

## IMPLEMENTING REGULATORY HARMONIZATION AT THE SEC

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**I. Introduction**

There is an irony embedded in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>1</sup> Section 913 requires the Securities and Exchange Commission (“SEC” or “Commission”) to conduct a wide-ranging study regarding gaps or deficiencies in the regulation of broker-dealers and investment advisers.<sup>2</sup> These firms often perform similar functions but are regulated differently under an antiquated regulatory scheme. Congress set forth no fewer than fourteen items the SEC must consider, including a catchall: “any other consideration” the SEC deems appropriate.<sup>3</sup> Section 913 also grants the SEC new rulemaking authority.<sup>4</sup> The Commission’s new authority, however, falls short of empowering it to fully address the study’s potential findings. Thus, the provision intended to address gaps or shortcomings in regulation has a gap of its own—a gap between problems the SEC must study on one hand and the tools provided to

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824 (2010) (mandating study and rulemaking regarding obligations of brokers, dealers, and investment advisers).

<sup>2</sup> *Id.* at § 913(b)-(b)(1) (“The Commission shall conduct a study to evaluate . . . the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers . . .”).

<sup>3</sup> *Id.* at § 913(c)(1)-(14) (providing a list of fourteen considerations the SEC must consider in its study, including, under subsection (14), “any other consideration that the Commission considers necessary and appropriate in determining whether to conduct a rulemaking under subsection (f).”).

<sup>4</sup> *Id.* at § 913(c) (“The Commission may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers.”).

address the study's findings on the other. The irony might be intentional. Congress recognized that additional legislation may be needed in an ongoing effort to reform the regulation of brokers and advisers. The SEC's report must state whether deficiencies exist that should be addressed through additional legislative changes.<sup>5</sup>

In light of the inconsistency between the study's scope and the SEC's new authority, one might ask how the Commission should proceed. Should the study focus on problems the SEC can resolve through rulemaking? Or is the suggested rulemaking part of a larger agenda to enhance the regulation of financial services providers? This essay analyzes the SEC's new authority and suggests a process for the SEC to pursue when conducting the study and beyond. Elsewhere I have discussed substantive aspects of this debate, addressing several of the considerations the SEC must examine.<sup>6</sup>

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<sup>5</sup> *Id.* § 913(b)(2) (requiring evaluation of potential regulatory gaps, shortcomings, and overlaps).

<sup>6</sup> See Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 *BUS. LAW.* 395 (2010) (exploring the history of the harmonization debate and arguing that the broker-dealer exclusion in the Investment Advisers Act has outlived its usefulness). *The Business Lawyer* article is responsive to considerations (1), (2), (6), (9), (10), (11), (12), and (13) set forth in section 913(c); see also Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 *VILL. L. REV.* 101 (2010) (discussing differences between duties imposed on brokers and advisers today, focusing on the nature of the relationship, requirements of disclosure, and restrictions on principal trading). *The Villanova Law Review* article is responsive to considerations (2), (6), (7), and (11) set forth in the statute. Other articles address substantive aspects of this debate. See, e.g., Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 *FORDHAM J. CORP. & FIN. L.* 31 (2005) (advocating to expand broker-dealers' obligations to their customers); Donald C. Langevoort, *Brokers As Fiduciaries*, 71 *U. PITT. L. REV.* 439, 448 (2010) (discussing challenges in expanding brokers' duties to their customers); Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 *SEC. REG. & L. REP. (BNA)* 776 (Apr. 27, 2009) (discussing harmonization of the regulation of broker-dealers and investment advisers); Thomas P. Lemke & Steven W. Stone, *The Madoff "Opportunity: Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice*, *WALL ST. LAW.*, June 2009, at 1, available at [http://bx.businessweek.com/retirement-scams/view?url=http%3A%2F%2Fwww.morganlewis.com%2Fpubs%2FWSL\\_TheMadoffOpportunity\\_June2009.pdf](http://bx.businessweek.com/retirement-scams/view?url=http%3A%2F%2Fwww.morganlewis.com%2Fpubs%2FWSL_TheMadoffOpportunity_June2009.pdf) (describing how the Madoff scandal has reinvigorated efforts to harmonize the regulation of broker-dealers and

When considering process, one might best view Section 913 as directing the SEC to move along two tracks. The first track is conducting the required study independent of the rulemaking authority provided later in the section. The key to conducting a comprehensive study is to unburden the SEC from a background requirement to later address each of its findings. The SEC, in other words, should feel free to conduct a robust analysis and draw bold conclusions, even if additional legislation is necessary and some of its conclusions cannot be addressed at this time. In any case, the rulemaking authority in Section 913 ought not shackle the SEC's willingness to conduct a comprehensive inquiry.

