Voices Veres: Winners and losers from SEC advice rule

By Bob Veres April 19, 2018, 12:38 p.m. EDT

The SEC's proposed advice rule will likely drive a wedge between the interests of financial planners and consumers.

Surprised? Let me explain.

For years, the Financial Planning Coalition's position has been virtually identical with that of consumer groups such as the Consumer Federation of America. This ignored a real divide. Consumers would benefit by a rule that required anybody giving advice to put their interests first. Advisors, however, benefit if there is a double standard — where brokers live under lesser standards and they have a point of competitive distinction — particularly if the public knows the difference.

The SEC's proposed regulations seem to be a potentially significant victory for the fiduciary professionals, a modest victory for the brokers and broker-dealers, and a disappointingly small victory for consumers.

Start with fiduciary professionals. When it became clear that the SEC was considering a "fiduciary" rule which would resemble the existing suitability standard, fiduciary advocates were forced to abandon their hope of forcing brokers to act as fiduciaries.

The inevitable alternative was too damaging to consider. The brokerage industry was powerful enough to emasculate and co-opt the term "fiduciary," defining it as the suitability standards they currently operate under, and thereby allowing brokers to do an even better job of posing as advisors.

The SEC proposal uses the term "best interest," preserving "fiduciary" as a distinction for fee-only and SEC-registered professionals. This is a victory for real fiduciary planners, who can maintain a meaningful competitive distinction in the marketplace.

It gets better. The fallback lobbying position for fiduciary advisors, stepping back from lobbying "fiduciary for everybody," was to ask the SEC to create a clearer distinction between those who were required to act as fiduciaries (theoretically everybody registered with the SEC), and those whose primary loyalty was to their brokerage employer or, too often, themselves. This distinction was clearly on the mind of Congress when it passed the Investment Advisers Act of 1940; indeed, the House report on the act declared that the intent of the legislation was "to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment advisor against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."

For decades, the term “advisor” actually meant something significant in the marketplace. You could call yourself an advisor, for investment purposes, if you intended to live up to the evolving standards of SEC registration — eventually defined as fiduciary obligations by the U.S. Supreme Court.

The SEC gradually opened those doors, to the point where today any broker is allowed to use the terms financial planner, investment advisor, financial advisor and so on. But the SEC’s recent proposal looks like a step toward making the “advisor” term special again. It proposes to restrict broker-dealers and reps from using the terms “adviser” or “advisor” as part of their name or title with retail investors.

Score a potentially huge victory for fiduciary planners.

There’s a third win here. One great fear in the fiduciary community was that an SEC effort to harmonize standards would not only emasculate the distinctions between those on the side of the consumer and those working for the house, but also inflict some of the more onerous sales-related regulatory obligations (supervision of client communications among them) on fiduciaries. The SEC was wise enough to create different standards for different service models, which is one more thing advisors can cheer about.

The nightmare scenario for the brokerage industry would have been for the SEC to require them to stop selling products, and only give advice under a fiduciary standard. This would have made it hard to justify recommendations of, say, non-traded REITs, equity-indexed annuities with 20-year surrender charges or separately-managed accounts with hidden layers of fees and under-the-table payments for shelf space (disguised as revenue-sharing arrangements).

They shouldn’t have worried. It appears that the SEC bought their “choice” argument right from the beginning, that people should have the choice of working with a sales agent or a fiduciary, even though, as noted in the proposal's preamble, many of them didn’t understand the distinction or potential consequences.

Is a best interest standard stronger than suitability? You decide. The summary documents call for disclosures (discussed later), a care obligation and conflict of interest obligations. The care obligation requires the broker or dealer (or associated person) to:

- “understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation would be in the best interest of at least some retail customers,
- have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer’s investment profile and the potential risks and rewards associated with the recommendation; and
- have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest when taken together in light of the retail customer’s investment profile.”

If that differs from the current suitability standard, then I hope somebody will explain it to me. It appears that the SEC simply cut and pasted from the FINRA definition of its existing standards.

