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Fiduciary Reference

Analysis of Investment Fiduciary Issues

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SEC Office of the Investor Advocate / RAND study offers new insights into retail investor, financial reps misunderstandings of brokers and advisers; study offers guidance for Reg BI

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Executive Summary and Introduction

The RAND 2008 study, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, documented that many retail investors fail to understand how brokers and advisers differ.[1] The Office of the Investor Advocate / RAND 2018 study (OIAD), The Retail Market for Investment Advice, seeks to "determine how well investors understand the retail market for investment advice and to identify and test actionable policy innovations." [2] OIAD reaffirms Key RAND 2008 findings. It also offers new insights to better explain retail investor misunderstandings as result of industry and regulatory communications, and to provide guidance for the SEC's Reg BI.

- Both RAND 2008 and OIAD capture investors' misunderstandings well. OIAD also offers insight into *why*, and focuses on the disclosures themselves and the difficulty financial reps have understanding them. The longstanding focus on "investor confusion" is put in question.
- The OIAD focus group disclosure, like SEC's Form CRS, ignores BD and IA key differences; there should be no surprise investors don't understand how IA and BD differ.
- OIAD highlights the divide between what investors believe is important and in their best interest and what key SEC officials and BD industry believe is in investors' best interest.
- OIAD offers guidance for Reg BI.

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[1] https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf, at 87 ("[M]ost survey respondents and focus-group participants do not have a clear understanding of the boundaries between investment advisers and broker-dealers. Even those who have employed financial professionals for years are often confused…[P]articipants also understand relatively little about the legal distinctions between investment advisers and broker-dealers").

[2] The Retail Market for Investment Advice, https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf

Key Focus Group Findings

Thirty-five individuals participated in four focus groups in Baltimore in January 2018.[3] The focus group findings offer new insights into participants' views of conflicts of interest, compensation, and the differences between IAs and BDs.

Conflicts. On conflicts, the report notes, "In all three groups that had experience using a financial professional, when asked, participants reported that their professional had not reported any conflicts. However, it is not clear whether these responses reflect an actual absence of conflicts, an omission by financial professionals to disclose conflicts, or a failure of participants to recognize the disclosure of conflicts when disclosed."[4]

Key point. The report does not suggest which potential scenario best explains why participants said their financial reps "had not reported any conflicts." However, it raises the question of whether written disclosure of material conflicts and written informed client consent could reduce this knowledge gap.

Compensation. On compensation, the report notes, "Participants generally preferred that a professional be compensated by the client alone, believing that such advice would be of a higher quality."[5] This said, some participants also noted that may not rule out a broker receiving commissions if the additional compensation was disclosed in a "transparent and 'up front'" way.

Key point: This finding associating fee-only compensation with higher quality advice is significant.

Differentiating IAs and BDs. Participants were provided definitions of BDs and IAs. The report: "We found that, even with the explanations of the differences between IAs and BDs, participants evaluated the two types of financial professionals differently. Although some participants demonstrated a basic understanding of IAs and BDs, other participants appear not to have understood the distinctions. We realized we needed to find new ways to define and ask about the two types of professionals… [and] the need for more effective ways of communicating to investors the differences between IAs and BDs. Some comments also suggest that the possibility of … being both a BD and an IA might serve as a barrier to understanding the roles of professionals."

Key point. The definitions suggest brokers and advisers are very similar. For example, brokers charge a fee or commission for buying/selling securities and also make recommendations, while advisers are in the business of giving advice about securities and charge an ongoing fee. These statements sound a lot alike. However, that brokers operate contractually to distribute securities on behalf of issuers and that advisers have a fiduciary duty to represent their clients are not stated. There can be no surprise some participants "appear to not have understood the distinctions" when such key distinctions are omitted.

[3] For greater detail on study methodology, see Ibid, at 15.
[4] Ibid, at 23.
[5] Ibid.

Key Survey Findings

The survey was conducted in February 2018. 1816 respondents, part of Rand's ALP database of 3400 households, completed the survey.

Advice fees. Respondents on what types of fees they paid? "In most categories about a quarter of respondents … stated they did not know if they paid that type of fee or not. In the case of commissions and asset-based fees, these "don't know" responses are narrowly exceeded by the number of "yes" responses. However, for other categories, the 'don't know' responses are provided as much as three times more frequently than the 'yes' responses. In the case of the 'other' fee type category, nearly 40% of respondents reported 'don't know.' *… the high frequency of 'don't know' responses suggests a high degree of uncertainty about the types and levels of fees paid* (Emphasis added)."

Key point. This "high degree of uncertainty" reflects the ambiguity and opaqueness around fees. The remedy is transparency and clarity in the SEC's Form CRS followed by personalized fee reporting.

