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**Statement of the Shadow Financial Regulatory Committee**

**Regulation of Broker-Dealers and the Dodd-Frank Act**

September 13, 2010

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act gives the Securities and Exchange Commission (SEC) broad powers to establish wide-ranging rules to regulate the standard of conduct of broker-dealers in relationship to retail customers. The Dodd-Frank Act requires that “[s]uch rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers. . . . “As the functions of investment advisers and broker-dealers differ, the Shadow Financial Regulatory Committee believes that a single standard cannot apply to both investment advisers and broker-dealers.

The Dodd-Frank Act also requires that the SEC submit a report on any gaps in the regulation of broker-dealers in providing “personalized investment advice” to their “retail customers.” The Committee supports such a study, but the study must be carefully designed to obtain useful information. As with any study, the devil is in the details. For example, the Act introduces but does not define the term “personalized investment advice”. How the SEC defines this term will be critical. Would a buy recommendation on a specific security circulated in a newsletter to retail customers be considered “personalized investment advice”? Would a registered representative who referred to such a report in an oral conversation with a customer

be giving “personalized investment advice”? In short, how individualized does the advice need to be to be covered under this act? Further, what is meant by a “retail customer”? Is an experienced customer with substantial assets a “retail customer”?

Broker-dealers provide a wide range of services to retail customers. Some broker-dealers provide only execution services to its customers, often at low prices. Others may be recommending low-cost index funds. The Committee is of the opinion that such broker-dealers are not giving “personalized investment advice”. Other broker-dealers are providing the same type of advice that investment advisers routinely give and in some instances even have de facto discretion over the account. The Committee believes that these broker-dealers should register as investment advisers or at least be subject to the same standard of conduct. The SEC will face a difficult task in defining how individualized advice needs to be in order to be deemed “personalize investment advice”.

If a broker-dealer provides only a limited subset of the services of an investment adviser, the broker-dealer should not be viewed as a fiduciary. Still, retail customers need to be well served in their dealing with broker-dealers. In this regard, the SEC has taken an important step through its recent rule proposal on the distribution fees that mutual funds charge. It proposes the elimination of the fixing of distribution fees by mutual funds, which is a type of resale-price maintenance, and that individual broker-dealers be allowed to charge their own distribution fees. Just as with the unfixing of commissions in equity trades in May 1975, the Committee believes that such a rule would over time greatly reduce the costs of buying and selling mutual funds. Another less important part of its proposal is to rename a “12b-1 fee” as something more descriptive as, for example, “ongoing sales charge”.

In its study, the SEC should also determine how valuable it would be for retail customers to be given information on how a registered representative is compensated and particularly whether the representative is receiving special compensation for recommending a particular product. At first sight, this change should help retail customers better understand the motivation of a registered representative, but it may just generate unread paper work. The SEC study could determine how such disclosure could be meaningfully imparted and whether it would have any benefits at all. If it does have a benefit, the SEC should then ask whether these benefits exceed the costs. These benefits and costs should be broadly defined to include the indirect effects of SEC actions on the structure of the brokerage industry and how changes in this structure impacts the welfare of “retail customers”.

In conclusion, the Dodd-Frank Act has given the SEC wide powers and discretion in improving services to retail customers. Except in the case where a broker-dealer is acting also as an investment adviser, the Committee believes that a broker-dealer ought not be held to the same standard of behavior as an investment adviser, as their functions differ. Nonetheless, the SEC should encourage high standards of service to “retail customers”, and its mandated study, if properly executed, could facilitate this effort.