on the ability of broker-dealers to provide a variety of financial products to consumers. Many consumers may demand products whose appropriate use is difficult for a registered representative to defend as being in the customer's best interest. For example, there may be mutual funds that pay a commission to the broker that are less efficient than comparable mutual funds that pay no commission. The brokerage industry has argued that since moderate income clients are less attractive to investment advisers, who are often compensated based on a percentage of assets under management, these clients often seek financial advice from registered representatives compensated through product commissions (Headley, 2011). These less wealthy clients may be less able to receive much-needed financial advice incidental to the sale of commission products if brokers incur increased liability under a fiduciary standard. The application of a standard of care that assumes a fiduciary relationship between registered representative and customer may constrain the ability to make product recommendations and limit the range of available financial products.

While the industry has suggested that fiduciary regulation will have an adverse impact on the industry, there are no existing empirical studies that examine the impact of a change in regulatory policy on the marketplace for financial advice. This study takes advantage of heterogeneity in broker-dealer regulation among states to test whether a relatively more strict application of a common law fiduciary standard of care impacts the number of registered representatives doing business within the state. We also conduct a survey to assess differences in perceived ability to provide financial products among states subject to stricter fiduciary standards. We find that the saturation of registered representatives within states does not vary significantly among states with different fiduciary regulation. When advisers in states that have a stricter fiduciary standard are asked whether they are constrained in their ability to recommend products, or if they are unable to serve lower-wealth clients, we find no statistical difference between advisers from states that do and do not apply a common law fiduciary standard.

II. Background

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 913 of the Dodd-Frank Act required the SEC to conduct a study to evaluate, among other things, (1) the effectiveness of existing legal or regulatory standards of care (imposed by the Commission, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers; and (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute. In one of the early legislative drafts, Dodd-Frank would have eliminated the broker-dealer exception from the definition of investment adviser under the Advisers Act, but the legislation as adopted included a compromise to conduct further study of the issue. The Dodd-Frank Act defines "retail customer" as a natural person, or the legal representative of a natural person, who receives personalized investment advice about securities from a broker or dealer or investment adviser and who uses that advice for personal, family, or household purposes.

In January 2011, the SEC released its Study on Investment Advisers and Broker-Dealers (Staff of the U.S. Securities and Exchange Commission, 2011). In its report, the SEC staff noted that "the regulatory regime that governs the provision of investment advice to retail investors is essential to assuring the integrity of that advice and to matching legal obligations with the expectations and needs of investors," and found that investors are often confused by differing standards of care that apply to investment advisers and broker-dealers (Staff of the U.S. Securities and Exchange Commission, 2011). The SEC study recommended the adoption of a uniform fiduciary standard for investment advisers and broker-dealers that provides:

> The standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the consumer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice (Staff of the U.S. Securities and Exchange Commission, 2011).

The SEC study recommends that the Commission, in implementing a uniform fiduciary standard, should engage in rulemaking and provide interpretive guidance addressing the two major components of a uniform fiduciary standard: the duties of loyalty and care. When addressing the duty of loyalty, the report suggests that a uniform fiduciary standard will obligate both investment advisers and broker-dealers to eliminate or disclose conflicts of interest. The report notes, "[t]he Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements." When it comes to duty of care, the study suggests that minimum baseline professional standards should be adopted that could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor.

III. Traditional standards of care for Investment Advisers and Broker-Dealers

A. Investment Advisers

Section 202(a)(11) of the 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, as to the value of securities or as to 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 concerning securities.

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of an investment adviser any broker or dealer that meets the following requirements: (1) the performance of investment advisory services is ‘solely incidental’ to the conduct of its business as a broker-dealer, and (2) no “special compensation” is received for advisory services.

Investment advisers owe their clients a fiduciary duty of care (SEC v. Capital Gains Research Bureau, Inc., 1963; Transamerica Mortgage Advisors, Inc., 1979). The fiduciary standard that applies to investment advisers encompasses the adviser’s entire relationship with its clients and prospective clients (SEC v. Capital Gains Research Bureau, Inc., 1963) and imposes a duty of loyalty and a duty of care.

