INSTITUTE FOR
THE FIDUCIARY STANDARD

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Fiduciary Reference
Analysis of Issues in Financial Advice

Fiduciary Leaders call on SEC to repair defects of rulemakings and interpretation to restore investor trust

Major repairs to Reg BI, Form CRS and Adviser Act guidance are proposed to affirm broker and adviser differences and to level with investors

Knut A. Rostad, Ron Rhoades, Brian Hamburger *

Summary

The SEC June 2019 rulemaking on conduct standards is as significant as it is fundamentally misguided. The Institute for the Fiduciary Standard has identified five recommendations that would have a critical impact on raising standards to better serve and finally level with investors:

- Rebrand Reg BI as a ‘New Suitability’ standard for broker-dealers; affirm broker-dealer product recommendations are distinct from best-interest fiduciary advice;
- Strengthen broker-dealer ‘New Suitability’ standard by eliminating certain conflicts;
- Provide new guidance and clarity for the broker-dealer standard of conduct;
- Mandate disclosure in Form CRS to express the stark differences between fiduciary advice and product sales and test such language with consumers; exempt registrants if disclosure is also contained in other disclosure statements.
- For the Advisers Act, conflicts of interest that inherently violate the client’s best interest must be avoided; disclosure alone is insufficient. Further, strengthen the application of the Advisers Act’s fiduciary standard through guidance on state common law.

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* Knut A Rostad is President of the Institute for the Fiduciary Standard. Ron A. Rhoades is Associate Professor of Finance, Western Kentucky University’s Gordon Ford College of Business. Brian Hamburger is President and CEO of MarketCounsel Consulting. Rhoades and Hamburger are advisors to the Institute.

Introduction

The SEC's rulemaking on Regulation Best Interest (Reg BI), Form CRS as well as its Interpretation Regarding Standard of Conduct for Investment Adviser, were finalized in June 2019. At the time, former SEC Chairman Jay Clayton stated that the rulemaking was needed to address:

- The "misalignment" between reasonable investor expectations and the actual standards; and
- Investor confusion over the differences between investment advisers and broker dealers.

We agree that rulemaking should address these issues. However, many of the 2019 Commission actions actually made matters worse. They increased investor confusion by widening the disparities between investor expectations and the actual standards of conduct. Hence, we propose that the Commission move swiftly to correct the prior rulemaking and interpretations. Doing so will provide significant, positive and immediate impacts on investor protection and capital formation. In addition, these changes will advance the emerging investment adviser profession.

Rulemaking Concerns

Reg BI

The deficiencies of Reg BI have been widely identified by fiduciary proponents.

- The standard is not "best interest." The rule "fails to require that investors interests come first" and "relies on a weak mixture of measures that are unlikely to make much difference in improving advice." In fact, Reg BI "goes out of its way to say that it doesn't require broker-dealers to recommend [one] best product." *(former Commissioner Robert J. Jackson, June 5, 2019 statement)*

- "The SEC has failed to provide a single example of a practice … permitted under existing suitability rules (and) impermissible under Reg BI." *(Consumer Federation of America, "… Bait and Switch", June 3, 2019*)

- The standard is mis-named. "The phrase 'best interests' is a phrase that has been reserved under the law for a fiduciary-client relationship, not a salesperson-customer relationship. The proposed modifications incorporating such a 'best interests' standard without the imposition of bona fide fiduciary obligations is wholly inappropriate." *(Ron Rhoades, August 6, 2018 comment letter)*

- The standard is defined by ambiguity. Reg BI's "fundamental flaw stems from extrapolating the two most important words from the fiduciary standard, "best interest" and grafting them to a suitable transactional standard … Leaving the term 'best interest' undefined" allows for 'disparate' interpretations from SEC commissioners themselves. Commissioner Stein says it 'Maintains the status quo' and Commissioner Peirce calls it 'Suitability plus.' Meanwhile, Chairman Clayton added, 'It is definitely a fiduciary principle.' *(MarketCounsel Consulting, August 7, 2018 comment letter)*

- Interpretation and initial compliance is left to firms. "Reg BI leaves to broker-dealers the important task of crafting policies and procedures to ensure compliance with the rule. Yet, broker-dealers' lack experience and expertise in addressing conflicts, providing effective disclosures or meeting a standard of care obligation." *(Institute for the Fiduciary Standard, August 6, 2018 comment letter)*

- Rulemaking should be described clearly. We urge all participants "To align on the priority of leveling with investors." *(MarketCounsel Consulting)* This point is not stressed enough. Clarity in describing the standards is vital. Yet, ambiguous or misleading language in describing the rule is all too common.

