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The SEC's New Failure to Protect Investors: The Defeat of The Proper Application of Fiduciary Duties To Investment Advisory Activities

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Over the past several decades, and particularly in the past several years, the U.S. Securities and Exchange Commission ("SEC") has thwarted the will of Congress by failing to apply the Investment Advisers Act of 1940 ("Advisers Act") to the investment advisory activities of registered representatives and others. Moreover, the SEC has proceeded down a slippery slope when applying the Advisers Act by stressing mere disclosure of conflicts of interests by investment advisors, instead of counseling advisors to avoid conflicts. This article examines the potential consequences of the SEC's present course of action. This article suggests that the market forces compelling investors to seek out fiduciary advisors will, eventually, render the SEC irrelevant as a leader in the protection of both individual and institutional investors.

THIS ARTICLE SUGGESTS THAT THE MARKET FORCES COMPELLING INVESTORS TO SEEK OUT FIDUCIARY ADVISORS WILL, EVENTUALLY, RENDER THE SEC IRRELEVANT AS A LEADER IN THE PROTECTION OF BOTH INDIVIDUAL AND INSTITUTIONAL INVESTORS

The Merrill Lynch Rule

In late 1999, in response to broker-dealer inquiries and without the benefit of public commentary, the SEC adopted what has become known as the "Merrill Lynch Rule." In this unprecedented "Proposed Rule," the SEC sought to exempt fee-based accounts of broker-dealer firms from the application of the Advisers Act. Within the Proposed Rule was a "no-action letter" entitling broker-dealer firms to rely upon the Proposed Rule while it was pending comments and final action. This no-action position, combined with years of inaction, in essence, resulted in rule-making without proper adherence to administrative procedures. Finally, in response to the filing of a law suit by the Financial Planning Association, the comment period on the Proposed Rule was re-opened in July 2004. Since then over 1,000 comments have been received by the SEC, the vast majority in opposition to the Merrill Lynch Rule (including comments by AARP, Consumer Federation of America, Fund Democracy and this author). Despite overwhelming consumer interest group opposition to the Merrill Lynch Rule, the SEC appears to be proceeding within the next few weeks or months toward adoption of the Merrill Lynch Rule (although greater disclosures attached to broker-dealer fee-based accounts may be required). In so doing, the SEC has contorted the clear language and plain meaning of the Advisers Act language which restricts broker-dealer firms and their registered representatives to advisory services which are "incidental" to the sale of a security. (Not just "incidental," by the way, but "solely" incidental. Oh, and not just "solely incidental," but also "for which no special compensation is received.") As had been pointed out in the comments submitted to the SEC, anyone with a Webster's Dictionary and a little bit of common sense can see that fee-based brokerage accounts (under which registered representatives develop financial plans and implement asset allocation strategies while receiving asset-based percentage fees on a continuous basis) fail to fit both the "solely incidental" and "no special compensation" restrictions imposed upon the advisory activities of registered representatives.

Through the adoption and promotion of the Merrill Lynch Rule, the SEC has eviscerated the importance of the protections afforded investors under the Advisers Act. The vast majority of individual investors possess no understanding of the difference between registered representatives (which tout "objective advice" through multi-million dollar advertising campaigns) and investment advisors. With the enactment of the Merrill Lynch Rule, individual investors are bound to be even more confused.

The SEC’s Own Failure to Note The Differences Between Brokerage Firms and Investment Advisors

Even in advance of final rule-making, the SEC’s own consumer publications fail to clearly set forth the different duties imposed upon registered investment advisors (the broad fiduciary duties of loyalty and due care) and registered representatives (limited duties of suitability, etc.). These publications even go so far as to state that each type of professional can render “investment advice” (without noting that in broker-dealer firms that advice can only be “solely incidental” to the sale of a product and for which “no special compensation” is to be received).

Recent Rules Acknowledge The Existence of Conflicts of Interest, But Not Prohibiting Them

