Commentary: New Wine in Old Wineskins

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Originally Published in *Traders Magazine* on July 8, 2009

http://www.tradersmagazine.com/news/-103985-1.html

The Obama Administration's proposal for reform of financial services regulation, sometimes called the "White Paper," would "establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers." Some commentators have immediately concluded that the inevitable result of imposing fiduciary duties on broker-dealers would be to preclude broker-dealers from selling securities to their clients from inventory, unless the client waived the conflict. Since market makers traditionally deal with clients on a principal basis, it has been argued that the proposal would mean the end of making markets, as we know it.

These fears are based on that part of the proposal that would eliminate the exemption from investment adviser registration available to broker-dealers that provide incidental investment advice to their customers without charging a separate fee. The devil is always in the details, but it can be argued that broker-dealers cannot operate without providing investment advice from time to time. It is common, for example, for institutional investors to ask for a market maker's view on current market conditions for a particular stock, essentially to find out how the market might respond to a large order. The market maker's opinion on the softness of a market could be considered investment advice. Arguably, the Obama proposal would require all but proprietary shops to register as investment advisers.

It is also true that rules promulgated by the SEC under the Investment Advisers Act prohibit principal trades with a customer without obtaining the customer's consent prior to each trade. It is impractical to obtain consent prior to every trade. Current rules would therefore arguably eliminate market makers if they were required to register as investment advisers as the rules currently exist under the Investment Advisers Act.

It seems to me that this argument proves too much.

The White Paper points out, correctly in my view, that retail investors are often confused about the differences between investment advisers and broker-dealers. It then argues that the difference between a broker-dealer's relationship with a customer and an investment adviser's relationship is that the investment adviser is a fiduciary, while a broker-dealer's relationship is not legally a fiduciary relationship. It seems to me that the Obama Administration is as confused about the broker-dealer's relationship with its customer as the retail investor its proposal is intended to protect.

Many volumes have been written about fiduciary duty, described famously by the late Justice Cardozo as the "finest loyalty . . . not honesty alone, but the punctilio of an honor the most sensitive." More plainly stated, a fiduciary is obligated to put the beneficiary's interests ahead of its own. On numerous occasions, the SEC has found that a broker-dealer owes a fiduciary duty to its customers under certain circumstances.

To cite an example well-known to market makers, in 1988 the SEC found that E.F. Hutton owed a fiduciary duty to William Manning, a sophisticated, professional investor. In that case, Manning objected to Hutton selling Genex stock for its own account at prices equal to or higher than Manning's limit order. The SEC found that when Hutton accepted Manning's order, it became Manning's fiduciary and violated its duty by placing its own execution interests ahead of Manning's interests. Various twists on the "Manning Rule" have been a fixture in the over the counter equity markets ever since.

The Manning case tells us that there is nothing inherently problematic about a fiduciary selling securities out of inventory to its customers – market makers that accept limit orders from customers do it all the time. No fiduciary principle would have been violated if Hutton simply filled Manning's order from inventory at the limit order price. But, having accepted the customer's order without immediately filling it, Hutton was obligated to put its customer's order ahead of its own.

The common law concept of fiduciary duty evolved from the law of trusts developed in England's common law courts several centuries ago. Fiduciary duty was conceived originally as the duty of a trustee to the beneficiary of a trust. The common law did not prohibit a trustee-fiduciary from selling property owned by the trustee to the trust. It did require the trustee to prove that the beneficiary of the trust was not disadvantaged by the sale.

Fiduciary duty shows up in lots of legal doctrine. Congress famously employed the concept in the Employment Retirement Security Act of 1975 (ERISA). Pension money is required to be held in trust. The persons responsible for managing and administering this money are "fiduciaries." Under ERISA, a fiduciary is prohibited from selling property it owns to a pension trust. By prohibiting such transactions, Congress was taking the ancient fiduciary burden of proof and transforming it into a hard prohibition. The Investment Advisers Act does not go this far. Instead of a hard prohibition, the rule is one of disclosure, as is typical for the design of the federal securities laws. The investment adviser as fiduciary must disclose the transaction to its customer and obtain consent prior to engaging in the transaction.

So, merely labeling a broker-dealer a "fiduciary" doesn't accomplish much, with all due respect for Justice Cardozo. The duty may entail a prohibition on certain activities, disclosure obligations or merely an obligation of fair dealing. Broker-dealers are already under an obligation to treat their customers fairly, and in that sense, are fiduciaries.

Apart from the confusion about fiduciary duty, there is little doubt that the general public cannot discern the difference between investment advisers and broker-dealers. I would go a step farther and say that most of the financial services industry, including many employees of broker-dealers and investment advisers, has a difficult time articulating the difference.

Moreover, it is often investment advisers that are found to be engaged in activities that should only be conducted by registered broker-dealers. From time to time, I have been consulted by investment advisers that would like to arrange a trade for a commission. Sometimes, people who should know better argue that they are only acting as a "finder," because they are not really doing this as a business. They are, however, in the securities business, and arranging securities trades for a commission is an activity that can lawfully be performed only by a registered broker-dealer.

The distinction between investment adviser and broker-dealer activities, to the extent that it was ever clear, has been eroded by technology. At a minimum, it used to be true that only broker-dealers enjoyed front-row access to markets. This privileged position has been erased by the advent of electronic markets that only have seats in our imagination.

The only sensible way to regulate these activities is to bag the labels. All firms that engage in securities activities, whether through execution, advice or clearing, should register as the same sort of thing. It doesn't matter whether we call them broker-dealers, investment advisers, broker-advisers, investment dealers or something else. I would drop banks that would like to engage in securities activities into the same pot. Then, firms should be regulated according to what they do. The obligations of a firm to its customers, or even the general public, should be defined by its lines of business.

This is not a novel concept. Today, FINRA divides broker-dealers into nine lines of business. Broker-dealers are required to obtain permission to engage in any one of them. Broker-dealers that underwrite corporate securities have greater capital requirements and different compliance procedures than broker-dealers that advise clients with discretionary accounts, a business that is indistinguishable, even by securities lawyers, from investment advice.

It would be relatively simple to add an investment advisory line of business to the mix. I would argue that all that would be required is to rename the category of discretionary brokerage. If a firm engaged in providing investment advice decided to expand into underwriting, they would only need to convince FINRA that they have the capital, management capability and compliance machinery to perform that business properly.

Regulation by business activity would clear up a lot of confusion among investors, eliminate unnecessary barriers to competition and reduce transactions costs. That said, the political reality is that the public interest is antithetical to many current business models. There are plenty of firms, protected from competition by the current regulatory categories, that would prefer things gradually change until they stay the way they are.

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