THE HARMONIZATION TRAP

Why advisors should demand truth-in-labeling
rather than a uniform fiduciary standard.

Scott MacKillop, J.D.

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Harmony—Such a Beautiful Word

The word "harmonization" has such a soothing feel to it. It conjures up images of combatants laying down their weapons, putting aside differences, and working hand-in-hand to find that common ground that would allow them to live in peace forever, world without end, amen.

For that reason, it is the perfect banner for the brokerage industry to raise as it continues its efforts to avoid being held to a true fiduciary standard when brokers give personalized investment advice to clients. It is a beautiful smoke-screen—a dangerous deception.

If you care about the integrity of the current fiduciary standard, avoid the temptation to jump on the harmonization bandwagon. It is a trap. To appreciate how artfully the trap has been laid, we need to quickly trace the evolution of fiduciary regulation of brokers and advisors.

An Eye-Opening Walk Down Memory Lane

When Congress enacted the Investment Advisers Act of 1940 (Advisers Act), it made a distinction between brokers and advisors. Those who provided personalized investment advice to clients, with some exceptions, were subject to the Advisers Act. Brokers were one of the exceptions. If the advice provided was "solely incidental" to their work as brokers, and they received no "special compensation," brokers were not subject to the Advisers Act.

This distinction made sense. Brokers sold securities. Advisors gave advice. In 1940, life was simpler. Everyone could tell the difference. Sure, in selling securities a broker might say something that sounded like advice. "Mrs. Jones, XYZ company stock is a great opportunity and we are recommending it to all our clients." But if those statements were "solely incidental" to selling securities and the broker received only a standard commission in connection with the transaction, that advice did not turn the broker into an advisor under the Advisers Act.

The Advisers Act does not explicitly impose a fiduciary duty on advisors. But in 1963 the Supreme Court ruled that advisors subject to the Advisers Act had a fiduciary duty to their clients. Since that case, it has been clear that, under federal law, advisors have a fiduciary duty to their clients and brokers do not. Brokers are subject to the lesser "suitability" standard, arising under the Securities Exchange Act of 1934 (Exchange Act) and associated regulations.

By the 1990s life was not so simple. The lines between brokers and advisors had blurred. SEC Chairman, Arthur Levitt, formed a committee in 1994 led by Dan Tully, the Chairman and CEO of Merrill Lynch. The committee's mandate was to take a hard look at the brokerage industry and make recommendations for managing its conflicts of interest. In 1995, the committee issued the "Tully Report," which recommended, among other things, that brokers should use asset-based fees, rather than commissions, to reduce conflicts of interest.

Fee-based brokerage accounts proliferated. At the same time brokers increasingly operated using titles like "financial advisor." A broker calling himself a financial advisor and charging an ongoing fee looked an awful lot like a fee-based advisor who was subject to the Advisers Act.

Concerns grew among the brokerage industry and the SEC about the status of fee-based brokerage accounts under the Advisers Act. Why would clients ever pay a broker an ongoing fee if they weren't expecting to receive ongoing, rather than incidental, advice? Didn't the broker's ongoing fee constitute "special compensation?" Shouldn't brokers, who were providing essentially the same services as advisors, be held to the same standards?

In 1999, the SEC proposed a rule to allow brokerage firms to offer fee-based brokerage accounts without registering under the Advisers Act. The so-called "Merrill Lynch Rule" was strongly supported by the brokerage industry, which did not want fee-based brokerage accounts subject to the fiduciary standard. Though the Merrill Lynch Rule was not formally adopted, the SEC let the brokerage industry know that it could act as though it was in effect.

In 2004, the Financial Planning Association took the SEC to court arguing it had violated federal procedures by failing to adopt the Merrill Lynch Rule after four years. In response, in 2005 the SEC adopted the Rule. The FPA then filed a lawsuit saying the SEC had exceeded its authority by turning the limited "solely incidental" loophole into an unlimited license for brokers to provide advice without being subject to the safeguards of the Advisers Act and the fiduciary standard.

