Volume 9, No. 1

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

Mixed Signals: Has The SEC Staff Interpretation Of The Merrill Lynch Rule Made Fiduciary Responsibility Irrelevant Within NASD Member Brokerage Firms?

by Stephen C. Winks

The all-important issue of what is advice, which promises to redefine the financial services industry around fiduciary principles, will be decided in the next several weeks. We have a new SEC disclosure statement required but we don't know how the industry will respond. The advancement of fiduciary responsibility all depends upon how our industry's largest firms, that support the most advisors and the vast majority of consumer assets, will respond. Will the industry's advisors be able to declare their fiduciary obligations to their clients or will they be forced to use the disclosure statement that says they are acting in a sales capacity and are not obligated to act in the consumers best interest? Historically the advisors obligation to fulfill their fiduciary responsibilities has been successfully obfuscated by Wall Street's very powerful SEC lobby, so the stakes are extremely high in advancing fiduciary counsel and the outcome is in doubt.

WILL THE SEC CLARIFY TWO STAFF INTERPRETATIONS WHICH, IF NOT RESOLVED IN THE FAVOR OF THE CONSUMER, WILL RENDER FIDUCIARY RESPONSIBILITY IRRELEVANT WITHIN NASD MEMBER BROKERAGE FIRMS?

The SEC is unique in its absolute ability to protect the best interests and the trust of the investing public. There is no other equivalently powerful advocate of the investing public's trust than the SEC. Thus if the SEC chooses not to strongly reinforce the advisor's fiduciary obligations to the consumer or if the SEC compromises the clear responsibility of the advisor to act in the consumer's best interest, fiduciary responsibility will have suffered an irreversible set back. Why would any advisor or any firm supporting advisors want to work so hard and commit the resources to do the right thing if it doesn't make any difference? As we will see, this is precisely what Wall Street would like to have occur and is precisely what Wall Street has in the works. This is history in the making. Will the industry progress or regress? Over the next several weeks the actions of the SEC and the response of the industry's NASD member brokerage firms will set in concrete the role and responsibilities of the advisor for many decades to come. The industry redefining question is whether the SEC will clarify several controversial staff interpretations which, if not resolved in favor of the consumer, will render fiduciary counsel of no substantive consequence within NASD member brokerage firms.

No one should fault the brokerage industry or its trade association, the SIA, for lobbying the SEC to explore ways to mitigate as much liability as it can. The SIA's lobbing of the SEC to seek favorable rulings or interpretations of rulings is an important part of its work. Certainly the SEC's revolving door to Wall Street has greatly empowered the brokerage industry's lobby, as it doesn't hurt if the SEC's staff sees issues from the same perspective of Wall Street. So in effect, the SEC staff's interpretation of SEC rulings almost always favors Wall Street's perspective, not the consumer's. It is understandable that the industry fears the fiduciary liability of tens of thousands of its advisors providing and being accountable for the advice they render. Yet it is from this vantage point that the SEC staff interprets SEC rulings. But because of the SEC's unique responsibility to protect the trust and the best interests of the investing public, the SEC's responsibility should be focused on Wall Street professionally managing its fiduciary obligations rather than denying them. By the SEC not being

adamant in its support of fiduciary responsibility, the brokerage industry has made it a violation of its internal compliance protocol for their advisors to acknowledge their fiduciary obligations to their clients. It is impossible for middle and upper management within NASD member brokerage firms to even suggest that supporting resources be developed in support of their advisors fulfilling their fiduciary responsibilities. This is terribly regressive thinking especially for today when the technology exists to bring fiduciary counsel within the reach of all advisors. The industry simply has not been pushed by the SEC to support fiduciary responsibility, which is the unique role and responsibility of the SEC. The public good is often co-opted in deference to the brokerage industry viewpoint/lobby, at the expense of the consumer. We are at an historic inflection point—the question is whether the investing publics best interest will be served.