Parts II and III of this essay discuss the required study and the authority for new rules; Part IV points out gaps between these provisions. To assist the SEC in conducting a comprehensive analysis, Part V suggests reference to the "Yellow Book," a set of government auditing standards published by the U.S. Government Accountability Office ("GAO").<sup>7</sup> Part VI concludes this essay.

## II. Study

The SEC's study must be comprehensive. Section 913 instructs the Commission to "evaluate" two items.<sup>8</sup> The first is the "effectiveness" of existing legal or regulatory standards of care for brokers, dealers, investment advisers and their associated persons, for providing personalized investment advice and recommendations about securities to retail customers.<sup>9</sup> The study must take into

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investment advisers); Tamar Frankel, *Fiduciary Duties of Brokers-Advisors-Financial Planners and Money Managers* 18 (Boston Univ. School of Law Working Paper No. 09-36, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1446750](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1446750) (arguing for imposing a fiduciary duty on all financial intermediaries, including broker-dealers); Thomas Lee Hazen, *Stock Broker Standards of Conduct—Principles, Rules and Fiduciary Duties* (unpublished manuscript, 2010), available at [http://works.bepress.com/thomas\\_hazen/2](http://works.bepress.com/thomas_hazen/2) (exploring whether new broker-dealer regulation should address specific types of conduct).

<sup>7</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-731G 1, GOVERNMENT AUDITING STANDARDS 1 (2007) [hereinafter *GOVERNMENT AUDITING STANDARDS*] (providing a "framework for performing high-quality audit work with competence, integrity, objectivity, and independence.").

<sup>8</sup> Dodd-Frank Act § 913(b) (providing two criteria for the SEC to conduct its study regarding fiduciary obligations of brokers, dealers, and advisers).

<sup>9</sup> *Id.* at § 913(b)(1).

account standards imposed by Congress, the Commission, the Financial Industry Regulatory Authority (FINRA) and other federal and state standards.<sup>10</sup> The second item the SEC must evaluate is whether there are gaps, deficiencies, or overlaps in these standards that should be addressed “either by rule or statute.”<sup>11</sup> Including the term “statute” is significant, suggesting that additional legislation may be needed. Although the SEC may conclude that current legislation is adequate, the evaluation must take place.<sup>12</sup>

The SEC must consider fourteen items when performing its analysis.<sup>13</sup> These mandatory considerations make the study a formidable task. The Commission must examine the types of services provided across the broker-dealer and investment adviser communities.<sup>14</sup> It must assess legislation and regulation at the federal and state levels, including standards promulgated by FINRA.<sup>15</sup> The study must compare and contrast broker and adviser regulation, pointing out specific instances where one exceeds the other.<sup>16</sup> The SEC must inquire into investor perceptions and understanding regarding regulation, asking whether differences cause confusion.<sup>17</sup> It must assess how scarce resources of the SEC, the states and FINRA are being used, and whether such use is efficient.<sup>18</sup> The study also requires the SEC to speculate on the effects of changes to the regulatory scheme on both investors and regulators.<sup>19</sup> The time frame to complete the work is short; the SEC was given only six months from the passage of Dodd-Frank to finish.<sup>20</sup>

### **III. Rulemaking**

Congress included two rulemaking provisions in Section 913. The first, Section 913(f), states that the Commission may commence a rulemaking to address the legal and regulatory standards

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<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at § 913(b)(2).

<sup>12</sup> *Id.* at § 913(b).

<sup>13</sup> *Id.* at § 913(c).

<sup>14</sup> *Id.* at § 913(c)(4).