The duty of loyalty requires a fiduciary to act in the best interests of the client even if doing so may not be in the financial interests of the fiduciary. Under the duty of loyalty, a fiduciary is required to disclose potential conflicts of interest so that the client is aware of those matters where the adviser, either consciously or unconsciously, might render advice which was not in the best interest of the client (SEC v. Capital Gains Research Bureau, Inc., 1963).

The duty of care requires a fiduciary to “make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information (U.S. Securities and Exchange Commission, 2003). Investment advisers, as fiduciaries, must make suitable and reasonable investment advice to their clients based on the client’s financial situation and investment objectives.

B. <u>Broker-Dealers</u>

Traditionally, a broker-dealer has acted as an intermediary between a buyer and seller of securities. Unlike investment advisers, which are subject to a fiduciary standard, broker-dealers have traditionally been subject to a less stringent standard referred to as the “suitability standard.” The suitability standard requires broker-dealers to provide suitable investments to customers, but does not require the broker-dealer to act in their best interest (Simon, 2005).

Broker-dealers do, however, have an obligation to deal fairly with customers. Courts have found that broker-dealers make an implicit representation to customers that they will be treated fairly in a manner that is consistent with the standards of the profession (Charles Hughes & Co. v. SEC, 1943). Through various rulemaking initiatives, FINRA (and its predecessor organization, the National Association of Securities Dealers, or NASD) has helped define the duties implied by this fair dealing standard. Among these duties are requirements for broker-dealers to have a reasonable basis for recommendations that are made after considering the customer’s financial situation (i.e., a “suitability standard”) (NASD Rule 2310); engage in fair and balanced communications with the public (NASD Rule 2210(d)); provide timely and adequate confirmation of transactions; provide account statements (NASD Rule 2340); disclose conflicts of interest (NASD Rule 2720; NASD Rule 3040); receive fair compensation in agency and principal transactions (NASD Rule 2440; FINRA Rule 5110(c)); and give customers an opportunity to resolve disputes through arbitration.

Broker-dealers typically hire agents to provide their services directly to the public. Stockbrokers, for example, are considered agents of a broker-dealer. This agency relationship further complicates matters (and leads to confusion by the public about the varying standards that apply to investment advisers and broker-dealers) because an agent owes his or her primary duty to the principal (which, in this case, would be the broker-dealer). The duty of loyalty owed to the principal (broker-dealer) transcends any duty that the agent may have to a customer while acting in the role of an intermediary. "Even if a non-fiduciary stockbroker wanted to follow the trust standard of law and become a fiduciary to its clients, it cannot do so because of the conflict it has with its broker-dealer. Such contracts require the stockbroker to place the interests of the broker-dealer before the interests of the stockbroker's clients" (Simon, 2005).

While broker-dealers are not subject to the fiduciary standard under federal law, state common law may impose a fiduciary standard on broker-dealers providing services within that state in addition to rules and regulations imposed by the federal government for transactions and services. Courts in four states have chosen to impose an unambiguous fiduciary standard on broker-dealers.

IV. Study Objective

As a response to the regulatory problems and perceived fraud in financial markets that contributed to the financial crisis, Congress passed, and the President signed into law, the Dodd-Frank Act. Prior to the financial crisis, some private self-regulatory organizations, such as Certified Financial Planner Board of Standards, Inc. (CFP Board) sought to distinguish designees from other providers of financial services by holding certificants to a fiduciary standard of care when dealing with clients. These events, along with a perception by lawmakers that higher standards should be applied to providers of financial products and advice, led Congress to call for the completion of a study by the SEC to determine whether it would make sense to impose a unified fiduciary duty of care on both investment advisers and broker-dealers when providing personalized investment advice.