We see how all this works in the attached letter from Robert Plaze of the SEC to Ira Hammerman of the SIA. We gain insight into how the brokerage industry petitions the SEC for guidance by requesting the SEC's staff interpretation of SEC rulings. In this case, the SIA is exploring ways to best minimize the impact of the Merrill Lynch Rule (Rule 202(2)(11)-1). We will see how two unvetted SEC staff interpretations have in effect nullified the gains achieved by the SEC mandated disclosure statement. These SEC staff interpretations cannot withstand the scrutiny of prudent experts if subject to comment in the public domain. Clearly the facts and the consumer's best interests will prevail if there is an opportunity for public comment on the two unvetted SEC staff opinions. Because these staff interpretations are not rules, regulations or statements of the SEC, they can be overturned. But here is the rub. There is not organized large-scale consumer/advisor advocacy group to act as a countervailing force to offset the brokerage industry in protecting the consumer's best interest and advance fiduciary counsel. Advisors within NASD member firms have been silenced because it is a violation of the internal compliance protocol of their supporting firms to advocate their fiduciary responsibilities. So does fiduciary counsel automatically loose by default? Do the tens of millions of consumers served by the 658,000 advisors working with in NASD member firms have no hope of their advisors acting in their best interests and fulfilling their fiduciary responsibilities? We are relying on the SEC to protect the consumer, but as we can see the SEC staff is not an expert in advisory services and are easily swayed by the brokerage industry point of view, especially when there is no alternative. If these two controversial SEC staff interpretations were challenged, they would be overturned without question. So it is up to us as advisors to stand up and be heard. If we don't see advisors, consumer advocacy groups and trade associations united to preserve fiduciary responsibility as a consumer protection and professional standard, then we are complicit in its demise. It should be clear to all, hanging in the balance is the relevancy of fiduciary counsel as a consumer protection and a professional standard. This is an opportunity that will not present itself again for many years to come. We must speak now or forever hold our piece.

WHY WOULD ANY ADVISOR OR FIRM SUPPORTING ADVISORS WANT TO EXPEND THE RESOURCES AND ASSUME THE ACCOUNTABILITY OF FULFILLING THEIR FIDUCIARY OBLIGATIONS, IF IT MADE NO DIFFERENCE.

The Staff Interpretation Letter

On December 16th Robert Plaze, Associate Director of the SEC, wrote Ira Hammerman, General Counsel of the SIA, a letter clarifying the Commission's April 12th Merrill Lynch ruling. In his letter Mr. Plaze advances the SEC staff interpretation of two important aspects of the Merrill Lynch Rule, which could in effect create a disincentive for the brokerage industry to acknowledge and support the fiduciary responsibilities of its advisors. Though Mr. Plaze is responding to a SIA inquiry, as he has every right to do, it is troubling that in providing his response to the SIA, he is not necessarily advancing the best interests of the consumer. The consumer is at a distinct disadvantage in such an exchange.

Many of us were heartened by the SEC's ruling of April 12th that either required advisors to declare their fiduciary status or to use a disclosure statement. It is finally going to become clear to consumers whether their advisor is acting in a fiduciary capacity or a sales capacity. There is finally a reason for Wall Street to build large-scale institutionalized support for fiduciary counsel so its advisors can acknowledge and fulfill their fiduciary obligations. It is finally possible for fiduciary counsel to be openly discussed within a NASD member brokerage firm without fear of reprisal. But, Mr. Plaze's staff interpretation of the Merrill Lynch rule may have abruptly rendered fiduciary responsibility irrelevant as a consumer protection and professional standard with in a NASD member brokerage firm.

Every major firm has used Mr. Plaze's letter to Mr. Hammerman as their rationale for backing away from acknowledging their advisors fiduciary obligations. This would be good if it meant that firms were in fact going to support fiduciary counsel but because their advisors weren't ready they needed time to build a prudent investment process that could be audited back to statute, case law and regulatory opinion letters, but that is not the case. The industry's intentions are clear. Based on Mr. Plaze's letter the industry has no reason to acknowledge or support fiduciary counsel. Fiduciary counsel has been obfuscated so it is indistinguishable from commission sales, thus rendering it irrelevant.

