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Round Table: Regulation - Round-Table discussion transcript

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The following is an edited transcript of the round-table discussion.

Ms. Hansard: According to the Rand report, "the financial service industry is at a crossroads regarding its regulatory and legal status." Where would everyone like to see the regulations for broker-dealers and investment advisers head next?

Mr. Thompson: Functional regulation is the way to go. That's what Congress endorsed about eight years ago when it looked at the restrictions on consolidating services under one umbrella. They said, "That's OK, but we also recognize the need to have separate regulators for different functional activities." That's also true in the securities industry.

Vincent Ricardel

Duane Thompson, David Strege: *Favor fiduciary standards for all advisers.*

You see the blurring in activities because you see registered representatives recognizing that advice is really the premium service being offered and migrating over to advisory platforms. Then suddenly, you have the Investment Advisers Act [of 1940] coming into prominence be-cause people are demanding competent, ethical advice.

It's not so much that we have to muddy the water and look at re-structuring the way that financial services representatives are regulated, but to look at improving the protection for consumers under the Advisers Act.

Mr. Hammerman: One of my take-aways from the Rand study is that 75% of all customers, whether they are customers of investment-adviser-only firms or broker-dealer firms, are very satisfied with the services that they are receiving. That 75% approval rating is fantastic regardless of which side of the debate you are on. So my first way of approaching this topic is a little bit like the doctrine of: "Do no harm." Can there be improvements? Yes, but it's not as broken as some might suggest.

The [Securities and Exchange Commission] should consider improvements to disclosure. We can't discount a comment in the Rand study that people don't read disclosures. We collectively need to put our heads together and come up with the best and brightest, clearest way to get the disclosure that in-vestors understand. One way to preserve choice is to also improve the disclosure so people have a clear understanding of what services they are getting, whether you are going for insurance products, investment adviser products or brokerage products.

Mr. Rhoades: Back in the days of 1940, there were stocks and bonds and a few mutual funds. Nowadays, not only do we have a massive amount of financial products but all types of fees and costs often hidden within them. We are also struggling with consumers who are just mystified by complex tax planning and retirement planning. On top of that, we are seeing the demise of the pension plan. The world is much more complex, and the responsibilities shifted on to individual investors at the same time are much more burdensome.

In reaction to this huge demand for advice, registered representatives have desired to enter into the advice business, which I think is a good thing. We need more people who are both qualified to act as advisers and actually give advice. But what I don't like is the fact that they give advice without being held to the same standard of conduct. I would characterize the SEC reaction to this as ineffective. They have allowed the use of titles like financial consultant and financial adviser by registered representatives who are not subject to the Advisers Act requirements.

Is disclosure adequate to solve that? The Rand study confirmed that consumers don't read disclosures, and even when they read them, they don't understand them. Not that we shouldn't try to educate. We should. But we have tried it for decades now, and it is just not coming to fruition.

The answer is to protect consumers by applying that fiduciary standard of conduct, to always put the client's best interest first and foremost. That to me is the answer for the dilemma facing individual investors today. To that degree, I would say the Rand report confirms that we need trusted advisers. We need the Advisers Act, and we ought to apply it a lot more broadly.

Mr. Bellaire: It is strange to expect investors to understand arcane legal definitions and their application to the service that they receive. Do I think we could improve their understanding through some disclosure? I do. Much of the disclosure, though, that I have seen, tends to exalt the role of investment advisers while really insulting brokers that provide services to investors.

As I read the Rand report, I was struck by the investors who concluded that in the real world, the various standards would not differ much in practical application. I think that's in large part true. Unfortunately, I have had to participate in an arbitration hearing or two. I have never seen one in which the plaintiff's attorney didn't reference the obligation of a fiduciary within their claim. I think the common law in nearly every state requires a broker to live up to the fiduciary standard.

Anyone that seriously is committed to this business provides the ongoing support and service that they would expect their own family members to get. They want that referral business. They want to build the business through developing a reputation for professionalism. As a result, I think that most of them are living up to a very high standard. The report also notes that investors see benefits to both working with registered reps without large ac-count minimums and so on, and working with investment advisers. So having that choice is essential. We should draw the line a little bit clearer through some disclosure that makes sense.

MISSING SAFEGUARDS

One aspect about working with an adviser that I think needs to be brought to the forefront is, advisers hire their own compliance people. In the retail world, that often means a small adviser hiring a young person who has minimal experience to serve in the role of the compliance person. In the broker-dealer world, you get experienced people evidencing certain basic knowledge. They have a "reputational" and financial commitment to doing good work in the compliance field. The registered reps' advertising, correspondence and trading is reviewed on a regular basis. Annual audits are performed. But in the investment adviser world, all those safeguards that I just described are largely missing.

So I think that what it comes down to is the moral compass of the individual involved in providing the service, much less than their registration status. So when I hear the adviser exalted and on this high moral plain, I really have a problem with that. There is a flip side to that, which is that the suitability standard is backed up by a heck of a lot of compliance work, policies and procedures that just don't exist on the investment adviser side of the ledger.

