

InvestmentNews

Battle over broker rule heightened by SEC guidance

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The financial services industry is in the midst of a major battle, and the Securities and Exchange Commission has opened a Pandora's box.

Thanks to the SEC, history is in replay mode, and the consumer again is at the bottom of the pile. On April 12, 2005, the SEC adopted Rule 202(a)(11)-1 (aka the Merrill Lynch rule), which appeared to ban brokers from providing financial planning services (i.e., something more than incidental advice) under Washington-based NASD's rules of fee-based services.

The rule would exempt certain brokers from registering as advisers under the Investment Advisers Act of 1940. This initiative, in concept and in spirit, was to provide the consumer with some insight as to how the adviser was providing services. Was the adviser advising or selling? As Donald B. Trone pointed out in an earlier Fiduciary Corner column, an SEC investigation has found that more than half of the firms examined had continuing conflicts of interest.

But thanks to the heavy lobbying efforts of the Securities Industry Association of Washington and New York, a proposal that many hoped would provide clarity in consumer protection has been watered down to the same old, same old. The SEC has had more than six years to make a determination and to define which investment advice of a broker-dealer is incidental, only to arrive at this conclusion: "We are not sure."

The SEC, under inquiry (for a loophole), issued a guidance letter Dec. 16 to SIA general counsel Ira Hammerman as to what defines a financial plan. The same communication, from Robert Plaze, associate director of the SEC's division of investment management, dissected the components of the described financial plan and stated that separately, the components are not a financial plan but that each component is a tool.

This guidance never defines a financial plan but allows that the adviser, if presenting each tool separately, does not have to abide by the broker-dealer rule of declaring fiduciary status in the relationship. This presumption, lacking any prudent or fiduciary standards, allows the adviser to wear two hats: 1) adviser for fee, and 2) adviser for sale. Unfortunately, under this loophole, the adviser is only an adviser for sale.

Deja vu

This is a replay of the early 1970s, when the insurance industry had an identity crisis. It was difficult to get the consumer to talk to an insurance agent, so we became planners.

The father of financial planning, John Bell Keeble, stated that financial planning is designed for needs-based selling. Hence, as "planners," a lot more life insurance and other products via the

development of a financial plan could be sold. Now, according to the climate established by the SEC, I still can promote myself as an adviser, present a disclosure statement of possible conflict in compensation (once I employ the tools) but do not have to acknowledge any fiduciary responsibility (such as full disclosure, non-conflict advice and the many principles that lead to a higher bar of professionalism).

What is interesting is how the SIA and brokerage firms are reacting to this challenge. Instead of embracing standards of professional excellence, there is scurrying around to circumvent the "client first" spirit in the initial intent of the rule for consumer protection and guidance. Their response is congruent with the old "confuse and conquer" battle strategy.

Although there are various battlefronts, the real war has to do with two growing dynamics that are about to confront each other, and we are right in the middle of this historic battleground.

Dynamic No. 1 is the growing trend, and need, of the consumer to seek out and find advisers that can provide guidance in a fee engagement venue that reduces or eliminates conflict and bias. Dynamic No. 2 is the trend of increased profitability by brokers and dually registered firms that capitalize on this need by marketing a bait-and-switch professional assumption.

The one caveat put forth by the SEC is in regard to a reasonable investor's perception of the services being provided as an important consideration in determining whether the breadth and scope of advisory services constitute financial planning.

According to The Spectrem Group Inc.'s Affluent Study 2005, released in January, more affluent advisers are using full-service brokers as their primary advisers. George Walper, president of Spectrem in Chicago, stated: "We see that the [brokerage] industry as a whole has made some significant enhancements to their product offerings; far more of them are advice based, as opposed to strictly talking about product. There is less press now about conflicts of interest and scandals within the brokerage industry." Firms with fee-based programs still are garnishing higher growth and satisfaction, he said. Spectrem's research unequivocally has validated what the consumer's perception of the broker is, which is contrary to what the SEC now has established by failing to address this specific issue.

Unfortunately, much of the debate employs secondary issues, such as methods of compensation or professional designations. Here are where the major problems lie:

- Financial planning has evolved over the past few decades, but professional and regulatory bodies have not clearly identified or guided this new professional engagement of comprehensive financial planning and the fee engagement fiduciary venue.
- If the SEC focused on the tool, or component of investment activity (which is an integral part of any financial plan), its decision should be easy. There are years of regulatory and statutory positions that clearly form the basis of fiduciary requirements and standards. That is a no-brainer.
- Financial planning, by definition, employs and requires functionality. "Planning," "advising," "consulting" are action words. These are not passive functions. I can deliver to you a financial plan (passive). But if I engage in planning (active), I am providing advice, counsel, etc.
- The components (tools) engaged in the financial planning process may require the use of products for implementation that are available only in a commission format. This reality is the major sticking point of integration and transition to maintaining fiduciary standards in the financial planning process. How does one operate in a fiduciary capacity as a financial planner (adviser, etc.) when there is no history of regulatory or statutory guidelines for the commission-based venue of product delivery?

A new study by Moss Adams LLP of Seattle claims that the dually registered (SEC/fees and NASD/commission) firm may be the model of the future, as such hybrid operations are more profitable. Again, we have the clash between the fee culture and the commission culture.

The astute observer will take notice of similar forces that are affecting our profession on both sides of the debate. There has been a rash of litigation by states, class actions and investigative activity in regard to insurance-related products. Embedded in each and every instance is the focus on full disclosure, conflict of interest, bias and client interest. Sound familiar?

In order to resolve the integral issues at hand, there must be recognition by all regulatory bodies that there needs to be a fully disclosed and transparent methodology regarding commission products. This includes increased responsibility and action by the National Association of Insurance Commissioners in Kansas City, Mo., to review, revamp and update archaic legislation and regulation so that it better addresses the products in the market.

For instance, the use of no-load (fee-based) life insurance and annuities can fulfill the full disclosure, transparency and client-first standards of fiduciary responsibility. But there is no pressure being placed on the insurance industry to revise its marketing strategies from offering high-commission options and bonuses, which create biased conflict and which are never disclosed.

Neither is there any pressure for full disclosure to any life insurance policy that is sold on the basis of illustration. Such policies, which include universal life, variable life and participating whole life, are the highest revenue generators for the brokerage and dually registered firms.

There are those standards of fiduciary responsibility that can be applied to the commission side of the financial planning process, but very few are interested in developing that format.

The reality is that with all of the money and politics involved, the only chance that consumers have is for those in our profession who desire a higher bar of excellence and professionalism to move forward and educate the consumer and the media, and make change one client, one issue, one policy at a time.

Choices to make

We, as professionals, have choices to make. Who is to establish our bar of professional ethics? Once such standards have been established, do we attempt to curtail them via sought-out loopholes? Are we satisfied with attaining minimum standards? Do we reach higher and accomplish greatness?

Once we make our choice, then we can share and practice these standards by selecting the company we keep and the firms with which we do business. The selection should be congruent with our standards, as the consumer often will judge our professional intent by such association.

As Groucho Marx once said, "The secret of life is honesty and fair dealing. If you can fake this, you got it made." It is our individual responsibility to decide if we are going to fake it or press for excellence.

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