<sup>15</sup> *Id.* at § 913(c)(5).

<sup>16</sup> *Id.* at § 913(c)(6).

<sup>17</sup> *Id.* at § 913(c)(7)(A)-(B).

<sup>18</sup> *Id.* at § 913(c)(10)(C)(i)-(ii).

<sup>19</sup> *Id.* at §§ 913(c)(9), (c)(13)(B).

<sup>20</sup> *Id.* at § 913(d)(1).

imposed on brokers and advisers for providing personalized advice.<sup>21</sup> This section instructs the SEC to consider the findings, conclusions and recommendations in the study when writing new rules.<sup>22</sup> Section 913(f) is ambiguous. Although it purports to give the SEC new authority, stating that the SEC “may commence a rulemaking . . . to address the legal or regulatory standards of care for brokers . . .” it is general in nature.<sup>23</sup> The Dodd-Frank Act’s instruction to “address” is necessarily limited by fiscal considerations and existing language of the federal securities laws. By contrast, the second rulemaking provision, Section 913(g), is specific. Section 913(g), entitled “Authority to Establish a Fiduciary Duty for Brokers and Dealers,” comprises detailed amendments to the Securities Exchange Act of 1934 (“Exchange Act”) and the Investment Advisers Act of 1940 (“Advisers Act”) to accomplish that objective.<sup>24</sup>

How will the SEC and the courts view these two provisions? A well-known canon of statutory construction is that the specific governs over the general, but only where the specific is meant to limit the general.<sup>25</sup> Another canon, fanciful as it sounds, is that a later provision prevails over an earlier inconsistent one in the same statute.<sup>26</sup> Here the better view is that Section 913(g) does not limit Section 913(f) because no conflict or inconsistency exists.<sup>27</sup> Congress simply was taking no chances, spelling out in Section 913(g) the authority to create enhanced duties for brokers, although that same

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<sup>21</sup> *Id.* at § 913(f).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* (“The Commission shall consider the findings conclusions, and recommendations of the study required under subsection (b).”).

<sup>24</sup> *Id.* at § 913(g).

<sup>25</sup> *See, e.g.,* *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932) (citations omitted) (“Specific terms prevail over the general in the same or another statute which otherwise might be controlling.”); *see also In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 307 (3d. Cir. 2010) (stating that the specific governs the general canon applies only when the specific provision clearly limits the general (citing *Varity Corp. v. Howe*, 516 U.S. 489, 511 (1996))).

<sup>26</sup> *See* REED DICKERSON, *THE INTERPRETATION OF STATUTES* 249 (1975) (discussing methods of judicial statutory interpretation).

<sup>27</sup> Another difference is Section 913(f) gives the SEC authority to “commence” a rulemaking whereas section 913(g) gives authority to “promulgate” rules, but this is a distinction of little substance. Dodd-Frank Act §§ 913(f)-(g). The power to commence a rulemaking must include the power to adopt rules.

authority is covered more generally by (f). That said, to avoid risk that a court could vacate new rules on legal authority grounds, the SEC is likely to hew closely to the well-defined authority in Section 913(g). Moreover, because Section 913(f) requires the SEC to consider the study's findings, a rule adopted under Section 913(f) could be subject to challenge based on potential flaws in the study.

Because the SEC is likely to rely on the authority in Section 913(g), one must explore the scope of authority in that section to identify gaps between the scope of authority and the scope of the study. Understanding Section 913(g) entails cross-referencing between the revised provisions of the Exchange Act and the Advisers Act. Section 913(g)(1) amends the Exchange Act such that the SEC can adopt rules to provide that a broker or dealer, when providing personalized investment advice about securities to a retail customer, has the same standard of conduct applicable to an adviser under Section 211 of the Advisers Act.<sup>28</sup> What then is the standard applicable under Section 211 of the Advisers Act? Section 913(g)(2) amends Section 211 of the Advisers Act to provide that the SEC can adopt rules to provide that the standard of care for brokers, dealers and advisers, shall be to act in the "best interest" of their customers.<sup>29</sup> This raises the question of whether "best interest" is tantamount to a fiduciary standard, a matter of disagreement.<sup>30</sup> If one believes a best

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<sup>28</sup> *Id.* at § 913(g)(1) (authorizing the SEC to promulgate rules regarding brokers' and dealers' duties to customers when dispensing personalized investment advice).

