Clayton "BI" Proposal is a Step Backwards That Will Not End Conflicted Advice and Investor Confusion

The Securities and Exchange Commission (SEC) is scheduled to vote June 5 on a four-part regulatory package laying out the rules for broker-dealers and investment advisers providing investment advice and recommendations to individual investors. Based on our meetings with SEC Chairman Clayton, we have a very clear sense of what his "Regulation BI" package will look like. As detailed below, the final package will fall far short of what investors need and deserve. There is a reason why Wall Street is clamoring for the Clayton plan and why it has encountered nearly universal opposition from investor advocates. While the Chairman's plan is being pitched to the news media and Capitol Hill as improving protections for retail investors, the truth is that it is actually a step backwards: It will leave investors with fewer protections in important areas than they would have had if the Commission had not acted. If truthfully labeled in terms of its impact on investors, it would be called Regulation NBI (Not Best Interests].

Regulation Best Interest

The SEC will approve a final rule that purports to require brokers to act in their customers' best interests and to prohibit brokers from placing their own interests ahead of their customers' interests. However, the new standard will be fully satisfied through compliance with disclosure, care, and conflict obligations. These obligations, which form a compliance safe harbor, largely codify existing requirements under FINRA rules.

The standard will not actually require brokers to act in their customers' best interest.

The "best interest" standard will not require brokers to recommend the investments they reasonably believe are the best available option for the investor. Instead, the rule will simply codify existing FINRA know your customer and suitability requirements to analyze the customer's financial profile and make recommendations that are "consistent with the best interests of the investor."

The new rule will not require brokers to weigh the relative risks, costs and benefits of different strategies or different types of investments available to achieve the customer's goals. Instead, a broker will only be required to consider cost when deciding which of two otherwise identical securities to recommend, something FINRA already requires.

The standard will not prevent brokers from placing their own interests ahead of customers' interests.

The prohibition on placing the broker's interests ahead of the customer's interests is not included in the disclosure, care, and conflict obligations that fully satisfy compliance with the rule, rendering it unenforceable. Brokers will continue to be permitted to have conflicts that threaten their ability to act in a customer's best interests.

The conflict obligation doesn't prohibit firms from creating conflicts that would reasonably be expected to encourage and reward advice that is not in customers' best interests – such as imposing sales quotas for the sale of in-house products or paying brokers more to recommend funds that make revenue sharing payments.

The conflict obligation simply requires firms to develop and enforce policies and procedures to "mitigate" most conflicts, including those the firm created. It doesn't explicitly require those policies to be reasonably designed to prevent conflicts from tainting the broker's recommendations.

The standard will apply on a transaction by transaction basis regardless of the nature of the relationship between the broker and customer.

Even brokers who offer periodic or ongoing advice in the context of long-term relationships of trust and confidence will have no obligation to the customer between transactions. For example, brokers will not be required to monitor customer accounts to ensure investments remain on track, something that most investors reasonably expect their brokers to be doing. This weakens protections investors currently receive under state common law fiduciary standards.

While theoretically an enhancement to FINRA rules, the required "point of sale" cost and conflict of interest disclosures will not provide investors with timely, usable information.

Firms will remain free to provide information on costs as percentages or ranges, rather than the dollar amounts likely to be better understood by investors.

Firms will be able to fulfill their obligation to provide information prior to the sale through boilerplate disclosures, with actual cost and conflict information delayed until after the sale.

In the one expected "improvement" to the rule, the standard will likely extend to account-opening recommendations, such as rollover and account recommendations.

FINRA already holds such recommendations to a suitability standard. Because the "best interest" standard is so weak, investors will not reap significant benefits from this change in the proposal.

INVESTMENT ADVISER ACT GUIDANCE

The SEC will approve guidance regarding the standard of conduct that applies to investment advisers' advice to retail investors which will substantially weaken the Commission's traditional interpretation of that standard.

Investment Advisers will be able to satisfy the standard through disclosure alone, allowing them to place their interests ahead of their clients' interests.

For many years, the Commission has steadfastly asserted that investment advisers, as fiduciaries, must always place their clients' interests first and that this obligation cannot be disclosed or negotiated away. However, it is expected that the Commission will adopt guidance which is consistent with its recent enforcement actions, suggesting that investment advisers can satisfy their fiduciary duty while engaging in conflicted conduct that is harmful to investors as long as they provide full disclosure of their harmful practices in a document few investors will ever read and fewer still will understand.

CUSTOMER RELATIONSHIP SUMMARY

The SEC will approve a final rule that requires broker-dealers and investment advisers to provide disclosures to customers at the point of engagement that describe in very brief terms key features of their business, including the nature of services offered, their legal obligations to the client, conflicts of interest present in their business model, and how they charge for their services.

The disclosures will be confusing and will not help investors make informed decisions.

Testing has shown the proposed disclosures do not enable investors to make informed decisions about the services they need or the individuals who provide those services. While the Commission is expected to make changes to the CRS disclosure obligations, it has not conducted additional testing to ensure any disclosures required will be meaningful for investors. As a result, investors will likely remain confused about essential elements of the professional relationship in which they are engaging.

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