

“No Problem... We Can Amputate!”

By Jon Castle, CFP[®], ChFC[®]

Over the past several months, independent financial advisors across the nation have eagerly awaited the outcome of a highly publicized court battle between the Financial Planning Association and the SEC concerning SEC Rule 202(a)(11)-1 –known as the “Broker Dealer Exemption Rule.” While most people who do not work in the financial services industry may be unaware of this far-reaching battle, its results will no doubt be felt in some fashion by millions of investors nationwide.

This court battle has actually been over 60 years in the making. In 1940, Congress passed the Investment Advisers Act of 1940, which requires individuals who are “in the business” of rendering investment advice, to register with the U.S. Securities and Exchange Commission. Additionally, this registration comes with an additional requirement: to accept the responsibility of a *fiduciary* – to always put the client’s best interest first – and not just make suitable recommendations incident to a sale. This registration also requires additional study and licensing beyond the standard securities licensing of securities sales representatives.

In 2002, the SEC ruled that broker dealers would be allowed to provide investment advice – and provide fee-based accounts - and be *exempted* from the registration, licensing, and the fiduciary responsibility that the 1940 Act requires – as long as these recommendations were *incident* to a sale – and they disclosed to the client that they may recommend investments that would benefit the firm to sell. In other words, as long as the investments recommended were *suitable* for the client, AND the firm disclosed the fact that it could act in its own best interest instead of that of the client – then the broker dealer could provide investment advice for a fee. This ruling is known as the Broker Dealer Exemption Rule.

Sound confusing? It is.

The Financial Planning Association, closely related to the CFP[®] Board of Standards, Inc., and

the chief proponent of the CERTIFIED FINANCIAL PLANNER™ practice standards and education, took issue with the SEC's ruling and challenged them in court. This action stunned the industry and awakened the industry giants to mobilize behind the SEC to protect their exemption from registration and acceptance of fiduciary responsibility. However, on March 30th of this year, the US Court of Appeals for the District of Columbia Circuit ruled against the SEC and struck down the Broker Dealer Exemption Rule.

The fallout of this ruling has just begun. Millions of investors have accounts with broker dealer firms who charge a fee to manage their assets (known as “wrap” accounts) but who are not registered with the SEC as Investment Advisers. Literally thousands upon thousands of financial advisors have been doing business under this exemption and will either be required to become licensed as an adviser and accept responsibilities as fiduciaries, or move their client's assets to commission-based accounts that the investor may or may not like.

The crux of the issue is that with the B/D Exemption Rule in place – the broker dealer was only required to recommend what is *suitable* – in other words –not *bad* for the client – but was not necessarily bound by a *fiduciary* responsibility to actively seek the *best* possible recommendation for the client's particular needs – which, in some cases, might even mean referring the client elsewhere for business. The fact is that the levels of care are different – one means “not bad,” while the other means “best possible.”

Putting this into the framework of a story will make this much clearer. I'll take this opportunity to relate a story told to me by one of our clients who happens to work for a well-known Jacksonville-based shipping firm. One day, while working on a ship as it pulled into port in Europe, one of his crew members nearly cut off his thumb. My client rushed his crewmate to the nearest medical clinic for treatment. Now – they just happened to be in a country which has socialized medicine – so anyone who walked into the medical facility was afforded medical treatment free of charge.

Upon examining the injured man's hand, the doctor informed him that if he would wait a few minutes, he would get the operating room prepared and would be able to amputate his thumb within a few minutes. The man was visibly dejected – how would he support his family now? He was a merchant mariner who needed the full use of his hand to do his job. In America, disability usually means less money – and merchant marines have difficulty getting top notch

disability insurance because of their job. Those thoughts, on top of the trauma of losing his thumb, raced through his mind.

My client, fortunately, spoke up and asked if the doctor could repair the thumb and reattach it instead of amputating it. The doctor thought a minute, and said, “Oh, yes, we could certainly do that. But he might not regain full use of his thumb. Would you rather do that?”

”Well, of course!” replied the injured man. So the doctor took the man back into the operating room, and sewed the man’s thumb back on. Eventually, with therapy and continued medical attention, the crewman regained full use of his thumb and works in the shipping industry to this day.

In my mind, this story aptly demonstrates the difference between a level of care which might be *suitable*, and one that is *fiduciary*. If the doctor had been acting as a fiduciary, he would have taken the time to discover that his injured patient just might be best served by not having his thumb amputated. While it might certainly be *suitable* to amputate a severely injured body part (just ask any Civil War Re-enactor), most people would agree that it might not always be the *best possible* recommendation.

Ultimately, I have to agree with the FPA, and the Court’s position. As you plan for your future, knowing that the financial decisions that you make will have a significant impact upon your quality of life, I would suggest that you choose to work with a financial advisor who readily accepts the role of a *fiduciary* – pledging to always provide the standard of care that involves always putting the client’s interest ahead of their own – and makes the best possible recommendations based upon a careful examination of all the facts – and not just picking products of a very narrow shelf.

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