

Fiduciary versus suitability

– the debate continues

Fiduciary versus suitability obligations have been at the center of a long, controversial debate between the investment adviser and broker-dealer communities. The issue was central to the March 30 decision by the DC Circuit Court of Appeals to vacate the Securities and Exchange Commission's adoption of rule 202(a)(11) under the Investment Advisers Act of 1940. This rule is known colloquially as the Merrill Rule because of the significant offering of these accounts by the brokerage firm Merrill Lynch. It exempted broker-dealers offering certain fee based advisory and brokerage services from the definition of investment adviser, and therefore from regulation under the Advisers Act.

Since the SEC's initial rule proposal in 1999, financial planners have argued that brokers have been allowed to offer essentially the same services, including financial planning and advice, without adhering to the strict fiduciary standard that governs investment advisers under the Advisers Act.

Opposing parties

The Financial Planning Association, an industry trade group representing the interests of the financial planning community, has been challenging the Merrill Rule since its adoption. The FPA's biggest opposition in this spirited dispute has come from the Securities Industry and Financial Markets Association, an organization that represents some of Wall Street's largest broker-dealers. SIFMA suffered a substantial setback in early May when the SEC elected not to appeal the Circuit Court's decision to vacate or to request a new hearing concerning the court's decision. SIFMA and its members, including a number of broker-dealers

that had been conducting activities pursuant to the Merrill Rule, were left scrambling to make operational and compliance changes in order to bring their business operations into compliance with the scheduled effective date of the court's ruling. In deference to these issues, the SEC applied for, and received, a stay of the court's order until October 1.

Immediate effects

The vacating of the Merrill Rule resulted in the need for broker-dealers to review more than one million fee based brokerage accounts, representing approximately \$300bn in assets, to determine their future status (brokerage or investment advisory). Broker-dealers vis-à-vis their customers were presented with two options:

- change the method of fee payment to transaction-based compensation and continue to service the account as a brokerage account (e.g., a traditional, full-service brokerage account that charges standard commission and other transaction fees); or
- change the status of the account to an investment advisory account serviced through an investment adviser and continue to charge asset-based or flat fees.

To effect these changes, broker-dealers were required to obtain affirmative, written consent from all client accounts affected by the rule implementation prior to any account transition.

One of the most significant regulatory issues that has been identified in the switch from brokerage accounts to advisory accounts is related to principal transactions. These transactions take place when an adviser buys from/sells to a client a security in to/out of its own inventory (or that of an affiliate). Investment advisers generally are prohibited from engaging in principal transactions unless they provide written disclosure and obtain consent from their client before settlement of each such transaction. Due to the impracticality

of obtaining consent from the newly converted advisory accounts, the SEC adopted temporary rule 206(3)-3T under the Advisers Act on September 19.

This rule provides relief to an investment adviser that is registered as a broker-dealer and provides non-discretionary advisory services. Investment advisers may only rely on the rule after they have provided written disclosure and secured the client's written revocable overall consent. For every principal transaction, the adviser must inform the client verbally or in writing of its capacity in acting as a principal and obtain the client's consent, also verbally or in writing. The client also must receive a confirmation of the transaction disclosing that the adviser has acted as principal and that the client authorized the transaction. Finally, the adviser must provide to the client an annual report itemizing all the principal transactions that took place within the past year.

Advisers should note the limitations contained in this rule. First, the rule may only be relied on for principal transactions in non-discretionary advisory accounts. Second, the rule prohibits principal transactions involving any securities (except for investment-grade bonds) issued or underwritten by the adviser or an affiliated broker-dealer. Most importantly, the rule contains a sunset provision that will cause it to expire on December 31, 2009.

Controversy

Confusion over the concept of fiduciary and suitability among the investing public has been a major hurdle for most broker-dealers and their customers. Investors want a clear explanation of the difference, and financial professionals have turned to the regulators for definitive answers. Unfortunately, a clear, definitive explanation has not been rendered to date and, further confusing the situation, investment adviser and brokerage professionals

have been debating their duties in public.

Fiduciary duty generally is considered to be the highest legal duty that one party can have to another. According to the Investment Adviser Association's definition found in its standards of practice:

As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser's fiduciary duty depend on the scope of the advisory relationship and generally include:

- the duty at all times to place the interests of clients first;
- the duty to have a reasonable basis for its investment advice;
- the duty to seek best execution for client securities transactions where the adviser directs such transactions;
- the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines and restrictions;
- the duty to treat clients fairly;
- the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and
- the duty to respect the confidentiality of client information.

NASD rule 2310 alternatively discusses the suitability requirements that must be followed by a registered representative as they relate to a recommendation or a particular transaction. Once applied, the suitability obligation generally ceases within the same timeline of the transaction itself.



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Another distinguishing characteristic is that an adviser is primarily held to the fiduciary obligations outlined in the anti-fraud provisions of the Advisers Act, while brokers are required to comply with various self regulatory organization rules and interpretations.

Although an adviser's duties are much broader than those of a broker, regulatory agencies have implied that both fiduciary and suitability obligations apply to all market participants. This was evident in a speech by Doug Shulman, vice chairman of the Financial Industry Regulatory Authority, at the 16th Annual FINRA Spring Securities Conference. Shulman stated:

“As investors turn to financial professionals to help them manage their assets, they often do not know the difference between insurance and securities products, or fiduciary duties versus suitability obligations. They just want someone they can trust to help them put their money to work so they can meet their financial and life goals.”

Shulman's comments clearly show that regulatory agencies consider it the responsibility of securities professionals to properly educate and disclose to investors overall account and service characteristics. Investors primarily put their faith and trust in their investment professionals regardless of title or industry-defined obligations. Most investors would like to believe this standard is the one their investment representatives abide by.

Can financial professionals fulfill their obligations to investor protection and market integrity without considering both fiduciary and suitability standards in their actions? FINRA arbitration statistics would indicate the answer is no. The majority of arbitration claims have addressed some aspect of the suitability standard. Since 2005, there has been a total of 12,832 arbitration cases filed, and two of the issues most consistently arbitrated over are breach of fiduciary duty and unsuitability. These statistics indicate that the financial industry

faces a challenge in trying to define the overall differences between fiduciary and suitability obligations for investors.

While the opposing sides in this debate do not agree on most issues, most market participants would concur that the suitability obligations of brokers and advisers are similar, yet the sources of the standards are different. Although the scope of duties may differ slightly, the suitability of recommendations remains a common characteristic.

Debate conclusion?

With the Merrill Rule officially dead and temporary rule 206(3)-3T firmly in place, is the debate finally over? The answer to this question lies primarily in the hands of the SEC. Industry participants remain confused about the definitions and limitation of the fiduciary and suitability standards. This has caused the SEC to recognize the need to complete a study analyzing the ways broker-dealers and investment advisers operate and their effects on investors. The report, which is being prepared by the Rand Corp, is expected to be issued in December and could result in a fundamental restructuring of the regulations governing investment advisers and broker-dealers. In the end, investment advisers and broker-dealers could operate under a single regulatory scheme and a defined universal duty of care for all investors.

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