Importance of fee-only compensation. Participants were asked "How important would it be to you that your financial professional receives all of his/her compensation from you directly?"[6]

Not important, not at all important	22%
Neither	28%
Important, extremely important	51%

Key point. This data is fresh and important. It quantifies just how much investors prefer an adviser be compensated by the client alone. With the focus group finding, these data provide a strong basis to conclude that investors prefer 'fee-only' compensation and associate fee-only advice with higher quality advice. Conversely, while lower quality advice seems associated with compensation conflicts, higher quality here seems to underscore principles intertwined with objectivity, loyalty and professionalism. They are also reminiscent of Professor Arthur Laby's point that "advice" means "disinterested advice" and that this is "commonsense."

The data are more relevant in illustrating how investors views differ from the views of some SEC officials, (including former Chairs Schapiro, Walters and White) brokers-dealers and CFP Board. Each has suggested a contrary view that downplays the importance of conflicts generally and material differences between BDs and IAs or fee versus commission compensation as they regard conflicts. These views suggest that BDs and IAs are, for all practical purposes, the same and that neither commissions nor fee-only compensation are, per se, better for clients. The differences in these opposing views between investors and these officials are stark.

[6] See language on pg. 65.

Views of individuals who do not use an adviser. The report identifies numerous views of these individuals that may help explain why they choose to not work with an adviser. These views concern their perceptions of brokers or advisers value proposition, trust issues, and searching for an adviser.[7] Regarding the issue of trust or distrust, these individuals speak loudly. When asked to agree or disagree to the three statements below, only small percentages reported they agree.

Most financial professionals care about the wellbeing of their clients.	24%
Financial professionals are honest in their dealings with their clients.	17%
Its' easy to find a trustworthy financial professional.	13%

Key Point. Distrust of financial professionals remains strong.

The meaning of 'best interest'. This may be the central question raised by Reg BI. The report provides guidance by asking respondents about certain specific tasks a 'best interest' standard should require of a financial rep.[8] The responses to three questions by investors who are currently using advisers are especially pertinent. Below are the statements and the percentages of investors who agree / disagree.

	Agree - Disagree
Will help me choose the lowest cost products, other things equal.	73%-11%
Will disclose payments they received that may influence them.	59%-15%
Will avoid higher comp when a similar, less costly product is available.	61%-19%

Key point. Investors are not ambivalent or uncertain about what they expect from their financial rep. They expect a financial rep to represent them. They expect the rep to provide clarity and transparency on conflicts and fees.

Who am I working with? The report notes, "The survey allowed us to assess, for a subset of respondents who reported using advice, the accuracy of their perceptions about their professional's registration status, as determined by comparing survey reports of registration status to the reported professionals verified registration status" in the IAPD. Survey participants who reported working with a financial rep indicated that 54% were IAs, 34% were dually registered and only 6% were BDs. This self-reporting was significantly different *as compared to actual registrations*. When participants offered an individual or firm name, their registration status was checked in the IAPD data base. Among those that could be "matched," 86% were found to be dual registrants.[9]

Key point. Investors' widespread misunderstandings of their rep's registration status are not surprising because so much ambiguity is permitted. Transparent, clear and written disclosure and explanations are not required by federal rules.

[7] Ibid, at 69.
[8] Ibid, at 72.
[9] Ibid, at 75.

Back to the RAND 2008 Study

A review of the RAND 2008 study that addressed similar issues of IAs and BDs and investor understandings of their differences.

RAND 2008 Study findings. "Overall, we found that many survey respondents and focus-group participants do not understand key distinctions between investment advisers and broker-dealers, their duties, the titles they use, the firms for which they work and the services they offer …. Even after explaining to them that a fiduciary duty is generally a higher standard of care, focus group participants expressed doubt that the standards are different in practice."[10]

Why the misunderstandings? Firms' regulatory disclosure, referred to as "administrative data," and other disclosures are hard to compare. Inconsistencies were reported. Many financial reps were unsure about how to report their own activities.[11] Focus groups were presented with fact sheets about brokers and IAs, with common job titles, legal duties and typical compensation. RAND noted, "Even after being presented with fact sheets, participants were confused by different titles. They noted that the common job titles for investment advisers and broker-dealers are so similar that people can easily get confused."[12]

RAND's explanation? With the "complexity of the financial services market, we were not surprised to find" many … "did not understand" how IAs and BDs differ. Similar-sounding titles, like "advisor," "consultant," or "planner" held to different standards" confused regulators and financial reps.[13]

Key point. The RAND 2008 study is exhaustive and important. Yet, RAND falls short explaining why so many investors so misunderstand disclosures, advertisements, and the "fact sheets." For a decade the blame has been put with investors and the rallying cry has been "investor confusion." Yet, RAND suggests financial reps found it difficult to make sense of the "administrative data", and had difficulty disclosing their own practices. This suggests the problem is not just about investors' shortcomings; but about the shortcomings of the communications themselves.

