

Can Self-Regulation in Securities Distribution or Advice Reduce Costly Regulatory Violations?

Boston University School of Law

April 19, 2017

Knut A. Rostad, President

Institute for the Fiduciary Standard

www.thefiduciaryinstitute.org

The Purpose of this Lecture

- To show how “self-regulation” is growing and is meeting or exceeding regulatory requirements
- To offer data, ‘real life’ examples and experiences
- To suggest that self regulation and market regulation will become the dominant “regulatory” force, the “visible hand” advice to individual investors

Marty McFly and Self-Regulating Wall Street?



Background: The Future of Advice is *Advice* -- as understood in the Advisers Act of 1940 and expressed by the Supreme Court in SEC v Capital Gains Research Bureau

“It requires but little appreciation... of what happened in this country during the 1920’s and 1930’s to realize how essential it is that the highest ethical standards prevail’ in every facet of the securities industry...”

375 U. S. 180 (1963)

‘An investment adviser should continuously occupy an impartial and disinterested position ... ‘

”The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations... ‘(an investment adviser) should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice...”

375 U. S. 180 (1963)

‘Two principles ... not engage in any other activity, such as security selling and brokerage ... remuneration “solely” fees ’

“The president of the ICA of America ... testified: ‘two fundamental principles ... were, first, that they would limit their efforts and activities to the study of investment problems from the investors standpoint, not engaging in any other activity, such as security selling and brokerage, which might directly or indirectly bias their investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees, fully disclosed in advance...”

375 U. S. 180 (1963)

*“When is a “financial advisor” really an advisor and when ... just a salesperson?”**

- From the websites of brokerage firms:
- “Choose a financial advisor that lives and breaths a client-centered approach to advice Putting clients first is ingrained in the way we do business.”

** Financial Advisor or Investment Salesperson: Brokers and Insurers Want to have it Both Ways, Consumer Federation of America, January 2017*

*“When is a “financial advisor” really an advisor and when ... just a salesperson?”**

- From the plaintiffs challenge to the DOL Rule:
- “Broker-dealer reps and insurance agents described “sales people” whose “essence is sales” The Chamber et al. states, “a difference exists between sales activity and fiduciary activity”