Other rules have come from the SEC of late, and these rules are troubling in their lack of emphasis on the need to avoid conflicts of interest by investment advisors. For example, take the final rule adopting the requirement for compliance programs of investment advisors and investment companies. While the rule acknowledges that an investment advisor has a fiduciary duty to act in the best interests of a fund or individual investor it advises, contained within that rule are these statements: “We would expect smaller advisory firms without conflicting business interests to require much simpler policies and procedures than larger firms that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms .... [A]n advisor that is acquired by a broker-dealer or by the corporate parent of a broker-dealer should assess whether its policies and procedures are adequate to guard against the conflicts that arise when the advisor uses that broker-dealer to execute client transactions, or invests client assets in funds or other securities distributed or underwritten by the broker-dealer.” In a footnote to that final rule, the SEC went on to state, “Even small advisors may have arrangements, such as soft dollar agreements, that create conflicts. Advisors of all sizes, in designing and updating their compliance programs, must identify these arrangements and provide for the effective control of the resulting conflicts.” Interestingly enough, there is only discussion of the need to identify and manage conflicts, and little if no encouragement by the SEC for firms to avoid conflicts of interest (not even as a suggested “best practice”). The rule, by mentioning proprietary product sales and the use by an investment advisor of its associated broker-dealer firm, implicitly endorses the undertaking of such conflict of interests. Moreover, the recently enacted requirement for investment advisor firms to adopt a Code of Ethics, while requiring documentation of standards of business conduct that advisors require of their supervised persons, and stating that this “standard must reflect your fiduciary obligations,” does not even expressly mention either the avoidance of, or full disclosure of, conflicts of interest.

DOES ANYONE REALLY BELIEVE THAT THE FINANCIAL SERVICES INDUSTRY HAS HAD “SUCCESS” IN MANAGING ITS CONFLICTS OF INTEREST, CONSIDERING THE RECENT YEARS OF SCANDAL FOLLOWING SCANDAL?

Are Conflicts of Interest “Inherent” in the Financial Services Industry?

Perhaps the SEC fails to understand the true nature of a fiduciary duty. This was somewhat revealed in remarks by Stephen M. Cutler, Director of the SEC’s Division of Enforcement, on September 9, 2003 in which he stated: “Conflicts of interest are inherent in the financial services business. When you are paid to act as an intermediary, like a broker, or as another’s fiduciary, like an investment advisor, the groundwork for conflict between investment professional and customer is laid. The historical success of the financial services industry has been in properly managing these conflicts, either by eliminating them when possible, or disclosing them.” With due respect to Mr. Cutler, I would disagree that conflicts of interest are “inherent” in the financial services business. Does acting as a fiduciary to a client creates a conflict of interest between an investment professional and a customer? (No.) Does anyone really believe that the financial services industry has had “success” in managing its conflicts of interest, considering the recent years of scandal following scandal?

It Is Possible For Investment Advisors To Avoid Conflicts of Interest?

I submit that it is possible to structure investment advisory firms to avoid nearly every material conflict of interest (including the many cited by Mr. Cutler in his remarks that day). Perhaps the only conflicts of interest which remain involve the need for the (fee-only) investment advisor to receive adequate compensation. The conflict of interest involving the amount of the fee charged should be reviewed under a standard of reasonableness. Other conflicts of interest which might affect the fees charged to individual clients, such as advice relative to decisions to pay down debt, maintain margin balances, or use resources to invest in (non-managed) private equity investments, can all be adequately managed through full disclosure, frank discussion with the client and a policy of resolving issues which are “close” in favor of the course of action which does not benefit the investment advisor. The many conflicts of interest which arise from third-party fees (commissions, 12b-1 fees, hard dollar and soft dollar compensation, etc.), referral arrangements and other third party arrangements can all be handled with just three words: “Just Say No.”

Suppose the investment advisor representative works within a larger financial services firm, which possesses an underwriting division, a broker-dealer division, an insurance products division and a securities products division (i.e., the manufacture of mutual funds, hedge funds, etc.). Just like the resolution of stock analyst conflicts of interest, it would be

possible to create a Chinese wall between the investment advisor representatives and the other divisions. What if the investment advisor desires to sell the proprietary products of that financial services giant? Just say no. Want to effect trades through the broker-dealer? Just say no. Want to promote insurance products of the firm? Just say no. Want to encourage clients to invest in IPOs that the firm underwrites? Just say no. With all of the custodial and investment choices available in the world today, it is simply not rational to assert that the investment advisor "has to" be able to sell the products of his or her own firm. Avoidance of material conflicts of interest will dictate such types of restrictions be imposed upon the objective investment advisor. An investment advisor representative, even acting within a larger financial services conglomerate – if given the proper freedom to act in accordance with his or her absolute duty of loyalty to the client – can avoid material conflicts of interest.