While there has been some recent convergence of the regulatory duties performed by investment advisers and broker-dealers over time, particularly in the area of disclosure, there remain some differences in the scope of services provided by these professionals. Investment advisers have traditionally served higher income/higher net worth clients and are often compensated on an assets under management basis. Depending upon the scope of the engagement, and whether they hold discretion, investment advisers may also hold a duty of care to clients to carefully monitor investment performance. Beginning in the late 1980s and early 1990s, the landscape for the delivery of investment advice began to shift when broker-dealers began to increasingly offer financial advice, relying on the "solely incidental" exemption in the Advisers Act, or becoming dually registered as investment advisers to provide fee-based advisory services. The investment advice provided on the brokerage side, however, tends to be episodic and focused on specific products and transactions that are suitable for a given client. Broker-dealer agents are usually compensated on a commission basis, and traditionally do not owe customers an ongoing duty to monitor their client's financial position. Broker-dealers have claimed to provide lower-cost advisory services, offset by transaction fees, for customers who do not wish to pay, or cannot afford to pay, the higher direct fees charged by investment advisers.

Due, in part, to the imposition of the suitability (as opposed to fiduciary) standard on broker-dealers, the current debate over the costs of providing advisory services to retail customers has focused on the potential economic effects of broker-dealers being held to the higher fiduciary standard of care. The brokerage industry argues that the imposition of a fiduciary standard will result in an increased risk of a fiduciary breach that would have the effect of increasing the compliance and liability costs of providing traditional broker-dealer services, and, consequently, may make those services too expensive for many lower or middle income clients (Headley, 2011).

Further, while imposing a fiduciary standard of care may provide additional protections for brokerage customers, critics assert that the imposition of such a standard may result in some customers losing access to financial advice if the cost of that advice rises due to the imposition of the standard, or, alternatively, some customers may find that they will have to pay more for the investment advice they receive without experiencing a significant change in service due to the increased regulatory and liability costs imposed by regulation.

In order to test claims that the brokerage industry and their customers would be adversely affected by the imposition of a stricter fiduciary standard, this study surveyed registered representatives (brokers) of broker-dealers in states that impose a fiduciary duty on the provision of investment advice to retail investors, and in states that did not impose such a duty. The survey avoided brokers who are dually registered as investment adviser agents and who, in that capacity, provide fiduciary investment advice. If presence of a fiduciary duty for brokers results in higher costs associated with that standard, it would suggest that states that impose the higher fiduciary standard have a lower saturation of brokers to households within that state. This would imply that there is an additional service cost attached to imposition of the fiduciary standard by reducing the number of service providers for lower or middle-income customers.

V. Differentiating State Law

States were divided into three categories: 1. states that unambiguously apply a fiduciary standard to brokers in that state; 2. states that unambiguously apply no fiduciary standards to brokers; and 3. states where there is evidence of a limited fiduciary standard applied to brokers.

Four states have imposed an unambiguous fiduciary standard on broker-dealers (fiduciary states). These states are California, Missouri, South Dakota, and South Carolina. California, Missouri, and South Dakota courts expressly impose a fiduciary duty on broker-dealers.

California courts, for example, have held that a broker's fiduciary duty requires that he or she act in the highest good faith toward the customer (Hobbs v. Bateman Eichler, Hill Richards, Inc., 1985). Missouri courts have held that, "stockbrokers owe customers a fiduciary duty. This fiduciary duty includes at least these obligations: to manage the account as directed by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies" (State ex rel Paine Webber v. Voorhees, 1995). South Dakota courts have held that 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 (Dismore v. Piper Jaffray, Inc., 1999). While South Carolina courts have not expressly stated that broker-dealers must live up to a fiduciary standard, the courts have imposed duties commensurate with those required when a fiduciary duty applies, including a duty to refrain from acting contrary to a customer's best interest, avoiding fraud, and communicating information to the customer that would be in the customer's advantage (Cowburn v. Leventis, 2005). South Carolina courts have clearly imposed a duty of care commensurate with the duty required by a fiduciary that exceeds the suitability standard that applies under federal law to broker-dealers.

States that do not impose a fiduciary standard on broker-dealers are Arizona, Arkansas, Colorado, Hawaii, Massachusetts, Minnesota, Mississippi, Montana, New York, North Carolina, North Dakota, Oregon, Washington, and Wisconsin.

