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What is "Good Advice?"

Knut A Rostad *

Introduction and Summary

Questions of good advice and financial planning are timely. 2016 will initiate the DOL COI Rule era, 76 years after the Advisers Act of 1940, and 47 years since the "birth" of financial planning. And *timeless*. The force behind the DOL rule reflects the "shared mission" and question that attracted the financial planning founders in 1969: Can *advice* replace *sales* as the industry "driving force?[1]

2016 is important to the question of "good advice" because regulatory, technological, and market forces remind us why the foundation of good advice must be disinterested advice. Here, I highlight the arguments on fiduciary advice. I then discuss, citing the work of Arthur Laby, a basic (and overlooked) rationale for disinterested advice: common sense. Common sense informs investors' views of sales and advice, generally, and do so for "good advice" as well.

Regulatory and Market Changes

The Department of Labor Conflict of Interest (DOL COI) rule resets the foundation of retirement and investment advice. For some firms, the rule will be shock therapy that requires fundamental changes; for all firms, adjustments will likely be needed. It also puts mounting pressure on the Securities & Exchange Commission (SEC) to do its own rule.

Additionally, market forces are already transforming how advice and product recommendations are being delivered. New technology (including robo digital platforms), products and aroused cohorts of disgruntled investors are demanding new advice relationships based on transparency, straight talk, broad planning expertise and reasonable fees. As in the TV ad for a BD firm, at the end of a father-son conversation about investing, the millennial advises his boomer father, "The world is changing."

At issue is whether these transformations rejuvenate "good advice" in securities regulation and advisory firms. The jury is out. Much will depend on what advisors do. Will advisors speak out on and actively explain how true fiduciary advice differs so sharply from product recommendations? Or not.

Knut A. Rostad is president of the Institute for the Fiduciary Standard, a non-profit formed in 2011 to advance fiduciary principles in investment and financial advice through research, education and advocacy. Information about the Institute can be found at www.thefiduciaryinstitute.org.

The Current Battle

The current seven-year battle between investor advocates and industry advocates is a battle over "good advice." A battle over what most fiduciary advocates consider to be a core element of "good advice:" Avoiding conflicts of interest and getting as close to "conflict-free" as is humanly possible.

The two sides remain far apart. This is understandable because what separates them is not small differences or mere nuances. No, what separates them is a principle. A principle which, when fully transparent, resonates strongly. It resonates because it involves fixed notions of fair play and common sense based on everyday experiences.

The principle, as Professor Arthur Laby points out, is that "advice" must mean the advisor is "disinterested." Fiduciary advocates espouse this principle, while industry advocates who oppose the DOL rule do not. While industry advocates say brokerage customers' best interests are served, when their words and deeds are closely examined, it's clear they are not. Which is no surprise. Industry advocates reject disinterested advice because they must – as long as their primary business entails distributing products, and their primary compensation is based on product recommendations.

**The 'Conflicts *Are* OK' View
Is Prevalent in Washington**

As such, key federal regulators and industry advocates implicitly argue that conflicts are okay when they explicitly espouse that product recommendations are advice and disclosure the remedy to conflicts. I call this the 'Conflicts are Okay' view.

The views of the SEC, the Financial Industry Regulatory Authority (FINRA) and business lobbyists led by the Securities Industry Financial Markets Association (SIFMA) are key. Their views differ in tone but are grounded in common assumptions. The key assumption is conflicts of interest are omnipresent and inherently part of "advice." Their presence is inevitable. As such, they are accepted as normal, and expressed as "acceptable" and "permissible." The message, now explicit, is that conflicts are permissible and need not be avoided and need not be minimized.

This "Conflicts *are* Okay" view means the regulatory issue is no longer about avoiding conflicts – or even managing the harms of unavoidable conflicts. Instead the regulatory issue is about disclosure, sometimes with true consent but rarely with true client understanding of the nature and potential harm of the conflict (that is, anyway, according to volumes of research and experience).

<u>SIFMA</u>. The "Conflicts *are* OK" view is evident in the writings of SIFMA. The wide acceptance of conflicts is evident in SIFMA's July 14, 2011 comment letter to the SEC: *Proposed Framework for Rulemaking Under Section 913 (Fiduciary Duty) of the Dodd-Frank Act*. There is no mention here of why conflicts have been viewed historically as undermining objective advice; of why conflicts should be avoided if possible and why disclosures are inherently ineffective. To the contrary, there is explicit mention that proprietary products and a limited selection of product choices is not presumptively a fiduciary breach.

