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Proposed Fiduciary Standard Could Alter How Funds Are Sold

By Julie Goodman September 1, 2009

A new fiduciary standard for broker-dealers proposed by the Treasury Department could impact the way mutual funds are sold.

The proposal, included in the Investor Protection Act of 2009, would grant the SEC broader investor protection authority and broader power to regulate broker-dealers.

SEC chairman Mary Schapiro has said the SEC is looking closely at how to harmonize broker-dealer and investment advisor regulatory regimes, and that she backs the standard proposed by the Treasury to require the two to act only in the interest of customers when giving advice.

“It is essential that when investors receive similar services from similar financial service providers, the service providers should be subject to the same standard of conduct and regulatory requirements, regardless of the label attached to the providers,” she said, according to a transcript of recent testimony.

The Treasury proposal would allow for stronger disclosures to investors on the terms of their relationships with investment professionals.

It also would authorize the SEC to promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisors that work against investor interests.

Jeff Keil, principal member of **Keil Fiduciary Strategies**, says the fiduciary standard could be seen by some as a “knee-jerk” reaction to the market meltdown and investors who thought they were misinformed.

Niels Holch, executive director at the **Coalition of Mutual Fund Investors**, says that the sale of funds would be affected.

“You have conflicts of interest with affiliated organizations; you don’t have point-of-sale disclosure for mutual funds right now. It’s all a little opaque on what disclosures are required, or at least encouraged, before a decision is made to invest,” he says.

While disclosure improvements have been made over the years, the rules by which brokers actually communicate with their customers haven’t really changed.

But that relationship, along with how funds are sold, would change with a fiduciary standard, as it would with Rule 12b-1 reform or point-of-sale rulemaking, he says.

The hope, he says, is that investors would make better decisions than they do now with more information about the relationship between the broker and the fund or some type of affiliated organization.

SEC commissioner Luis Aguilar explained in a speech earlier this year that historically, broker-dealers who carried out transactions as directed by their clients did not offer investment advice, which is why they were excluded from the definition of an “investment advisor.”

In that context, their advisory services were “solely incidental” to their broker-dealer activities and special compensation was not received, he said, according to a transcript.

But that changed with fee-based brokerage accounts that came in the 1990s.

There has been a rise since then of broker-dealers selling programs in which they provide investment advice and receive an asset-based fee, bringing with it critics pointing to conflicts of interest, as the entity selling the security is also the one providing advice.

“As a consequence, it is hard to say that broker-dealers are not acting as investment advisors in this context,” Aguilar said.

He added that as they increasingly provide investment advice, they work outside the regulatory framework for investment advisors.

The challenge for the SEC is to regulate the two equally while recognizing their differences, he said. While the primary purpose of broker-dealers is largely to distribute and sell securities, that of investment advisors is to provide ongoing advice.

Broker-dealers say they have no fiduciary duty to customers, absent special circumstances.

Mercer Bullard, founder and president of **Fund Democracy**, disagrees that the proposed fiduciary standard will amount to anything. The language means little because it does not expressly require that the SEC impose a fiduciary duty on investors who provide investment advice.

“Instead, it gives them the leeway to pick and choose what that duty would look like... gives them the ability to pick and choose the situations in which the fiduciary duty would apply and to narrow its scope in those situations,” he says. “The act as written would accomplish nothing.”

If the commission really wanted a fiduciary duty to apply, he says, it should adopt a more reasonable interpretation of “solely incidental.” He calls the current definition “an absurdly broad interpretation.”

The act needs to state that the SEC “shall” adopt rules that say those who provide retail investment advice are subject to a fiduciary duty, which includes acting solely in the best interests of the client without regard to the broker’s financial gain.

In commentary posted on its website, law firm **Baker Hostetler** also notes that the SEC’s authority to “promulgate fiduciary duties” is discretionary, and can be declined or scaled back.

“In particular, the legislation appears aimed at compensation structures that potentially reward intermediaries for short-term gains at the expense of long-term growth,” the firm says.

One of the co-authors of that commentary, partner Marc Powers, says the creation of a fiduciary duty for broker-dealers and allowing the SEC to promulgate rules to implement that duty makes a lot of sense.

Customers of these broker-dealers already believe that they are owed a fiduciary duty, so it does make sense to bring the reality in line with their expectations, he says.

Having said that, Powers says some of his firm's clients, such as insurance company clients, are terrified that such a standard might not allow them to conduct business, either through disclosure of possible conflicts or modification of their business practices.

With several affiliated entities involved in creation through distribution of products, many products have inherent conflicts of interest that may not be adequately addressed by SEC standards through disclosure.

“From a customer point of view, it is something that makes a lot of sense and will make it easier for her to proceed successfully against her broker if he’s engaged in wrongdoing whether it’s in the arbitration forum or court,” Powers says in a written statement.

Brokerages seemed reluctant to elaborate on the proposal.

Edward Jones spokesman John Boul would not comment on how a fiduciary standard might impact the brokerage firm, saying it was too early to speculate.

Thomas Poehling, president of **Poehling Capital Management**, a registered investment advisory firm, says there may be less of an emphasis on the promotion of proprietary funds if broker-dealers or the individual companies know they are under greater scrutiny.

“Obviously, the profitability to the broker-dealers or the parent companies would go down, but they usually find a way... to recoup it some way, somehow,” he says.

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