Collapsing the Distinction Between Broker-Dealers and Investment Advisers

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Last week's article described the regulatory philosophy popular in the United States to provide a separate regulatory structure for different business functions. This is associated with an effort to segregate businesses within the financial service industry and a theory that certain business activities should not be conducted by certain types of firms. So, banks are segregated from broker-dealers, and until relatively recently, banks were prohibited from engaging in broker-dealer activities and broker-dealers were not permitted to engage in the business of banking. This regulatory separation has been steadily eroding since its inception more than 70 years ago.

One of the regulatory structures under attack at present is the distinction between broker-dealers and investment advisers. Congress, not the SEC, created this regulatory segregation. Broker-dealers are regulated under the Securities Exchange Act of 1934, while investment advisers are regulated under the Investment Advisers Act of 1940. The SEC has been ordained by Congress to make rules, interpret and enforce both statutes.

Broker-dealer regulation is much more intense than investment adviser regulation in several areas. First, much of broker-dealer regulation has been delegated by the SEC to FINRA, a self-regulatory organization. Without going into the details of self-regulatory organizations, they primarily are a mechanism for requiring the regulated to pay for the cost of their regulation, rather than making the taxpayer pay for it. The SEC controls the rules that self-regulatory organizations make for their "members," and otherwise has a lot to say about how strictly they are enforced, without being required to use as much of its resources to accomplish this task. Second, the investment adviser rules primarily deal with disclosure, while broker-dealer regulation is focused on customer protection, which might be described as disclosure plus. Finally, customers of investment adviser cannot sue for violations of the Investment Advisers Act, while customers of broker-dealers can sue for violations of the Exchange Act.

The fact is, however, that the distinction between broker-dealers and investment advisers is not as clear as the statutory design might suggest. Managers of mutual funds and other investment companies clearly fall within the "investment adviser" category. (The management of a fund has traditionally been called "investment advice.) But, broker-dealers give advice about securities to their clients frequently. To avoid this problem, the statute provided an exemption for broker-dealers whose advice was "incidental," provided that they didn't receive a separate fee for the

advice. Broker-dealers are defined in the Exchange Act as in the business of buying and selling securities for their own account or for the account of others. But, investment advisers often maintain a "trading desk," that closely resembles the trading desk of over-the-counter dealers.

Since it is difficult to distinguish broker-dealers from investment advisers by the nature of their business, for a long time, broker-dealers were distinguished from investment advisers by the nature of the fees they charged. Broker-dealers charged commissions, or mark-ups, while investment advisers were paid based on the amount of assets under management.

The distinctions between broker-dealers and investment advisers, always a bit ephemeral, virtually disappeared with the advent of modern technology. Investment advisers could not become members of national securities exchanges, which clearly distinguished them from broker-dealers. But Instinet and other ECNs enabled investment advisers to buy and sell stock without transmitting orders to broker-dealers, making exchange membership much less important. This capacity enabled investment advisers to attract business that looked a lot like the retail accounts of broker-dealers. In response, the broker-dealer industry began to look for ways to modify their fee structure to charge asset-based fees to compete with investment advisers.

Initially, the SEC responded by trying to make some minor fixes. It commissioned a study from an industry group led by a former chairman of Merrill Lynch. The Tully Committee, in 1995, produced a study, *Report of the Committee on Compensation Practices,* which argued that the customers of full-service broker-dealers would be better off if brokerage firms charged asset-backed fees because this would eliminate the incentive for registered representatives to churn customer accounts. Supported by this Report, the SEC proposed a rule in 1999, which was adopted in 2005 after voracious comments were received from industry groups, that would allow broker-dealers to charge asset-based fees without registering as investment advisers. This rule-making was struck down by the DC Court of Appeals in 2007 as a result of a lawsuit by members of the investment adviser industry.

Most recently, the SEC hired the LRN-RAND Center for Corporate Ethics to evaluate the problem. The RAND report, which was officially published last month, determined that many investment advisers are probably conducting business that requires broker-dealer registration. The report observed that industry participants are confused about the registration requirements. And, customers cannot tell the difference. The report also contends that the business models of investment advisers and broker-dealers have merged.

Then there is the Treasury's "Blueprint for Financial Services Reform," released last week. Among other things, it proposes that investment advisers should be members of a self-regulatory organization. The easiest thing would, of course, to make them members of FINRA.

So, where is all of this headed?

My guess is that we will soon see a bill from Congress, which is chomping at the bit to respond to the current crisis in financial services, to abolish the Investment Advisers Act and require investment advisers to register as broker-dealers. As an aside, hedge funds will probably end up reporting to the Fed. I expect the investment advisory industry will be diametrically opposed to this legislation. I think it will pass.

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