AN INVESTMENT ADVISOR REPRESENTATIVE, EVEN ACTING WITHIN A LARGER FINANCIAL SERVICES CONGLOMERATE – IF GIVEN THE PROPER FREEDOM TO ACT IN ACCORDANCE WITH HIS OR HER ABSOLUTE DUTY OF LOYALTY TO THE CLIENT – CAN AVOID MATERIAL CONFLICTS OF INTEREST

The Investment Advisor's Duty To Avoid Conflicts of Interest

It may sound somewhat fanciful to imagine that investment advisors can operate in an environment in which the vast majority of conflicts of interest are removed. But, as the remainder of this article will address, this is precisely what the Advisers Act envisions and, in fact, mandates. The key question facing the financial services industry today, at least from the standpoint of the investor seeking objective advice, is whether investment advisors possess a duty to avoid material conflicts of interest when such is possible. Or, as set forth in recent regulations, is it permissible for an investment advisor's conflicts of interest to merely be disclosed?

SEC vs. Capital Gains

The beginning point for any examination of the true scope and intent of the Advisors Act true is the U.S. Supreme Court's landmark decision, <u>SEC vs. Capital Gains Research Bureau</u>, 375 U.S. 180 (1963). All investment advisors and securities regulators would be well served to re-read this landmark case in its entirety. Given the importance of the language of this decision, following are extensive excerpts from the Capital Gains decision: *The Public Utility Holding Company Act of 1935 "authorized and directed" the [SEC] "to make a study of the functions and activities of investment trusts and investment companies .... The report reflects the attitude – shared by investment advisors and the Commission – that investment advisors could not "completely perform their basic function – furnishing to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments – unless all conflicts of interest between the investment counsel and the client were removed." The report stressed that affiliations by investment advisors with investment bankers, or corporations might be "an impediment to a disinterested, objective, or critical attitude toward an investment by clients ...."*

This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisors and the Commission were well aware that whenever advice to a client might result in financial benefit to the advisor – other than the fee for his advice – "that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated ...." The report quoted one leading investment advisor who said that he "would put the emphasis ... on subconscious" motivation in such situations. It quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a "deliberate intent" to obtain a financial advantage but rather, the existence "subconsciously [of] a prejudice" in favor of one's own financial interests. The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon: "[An investment advisor] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect."

Other canons appended to the report announced the following guiding principles: that compensation for investment advice "should consist exclusively of direct charges to clients for services rendered," that the advisor should devote his time "exclusively to the performance" of his advisory function; that he should not "share in profits" of his clients; and that he should not "directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice." These canons were adopted "to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand ...." This study and report culminated in the preparation and introduction of the bill which, with some changes, became the Investment Advisers Act of 1940. In its "declaration of policy," the original bill stated that: *"Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission, ... it is hereby declared that the national public interest and the interest of investors are adversely affected ... when the business of investment advisors is so conducted as to defraud or mislead investors, or to enable such advisors to relieve themselves of their fiduciary obligations to their clients .... It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section ...."*

Hearings were then held before Committees of both Houses of Congress. In describing their profession, leading investment advisors emphasized their relationship of "trust and confidence" with their clients and the importance of "strict limitation of [their right] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public." The president of the Investment Counsel Association of America, the leading investment counsel association, testified that the "two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance."

Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental purposes of the legislation. The broad proscription against "any ... practice ... which operates ... as a fraud or deceit upon any client or prospective client" remained in the bill from beginning to end. And the Committee Reports indicate a desire to preserve :the personalized character of the services of investment advisors," and to eliminate conflicts of interest between the investment advisor and the clients as safeguards both to "unsophisticated investors" and to "bona fide investment counsel." The Investment Advisers Act of 1940 thus reflects a Congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a Congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment advisor – consciously or unconsciously – to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients ....

Congressional Intent to Eliminate Investment Advisor Conflicts of Interest

As stated in the SEC vs. Capital Gains decision, the Congressional committee reports accompanying the Advisers Act "indicate a desire to ... eliminate conflicts of interest between the investment advisor and clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel'." The intent of the Advisers Act was to create a new profession. The intent of the Advisers Act was to ensure that investors seeking investment advice would be counseled not by a product sales-driven mentality but rather, by completely objective, trusted investment fiduciaries.

THE INTENT OF THE ADVISERS ACT WAS TO ENSURE THAT INVESTORS SEEKING INVESTMENT ADVICE WOULD BE COUNSELED NOT BY A PRODUCT SALES-DRIVEN MENTALITY BUT RATHER, BY COMPLETELY OBJECTIVE, TRUSTED INVESTMENT FIDUCIARIES

What Is A Fiduciary?