Courts in Arkansas, Hawaii, Massachusetts, Montana, and Washington have expressly stated that, under state law, a fiduciary duty does not exist between a client and a broker-dealer. The U.S. Federal District Court, and the U.S. Court of Appeals for the 8th Circuit have held that under

Arkansas law, no fiduciary duty is owed by a commodities broker to a nondiscretionary account holder (Greenwood v. Dittmer, 1985). Likewise, the Federal District Court of Hawaii has concluded that Hawaii law does not impose a fiduciary duty on brokers (Unity House, Inc. v. North Pacific Inv., Inc., 1996). Courts interpreting Montana and Washington law have expressly stated that a broker–dealer does not owe a fiduciary duty to a non-discretionary account holder (Willems v. U.S. Bancorp Piper Jaffray, Inc., 2005; Chor v. Piper, Jaffray & Hopwood, 1993; Sherry v. Dierks, 1981). Massachusetts courts have expressly stated that "Under Massachusetts law, a 'simple' broker-customer relationship is not fiduciary in nature…" (Pastos v. First Albany, 2001; Vogelaar v. H.L. Robbins & Co., 1965).

Courts in Arizona, Colorado, Mississippi, New York, North Carolina, North Dakota, and Oregon have all concluded that broker-dealers do not owe a fiduciary duty to holders of non-discretionary accounts (SEC v. Raucher Pierce Refsnes, Inc., 1998; Rhoads v. Harvey Publications, Inc., 1984; Hudson v. Wilhelm, 1987; Puckett v. Rufenacht, Bromagen & Hertz, 1991; Fesseha v. TD Waterhouse Investor Servs., 2003; Sterner v. Penn, 2003; Ray E. Friedman & Co. v. Jenkins, 1984; Berki v. Reynolds Securities, Inc., 1977; Wallace v. Hinkle Northwest, 1986). In Minnesota and Wisconsin, state law provides that a broker does not owe a fiduciary duty to customers absent a special agreement between the parties (MERF v. Allison-Williams Co., 1993; Rude v. Larson, 1973; Merrill Lynch v. Boeck, 1985).

The remaining states (Alabama, Alaska, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, New Hampshire, New Jersey, New Mexico, Nevada, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming) impose either a limited fiduciary standard, or the courts have interpreted state law to impose duties that appear to be fiduciary in nature. In this study, these states are referred to as quasi-fiduciary states. Quasi-fiduciary states impose standards that exceed the suitability standard set forth under FINRA rules, but do not expressly classify broker-dealers as fiduciaries. The duties imposed, and the manner in which they are imposed, vary among these states. In Alaska, for example, courts have found that fiduciary duties arise “when one imposes a special confidence in another, so that the latter, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one imposing the confidence” (Enders v. Parker, 2003). While the Enders court did not specifically consider whether a fiduciary duty is imposed on a broker-dealer, the court’s standard for imposing a fiduciary duty could reasonably be interpreted to create a duty for a broker-dealer in some circumstances. Other states, such as Connecticut, refrain from imposing an express fiduciary duty, but did find an agency relationship between a broker and a client which required the broker to exercise “reasonable skill, care, and diligence” (Precision Mechanical v. T.J.PFund, 2003). Connecticut’s approach is intriguing in that an agency relationship exists with both the registered representative’s employer (the broker-dealer) and with the customer. Connecticut law, as currently expressed, cannot impose a fiduciary duty on registered representatives due to the inherent conflict of interest created by the state’s imposition of a customer-representative agency relationship which suggests that the registered representative serves two masters, not one. Iowa courts have not traditionally imposed a fiduciary duty on a broker-client relationship, but do so when certain circumstances exist, such as when the client lacks prior investment experience, the advice offered by the broker-dealer is significant, the client relies (to his detriment) on the advice provided by the broker dealer, and the broker-dealer was aware that the client had not read any literature concerning the subject (McCracken v. Edward D. Jones & Co., 1989).