The conflict of interest obligation, meanwhile, reads as follows:

“The BD must establish, maintain and enforce written policies and procedures reasonably designed to identify and then to (A) at a minimum disclose, or eliminate, material conflicts of interest associated with the recommendation, and (B) disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation.”

The way I read that, you have a choice of either disclosing or eliminating these conflicts. I’m guessing which option the brokerage firms and sales reps will choose, but maybe I’m being cynical.

Finally, in a line that seems to give the game away, the SEC’s proposal says “we do not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result.”

I don’t know any other way to read this, except that the SEC doesn’t intend brokers to be held to these putatively higher standards in any court or arbitration system.

But doesn't the very term "best interest" imply that brokers should ignore their own interests and focus solely on the customer's? This is addressed directly on page 48: "Certain conflicts of interest are inherent in any principal-agent relationship. We do not intend for our standard to prohibit a broker-dealer from having conflicts when making a recommendation." How much clearer can they be?

Let's call that a big win for the sales community, especially because they are likely, through the comment period, to ensure that tomorrow's "best interest" doesn't deviate one iota from today's "suitability." I'd bet all the money in my pocket that, once the final rules are drafted, a broker will still be able to frighten consumers about the possibility of losing money in the markets, document the fear they managed to elicit, and then justify the sale of that equity-indexed annuity as in the best-interests of that poor frightened investor.

But the brokerage and sales community did not get off scot-free. The SEC proposal also includes disclosure requirements, and you can find a hypothetical disclosure document for broker-dealers here.

It seems to imply to the potential customer that the broker is, in fact, a fiduciary when it says "we must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities." Really? That doesn't sound at all like the standard they will actually be held to as defined elsewhere in the proposal.

"From a consumer protection standpoint, disclosures are a terrible substitute for actually being required to treat your client the way you would treat your mother."

The hypothetical disclosure document for a fiduciary advisor is even more flawed (see here) declaring that "our investment advice will cover a limited selection of investments. Other firms could provide advice on a wider range of choices, some of which might have lower costs." The proposed document hints at conflicts all over the place, undermining the potential for trust. And it assumes that every advisor will be paid via AUM, ignoring flat fees, hourly fees and any other form of compensation.

From a consumer protection standpoint, disclosures are a terrible substitute for actually being required to treat your client the way you would treat your mother.

On the other hand, the SEC has never seemed to care about the nature of the disclosures before, whether they were buried in the fine print or hidden somewhere in a document that was cleverly designed not to be read. If the SEC monitors the length and readability, and perhaps even the language of some of these explanations, then perhaps disclosure won't be the total lost cause it has been in the past.

Which brings us to clients, who should be not just the most, but the ONLY focus of the SEC's concern, given its consumer protection mandate. They gain very little under this proposal.

The perfect outcome for consumers would have been for all providers of financial advice to have to act as true fiduciaries in a strict sense, and this proposal is light years from that.

However, clients gain a little bit by restrictions on the word "advisor" because this might dispel some portion of the rampant confusion in the marketplace over who can and cannot be trusted with your financial life. They may also gain a little bit with the disclosure requirement, although exchanging fiduciary for disclosure is what brokerage professionals would call a sucker trade.

Finally, the SEC proposal gently nudges brokerage firms and broker-dealers away from some of the incentive structures that induce the worst kind of advice to clients: the sales incentives, trips, the sales grid where you're paid more the more you sell etc.

Now that the full text of the rule has hit the SEC website, and you will learn a lot by the pronouncements of the various organizations, from trade group such as SIFMA and consumer advocates such as the Consumer Federation of America.

I strongly urge everyone to check out the proposals — and comment. But you should be warned that this may be the best deal that true fans of fiduciary will be able to get out of this SEC. Any revisions will probably come at the behest of the sales industry. For the next three months we'll be playing defense on a proposal that isn't close to what we or the consuming public would have preferred — and reminding ourselves that some of the alternative possible SEC proposals would have been worse.

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