Take fee disclosure. The rule states there must be disclosure of "the material fees and costs that apply … to transactions, holding and accounts." While this may seem straight forward, for the SEC it's not because the intent is not to "*disclose fees*." Actual fees and charges can remain hidden. The SEC interprets this to mean *how* the broker or adviser is paid or the *types of fees* charged. This is no small point. Who evaluates products or services by comparing *types of fees?* Be they fees for "research" or "labor" or "parts" or "experience". Or how they pay, by credit card, for instance. This would be laughable anywhere else. Yet, under Reg BI the *types of fees* is what's delivered when "What fees will I pay" is promised.

Form CRS

The former SEC Chairman explained that Form CRS "significantly advances our goals of providing transparency and comparability … among the two different types of firms in a way that is distinct from other required disclosures."

Unfortunately, Form CRS is not only unhelpful; it is actually harmful to investors. It makes BDs and IAs sound almost identical except for a few relatively minor things (how often they provide advice, whether they monitor accounts, etc.) The core different purposes of BDs (product sales) and IAs (fiduciary advice) are essentially ignored, and the resulting obfuscating communication misleads consumers. Fiduciary proponents note:

- "The Commission does nothing to clarify the different roles that broker-dealers and investment advisers play in the market." *(Consumer Federation of America)*

- "Form CRS and Reg BI implicitly and explicitly suggest that the differences between investment advisers and broker dealers are nil. The chief difference: Investment advisers provide ongoing advice and broker-dealers do not". *(Institute for the Fiduciary Standard, April 15, 2020 paper)*

The similarities between the two standards are evident in the key language in Form CRS:

> *"If you are a broker-dealer that provides recommendations subject to Regulation Best Interest, include (emphasis required): 'When we provide you with a recommendation, we*

> *have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests....'*

Compare the foregoing BD disclosure, with the SEC's mandated disclosure for IAs:

> *"If you are an investment adviser, include "When we act as your investment adviser, we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests….."*

Form CRS should be scrapped. Any new disclosure regime the SEC adopts should emphasize and highlight the fundamental differences between the two*,* rather than ignore or gloss over them.

IA Interpretive Guidance

The IA Interpretive Guidance operates to weaken the fiduciary duty of loyalty found in the Advisers Act, as informed by the common law.

- Clients' interests first. "The majority approves today removing "Language from last year's proposal stating that the law "requires an investment adviser to put its clients' interests first … I disagree." *(Commissioner Robert J. Jackson)*

- A weak substitute. "To state only that you cannot subordinate the client's interests to your own represents a very weak substitute that may allow the investment adviser to still give considerable weight to its own interests." *(Statement of Concerned Securities Law Professors)*

- Disclosure of conflicts is insufficient. The new interpretation "Weakens the existing fiduciary standard by suggesting that the liability for nearly all conflicts can be avoided through disclosure. I do not believe this is what an investor would reasonably expect from a fiduciary nor does it align with ways real world fiduciaries tend to view their fiduciary obligation." *(Rick Fleming, SEC Investor Advocate)*

- No client should be presumed to consent to be harmed. The SEC's view "that all that is required when a conflict of interest is present is disclosure of the conflict, followed by 'mere' (not 'informed') consent – has no foundation in the law … Under state common law, for estoppel to make unactionable a breach of a fiduciary obligation due to the presence of a conflict of interest, it is required that the fiduciary undertake measures, far beyond under-taking mere disclosure of the conflict of interest … [even with disclosure and informed consent,] the proposed transaction must be and remain substantively fair to the client … As stated by Professor [Tamar] Frankel, "Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests.'" (*Ron A. Rhoades)*

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Summary Recommendations on Reg BI
Form CRS and the IA Interpretive Guidance

Reg BI Recommendations

The fiduciary standard has been defined by the courts to include serving the best interest of the client. *Best interest* is inherently associated in law with *fiduciary.* Yet, the fact is that broker-dealers simply cannot meet the Advisers Act best interest fiduciary standard. Broker-dealers work under "selling agreements" with product issuers. The core broker-dealer mission - to distribute products on behalf of product issuers and other sellers – is in direct conflict with the core investment adviser mission to render fiduciary advice on behalf of clients.

As stated early on by the U.S. Supreme Court: "The two characters of buyer and seller are inconsistent: *Emptor emit quam minimo potest, venditor vendit quam maximo potest*." (*Wormley v. Wormley,* 1823). As stated by many jurists, "No man can serve two masters."

President Biden said in his inaugural address, "I will always level with you." We too must "level with" investors. This means truthfully describing the different conduct standards of advisers and brokers. Leveling starts with the truth about BDs. BDs are not able to act in their customers' best interest. As such, Reg BI should be renamed, and rewritten, to reflect its lower BD suitability standard. Additionally, suitability should be strengthened and modernized to reflect the greater complexities in the market and the non-fiduciary advice commonplace in brokerage transactions.