States that impose a limited fiduciary duty include Delaware, Florida, Georgia, Illinois, Kansas, Louisiana, Maryland, Michigan, Ohio, Pennsylvania, Tennessee, and Texas. Almost all of these states impose a standard higher than the suitability standard imposed by FINRA for non-discretionary accounts. Louisiana does not expressly impose a standard of conduct higher than the suitability standard, but does require a court to consider a variety of circumstances when determining whether a higher standard should exist. The items that Louisiana courts must consider include the relationship between the broker-dealer and client, the nature of the account, and the sophistication of the customer (Beckstrom v. Parnell, 1998).

VI. Criticisms of the impact of imposing a fiduciary standard

Under current law, investment advisers are subject to a fiduciary standard under the Advisers Act, while broker-dealers are subject to a suitability standard. Differing client characteristics have resulted in different business models used by investment advisers and broker-dealers to deliver cost effective advice to their clients. Imposing a uniform fiduciary standard on both investment advisers and broker-dealers may have unintended consequences.

Some in the brokerage industry have argued that the imposition of fiduciary regulation will lead to reduced consumer access to financial advice, particularly among middle-class households that may not have access to investment advisers. Many broker-dealers provide financial services other than the sale of securities to their clients, including insurance products and brokerage services to qualified retirement plans. The president of the National Association of Insurance and Financial Advisors (NAIFA) testified before the House Committee on Financial Services that broker-dealers are typically subject to both additional state and federal regulation for these services, and these regulations generally provide constraints on behaviors that may be considered abusive (Headley, 2011).

Imposing the higher fiduciary standard than currently applies to investment advisers may increase the compliance costs of broker-dealers. A study conducted by NAIFA in 2010 found that an unintended consequence of imposing a uniform fiduciary standard would be to "negatively impact product access, product choice, and affordability of customer services for those customers who are in most need of these services" (Headley, 2011). Specifically, the study indicated that imposition of a uniform fiduciary standard may "create the potential for market disruption and reduced choices for investors when it comes to who they work with and how they pay for services" (National Association of Insurance and Financial Advisors (in Partnership with LIMRA), 2010). The NAIFA study indicated that most of its members are "concerned that the additional regulatory requirements and potential legal implications of a fiduciary standard could significantly increase their compliance costs" (Headley, 2011; National Association of Insurance and Financial Advisors (in Partnership with LIMRA), 2010). In the NAIFA study, sixty-five (65) percent of NAIFA members indicated that if compliance costs rose by 15 percent, they would limit their practice to affluent clients only (31 percent of those surveyed), would not offer securities to their clients (20 percent of those surveyed), or would increase fees for their clients (14 percent of those surveyed) (Headley, 2011).

An SEC staff study indicated that investors "generally were satisfied with their financial professionals" (Staff of the U.S. Securities and Exchange Commission, 2011), but that customers are confused with the varying standards that apply to different types of financial advisers and based on this conclusion recommended the adoption of a uniform fiduciary standard (Staff of the U.S. Securities and Exchange Commission, 2011). While the industry raised concerns that imposing a uniform standard that increases compliance costs for broker-dealers may result in limited access to suitable investment advice for middle-income clients, the SEC staff noted the possibility that the change in standards might result in reduced administrative and compliance costs (Staff of the U.S. Securities and Exchange Commission, 2011).

Opponents of the fiduciary standard are often criticized for having no data to substantiate claims about increased costs that may arise upon imposition of a uniform fiduciary standard (Consumer Federation of America, 2011). In particular, proponents of a uniform fiduciary standard assert that "claims about increased liability costs associated with a fiduciary duty are…unsupported and ignore the legal environment in which brokers currently operate" (Consumer Federation of America, 2011) because "the SEC proposal makes clear that it intends to provide extensive guidance to assist brokers in implementing the fiduciary standard" (Consumer Federation of America, 2011). Proponents of a uniform standard claim that the SEC proposal "would not require brokers to charge fees", and that the proposal preserves "the ability of brokers to offer transaction-based advice…[while] at the same time…rais[ing] the standard that applies to those transaction based recommendations" (Consumer Federation of America, 2011).

