

The Minnesota Investor: A ruling for the clients

A court says broker-dealers who want the same fee structure as registered investment advisers must do better at putting their customers' interests first.

Gene Walden

Last update: July 07, 2007 – 4:30 PM

In an era when the financial services industry has been accused of exploiting lax consumer protection laws to stick it to their customers, the U.S. District Court of Appeals in Washington, D.C., recently struck a rare blow for the consumer.

The court struck down the Securities and Exchange Commission's (SEC) broker-dealer exemption law -- known as the "Merrill Lynch rule" -- that gave brokers many of the same benefits of a registered investment adviser without the same obligation to serve the best interests of their clients.

"It helps clear up the muddy waters and gives the client a fair shake," contends Richard Brown, CEO of Bloomington-based JNBA Financial Advisors, which is a registered investment adviser. "Now if you're talking to a financial professional who identifies himself as an investment adviser, you'll know that that adviser is obligated to put your interests first."

The broker-dealer industry, on the other hand, argues that the Merrill Lynch rule did indeed serve the interests of consumers. The law gave brokers the opportunity to charge their clients a fee based on the amount of assets under management rather than charging a sales commission on each transaction, which tends to encourage excessive trading.

But there were two key parts to the controversial Merrill Lynch rule -- the fee structure and the fiduciary responsibility -- and it was the fiduciary responsibility part that ultimately sunk the rule.

Suitability vs. best interests

In a nutshell, securities law states that a registered adviser must, at all times, act in the best interest of his or her clients. Your registered investment adviser must be able to demonstrate that any investment he or she sells you benefits you rather than the adviser.

By contrast, the broker-dealer has no such obligation. Their sole obligation is to demonstrate that an

investment is "suitable" for the client. In other words, a broker-dealer can sell you any stock, bond, mutual fund or annuity -- as long as it fits your investment profile -- without regard to the commissions and other expenses incurred by the investor.

"The big difference," explains Spenser Segal, CEO of ActiFi Inc., a Plymouth-based consulting firm that helps advisers improve client service, "is that brokers can use any process to choose an investment as long as the investment is suitable for the client. [Registered investment advisers] must use a process to select suitable investments for their clients that an expert would deem as reasonable and in the client's best interest."

Given a choice between a no-load mutual fund and a similar fund with a high front-end commission, for instance, a broker-dealer is allowed to sell you the high-commission fund to bolster his bottom line even though it is not in your best interest. A registered investment adviser has an obligation, by law, to put your interests first and sell you the investment products that make the most sense for you.

"When we buy a mutual fund for our clients," says Brown, "we buy it at net asset value -- no load -- and in some cases we are able to do it without transaction fees. The only way to be on the same side of the table as your client is to be compensated by a percent of assets under management rather than by sales commissions. Under that arrangement, if their portfolio goes up, so does our compensation. So there's no conflict of interest. What's in the client's best interest is also in our best interest."

It's that exact argument, however, that proponents of the broker-dealer exemption use to justify the rule. It allows broker-dealers to charge fees based on assets under management (sometimes referred to as a "wrap fee") rather than product commissions -- just as the registered investment advisers do. If the client's portfolio goes up in value, so does the broker's compensation. Brokers no longer have to push products to earn a reasonable return from their clients.

Show me the bill

The problem with the rule, however, is that not only does it exempt brokers from fiduciary responsibilities, it also exempts them from disclosing all of their sources of income. Registered investment advisers must disclose all compensation they receive from investments they choose for their clients. Broker-dealers have no such responsibility. If they earn a markup on a bond that their firm has in inventory or a spread on a stock that their firm makes a market in, they are not obligated to disclose those extra earnings to you.

The new ruling stipulates that brokers can no longer represent themselves as "advisers" and charge a wrap fee unless they either register as a registered investment adviser or become an investment advisory representative under their firm's registered-investment-adviser mantle. That change would subject them to the same fiduciary obligations as other fee-based advisers.

Although the SEC did not appeal the ruling, the broker-dealer industry may not go down without a fight.

Brokerage firms such as Merrill Lynch and Smith Barney have an estimated 1 million fee-based brokerage customers with about \$300 billion in assets that may have to be converted back to commission-based accounts under the new rule. That promises to be a logistical nightmare.

"These firms are going directly to Congress to try to get new legislation to override the Investment Act of 1940," Segal says. "Their hope is to bring back their ability to offer their clients fee-based advisory accounts without the fiduciary responsibility."

© 2007 Star Tribune. All rights reserved.