SEC. The SEC's broad acceptance of conflicts of interest is discussed in an Institute paper covering SEC recent developments; *Conflicts of Interest and the Duty of Loyalty at the Securities & Exchange Commission.* Among these developments: the March 2013 SEC Request for Information on a potential uniform rule for advisers and brokers sets out parameters which effectively encourage conflicts and narrow the reach of fiduciary duties. Furthermore, a number of recent SEC administrative decisions dealing with conflicts rest on the premise that disclosure sufficiently addresses conflicts. The question of whether the client's best interest is served is not addressed. Finally, a February 26, 2015 speech by Julie M. Riewe, Co-Chief, Asset Management Unit (AMU) SEC Division of Enforcement, provides the rationale and analysis for concluding that disclosure alone presumptively addresses conflicts.

This broad acceptance of conflicts is part of a more fundamental view, advocated by the brokerage industry, that brokers and fiduciary advisers are, for regulatory purposes, largely indistinguishable. In March 2015 SEC Chair White discussed her support for SEC rulemaking on a uniform standard. In part, she explained: "*You have to think long and hard before you regulate differently, essentially identical conduct.*"[2]

Chair White seems to suggest that whatever differences there may be between advisers and brokers, from a regulatory view today these differences are immaterial. This would seem to mean that investment advisers, who are compensated and contractually obliged to be fiduciaries to their clients, are no different from brokers-dealers, who are compensated and contractually obligated "to distribute the very securities that they provide advice and recommendations on to investors.[2]

The 'Conflicts are Harmful" View is Supported in Law and Logic and Common Sense – And by Many Investor and Advisor Groups

On the other side, the DOL, investor advocates, the association of state securities regulators, NASAA, and advisor groups are the bulwark of the defense of fiduciary duties. These groups reject the premise, "Conflicts are OK." Instead, they advocate that conflicts of interest are inherently harmful and should be avoided. Unavoidable conflicts must be managed to minimize their harms to clients. The inherent harms that can flow from conflicts are the core rationale for the DOL COI rule, and based on research and investor experiences. This evidence is very compelling, but it is not the only basis for concluding, "Conflicts are Harmful." Law, logic and common sense also support this conclusion.

Rutgers University law professor Arthur Laby discusses the law and logic in his paper, *Selling Advice and Creating Expectations: Why brokers should be fiduciaries*.[3] Laby starts with the Oxford English Dictionary definition of "advice" meaning "to state one's opinion as to the best course of action, to counsel, to make recommendations … (and) implicit in the "term" is that the guidance given will be the best guidance for the recipient of the advice, tantamount to a best interest standard." Laby notes, "An advisor's impartiality is implicit in the profession and the hallmark of adviser regulation."[4]

Laby notes an underlying concern of the crafters of the Advisers Act of 1940, as expressed by one participants, A. A. Berle, was "the presence of tipsters who were disguising themselves as legitimate advisers." Laby notes that "Investment counsel would advise in a client's best interest whereas other securities professionals were trying to make a sale."

Laby concludes, "When one advises another, he is purporting to provide independent, impartial information in the best interest of the recipient. This is common sense. … The propensity to rely on a disinterested adviser is illustrated by a venerable common law doctrine that distinguishes between advice given by a seller and advice given by one who holds himself out as disinterested." Laby goes on to note the "rule of the disinterested adviser" dates to the 1800s and cites a case where a court distinguished a seller of property who might be inclined towards "hyperbole" because "a reasonable buyer would understand … hyperbole (while) … the same false statement by a person purporting to be independent would result in liability."[5]

"This is common sense"

Laby raises a significant point that is rarely mentioned in the common discourse:[6] That "common sense" tells us advice should be in the best interest of the recipient. Laby notes a student has a "reasonable expectation" for advice from an academic counselor to be in his or her best interest." The Oxford dictionary says common sense is "good sense and sound judgment in practical matters." Laby's point resonates – it is, "The Laby Principle." The Laby Principle should be considered broadly, as in how consumers usually apply common sense fairly well to distinguish sales and advice.

<u>Advice.</u> In practice we usually know "disinterested" advice when we see it, be it our children's pediatrician, our tax accountant, or the high school college counselor. Based on our experience we reasonably believe their advice is founded on their expertise and our interests and objectives. And if we were to discover our pediatrician only recommended medications from a drug company from which he received consulting fees, or the counselor received payments from colleges for each enrolled student, we'd be very upset. We'd feel – at a minimum – that a trust had been violated.

