

Financial Planning

Failed Experiment at the SEC

By [Bob Veres](#) August 18, 2014, 3:09 p.m. EDT 6 Min Read

I've been indulging my guilty pleasure lately by reading about the SECs complicated history with the fiduciary standard. Ron Rhoades of Alfred State College (and chairman of the Committee for the Fiduciary Standard) and W. Scott Simon, author of *The Prudent Investor Act: A Guide to Understanding*, have been blogging about this extensively, but here's the CliffsNotes version: When the SEC was created, there was no question that the intent was to separate brokers and stock touts from honest advisors in the nations regulatory scheme.

In case this was unclear, the SECs Seventh Annual Report, issued in 1941, stated that if the transaction is in reality an arm's length transaction between the securities house and its customer, then the securities house is not subject to fiduciary duty. However, the necessity for a transaction to be really at arm's length in order to escape fiduciary obligations has been well stated by the U.S. Court of Appeals. ... He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector.

(I'm guessing there weren't many women brokers back then.)

The commission clarified the point in a 1963 SEC study, writing that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists.

The SEC further suggested that such a relationship might apply at broker-dealers, whose advertising may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisors. ... Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the later, the salesman is, in effect, an investment advisor, the commission concluded.

Of course, the current reality is completely different.

TV ads tout how brokerage firms can give you the financial wherewithal to meet your goals, and brokers call themselves financial advisors on their business cards. The whole conversation is about trust; the worst insult to a broker these days is calling him a sales agent or asset gatherer.

And yet the SEC doesn't require employees of the wirehouse firms to register as RIAs and doesn't hold them to a fiduciary standard.

FAR AFIELD

How did we stray this far from the original regulatory framework?

To me, the genie started climbing out of the bottle in 1995, when the SEC chairman, Arthur Levitt, prodded the securities industry to go back to the drawing board and decide how the brokerage industry should ideally interface with its customers.

The resulting Tully Commission, chaired by Merrill Lynch CEO Daniel Tully, included Warren Buffett, Thomas OHara of the National Association of Investors, Legg Mason CEO Raymond Mason and Samuel Hayes of Harvard.

The commission's report discussed the conflicts of interest inherent in compensation and issued some startling recommendations. It called for an end to commission structures that favored in-house over nonproprietary products, a prohibition of sales contests, and a separation between reps and the sale of inventory out of the brokerage firm's own investment account.

Ideally, it said, brokers would be compensated based on client assets. Later, it recommended that registered reps be provided with, and trained in, financial planning tools.

I wondered at the time whether, if the recommendations were followed, most registered reps would be required to register as RIAs so I asked a senior staff person at the SEC about the study.

The plan, the staffer said (on background), was to allow the brokerage firms to follow the evolutionary course outlined in the Tully report, away from commissions toward fees, away from proprietary product sales toward financial planning but without imposing a lot of additional (read: fiduciary or registration-related) requirements on them.

Eventually, he told me, as the evolution played out, the brokerage firms would see no reason not to register just as the independent B-D reps were voluntarily registering.

It was obvious that this person was talking about a staff consensus that had been reached. He seemed to believe that he and his cohorts would be remembered for having encouraged a consumer-friendly revolution in the general wirehouse culture.

Since then, however, we have witnessed scandal after scandal, from the brazen cooperation between stock analysts and their IPO departments to price-fixing the LIBOR rates, the Orange County derivatives scandal, Fabulous Fab's sales of shady CDOs and the near-collapse of the global financial structure. There have been a staggering 89,440 FINRA arbitration cases since 1999.

So it seems that the brokerage industry took full advantage of what the SEC saw as temporary leniency, and now aims to make it permanent.

FAILED IDEALISM

What's the point here? In all the talk about imposing a fiduciary standard on the brokerage industry, an important point has been lost.

I think it's time we stopped talking about forcing the brokerage industry to live under a fiduciary standard. Instead let's revisit that odd deviation from the SEC's clear initial mandate and policy. It's long past time to declare the SEC's experiment a failure and to recognize that this (perhaps noble, certainly idealistic) effort to reform the Wall Street culture is clearly not bearing the fruits that were intended.

The SEC can then declare that the brokers who want to remain brokers, and clearly maintain that arms length relationship with their customers, are not required to register as RIAs and, in fact, are not even invited to. Meanwhile, those brokers however many or few who hold themselves out as financial advisors, planners, consultants or trusted confidants should be taken at their word and welcomed into the fold of RIAs, which is just as the SEC, Congress and the law of the land intended. As they seek a position of trust and ask clients to rely on their best advice, they and they alone in the brokerage world will be held to the same fiduciary principles as all RIAs.

ACTION REQUIRED

The best part about this simple course of action is that SEC Chairwoman Mary Jo White can make it happen without an act of Congress just as the SEC staff created the deviation from established policy without congressional oversight or approval. She has ample precedent in the 1940 Act itself and in the SEC's own reports and, of course, in the 2007 D.C. Circuit Court ruling that found the SEC should not, under the 1940 Act, exempt brokers who manage fee-based brokerage accounts from having to register as RIAs.

All White would have to say is that anybody affiliated with any firm Wall Street or otherwise who claims to be an advisor and gives personal advice and asks for trust from the customer is an RIA and should register as such.

I believe White well understands the issues involved. Unlike her immediate predecessors, she isn't a shill for the brokerage world; and she knows her job is to protect consumers, not the industries that serve them.

The problem is that lobbyists, Wall Street, lawmakers and the emergent fiduciary nation are all bombarding her with complicated proposals. She will be remembered, for good or ill, for how she resolves the fiduciary/RIA mess she inherited, which has been festering since the 1990s.

As I see it, she has three choices. She can give in to the brokerage lobbyists and harmonize the RIA regulations with FINRA sales regulations. She can kick the can down the road to her successors. Or she can declare an end to the SEC's experiment with allowing Wall Street to evolve a fiduciary mindset, and take us back to those pre-scandal days when the SEC followed and enforced the law of the land.

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