A fiduciary has rights and powers which must be exercised for the benefit of another (i.e., a trust beneficiary or an investment client). A fiduciary has rights and powers which would normally belong to another person. The fiduciary holds those rights which he or she must exercise to the benefit of the beneficiary (i.e., investment client). A fiduciary is a person in a confidential relationship who owes a duty of trust, utmost loyalty and good faith to another. A fiduciary must not allow any conflict of interest to infect their duties towards the beneficiary and must exercise a high standard of care in protecting or promoting the interests of the beneficiary. A registered investment advisor, as a fiduciary, possesses a legal duty arises to put the client's interest above his own. As such, an investment advisor must act with a high degree of care, skill, diligence and prudence, and must act objectively on behalf of the investor client.

Can A Registered Representative Become A Fiduciary?

A registered representative is not a fiduciary if the client simply orders the registered representative to buy a certain number of shares of stock in a specified company. In such instance, the client is clearly not relying on the registered representative's professional skills and knowledge, and no fiduciary duty exists. However, if the client says that he has money to invest and asks for the registered representative to develop and implement an overall financial or investment plan for the client, the fiduciary duty clearly arises. No longer is the registered representative a mere "order-taker" and no longer is the advice "merely incidental." Despite the SEC's Proposed Rule which would greatly expand the exemption provided to registered representatives who provide "incidental advice" to clients and thereby removes fee-based brokerage accounts from the application of the Investment Advisers Act of 1940, it is clear that the registered representative has, in such instance, been placed in a position of trust and confidence and should have applied to him or her a broad fiduciary duty.

What Is A Material Conflict of Interest?

A conflict of interest generally arises when a person's or entity's duty of loyalty to another clashes with other interests of that person or entity. A material conflict of interest exists when there is any circumstance which might incline an investment advisor to not be completely objective in the rendering of advice.

The Fiduciary Duty to Eliminate Material Conflicts of Interest

Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 546

(1928), described a fiduciary's duty of loyalty as follows: "Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

As alluded to by Judge Cardoza, investment advisors are simply held to a higher standard. Adherence to this higher standard must dictate the manner in which business is developed by the investment advisor. For the investment advisory profession to advance to serve the best interests of the investment public, fiduciaries should eliminate (and not just disclose) conflicts of interest wherever possible. Only in those instances where removal of a material conflict of interest would not be possible should the investment advisor seek to fully disclose the conflict of interest. Even then, proper management of the conflict of interest should be required in order to keep the best interests of the client paramount.

FOR THE INVESTMENT ADVISORY PROFESSION TO ADVANCE TO SERVE THE BEST INTERESTS OF THE INVESTMENT PUBLIC, FIDUCIARIES SHOULD ELIMINATE (AND NOT JUST DISCLOSE) CONFLICTS OF INTEREST WHEREVER POSSIBLE

Clients Know A Fiduciary Cannot Serve Two Masters

The clear intent of the Advisers Act is to encourage investment advisors, as fiduciaries, to remove conflicts of interest which may affect their independent judgment in dealing with their clients. The existence of conflicts of interest, even when they are fully disclosed, can serve to undermine the fiduciary relationship and the relationship of trust and confidence with the client. The client instinctively knows that a fiduciary "cannot serve two masters."

Why Are Objective Advisors Sought Out?

Why do so many individual and institutional investors seek out investment advice, when there are so many "self-help" investment options are now available? It's a complicated financial world out there, with a broad array of often-confusing financial products. Added to this mix are complications brought about by various tax laws (which present opportunities which can be utilized to the best advantage of the investor as well as perils for the unwary). Also, the vast majority of investor clients do not, and cannot be expected to, understand the manner in which portfolios can be constructed to minimize various risks. And, perhaps most important, the vast majority of investors often require a guiding hand through both times of market exuberance and market turmoil, in order that long-term investment strategies not fall by the wayside as the investors deal with their complex emotions, including those of greed and fear. In other words, investors must be taught not to chase returns. A trusted, objective advisor who is educated and trained in how to provide comprehensive, holistic investment advisory and planning services and who can apply a steadying hand to help guide the investor, can add great value.

Conclusion

Those who provide investment advisory services are clearly, under the Advisers Act, and with very limited exceptions, fiduciaries to their clients. Investment advisors should seek to proactively identify and whenever possible avoid conflicts of interest. When material conflicts of interest are identified which cannot be avoided, investment advisors should affirmatively disclose the conflict of interest to the individual client (and, if it is a conflict of interest which may affect many clients, disclose it in the advisor's ADV), and then proceed to counsel the client as objectively as possible. Should the decision at the heart of the conflict of interest be a "close one," the advisor should err on the side of counseling the solution which would not benefit the advisor's pecuniary interests. As fiduciaries, investment advisors should always place the bests interests of the client first and foremost.

