The Real Obstacle to a Fiduciary Standard

By Editor Test *Sun, Sep 9, 2012*

"Resolving the issue of principal trading is one of the great difficulties in finding a way forward in achieving harmonization," writes Arthur Laby, a Rutgers University law professor who specializes in securities law.

Anyone who wants to understand the legal context of the fiduciary/suitability debate should read the lucid, non-partisan papers written about it by Rutgers University law professor Arthur Laby. The most recent one was discussed at the Pension Research Council's symposium last May and published by the PRC last month.

Before reading them, I had not thought much about the meaning of the compound term, "broker-dealer.' But the hyphen is apparently where all the trouble lies (though Laby's paper doesn't say this in so many words). Laby also traces the origins of this high-stakes turf war, which is as old as the SEC.

As I personally have watched (off and on, I must admit) the debate over "harmonization"— i.e., the uniform application of the "fiduciary" standard to anyone who charges for financial advice, including brokers who have recently switched from commissions to asset-based fee compensation—my attention has dwelled on the question of whether the a broker operating under the suitability rule might act in his or her *own* interest instead of the *client's*.

After reading Laby's paper, I felt naive for having missed what now seems obvious. Laby lasers on the question of whether a broker-dealer and its representatives can ever meet a fiduciary standard as long as the business includes proprietary trading. He reasons that when the rep is selling a product that the company deals in (or has underwritten), the rep can't serve the client and the company equally well.

"The real problem is that firms are permitted to act as both brokers and dealers," Laby writes, explaining that "Brokers often sell securities from their own accounts to customers, and they also buy securities for their own accounts from customers, either as a market maker in particular securities or as a market participant seeking to generate trading profits. Engaging in this trading activity is the very definition of dealer in the Exchange Act [of 1934]."

Laby adds, "Resolving the issue of principal trading is one of the great difficulties in finding a way forward in achieving harmonization. On the one hand, any broker-dealer that provides advice should be required to act in the best interest of the client to whom the advice is given. On the other hand, imposing a fiduciary duty on dealers is inconsistent, or not completely consistent, with the dealer's role. A dealer's profit is earned to the detriment of his trading partner, the very person to whom the dealer would owe a fiduciary obligation."

This sort of conflict, for instance, was at the heart of the SEC's complaint against Goldman Sachs—a broker, a dealer and an underwriter—after the financial crisis. At the time, there was widespread consternation that Goldman Sachs advisors could be advising clients to buy collateralized debt obligations

when, for another client, Goldman Sachs' financial engineers were tailoring a high-tech credit default swap to pay off when the same CDOs plummeted in value.

But, wait. In his paper, Laby, for some reason, didn't distinguish between the wirehouses, which own their own broker-dealers, and what I think of as independent broker-dealers. Yet it seems hard to equate them all, because they don't all do prop-trading. Raymond James is an independent broker-dealer that also does underwriting. It has both captive brokers and independent advisors who trade through Raymond James. LPL Financial, by contrast, doesn't do underwriting or proprietary trading. As one LPL advisor said on his site: "LPL Financial does not engage in the business practices of investment banks or provide other alternative financial services. They do not engage in market-making activities trading out of their own inventory, which means they do not hold any securities on their balance sheet that are open to market risk."

In light of that, it's not surprising that statements from Raymond James suggest that it stands closer to the wirehouses on the fiduciary question than LPL Financial does. According to press reports, Raymond James chairman Dick Averitt has expressed ambiguous support for the fiduciary standard. He said he supports the "concept." This isn't far from what SIFMA, the Securities Industry & Financial Markets Association (whose members include the wirehouses as well as LPL Financial and Raymond James), says on its website:

"Since early 2009, SIFMA has consistently advocated for the establishment of a new uniform fiduciary standard, and not application of the *Advisers Act* fiduciary standard to broker-dealers… When considering the Department of Labor's (DOL) definition of fiduciary under the *Employee Retirement Income Security Act* (ERISA), the consequences for a broker being deemed a fiduciary include potential prohibitions on engaging in principal transactions, as well as difficulty receiving fees or commissions. As written, SIFMA believes the proposed rule would ultimately harm investors by raising the cost of saving. SIFMA is working with the DoL through the regulatory process to avoid the harmful effects of this proposed rule."

In January 2011, LPL Financial chairman Mark Casady issued a statement, reprinted in *Financial Planning* magazine, that seemed to fully embrace a uniform fiduciary standard: "We agree with the [SEC] report's recommendation for a uniform fiduciary standard, as we believe this is right for investors, financial advisors and the industry," Mark Casady, LPL's CEO and chairman, said in a written statement. "We are confident this would help drive greater consistency and evenhandedness in the supervision of the broker-dealer and advisory sides of our business."

So there it is. The core of the harmonization controversy isn't about personal ethics or channel competition or commissions per se, or about raising costs for the mass affluent investor. It's about a threat to the survival of the vertically integrated financial services firm that includes manufacturing/underwriting, prop trading, and distribution through a brokerage. What would happen to its business model if its indispensable "top producers" had to meet the fiduciary standard and start advocating on behalf of the clients whose accounts they manage?

"The dealer question is very important, and, in my mind, probably the hardest issue in the proposal to place a fiduciary duty on broker-dealers that give advice," Laby told *RIJ* in an e-mail. "It is very difficult to square acting as a dealer and acting in a fiduciary capacity."