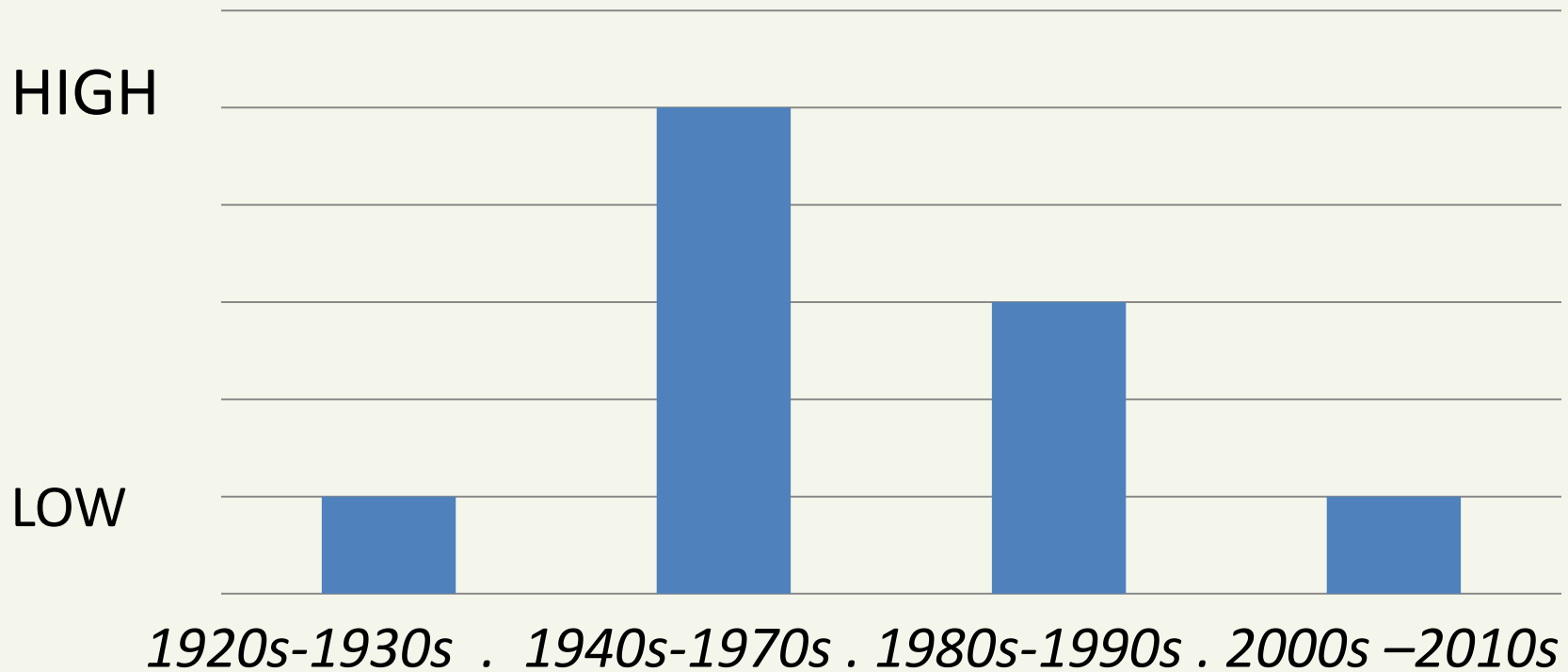
** Financial Advisor or Investment Salesperson: Brokers and Insurers Want to have it Both Ways, Consumer Federation of America, January 2017*

*Labor Department Mutiny**

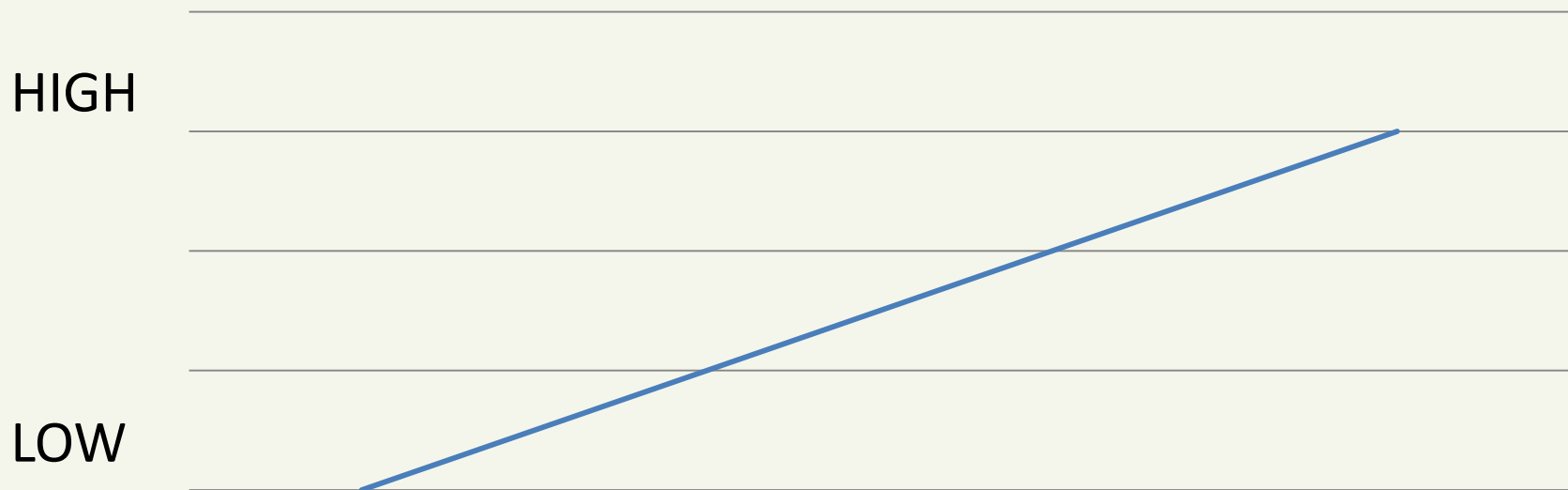
- Editorial on the Department of Labor April 4 decision to delay the Conflict of Interest / Fiduciary Rule: (54 words to remember.)
- “Proponents argued the new rule would raise the standards for advice given to retirement investors. In reality, it would make that advice more expensive, while opening up another lucrative vein for the plaintiffs bar. In anticipation of the rule, some financial firms have already announced they are dropping their business for these small investors.”

