Regulation of Financial Intermediaries

Barbara Roper
Consumer Federation of America

Background

The vast majority of those who invest in the securities markets outside a workplace retirement plan do so with the assistance of a financial intermediary—a broker, financial planner, or investment adviser. Moreover, investors typically rely heavily on the recommendations they receive from such financial intermediaries, doing little if any additional research to determine the appropriateness of the recommended investments. This makes the selection of a financial intermediary the most important investment decision most investors will ever make.

The law treats brokers and investment advisers differently. Reflecting the relationship of trust they have with clients, investment advisers are required to act in their clients' best interests, must disclose material information about their business, and are prohibited from engaging in certain practices, such as principal trading, that create a significant conflict of interest. Brokers are held to a lower standard appropriate to a sales relationship. They are required to make suitable recommendations but are not required either to provide the same types of pre-engagement disclosures that advisers must provide or to avoid conflicts of interest. Financial planners, who typically both provide investment advice and sell financial products to implement their recommendations, are subject to regulation both as investment advisers and, when they sell securities, as registered representatives of a broker-dealer.

The Problem

Over the years, the lines between brokers and investment advisers have become blurred. Not only has the financial planning profession grown up as a hybrid of these two traditional functions, but brokers have increasingly come to resemble the advisers with whom they compete for clients. Specifically, brokerage firms typically call their sales reps financial advisers, they offer extensive investment planning services, and they market their services based on the advice offered. Although this clearly constitutes conduct that Congress intended to regulate under the Investment Advisers Act, the Securities and Exchange Commission has over several decades permitted brokers to conduct this transformation without subjecting them to regulation as advisers. At each point when the SEC was forced to choose between protecting investors and protecting the broker-dealer business model, it has chosen to protect the industry at investors' expense. As a result, investors are left unable to distinguish a securities salesperson from an adviser and to make an informed selection based on that knowledge, and those who invest through brokers are led to believe they are in a relationship of trust without receiving the legal protections that such a relationship implies.

The Solution

Brokers who either portray themselves as advisers or offer advisory services should be subject to the same standards that govern other advisers. Specifically, they should be subject to a fiduciary duty that requires them to act in their customers' best interests. Moreover, this must be a full-fledged fiduciary duty, not a version that has been watered down to accommodate the broker-dealer business model. It must apply throughout the relationship, for example, not just during the advice-giving stage. It must include an obligation to mitigate conflicts of interest, not just disclose them, and where the conflict is extreme to refrain from activities that are inconsistent with a relationship of trust. To the degree that advisers engage in conduct that is more appropriately regulated under the broker-dealer regulations, they too should be regulated accordingly.

To assist investors in making an informed selection among different types of financial intermediaries and different types of investment services, all such intermediaries should be required to provide pre-engagement, plain English disclosure that covers the key factors most relevant to such a selection. These would include, for example, the nature of services to be provided, the method of compensation, the nature and degree of any conflicts of interest, the legal obligation owed to the client, and the intermediary's disciplinary record. Investment advisers and financial planners are already required to provide such information, though not in a form that is succinct and readable. That requirement should be applied to all financial intermediaries in a user-friendly manner.

Compensation practices in the securities industry are rife with conflicts of interest. Investors are harmed when money that could have gone toward their investments is funneled off to pay high fees or when they are pushed into products that are not ideally suited to their needs but which pay generous compensation to the salesperson. A fiduciary duty should help to curtail such practices if it is adequately enforced. However, broader reform of compensation practices is needed to reduce incentives for financial intermediaries to act in ways that conflict with the interests of their customers. In addition, to assist investors in making informed decisions about the investment products they purchase, they should receive clear disclosures about the key features of those products—including costs, conflicts, and risks—in advance of the sale, preferably when the investment is recommended to them.

Brokers and investment advisers are subject to different regulatory regimes. Investment advisers are overseen directly by either the Securities and Exchange Commission or state securities regulators, depending on the size of the firm. Primary oversight of brokers is provided by an industry self-regulatory organization, FINRA, which conducts inspections, can bring enforcement actions, and has rule-making authority, subject to approval by the SEC. Particularly in the wake of the Bernie Madoff scandal, FINRA and some at the SEC have argued that the SRO model provides for more robust regulatory oversight and should be extended to investment advisers. However, for the first several decades during which Madoff operated his scheme, he was regulated exclusively as a broker-dealer, and FINRA and its predecessor (the NASD) failed to uncover the fact that he was lying about the nature of his business operations. Despite FINRA's statements to the contrary, that failure had nothing to do with FINRA's lack of jurisdiction over the advisory activities of broker-dealers. In addition, FINRA has for decades taken the brokerage industry's side in arguing against applying a fiduciary duty and other Advisers Act obligations to brokers' advisory activities. As a result of these twin failures, we believe investors would be better served if the SEC and state securities regulators retained responsibility for investment adviser oversight and were given the resources they need to perform that function effectively.