Imposing a fiduciary standard on transaction-based advice may increase the potential for legal liability of the registered representative, requiring the broker to be compensated for that additional risk. NAIFA members have expressed concern that the increased duties they owe transactional clients under a fiduciary standard may result in potential legal implications that increase their cost of doing business (National Association of Insurance and Financial Advisors (in Partnership with LIMRA), 2010).

VII. <u>Methods</u>

In order to estimate how the imposition of a stricter universal fiduciary standard will impact the provision of financial advice within the brokerage industry, we obtained the names and addresses of 544,000 registered representatives active in November 2011 and sorted them into categories based on the application of a fiduciary standard. There are four states that apply a strict fiduciary standard, 14 that apply a limited fiduciary standard, and 32 states (and the District of Columbia) that apply no fiduciary standard.

Our objectives were to assess perceived differences in business conduct among registered representatives sorted by fiduciary regulation and to assess the market saturation (representatives as a proportion of total households) of registered representatives among these states. To assess whether registered representatives' business conduct differs in states that apply a strict fiduciary standard, we developed a survey among a sample of registered representatives in states that apply no fiduciary standard and states that provide a strict fiduciary standard. The survey was conducted in the months of November and December, 2011. Participants were drawn randomly from both categories of states and were asked twelve questions. These questions were based on brokerage industry statements and testimony before Congress suggesting that a stricter fiduciary standard will result in differences in ability to serve moderate wealth customers, to offer a variety of products, to provide product recommendations that are in the best interest of their customers, and whether representatives experience a greater compliance burden. Representatives were phoned in their offices and those dually registered as investment advisers are excluded from the analysis since we are unable to differentiate whether their responses relate to their activities conducted under a fiduciary or suitability regime.

Broker-dealers in fiduciary and non-fiduciary states were asked the following questions:

1. Are you a registered investment adviser? (If so, survey is over.)
2. What percentage of your clients have incomes of less than $75,000?

3. What percentage has investable assets of over $750,000?
4. Are you able to serve the financial needs of low to moderate wealth clients?
5. Do your state's security regulations limit your ability to recommend a broad range of financial products?
6. Do you offer your clients a choice of financial products that meet their financial needs and objectives?
7. Do you provide advice tailored to the specific needs of your clients?
8. Do you feel that less affluent clients avoid obtaining your services due to cost?
9. Are you able to recommend products that provide a commission?
10. How significant is the cost of compliance?
11. Do you feel that you make product recommendations that are in the best interest of your client?
12. Among the following options, which do you consider to be the most important single factor in pricing your investment advice to clients: competition in the marketplace, firm brand, personal qualifications, legal and compliance burden, or other?

In order to provide insight into whether the imposition of stricter fiduciary standards leads to reduced supply, we compared the saturation of registered representatives within the total population of states sorted into the three fiduciary categories (strict, limited and no fiduciary standard). Individuals complete examinations conducted by FINRA in order to become registered representatives that are able to facilitate transaction with individual investors. Completion of the Series 6 and Series 7 examinations is necessary to sell, respectively, investment company products and individual securities, to the public. Only registered representatives who have completed Series 6 or Series 7 examinations were included in the analysis.[1] We provide both a descriptive comparison of saturation among states and a multivariate analysis that includes dummy variables for strict fiduciary and non-fiduciary standards with limited fiduciary as the reference category. Due to the small sample size (50 states and the District of Columbia), we include one control variable to account for the log of mean household income within the state.

[1] This constraint excludes less than 5% of the original sample and has no impact on the empirical results.

New York housed five of the 17 largest broker-dealer firms in the United States in 2011 (Investment News, 2012). The saturation of brokers within New York state is more than three times the national average and twice as high as the second largest state (Colorado). Since New York is the traditional center of the brokerage industry and may include a large number of registered representatives not primarily engaged in selling securities directly to individual clients, we include descriptive statistics with and without New York state and include an additional multivariate analysis with a dummy variable to control for the New York effect.