** Review & Outlook, Wall Street Journal, April 13 2017*

'Working Standard' of Brokers, Advisors and Advisers, 1920's --2017

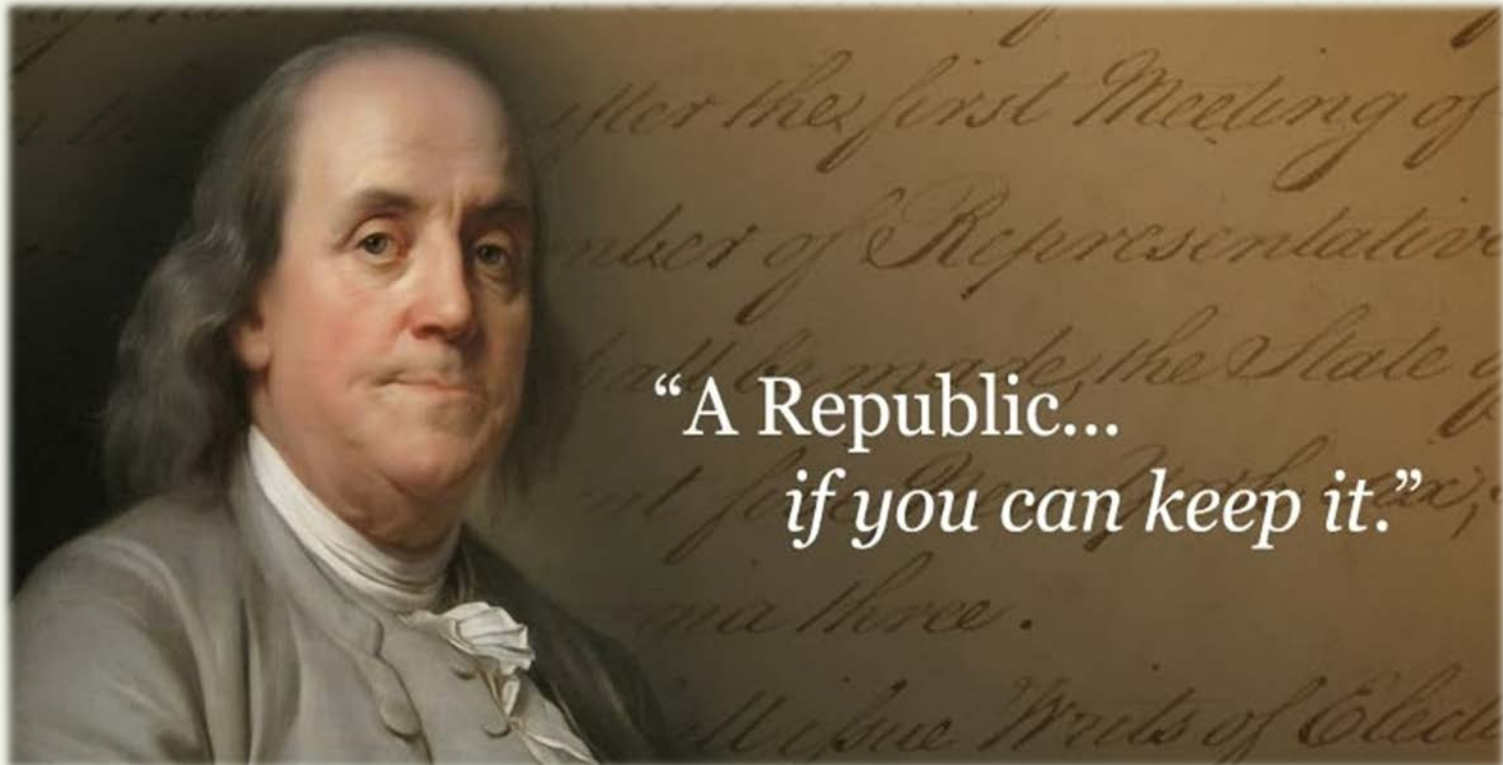


'Working Standard' of Brokers, Advisors and Advisers in 2017



Sales "suitability" . SEC . 1940 ACT . ERISA . Professional

“Self-Regulation in Government and Finance”



Self-Regulation: What Does it Mean?

How do you ‘Know it When you See it’?

- “Regulating ones-self or itself”
- ... And adhering to a professional standard?
- ... And choosing one’s regulator?

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- Institute research of Form ADVs of nine large financial services firms with AUM of \$2.54 trillion and 135 independent RIAs with AUM of \$465 billion.
- Large financial firms range from \$11.2 to \$575 billion.
- Independent RIAs from \$250 million to over \$50 billion.

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- Self reporting of conflicts of interest.
- Survey gathered data on registration, lines of business, proprietary products and principal trades, lines of business, non client compensation and material conflicts of interest.
- Disclosure on questions from Item 11 in Part 1; Items 9, 10, 12, and 14 in Part 2

**Survey Information Reported in Full in Institute's Whitepaper "What Investors Can Learn About An Advisor's Conflicts in Form ADV: 'But Were Not Sure How to Ask,'" which can be found here: <http://www.thefiduciaryinstitute.org/wp-content/uploads/2016/09/ADV-Research-91116-1.pdf>*

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- 35% of RIAs and 100% of Large Financial Services Firms (LFSFs) report employees who are registered reps of a broker-dealer.