<sup>29</sup> *Id.* at § 913(g)(2) ("Section 211 . . . is further amended by adding at the end the following new subsections [that the] . . . Commission may promulgate rules to provide that 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.").

<sup>30</sup> Some courts suggest "best interest" is the same or similar as fiduciary duty. *See* CFTC v. Weintraub, 471 U.S. 343, 348-49 (1985) (citations omitted) ("The managers, of course, must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation and not of themselves as individuals."); *see also* Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006) (citation omitted) (explaining that the SEC recognizes the fiduciary duty is a "best interest" standard); U.S. v. Tiojanco, 286 F.3d 1019, 1021 (7th Cir. 2002) (stating that advisory clients have an understanding that advisers will act in their best interests). A common formulation of fiduciary duty, however, suggests that the duty to act in another's best interest is only one component of the fiduciary

interest standard implies a fiduciary standard, then the Commission has been given the authority to establish a fiduciary duty standard for brokers that give advice. Material conflicts must be disclosed, Congress wrote, although they can be consented to.

In addition, according to the new language in Section 211, such rules, if adopted, shall provide that the standard of conduct applicable to broker-dealers be “no less stringent” than the standard applicable to advisers under Sections 206(1) and 206(2) of the Advisers Act.<sup>31</sup> When interpreting Sections 206(1) and (2), the general antifraud provisions in the Act, the Supreme Court stated, in the 1963 case of *SEC v. Capital Gains Research Bureau, Inc.*, that advisers as fiduciaries must comply with a duty of utmost good faith and full and fair disclosure of material facts.<sup>32</sup> Years later, the Supreme Court explained that Congress intended the Advisers Act to establish a federal fiduciary standard for advisers, although the fiduciary duty does not appear in the statute.<sup>33</sup> Thus, by reference to Sections 206(1) and (2) and a “best interest” standard, Congress has arguably given the SEC authority to place a federal fiduciary duty on broker-dealers.

#### **IV. Gaps**

The SEC’s rulemaking authority under the Dodd-Frank Act is not without limitation. Section 913(g) does not give the SEC authority to impose on broker-dealers the full panoply of requirements imposed on advisers. The statute does direct the SEC to facilitate simple and clear disclosure to investors, and it provides the SEC with authority to prohibit or restrict certain sales practices, conflicts of interest and compensation schemes.<sup>34</sup> These provisions,

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obligation. *See* BLACK’S LAW DICTIONARY 581 (9<sup>th</sup> ed. 2009) (stating that a fiduciary must act “with the highest degree of honesty and loyalty toward another person *and* in the best interests of the other person . . .”).

<sup>31</sup> Dodd-Frank Act § 913(g)(2) (“[the] rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of . . . [the Investment Advisers] Act when providing personalized investment advice about securities . . .”).

<sup>32</sup> 375 U.S. 180, 194 (1963) (citations omitted) (discussing fiduciary duty in the investment advisory context).

<sup>33</sup> *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 n.11 (1977) (“Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”).

<sup>34</sup> Dodd-Frank Act § 913(g)(1) (2010).

however, do not give the SEC power to require brokers to register as advisers and become subject to all provisions of the Advisers Act.

Moreover, absent from the language in Section 913(g)(2) are references to Advisers Act Sections 206(3) and 206(4). Section 206(3) places a restriction on principal trading by advisers.<sup>35</sup> Section 206(3) recognizes implicitly that anytime one party tries to sell something to another, there is an inherent conflict of interest in the relationship. As fiduciaries, advisers are severely restricted from selling to or buying from clients.<sup>36</sup> Advisers must provide prior written notification and obtain consent before each trade.<sup>37</sup> Most advisers, therefore, simply refrain from engaging in principal trades. Broker-dealers by contrast face no such restriction. Thus, one of the most fundamental tenets against self-dealing, and an important mechanism by which Congress ensured advisers act in clients' best interest, is omitted from the explicit rulemaking authority over broker-dealers.