In 2007, the D. C. Court of Appeals agreed and overturned the Merrill Lynch Rule. This left the status of fee-based brokerage accounts under the Advisers Act in serious question. Should brokers who provided personalized advisory services through these accounts be subject to the Advisers Act's fiduciary standard? That question hung in the air unanswered.

In 2008, The RAND Corporation issued a report, commissioned by the SEC, showing that the investing public was confused about the nature of the services offered by, and the different standards applicable to, brokers and advisors. The report made clear that much of the confusion was caused because both brokers and advisors used the same titles to describe themselves. Examples included terms such as "advisor" and "consultant."

In 2009, the Treasury Department proposed the SEC establish a fiduciary standard for brokers offering investment advice and "harmonize" the regulation of brokers and advisors.

Later in 2009, the brokerage industry joined Treasury in calling for "harmonization" of the standards applicable to brokers and advisors. "When broker-dealers and advisers engage in identical service, they should be held to the same standard of care," said Randolph C. Snook, Executive Vice President, Securities Industry and Financial Markets Association (SIFMA) in his testimony before the House Committee on Financial Services in 2009.

In 2010, the harmonization concept was incorporated into the Dodd-Frank financial reform law. Dodd-Frank directed the SEC to consider applying a fiduciary standard to brokers no less stringent than that applicable to advisors. It also gave the SEC a seemingly impossible task—maintaining

the stringency of the Advisers Act standard, while harmonizing it with brokerage practices like accepting commissions, principal trading, and selling proprietary products.

In 2010, the Department of Labor recognized that the world had changed since ERISA was enacted in 1974 and proposed a new expanded fiduciary rule to reflect those changes. The rule was met by withering opposition from the brokerage and insurance industries. In 2011 the proposed rule was withdrawn for further study and consideration.

In 2011 the SEC staff issued a report calling for a uniform fiduciary standard for brokers and advisors. The idea was supported by SEC Chairwoman Mary Shapiro, but harshly opposed by the two Republican members of the Commission. They said the report failed to provide evidence that investors were "being systematically harmed or disadvantaged." They also questioned whether a uniform standard would eliminate investor confusion.

In 2015 the DOL proposed a new rule expanding the definition of "investment advice fiduciary" and modifying related regulatory interpretations (i.e. prohibited transaction exemptions). The DOL's proposal swept individual retirement accounts (IRAs) under ERISA's fiduciary umbrella for the first time. Again, the rule was strongly opposed by the brokerage and insurance industries.

In 2015, SEC Chairwoman Mary Jo White announced her support for a uniform fiduciary standard for brokers and advisors. She was no more successful than Chairwoman Shapiro in garnering the needed support among fellow SEC Commissioners to advance the idea.

In 2016, the DOL finalized its new fiduciary rule and related changes to its prohibited transaction exemptions. These regulations applied to brokers and advisors working with retirement plans, including IRAs, but did not affect brokers or advisors operating outside the retirement plan environment. The applicability date was set for April 10, 2017.

Brokerage industry representatives, among others, filed a series of lawsuits throughout the country challenging the new DOL regulations. Brokerage industry representatives also successfully lobbied members of Congress to introduce legislation to kill the DOL regulations.

In February 2017, the Trump administration ordered a review of the new DOL regulations. Ultimately, the applicability date for a portion of the new regulations was moved to June 9, 2017. Implementation of other portions—those that were most objectionable to the brokerage industry—was delayed until July 1, 2019. The rule is now under review and its fate is uncertain.

That Was Then and This is Now

On May 4, 2017, Jay Clayton was sworn in as SEC Chairman. He was aware of his agency's persistent failure to make progress on establishing standards of conduct for brokers and advisors who provide investment advice to retail investors. He also knew the DOL's activities in this area had a direct impact on many firms under the SEC's regulatory supervision.

On June 1, 2017, Chairman Clayton expressed his willingness to "engage constructively" with the DOL as both agencies pursued the ongoing analyses of their options. He also sought public comment on a laundry list of questions, including the following potential actions:

1. Maintaining the existing regulatory structure.
2. Requiring enhanced disclosures to mitigate investor confusion.
3. Developing a separate best interest standard for brokers.
4. Developing a uniform standard of conduct for brokers and advisors who provide personalized investment advice to retail investors.