Discussion

The RAND 2008 study documented that many retail investors don't understand how brokers and adviser roles differ. RAND found the roles were "confusing" to investors. RAND further suggested that this confusion is also shared by financial reps and that regulatory pros share the responsibility for this confusion. The OIAD study corroborates these findings, and adds new insights into retail investors and their misunderstandings regarding the roles of brokers and advisers.

Investor or communications confusion? Conventional wisdom says that investor confusion is the problem. A closer review suggests that the communications themselves -- communications confusion – is at play. Communications confusion as when communications stress similarities and omit BD and IA differences. And as with poorly drafted disclosures or advertisements from the firms themselves.

[10] https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf, at 118.
[11] Ibid, at 116.
[12] Ibid, at 111.
[13] Ibid, at 117.

It's communications confusion. The Focus Group Handout 1 (attached to this document) seeks to explain the role of BDs and IAs. Unfortunately, it does not succeed. It says of brokers: "A broker is an individual or firm that charges a fee or commission for buying or selling securities for investors." Of advisers, "An investment adviser is an individual or firm that is in the business of giving advice about securities to clients." About both, "A financial professional can be both a broker and an investment adviser, and a firm can be both ... The handout suggests the greatest difference is: "The broker does not typically monitor … your account:" … "The adviser typically monitors your account."

To its credit, OIAD acknowledges the handout failed and stated, "more effective ways of communicating to investors the differences" are needed.

Differences between a distributor operating under brokerage sales rules and an adviser under fiduciary rules are omitted. That manufacturers pay BDs' commissions to sell products to their BD customers (in a relationship of three) and clients pay IAs for fiduciary advice (in a relationship of two) isn't said. These omissions are glaring. These largely features define IAs and BDs. RAND suggests investors believe they are important and want to know about them. Here-in is the divide between investors and BDs and regulators. While investors believe fee-only comp, real fee transparency and reps working to minimize costs are important, key SEC officials and the BD industry apparently do not.

Investor clarity. Investors are clear. They want a best interest standard and a financial rep to:

- Receive compensation from clients directly.
- Represent their interests, not the interests of others.
- Avoid higher compensation costs and recommend "lowest cost" products, other things equal.
- Explain any payments that may impair their objectivity.

Conclusions

RAND 2008 squarely rests its' analysis on "investor confusion," investors' inability to decipher market complexities. Implicitly, investors are faulted. OIAD, however, highlights firm communications and regulatory disclosure in explaining misunderstandings of both financial reps and investors. The importance: OIAD notes how many investors misunderstand OIAD "definitions," (such as job titles, legal duties and methods of compensation) "even with explanations" provided. The reason: IAs and BDs are portrayed as virtually the same, while legal and contractual "key distinctions" are omitted. "Communications confusion" is significant and the mantra of "investor confusion" is misplaced.

OIAD also highlights the investor / industry-regulatory divide on a best interest standard. Reg BI, for example, suggests a limited menu of proprietary products is presumed to be okay. Investors disagree and say they expect their financial rep to, for example, choose the lowest costs products, other things equal. Investors' preference for compensation by the client alone is also a noteworthy finding.

SEC Chairman Clayton has repeatedly said that financial reps should be held to standards that meet investors reasonable expectations. OIAD highlights some of these expectations. They should be given full consideration. Let the conversation continue.

Appendix 7. Focus Group Handout 1

Definitions

A broker is an individual or firm that charges a fee or commission for buying or selling securities (like stocks, bonds, or mutual funds) for investors.

There are different kinds of brokerage accounts you can choose. You can choose an account where you research an investment yourself and just place orders with the broker, or you can choose an account where the broker makes recommendations to you. With both types of brokerage accounts, you approve each order to buy and sell investments in your account, and you are charged a fee each time you buy or sell an investment. This fee is not based on the value of assets in your account.

A broker may give you some advice to help you decide what to buy or sell, but the broker does not typically monitor the performance of your account or offer investment advice on a regular basis.

An investment adviser is an individual or firm that is in the business of giving advice about securities to clients. The adviser typically monitors your account and offers advice on a regular basis. The advice may include recommendations about specific investments to buy or sell, or it may be more general advice such as how to properly balance your portfolio between stocks and bonds.

There are two different kinds of advisory accounts you can choose: an account where the adviser gives you recommendations and you make the final decision before securities are bought or sold, or an account where you give the adviser the discretion to buy or sell investments on your behalf without seeking prior approval. In either type of account, an adviser will charge you an on-going fee that is usually based on a percentage of the value of assets in your account.

Sometimes, an investor may want a one-time service from an adviser, such as a written financial plan, and an adviser may charge a one-time fee for that type of service.

A financial professional can be both a broker and an investment adviser, and a firm can be both a brokerage firm and an investment advisory firm.