INSTITUTE FOR THE FIDUCIARY STANDARD

June 11, 2018

TO: Friends of the Institute
RE: SEC Proposed Rule(s) on broker dealer and investment adviser Standards of Conduct

Summary

The proposed rules affirm the view of key SEC officials that brokers and advisers are "essentially identical." This is how. Key BD and IA differences are glossed over; the proposed 'best interest' standard looks more like a 'suitability' standard; conflicts are deemed ubiquitous and "OK"; disclosures comparing IAs and BDs are misleading to retail investors. The implications of these proposals are far-reaching.

If enacted, the proposals would essentially create a uniform broker dealer standard and this uniform standard would be dominant over the far higher standard of fiduciary advisers. The message: in 2018 retail investors no longer need an adviser who is driven by fiduciary principles and who serves in an "intimate relationship" in a position of trust and confidence.

Introduction and Background

The SEC has released two proposed rules on conduct standards for brokers-dealers and investment advisers. The rules, entailing over 900 pages, are found on the SEC website. https://www.sec.gov/rules/proposed.shtml
The Institute will submit a comment to the SEC by August 7, the end of the comment period. In the meantime the Institute will continue to collaborate with other fiduciary advocates, speak out on the proposed standards and meet with commissioners to press our views. We are scheduled to meet June 19 with Chairman Jay Clayton.

For over 25 years broker dealers have held themselves out as trusted advisers. For a decade top SEC officials have said that differences between broker dealers and investment advisers have become small, their similarities large. So it is no surprise that surveys of investors (such as the 2008 Rand study) have shown that investors have a hard time distinguishing advisers from brokers. The SEC says this "confusion" is an important rationale for the proposed rules. The SEC's Regulation Best Interest and CRS Relationship Summary are discussed here.

Regulation Best Interest

Regulation Best Interest seeks to raise the suitability standard and requires brokers fulfill three tasks.

- Disclose prior to the recommendation the material facts relating to the scope and terms of the relationship and "all material conflicts associated with the recommendation";
- Exercise reasonable care, skill and prudence, so as to have a "reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers"; and
- Maintain written policies and procedures to "at a minimum disclose and mitigate, or eliminate all material conflicts of interest arising from financial incentives associated with the recommendation."

In contrast, a best interest broker standard should be functionally equivalent to a fiduciary standard and require:

- Investment advice reflects the care, skill, prudence and diligence of a prudent person in a similar capacity and circumstances, without regard for the financial or other interests of the financial institution.
- Misleading statements to be avoided.
- Compensation and all fees are reasonable and transparent; expenses are minimized. All-in personalized fees and expenses are reported periodically.

- Material conflicts are a serious threat to fiduciary conduct. They are avoided, if humanly possible. Conflicts not avoided are mitigated, written informed client consent is obtained, and the transaction is only completed if deemed fair and reasonable.
- Avoiding egregious material conflicts. Refrain from incentives intended to deviate from client interests (quotas, bonuses, differential compensation, third-party payments, proprietary products.).
- Disclosures of business practices. Brokers participating in offerings are hired by issuers to distribute products and get paid when they sell. Their advice is incidental to the brokerage transaction; it is not in an intimate relationship from a position of trust and confidence as set out by the 40 Act framers.
- Policies and procedures that follow guidance set out by the SEC.
- A mandatory waiting period before client consent is delivered for certain material conflicts.

Takeaway. The proposal falls well short of a best interest standard functionally equivalent to a fiduciary standard. It also raises a key question: Should the SEC seek to set a best interest standard in one rulemaking? Can it? It's *hard*. Some might say impossible. Look at the proposal. Try as they might, the SEC's best efforts fell short. This is not surprising. After all, transforming an industry that is built to manufacture and sell products into a profession to deliver fiduciary advice is a huge task that no one can deny. This task requires much time, effort, and leadership. It requires instilling new norms, practices and policies that do change established cultures, so brokers *can* comply. Firms need time to change; brokers need time to learn. Rulemaking is vital, but it is insufficient by itself to remake brokerage conduct into fiduciary conduct.