On July 21, 2017, SIFMA, the self-proclaimed "voice of the U.S. securities industry," submitted comments in response to Clayton's request. Surprisingly, SIFMA, which had fought a years-long battle to delay, dilute, and derail the DOL's fiduciary rule, welcomed the SEC's efforts to develop one. It also openly encouraged cooperation between the SEC and the DOL in developing the new standard.

This seeming contradiction makes sense. Without a well-defined best interest standard, the brokerage industry remains in a precarious position when it comes to delivering personalized advice to retail clients. It is in danger of being swept under the Advisers Act fiduciary standard, an outcome that would disrupt its current business model. It needs a safe harbor.

Also, advisers have gained a distinct marketing advantage over brokers because of the higher standard to which they are held. According to Cerulli Associates, 42% of all assets managed by a financial advisor are now subject to a fiduciary standard, up from 25% in 2005. Many of the brokerage industry's best and brightest have migrated to the fiduciary advisor world. Some of the largest players in the brokerage industry recently left the Brokerage Protocol in an attempt to stem the flow. Putting a fiduciary-lite standard in place for brokers would be another way.

Further, the brokerage industry does not like the best interest standard contained in the DOL's fiduciary rule. It is as long and complex as an organic chemistry text book. The industry views its rules-based approach as a compliance nightmare. It allows individual investors to sue for violations of the standard. The DOL standard is the worst of all possible worlds for brokers.

Involving the DOL in the dialog with the SEC might create more palatable alternatives. If the resulting SEC standard is pleasing enough and the DOL is involved in its creation, portions of it might be incorporated into a revised DOL rule. The brokerage industry might be able to substitute a principles-based upgrade for the nit-picky details of the existing DOL rule.

The Brokerage Industry Shows its Cards

SIFMA's comments make the brokerage industry's strategy for achieving its goals quite clear. First, it rejects the existing regulatory structure for the reasons described above. It also rejects the idea of using disclosure to deal with the problem of investor confusion. The brokerage industry does not like the prospect of clearly stating that advisors are subject to a fiduciary standard, while brokers are subject to the lower suitability standard.

SIFMA further rejects the idea of a "uniform standard that is 'no less stringent than' the Advisers Act standard." It bases its position on the "inherent differences between BDs and [RIAs]." SIFMA correctly assumes that it would be impossible to develop a standard that both maintains the stringency of the Advisers Act standard, while allowing brokers to charge commissions, principal trade, and sell proprietary products.

After rejecting these other alternatives, SIFMA lays out its vision for a "uniform fiduciary standard that applies equally to BDs and [RIAs] when providing personalized investment advice about securities to retail clients." Upon examination, however, SIFMA's vision is neither uniform, nor does it apply a fiduciary standard to brokers.

SIFMA proposes that advisors should continue to be subject to the fiduciary standard under the Advisers Act. Brokers would not be. Instead, the SEC would direct FINRA, the brokerage industry's self-regulatory body, to engage in rulemaking under the Exchange Act. FINRA, with the SEC's approval, would "consider establishing a best interest standard of conduct for BDs that builds upon their existing regulatory regime." In other words, create a separate regulatory scheme for brokers, administered by brokers, that looks like a true fiduciary standard, but isn't.

The details of SIFMA's proposal are revealing. First, none of the principles or precedents developed under the Advisers Act fiduciary standard would apply to brokers. Rather, brokers would be subject to an enhanced suitability rule requiring them to act in a client's best interest at the time a recommendation is made, but not on a continuing basis. The new standard would be "principles-based" so it would not come with all the messy, detailed requirements that were incorporated into the DOL's new fiduciary rule. Brokers could charge commissions, principle trade, and offer proprietary products. Almost business as usual.

Only Two Things Can Happen

The brokerage industry recognizes the inevitability and even the desirability of some sort of fiduciary or best interest standard of conduct. The industry fought the DOL's version of it for years and was successful in semi-gutting the rule by delaying its most odious provisions. But much of the rule is in place today. Momentum for a higher standard of conduct is building.

