

Money and You: Stockbrokers' legal role in giving advice is up in the air

by Lynn_O'Shaughnessy

In 1999, the Securities and Exchange Commission tossed out a proposal that anyone with just a left or right brain could have found alarming.

The SEC suggested that stockbrokers could give some financial advice to customers without having to become registered investment advisers. The SEC's proposal was puzzling because it would have helped to gut an excellent investor protection that Americans have enjoyed since World War II.

The regulatory distinctions between investment advisers and stockbrokers, which had held fast for decades, go well beyond semantics. Only registered investment advisers must act as fiduciaries, which means they must place the interests of their clients first.

Traditional stockbrokers aren't burdened by this requirement. Their first allegiance is to their employer, whether it's Merrill Lynch, Morgan Stanley, UBS or some other brokerage firm. Brokers don't have to suggest the best investments for their clients. Their recommendations must only be deemed "suitable."

Ultimately, the SEC did something even odder after it laid out its controversial plan. For years, the SEC never got around to deciding whether its proposal, which was later nicknamed the Merrill Lynch rule, should become the law of the land. You might assume that this inaction would have punctured the SEC's trial balloon. That, however, did not happen. Thanks to bureaucratic machinations in Washington, D.C., the brokerage industry was allowed to behave as if the rule had been officially approved.

Across the country, brokerage firms started launching so-called fee-based accounts that are now estimated to contain \$275 billion to \$300 billion in assets. Along with the brokerage firm rollouts came advertising blitzes aimed at investors that portrayed stockbrokers as being endowed with the gravitas of Walter Cronkite and the financial acumen of Warren Buffett. I think it's safe to say that the investors who moved their money into these fee-based accounts - there are about 1 million of them - assumed that the counseling they received was coming from bona fide investment advisers.

This charade lasted for years until the Financial Planning Association, to its credit, got fed up with brokerage firms using the loophole for a masquerade party. In 2004, the professional trade group filed one of two lawsuits to bury the stockbroker exemption.

Such groups as the Consumer Federation of America, AARP and the North American Securities Administrators Association, which represents investment regulators from all 50 states, applauded the FPA's move. In late March, the U.S. Court of Appeals ushered a jolt of sanity into the standoff by invalidating the

Merrill Lynch rule.

The court decision has inevitably led many smart people to ask this question: What's going to happen next? No one knows. The SEC may balk and try to kick this question up to the U.S. Supreme Court. Insiders are expecting that the powerful brokerage industry will try to shred the judicial decision by getting its pals in Congress to pass legislation that, at the very least, protects what has been the illogical status quo.

Without the courts or politicians intervening, these fee-based accounts will have to be treated differently. Brokerage firms could end up converting these accounts into the traditional commissioned-based model. Rather than paying a fee for services, customers would be charged through the commissions generated through mutual fund purchases, stock trades and other financial transactions.

This would not be a happy development because compensation through commissions creates worrisome conflicts of interest. To get paid, a broker must select investments that carry commissions even if they don't represent the best choices for the customer. Under this system, some brokers would also be more inclined to recommend variable annuities and equity-indexed annuities, which generate unusually large commissions, but are almost always dreadful choices. The commissioned approach can also encourage unethical brokers to churn accounts by trading stocks simply to generate new commissions.

The better solution would be for brokerage firms to tear off their Darth Vader masks and allow brokers, who desire to become fiduciaries, to do so. There are untold numbers of intelligent and conscientious brokers who are very eager to embrace the fiduciary mantle. They just need permission.

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