Advisors Rocked By SEC's Proposed Advisor Conduct Rule

April 19, 2018 • Tracey Longo

The investment advisor industry has been left scratching its head over a controversial new advisor conduct rule that was among three proposals the Securities and Exchange Commission approved by a 4 to 1 vote late Wednesday.

“The Adviser Standard of Conduct” proposal seeks to expand advisors' current duties and disclosure, while pushing for federal licensing, net capital requirements, a fidelity bond mandate and continuing education requirements.

The proposal, open for public comment for 90 days, has come as a shock to the advisor industry, which met numerous times with SEC Chairman Jay Clayton and SEC staff over the past 11 months as the agency worked on the proposal. Yet the industry now finds itself caught off guard.

The new advisor standard of conduct seeks to codify and collect in one place all of the numerous court and regulatory decisions that the investment advisor fiduciary standard has been built on over the past 80 years.

But even commissioners wonder if the proposal goes too far and may in fact distract from the larger package of proposals the SEC approved.

The package includes a “Regulation Best Interest” for brokers that falls short of a fiduciary standard and a new four-page client disclosure form that will require advisors and brokers to disclose fees, conflicts of interest and whether or not they provide ongoing account service to clients.

“I’ll be looking forward to public comments to see whether we are making new law,” said SEC Commissioner Hestor Peirce, who called the advisor proposal a paradigm shift that may go beyond the agency’s authority. For instance, the proposal would for the first time allow “advisors and clients to shape their relationship with informed consent. This is new,” he said.

Peirce also worried if the timing of the proposal “is a distraction from the [other] proposals to encourage greater clarity between brokers and their clients."

“I worry that what this package may provide just another excuse of for investors to avoid thinking about their finances at all,” said Peirce, who added that she was “hesitantly” voting to release the spate of proposals for comment as a starting point for discussions only.

Peirce was not alone in her concerns.

“The SEC proposal for RIAs raises a whole host of questions, and generally looks to be playing catch-up to rules imposed on registered representatives and state RIAs,” Duane Thompson, senior policy analyst at Fi360, told Financial Advisor Magazine.

“What is curious to me is that these state requirements have been floating out there for decades, but the SEC has ignored them,” said Thompson. “Why suddenly attach them to a fiduciary package that was originally focused on market conduct standards for broker-dealers? This particular proposal seems to be coming out of left field. Maybe it’s code speak by the SEC, implicitly telling brokerage firms that if they are going to be subject to a slightly higher market conduct standard, then advisory firms are going to have to take their medicine, too.”

The provisions in the proposal requiring net capital requirements and fidelity bonds are generally required by the states for state RIAs to help protect investors by ensuring that their advisor’s firm is solvent.

The impetus for increasing requirements does not appear to be rooted in reported abuses and malfeasance on the part of advisors—as the new broker requirements clearly are.

“We haven’t seen OCIE [the SEC Office of Compliance Inspections and Examinations] report this as an issue with SEC-registered advisors or make it an examination priority since they began announcing priorities five or six years ago. It makes one wonder why, after the states have imposed these kinds of requirements for decades, the SEC has suddenly discovered net capital and bonding requirements for investment advisers,” Thompson said.

While state regulators have been discussing a model for advisor continuing education requirements, “this is the first time ever I’ve seen the SEC express an interest in imposing education requirements on SEC-affiliated advisors," he said. "There is a strong public policy case to be made for minimum competency requirements since, as fiduciaries, advisors have a duty of care to make only suitable recommendations. As a consequence, they must be conversant with suitable products and investment strategies for their client demographic.”

The proposal seeks to clarify and in some cases expand advisors duty of care, loyalty and duty to provide advice and monitoring, as well as their duty to seek best execution for clients.

To more clearly differentiate between advisors and brokers in order to cut down on investor confusion, the B-D best-interest proposal would also prohibit brokers who aren’t registered as advisors from using the title “advisor” or “adviser” in any fashion, including advertising, business cards and websites. The “titles” prohibitions are a nod to advisors’ longstanding concerns over registered reps and dually-registered reps portraying themselves to consumers as trusted advisors. However, even some commissioners believe that the proposal doesn’t go far

enough in anticipating the creativity of the brokerage industry and brokers to find new titles to muddy the water.

What is clear is that there is something for everyone to hate in the SEC's spate of proposals.

One of the most outspoken critics is Democrat Commissioner Kara Stein, who called "Regulation Best Interest" the "Regulation Status Quo" because of its failure to institute a fiduciary standard for B-Ds or even define what "best interest" is.

"One might say the emperor has no clothes," said Stein, who voted against releasing the three SEC proposals. "For at least the last decade, investors have been asking for some type of fiduciary duty. The proposal today squandered the opportunity for us to act in retail investors' best interests."

Stein said the SEC's failure to create a fiduciary standard for brokers was particularly painful after listening week after week to SEC examiners report back on findings of broker fraud.

"Does this regulatory proposal require B-Ds to put their investors interest first? No," Stein said. "Does this proposal require all financial professionals to do so as fiduciaries? No. "Does this proposal require brokers to provide retain investors with the best available investment options? No."

The SEC could have proposed a best-interest rule that did all of these things, Stein said. "Unfortunately, today we are not. ... Because there is no definition of best interest in the proposal, the name of the rule in and of itself is confusing. Perhaps it would be more accuratate to call this 'Regulation Status Quo,'" Klein added, before voting against the proposals.