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Investor protection: New rules threaten traditional brokerage model

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Dodd-Frank Act US fiduciary standard hits brokers; Costs likely to increase for issuers and investors

As the SEC's comment period for the Dodd-Frank regulation that seeks to make investment advisory a level playing field draws to a close, the future of traditional brokerage models in the US looks set to change.

According to a survey released in September by a group of consumer organizations in the US, more than two-thirds of individual investors believe they receive the same quality of advice from a broker as they would from a registered investment adviser. They are lucky if they do.

Different standards

The fiduciary standard that at present applies to registered investment advisers ensures that clients' interests are put first at all times, that all advice must be transparent, expenses are to be controlled and fees and costs are fully disclosed.

Brokers have only had to comply with a "suitability standard". Often called "financial advisers" – a term that fudges the distinction with the more tightly regulated investment advisers – brokers need only disclose conflicts of interest, but do not have to avoid them, and do not have to seek the best pricing for investors.

The new regulation seeks to ensure that brokers and investment advisers adhere to the same "fiduciary standard". It is set to be formally agreed by the SEC in three months, and will shake up the way advisers within large brokerage houses such as Bank of America Merrill Lynch or Morgan Stanley Smith Barney do business.

Dov Schlein, chairman of investment advisory firm Nuverse Advisors in New York, says: "As part of the fiduciary standard, advisers are required to prove that they get pricing from several different brokers and obtain the best price possible for their client when buying securities. The salesforce at traditional brokerage houses will therefore have to do the same. That's a change in mindset." Schlein adds that brokerages tend to offer just securities or products that are provided in-house. Commissions charged also tend to be opaque, whereas registered investment advisers charge a management fee and performance fee and disclose all costs.

"It might end up being a competitive advantage for the brokers, which tend to be great asset gatherers to begin with"

Liz Nesvold, Silver Lane Advisors



"Under the fiduciary standard, brokerages will have to be more open to clients about rebates and the amount of in-house products they are selling. That's a big shift in philosophy for them, and could cost them clients," says Santiago Ulloa, president of the international business of GenSpring Family Offices, an independent adviser specializing in family offices and high-net-worth individuals.

While the large brokerage houses have said that they welcome a uniform landscape – most operate with many advisers already adhering to the fiduciary standard – there is concern that the rules might hit their ability to sell IPOs or bonds that are underwritten in-house.

The SEC has yet to decide the extent to which conflicts of interest will be managed but might require brokers to make clients sign disclosure forms for each IPO sold, confirming that they are aware of the conflict, and understand the pricing. Sifma, whose members are

predominantly broker dealers, has disagreed with this decision, saying that it would slow up IPO sales, and might mean that clients miss out on them.

One could argue that given that many of this year's IPOs are now trading below their issue price, that might not be such a bad thing. However, Andrew deSouza, spokesman for Sifma, says: "Broker dealers have many roles, and so long as the investor is made aware that the firm is underwriting the IPO that it is offering to clients at the beginning of their relationship, then that means the investor has the choice. The main thing is that investors have a choice."

A senior manager at a Wall Street brokerage firm says that clients choose his firm precisely because it underwrites IPOs and bonds, and that preventing or hindering sales of those would be to the clients' detriment.

It's a self-serving argument but raises the question of how much sand the new rule will throw into the engine of capital formation.

Higher investor costs

Stephen Saali, managing partner at Nuverse, says that the new rules are likely to lead to higher costs for independent investors. "If brokers now have to take greater responsibility for the products they are selling or their recommendations, then they will want to charge more for that responsibility." He also says it could adversely affect issuers of stock and bonds. For example, if it is deemed inappropriate to sell a client a stock about which they are uninformed, then under the fiduciary standard, the broker would be unable to sell it without explaining all the risks, and the client might be deterred. Although that is positive for the investor, it might lead to fewer sales of securities. Saali says the issuer might end up paying the price. "If issuers cannot sell as much as before, then the cost of capital naturally increases for them," he says.

A similar rule is being introduced in the UK. The Retail Distribution Review proposed by the Financial Services Authority in March this year will force UK financial advisers to say goodbye to commission structures and offer greater clarity over pricing of both products and advice.

Liz Nesvold, managing partner of financial services M&A advisory firm Silver Lane Advisors, however, says that new regulation will ultimately help the traditional brokerage houses. "Up to now, independent advisers have been able to use their lack of conflicts and transparency as a means of attracting clients," she says. "That has often been misleading, as a disproportionate share of financial advisers at brokerage houses do act in the best interests of their clients. If the playing field is levelled via transparency and conflicts management requirements, independent firms will no longer be able to play that card. As much pain as it could be to make the transition, it might end up being a competitive advantage for the brokers, which tend to be great asset gatherers to begin with."

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