Rebrand Reg BI. To have Reg BI meet reasonable investor expectations its branding must be revised. As Rhoades points out, "best interest" is intrinsically a term used in hundreds of judicial decisions to describe the fiduciary duty of loyalty. Reg BI is misleading, in its very name. Words matter. Branding matters. One option to consider: "New Suitability."

The re-branded Reg BI must not mislead investors. Product recommendations are not similar, associated or related to fiduciary advice. Recommending a product is not fiduciary in nature or by design; it is non-fiduciary advice, like many types of advice discussed by law professor Arthur Laby. *(Advisors as Fiduciaries, 3-20.)*

Reduce Conflicts to Strengthen BD Regulation

- Introduce a duty of care upon brokers when recommending investment advisers to clients (including recommendations of mutual funds, ETFs, separate account managers, etc.)
- Level commissions, as a means of limiting the pernicious effects arising from the economic incentives that often exist to push inferior products.
- Act to eliminate 12b-1 fees ("advisory fees in drag") and other forms of revenue sharing, prohibit sales contests, and limit marketing support payments.
- Restrict soft dollar payments to ensure that only reasonable compensation is provided by funds to broker-dealers for investment research, and that such research is material.
- Require point-of-sales disclosures of the dollar amount of fees and costs incurred whenever a product is sold.

Form CRS Recommendations

Form CRS is based on a faulty premise that broker-dealers and investment advisers should be regulated similarly because they appear to provide similar services. This faulty premise was interpreted wrongly to mean a uniform or harmonized standard is the answer.

Yet, "[w]hile a superficial review supports this notion, closer analysis reveals that the activities of broker-dealers and investment advisers and the investment advice they provide differ in significant and meaningful ways. … Fundamental is their relationship with clients … broker-dealers and their RR's are salesmen. It will not be possible to revise one of the fundamental purposes served by many broker-dealers, which is to distribute and sell securities." *(Koffler, Six Degrees of Separation …)*

The fundamentally different roles, purposes and functions of investment advisers and broker-dealers must be clear in any revised Form CRS. This is especially true of dual registrants. The ability of a dual registrant to wear "two hats" and to "switch hats" is contrary to the principle that fiduciary status, once assumed, extends to the entirety of the relationship between the fiduciary and the client.

A revised Form CRS must describe IA / BD distinctions in clear, candid, and concise language, and it should be tested with consumers prior to its adoption.

Lastly, IAs current substantial disclosure requirements in Form ADV should be noted. Redundant disclosures create burdens on IAs and can confuse consumers. Hence, IAs should be exempt from Form CRS disclosures, provided such disclosures are contained within their Form ADVs.

IA Interpretive Guidance Recommendations

Conflicts of interest. In the SEC's Release IA-5248 in 2019, the SEC appeared to inappropriately misinterpret the requirements of the investment adviser's fiduciary duties, when a conflict of interest is present, by suggesting that such duty can be met by *either* their elimination or by disclosure. The SEC needs to re-visit and revise IA-5248 to ensure that investment advisers understand that the fiduciary duty of loyalty, and its embedded "no profit" and "no conflict" rules, require the avoidance of the conflict of interest in many situations.

The SEC's Investor Advocate, Rick Fleming, points out the significant material difference between what the longstanding legal analysis of *SEC vs. Capital Gains Research Bureau* means and what the Commission did to essentially overturn this precedent in their footnote. Fleming's comment is worth noting in its entirety:

> *The Commission Interpretation Regarding Standard of Conduct for Investment Advisers gives very little weight to the single most important action of the Commission on this topic. In General Instruction 3 to Form ADV Part 2, which is a portion of Form ADV that is used to disclose information to investors about an adviser's services, the Commission instructs investment advisers as follows:*

> *You are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients …*

The Commission approved this instruction as part of its amendments to Form ADV in 2010 … However, buried within footnote 57, today's Fiduciary Interpretive Release brushes aside that action. The footnote asserts, in effect, that the prior Commission intended to capture the fiduciary duty described in SEC v. Capital Gains Research Bureau, Inc. Thus, the phrase "seek to avoid" must have been intended to mean that an adviser must eliminate or disclose conflicts of interest.

I believe it is more likely that the prior Commission chose to build upon Capital Gains by requiring disclosure and conflict avoidance, as the plain language of General Instruction 3 indicates. In my view, then, the new Fiduciary Interpretive Release weakens the existing fiduciary standard by suggesting that liability for nearly all conflicts can be avoided through disclosure. I do not believe this is what an investor would reasonably expect from a fiduciary, nor does it align with the ways that real-world investment advisers tend to view (and describe) their fiduciary obligation.

The SEC should restore the proper application of the Advisers Act's fiduciary standard by providing revised guidance. This should include providing guidance that is consistent with state common law application of fiduciary duties of due care, loyalty, and utmost good faith, as advisor duties are tested via application of state common law when disputes with clients occur. The Advisers Act's interpretation is appropriately informed by, and consistent with, the common law.