Mr. Strege: The whole purpose of the financial services profession is to help individuals with proper financial management of their resources so they can meet life goals. One of the things that concerned me in the Rand report is that well over a third of those surveyed and responding said they would never use an adviser. If I remember correctly, 20% said, "I just plan to do it myself." What I have observed is a lot of consumers' just having apathy. They really don't care. Part of that is because of the confusion that comes from so much complexity in financial services. And it is going to continue to get more complex.

Consumers are relying on trust. We must have regulation in place that imposes action against professionals when they violate that trust, so that the consumer has confidence when they go to the professional. If they don't have that confidence, they are not going to seek the advice. They are going to try to do it themselves, and they will learn through trial and error, which is a very expensive proposition. The Certified Financial Planner Board [of Standards Inc. of Washington] is requiring all CFP professionals as of July 1 of this year to put the client's interest before his or her own. That's a critical step.

Vincent Ricardel

Karen Tyler, President, NASAA: *The work of the industry has never been as important as it is today, whether it is the broker-dealer community or the investment adviser community."*

Ms. Tyler: With respect to regulatory change, our perspective is based on three threshold matters. First of all, the work of the industry has never been as important as it is today, whether it is the broker-dealer community or the investment adviser community. No. 2, I don't think investors have ever had as much at stake as they have today, with all of the challenges that are faced in achieving financial security. And No. 3, the responsibility of regulators to ensure that investors are protected has never been greater than it is today, primarily because so many people are turning to our capital markets to achieve financial security.

So we are very concerned about all of this pressure coming in to the idea that there needs to be regulatory change. We want to ensure that the protection of the small investor remains the centerpiece of the U.S. regulatory structure. I'm starting to sense that in this debate about broker-dealers' acting as investment advisers, that the focus is shifting away from the protection of in-vestors and more toward business model evolution. The Rand report perhaps inadvertently has facilitated this shift. Its opening line was about broker-dealers and investment advisers, their business models and whether or not investors understand the differences.

When we think about what was originally mandated by [former SEC] Chairman [William H.] Donaldson in 2005, that wasn't the question that was being asked. The focus was intended to be the differences in protections afforded by the [Securities and Exchange Act of 1934] and the Investment Advisers Act, and: What do we need to do to fill the gap? In looking at what came out of the Rand report, that is not what we have. So we are very concerned that there has been a shifting focus, and from our perspective, we need to shift back to maintaining investment protection as a centerpiece of this regulatory structure.

Ms. Hansard: Should there simply be a fiduciary standard for everybody in the business of giving advice? Are there any drawbacks to going that way?

Mr. Hammerman: The fiduciary-duty standard is not contained in the Investment Advisers Act per se. We are talking about 12 double-sided pages, and it does not have the words "fiduciary duty" in it. To get to fiduciary duty, you have to get to a Supreme Court case. "Fiduciary" is a wonderful word, but I have a hard time clearly explaining to a customer what it means. It will mean different things depending on which state law you are talking about.

I would have a much easier time describing to a customer what suitability means, and as [the Financial Industry Regulatory Authority Inc. of New York and Washington] has it in their rule book, 23.10, the requirement that each recommendation made to a customer take into ac-count the customer's understanding and risk tolerance. While I can certainly see the attraction of saying fiduciary is the way to go and everybody should be subject to the same standard, I think that is a bit too simplistic and doesn't reflect the complexity of the investing world.

Investors come in different shapes, sizes and needs. You have an investor that comes to you with a highly concentrated stock position. They have worked for a particular company for many years, and 30% or 40% of their net worth is tied up in that company's stock, and they know it and like it. That notion might be entirely inconsistent with the fiduciary-duty standard, which would require diversification.

FIRE OR NEGOTIATE?

So then you are going to run into the problem of either the fiduciary having to fire the client, basically saying, "I'm sorry, I can't manage your money, because you refuse to diversify," which I think is the prudent thing to do, or you are going to have to negotiate one-on-one contracts with every customer on what is covered by the relationship and what is not.

Any of the big firms that are the household names are already registered as investment advisers and as broker-dealers. For some of their business, where it is warranted, they are investment advisers subject to a fiduciary-duty standard. In other cases, like my example with the concentrated stock position, that's probably more appropriately maintained in a traditional brokerage account. So I think it is too much of a challenge and not really the right fit to say in every situation fiduciary duty is the way to go.

Mr. Thompson: The elephant in the room here is liability by clearly adhering to a fiduciary standard. It is clearly a higher standard. It creates more liability for the firm and more protections for the customer. You have to make that choice. If you want to stay on the brokerage rules and act under suitability standards, that's OK, as long as the consumer clearly understands the capacity you are acting under. But changing the titles from the '80s and the '90s, of "account representative" and such, to "financial adviser," which implies a duty of care and trust, changes the whole thing. The customers don't really understand or care to understand the nuances between the different laws. What they want is someone they can trust to give them objective advice. If one thing came out of the Rand report that was crystal clear, [it is that] they want to have uniform standards of accountability for their advisers.

Mr. Rhoades: [The National Association of Personal Financial Advisors, based in Arlington Heights, Ill.] has always expressed the view that consumers should have choices. What we have seen, however, is the SEC ignoring the words "solely incidental."

