FPA Rises Up for Consumers…and Wins

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A Special Commentary

In a landmark 2-1 decision handed down on March 30, 2007, a panel of the U.S. Court of Appeals for the District of Columbia rejected the controversial Securities and Exchange Commission (SEC) so-called Merrill Lynch rule, which had exempted broker-dealers from complying with the Investment Advisers Act of 1940 (IAA) in connection with fee-based—as opposed to commission-only—brokerage accounts.

Read the Court's Opinion on the "Merrill Lynch" rule

The dispute has been simmering since the SEC proposed the rule in 1999. When the final rule took effect in 2005, the Financial Planning Association (FPA) challenged the SEC's authority to issue the rule, making two principal complaints:

- an uneven playing field had been created for the benefit of broker-dealers (mostly large Wall Street firms)—at the expense of Registered Investment Advisers; and
- the rule was injurious to consumers of investment advice.

Summary: Time to Lawyer Up

Delivering a victory to consumers of investment advice, the Financial Planning Association prevailed against the Securities and Exchange Commission, overturning the 2005 "Merrill Lynch rule." The rule exempted broker-dealers' fee-based accounts from the fiduciary requirements of the Investment Advisers Act.

This decision may seem like just another technicality amidst the endless regulatory structure governing financial professionals. But, every investor should put their lawyer's cap on and dive into the details of this ruling, because it impacts the most critical and basic fiduciary question: **Who's side is the advisor required to be on?**

History: Upheaval Brings Regulation

Following the 1929 stock market crash and the Depression, Congress passed the Securities Exchange Act of 1934 to govern the securities industry and the conduct of brokers and dealers. Six years later, it passed the IAA, placing further requirements on persons providing investment advice to the public:

- they must register with the SEC,
- they must be free of conflicts of interest, and
- they must conform their conduct to a fiduciary standard of care—i.e., placing their clients' interests above their own.

By contrast, broker-dealers are not required to completely disclose their conflicts of interest and are subject only to a "suitability standard" when selling investment products to their customers.

Congress created a specific broker-dealer exemption to the IAA requirements under certain circumstances—the meaning of which was the subject of the FPA challenge. Congress also established a catch-all, allowing the SEC to grant discretionary exemption to persons *not* covered by other exemptions.

The broker-dealer exemption contains a dual requirement for broker-dealers to become exempt:

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- investment advice must be "solely incidental" to the broker's basic services; *and*
- the broker must not receive "special compensation."

The SEC established the Merrill Lynch rule in response to industry changes during the 1980s and 1990s: the elimination of fixed commission rates, the advent of discount brokers (e.g., Fidelity and Schwab), and consumers discovering the advantages of working with a Registered Investment Advisor. To formulate the rule, the SEC determined that fee-based brokerage was "not…fundamentally different from traditional brokerage programs."

Although it acknowledged that receiving fees was indeed "special compensation" within the meaning of the Act, the SEC granted exempt status to "fee-based programs" on the condition that investors receive a specific disclosure that such accounts were not protected by the fiduciary standards of the IAA.

The Decision: Letter of the Law

The majority ruled that, because a specific exemption to the IAA fiduciary requirements for broker-dealers already existed, the SEC did not have authority to exempt broker-dealers under the catch-all. In effect, the rule "rewrite[s] the statute." (The dissenting judge disagreed.)

Further, the legislative history convinced the majority that, despite industry changes over the decades, the original dichotomy established by Congress—salesperson vs. advisor—remains a profound basis for regulatory distinction. Congress's use of the conjunctive "and" in the exemption identified for the court a clear legislative intent to require IAA compliance by brokers not charging commissions.

Due to the clarity of the broker-dealer exemption to the IAA, the majority found it unnecessary even to address the SEC's purported rationale for promulgating the rule (embraced by the dissent): discouragement of churning, recommending unsuitable securities, and aggressive marketing by broker-dealers. Moreover, this decision is consistent with a half century of SEC interpretations that brokers receiving special compensation *should* be considered investment advisors.

