Where Regulators Will Land on the Fiduciary Issue and Why You Should Care

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Where Regulators Will Land on the Fiduciary Issue and Why You Should Care

by Keith Hickerson, MSM

> What issues related to the financial reform bill are of greatest concern

The massive Dodd-Frank financial reform bill requires more than 400 rulemakings and studies, impacting 21 different federal agencies. This cumbersome process will keep going, extending years into the future. It's small wonder that for those of us who will ultimately be affected, fatigue can easily set in at various points during this regulatory marathon. But we lose focus at our peril: One phrase incorrectly written, one cost-benefit analysis left undone, and the consumers our profession serves could be left with less access to advice, fewer product choices and higher prices.

The biggest challenge is to inject thought discipline into the rush to regulate, making sure policy makers understand the full impact of any rules they're considering. Fortunately, there's been a little good news on that front since our last update.

**FIDUCIARY MISINFORMATION: the question nobody's asking**

Both the Securities and Exchange Commission (SEC) and the Department of Labor (DOL) are working on new fiduciary rules that will change standards of care for both broker-dealers and, though it's seldom discussed, for investment advisors. Any debate on the subject quickly moves to wording of a harmonized standard, enforcement and how to deal with the impact to differing business models. If you ask why it's important to make the change in the first place, the answers get fuzzy quickly. That's the question no fiduciary advocate really likes to discuss. There is no quantifiable consumer harm under the existing standards of care. Fiduciary advocates point to some level of consumer confusion or potential conflicts of interest under suitability—both of which may be valid points—but suitability advocates point to much stricter, more frequent enforcement. It's very difficult to demonstrate that consumers are not served well by an environment of choice, low costs, and flexible access to products and advice.

"Because it sounds good" is not a meaningful approach to public policy. The cold, hard fact is that enforcing a vague principles-based standard is more difficult than enforcing a rules-based standard. Ask investment advisors if they would like to be examined as frequently as FINRA-regulated registered reps are under a strict rules-based enforcement system. You may be surprised at the answer.

**FAST START, PROMISING DELAYS: where the SEC is headed**

This time last year the SEC had just released a staff study recommending adoption of the fiduciary definition embedded in Dodd-Frank for both investment advisors and broker-dealers. Howls went up from several SEC commissioners in the form of sharply worded letters to Congress, and Congressional leaders on both sides of the aisle advised the SEC to move with caution, making sure they do a full cost-benefit analysis prior to rulemaking. The staff study was notably light on the impact side of the ledger: Essentially, they had no clue what a harmonized standard might do to the marketplace or to consumers. During the summer the SEC lost a court battle on a separate issue, the controversial proxy-access rule, based on lack of understanding of the costs. Specifically, the court said the SEC had acted "arbitrarily and capriciously."
It took the court ruling to convince the SEC to apply the breaks on the fiduciary issue as well, leaving more time to do a full cost-benefit analysis. Interestingly, some of the same people who supported the deeply flawed staff study are reportedly engaged in the new cost-benefit work. The SEC has indicated there will be another request for public input soon, and they’ve also said that any proposed rule will be “business-model neutral.” Encouraging signs, but we need to see what “business-model neutral” will mean in practice. It may be that both the broker-dealer and investment advisor models are preserved with more disclosure to consumers about the nature of the services they are receiving, but we’ll have to wait and see which direction the SEC takes.

It’s important to remember that the SEC is proposing adding a fiduciary definition to the Investment Advisors Act, as well as changing the standard for broker-dealers. Fiduciary responsibilities for investment advisors have been established through case law, rulemakings and precedents, but the definition of the standard itself is not currently in the act. While the SEC’s intent may be that the addition of this new wording will not change an advisor’s responsibilities or impact their potential liability, that may not be the practical outcome. It’s odd that most investment advisors seem not to be concerned about this significant change. In reality, it’s only a matter of time before increased legal activity around investment advice becomes the norm. Crafting a harmonized definition of fiduciary, regardless of the regulator’s intent, may not turn out to be a welcomed change for investment advisors, either.

**FAST START, WRONG DIRECTION: the determined DOL**

While the SEC’s drama was moving forward, the Department of Labor was revising a 35-year-old fiduciary definition under ERISA. A number of issues were emerging from their proposed approach, but the most troubling was their fixation on IRA advice. Essentially, their rules—absent any appropriate exemptions—would have subjected any advice provided to IRA account holders to a fiduciary level of care.

Many projected that the practical result of this definition would have been to drive financial professionals away from providing advice to holders of smaller-value IRAs. Without enough assets to make a fee-based arrangement workable, many working Americans would be denied some of the options they now enjoy. It’s a classic case of the perfect becoming the enemy of the good, and again, complaints about the approach came from all parts of the political spectrum.

The DOL moved back to the drawing board, but with an accelerated request for extensive IRA data from a number of industry groups. The depth of data may not be available at all, and what is there must be delivered in a very short timeframe. The DOL has indicated they are working on a fast cost-benefit analysis, but we can only be hopeful that it’s not an exercise in justification for a decision they’ve already made. This effort bears watching, and it’s consumers saving for retirement who are most at risk of suffering an adverse impact.

**THE ENFORCEMENT BATTLE: who answers to whom?**

Even with a recent funding increase for the SEC, the agency still does not have the wherewithal to perform adequate examinations of investment advisors. The examination rate is still stuck at about 10 percent, and most experts agree it should be substantially higher to achieve effective oversight. It’s a high-profile battle—and one that requires Congressional approval—to determine how that enforcement should be handled. The choices haven’t changed:

1. Increase funding for the SEC to handle the task, potentially through increased user fees.
2. Charge one or more self-regulatory organizations (SROs) with the enforcement work.
3. Allow FINRA to supervise dual registrants.

Investment advisor groups are adamantly opposed to oversight by FINRA, objecting to the rules-based rigor and exam frequency. Others feel FINRA is the logical, scalable resource to handle the task. A recent study by several groups who have publicly promoted increasing SEC funding found—not surprisingly—that the other two options would be much more expensive (a finding made more interesting by the fact that those conducting the study talked with neither FINRA nor the SEC).

The enforcement protocol that ultimately emerges will be inherently tied to whatever final standards of care are adopted. We’ll have to wait and see if the disappointment with prior enforcement efforts by the SEC impacts this issue in Congress later this spring.

**STAY TUNED**

As always, the parting message is to remain engaged in these critical issues that could impact our profession, certainly, but more importantly the consumers we all serve. Now more than ever, it’s important that we support NAIFA, AALU and the other advocacy organizations that are focusing legislators and regulators on the importance of doing what’s really best for consumers over the long run.