Through its actions and inaction, the SEC has permitted the fiduciary standard to either not be applied for the protection of investors, or (even worse) has sought to proceed down a slippery slope by encouraging firms to "manage" conflicts of interest instead of avoiding them. The SEC has refused to embrace the "big gun" it was handed by Congress for the regulation of investment advisory services (i.e., the Advisers Act) and instead, seeks to apply the "little guns" afforded to it (i.e, the Securities and Exchange Act of 1934). What would you rather have if you were a securities regulator ... a big Winchester rifle able to shoot straight at any breach of fiduciary duty, or a bunch of little pellet guns loosely aimed as breaches of far lesser duties (such as suitability)?

The SEC's actions favor only the broker-dealer industry and not the interests of the investors it was created to protect. By permitting investment advisory services to be provided other than under the protections afforded by the Advisers Act, the SEC's actions will continue to promote a scandal-ridden industry as conflicts of interest continue to exist. The capital markets will continue to suffer from a loss of investor confidence, and the SEC will continue to fail in its primary mission. All of the SEC's other actions to clean up the securities industry will mean absolutely nothing if the SEC fails to protect the investor at the point at which investment advisory services are delivered through a clear and unequivocal application of the Advisers Act.

Fortunately, although the near future appears grim, all is not lost. Despite the SEC's obstacles, in the end the investment marketplace will continue to march forward. The forces of disintermediation have long begun to affect the securities industry. For many years investors have possessed direct access to high-quality, low-cost investment products, without the need for a "full-service broker" who professes to guide the way. However, especially after the 2000-2002 period, many investors know they require a trusted guide through the maze of financial, tax, estate and asset protection issues, the ever-increasing number of investment options and the intricacies of portfolio construction in a manner which seeks to either reduce risks, increase returns, reduce taxes and costs, or all of the foregoing. Investors increasingly seek out objective, fee-only investment advisors to act as their guide and coach. As noted by several recent studies, sophisticated investors are already turning away in large numbers from the large broker-dealer firms and the many conflicts of interest they possess and toward objective, independent and trusted investment advisors. This trend is continuing to expand, as the "mass market affluent" begins to be served through new fee-only advisory firms and new fee types of arrangements (hourly fees, fixed fees, retainers and asset-based percentage fees).

What will be the result of these marketplace changes? The large, traditional Wall Street broker-dealer firms and its affiliated financial services companies of today could easily be called a dinosaur. Take heed, for the next extinction event is about to occur. Even the mighty SEC will be unable to prevent this transformation from occurring.

Will the SEC itself be caught up in this extinction event? Must the SEC be dragged toward the future of the financial services by individual investors who clamor for objective advice? Must the SEC be led by state securities regulators who proceed to enforce their own investment advisor statutes? Must the SEC again be led by N.Y. State Attorney General Elliott Spitzer, who undoubtedly will, at some time, put two-and-two together and realize that broker-dealer firms providing comprehensive investment advisory services have failed to comply with New York's own investment advisers act, while failing to disclose multiple conflicts of interest? Imagine the multi-billion dollar settlement that action could bring about!

One can only wonder what the heads of large broker-dealer firms are now thinking. Do they really desire that their registered representatives provide investment advisory services but in a manner which is not in the best interests of the investor? Do they really want their firm's opposition to the rule (through their trade group, the Securities Industry Association) to loudly proclaim for all to hear that broker-dealer firms don't desire fiduciary duties when providing investment advisory services and hence, don't really want to put customer's interest first (despite all that advertising to the contrary)? Do they really want to risk action by some future state regulator or savvy plaintiff's lawyer who will be able to hold registered representatives acting under fee-based brokerage accounts to a fiduciary duty standard under either state or federal laws, despite what the SEC might now say?

The SEC's actions with respect to the Merrill Lynch Rule will, in the end, be a futile attempt to rescue broker-dealer firms from the application of the fiduciary duty standard. The SEC's failure is one in which it denies the will of Congress as expressed in the Advisers Act. This Congressional intent was even clearly set forth in the U.S. Supreme Court's decision, SEC vs. Capital Gains. The SEC's Merrill Lynch Rule is an obstacle in the market forces which are driving investors toward truly objective advisers – those who seek to remove conflicts of interest, not just disclose them. By taking such a stand, and by its long inaction in not promoting investment advisors as a separate and distinct profession, and in not encouraging investment advisors to be conflict of interest-free fiduciaries to their clients, the SEC risks becoming both irrelevant and obsolete. ■

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