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Is a Best Interest Standard the Future of Broker-Dealer Regulation?

By *Andrew Hartnett*

Many commentators have suggested that the idea of some kind of best interest standard applicable to broker-dealers is here to stay, even as the election of President Donald J. Trump created uncertainty about whether the Department of Labor's (DOL) fiduciary rule would be implemented. Developments related to the DOL fiduciary rule, at the Securities and Exchange Commission (SEC), in Nevada, and at the Certified Financial Planner Board over the past several months strongly support the idea that a best interest standard is the future of broker-dealer regulation. It remains very uncertain what that standard will look like, however, and whether there will be one best interest standard or several.

Department of Labor Fiduciary Rule

Shortly after President Trump was elected, the DOL fiduciary rule appeared to be on the chopping block. Gary Cohn, the director of the National Economic Council, suggested that the rule would be eliminated, calling it "a bad rule for consumers." In a memorandum issued Feb. 3, 2017, the president directed the DOL to "prepare an updated economic and legal analysis" of the rule and, if supported by the new analysis, to revise or rescind the rule. [1]

The DOL sought to delay the rule's April 10 effective date to give it time to conduct this new analysis. When the final rule delaying the effective date came out, however, it indicated that certain parts of the rule would become effective June 9, a curveball that prompted the Wall Street Journal to describe the DOL's bureaucracy as being "in open rebellion" against the president.[2]

Where most observers had expected the entire rule and all of the associated prohibited transaction exemptions (PTEs) to be delayed indefinitely, the fiduciary rule (i.e. the new fiduciary definition) became applicable on June 9 and the Best Interest Contract and Principal Transaction exemptions also became available on June 9. The exemptions, however, only require fiduciaries to adhere to certain Impartial Conduct Standards:

(1) providing advice in retirement investors' best interest;
(2) charging no more than reasonable compensation; and
(3) avoiding misleading statements.

The applicability of other requirements of those exemptions, such as representations of fiduciary compliance, contracts and warranties about firm's policies and procedures, is delayed until Jan. 1, 2018, while the DOL performs the review mandated by the president.

Some had hoped that the confirmation of DOL Secretary Alexander Acosta would provide a reprieve from the June 9 partial applicability date. However, Acosta announced in a Wall Street Journal op-ed published roughly three weeks before June 9 that he would not change the date, writing, "We have carefully considered the record in this case, and the requirements of the Administrative Procedure Act, and have found no principled legal basis to change the June 9 date while we seek public input. Respect for the rule of law leads us to the conclusion that this date cannot be postponed."

On June 29, the DOL announced that it was releasing a new request for information, with a 15-day comment period regarding whether to delay the Jan. 1, 2018, applicability date of the rest of the exemptions and a 30-day comment period regarding a variety of other questions, including questions about innovations in the marketplace, such as clean shares and fee-based annuities, since the rule was initially filed.[3]

[1] Fiduciary Duty Rule, 82 Fed. Reg. 9675 (February 7, 2017).
[2] Definition of the Term Fiduciary, 66 Fed. Reg. 16902 (April 7, 2017) (to be codified at 29 C.F.R. pt 2510).
[3] Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions, 82 Fed. Reg. 31278 (July 6, 2017).

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SEC Request for Information

Roughly 10 days after Acosta's op-ed, SEC Chairman Jay Clayton announced that the SEC is soliciting input on the standards of conduct for investment advisers and broker-dealers.

Noting that the SEC had reviewed the issue in 2006, from 2010-11, and again in 2013, Clayton said that developments in the marketplace since 2013, including "financial innovations, changes to investment adviser and broker-dealer business models, and regulatory developments — including the issuance and pending applicability of the Department of Labor's Fiduciary Rule" necessitate the updated analysis.

In addition to seeking general comments on what the appropriate advice standard is, the SEC announcement poses a series of specific questions, including, among other topics:

- whether investor confusion remains about the types of professionals providing advice,
- whether conflicts of interest have been appropriately addressed,
- how the DOL fiduciary rule has affected the marketplace,
- who should be considered a retail investor, and
- how "investment advice" should be defined.

The SEC request for information confirmed what had come to seem increasingly likely. The first hint that the SEC might be preparing to consider a fiduciary rule came when Commissioner Michael Piwowar, then the SEC's acting chairman, said in April that the SEC should "reassert its role" in setting advice standards. This statement was notably absent from remarks he made in early March at the Investment Adviser Association compliance conference. There, he blasted the DOL rule but seemed skeptical about the SEC promulgating a fiduciary rule: "It is a really, really, really hard issue to deal with."

