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SEC Study Could Prompt New Fund Regulations

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A proposed SEC study of regulations and financial advisors could result in new regulations for mutual fund managers.

The SEC recently announced that it was seeking comments on a draft document that would ask consulting firms to pitch research services to the regulator. The document,[1] which is 33 pages long, says the regulator will tap a research firm to assess the impact of regulations on investors. More specifically, it says it will assess regulations of broker-dealers and registered investment advisors.

Industry observers say the study is an outgrowth of the controversial "Merrill Lynch Rule[2]," which allows registered reps to be called financial advisors. The rule has had little or no impact on the fund industry, but the proposed survey could.

The Merrill Lynch Rule was adopted despite much opposition from registered investment advisors. Many have expressed concern that the rule will blur the distinction between brokers and advisors. Brokers are compensated with sales commissions and trading commissions. Advisors, however, are compensated with an advisory fee based on assets under management.

The Merrill Lynch Rule, meanwhile, still faces opposition. The **Financial Planning Association** is moving forward with a legal complaint that maintains the SEC overstepped its authority when it adopted the rule, says Duane Thompson, director of government relations with the association.

Regarding the litigation, both the SEC and FPA have submitted legal briefs and are waiting scheduling for oral arguments, he says.

Regarding the proposed research of investors, one former SEC staffer says the study will evaluate how registered investment advisors are regulated. Those advisors include firms that manage mutual fund portfolios. Therefore, the former SEC staffer says, any new regulations for advisors that are adopted by the SEC as a result of the study also will apply to fund firms.

John Nester, an SEC spokesman, declined to speculate about the outcome of the study. He maintains the SEC is still finalizing the issues that will be researched, which makes it difficult at this point to understand the impact the study may have on fund firms.

Other SEC watchers agree with the conclusion that the study could result in a change in how investment advisors are regulated. Furthermore, the study could result in new regulations for broker-dealers and investment advisors. Those rules could then change how fund firms distribute their portfolios.

"The SEC has said it wants to harmonize different rules or regulations for investment advisors and brokers," says Jackson Galloway, senior counsel with **Goodwin Procter**. "Obviously, both of those channels are important for fund firms, so it could have a big impact on the fund industry."

Jackson Galloway
Senior Counsel

He adds that one potential regulatory change may deal with how fund firms disclose the compensation they provide to broker-dealers that pitch their products.

The study also may shed light on investors' overall confusion with the regulation of broker-dealers, registered reps and fee-based planners.

Registered reps are regulated by the NASD, he explains. In comparison, registered investment advisors fall under the authority of the SEC. The study will help assess if individual investors understand the different regulatory responsibilities of registered reps and advisors, Galloway says.

With that in mind, some SEC watchers maintain that the study may not prompt new regulations for the fund industry. The draft document appears to focus on the functions of brokers and advisors that work with individual investors, says Niels Holch, executive director of the **Coalition of Mutual Fund Investors**. He expects most of the proposed research to focus on investors' understanding of how brokers and advisors are compensated.

The FPA's Thompson says the study may shed light on the need for clearer regulations on brokers' use of proprietary mutual funds. In some cases, brokers are provided with additional incentives to push funds offered by their own firms. That can create a conflict of interest, as those funds may not always be the most appropriate for investors.

Additionally, fund shops such as Fidelity that manage portfolios of mutual funds on behalf of clients may face new regulations as a result of the study, he says.

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1. http://www.sec.gov/rules/other/2006/34-54077.pdf
2. http://www.sec.gov/rules/final/34-52407.pdf