Recall that the standard to be imposed on brokers shall be "no less stringent" than the standard imposed on advisers under Sections 206(1) and (2) of the Advisers Act.<sup>38</sup> Thus, the standard imposed under Sections 206(1) and (2) could act as a floor, giving the SEC the flexibility to impose on brokers the requirements in Advisers Act Section 206(3). Even if the SEC had such authority, however, it is unlikely to impose the restrictions of Section 206(3) on all broker-dealers because of the effects that such restrictions might have on market liquidity.<sup>39</sup>

Similar questions are raised by the failure of Section 913(g)(2) to reference Section 206(4) of the Advisers Act. Section 206(4) is a general grant of rulemaking authority, permitting the SEC

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<sup>35</sup> Investment Advisers Act of 1940 § 206(3), 15 U.S.C. § 80b-6(3) (2006) (requiring that an adviser not sell or purchase any security from a client as principal "without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.").

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> Dodd-Frank Act § 913(g)(2).

<sup>39</sup> See Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, *supra* note 6, at 424-34 (discussing substantive and procedural issues that would result from imposing fiduciary duties on broker-dealers).



to adopt prophylactic rules reasonably designed to prevent fraud.<sup>40</sup> The SEC has adopted several rules under Section 206(4). Examples include rules governing certain advertisements,<sup>41</sup> custody over client funds or securities,<sup>42</sup> voting proxies in clients' best interests,<sup>43</sup> and compliance policies and procedures.<sup>44</sup> The omission of Section 206(4) from Section 913(g)(2) suggests that Congress has not given the SEC authority to adopt such rules for broker-dealers that provide advice to the same extent that such rules can be imposed on advisers.

Again, the phrase "no less stringent than" in Section 913(g)(2) of the Dodd-Frank Act<sup>45</sup> might give the SEC authority to impose on broker-dealers all requirements adopted under Section 206(4) for advisers, but there are questions regarding that approach. Many Section 206(4) rules apply only to advisers that are registered or required to be registered as investment advisers under Section 203 of the Advisers Act. The Dodd-Frank Act does not on its face include authority to require brokers to register as advisers. Thus, if the fact of registration is tied to the necessity for certain rules under Section 206(4), the authority in Section 913(g)(2) might not extend to those particular rules.

The SEC already has authority to adopt antifraud rules for brokers under Section 10(b) of the Exchange Act, but that authority is narrower than the authority under the Advisers Act.<sup>46</sup> Section 10(b) applies in the context of a purchase or sale of a security. The

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<sup>40</sup> 15 U.S.C. § 80b-6(4) (authorizing the SEC to adopt rules and regulations designed to prevent "fraudulent, deceptive, or manipulative" conduct by investment advisers).

<sup>41</sup> Advertisements by Investment Advisers, 17 C.F.R. § 275.206(4)-1 (2010) (proscribing certain forms of advertising by investment advisers).

<sup>42</sup> Custody or Possession of Funds or Securities of Clients, 17 C.F.R. § 275.206(4)-2 (2010) (establishing standards for investment advisers with custody of client funds or securities).

<sup>43</sup> Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2010) (providing that investment advisers must adopt and implement written policies and procedures reasonably designed to ensure that they vote client securities in the best interests of the client).

<sup>44</sup> Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7 (2010) (requiring that investment advisers adopt, implement, and annually review written compliance policies and procedures).

<sup>45</sup> Dodd-Frank Act § 913(g)(2).

<sup>46</sup> Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006) (proscribing manipulative and deceptive conduct in contravention of any SEC rule or regulation adopted in the public interest or for investor protection).

Advisers Act contains no such requirement and applies more broadly to the dispensation of advice. A similar disability exists under Exchange Act Section 15(c), which also grants authority to adopt antifraud rules.<sup>47</sup> The broader point regarding the failure to reference Sections 206(3) and (4) of the Advisers Act is simply that the rulemaking authority in Section 913(g) of the Dodd-Frank Act may stop short of allowing the SEC to create a unified standard of care.