Against this background, the brokerage industry sees an opportunity. Rather than standing in opposition to the process, why not join in and play a role in shaping the final form of the standard? Accept the inevitable and work from within.

If the brokerage industry is successful in promoting its enhanced suitability standard as an alternative for a fiduciary standard, one of two things will happen and both are bad. Either we will end up with a two-tiered system that imposes a tougher standard on advisors than on brokers, or we will end up with a single, diluted best interest standard that applies to both.

SIFMA's current proposal would result in a two-tier system. The two standards would be more similar than the current standards, so the public would be even more confused about the

differences between brokers and advisors. RIAs would lose an important point of differentiation, while being forced to compete with brokers on an uneven playing field.

This two-tiered solution would also violate an important regulatory principle. Substantially similar behavior should be regulated in a consistent and uniform manner. Those who provide personalized investment advice to retail clients should be subject to the same standards of behavior. SIFMA's Snook even said so back in 2009. Any other result would be unharmonious.

But beware of insisting on a level playing field and harmonization of the standards applicable to brokers and advisors. This could easily result in a single "best interest" standard that dilutes the current fiduciary standard. It could happen if the drive for uniformity and a level playing field takes precedence over the best interests of investors.

Brokers can't live under a true fiduciary standard and continue the practices that are common to their business model today. But advisors could live under a lower standard that would permit brokers to be brokers. We could have uniformity if the bar was sufficiently lowered to allow brokers to charge commissions, principal trade, and sell proprietary products. But the investing public would suffer by being deprived of the higher fiduciary standard.

A Simple Proposal

A better approach is to give up on the idea of a uniform standard that harmonizes advisor and broker business models. Let's recognize that the needs and practices of brokers are different from those of fiduciary advisors. Stop trying to fit the broker peg into the fiduciary hole.

Instead, let's start by addressing the problem everyone agrees exists: the public is confused. Eliminate the confusion by requiring truth-in-labeling. Require brokers to call themselves "brokers" or some other acceptable term. Require fiduciary advisors to call themselves "advisors" or some other acceptable term. The specific designations don't matter as long as they are different from each other. Call a spade, a spade.

Then educate the public about the duties performed by, and the standards applicable to, both groups. This would involve both simple point-of-sale disclosures and a more extensive public awareness campaign. Let the public decide which business model is right for their needs.

If brokerage firms want to enter the advice business, they should be welcome to do so. But they would need to register under the Advisers Act and be subject to its fiduciary standard. This will maintain the protections currently available to investors under the Advisers Act, while ensuring a level playing field for all professionals who give advice.

Brokerage firms may need to create separate business units to provide brokerage and advisory services. That is a small price to pay to maintain current investor protections and promote regulatory fairness. The brokerage units could continue all the practices that are subject to a suitability standard. Their advisory units could provide fee-based advice subject to a true fiduciary standard.

This would restore the balance created by Congress when it enacted the Advisers Act in 1940. Product sales would be clearly delineated and regulated separately from advice. The public would have a clear understanding of their choices and could make informed decisions.

SIFMA argues that the nature of the advice typically provided by brokers is different from that provided by advisors and so the standards applicable to each should be different. They say brokers provide non-discretionary advice on a periodic basis, while advisors provide discretionary advice on an ongoing basis. Even if this were true, it is a distinction without a difference. Advice is advice to those who rely on it. Investors seeking advice should be able to count on the fact that those offering it put the investor's interests before their own.

Harmonization is a trap. It is not possible to create a standard of conduct that maintains the stringency of the Advisers Act fiduciary standard, while allowing brokers to continue their traditional business practices. Clients will suffer if we act like it is. Let's accurately label the players, educate the public, and maintain the integrity of the fiduciary standard.

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ABOUT THE AUTHOR

Scott MacKillop is CEO of First Ascent Asset Management, a Denver-based firm that provides investment management services to financial advisors and their clients. He is a 40-year veteran of the financial services industry. He has served as President of five asset management firms and spent the first 15 years of his career practicing securities and ERISA law in Washington, D.C. He can be reached at scott@firstascentam.com.