Yes, we still have the disclosure statement, but if brokers can literally do the same things as advisors with out having to declare fiduciary status or being held accountable, why would anyone one within a NASD member firm want to be an advisor. The SEC staff opinion completely subverts any motivation of the advisor or their supporting firm to act in the consumer's best

interests and fulfill their fiduciary obligations. This is why the SEC staff interpretations cannot stand. They are clearly not in the consumer's best interest. The SEC staff interpretation maintains that fiduciary counsel is like a hat you can put on and take off when convenient. The SEC staff also believes because financial planning has modules like retirement planning, estate planning, etc that each module is a tool and does not constitute advice or require the advisor to be held to a fiduciary standard of care. Similarly because investment management consulting is comprised of a six financial services investment process (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) the SEC staff deems each financial service to be a tool and not investment advice, which is capable of being held to a fiduciary standard. This is despite the fact that each of the six financial services adds value in and of themselves. Thus Mr. Plaze's letter takes on incredible importance in the advancement of fiduciary responsibility as it may have terminated its importance as a consumer protection for 658,000 licensed advisors who advise the vast majority of consumers. If financial planning and investment management consulting are comprised of a series of tools, and each of which is not considered advice and does not require the advisor to be held to a fiduciary standard of care, then fiduciary responsibility has in deed been rendered irrelevant. Its like an anesthesiologist not being held to a fiduciary standard of care because he didn't do the surgery. These SEC staff interpretations cannot withstand the scrutiny of prudent experts if vetted in the public domain. It is terribly important that the SEC not acquiesce to the best interests of the brokerage industry. The professional standing of all advisors, who are committed to do the right thing, is in question.

> THE SEC IS UNIQUE IN ITS ABSOLUTE ABILITY TO PROTECT THE BEST INTERESTS AND TRUST OF THE INVESTING PUBLIC. THERE IS NO OTHER EQUIVALENTLY POWERFUL ADVOCATE OF THE INVESTING PUBLIC.

Does The SEC Have Two Conflicting Voices?

Mr. Plaze makes it clear his staff's interpretation of the Merrill Lynch rule is not a rule, or regulation or a statement of the SEC. Yet this staff interpretation, which has not withstood the rigor of prudent expert scrutiny within the public domain or the official vetting by the SEC, is the basis upon which the SIA and its member brokerage firms will make decisions in support for or against acknowledging the fiduciary obligations of the industry's advisors. There are two interpretations pertaining to the SECs April12th ruling that Mr. Plaze makes which are not in the consumer's best interests, which the SIA has pursued in order to minimize the affect of the Merrill Lynch Rule. Here the brokerage industry's lobby looms large to the point of overwhelming greater good of the investing public. We all hope that preserving the trust of the investing public continues to be an important consideration in SEC's staff interpretation of the Merrill Lynch Rule. Yet even though Mr. Plaze uses the exculpatory language in his letter to the SIA that " the staff's view does not constitute a rule, regulation or statement of the SEC", the question arises if the letter was not a rule, regulation or statement of the SEC, then why is there an obligation for Mr. Plaze to comment until his staff's opinion has gone through the vetting and transparency associated with the establishment of public policy. The precedent of there even being an unvetted staff interpretation is not in the consumer's best interests. We are relying on the SEC to hold the line on Fiduciary Responsibility. The consumer's best interests have already been thwarted with in the NASD member firms because it is a violation of the internal compliance protocol of most NASD member firms for advisors to acknowledge their fiduciary obligations. Though there are many staff managers at NASD member brokerage firms who want to do the right thing and want to support their advisors in fulfilling their fiduciary responsibilities, if they were to do so they would be terminated or worse, be deemed as not being a team player (the go along to get along philosophy that inhibits innovation). We are relying on the SEC to protect the investing public because it has simply not been possible to advocate on behalf of the consumer within a NASD member firm. Thus SEC's passage of the Merrill Lynch Rule is a massive breakthrough. It actually makes it possible to discuss the advisor's fiduciary obligation within NASD member firms and to even broach the topic of the construction of the enabling resources necessary to support advisors in the fulfillment of their fiduciary obligations. Yet Mr. Plaze's staff interpretation letter has rendered much of this discussion dangerously hopeless for those working within major firms.

