Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

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Consumers Union
Publisher of Consumer Reports

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Consumer Groups Express Support for FPA Petition to Rescind Illegal Broker Exemption from the Investment Advisers Act

SEC Rule Deprives Investors of Important Protections

The Consumer Federation of America, Fund Democracy, Consumer Action, and Consumers Union strongly support the Financial Planning Association's lawsuit challenging the Securities and Exchange Commission's proposed rule expanding the broker-dealer exclusion from the Investment Advisers Act.

The Investment Advisers Act exempts brokers, but only to the extent that they limit themselves to giving advice that is "solely incidental" to effecting transactions in securities and do not charge "special compensation" for that advice. For years, the SEC has effectively removed the "solely incidental" standard, by allowing brokers to hold themselves out to the public as advisers and offer extensive advisory services without being subject to the fiduciary duty and disclosure requirements of the Advisers Act. The 1999 rule being challenged by FPA goes a step further by removing the "special compensation" test for non-discretionary, fee-based accounts.

"The SEC has given brokers a wholesale exemption from the Advisers Act that Congress never intended," said Barbara Roper, CFA's director of investor protection. "The recent mutual fund scandals provide ample evidence of the enormous gap between the advisory image brokers promote and the seamy reality of their conduct. This is the predictable result of allowing advisory services to be offered under a sales-oriented standard of conduct.

"It is long past time for the SEC to withdraw this ill-conceived rule and require brokers to either abide by the standards appropriate to an advisory relationship or stop misrepresenting their services to the public," Roper added. "We are hopeful that the FPA lawsuit will spur the agency to respond appropriately. Only then will investors receive the assurance they deserve that all those offering investment advice to the public are subject to the same rules."

When it issued its rule "proposal," the Commission agreed that, pending final adoption, it would not recommend an enforcement action against a broker for conduct that complies with the proposed rule but that would otherwise be in violation of the Advisers Act. This situation persists to this day, despite the hundreds of letters opposing the rule received by the Commission.[1] By

[1] See, e.g., Letter from Barbara Roper, Director of Investor Protection, Consumer

leaving this highly controversial rule proposal in effect for nearly five years without taking formal action, the SEC has violated procedural rules by effectively adopting the rule without an opportunity for comment.

"The SEC's non-enforcement position violates fundamental rulemaking procedures, and the broker exemption is an abuse of the SEC's authority," said Mercer Bullard, president and founder of Fund Democracy and a securities law professor at the University of Mississippi School of Law. "It is disheartening that the SEC still supports exempting brokers from their fiduciary duties in the wake of years of unrelenting scandals in the financial services industry."

"Investors expect the SEC to protect their interests," said Sally Greenberg, senior counsel with Consumers Union. "The SEC's actions – exempting brokers from being held to fiduciary standards when they advise clients on investments – represent a retreat from the Commission's mandate to protect the investing public."

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Federation of America, David G. Tittsworth, Executive Director, Investment Counsel Association of America, Mercer Bullard, President and Founder, Fund Democracy, Duane Thompson, Director of Government Relations, Financial Planning Association, Michael Herndon, Director, Public & Government Affairs, CFP Board, Susan M. John, CFP, Government Affairs Liaison, National Association of Personal Financial Advisers to the Honorable William Donaldson, Chairman, Securities and Exchange Commission (May 6, 2003).

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Facts About the SEC Rule Proposal Expanding the Broker Exemption from the Investment Advisers Act

The broker-dealer exclusion from the Advisers Act is based on a two-prong test. To rely on the exclusion, the broker must only give advice that is "solely incidental" to the broker's primary business of effecting transactions in securities. Even then, if the broker charges "special compensation" for that advice, he or she is to be considered an adviser as well as a broker. The Advisers Act offers several additional important investor protections that are appropriate to the advisory role. These include a fiduciary duty to place the client's interests ahead of their own – a much higher standard than the suitability standard that governs brokers' sales recommendations – and a duty to provide full disclosure regarding their services, their compensation, and any conflicts of interest that may bias their recommendations.

The SEC rule proposal, which removes the special compensation test for certain accounts, is in conflict with the law it is intended to implement. It deprives investors who rely on the "advice" offered by brokers of important protections. And the process which has allowed it to be in effect for almost five years without formal Commission action is unacceptable and cannot be allowed to continue.

The proposed rule is in conflict with the law.

The proposed rule allows brokers who receive special fee-based compensation for advice to nonetheless claim the exclusion, as long as they limit themselves to solely incidental advice, the account is not a discretionary account, and the account is identified as a brokerage account. This is in direct conflict with the statutory language, which clearly specifies that receipt of special compensation for advice is intended to subject the broker to the requirements of the Advisers Act.

The proposed rule is harmful to investors.

Brokerage firms that rely on the broker-dealer exclusion routinely use titles for their salespeople, such as financial consultant or financial adviser, designed to portray them as advisers. They market their firms generally, and their fee-based accounts in particular, as if advice were the primary service they had to offer. As a result, financial professionals who are subject to two different legal standards offering two very different levels of investor protection are rendered indistinguishable to the consumers who must choose between them.

In engaging in these practices, brokers are, of necessity, guilty of one of two abuses. Either they are actively misrepresenting the services they offer, or they have long since ceased to limit themselves to the type of advice a reasonable person would consider to be "solely incidental" to the business of effecting securities transaction. If the latter is the case, then they clearly do not

qualify for the broker-dealer exclusion, regardless of whether they earn special compensation for advice.

The recent mutual fund sales practice scandals tend to support the first interpretation, that brokers are misrepresenting their services as advice-driven.[2] In actuality, however, many brokers may be guilty of both abuses – offering advice that is more than solely incidental to securities transactions, but hiding the degree to which their recommendations are driven by concerns other than the interests of the client. Instead of solving this problem, the proposed rule makes it worse, by allowing brokers to charge a fee that in some instances they describe as a fee for advice and still escape the fiduciary duty and disclosure obligations that come with regulation under the Advisers Act.

The process which has allowed the proposed rule to take effect without formal Commission action is unacceptable.

When the SEC proposed the rule, it took a "no action" position that allowed brokers to rely on the rule proposal pending final adoption. That was more than four years ago. For all that time, and despite the controversy surrounding it, the proposed rule has essentially been in effect without the Commission ever having taken the kind of formal action the Administrative Procedures Act demands when adopting rules. If rules can be put into effect without agency action, citizens are deprived of important protections guaranteeing both the transparency of the regulatory process and accountability in our government officials.

We are hopeful that the FPA lawsuit will spur the SEC to act. However, simply adopting this deeply flawed rule proposal in order to resolve the procedural issues would not satisfy our concerns. To be acceptable to investors, any resolution must ensure that those brokers who operate exclusively under a sales standard cannot portray themselves to the public as advisers, and, conversely, that those brokers who operate as advisers, or portray themselves as such, must comply with the standards appropriate to that role. Nothing less will ensure that investors are not misled about the services they are receiving from their financial professionals.

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[2] See, e.g., Morgan Stanley DW Inc., Securities and Exchange Act Rel. No. 48789 (Nov. 17, 2003) available at http://www.sec.gov/litigation/admin/33-8339.htm.