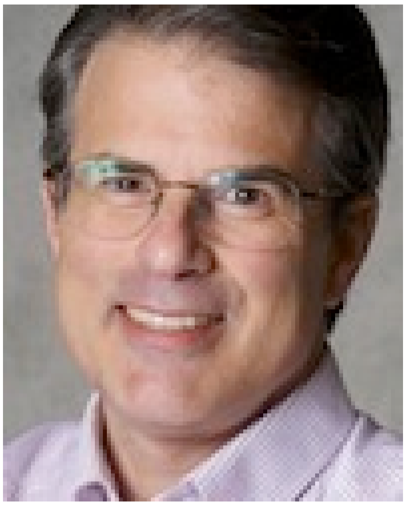
SEC Had to Fudge the Definition of ‘Best Interest’

By Kerry Pechter *Thu, Jun 7, 2018*

Unlike the DOL, the SEC doesn't need to score to win this game. It can afford to punt.



My sympathies go out to the writers at the SEC.

The Securities & Exchange Commission did not define “best interest” in its Regulatory Best Interest proposal. Why? A true definition isn’t an option for it or the financial industry… or even for most clients.

A client’s interest is best served when he/she pays a self-employed expert–be it an advisor, doctor or plumber–whose own interest is to win the client’s trust and act as his/her loyal guide. Best interest is no more ambiguous than the Hippocratic Oath or the Golden Rule.

But a straightforward definition is unworkable as a standard for real-world behavior; it is incompatible with the industry’s structure. First, self-employed advisors are relatively scarce, given the flood of investors created by the 401k system.

Second, the third-party product distribution model appears to be independent but creates invisible ties between advisors and manufacturers. (Hence the inevitable, unmanageable conflicts.)

Third, clients themselves are complicit; they’re reluctant to write personal checks for bespoke advice. So a true definition of best interest can’t be written. It must be fudged.

After I expressed these opinions on LinkedIn last week, Stephen Mitchell, a managing consultant at BrightPoint asked, “Why do you make the distinction ‘self-employed’ expert? Does this suggest that a firm of any type can’t act in the client’s best interest? How the firm makes money may make it more or less difficult, but I’m not sure it’s that different that for a self-employed advisor… and a large firm collectively has more expertise.”

The point isn’t that an employee-advisor will never steer me right, or that a self-employed advisor will never steer me wrong. Reality is a mixed bag. The point isn’t that only self-employed advisors should advise. That’s not practical. (To me, “self-employed” implies that the client alone pays the advisor; but a transparent “A” share commission might suffice.”)

But I don’t think a claim to acting in a client’s “best interest,” if that term is going to be a legal standard and not a loophole, can or should be made by someone trying to serve more than one master. As for expertise, a large firm can have lots of it, but I can’t be sure that it will be used to my advantage.

James Watson III, an attorney, CFP and CEO at InvestSense LLC, commented, “The SEC speaks of harmonization between it and the Department of Labor. If that is its true goal, then the easiest solution would be for the SEC to adopt the ‘best interest’ definition from the DOL’s rule.” That may be true, but the brokers won’t stand for it.

The core issue isn’t hard to describe. Tax-deferred rollover IRAs fall into a regulatory grey zone where the pension and the brokerage worlds overlap. While it’s not quite right to apply pension fiduciary standards to brokerage accounts, it’s also not quite right to apply brokerage suitability standards to pension accounts.

Given the stakes involved—access to $9 trillion in IRAs—sheer political power can be expected to decide the outcome. With the 2016 election, “ball possession” changed from the pension-oriented DOL to the brokerage-oriented SEC. Unlike the DOL, the SEC doesn’t need to score to win this game. It can afford to punt.