Piwowar went on to talk about trying to mitigate investor confusion about the different advice standards applicable to brokers and to investment advisers. Notably, this issue is the first of the 17 bullet points of questions posed by the SEC.

Nevada Statute

Nevada is also implementing a fiduciary standard applicable to broker-dealers. Senate Bill 383, which Nevada Gov. Brian Sandoval signed June 2, revises the Nevada Securities Act to mandate that any "broker-dealer, sales representative, investment adviser or representative of an investment adviser shall not violate the fiduciary duty toward a client" imposed in a separate statute.

That statute, NRS 628A.020, imposes the "duty of a fiduciary" on all financial planners.[4] Senate Bill 383 also modifies the definition of "financial planner" to remove from the exclusion for broker-dealers, their representatives, investment advisers, and their representatives.

Senate Bill 383 does not clarify exactly what this fiduciary standard entails. First, it gives the Nevada securities administrator the authority to write rules defining the standard, though no regulations have yet been proposed. Second, NRS 628A.020 contains two specific requirements: (1) disclose any gain the financial planner receives if the advice is followed and (2) ensure the planner understands, on an ongoing basis, the client's financial condition. The new statute is effective on July 1, 2017.

[4] Nev. Rev. Stat. § 628A.020 (2015).

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CFP Board Draft Revisions

On June 20, the Certified Financial Planner Board issued a request for public comment on revisions to its Standards of Professional Conduct that expanded the scope of when a CFP professional would have to act in a fiduciary capacity. The revised Standards of Professional Conduct require that CFP professionals act as fiduciaries whenever they are providing financial advice to clients, whereas the currently applicable standards only require that a CFP professional act as a fiduciary when preparing a financial plan. The comment period ends August 21.

Conclusion

In short, the DOL has partially imposed its fiduciary duty rule while it considers revising additional parts of it; the SEC has solicited public comment on whether to impose a fiduciary standard; Nevada has imposed a fiduciary standard, though clarifying regulations remain to be implemented; and the Certified Financial Planner Board is seeking comments on expanding the applicability of its fiduciary duty to whenever a CFP professional is giving financial advice. Taken together, these developments seem to make clear that a best interest standard – or standards – is coming.

Whether these developments end with one standard, coordinated standards, or multiple standards remains very uncertain. In Secretary Acosta's op-ed, he explicitly invited the SEC to work with the DOL as it works to revise the fiduciary rule: "[T]he SEC has critical expertise in this area. I hope in this administration the SEC will be a full participant." Clayton noted in his announcement that he "welcome[s] the Department of Labor's invitation to engage constructively" as the commission analyzes a fiduciary rule. Clayton subsequently noted in a budget hearing before the Senate Appropriations Committee's Subcommittee on Financial Services and General Government that he intended to move forward with his fiduciary analysis "in a way that is coordinated" and that he was confident the agencies would cooperate with each other. Acosta similarly reiterated his desire that the SEC "be a part of the conversation" in a Senate hearing. Of course, this coordination will get thornier and more complicated given the different regulatory regimes and that the DOL has a partially implemented rule and a (likely-to-be-delayed) applicability date in six months while the SEC has just begun soliciting information.

In addition to the uncertainty surrounding the SEC and the DOL's efforts to coordinate, it is unclear where Nevada's rulemaking will end up, and the CFP Board rulemaking remains a draft. What seems clear, though, from all of these initiatives is that some sort of best interest standard is coming. The precise requirements of such a standard, and whether one standard or multiple standards results, remains to be seen. Hopefully, a coordinated, uniform standard can emerge, as this would be in the best interest of both investors and financial advisors.

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As Missouri's Commissioner of Securities from 2013 to 2016, Mr. Hartnett directed the Missouri Securities Division and helped formulate policy nationwide through his work at the North American Securities Administrators Association (NASAA). He led the team that created the cybersecurity program now used by most state regulators and chaired the Broker-Dealer Section and the Enforcement Section for NASAA, as well as committees focused on cybersecurity, technology, and federal legislation. He has spoken at events nationwide on topics including state securities regulations, cybersecurity, and protection for senior investors.

Prior to his time as Commissioner of Securities, Mr. Hartnett served as Chief of Staff to then-Missouri Attorney General Chris Koster and as an Assistant Attorney General in the Consumer Protection Division, handling all aspects of consumer protection, antitrust and securities investigations and litigation. He began his career in private practice in St. Louis and is a graduate of Saint Louis University School of Law.