When I read the briefs, I couldn't figure out how the court could decide the case without coming to grips with two difficult questions:

- what, exactly, is "investment advice" in the context of a brokerage relationship, and
- under what circumstances is that advice solely incidental?

The record seemed devoid of a sufficient evidentiary basis to decide these questions. But the drafters made it easy: if the broker is receiving fees rather than commissions then, *by definition***,** the investment advice is *not* solely incidental. The majority determined that fee-based brokerage *is* fundamentally different than traditional brokerage programs.

Why Do Brokers Care?

During the "Gilded Age" of brokerage, through the late 1980s, this dichotomy was not a problem for the industry: when it cost $500 to trade a round lot, mutual funds carried an 8.5% load, and municipal

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bonds came with a 5% mark-up, only the very wealthy used brokerages. These commissions provided brokers with sufficient compensation for whatever investment advice was rendered. Further, brokerages were the only source for these transactions. At the time, modern portfolio theory was mostly an academic exercise and financial planning wasn't even in its infancy. This model may have served customers fairly well—in the case of a scrupulous firm and a client who was paying attention.

Enter discount brokerages, no-load mutual funds, and internet trading: market access became a commodity rather than a service. Sixty-seven years after the prescient IAA, the court recognized that competent and disinterested advice is the service of value and, ironically, the brokerage is incidental. By accepting the FPA's assertion that the investor public would be injured by the double standard created by the Merrill Lynch rule, the majority undermined the brokerage business model in the context of today's marketplace.

FPA: In the Ascendant

As a threshold matter, the court addressed the FPA's standing to pursue the challenge—easy to dismiss as a mere technical hurdle before the court could reach the merits. This deliberation serves as a portal into the majority's policy concerns: the importance of adhering to IAA regulation of brokers and consumer protection must have weighed heavily for them to overrule the SEC.

In addition, an organization that "exists to advance the financial planning profession"—of whose 27,000 member many are "bona fide" investment advisers competing with "advisors who do not fully disclose their conflicts of interest"—clearly impressed them.

The astonishing dearth of precedent in this field of law belies the hundreds—if not thousands—of disputes between investors and their advisors each year. Other consumer protection fields (e.g., food and drug, commerce and trade) fill legal tomes with decided cases. But, all of the significant precedents under the Advisers Act from the U.S. Courts of Appeal could fit on a cocktail napkin—*SEC vs. Capital Gains Research Bureau, Inc. (1963)* being the only significant Supreme Court case. Mandatory broker arbitration and quiet settlements by banks and trust companies have created this legal vacuum.

By propagating a profession of competent and disinterested advisors, and by bringing the suit with the support of a veritable legion of such professionals at their backs, the FPA publicly opened a window on this very important consumer and industry subject.

Wall Street's Wagons Will Circle ...but You Might Still Win

Will the SEC or the brokerage industry acquiesce to this decision? An appeal is likely. Next, Wall Street lobbyists will target Congress in the quest for big firms to provide financial advice without having to place clients' interests first. But Congress may not be so hospitable. The Pension Protection Act of 2006, passed last August, mandated a fiduciary standard for brokers providing advice to 401(k) participants. The tide may very well have permanently turned in investors' favor.

According to the Securities Industry and Financial Markets Association, the brokerage industry advocacy organization, one million fee-based brokerage accounts currently hold $300 billion in assets. Is one—or more—of those accounts yours? If so, expect changes. If this court ruling is maintained, any number of steps may be taken to bring these accounts into line—from a new credentials requirement to a change in representatives to the withdrawal of investment advice.

Regardless, all investors should take it upon themselves to understand their relationship with their advisor. Right now, the bottom line is this: if you pay commissions, your representative's allegiance is to himself and his brokerage first; if you pay fees, have your representative put in writing that she bear fiduciary responsibility.

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