"Incidental" in the dictionary means minor, minor advice. "Solely" was a direct point of emphasis in that broker-dealer exclusion. Perhaps that translates to extremely minor advice being given. But the Advisers Act is not just the sole source of the imposition of fiduciary duties. In fact, it perhaps sets a floor, not a ceiling, for the fiduciary duties that are imposed on those who are in relationships based upon trust and confidence.

There is a large body of state common law that has developed, and new cases are coming out every year. The [Western Reserve Life Assurance Co. of Ohio vs.] Graben case of 2007 is just one indication that under state common law, the courts are going to find fiduciary duties exist, regardless of whether the SEC declares that a fiduciary duty exists.

One of the big dangers in the regulatory environment is that the commission tries to provide exceptions, either through regulation or by going to Congress, on what is not subject to the Advisers Act, when in fact state common law will be quite different. Trying to figure out exactly what standard they should be held to at all times is really going to put those involved in the securities industry in a real dilemma.

If you think about fiduciary duty, it is the high standard in the law. The fiduciary standard of conduct being the highest standard of conduct under the law is the ultimate in principles-based regulation. That doesn't mean we shouldn't have more specific regulation. I agree that fiduciary duty should be perhaps more carefully

defined and illustrated, but I can explain it quite simply. It is the duty to act with due care in utmost good faith and also in the best interests of the client under the duty of loyalty. That's very broadly accepted by all the courts and all the states.

TIME CONSUMING

And last, to go back to a point made about the compliance aspects of investment advisory firms, I am the chief compliance officer of a small investment advisory firm. We have only four advisers in our firm, a total staff of about nine. I spend a tremendous amount of time on compliance activities in our firm. As a compliance officer, my reputation is at stake, and I'm financially at risk as well.

Broader regulation in the broker-dealer community exists because they are involved in so many different things. As an adviser, we em-brace that fiduciary principle at all times. Essentially that fiduciary duty is explainable. It is a high standard that consumers can understand, and it acts in the best interest of the client.

Ms. Hansard: Some people have said that the way to go is to just have everybody who is giving advice to clients come under a fiduciary standard.

Mr. Bellaire: I'm not sure that a fiduciary standard is appropriate in all situations. I agree that the suitability standard is easy to understand. There has been a suggestion that registered reps have been trying to blur that line and look more at the advisers. There may be some truth to that.

There is also regulatory pressure to expand suitability. We have seen it expanded to a review of the share class, the pricing structure of the investment, the new Finra variable annuity rule. These are things that good registered reps have been doing for a long time. But we are seeing regulators expand that.

In a sense, we are moving toward a very similar regulatory principle and obligation. But what I'm hearing is a lot of focus on the words that define what a fiduciary is. But there's a lot more substance behind that standard of suitability. Broker-dealer registered reps need to take qualifying exams and participate in continuing education. A professional compliance staff reviews their advertising and correspondence and their trading activity on a daily basis using sophisticated tools. They perform annual audits of offices. They respond to customer complaints, research, evaluate them and report them to regulators if necessary. All that infrastructure exists to back up that suitability standard.

With due respect to a smaller shop — four financial advisers providing services, dedicating part time to compliance functions — I'm not sure that that really matches up with the infrastructure behind the broker-dealer support of that suitability standard. If we want to disclose to clients the differences in the standards, we should also disclose some of the differences that exist in that regulatory structure that back them up and provide substance to them.

MANY DEFINITIONS

Mr. Strege: When the CFP Board of Standards looked at this as we revised our standards of professional conduct, we found many definitions of fiduciary. The concern was how that would be applied. So in our revised standards, we made sure that when there are CFP certificants providing financial planning services, that we raise that duty of care. The CFP rules of conduct define fiduciary as "one who acts with utmost good faith in a manner he or she reasonably believes to be in the best interests of the client."

Vincent Ricardel

David Strege, Chairman, CFP Board: *"When the CFP Board of Standards looked at this as we revised our standards of professional conduct, we found many definitions of fiduciary."*

The issue going forward is defining some of these words. What is financial planning? That's going to come from case law as there are violations of CFP certificants that get re-viewed. The next one is "reasonably believes." You talk about suitability being well-defined, but we don't have enough case history. It is going to be a review of cases over time that is going to determine that. And then the last statement, "best interest of the client." That is going to be defined and that will take education over time. That's the challenge.

Ms. Tyler: We think the in-terest of the client must come first at all times. This is not just isolated to the securities arena. I believe this for the banking arena, the insurance arena and the securities arena, because every financial services professional today is representing to that client across the desk, "I can take care of you and every financial need that you have."

The biggest firms, the biggest dual registrants, thus far have had perhaps the biggest concerns about fiduciary duty — and it is understandable — the concern about principal trading. But ironically, we are talking about a body of law that is designed to protect the small retail investor — in-vest-ors that the big dual-registered firms don't want to do business with anyway. We understand the concerns of the large firms. But should we be altering a body of law that is designed to protect a client that the large firms aren't pursuing?

