The Solidarity Challenge

By David G. Tittsworth

"United we stand, divided we fall." Aesop

"Even if you're on the right track, you'll get run over if you just sit there." Will Rogers

The investment advisory profession is facing a number of serious policy issues that could dramatically alter the manner in which it is regulated and transform the high ethical standards that have been a hallmark of the profession for decades.

As the 111th Congress commenced its work in 2009, "financial services reform" was high on the priority list in the wake of the seismic changes wrought by the subprime debacle. Other developments, notably the Bernard Madoff scandal involving an alleged $50 billion Ponzi scheme, have created a perfect storm environment for consideration of unprecedented changes to the manner in which investment advisers are regulated.

Possibilities that were nearly unthinkable a short time ago are now open for active discussion and potential action.

The Case for Solidarity: What's at Stake

What should investment advisers be fighting for (or against)?

The basic elements of the legal and regulatory structure governing investment advisers have much to offer. Compared to many other laws, the statutory framework of the Investment Advisers Act is relatively simple and straightforward. Since 1996, the law has designated a single regulator – the SEC – to oversee investment advisers that manage at least $25 million is assets. If appropriately implemented, the single regulator model promotes efficiency, accountability, and subject matter expertise. The Advisers Act is principles-based. The law relies on broad anti-fraud authority rather than specific statutory requirements and prohibitions – it makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[1] The Advisers Act largely relies on full and fair disclosure to effectuate its purposes.

The following statement from former SEC Chairman Arthur Levitt summarizes the essential ingredients of the Advisers Act:

> Unlike some of the other securities laws, the Advisers Act does not contain detailed rules governing the way advisers conduct their businesses. Rather, the Act broadly prohibits fraud and holds advisers to rigorous fiduciary standards

[1] Section 206, Investment Advisers Act of 1940.

> when dealing with clients. Investment advisers have two choices under the Act. They must rid themselves of all conflicts of interest with their clients – conflicts that might influence them to act in their own best interest rather than in the best interest of their clients. Or, they must fully disclose any conflicts to clients and prospective clients.[2]

One of the central purposes of the Advisers Act is investor protection. The fact that investment advisers have a legal responsibility – a fiduciary duty – to place the interests of their clients ahead of their own interests is central to the design of ensuring that investors will be protected.

That the Advisers Act it has worked well for decades – particularly when considering the extreme diversity within the advisory profession and the dramatic changes that have taken place since its inception – is a testament to its relative simplicity and flexibility. The essential building blocks of the investment adviser law are sound – and worth fighting for.

This is not to say that investment advisers enjoy a perfect regulatory environment. During the past few years, a literal revolution in investment adviser regulation has occurred (much of it on the heels of the mutual fund "scandals" that arose in September 2003). A number of new and sweeping regulations have been adopted. As a result, the compliance burden for investment advisers has increased significantly. SEC oversight has become more aggressive. The complexity and costs of regulation have proliferated dramatically. In fact, one of the important reasons to support solidarity within the advisory profession is to advocate for appropriate and reasonable regulations. There is a compelling need for the profession to support a unified effort to engage in a dialogue with regulators and other policy makers, to develop relevant data and facts to support its positions, and to do the things that are required to be "on the record" (such as filing written comment letters on regulatory proposals).

Preserving what's good about how the advisory profession is governed – including a single regulator, anti-fraud and disclosure-based rules, and overarching fiduciary duty – will require concerted action by the advisory profession. It will not just take care of itself. Many of the basic building blocks that have served as the foundation for the advisory profession are in danger. Solidarity among investment advisers will be required to re-establish this foundation.

The Assault on the Advisers Act

Coming full circle, let's return to the current discussions in Washington, DC about changing the basic structure of how financial services firms are regulated.

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[2] Speech by SEC Chairman: Amendments to Form ADV: Opening Statement (Apr. 5, 2000). Available on the SEC web site (www.sec.gov).

In the fall of 2007, the Treasury Department requested public comment on a sweeping "regulatory review."[3] The proposal essentially asked for suggestions about how financial institutions – including banks, insurance companies, and securities firms – should be regulated. Following the formal comment period, the Department published a 218-pag document in March 2008, entitled "Blueprint for a Modernized Financial Regulatory Structure," that sets forth a number of short-term, intermediate and long-term options for improving the regulation of U.S. financial institutions.

The "intermediate-term" recommendations include a discussion pertaining to broker-dealer and investment adviser regulation. The document begins by noting that "convergence" is occurring in the securities industry and is "demonstrated by the ongoing debate regarding broker-dealer regulation and investment adviser regulation." It states that the regulations relating to broker-dealers and investment advisers originate in two distinct laws – the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 – and summarizes various characteristics of each. In outlining differences between broker-dealer and investment adviser regulation, the report explicitly recognizes the fiduciary duty owed by investment advisers:

> One critical factor that distinguishes investment advisers from broker-dealers is that investment advisers are fiduciaries, which means that they owe undivided loyalty to their customers and may not engage in any practices that conflict with their clients' interests (unless their clients have consented). Investment advisers, therefore, are generally required to take into account clients' financial resources, investment objectives, risk tolerance, and experience so as to provide their clients only with investment advice that is "suitable" for their particular needs and circumstances. Broker-dealers, which are subject to strong standards of conduct and 'suitability' requirements, generally are not fiduciaries of their clients and thus are perceived by some as having weaker obligations to customers.