The SEC plays an invaluable role in advancing fiduciary principles like no other institution can and for that reason Mr. Plaze's letter to the SIA and staff interpretations cannot stand. Should there even be a SEC staff interpretation, if the SEC staff does not speak for the SEC? If letters to the SIA representing the SEC staff are allowed, creating a second independent voice of the SEC, then is this not working at cross-purposes of the SEC in protecting the best interests of the investing public? We must trust the SEC will in fact act in the consumer's best interests, as there is no one else to act in that capacity. It is very disconcerting that the SEC has more than one voice especially when that voice has the brokerage industry's best interests in mind more so than the consumer's. The vetting of the SEC's response to the SIA's inquiry should be in the public domain. Transparency is the only way to level the playing field so the consumer's best interest will always prevail. Limiting the debate to parties who have the industry's interests in mind at the expense of the consumer, is a sure way to destroy the trust

of the investing public. Transparency goes a long way in resolving very complex issues, and all advisors of good faith who wish to act in their clients best interests, must demand that Mr. Plaze's staff interpretation letter be vetted in the public domain.

Two Interpretations That Must Be Vetted

In response to the SIA's inquiry, Mr. Plaze advances the notion that financial tools which include questionnaires, financial calculators, asset allocation, cash flow analysis are not considered advice or financial planning because the breadth and scope of advisory services is not comprehensive in nature. This means that the brokerage industry can represent they offer literally everything (tools) that registered RIAs (who are held to a fiduciary standard of care) offer, but because the client chooses not to engage a service or because an advisor doesn't offer a service, the brokerage industry advisor has no fiduciary responsibility to the client. If this were vetted in the public domain it would not pass the scrutiny of prudent experts. Mr. Plaze has it backwards, any resource that takes the investment consideration beyond a transaction, which addresses and manages values like risk, return, tax efficiency, liquidity, cost structure, etc. in the context of all a clients holdings, constitutes advice. Whether the advice is comprehensive enough or not, is moot. We have a fiduciary obligation to act in our clients best interests whether we are privy to all their holdings or not, whether we have discretion or not, whether our advice is comprehensive or not, whether we are compensated by a fee or not. Who would argue this is not in the client's best interests. The fact that these points are even debatable is telling. The only thing that is not advice is a series of disjointed unrelated transactions where by definition it is not possible to add value. The debate should be on why the industry isn't developing the resources necessary to professionally manage its fiduciary obligations. The SEC staff has confused prudent process with tools. Asset allocation is an essential element of the prudent investment process based on statute, case law and regulatory opinion letters, and in fact constitutes advice on a stand-alone basis. The processes and technology exist to provide fiduciary counsel and to professionally manage any associated fiduciary liability—why isn't the SEC pressing the industry to do the right thing and support fiduciary counsel? By definition there is less liability associated with an advisor providing fiduciary counsel than commission sales.

IF THERE IS NO LARGE COUNTERVAILING FORCE TO THE BROKERAGE INDUSTRY'S LOBBY TO ADVANCE THE CONSUMER'S BEST INTERESTS, DOES FIDUCIARY COUNSEL LOOSE BY DEFAULT?

In response to the unvetted Plaze staff interpretation, some firms have already terminated their advisor's ability to use outside third party software and only allow the use of proprietary tools and resources, so, they maintain, they can verify the algorithms. The arrogance of this response is palpable. If the medical profession were run this way, each hospital would have to invent their own proprietary heart and lung machine, etc, etc. Would the medical profession ever have an edict that would dispense with all diagnostic and therapeutic resources? It makes no sense, but shows how little thought the industry has given to the support of their advisors in fulfilling their fiduciary obligations. Over the next several weeks the firms and advisors that have vision and know how will be separated from those that don't. A prudent investment process is required that can be audited against statute, case law, regulatory opinion letters and best practices, utilizing best in class web based technological solutions for maximum responsiveness and flexibility to accommodate technological innovation. Thus prudent investment process takes on extraordinary importance. For the first time in the history of the financial services industry, how the advisor conducts their business becomes important, because there is professional standing for advisors who can fulfill their fiduciary responsibilities.