- 88% of the LFSFs employees are also registered reps.
- 39% of RIAs and 100% of LFSFs report employees who are licensed to sell insurance.
- 2% of RIAs and 89% of LFSFs report the entity or a related person buy or sell securities from advisory clients to advisory clients.
- 17% of RIAs and 78% of LFSFs recommend securities (with) some proprietary interests.

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- Part 1A. Item 11. “Disclosure Information”
- 5 Highlighted Questions and Answers to the Survey

	Yes, RIAs %	Yes, Large Fin Firms %
Convicted or pled guilty (nolo contendere) to a felony	0	56
In the past ten years, been charged with a felony	0	56
SEC / CFTC ever found you involved in a violation	1	89
SEC / CFTC ever imposed a civil money violation	1	89
Any other federal / state agency ever found you to have Made a false statement, omission, or been dishonest ...	1	89

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- Part 1A. Item 11. “Disclosure Information”
- “Among the LFSFs, 115 infractions resulting in \$4 billion in fines or restitution were disclosed.
- Among RIAs, three infractions were disclosed. One incurred a fine of \$5700. One, a fine of \$62,000. The third, fines to the state of Florida “exceeding five figures” and credits to clients, “exceeding five figures” also to the state of Florida.

Self-Regulation: How Independent RIAs and Large Financial Services Firms Differ

- LFSF fines are 0.157% of their total AUMs.
- RIA fines are 0.000018% of their total AUMs.
- This means RIAs paid 1/10,000th of what the large banks paid in % terms.
- So, if both groups of firms had a \$billion in total AUMs, LFSFs would pay \$1,570,000 while RIAs would only pay \$180.



“Houston, we have a problem.”

