REGULATIONS

Washington Surprise: A Glimmer of Agreement in the Fiduciary Wrangle?

by Keith Hickerson, MSM

> Learn the state of the debate over settling on a fiduciary standard for industry professionals

It's common knowledge these days that the right and left never agree on anything. So why is Barney Frank writing letters to the SEC cautioning them on overreach in their extension of the fiduciary standard? Why are House Republicans and some Security and Exchange Commission (SEC) commissioners expressing concerns? It's becoming increasingly clear that it's middle-income Americans who may get hurt by an unreasoned, one-size-fits-all approach to a fiduciary standard that could force brokers and dealers into a new business model.

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WHAT'S AN AVERAGE INVESTOR TO DO?

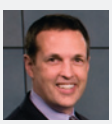
This change is much more of a problem for those making $50,000 a year than for those making $250,000 a year. Let's suppose a broad fiduciary standard is put in place for broker-dealers, creating additional compliance costs, potentially limiting the distribution of proprietary products and resulting in more financial professionals moving to a fee-based model. Would an investor of average income want to pay for a standalone financial plan? Would she meet the required asset threshold to be a meaningful client for a fee-based advisor?

For average investors, the consequences could include fewer individuals seeking qualified financial advice. In fact, a recent study suggests that the cost of advice could double for those at the lowest end of the investment spectrum. According to a high-ranking official at Morgan Stanley Smith Barney in a recent issue of *Investment News,* the first signs of the business-model shift may already be occurring as brokers work to get ahead of the coming regulatory change. It quickly becomes clear why neither liberals nor conservatives want to be tagged with this one.

RUNAWAY REGULATION IS THE ORDER OF THE DAY

The Dodd-Frank bill took a decidedly odd approach to regulation, missing an opportunity to do more on derivatives or with the government-sponsored entities that helped cause the mortgage crisis while meddling in everything from debit card fees to creating an unwieldy new consumer agency. One result of the massive legislation was to send government agencies scurrying off to conduct studies and write rules ad infinitum.

The mandated SEC staff study on standards of care came back advocating a single standard of care for investment advisors and broker-dealers, after spending dozens of pages explaining why they weren't sure what the impact of the change would



Keith Hickerson, MSM

Senior Strategy Consultant at The American College, Keith previously served as an executive at UNUM.

keith.hickerson@TheAmericanCollege.edu

be. Nowhere did they identify the specific consumer harm they hoped to mitigate. Still, they thought implementing a uniform standard of care was a good idea. The proposed standard would require broker-dealers and investment advisors providing personalized investment advice to retail clients to "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment advisor providing the advice." Certainly sounds good, doesn't it?

The SEC has slowed their work on the fiduciary issue somewhat, both because of limited resources and because of the emerging complexity of their regulatory challenge.

LET'S PLAY THE BEST-INTEREST GAME

Every successful financial professional works hard to serve clients effectively and well, and acting in the long-term interest of clients is the only path that leads to customer satisfaction, retention and referrals. Using the legal definition the SEC staff study suggests, however, creates some issues. There's nothing in the language about risk tolerance, client circumstances or the financial professional's best knowledge at the time the advice is delivered. There is also no suggestion as to when best interest might be determined: Over the next quarter? The next year? The next 20 years?

Consider the timing of making that best interest determination as it might relate to the sale of a variable life insurance product. If the client were to die within a few years after the sale, in hindsight, a policy with the highest death benefit would have been in the client's best interest. If a raging bull market occurs over an extended period, an aggressive variable policy with exposure to a portfolio of equities might have been the best choice for the client. Were the market to fall, stronger guarantees would have been a better choice. What seems simple—a noble concept of client best interest—is actually very complicated as the basis for regulation. It's easy to see the increased litigation potential, as well.

Remember, too, that the uniform standard will technically change the existing definition for investment advisors. Even though the SEC has suggested interpretive guidance may not change, the core language that drives regulation and litigation will be transitioning for both business models, advisors and broker-dealers.

Broker-dealers work now under a suitability standard, with clear rules established before the fact that govern their business activities. Advisors working under the fiduciary standard, however, face conduct evaluation after the fact. Regulating a principles-based fiduciary standard based on the lack of clear rules for action is much harder. Currently, broker-dealers are inspected every two years, while investment advisors are inspected only once every 10 years on average. In fact, according to the SEC, one-third of investment advisors have never been inspected. Fiduciaries like Bernie Madoff can escape detection for a long time, creating considerable investor harm in the interim.

WHERE'S THE CONSUMER BENEFIT?

The oversight disparity between the two models leads to a fundamental question: will consumers be better off practically with more financial professionals working under a fiduciary standard? Ask advocates of a universal fiduciary standard for a concise description of how consumers will benefit, and you'll get few solid answers. Most will say that eliminating consumer confusion is important. There's some truth to the fact that consumers are confused by the entire issue of standards of care, but they also indicate that they are happy with their financial professionals and their level of market choice. Any issue of consumer confusion—if that's really the core issue—could be solved much more easily, with less potential harm, through more robust disclosure requirements.

Consumer advocates also talk vaguely about increased consumer protections of the standards change, but pushed for details they offer few. Strangely, these same advocates mention none of the potential harm to consumer choice, costs and access—harm that could be significant and hit middle-income consumers hardest.

HAS THE DEPARTMENT OF LABOR (DOL) SEEN THE LIGHT?

The Employee Benefits Security Administration (EBSA) has also been working to update its definition of which retirement plan professionals are fiduciaries. The long-standing multi-part test could be broadened, with potentially negative impact to investors with IRAs or employer-sponsored plan

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participants who are seeking professional advice.

The fundamental issue is the same as in the SEC debate: the "fiduciary" concept may sound appealing, but without careful attention to the way consumers access advice and the business models that make that advice readily available, consumers at the lower end of the investment spectrum could be harmed—especially those with IRAs. Less access to professional advice and products is a critical concern when families are facing significant retirement income shortfalls over the coming decades.

Finally, following wave after wave of protests from virtually every quarter, the DOL is backing down. They've agreed to re-propose their rule sometime early next year, hopefully in a more acceptable form that does less harm to consumers.

WHERE DO WE GO FROM HERE?

As the debt and deficit discussions continue in Washington, the SEC has slowed somewhat their work on the fiduciary issue because of the emerging complexity of their regulatory challenge, limited resources, and the pursuit of (at last!) a stronger cost/benefit analysis. They have indicated that they will study the potentially negative impact to consumers of their staff proposal, but it is unclear how extensively they might apply their limited resources to that important work.

Congress recently held hearings that touched on these important issues – with fewer of the same tired groups chanting the word "fiduciary" while offering no supporting consumer benefits or analysis of potential consumer harm. The testimony and dialogue began to generate a greater understanding of the real issues at play for middle-income investors. Good intentions have never protected consumers. Well-reasoned public policy can, and there's a glimmer of hope now that more nuanced and practical thinking may ultimately prevail.