Imperfect Harmony

By Kerry Pechter *Tue, Aug 31, 2010*

Hundreds of riled-up advisors and brokers, including Harold Evensky, have responded to the SEC's RFI on "harmonizing" their standards of conduct. Here's some of what they wrote.

As the hundreds of comments on the Security and Exchange Commission's website demonstrate, there's plenty of discord over the question of "harmonizing" the ethical rules that registered representatives and investment advisers play by.

In July, the new Dodd-Frank Wall Street Reform and Consumer Protection Act punted the political football of creating uniform rules of engagement for brokers and investment advisors over to the SEC, asking the SEC to recommend new rules in six months. The SEC, in turn, invited public input.

The question is whether registered broker-dealer representatives should meet a *fiduciary* standard and to act in the "best interests" of their clients at all times, as registered investment advisors are required to do, or if reps may continue to follow the more flexible *suitability* standard, which tolerates conflicts-of-interest that don't violate the interests of the client.

The issue isn't merely an academic or legalistic one. It involves turf rights in the financial services landscape. More brokers want to be able to play in the advice space, a potentially more lucrative realm than the increasingly cutthroat transactional space. Advisors, understandably, would like to keep their profession's barrier-to-entry as high as possible.

Thus the uproar. Meanwhile, Baby Boomers go begging for guidance on how to spend their retirement savings, but vastly distrust the providers of financial services, in part because the rules of the game are so opaque and so fluid. If the SEC can resolve this matter and restore a bit of confidence in the system—a very big if—everyone should be better off.

Vox populi

Over the past five weeks or so, the SEC has received an earful from brokers and advisors. Virtually all of the brokers' emails urge the government not to subject them to a new and costly layer of regulation. Most, but not all, of the investment advisors' comments call for extending the fiduciary standard to any intermediary who provides, as one letter put it, "a scintilla" of advice."

Harold Evensky, the well-known advisor and co-editor of *Retirement Income Redesigned* (Bloomberg, 2006), believes that it is easy to tell when the fiduciary rule applies. "I believe that for practitioners there is a simple test to determine when they will be subject to a fiduciary standard," he wrote.

"I refer to this as the 'YOU' standard. If an investor calls and says, 'I'd like to buy 100 shares of XYZ' – Suitability standard. If an investor calls and says, 'What does your firm think of XYZ stock?' and the advisor says 'we believe . . .' – Suitability standard. If the investor says 'Do you think I should buy XYZ stock?' and the advisor says ‘Yes, I think YOU . . .’ – Fiduciary!

Some advisors regard the brokerage industry as hopelessly compromised under the status quo.

“The only reason for brokers not to be held to a fiduciary standard is the self-interest of the brokerage industry,” wrote Brendan E. Connelly, a fee-only advisor in Madison, Wis. “I was a broker myself at one time and made the difficult yet accurate decision to transition to the fee-only/fiduciary model. Thank God I did as my conscience and my clients both love it. Do the right thing. Resist the lobbying money of the brokerage industry and hold them to a fiduciary standard.”

One-night stand?

Others feel that conflicts of interest are endemic to the brokerage world, and that better disclosures could adequately protect the average investor.

“I believe that extending the fiduciary standard to broker-dealers is not ethically possible. Broker-dealers sometimes work with both parties in a transaction, such as when taking a company public. How would it be determined who deserved the fiduciary obligation?” wrote Edward D. Hinds III, a financial planner in Paso Robles, Calif.

“Customers need to understand whether they are purchasing executions or advice. They need to understand whether it’s a one-night stand or a relationship. They do not understand that now,” wrote Peter J. Chepucavage, an attorney with Plexus Consulting in Washington, D.C.

Reps and agents bridle at the suggestion that they or their suitability standard render an inferior form of care, or that current FINRA regulations and state insurance laws are ineffective. Paul B. Crouch of Lake Forest, Ill., echoed the opinions of many when he wrote:

“I have been in the Insurance industry for over thirty (30) years, and a Registered Representative for seventeen (17) years. Over the years, I constantly receive more layers of regulation. Enough is enough. Adding another layer of regulation means another layer of compliance, and even more costs to consumers… There is a PERCEPTION that the legal fiduciary duty governing investment advisors provides greater investor protection than the suitability standard governing Broker/Dealers. This PERCEPTION is FALSE.”

Kyle Paterik, a Los Angeles financial consultant, expressed fears about exposure to lawsuits. He also took it for granted that the fiduciary rule is incompatible with taking commissions—an assumption that advisors don’t necessarily agree with.

Monday morning quarterback

“My concern with the new vague fiduciary standard is the unchecked ability of our clients to be a Monday morning quarterback and sue us for every dip and turn the market brings…” he wrote. And “by demanding all advisers work on a fee-based schedule, you will be creating a barrier to entry that will shut a large percentage of our population out of receiving quality financial advising and management."

A two-tier ethical scale is appropriate for a two-tier financial world, suggested Christen Gibbons, ChFC, ChLU, of Ithaca, New York. The fiduciary rule, in other words, may be a luxury that only the high net worth investor can afford.

"When I'm recommending a product to fill a specific insurance or investment need, I work as a representative under the suitability model," she wrote. "When I'm doing more sophisticated financial planning I am an advisor under the fiduciary standard model.

"This is more costly because of the required reporting and ongoing service including additional advisor liability. I can only do this type of work for people that have higher income or net worth."

Several reps argued, with reason, that the "best interest" standard of the fiduciary rule is tough to define. "In your consideration of the fiduciary standard, please tell me what is 'best'? asked Suzette Moline, a registered rep in Sundance, Wyoming.

"Would that be measured by historic underwriting, service standards, price (as in cheapest), premium relative to the benefit of a product, or perhaps the rating of the company providing the product? There are too many interpretations of such a standard… it adds a vague legal liability standard that looks back and is enforced after the fact by the SEC or trial lawyers who have perfect vision in hindsight."

Robert Ramos, a CFP in Waldorf, Md., agreed: "How on Earth can 'best interest' be determined with the myriad of solutions available in today's marketplace and the every increasing number of new products coming to market?"

Is water wet? Is grass green?

"If we want to study whether a 'fiduciary duty' is better for consumers, then we should also study if grass is green, if water is wet, and if deserts are dry," wrote Luke Dean, a professor of finance at William Paterson University in Wayne, NJ. "A fiduciary duty requires a 'professional' to do what is in their clients' best interest.

"How could anything less than this be good for clients or consumers or even a 'profession'? There shouldn't be a 'fiduciary-lite' created. Do what's best for the American consumers and force American corporations to do what's best for consumers instead of continuing to offer inferior products/advice with superior fees and expenses.

"John Adams said that one of his fundamental doctrines for government was that you had to 'protect the sheep from the wolves.' It is unreasonable to expect all American consumers to know the difference between an investment adviser regulated under the 1940 legislation and the 1934 legislation. It's also unreasonable that we're still using legislation that is over 70 years old for the financial services and its 'professionals.'

"Make all financial services professionals be fiduciaries, and you'll see that more consumers will utilize them. Make insurance companies and investment advisers offer best products at best prices in a transparent fashion, rather than just pushing their own companies' inferior products with superior commissions and fees."

As of August 30, more than half (236) of the 400-plus messages were what the SEC called Type A letters. These summarized the opinions of life insurance agents and protested the extension of the fiduciary rule. Less than one-third (131) were Type D letters. These represented the opinions of financial advisors, and recommended the extension of the fiduciary rule to all providers of investment advice. (It was unclear whether the SEC or specific trade organizations provided the boilerplate language for the five standard letters.)