Ms. Hansard: Do you think that the bigger firms don't really want the smaller clients? The other issue is fees. The Rand study noted customers wanted lower ac-count minimums, which you tend to get perhaps more with a brokerage account.

Vincent Ricardel

Ira Hammerman, Senior managing director and general counsel, SIFMA: *"The reluctance is not in putting the client's interest first. The reluctance is that 'fiduciary' is a loaded word."*

Mr. Hammerman: Whether you are on the broker-dealer side or investment adviser side, you will have some business decisions as to what type of client you want. Even if you are a four-person investment adviser shop, you may have a million-dollar account minimum be-cause you have made the de-cision that that's the efficient way to run your business.

The broker-dealer firms that I'm familiar with firmly believe and have as the core principal of doing business that their clients' interests come first. I don't know of any brokerage firm that stays in business if they are not putting their clients' interests first. So I don't think the advisers have a monopoly on putting the clients' interests first.

Mr. Rhoades: If brokerage firms have embraced putting the clients' best interests first, why don't they just go ahead and agree to a fiduciary duty for the registered representatives providing advice?

Mr. Hammerman: I gave one example earlier in the case of concentrated positions. I could probably take you through six or seven examples of how business has been conducted over the years that might be construed as inconsistent with the fiduciary duty yet consistent with providing good client service, whether that is letting your client trade on margin or letting your client engage in unsolicited transactions based on something they heard at their country club. So the reluctance is not in putting the client's interest first. The reluctance is that "fiduciary" is a loaded word. There is a lot of case law behind the notion of fiduciary. If fiduciary was applied to every broker-dealer, how would you handle these six or seven different examples which are legitimate daily occurrences for the clients that our members have?

Mr. Rhoades: Certainly there is a cost to firms of adopting the fiduciary standard. To comply with the duty of due care requires a higher degree of education. If you are going to give advice of a financial nature, it almost always in-volves some form of tax advice as well. So there is a lot of knowledge that is required and, to some degree, experience as well.

Perhaps the focus shouldn't be so much on the cost to firms of imposing a fiduciary standard, but the cost to investors. When we have a client from a full-service brokerage environment and we analyze their current portfolio, 90% to 95% of the time we explain the fees and costs they are paying and uncover all of the hidden

costs of the investments. We look into the soft-dollar payments, the brokerage commissions, market-impact costs, transaction costs and opportunity costs associated with investing.

Seventy-five percent of clients are satisfied, according to the Rand report, with their advisers. I think it is because they don't know any better. When we tell people about all these fees and costs — typically the person coming into our firm is paying somewhere between 2.5% to 3.5% in total fees and costs — we are able to reduce those costs significantly, often 30% to 70%. That's true for a lot of investment advisers who adhere to the precept that the fiduciary standard ought to be embraced fairly firmly.

LIABILITY ISSUE

Is there a liability issue of adopting the fiduciary standard? Certainly there is. There is a very interesting comment letter filed in connection with the fee-based brokerage ac-counts rule, and it was done by an insurance firm that was underwriting both broker-dealers and investment advisers. When they started to underwrite investment advisers after working with broker-dealers and the registered representatives for a long time, they suspected that they would see a lot more liability, both in terms of the number of claims and also the severity of claims because there was a higher standard of conduct. In reality, what they saw was the exact opposite — fewer claims per firm and claims of less severity.

They attributed it to the fact that there was a fiduciary standard of conduct to put the best interests first and that the advisers understood what that was, not this nebulous suitability concept, which may go to investment risk but perhaps it doesn't go to taxes. Ninety-nine percent of the portfolios that we take in from new clients are not structured tax efficiently when they are dealing with brokers.

Mr. Bellaire: What would be the cost of imposing Finra-like compliance obligations on investment adviser firms? That is as legitimate a question as asking the contrary of imposing this fiduciary standard. I have seen many registered reps decide to drop their securities licenses to become investment advisers only, and oftentimes the explanation provided is that they want to get out from underneath the supervision of their broker-dealer firm. I see that far more often than I see investment advisers coming back to broker-dealers and saying, "The compliance obligations of an adviser were just too much for me to handle."

Also I have seen many registered reps who have gotten into regulatory trouble, who have dropped their securities licenses and become investment advisers, and operated for years under that regulatory structure without any hassles from a broker-dealer overseeing their activity. I have also seen registered reps who decide they wanted to annuitize their practice.

They don't seek to change the way they do business in a significant way, but rather get paid on a steady basis by moving to an investment adviser structure — under-trading accounts to keep their costs down and continuing to receive an ongoing stream of income. If we are going to talk about changing the obligations of broker-dealer firms and their registered reps, we should also talk about imposing similar compliance standards on investment advisers.

BLURRING ROLES

Mr. Thompson: That gets back to the basic question about the blurring of roles of advisers and brokers. There is this suggestion out there that they are doing both. But you are not seeing investment advisers moving over to the brokerage side, as you just mentioned. If anything, you are seeing the brokerage reps and the firms moving over to advisory platforms. The Investment Advisers Act over the last 65-plus years has seen little in the way of major scandals or problems

compared to some of the systemic probes that we have seen on the brokerage side. Suggesting that advisers should have the same regulation as brokers does not make sense to me.

