DAILY REPORT
AT ISSUE

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Wall Street wants to keep consumers in the dark

DON'T KNOW THE DIFFERENCE between financial and investment advisors? Financial firms want to keep it that way

CONSUMERS HIRE FINANCIAL professionals for their expertise and expect to receive competent advice that is in their best interest. After all, who would entrust their hard-earned nest egg to someone who is not trustworthy? Wall Street firms spend millions of advertising dollars each year enticing new customers and reaffirming for their existing customers to put complete faith and trust in their broker's investment knowledge and expertise. From a legal perspective, of course, it would logically follow that these same firms accept the fact that they are fiduciaries and always place their clients' interests first, right? Not so fast.

Until the recent passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, one of Wall Street's dirty little secrets has been that these same firms that depict their financial advisors as the equivalent of a trusted family member feverishly act behind the scenes to deny and repudiate their status as a fiduciary. Since the 1930s and 1940s, the last time there was major securities reform, Wall Street has been able to create different standards of care among financial advisors who give personalized investment advice, i.e., the suitability standard and the fiduciary standard. The suitability standard requires only that financial advisors working for Wall Street firms ("stockbrokers" or "registered representatives") recommend investments that are suitable (or reasonable under the circumstances) for its customers. On the other hand, advisors such as fee-only registered investment advisors ("investment advisors"), who generally do not work for Wall Street firms, are held to the more stringent statutory fiduciary standard imposed by the Investment Advisors Act of 1940.

Investment advisors are required to always put their clients' interests first. Investment advisors are also statutorily required to disclose all actual and potential conflicts of interest. In contrast, according to Wall Street firms, the suitability standard does not require that they or their brokers put their client's interest first, or that they provide disclosure of conflicts, even when silence could be detrimental to its clients. By being held to merely the standard of having "reasonable grounds" for a recommendation, Wall Street is given cover to argue that it need not disclose conflicts of interest; it need not reveal all compensation earned on a trade; it need not monitor a customer's portfolio after the investment is made; and that neither the Wall Street firms, nor their brokers, have the obligation to fulfill most of the other duties that would assuredly be within the scope of the obligations owed to a customer that has entrusted a fiduciary to make or assist with their investments.

The Dodd-Frank Act requires that the Securities Exchange Commission complete a study by the end of January 2011 to determine whether the fiduciary standard, which requires that clients' interest comes first, should be applied to all financial professionals providing individualized investment advice. Given their advertisements, one would expect that Wall Street firms agreeing to eliminate the weak suitability standard and accepting the more stringent fiduciary standard sounds like a no-brainer, doesn't it? Not if you are a broker with a Wall Street firm who reeks of steak and/or fried fish after peddling variable annuities or real estate partnerships at free lunch seminars. And not if you are a broker who steers clients to a costly mutual fund or proprietary investment "products" sponsored or created by the firm when a less costly alternative (that not surprisingly, would have paid the firm and the broker little or no commission) would have been just fine. From Wall Street's point of view, requiring that stockbrokers adhere to a fiduciary standard will be costly—to their own wallets and pocketbooks.

Aug. 30 was the deadline set by the SEC for comments on the proposed uniform fiduciary standard. The SEC was flooded with approximately 2,700 responses during the 30-day comment period, most of which came from financial advisors, insurance agents and their respective trade groups. They largely opposed the proposal. According to John Nester, a spokesman for the SEC, this was "a robust response."

Industry trade groups representing Wall Street firms devoted much of their commentary to arguing that a uniform fiduciary standard would unnecessarily increase compliance costs to firms and also warned that investors stand to lose if more barriers are placed upon firms when recommending that an investor purchase securities from the firms' own inventories. In layman's terms, Wall Street makes a ton of money recommending and selling not only securities that are held by the firm (a "principal trade") but also by selling proprietary investment products to consumers. The industry does not want to be forced to disclose all of the conflicts of interest readily apparent in such transactions and otherwise have the obligation to act selflessly and in the utmost good faith and fidelity to the client when making a recommendation. The industry's objections speak volumes about where they rank their clients' interests.

Lost during the "robust response" from Wall Street was the release of a survey conducted by Opinion Research Corp./Infogroup. The survey results captured the essence of why the SEC should apply the uniform fiduciary standard to all financial professionals—whether stockbrokers, insurance agents or investment advisors—who provide personalized investment advice. According to a Sept. 15 article in InvestmentNews titled "Most Investors Think Brokers Are Fiduciaries, Survey Says," among 1,319 investors it surveyed, 91 percent believe that a financial advisor and investment advisor should follow the same investor protection rules, and 96 percent favor applying those uniform rules to insurance agents as well. In addition, 97 percent said that financial professionals should put investor interests ahead of their own and disclose fees and conflicts of interest.

The study also found that more than half of investors are confused about the standards of care that different advisors must meet, and that at least 60 percent said they assume that insurance agents and stockbrokers are already held to the fiduciary duty standard. What does Wall Street expect when you consider that these same companies' market trust and reliance as the cornerstones of the customer relationship they seek to develop?

Over the years, the confusion caused by the different standards of care has been felt in the courtroom as well. Throughout the country, federal and state courts have drawn a distinction between stockbrokers and investment advisors even though both render personalized investment advice. Also, courts have been divided on the issue of whether financial advisors owe a fiduciary duty to customers of Wall Street firms. Unfortunately, a large reason for these legal inconsistencies stems from the fact that many courts accepted Wall Street's argument that the type of account (discretionary vs. nondiscretionary) was the sole determining factor in whether a fiduciary or trust relationship existed between the broker and a client. Most courts have consistently held that stockbrokers owe a fiduciary duty to a customer where the broker has discretion to make trades without asking the client's permission first (i.e., discretionary account.) Courts have been more divided on the issue of whether financial advisors owe a fiduciary duty when the advisor is required to obtain client approval before making a trade (i.e., nondiscretionary). Fortunately, Georgia courts have consistently held that the relationship between a stockbroker and client is confidential in nature and that financial advisors owe a fiduciary duty to customers even when the account is nondiscretionary. *Holmes v. Grubman*, 286 Ga. 636, 691 S.E.2d 196 (2010).

Regardless, the niceties of this legal debate are completely lost on the investing public, who view discretionary and nondiscretionary accounts as a distinction without a difference. Stockbrokers are highly motivated and actively schooled by Wall Street to cultivate their clients' trust and allegiance, and clients have powerful incentives to believe that such advisors are trustworthy and acting solely in the client's best interests. Obtaining a client's trust and confidence, and convincing the client that he or she should rely upon the investment advice given, is at the heart of the broker/client relationship. Indeed, it is hard to avoid the media onslaught from Wall Street, which actively portrays their brokers as skilled advisors competent to handle every aspect of their clients' financial life, from investments to mortgages, life insurance, long-term care, estate planning and charitable giving. If a broker fails to live up to the caricature of trusted advisor portrayed in the firm's marketing materials, the retail investor is shocked to find that their trust was misplaced, with the broker claiming in essence, that they were merely an "order taker," with nothing other than the most nominal obligation to make sure an investment recommendation was "suitable."

Hopefully, the SEC will take this opportunity to focus on what is most important—that stockbrokers owe public investors the utmost good faith and loyalty, the cornerstones of the fiduciary obligation—and apply the uniform fiduciary standard to all financial professionals who provide personalized investment advice, including those who work for Wall Street. Barbara Roper, the Consumer Federation of America's director of investor protection, recently stated, "This lack of understanding [of the differences in the standards to which brokers and investment advisors are held] is not because investors are stupid, it is because the policy itself is stupid." We could not have said it better.

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