Perhaps the most significant gap between the required study under Section 913(b) of the Dodd-Frank Act and the grant of rulemaking authority is demonstrated through a review of consideration 10 of the study.<sup>48</sup> Consideration 10 requires the SEC to examine the impact of eliminating the broker-dealer exclusion from the definition of investment adviser in the Advisers Act.<sup>49</sup> Eliminating the exclusion was the approach taken in an earlier draft and would have required brokers that give advice to be regulated as advisers in all respects, unless later exempted.<sup>50</sup> If the SEC were to conclude in its study that the exclusion should be eliminated, Congress, not the SEC, would have to implement that change.

The gaps that exist between the required study and the proposed rulemaking commend the SEC to bifurcate the two tasks. Although the study must inform the SEC's rulemaking, the study

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<sup>47</sup> *Id.* at 15 U.S.C. § 78o(c) (directing the SEC to adopt rules and regulations designed to prevent “fraudulent, deceptive, or manipulative” acts and practices by brokers and dealers).

<sup>48</sup> Dodd-Frank Act § 913(b).

<sup>49</sup> *Id.* at § 913(c)(10) (requiring the SEC to consider “the potential impact of eliminating the broker and dealer exclusion from the definition of ‘investment adviser’ under section 202(a)(11)(C) of the Investment Advisers Act of 1940 . . . .”); Investment Advisers Act § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006). The exclusion is applicable as long as the broker’s advice is “solely incidental” to brokerage services and the broker receives “no special compensation” for providing advice. Special compensation refers to any non-commission based compensation. *See* S. REP. NO. 76-1775, at 22 (1940) (“The term ‘investment adviser’ is so defined as specifically to exclude . . . brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions) . . .”).

<sup>50</sup> SEN. COMM. ON BANKING, HOUSING & URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY ACT: CHAIRMAN’S MARK TEXT (Comm. Print 2009), *available at* [http://banking.senate.gov/public/\\_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf](http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf).

must be far more comprehensive. It presents an unprecedented opportunity to apply the SEC's resources, including empirical research, subject-matter expertise, industry knowledge and historical insight, to analyze how the industry has evolved since the 1930's and 1940's and how laws and regulations can be modernized to better serve investors.

## V. *Approach*

Other than the list of considerations and an injunction to seek and consider public comment, Congress gave no public guidance to the SEC with respect to methodology or approach to the study. An examination of the statutory language, however, is a useful starting point. Key words in the legislation are "evaluate" and "effectiveness."<sup>51</sup> The Commission must "evaluate" existing standards and whether "legal or regulatory gaps" exist.<sup>52</sup> To "evaluate" is "to examine and judge concerning . . . worth, quality, significance, amount, degree, or condition . . ." <sup>53</sup> Thus, the SEC cannot merely discuss, it must form judgments and arrive at conclusions regarding the considerations set forth.

Moreover, the SEC must evaluate the "effectiveness" of existing standards, including legal and regulatory standards, and the Commission's own inspection and examination program.<sup>54</sup> Effectiveness is the ability to bring about a desired result, condition, or outcome.<sup>55</sup> It is a relational concept. The Commission must locate a benchmark of what is to be achieved through application of the standards and compare regulation as it exists today to the benchmark. Only then can it judge whether the standards are effective; that is, whether they achieve the desired end. Proof of effectiveness "'in the air'" will not suffice.<sup>56</sup>

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<sup>51</sup> See Dodd-Frank Act § 913(b)-(b)(1).

<sup>52</sup> *Id.* at § 913(b)(2).

<sup>53</sup> WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED 787 (Phillip Babcock Grove ed., Merriam-Webster Inc. 1986) [hereinafter *WEBSTER'S DICTIONARY*].

<sup>54</sup> Dodd-Frank Act § 913(b)(1).

<sup>55</sup> See WEBSTER'S DICTIONARY, *supra* note 53, at 724-25 (defining "effect" as the "power to bring about a result" whereas "effectiveness" defines the quality or state of being effective").

<sup>56</sup> See *Palsgraf v. Long Island R.R. Co.*, 162 N.E. 99, 341 (N.Y. 1928) (quoting SIR FREDERICK POLLOCK, *THE LAW OF TORTS* 455 (11<sup>th</sup> ed. 1920)) ("Proof of negligence in the air, so to speak, will not do").