Battle Over Meaning of Advice

View in History, Law, Logic & Advisers Act

- Advice and sales are inherently different and are understood to be different by consumers
- AKA “Conflicts are Harmful View”
- Advice – Expert advisor who is objective, competent, credible, and is paid to represent me
- Sales – Expert sales person paid by company to distribute product, give product info, provide service

Battle Over Meaning of Advice

Industry View: ‘We are all salespersons, now’*

- Antithetical to history, law, logic and Advisers Act
- AKA “Conflicts are OK View”: Conflicts are everywhere, part of life, cannot be avoided; thus, “acceptable”
- Widely held by certain federal securities regulators and financial service industry

*With apologies to Milton Friedman, whose quote “We are all Keynesians now” was popularized by Richard Nixon

Battle Over Meaning of Advice

CFA Institute Managing Director, Kurt Schacht,
wrote in 2015:

“If you are transparent that you are not acting solely for the benefit of the customer and that you are not their personal investment adviser, that’s fine. (But) ... stop holding yourself out as someone’s personal financial adviser because you are not – you are a salesperson.”

2015 -- 2017: An Historic Time?

- Persistent, historically high levels of investor distrust in Wall Street, financial services
- Increased investor awareness of fiduciary v 'sales-suitable' standards from DOL Rule
- Continued movement from BD to IA registration
- Growing millennial voice of skepticism
- New technologies, products, delivery: 'Robos'
- Institute for the Fiduciary Standard Best Practices for Financial Advisors and Campaign for Investors

2015 -- 2017: An Historic Time?

- Advance self-regulation by voluntarily: deregistering as a broker-dealer and filling any brokerage needs through custodians (Schwab, ..)
- Avoiding selling any products and earning any commissions or 3rd party comp
- Advocating return to “demarcation” at SEC (Per Chair Piwowar)
- Embracing Institute for the Fiduciary Standard Best Practices for Financial Advisors

Institute for the Fiduciary Standard

- Institute for the Fiduciary Standard formed in 2011 as a non profit to advance fiduciary principles in investment and financial advice through research and education
- Institute produces white papers, webinars and blogs and spear heads 'Fiduciary September', et
- Institute Advisors include Vanguard Founder, Jack Bogle and Luis A. Aguilar, SEC Commissioner, 2008-2015

Institute for the Fiduciary Standard Best Practices Affirmation Program

- The 12 Best Practices distill core of duty of loyalty to a few tasks and actions – to do or to avoid
- Best Practices aim to be concrete, verifiable and understandable to individual investors
- The Best Practices Affirmation Program allows advisors to subscribe to Best Practices by putting Best Practices on their website and language on their ADV stating adherence to them

Institute for the Fiduciary Standard Best Practices Affirmation Program

- Put in writing that your fiduciary status exists at all times, important agreements and disclosures
- Put in writing what clients pay. In “total costs.” In fees paid and fees and expenses received by the firm
- Avoid conflicts if at all possible; put in writing unavoidable conflicts (including commissions, 3rd party comp), and how they are overcome and managed to mitigate harms to clients

Institute for the Fiduciary Standard Best Practices Affirmation Program

- Show third-party comp is reasonable, level, and completely transparent
- Put in writing your investment policy process or IPS
- Avoid proprietary products or principal trading
- In sum: Do what's reasonable. Put it in writing. Verify.

Best Practices Affirmation Program Self-Regulation for Investment / Financial Advice for Today

- Restores historic, commonsense meaning of “advice” and rationale to separate “advice” from “sales”
- Speaks intelligibly to individual investors
- Builds on current differentiation between brokers and advisers in conflicts and infractions (per Form ADVs), and trend of brokers to become investment advisers
- Leverages vital role and strength of adviser regulation
- Provides true fiduciaries a platform. To do more. To stand out. To speak out. To tell the SEC. To Lead.

Thank You

www.thefiduciaryinstitute.org

Knut A. Rostad, President
Institute for the Fiduciary Standard
Boston University School of Law
April 19, 2017