In the SEC's view financial planning is a tool, to the extent it can be divided into estate planning, retirement planning etc. According to John Bell Keeble, the father of financial planning, financial planning is designed for needs based selling rather than for portfolio management and construction essential for the continuous comprehensive counsel required for fiduciary counsel. The six financial service prudent investment process that comprises investment management consulting is based on statute, case law and regulatory opinion letters and coincides perfectly with the SEC's regulatory responsibilities. Some parts of financial planning are best practices for investment management consulting while other parts; particularly its needs based selling aspects, and have no statutory basis—though they are helpful in marketing in creating the motivation to invest. The impossible challenge the SEC faces is reconciling the non-statutory aspects of financial planning with fiduciary counsel. The SEC can resolve this controversy by simply limiting its consideration to statute, case law and regulatory opinion letters, which are within its purview. To that end the Society of Fiduciary Advisors has engaged the industry's leading advisors, technical experts and scholars to define fiduciary counsel to include best practices, see SENIOR CONSULTANT, December 2005, The Society of Fiduciary Advisors Fiduciary Investment Standards Initiative Best Practices For Individual Investors. Based on this solid factual foundation citing statute, case law and regulatory opinion letters, all parties are well served and a new profession of fiduciary advisors can be built.

By the SEC staff maintaining that financial tools that take the investment consideration beyond a transaction are not advice, the brokerage industry gains a license do anything the RIA can but without entailing fiduciary responsibility or incurring fiduciary liability. This is not in

the advisor's best interest because they have to explain the difference between a tool and a financial plan, and in doing so why wouldn't everyone want a comprehensive plan entailing accountability and the fulfillment of the advisor's fiduciary obligations. This is not in the consumer's best interest because it becomes impossible for the consumer to know the difference between a broker and an advisor. Even if the consumer were very sophisticated, if the broker and RIA offered identical services, the consumer would be correct to ask what difference would it make if one were fulfilling their fiduciary responsibilities or not. Only if the SEC wishes to completely subvert fiduciary responsibility, can this unvetted staff interpretation stand. It subverts the rules, regulations and statements of the SEC, discourages the creation of large-scale institutionalized support for fiduciary counsel, cripples the industry's natural evolution to transparency, full disclosure and fiduciary counsel, and most importantly does not address why it is still a violation of the internal compliance protocol of NASD member firms for advisors to acknowledge their fiduciary obligations. The SEC's staff interpretation will not stand up to rigorous scrutiny or in any way be considered to be in the consumer's best interests.

> **THE VOICES OF THE INDUSTRY'S 568,000 LICENSED ADVISORS HAVE BEEN SILENCED AS IT IS A VIOLATION OF THE INDUSTRY'S INTERNAL COMPLIANCE PROTOCOL TO ACKNOWLEDGE THEIR FIDUCIARY OBLIGATIONS.**

In response to a second SIA inquiry, Mr. Plaze opines to the dangerous precedent that an advisor can take off or put on their fiduciary hat whenever it is convenient to do so. Mr. Plaze maintains that disclosure by a broker should be sufficient to enable the client to reasonably understand that the broker dealer/advisor is removing itself from a position of trust and confidence with the client. So if the broker has on his fiduciary hat when doing the financial plan or creating the investment policy statement, and then decides to act in a commission sales capacity to execute the plan or investment strategy, as long as it was disclosed by the broker, the SEC staff, which is charged with looking after the consumer's best interest, sees nothing wrong. It is not surprising that this is the official position maintained by Merrill Lynch and this would be the official SEC staff interpretation of the Merrill Lynch rule. Every consumer in the country would want to know why is it ever in the consumer's best interest for an advisor to act in a fiduciary capacity to create a financial plan/investment strategy and then execute the plan/strategy in a commission sales capacity.

