

Regulation and Compliance—Harmonize, Harmonize

The term “harmonization” encompasses a broad range of issues geared at simplifying and tightening regulation of the financial services industry. One example is a major effort underway to examine the opportunities for harmonizing the regulation of futures and other securities. Currently, the Commodity Futures Trading Commission (CFTC) regulates futures and futures traders, while the Securities Exchange Commission (SEC) regulates other securities. These agencies held joint hearings and delivered a report to Congress on October 16, 2009.

The concept of harmonization is also found in legislation, which many have called the most significant overhaul of financial services regulation since the Great Depression, H.R.4173, The Wall Street Reform and Consumer Protection Act of 2009. This bill passed the House on December 11, 2009 and continues to work its way through the Senate.

Although financial advisors are indirectly affected by many aspects of harmonization, they are impacted most directly by provisions in H.R. 4173 relating to “investor protection.” In general, broker-dealers (whose advice is merely incidental to the sale of a security) would be subject to the same fiduciary standard of care in their dealings with clients that investment advisors (including for example, financial planners and wealth managers whose advice is central to the service and products they provide) are already subject to. Furthermore, the SEC would be authorized to issue rules requiring brokers-dealers and investment advisors to act in the best interest of the customer when providing personalized investment advice about securities to retail customers.

Current Regulation of Broker-Dealers

Broker-dealers are currently subject to a comprehensive set of Commission and SRO requirements that are designed to promote business conduct that would facilitate fair, orderly, and efficient markets and protect investors from abusive practices. Very basically, broker-dealers are required to deal fairly with their customers. This duty is derived from the anti-fraud provisions of the federal securities laws. Broker-dealers also are required by FINRA to observe high standards of commercial honor and just and equitable principles of trade. This includes having a reasonable basis for recommendations in light of the customer’s financial situation to the extent known to the broker (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account

statement disclosures, disclosing conflicts of interest, receiving fair compensation, and giving customers the opportunity for redress of disputes through arbitration.

Note that broker dealers are required to disclose conflicts of interest but are not required to put their clients' interests above their own.

Current Regulation of Investment Advisors

Investment advisors are, generally, subject to a higher standard of care when dealing with clients. The Investment Advisers Act of 1940 broadly prohibits advisers from defrauding their clients, which the Supreme Court has construed to impose on them a fiduciary duty to their clients. That fiduciary duty, which is a central proposition of the Advisers Act, requires investment advisers to act in the best interest of clients and to avoid conflicts with clients or, if conflicts cannot be avoided, to provide appropriate disclosure of the conflicts and to obtain client consent. Much of the Advisers Act is designed to enforce that fiduciary duty.

Investment advisers are required to register with the SEC (or the states). All registered investment advisers (RIAs) must, among other things deliver a brochure to clients and prospective clients containing information about their conflicts, fees and business practices; maintain books and records; adopt and implement effective compliance controls administered by a chief compliance officer; seek best execution of clients' transactions; provide only suitable investment advice to their clients; and establish, maintain and enforce written policies and procedures to prevent the misuse of material, non-public information.

Notice that the standard of care imposed on broker-dealers is "rules based," while the fiduciary standard of care imposed on investment advisers is "principles-based." Thus, the fiduciary standard currently imposed on investment advisers derives not from specific rules, but from SEC and judicial interpretation of the anti-fraud rule in the Advisers Act.

Proposed Changes

The new legislation is based on a wide-spread concern, especially in light of the Madoff and other recent scandals, that investors find it difficult to distinguish between investment advisers and broker-dealers. In a speech in June 2009, SEC Chairman Mary Schapiro commented on the

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If the new legislation’s imposition of a fiduciary standard on broker-dealers were not controversial enough, a second provision has also drawn fire. According to the legislation, the “principles-based” regime currently in place under the Investment Advisers Act is to be replaced by a “rules-based” approach.

To this end, the new legislation would impose the same standard of care on broker-dealers as currently exists for investment advisers, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide). Furthermore, where a broker-dealer sells only proprietary or other limited range of products, the broker-dealer must provide notice to each retail customer and obtain the consent or acknowledgment of the customer. A retail customer is defined as “a natural person, or the legal representative of such natural person, who--

(A) receives personalized investment advice about securities from a broker or dealer; and

(B) uses such advice primarily for personal, family, or household purposes.”

Finally, the SEC is directed to “(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”

Not surprisingly, this provision has drawn fire from broker-dealers and their representatives. Dale Brown, president and CEO of the Financial Services Institute (FSI), a trade group for independent broker-dealers, says he opposes applying the fiduciary standard to broker-dealers because it’s not appropriate for that business model. Instead, he says, a universal standard of care that works across all client situations and business models is the best way to improve regulation.

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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 customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers...when providing personalized investment advice about securities...”

Although a coalition representing the Certified Financial Board of Standards, the Financial Planning Association (FPA), and The National Association of Personal Financial Planners (NAPFA) have generally supported a “harmonized” standard of care to ameliorate client confusion, there are concerns with the new legislation. Some fear that the new “rules-based” approach to the fiduciary standard will create a new “super-fiduciary” standard that is higher than that imposed by the current investment adviser standard. In addition, there is concern that the new rules-based approach will create a potential conflict between the current fiduciary standard for investment advisors and the standard of care embodied in the CFP Board's principles-based *Standards of Professional Conduct*.

Bottom Line

Despite the concerns expressed by the industry, there appears to be widespread support in Congress for “harmonization” between broker-dealers and RIAs. Given that “harmonization” is widely-supported by consumer groups and consumers recently burned by Madoff and other unscrupulous advisors, the momentum seems to favor enactment of the new law.

If enacted, compliance officers will have a lot more on their plate in 2010.

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