Mr. Bellaire: There are a number of reasons for that. One is that investment advisers are a far more fragmentary group of people. When you put 10,000 reps under one broker-dealer's name and you find bad activity, it is going to be reported as underneath the name. Meanwhile, if there is trouble with a local investment adviser, that's a local story only. It doesn't get wide play, and it takes a lot more to uncover those issues when you have thousands of firms scattered about.

Two, I think we have seen a lot of registered reps move toward the investment adviser area over the years. There is a movement to make that business more of a retail business in small communities. So I'm not so sure that we have seen the impact of that. In my experience, the regulatory problems trail these trends rather than occurring as they are going on. So I'm not so sure that we won't see an increase in these issues as time goes on. The question is still open as to whether investment advisers just operate by virtue of registration status in a far more ethical manner.

Mr. Thompson: I'm not suggesting that the majority of registered representatives don't act in an ethical manner. The fact of the matter is, you have two different legal standards under which they operate. The problem with trying to compare apples to apples is that you have a [self-regulatory organization], obviously Finra, regulating brokerage firms. When they see some violations, they may not take the same kind of enforcement actions as the SEC. So it is very difficult to determine which one works better by looking at enforcement cases. As good as the Rand study was in setting some base lines, it certainly is incomplete in looking at the overall regulatory picture. It would behoove all of us to look at how effective enforcement activities are on both sides.

Ms. Tyler: A lot of those individuals who are giving up their Series 7 licensing and becoming registered as IAs are doing so under the misapprehension that they can somehow escape state regulation as well. They are doing it so that they can sell a particular product without being tagged as acting as an unregistered investment adviser, specifically — and this is coming out of our enforcement data — individuals who are making recommendations to liquidate securities portfolios so that they can fund the purchase of an equity-indexed annuity. This is a growing trend.

Investment adviser practitioners and associations need to focus in on this. Regulators need to focus in on this because it is a gross perversion of the IA model and of the fiduciary concept. The other friction you have here is between securities regulators and insurance regulators because the equity index annuity has not been clearly defined as a security, though it should be. And you have a jurisdictional issue. Can the securities regulators take action on these cases where you have the sale of what up to this point has been deemed an insurance product? That's one of the reasons we are seeing some changes in licensing status, and for the wrong reasons.

Mr. Strege: The Rand study doesn't really go into how common it is that principal trades are going to consumers. They talk about all these other cross-affiliations, but they didn't dig in to and really explain the compensation methods, the cross-fees, the flow of dollars. The concern is that if clients don't understand how much they are paying for services, how can they recognize and distinguish conflicts of interest? The CFP Board of Standards is trying to help that consumer understand. That's a challenge because the consumers don't read the disclosure reports. But at least they ought to be able to know what they are paying and how they are paying it.

Mr. Hammerman: We have two choices. We can start to license consumers and make them take a test before we allow them to invest or let's work on disclosure and find the way. We have all been there, whether it is when you buy your car, go to the doctor, or go to the ski slope. People are throwing something in front of you, and you don't read it. Let's come up with a way where you give them a one-pager that they have to read, they have to sign, that spells out these sorts of issues, whether you are the insurance person, the broker-dealer or the investment adviser.

Mr. Rhoades: Let me illustrate why that doesn't work. Various academic studies have shown that once you establish a relationship of trust and confidence, you can put anything in front of that person and they will sign it. NAPFA supports enhancing disclosure and simplifying it to a certain degree. You can't simplify it down to one page, be-cause it is a very complex world out there. Disclosure does not work to protect the interest of consumers alone.

FIDUCIARY MODEL

That's why you need to embrace the fiduciary model. To get back to this transition of broker-dealers and registered representatives to investment advisers, there is another reason for it. Basically, a lot of people are attracted to that model. NAPFA in particular has experienced tre-mendous growth, in part because it has a platform that enables registered representatives to be trained on how to become only advisers.

The people who moved in that transition — and I talk with them at conferences all the time — said they love it because they feel better; they like going to work. They are no longer selling a product to a client. They feel like they are representing the client's best interest and they are not subject to 300 or 400 rules. Rather, they are subject to a regulation that says you focus on doing the best for your clients. To a degree, it is escaping regulations. To a large degree, it is because the registered reps who have made the move enjoy their life better.

Mr. Hammerman: But one of the reasons they are enjoying their life better is that they don't have an SRO with 300 or 400 rules coming in for inspections. Maybe they see the SEC, if they are an SEC-registered adviser, once every decade, plus or minus. And maybe they see a state regulator also on an infrequent basis with 10,000 or so advisers out there. I would suggest that that is also in play as to why they are so happy to go to work every day.

Mr. Rhoades: The reason you see less inspections is because there is far less risk for those firms that are practicing a low-risk model, such as a fee-only environment — far less risk to the consumer, far fewer conflicts of interest that have to be disclosed or managed. NAPFA also believes that there should be some changes to allow more-consistent inspection and enforcement. There are all types of opportunities there.

