`Merrill Rule' a Bad Deal for Individual Investors: John Wasik

Aug. 2 (Bloomberg) -- How do you know if an investment adviser or broker is working in your best interest?

For starters, asking the question `what's in a name,' is crucial to protecting your wealth, especially when it comes to the vague, unregulated title of ``financial adviser.''

Titles matter because all advisers aren't the same in terms of experience, education or the type of registration that could provide a greater degree of investor protection. In a proposal known as the ``Merrill Lynch rule,'' the U.S. Securities and Exchange Commission wants to exempt fee-based brokers who offer financial advice from registering as investment advisers if their guidance is ``solely incidental.''

The agency first proposed the rule in November 1999, but never acted on it, which made it a de facto regulation.

Claiming the rule allows brokers to ``operate with virtually no disclosure of conflicts,'' among other legal issues, the Financial Planning Association (FPA), which represents certified financial planners, broker-dealers, attorneys and bankers, filed suit against the SEC on July 20.

``We'd like to see the SEC drop or dramatically amend the (Merrill) rule,'' said Elizabeth Jetton, president of the FPA. (Merrill Lynch is a minority investor in Bloomberg LP, parent of Bloomberg News).

Fee-Based Follies

The FPA and other investor groups argue that not registering fee-based brokers as investment advisers gives the securities industry an unfair advantage and an under-policed route to selling advice.

Case in point: Thaddeus Wong, a Chicago-based real estate agent, was working with a Morgan Stanley representative in a fee-based account four years ago. He invested about $1 million with the broker, who proceeded to trade technology stocks and lose all of the value of the portfolio.

Alleging excessive trading, misrepresentation and breach of fiduciary duty, Wong filed an arbitration claim against Morgan and the broker, who represented himself as a ``knowledgeable financial planner and consultant.''

Wong eventually settled with the brokerage house last year for $420,000. Morgan denied the allegations, claiming it ``reasonably supervised'' its broker. Wong would not comment. When contacted, SEC spokesman John Heine said the agency would have no comment on the Merrill Rule suit, which follows the agency's policy to not discuss pending litigation.

RIAS Offer More Disclosure

While hardly an infallible safeguard, registered investment advisers must disclose conflicts, file with state securities commissions and the SEC and generally act as fiduciaries with a legal obligation to represent clients' interests above their own.

``There's no question that investor protections are far stronger for clients of (registered) investment advisers than for clients of brokers,'' says Mercer Bullard, a former SEC lawyer, assistant law professor at University of Mississippi and president of Fund Democracy, a pro-investor group.

``It's especially ironic that at the same time the SEC is extending advisory regulation to cover hedge fund managers (under a new proposal), it's seeking to exempt brokers from such regulations,'' Bullard says.

The Fee-Based Business

The securities industry maintains that brokers are already covered by a raft of federal and state laws that hold them accountable.

``Brokers are covered by extensive regulations,'' says Jim Spellman, a spokesman for the Securities Industry Association (SIA), a trade group representing securities brokers. ``So they are subject to a high level of regulatory oversight that equates or exceeds that of investment advisers.''

Brokerage houses are also scrambling to recover from the bear market of 1999-2002 and myriad industry scandals by marketing ``wealth management'' and ``financial consulting'' services that combine advice and product sales in a fee-based package.

In 2002, the SIA reported that average gross commissions and fees for its members were down 10.6 percent from 2001 (the most recent year available). That followed a 17.5 percent decline in commissions in 2001.

In a trend that has been accelerating over the past decade, fee-based products accounted for about 28 percent of a broker's average commissions in 2002, up from less than 10 percent in 1996, the SIA said. In fact, ``fee-based accounts showed faster growth than any other segment of managed accounts over the past five years,'' according to Cerulli Associates, a financial consulting firm.

Customer Complaints Up

The muddle over fee-based accounts and adviser duties has led to thousands of complaints and arbitration filings.

While complaints for all but two individual investor categories tracked by the SEC declined in 2003, the agency said the number of complaints for fees, commissions and administrative costs rose 7 percent from 1,331 in 2002 to 1,428 last year.

More to the point, the single most frequent reason for securities arbitrations in 2003 was ``breach of fiduciary duty,'' which resulted in 5,565 cases in 2003, according to the NASD, the main regulator for the securities industry.

Arbitrations are procedures that involve impartial third parties to settle disputes out of court. They are required resolution vehicles for most brokerage and investment adviser customers.

Who's a Fiduciary?

``The fiduciary issue is crucial in arbitrations,'' said Andrew Stoltmann, a Chicago securities lawyer who represents investors in arbitrations against brokers.

``Brokerage firms argue at (arbitration) hearings that their broker is nothing more than an order taker. As more investors use a fee-based broker, it is imperative that the financial advisor be held to the (higher) standard of a fiduciary.''

The highest degree of protection often comes in disclosing what a broker does and not what they call themselves.

``Brokers call their sales reps by titles that imply they are advisers,'' says Barbara Roper, director of investor protection for the Consumer Federation of America, a consumer group. ``The real issue is the SEC's failure to enforce the requirement that that brokers limit themselves to `solely incidental' advice in order to escape regulation as advisers.''

Seek Fiduciary Duty

Ideally, anyone who offers financial advice should be a registered investment adviser and put it in writing that he has a fiduciary duty to you.

``Brokers and advisers should be bound by similar fiduciary standards,'' said Arthur Levitt Jr., the former SEC commissioner (and a director of Bloomberg LP, parent of Bloomberg News), who also favors a review of the Merrill Rule by the commission.

In that spirit, adviser registration should also be required of insurance agents, consultants, hedge fund marketers and brokers who recommend mutual funds, financial plans, retirement programs or other investments.

Don't wait for any government agency to help protect your nest egg, though. Use a simple smell test.

If someone offers you a customized financial plan in minutes or days instead of months or plugs commissioned products, move on. You're getting a list of products to buy, no matter what your adviser calls himself.