For additional guidance on how to formulate a study with these points in mind, the Commission might turn to the GAO's Government Auditing Standards, often called the Yellow Book.<sup>57</sup> The Yellow Book comprises Generally Accepted Government Auditing Standards ("GAGAS") to "provide a framework for conducting high quality government audits."<sup>58</sup> Although the SEC study might not qualify as an audit in the technical sense, the Yellow Book contains standards not only for financial audits, but also for attestation engagements and performance audits.<sup>59</sup> Performance audits are engagements intended to produce conclusions based on evaluation of evidence against stated criteria, such as "requirements, measures, or business practices."<sup>60</sup> Performance audits provide objective analysis so persons charged with oversight can improve program performance and operations.<sup>61</sup> The SEC study is akin to a performance audit, intended to evaluate federal and state regulation toward the goal of enhanced oversight and greater accountability.

The Yellow Book offers examples of objectives to be considered when evaluating program effectiveness.<sup>62</sup> Effectiveness objectives, according to the Yellow Book, often are related to efficiency objectives, which the SEC must consider as well.<sup>63</sup>

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<sup>57</sup> GOVERNMENT AUDITING STANDARDS, *supra* note 7, at 1. I thank David Gootnick, Director, International Affairs and Trade, GAO, for bringing the Yellow Book to my attention.

<sup>58</sup> *Id.* at 5-6 ("The professional standards and guidance contained in this document, commonly referred to as generally accepted government auditing standards (GAGAS), provide a framework for conducting high quality government audits and attestation engagements . . .").

<sup>59</sup> *Id.* at 6, 17 (describing the Yellow Book's standards for "attestation engagements" and "performance audits").

<sup>60</sup> *Id.* at 17 ("Performance audits are defined as engagements that provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices.").

<sup>61</sup> *Id.* ("Performance audits provide objective analysis so that management and those charged with governance and oversight can use the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability").

<sup>62</sup> *Id.* at 18-20 ("Performance audit objectives may vary widely and include assessments of program effectiveness, economy, and efficiency; internal control; compliance; and prospective analyses").

<sup>63</sup> *Id.* at 18 ("Program effectiveness and results audit objectives are frequently interrelated with economy and efficiency objectives.").

Examples of audit objectives in these categories include assessing the extent to which legislative and regulatory goals are being achieved, assessing the ability of alternative approaches to yield better performance, analyzing the cost-effectiveness of a program or activity, determining whether a program produced intended results and determining the status of program operations.<sup>64</sup> These examples are familiar and many appear in Section 913 of the Dodd-Frank Act.

Finally, to evaluate effectiveness, the Commission must make findings.<sup>65</sup> Here too the Yellow Book provides guidance by outlining what is meant by a “finding.” A finding includes four elements: criteria, condition, cause and effect.<sup>66</sup> Let us focus briefly on these elements.

The study should develop “criteria,” which is essential to measuring effectiveness. Criteria are benchmarks against which performance is compared.<sup>67</sup> Criteria identify the expectation of the evaluator and serve as a context for evaluating evidence in the study. Developing criteria for evaluating the effectiveness of broker-dealer and investment adviser oversight could be difficult. One might examine Congressional goals in these areas. Section 2 of the Exchange Act, for example, outlines the necessity for regulation and focuses on facilitating a national market system.<sup>68</sup> References to investor protection in Section 2 appear in the context of facilitating commerce. The purposes behind the Advisers Act, preserving the advisory relationship and exposing conflicts of interest, are different.<sup>69</sup> Similarly, one might ask what are the goals of the SEC’s

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<sup>64</sup> *Id.* at 18-19.

<sup>65</sup> Dodd-Frank Act § 913(d)-(d)(2)(A).

<sup>66</sup> GOVERNMENT AUDITING STANDARDS, *supra* note 7, at 154-56.

<sup>67</sup> *Id.* at 141-42 (“Criteria represent the laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation.”).

<sup>68</sup> Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (2006) (explaining that “transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . including . . . to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system . . .”).