VIII. Results

Descriptive statistics summarizing the responses received from a random survey of 207 registered representatives in the four strict fiduciary states and the 14 non-fiduciary states are presented in Table 1. The percentage of clients who have an income of less than $75,000 is statistically equal between both groups, and there is no statistically significant difference in either the percentage of high wealth clients or in the percentage of brokers who believe they serve the needs of low and moderate wealth clients. Nearly all respondents believe they are able to provide products and advice that meet the needs of customers. The percent who respond that they are able to recommend commission products is 88.5% in strict fiduciary states and 88.2% in non-fiduciary states. The largest percentage point difference among any of the questions is whether the cost of compliance is significant. 70.9% of respondents in fiduciary states felt the costs were significant compared to 61.9% in non-fiduciary states. This difference, and that of all other questions in the survey, was not statistically significant.

Mean rates of broker saturation calculated as the number of registered representatives divided by the number of households within the state are presented in Table 2. There is a wide range in saturation rates among states from a low of 1.31 per 1,000 households in New Mexico to a high of 13.41 in New York. Average saturation rates are lowest among states with a limited fiduciary standard (3.81) and highest among states with no fiduciary standard (6.33). However, the saturation rates were nearly identical among fiduciary categories when New York is excluded from the non-fiduciary states. Saturation rates are 3.96 for strict fiduciary states, 3.81 for limited fiduciary, and 4.04 for non-fiduciary states.

We then take Missouri, an average-sized state with a fiduciary standard, and compare it with other states that have a population between 2 and 3 million households (Table 3). The broker saturation rate in Missouri (2.65) is equal to that of Tennessee (a limited fiduciary state) and comparable to non-fiduciary states with similar income levels (Arizona is 3.12, Washington is 2.54). Other states with higher incomes have higher saturation rates.

In order to control for state saturation differences that may be caused by differences in income within states, we run a regression modeling individual state saturation rate as a function of fiduciary status and log household income. Results (Table 4) show that there is no statistical difference in saturation rates among fiduciary and non-fiduciary states relative to the reference group of limited fiduciary states. When a dummy variable is included to account for the elevated saturation within New York state, the coefficient suggests that the saturation rate in New York is 8.3 points higher than the predicted rate. Fiduciary status variables remain statistically insignificant.

IX. Conclusions

This study explores the regulation of registered representatives of broker-dealers in order to estimate whether the proposed application of a universal fiduciary standard will have a significant impact on the financial adviser industry. We take advantage of differences in the

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Table 1: Mean and frequency comparison of registered representatives

Question	Fiduciary States	Non-Fiduciary States	Difference (Fiduciary – NF)	P-Value Equal	DF
% clients income < $75,000	28.0%	27.9%	0.1%	0.982	174
% clients inv assets > $750,000	29.5%	34.5%	-5.0%	0.261	183
Serve needs of low/mod wealth	78.9%	79.8%	-0.9%	0.878	202
Regulation limits product range	21.3%	17.4%	3.9%	0.486	198
Products meet client needs	95.8%	97.3%	-1.5%	0.561	207
Advice tailored to client needs	91.7%	90.1%	1.6%	0.695	207
Less affluent avoid due to cost	23.6%	29.2%	-5.6%	0.374	195
Able to recommend commission	88.5%	88.2%	0.3%	0.936	206
Cost of compliance significant	70.9%	61.9%	9.0%	0.190	191
Act in best interest of client	97.8%	96.3%	1.5%	0.526	202