Ms. Hansard: What about the idea of bringing advisers under some sort of common SRO? And what would be the SRO?

Mr. Hammerman: I just need to clarify. SIFMA is not calling for an SRO for investment advisers; we are predicting that is something that will be on the SEC's radar screen.

Ms. Tyler: Our position really is pretty basic. If it walks like an adviser and talks like an adviser and gets paid like an adviser, there is a body of law that exists that should apply and there is a regulatory framework that exists to enforce that law. So an SRO is not necessary to make that happen.

Mr. Thompson: There are three pieces to the functional-regulation puzzle here. You have brokerage regulation of the markets and brokerage activities. You have investment advisers. And then you have financial planners. Many people treat financial planners synonymously with investment advisers because it is a core component of what they do. But it's not all they do.

It is a good, legitimate question to look at an appropriate regulatory mechanism for financial planners along professional lines such as you have for doctors and lawyers, accountants and architects, and the like. When you look at supervision, the professions don't have someone looking over their shoulder and saying, "You didn't write that prescription right." They have peer review. They have licensing boards that set qualifications and examinations, and they have ethics requirements.

That is the way the CFP Board is modeled, with the main exception being that it is a private-sector regulator, and it doesn't have any subpoena power and can't bar someone from practicing financial planning if they lose their CFP designation. When [former] SEC Chairman [Harvey L.] Pitt raised that concept back in 2003, all the different groups roundly rejected that concept as not necessary. The FPA would suggest, as we did then, that a professional regulatory-organization concept should be explored to see what the benefits would be for the public and for the professionals who call themselves financial planners.

Mr. Strege: Currently, the CFP Board is not pushing for any particular model. There are a variety of ways that it can be regulated. The discussions have to occur, and the CFP Board of Standards is willing to be part of those discussions. There has always been speculation that the CFP Board of Standards moved to Washington to set up for that. That is not the case. The CFP Board really moved to Washington to have more access to public policy. There continues to be speculation that the CFP Board is going to be an SRO. That's not the case. We determine who has the right to attain and retain the use of the certification marks in the United States. We are not a membership organization, and you have to have a membership organization in that role. So it just would not fit.

Mr. Bellaire: I don't know that an SRO is the answer. But the regulators need to be conscious of some important trends and react appropriately to them, perhaps by redirecting resources. I referenced earlier the perception of the lower regulatory burden on the investment adviser side. That is one reason we see a shift of folks from the broker-dealer community to the adviser side. We also see folks that are seeking to annuitize their practices.

But we have also seen some regulatory actions that have unintended consequences of pushing people in that direction. The review of 12(b)-1 fees, while there may be good reasons for it, causes concern in the minds of registered reps that have built practices that rely on 12(b)-1 fees. Taking that option off the table may cause some folks to consider becoming investment advisers.

We also have Finra's new variable annuity rule. Within our channel, there are a number of people that have decided to become dual registered because they have a lot of variable annuity business on the books that they continue to receive commissions on, and they want to maintain that. But they also want to be advisers. As variable annuities become far more difficult to sell and the paperwork becomes more complex, that's another unintended consequence that pushes people again to the adviser channel.

The regulators need to recognize those trends and be prepared to redirect some resources that way, because we don't have the broker-dealer compliance folks there to ferret out problems and bring them to the attention of regulators or to deal with them on the front lines. Instead, without those compliance people working to prevent and detect those violations, they have the chance of festering and growing into much larger problems.

Mr. Rhoades: I had a conversation with a Finra vice president a few months ago at a conference, and he said to me that not only had Finra considered the issue of investment adviser regulation, but they had determined the number of hours it would take for inspections and the levels they would have to staff up to provide that. As we see fewer registered representatives and fewer opportunities for Finra to inspect people as they move to investment advisers, we see Finra probably trying to protect its turf a little bit and perhaps saying something like, "Investment advisers, you need a self-regulatory organization, and we want to be it."

To me, that's a little bit disconcerting because the key word in self-regulatory organization is "self." Also, I don't think the SRO model works well for investment advisers. I don't think anyone would say Finra has done an exceptional job at regulating the broker-dealer industry with all of the scandals over the last 10 to 15 years.

Beyond that, the fiduciary standard of conduct is a professional standard of conduct, and professionals are generally regulated at the state level. At the same time, there is hesitancy in the investment advisory community in embracing state regulation, because of the tremendous cost of registering in so many different states.

Are you going to have adequate reciprocity between the states? Who is going to inspect you? All those issues have to be worked out at the state level. Even if we move to that state-based professional-regulation model, we are going to need some type of national standards board.

BEST PRACTICES

This is something I hope the CFP Board might transition into, perhaps both from the standpoint of financial planners and investment advisers. It is not just defining the standards; it is also coming up with best practices as guidance. What we don't need is 50 different state standards.

If we go to a national standard of conduct and a professional regulatory organization at the state level, and if the states can solve this problem of so many different registrations and so many different fees, then perhaps there could be some type of national fee. The state that does the regular inspections of that investment advisory firm gets the bulk of that fee, and all the other states share to some degree in the rest. Then perhaps it could work.

Ms. Hansard: Could both sides live with being fiduciaries?