The blueprint describes the "convergence" of brokerage and advisory activities that has occurred in the decades that have passed since the laws were originally enacted:

> Upon passage of the federal securities laws in the 1930s and 1940s, there was a clear difference between a broker-dealer and an investment adviser based primarily on how they were compensated. These differences have largely disappeared.

The report outlines the growth of fee-based brokerage accounts that prompted the SEC to commence a rulemaking in 1999 that "would have exempted a broker-dealer from registering as an investment adviser if the broker-dealer was not exercising investment discretion over the account, the investment advice was solely incidental to the brokerage services, and the broker-dealer disclosed to its clients the accounts were brokerage accounts." It goes on to outline the tortured history of the SEC rulemaking and the court decision, delivered March 30, 2007, that ultimately vacated the final rule adopted by the

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[3] Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions, TREAS-DO-2007-0018 (Oct. 11, 2007).

SEC in 2005. The narrative portion of the report ends with a description of the 2008 RAND report which found that investors often are unable to distinguish between broker-dealers and investment advisers and "fail to understand the differences in the standards of care of broker-dealers and investment advisers…"

The blueprint then sets forth the following recommendations:

> Treasury notes the rapid and continued convergence of the services provided by broker-dealers and investment advisers and the resulting regulatory confusion due to a statutory regime reflecting the brokerage and investment advisory industries of decades ago. An objective of this report is to identify regulatory coverage gaps and inefficiencies. This is one such situation in which the U.S. regulatory system has failed to adjust to market developments, leading to investor confusion. Accordingly, Treasury recommends statutory changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors. In that vein, Treasury also believes that self-regulation of the investment advisory industry should enhance investor protection and be more cost-effective than direct SEC regulation. Thus, in effectuating this statutory harmonization, Treasury recommends that investment advisers be subject to a self-regulatory regime similar to that of broker-dealers.[4]

Since the blueprint's publication, Treasury officials have confirmed that FINRA – the self-regulatory organization (SRO) formed by the merger of the NASD and the regulatory and enforcement arms of the New York Stock Exchange in 2007 – would be the SRO for investment advisers.[5] FINRA currently serves as the SRO for broker-dealers. Ironically, FINRA was the only entity that filed comments with Treasury indicating that a SRO for investment advisers should be considered (the Investment Adviser Association argued against the SRO in its comment letter).

The Treasury recommendations are an example of how rational public policy can be turned upside down. The Treasury report actually does a credible job of stating the facts. It is true that broker and adviser services have "converged" as an increasing number of brokers have migrated toward the advice model (due in large measure to the fact that the traditional commission model for equity trades has been transformed with the advent of electronic trading). It is true that investors are confused and have difficulty understanding the differences between brokers, investment advisers, financial planners, and others who provide some form of investment advice. But why should those facts translate to the "need" for an investment adviser SRO? If anything, it is more logical to conclude that those who provide investment advice (or market themselves as such) should be subject to the blanket fiduciary duty under the Investment Advisers Act. It is more logical to conclude that the principles-based structure of the Advisers Act should apply consistently to anyone who provides investment advisory services. It is more logical to conclude that the SEC should continue to be the regulator for investment

[4] The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008), at 125-126.

[5] *"Blueprint for change – or not."* Financial Times (May 5, 2008), at 15.

advisers, rather than FINRA, the self-regulatory organization that oversees broker-dealers.

Similarly, FINRA has used the Bernard Madoff scandal to argue for an extension of its jurisdiction over investment advisers. At the January 27, 2009 hearing before the Senate Bank Committee, Columbia Law Professor John Coffee noted that he could "see no reason that FINRA (or at that time the NASD) should have abstained from examining and monitoring the advisory side of Madoff Securities." Other legal experts and practitioners have confirmed this view. Nonetheless, FINRA has consistently stated that it had no authority to inspect the advisory activities of Madoff's firm. Instead, FINRA has used the scandal to argue that Congressional action is needed to fill the "regulatory gap" between brokerage and advisory activities by extending broker-dealer rules to investment advisers and subjecting investment advisers to "FINRA-type" oversight. FINRA's recommendation to "harmonize" broker and adviser regulation and oversight could eviscerate or water down fiduciary, disclosure, and other important requirements of the Advisers Act, such as eliminating provisions of the law that restrict investment advisers from self-dealing by trading to or from their own accounts with clients (referred to as principal trading).

These examples should serve as a wake-up call for the investment advisory profession. They represent the compelling need for investment advisers to come together to deal with potential issues that would affect the basics of how the profession is regulated and the standards that govern the profession.

If the advisory profession cares about the outcome, concerted and collective advocacy action is required to educate members of Congress and their staffs about relevant issues. Typical Congressional advocacy activities can involve a wide range of activities, including writing letters and meeting with elected officials, analyzing proposed legislation, providing testimony to Congressional committees, making political contributions, and communicating with executive branch officials and other appropriate agencies (such as the SEC).

Whether it is called advocacy or government relations or lobbying, exercising our First Amendment right to petition the government requires time, resources, and organization. Effective advocacy means supporting an organized effort designed specifically for the purpose of representing the interests of investment advisers. One hires an investment adviser when one needs advice about investments. Similarly, investment advisers need to hire professionals when legislative and regulatory issues are being debated and resolved. And, as with investments, a longer time horizon is much better than a short one. Running up to plead one's case on Capitol Hill or the SEC only when "nuclear" issues are being considered is generally less effective than establishing long-term working relationships designed to promote a better understanding of the profession and its issues.

The solidarity challenge is alive and well. Where do you stand?

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