CRS Relationship Summary

The Form CRS Relationship Summary proposal seeks to communicate how brokers and advisers compare and contrast. It doesn't succeed. Hypothetical disclosures underscore the SEC's view that the respective obligations are very alike. They do so by glossing over contractual and legal differences. Broker-dealers' primary obligation in offerings is to issuers and underwriters. And that investment advisers' sole obligation is to clients in a two-way relationship. This omission is glaring. Instead, Relationship Summaries for BDs and IAs depict practices that are hard to distinguish. They include:

- Re: Compensation, for BDs, "transaction fees" replace "commissions" to describe fees from a brokerage account "every time you buy or sell an investment". IAs, "You will pay an on-going asset-based fee".
- Re: The standard of care, for BDs, "We must act in your best interest and not place our interests ahead of yours when we recommend and investment involving securities." For IAs, "We are held to a fiduciary standard that covers our entire investment advisory relationship with you."
- Re: Conflicts, for BDs, "Our interests can conflict with your interests. When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them." For IAs, "Our interests can conflict with your interests. We must eliminate these conflicts or tell you about them in a way you can understand, so you can decide whether or not to agree to them."

Takeaway. These disclosures clearly say that BDs and IAs are, effectively, held to the same standard.

Key Assumptions Are Embedded in the Proposals – But Are Not Stated And Explained

There are key assumptions embedded in the proposals that are not stated and explained. They should be noted. First, core IA and BD differences do *not* matter. Core contractual and legal differences of BDs and IAs are not stated and explained. That broker dealers are in a three-way relationship and represent issuers and underwriters and are generally only paid commissions for making sales – is not said. That investment advisers are in a two-way relationship and exist to represent clients and render fiduciary advice and are paid by clients to do so – is also not said. These differences are fundamental.

The recent Fifth Circuit Court decision to vacate the DOL Rule also reflects these differences. The Court differentiates advice in an "intimate relationship" and a position of "trust and confidence" of advisers from brokers who render advice "merely as an incident to their broker-dealer activities." Instead of highlighting, underscoring and explaining these differences, the proposals gloss over them.

Second, conflicts are not inherently harmful; in fact, they're quite okay. Conflicts are deemed to be benign and generally unavoidable. The inherent and material harmful nature of conflicts is not stated and explained. The importance of avoiding conflicts is not discussed. The historical, legal and commonsense linkage between avoiding conflicts and the fiduciary duty of loyalty is not discussed. The overwhelming evidence in the academic research demonstrating the failures of disclosing conflicts is also not discussed. The difficulty to effectively manage or mitigate conflicts is also not discussed. Absent these discussions, there is no urgency for brokers and advisers to eliminate as many conflicts as humanly possible to serve a client's best interest. Conflicts are effectively deemed okay, but this is also not stated and explained.

Third, all conflicts are the same. Conflicts are deemed as created equal. That they differ, sometimes significantly, as to their frequency, complexity, potential harm and transparency is also not stated and explained. For example, the commission grids and incentives under which most brokers operate are ever-present, complex and opaque. Their impact can be great. In contrast, IAs' conflicts are often less complex and more transparent and episodic. IARs who hold insurance licenses, or advise a client on whether to pay off a mortgage can be conflicted. Yet, these conflicts are also transparent and more understandable to clients.

Fourth, fee and expense accounting is fine, but it is not essential. Generalized fee disclosure regarding when and how fees are assessed is discussed. This is good. A personalized fee and expense accounting of all in costs is also discussed. This is also good. The SEC, however, rejects requiring such fee accounting. Even though some advisers already provide such a report, the SEC says, it would be too burdensome and costly to require advisers or brokers do so. This is unfortunate. Research suggests this personalized fee and expense accounting is what retail investors want, would ameliorate investor confusion and help build trust. This is not stated and explained.

Conclusions and Recommendations

The proposed rules affirm a view expressed by key SEC officials (current and former) that brokers and advisers, as former SEC Chair White said, render "essentially identical conduct." The implications of adopting these proposed rules as written are far-reaching for IAs and BDs and investors.

The implications? If enacted, the proposals would effectively harmonize the standards in the minds of investors. Investors would see no differences between Reg BI and advisers' standard. *The* new uniform standard, Reg BI, would be a broker standard that should be called "Suitability plus." The far higher standard of fiduciary advisers would be marginalized. The implicit message would be there is no longer a unique and important rationale for an adviser standard for retail investors. Retail investors no longer need an adviser adhering to fiduciary principles and who serves in an "intimate relationship" and position of trust and confidence.

Two general recommendations should be priorities. These recommendations will be discussed in detail the Institute's comment letter in August. In sum: First, Regulation Best Interest must be raised to become functionally equivalent to a fiduciary standard. Additional provisions must include explicit warnings about conflicts, explanations of broker s' and advisers' differing obligations and guidance on policies and procedures. Second, the CRS Disclosure Summary hypothetical disclosures must be abbreviated to a main one-page document that more clearly compares and contrasts the core differences between advisers and brokers.