Mr. Rhoades: If everybody was a fiduciary, it would be a tremendous benefit for consumers. I'm not saying everyone should be a fiduciary. Consumers should have choices. But from a consumer model, that would be just a blessed event.

But realize that I'm also talking against my own self-interest. Now that we have seen the fee-based accounts rule overturned, we are seeing a flood of registered representatives also taking on an investment adviser role, and when they are asked, "Are you a fiduciary?" they say yes. So it has made it harder for me to distinguish what I do, compared to what they do. If we go to a fiduciary model for everybody, you are opening up the floodgates even more. So from the standpoint of competitiveness, from my standpoint, it would not be good.

From the standpoint of what it means for consumers and ultimately for this country, it would be fantastic. Consumers have to save more and invest wisely and get more returns. If they don't, we will see increased burdens on our government to assist people who have not done these things. However, if we transition to a fiduciary model, and people get trusted advice and make better decisions, then that's really going to help the country in the end.

As far as the SRO goes, my main contention is, who is the "self" in a self-regulatory organization? As an investment adviser, my clients are placed with broker-dealer firms. Many of those firms sell products. Do I want to be regulated by firms that I'm doing business with? On top of that, I don't think that Finra understands the fiduciary concept well. If you go back to statements made in connection with the Merrill Lynch rule, there is a letter by [Finra chief executive Mary] Schapiro in which she said, "The implied fiduciary duty simply cannot afford retail investors with the same level of protection as the explicit regulatory standards governing the conduct or business as a broker-dealer." With respect, I completely disagree. If the standards of conduct are lower, the protections afforded to consumers are also lower. So SRO, pro, and as long as it is not Finra, I would be very happy.

Ms. Tyler: The Rand report completely omits the state-registered adviser, which is a very local business. The state regulators are much-better-positioned to provide oversight to that type of business. It is our position that we would look with great skepticism on any recommendations or changes that affected the state-registered adviser, because the state-registered adviser simply is not part of this study.

Mr. Strege: The challenge is coordination between the states.

Ms. Tyler: There has been tre-mendous evolution in uniformity between the states in regard to IA regulation. As to the fee issue, I don't see it as a big hurdle to pay $60 or $70 a year for the privilege of doing business in the state. But that is something that is open to dialogue.

Ms. Hansard: Is the new principal-trade rule one way to start rationalizing the regulations be-tween broker-dealers and investment advisers?

Mr. Hammerman: The SEC should be given some credit in taking the first step in that regard as part of the abandoning of [rule] 202(a)(11), the Merrill rule. When we discussed the hypothetical about everyone being covered by a fiduciary duty, the first thing that came to my mind was, "OK, but are you still going to apply a principal-trading restriction? And if you are, then what happens to markets where the big firms are providing a valuable service by being willing to make a market and buy and sell?"

To the extent fiduciary duty is applied to traditional brokerage activity, we have to do a more comprehensive review of the principal-trading rule and provide a proper mechanism, again with full disclosure to customers, but to move away from what is currently required in the rules, which is trade-by-trade preapproval and written consent and the like, which in these fast-moving markets is just impractical.

Mr. Thompson: There is an expectation on the brokerage side that [the] interim rule [on principal trades] will be made permanent once it expires at the end of 2009. Our expectation is that the SEC should use this valuable period to look at the effectiveness of the interim rule before rushing to judgment.

Just because this restriction was part of the law enacted in 1940 doesn't mean that the conflict of interest has gone away over that time. Self-dealing is a huge red flag for regulators. It is something that the SEC should focus on in sweeps to see how it is working, see if there is any dumping of certain bonds or stocks, or price manipulations.

Secondly, it needs to look not just at the benefit to the markets themselves but also to the public. Maybe there should be some sort of studies done to show what the benefits might be to investors in principal trading. We have a couple of years to use that time and look at it.

Mr. Rhoades: Principal trading is problematic as a fiduciary because you are taking the position that's contrary to the client. A broker-dealer or investment adviser that engages in principal trading is saying both that we represent you, the client, in connection with this purchase, but we are also setting the price for this. It is extremely difficult to set pricing in a way that is fair to the client at all times. A fiduciary cannot have two masters.

PRINCIPAL TRADING

There are other problems with principal trading. One of them relates to dumping of securities. An article came out — in fact, it was in *InvestmentNews* — a couple of months ago which reported on a large broker-dealer firm selling securities that were backed by subprime mortgages. If you are a fiduciary, you could not do that, because you know that there is a risk with these securities and you are not informing the client of that risk. So there is a real problem with dumping the securities as a fiduciary as well. It is not just a best-execution problem.

Ms. Tyler: Underneath this issue is the general issue of financial innovation controlling regulation. I don't know what the answer is for principal trading, but we have firms that have migrated into the advisory business, and now they want to be able to have it both ways. Our primary concern is what this means for the small investor, because this is a bigger issue for the bigger firms, who do not necessarily seek out the business of the small investor.

