Insight

Is the SEC Proposed Regulation in the Best Interest of Investors?

THOMAS KINGSLEY | AUGUST 8, 2018

Executive Summary

- After the collapse of the Department of Labor's fiduciary rule, the Securities and Exchange Commission (SEC) is taking steps to meet the same goal of investor protection.
- Although no longer explicitly using the language of "fiduciary," the SEC's proposed Best Interest Regulation meets or exceeds that standard, including requiring financial advisors to mitigate, rather than simply disclose, conflicts of interest.
- The proposed rule would hold brokers to a higher standard of obligation without the imposition of undue regulatory burden. It would also better protect investors while still allowing them access to a range of financial advice.
- The proposed rule is not without flaws, most obviously a cumbersome disclosure form. In sum, however, it represents a measured, proportionate, and welcome exercise of the SEC'S regulatory authority.

Introduction

This is a tale of the convergence of two separate but connected business models: broker dealership and investment advisory. In the United States, would-be investors have a wide range of financial advisors they can turn to for guidance, most prominently stockbrokers and financial advisors. The activities that a broker and an independent financial advisor perform may look very similar; in fact, some financial advisors are both. The key differentiator is who regulates the professional and, relatedly, the duty each owes his or her customers.

Background

Investment advisors (if registered) are regulated by the Securities and Exchange Commission (SEC) and have, since the Investment Advisers Act of 1940, a "fiduciary" obligation to their clients. Fiduciary, which comes from the Latin "fides,", meaning "faith" (or alternately, "fiducia," meaning "trust"), requires investment professionals to put the best interest of their clients (the beneficiaries) first.

By comparison, brokers are usually, but not always, self-regulated by the Financial Industry Regulatory Authority (FINRA). They must meet a lower standard of duty to their clients, known as the five-part "suitability" rules. This is not to imply that the suitability standard is either too low or insufficient a protection for the investor, but it is clearly a lower bar; brokers are required to recommend to their clients a "suitable" product, rather than a product in their "best interest" (although it could be argued that this standard is more reasonable than some amorphous and unattainable "perfect" investing solution).

Brokers increasingly have moved from their original function, which was to facilitate investment transactions, into advisory-like activities. Although this trend has been apparent over the past 50 years, this movement was greatly accelerated by the recent Department of Labor (DOL) fiduciary rule (more on this below). Although

only partially enacted, the rule made it overly costly to sustain the brokerage model. Some smaller investors are not able to meet typical account minimums of advisory accounts, and therefore their only option is a brokerage account. Any regulation under which the brokerage model is not viable is not doing investors any favors.

As brokers performed increasingly advisor-like activity, some brokers assumed the title of "advisor," despite not being regulated by the SEC, and used the implied credential to sell investments that netted the largest broker commission. Not surprisingly, this did not always yield the best results for their clients. The Obama Administration's Council of Economic Advisers estimated that conflicts of interest led to $17 billion in lost income annually; This cost to investors, however, should be considered against the $100 billion the DOL itself estimated investors save from having access to financial advice. Raising the costs of the provision of financial advice would necessarily have reduced the amount of financial advice available.

Recent Regulatory Activity

The perceived lack of investor protection has motivated two notable recent regulatory responses: the first in the form of the DOL fiduciary rule, and the second in the recent SEC Best Interest proposed regulation.

The DOL fiduciary rule, first proposed in April 2016 and originally slated to be phased in from April 10, 2017, has lumbered to near death. While its goal of enhanced investor protection is laudable, one could argue that the suitability standard already provided sufficient protection. Moreover, the DOL fiduciary rule was executed in the worst possible manner.

The fiduciary rule sought to apply the fiduciary standard to all investment professionals who provided retirement investment advice, regardless of what they called themselves. Financial advisors would be required to disclose all conflicts of interest and compensation, and a lengthy and painful Best Interest Contract Exception (BICE) would be required in certain cases. BICE would allow financial advisors to recommend transactions that would otherwise be prohibited, provided that they had contractually committed to a fiduciary standard; BICE in itself, however, came with a significant number of caveats.

The fiduciary rule represented a significant expansion of the relevant regulation, the ERISA Act of 1974. Curiously, despite financial advisors largely falling under the SEC or FINRA, the Act fell under the purview of the DOL, which, as a result, had only retirement accounts within its scope. The SEC, slow to act on reform, was beaten to the punch by the DOL in what amounted to a significant regulatory land grab. The fiduciary rule has since received substantial opprobrium on a number of fronts: It was voluminous (over 1,000 pages); disclosure requirements for financial advisors were punitive, with the most attractive products in the industry (variable and indexed annuities) necessitating BICE coverage; and, most oddly, the executive power and expansion in scope the DOL arrogated to itself. Even putting all these considerations aside, the rule created higher costs for investment advisors, necessarily raising the cost of financial advice and reducing the financial advice available to consumers.

In June 2018, following the Trump Administration's unwillingness to defend the fiduciary rule, the Fifth Circuit Court of Appeals vacated the rule, noting that the DOL's implementation represented "an arbitrary and capricious exercise of administrative power." Shortly after, the DOL indicated that it would not be enforcing the rule, and there it languishes (the next step is perhaps the Supreme Court, but the deadline for intervention appears to have passed). Brokers (and insurers more broadly) spent millions of dollars preparing for a rule that only ever partially came into effect.

Into this environment the SEC has finally provided its own interpretation. The SEC was always the appropriate body for this rulemaking, and the proposed Best Interest Regulation would apply to all investment accounts, significantly decreasing the fragmentation and confusion of the fiduciary rule. Perhaps recognizing the fraught history of the term fiduciary, the SEC has suggested a "best interest" standard that all but knocks on the door of fiduciary. This is an inspired choice – there is a temptation in the financial services industry to treat fiduciary as a defined term of art when it is not. As SEC Commissioner Hester Peirce notes, fiduciary is a term that is " wonderful for marketing purposes, but potentially misleading for investors." Here we have a higher standard of investor protection couched in terms more readily identifiable – or at least, no less clearly defined than fiduciary. Some would criticize the rule for not specifically invoking the language of fiduciary duty, but that objection ignores both the vagueness and contentious history of the term.

The primary criticism against the Best Interest Regulation will be that "best interest" is not defined. To defend a definition of fiduciary duty and attack best interest smacks of solipsism. A standard that is clearly greater than suitability but less than fiduciary allows for development and debate. Some go even further and argue that the best interest standard is a greater protection than fiduciary, as brokers must mitigate and eliminate conflicts of interests, where under the fiduciary duty all that was required was disclosure. Further, the SEC provides for a spectrum of advisor-investor obligation, allowing investors to choose their desired level of protection based on their risk appetite and finances. The criticism of allowing this fluidity – that investors may not understand the duty of care provided by their advisor – has been mitigated by the SEC requirement that brokers at stand-alone broker-dealerships not be able to use the word "advisor" in their title.

Costs and Revisions

The SEC is taking deliberate steps to improve investor protection. And at what cost? Financial advisors must confirm and clarify their customer relationships in a customer relationship summary (CRS). Industry appears to have reached consensus that the CRS is overly proscriptive and practically unworkable; the SEC has indicated that it is open to improving the required disclosures.

One would hope that these measured and proportionate steps toward enhanced investor protection would be welcomed by all actors in the industry. The proposal has some flaws, of course, but the SEC has demonstrated a perhaps unprecedented willingness to incorporate public comment into the evolution of the standard and learn from the disasters of the fiduciary rule.