The net effect is the SEC staff interpretation completely eviscerates any possible regulatory initiative that would hold the brokerage industry accountable to supporting their advisors fiduciary obligations. Fiduciary obligations are observed in principle in conceiving investment strategy, but in practice the advisor does not act in the clients best interest nor provides the transparency required. Does this seem right? Does this in any way protect the consumer's best interests? The opportunity to advise the consumer that the advisor is moving from a fiduciary capacity to a sales capacity leaves an interpretation hole big enough to drive a truck through. Mr. Plaze states, "A mere statement of the change in the capacity in which the firm is acting would be inadequate ordinarily to effectively alter the fundamental nature of the relationship." But the SIA could easily maintain there is no advice being offered in any event, so wouldn't the consumer be better off with a financial plan and investment policy/strategy than without it? This completely muddies the water, confuses the consumer and works against every advisor who is expending the time and resources to fulfill their fiduciary obligations. The positive is Mr. Plaze acknowledges, "A mere statement of the change in the capacity in which the firm is acting would be inadequate ordinarily to effectively alter the fundamental nature of the relationship". The negative is this unvetted staff opinion has become the basis upon which Merrill Lynch and the industry has responded to the Merrill Lynch rule. If Mr. Plaze's assessment is correct, then the SEC staff interpretation cannot stand, because a "mere statement is inadequate to fundamentally alter the relationship."

Have We Won the Ruling Only To Have It Lost To Staff Interpretation?

So, what are we to do? Must we litigate or micromanage every single move the SEC makes? Where do we get the resources to do this? The brokerage industry can outspend the unorganized RIA community 1,000,000:1. The Banking and Trust industries don't have a dog in this fight. Can we count on the SEC to act in the consumer's best interests, given the brokerage industry lobby and the SEC staff's ability to act independently of the SEC? Clearly there is good reason to believe the regulatory deck is stacked against the advisor and consumer having a voice in support of fiduciary counsel and the consumer's best interests. Even if we can influence rulings, we still have to fight how they are interpreted. This is nothing new; it has been this way for sixty-five years. What is new is that fiduciary responsibility/liability can be professionally managed to make the compliance risk of a fiduciary advisor far les than a broker engaged in commission sales. Today fiduciary counsel can easily be within the reach of every advisor and though it many not become a regulatory imperative by virtue of SEC staff interpretation, all advisors who are compelled to act in their client's best interests, can make it a professional imperative.

If Fiduciary Counsel Is Not A Regulatory Imperative It Must Become A Professional Imperative

If brokers within NASD member brokerage firms aspire for professional standing and ever hope to make fiduciary counsel a profession, the brokerage industry must act now on the behalf of their best and brightest. Based on how things stand

today by virtue of the SIA elicited SEC staff interpretation, in order for an advisor to fulfill their fiduciary obligations, they have to renounce their brokerage licenses, work outside a NASD member brokerage firm construct, so support for fiduciary counsel can be provided. The balance of power in winning client assets has clearly shifted to the RIA. We are already seeing that consumers are attracted to a conflict free business environment where advisors can and will acknowledge their fiduciary responsibilities. Charles Schwab's 3,000 RIAs in Schwab institutional (who each have $100 million or more under advisement and each have relinquished their brokerage licenses) last year garnered $44 billion in net new assets relative to Merrill's 15,000 advisors who garnered$10 billion. In fact Schwab garnered more net new assets than all the major wirehouses combined. Perhaps it is meant to be that brokers will never be able to fulfill their obligations, though it is difficult to see why this is in the broker's best interests. So if the SEC does not seek to vet its staff interpretations in the public domain, and the brokerage industry continues to fight transparency, accountability and fiduciary obligations, then it is time to give up on any pretense of sophistication and attention to the client's well being by the brokerage industry. The brokerage industry will have won the battle but lost the war. All our efforts to elevate the role and counsel of the advisor must then turn to RIAs.

If there is no clear license with in the brokerage industry to excel in the support of fiduciary counsel, it will not happen. The only venue available for fiduciary counsel to thrive is the RIA community. It is up to the SEC and the brokerage community to resolve this. If they don't, fiduciary responsibility has forever been rendered irrelevant within the brokerage industry to their peril, as the RIA community gains a significant competitive edge that will attract the industries best and brightest. It is difficult to believe the industry we all know and love could be so short sighted? Fiduciary counsel has now become a professional imperative of the RIA, and by action of the SEC staff, brokers are precluded from having a seat at the table. Be careful what you pray for, you might actually get it. ■

Notes