We have seen this issue of financial innovation controlling regulation in this area of broker-dealers' acting as investment advisers. We have seen it in the insurance arena whereby insurance companies are no longer just in the business of ensuring risk; they are in the business of transferring risk to their clients through the sale of investment products. But the regulatory structure governing insurance companies has not kept pace. That's a significant problem.

Another example is in the area of alternative investments whereby hedge funds and other alternatives are in the pension portfolios of Main Street investors. Clearly, the risks associated with these alternative investments were contemplated through the various definitions of the Investment Company Act [of 1940] and the Advisers Act. Now Main Street investors' exposure to these alternatives continues to grow. It is across the financial services industry where financial innovation and evolution have outpaced, and regulators have to catch up.

Ms. Hansard: What should happen next?

Mr. Hammerman: We have heard a lot about different models that exist, from the four-person, fee-only IA shop to the 15,000-person registered rep firm. Preserving that choice is an important thing to do. "Do no harm" should be the tack that the SEC takes as they continue to consider and discuss the Rand report.

At the same time, we look forward to ongoing opportunities to improve customer education, information and disclosure so that each investor is well-protected and understands the services that they are getting, and the fees and conflicts that might apply, regardless of who their financial provider is.

Mr. Rhoades: With respect to the Rand report, NAPFA posted a response which noted first that there were several errors in the report. That is an indication that the researchers who did the report did not fully understand the securities industry. Second, the SEC was really extremely limited in the questions that were addressed. For this Rand report, which contains several very important errors and also has such a narrow focus, to serve as the basis for policymaking in the future, I find very troublesome.

NAPFA has suggested two things. The first is an annual forum to explore the fiduciary standard of care, when it applies, and what it is. The second is that a congressional committee be formed to really explore the issues relating to federal and state regulation of investment advisers and broker-dealers as they affect the individual investor. That stems from the fact that the SEC has done as much as it can in the last 10 years to not apply the fiduciary standard of conduct and has indicated that they are likely to go to Congress to try to seek relief from the application of the Investment Advisers Act.

Mr. Bellaire: I agree with the investors that participated in the focus groups with Rand that in practice, there is not a lot of difference between the two standards and that the trust in their financial services provider is far more important than the registration status of the person they are working with. The whole fiduciary-versus-suitability-standard debate misses other important factors. The fiduciary standard without enforcement mechanisms rings hollow. The suitability standard, while it may be lower, is backed up by all the various policies and procedures. And as a result, it is a standard with more meat on its bones and is more vibrant than the fiduciary standard.

I would like to see improvements in disclosure to help investors understand who they are working with. Those disclosures need to be very concise to promote folks' reading them and attempting to understand them. But the disclosures need to go beyond just what the standard is and talk about some of the practical realities of the regulatory structure. With that, investors will have a full and complete picture, and be able to make decisions about who they do business with.

Mr. Strege: One of the things that concerns me about the Rand report is trying to establish policy from it — and they talk about it in the report itself on Page 71: "The limited participation greatly limits the ability to extrapolate findings." And on Page 74, they say that the broker-dealers' response was very subdued. The state-registered groups really weren't addressed. They talk about IAs, and how more than 50% of them offer financial planning, but they don't really go into that. They

didn't go into the principal trading issue in-depth. The purpose of the report was to help provide an understanding of the profession. So they really don't answer all the questions there.

Mr. Thompson: In 1999, when the SEC proposed the Merrill Lynch [& Co. Inc. of New York] rule, it characterized it as simply a re-pricing of traditional brokerage services. Then five years later, it changed its tune and said, "No, there's confusion out there with the public," and it said when they adopted this rule that financial planning is a separate and distinct profession. What it did not do was define financial planning in contrast to brokerage services. That's been the huge rub all along in this whole debate. When it came to defining what title a person could use, the SEC said if you offer financial planning services, you should be subject to Advisers Act regulation. However, calling yourself a financial adviser and a registered rep is indicative of brokerage services.

CONSUMER CONFUSION

Yet, at the same time, consumer focus groups and survey data show that consumers are confused by the titles that are used in the industry. That's one of the things it will have to resolve if it wants to eliminate some of this confusion. The best thing the SEC can do at this point is look at the consumer focus groups, and its greater mission to protect the public.

Ms. Tyler: In regard to the Rand study, we end up with a bit of a paradox. As a result of the study, the SEC is going to contemplate changes to a regulatory structure designed to protect the small investor. The changes anticipated will have a lot to do with the evolution of large firms in the advisory world, which don't necessarily want to do business with the small investor. Add to that the fact that the state-registered adviser is more likely to work with the small investor, but has been entirely excluded from the study. So state regulators would have to view with great skepticism any recommendations coming out of this process that affect state-registered advisers.

In regard to financial evolution generally, we can't lose sight of the fact that securities laws are designed to protect the small investor. We will always have some number of financial professionals who would put their own interest before that of the client to achieve personal financial gain. So it is critical that we make investor protection the centerpiece of the dialogue.

In terms of disclosure, there should be some form of it at the point of establishing a relationship, which clearly identifies who that professional is, how they are licensed, how they are regulated, how they are paid [and] what their conflicts of interest are. Because from that point forward the client simply wants to be able to trust the recommendations and the advice of that professional.