Table 2: Broker Saturation Rates by States

	Registered Representatives	Households (000s)	Saturation
Fiduciary States			
California	56,945	12,392	4.60
Missouri	6,244	2,355	2.65
South Carolina	2,667	1,753	1.52
South Dakota	737	317	2.32
Total Fiduciary	**69,120**	**16,817**	**3.96**
Non-Fiduciary States			
New York	96,862	7,221	13.41
North Carolina	15,094	3,666	4.12
Washington	6,605	2,601	2.54
Massachusetts	16,207	2,521	6.43
Arizona	7,280	2,333	3.12
Wisconsin	10,164	2,282	4.45
Minnesota	8,644	2,093	4.13
Colorado	14,168	1,942	7.30
Oregon	5,291	1,506	3.51
Arkansas	1,787	1,120	1.60
Mississippi	1,728	1,085	1.59
Hawaii	974	443	2.19
Montana	949	404	2.35
North Dakota	1,049	278	3.77
Total Non-Fiduciary	**186,802**	**29,501**	**6.33**
Total W/O New York	**89,940**	**22,279**	**4.04**
Other States			
Texas	39,005	8,666	4.50
Florida	33,968	7,087	4.79
Pennsylvania	24,223	4,952	4.89
Illinois	17,258	4,768	3.62
Ohio	12,385	4,544	2.73
Michigan	8,130	3,815	2.13
Georgia	7,973	3,488	2.29
New Jersey	24,146	3,176	7.60
Virginia	7,836	2,986	2.62
Indiana	8,339	2,471	3.37
Tennessee	6,539	2,454	2.66
Maryland	9,781	2,122	4.61
Alabama	2,701	1,823	1.48
Kentucky	5,404	1,684	3.21
Louisiana	4,789	1,678	2.85
Oklahoma	3,837	1,429	2.68
Connecticut	12,682	1,361	9.32

Iowa	3,190	1,219	2.62
Kansas	2,691	1,106	2.43
Nevada	1,723	984	1.75
Utah	5,611	873	6.42
New Mexico	996	759	1.31
West Virginia	1,275	742	1.72
Nebraska	2,583	715	3.61
Idaho	1,727	574	3.00
Maine	1,291	550	2.35
New Hampshire	2,818	515	5.47
Rhode Island	2,074	408	5.08
Delaware	1,402	331	4.23
District of Columbia	1,872	256	7.31
Vermont	836	256	3.27
Alaska	593	251	2.36
Wyoming	568	219	2.58
Total Other States	**260,246**	**68,278**	**3.81**

Table 3: Comparison of Broker Saturation

This table compares characteristics of Missouri, a state that regulates brokers as fiduciaries, with all other states that have between 2 and 3 million households.

	State Regulation	Reps/ Hhlds	Median Income	Mean Income	% High Income	% College Education
Missouri	Fiduciary	2.65	45,829	60,760	5.36	25.31
Washington	Non-Fid.	2.54	56,911	73,854	8.99	31.02
Massachusetts	Non-Fid.	6.43	63,961	85,865	13.52	38.54
Arizona	Non-Fid.	3.12	49,214	65,552	6.68	26.12
Wisconsin	Non-Fid.	4.45	50,814	64,463	5.55	25.88
Minnesota	Non-Fid.	4.13	56,456	72,850	8.35	31.59
Virginia	Other	2.62	61,090	82,369	12.83	33.92
Indiana	Other	3.37	46,529	60,275	4.90	22.70
Tennessee	Other	2.66	42,612	58,360	5.37	22.92
Maryland	Other	4.61	70,017	90,800	15.18	35.58

Table 4: Broker Saturation Regression Analysis

Panel A
Dependent variable is the ratio of registered representatives to households within 50 states and the District of Columbia. Log income is the natural log of mean household income for each state. Fiduciary is a dummy variable indicating the four states that hold representatives to a fiduciary standard, and non-fiduciary includes the 14 states that do not apply a fiduciary standard to representatives. The omitted reference category is the remaining 33 states (and DC) that do not unambiguously treat representatives as either fiduciaries or non-fiduciaries.

Variable	Coefficient	P-Value
Fiduciary	-0.488	0.601
Non-Fiduciary	0.759	0.180
Log Income	8.941	0.000
Adjusted R-Square	0.39	

Panel B
Adds a dummy variable indicating New York State

Variable	Coefficient	P-Value
Fiduciary	-0.542	0.447
Non-Fiduciary	-0.154	0.726
Log Income	7.741	0.000
New York Dummy	8.290	0.000
Adjusted R-Square	0.65	