<u>Sales</u>. In practice we also usually know sales when we see it; whether a real estate agent, Home Depot rep. or our favorite clothier, there's no mystery. We know she is more interested and (perhaps) incentivized to make a sale than to carefully assess what is our best interest. This is not to criticize; this is to say the obvious. Sales is not the same thing as advice. It's also to say most of us would agree that many sales people and business owners enjoy great reputations *from* – not despite – their sales aptitude. And that many consumers have great stories they tell about these people and their companies.

This is, perhaps, to also stress the obvious: It's not product recommendations and sales that are a problem; it's opacity, contradictory messages and misunderstandings over basic notions that are a problem. For 30 years many brokers have simultaneously boasted "trusted advice" while widely following BD sales rules. Have these mixed signals "short circuited" investors? Some research suggests so. Today, it's hard for investors to know sales from advice, or much else about their own advisor. Investors can't tell the difference between an adviser and broker or fiduciary and suitability, or (if they can) they doubt it matters. They often ignore disclosures or misunderstand those they do read. Many investors don't even know what these services cost them or they believe they are "free."[7]

Sales and BD Rules. This reminds us of two facts. First, financial services seems associated with more than its share of inexplicable (irrational) investor behavior. Second, compared to other sales transactions, BD rules often handcuff brokers. They disallow or rebuff brokers' efforts to be transparent, clear and client-centric. How many BDs allow brokers to put a fiduciary agreement in writing? Or provide clients a list of their conflicts? Or deviate from unintelligible legalese in boiler plate contracts and disclosures? Or provide complete pricing transparency?

Strict BD sales practices are common. Yet, these practices would not be tolerated in any other sales situation. Take pricing transparency. Think for a moment if your contractor refused to tell you the cost of a new home he just designed, or if he put the price in a broad range, or if the Home Depot sales rep. proudly explained *how he was paid*, if you purchased the refrigerator -- but refused to tell you what you would pay. You'd laugh out loud. Or walk out. Or both.

Industry advocates repeatedly remind us *choice* is important. They have a *certain* point. Common sense is powered by logic and experiences and values. The more that questionable practices deviate from common sense and other choices are readily available, the faster these questionable practices will be replaced.

Common Sense "Good Advice"

The battle to define good advice has been waged for centuries. Its course has been closely followed since the Advisers Act of 1940. 2016 is set to be a tipping point because, as the millennial tells his dad, "The world is changing." Despite industry opposition, key regulatory, technological and market forces are aligning with history and law. The DOL rule is key. A new frame for advice is fast evolving. Its core is the principle that good advice is disinterested advice and this *is* common sense -- fair and reasonable and consistent with our experiences with sales and advice. This is the Laby Principle.

This is also a driving force in crafting the Institute's Best Practices for Financial Advisors. Best Practices seek to describe plainly and concretely the basis for what "good advice" requires that advisors do. It's a hope they will contribute to the missions of industry pioneers who helped craft the Advisers Act and, then again, found financial planning and fought for what it can become.
http://www.thefiduciaryinstitute.org/wpcontent/uploads/2015/09/BestPracticesSeptember302015.pdf

Notes

1. On December 12, 1969, thirteen men met at Chicago O'Hare Airport. "In The History of Financial Planning,"Denby Brandon and Oliver Welch write, "These men came out of curiosity and a sense of shared mission: to raise the level of professionalism in retail financial services and to make "financial consulting" rather than salesmanship the driving force of their industry." Page 3.

2. http:// www.wsj.com/articles/sec-head-seeks-uniformity-in-fiduciary-duties-among-brokers-advisers-1426607955

   It should be noted that certain SEC staffers have spoken out eloquently, in their individual capacities and not on behalf of the SEC, against conflicts of interest.
   In 2012, Carlo V. di Florio, then Director, SEC Office of Compliance Inspections and Examinations, spoke bluntly about why conflicts of interest are so important to the SEC.
   http://www.sec.gov/News/Speech/Detail/Speech/1365171491600#.VRBoKI4sq6U
   "Conflicts of interest can be thought of as the viruses that threaten the organization's well-being. … These viruses come in a vast array of constantly mutating formats, and if not eliminated or neutralized, even the simplest virus is a mortal threat to the body."

   Further, of course, RIAs, are directed to "seek to" avoid conflicts in instructions on the ADV Part 2. "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 that could affect the advisory relationship."

3. Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries, 87 Washington Law Review 707 (2012).

4. Ibid, 767.

5. Ibid, 769.

6. While I have not read all 3,000 comment letters to the DOL, the argument of "common sense" (to my knowledge) has been completely absent from the discussion over the past seven years.

7. See the Institute paper, "Fiduciary Duties Advanced in 2015 .." at www.thefiduciaryinstitute.org