<sup>69</sup> *See* S. REP. NO. 76-1775, at 21-22 (1940) (describing the problems and abuses of investment advisory services as encompassing individuals and companies that either “handle pools of liquid funds of the public or give

inspection and examination program? Are these examinations pedagogical in nature, a deterrent against misconduct, or both? When evaluating the effectiveness of the regulatory schemes, goals can serve as possible criteria.

Next, the staff must identify “condition.” Condition is the situation that exists now, and it is investigated, determined and documented throughout the audit.<sup>70</sup> Information about condition might be drawn from a number of sources, including enforcement investigations and cases brought by the SEC, FINRA and state regulators; data from inspections and examinations conducted by the SEC, FINRA, or the states; survey data, such as that collected by the Rand Institute for Civil Justice;<sup>71</sup> and information from industry groups such as the Securities Industry and Financial Markets Association, the Investment Adviser Association and the Investment Company Institute.

The GAO’s third element of a finding is “cause.” Cause identifies the reason a condition exists; it explains the gap between the desired state (the criteria) and the actual state (the condition).<sup>72</sup> Cause might include factors outside the SEC’s control, such as legislative language, or factors within its control, such as gaps in the SEC’s own rules or shortcomings with implementation or enforce-

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advice with respect to security transactions” and noting that prior law did not limit or restrict the activities of such individuals who may solicit funds).

<sup>70</sup> GOVERNMENT AUDITING STANDARDS, *supra* note 7, at 155 (“Condition is a situation that exists. The condition is determined and documented during the audit.”).

<sup>71</sup> ANGELA A. HUNG ET. AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008), [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf) (providing the SEC with a description of the current state of the investment advisory and brokerage industries for its evaluation of the legal and regulatory environment concerning investment professionals). Dodd-Frank has clarified the SEC’s authority to engage in investor testing programs. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 912, 124 Stat. 1376, 1824 (2010) (authorizing the Commission to engage in temporary investor testing programs as the Commission determines are in the public interest or would protect investors).

<sup>72</sup> GOVERNMENT AUDITING STANDARDS, *supra* note 7, at 155 (“The cause identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective actions.”).

ment. In many cases, identifying cause will assist the evaluators in preparing proposals for change.

The final element of a finding is “effect.” Effect is the impact of the difference between the condition and the criteria; effect is the result of the condition.<sup>73</sup> Measuring effect is difficult as well. Has a gap in regulation caused lower levels of investment—or is the level of investment dependent on factors exogenous to the regulatory scheme? Did gaps lead to spectacular frauds such as the Bernard Madoff investment scandal, or can the Madoff fraud be blamed on other factors? Are there negative effects to additional disclosure? One line of research suggests that additional conflict of interest disclosure by a financial services provider might make matters worse, not better, for investors.<sup>74</sup> The possibility of such negative effects should not be ignored, although resorting to outright bans of certain sales practices has problems of its own.<sup>75</sup> Again, the point is that the SEC should review effects, whatever they might be, as part of its findings.

## **VI. Conclusion**

The SEC has been grappling with questions posed in the Dodd-Frank study for over 10 years. The Commission has accumulated vast knowledge on this topic, supplemented by the Rand study, scholarly articles and numerous responses to the request for comment. The study, therefore, represents a singular opportunity to think carefully about the regulatory scheme, the future of the industry and most importantly investor protection. It would be appropriate for the Commission to suggest legislative changes to Congress if needed. By contrast, the grant of rulemaking authority to the SEC is limited in several respects and stops short of empowering

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<sup>73</sup> *Id.* at 156 (“The effect is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition.”).

<sup>74</sup> See Daylian M. Cain et al., *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. (forthcoming Feb. 2011) (explaining that disclosure, particularly if made in person, might reduce the ability to resist conflicted advice, and disclosure might increase regulators’ willingness to permit conduct that really should be banned).

<sup>75</sup> See Langevoort, *supra* note 6, at 448 (explaining that, in some cases, brokers’ additional compensation might have salutary effects on investors).

the SEC to impose on broker-dealers the universe of duties currently imposed on advisers. Thus, the SEC's two tasks—study and possible rulemaking—are best viewed as complementary but independent assignments.