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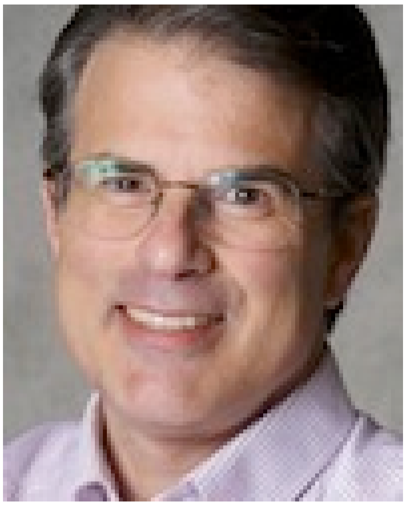
Why Eight States Are Suing Over ‘Reg BI’

By Kerry Pechter *Thu, Sep 12, 2019*

'Dually registered' advisers can switch hats between the broker/commission model and the adviser/AUM model as needed, to the confusion and expense of investors. Eight state attorneys general say the SEC's 'Reg BI' allows the deception to continue.



Which is greater: The SEC’s cynicism in using its sacred powers to protect the brokerage industry instead of the investing public, or the naïveté of eight state attorneys general in believing that they can bring the powerful brokerage industry to heel?

A U.S. District Court judge in the Southern District of New York has been asked to sort things out.

On Monday, the attorneys general of New York, California, Delaware, Maine, Oregon, New Mexico, Connecticut and the District of Columbia—all pro-Clinton in 2016—sued the SEC and asked the court to set aside the SEC’s recently passed Regulation Best Interest or “Reg BI.”

According to the **complaint**, Reg BI is wrong because it merely requires dually-registered financial advisers (who can sell securities on commission and give advice for an asset-based fee) not to put their own interests *ahead of* their clients’ when recommending products and doling out advice.

Instead, the suit says, the SEC should have carried out the directive of the 2010 Dodd-Frank legislation and created a regulation that required everyone selling securities or doling out financial advice to act as true “fiduciaries” and advise clients *without regard to* their own interests.

Wall Street is happy with Reg BI, as it should be. SEC chairman Walter “Jay” Clayton III, a 2017 Trump appointee, gave brokers and asset managers a best interest rule that understands their needs. In the Final Rule, Clayton wrote, “We have declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Advisers Act because it is *not appropriately tailored to the structure and characteristics of the broker-dealer business model.”* [Emphasis added.]

The ‘Merrill rule’ reclaimed

Reg BI affirms the status quo, which has been in place since before the Great Recession. In 2007, a federal appeals court panel reversed the so-called “Merrill rule,” which since 1999 had allowed brokers to earn asset-based fees from clients without registering as advisers or accepting a fiduciary responsibility—selflessness—toward their clients.

In response, “tens of thousands of brokers registered as Investment Adviser Representatives,” Ron Rhoades, a professor of finance at Western Kentucky and close observer of fiduciary legislation, told *RIJ* in an email this week. But many of them maintained their broker-dealer affiliations.

Their new “dual registration” allows them to accept asset-based fees under the selfless fiduciary standard and to accept commissions under the more self-interested suitability standard of conduct (akin to caveat emptor or “buyer beware”). In this way, brokers recovered the flexibility the 1999 Merrill rule had provided them.

“The SEC allows a person and firm to be both a salesperson (broker-dealer) and a fiduciary (investment adviser) at the same time, for the same client,” Rhoades said. “Typically the dual registrant has an ‘investment advisory’ account for part of the client’s assets on which AUM [assets under management] fees are assessed, while separate brokerage accounts exist for other assets of the client,” he said. “The SEC’s view is contrary to state common law, which generally holds that fiduciary status, once assumed, extends to the entirety of the relationship.”

Fred Reish, of the law firm of Drinker Biddle, told *RIJ* that this state of affairs will continue under Reg BI beginning on June 30, 2020, “except that ‘suitability’ will be replaced by ‘best interest.’

“Also, Reg BI will require that a dually registered adviser must select the account type through a best interest process when those rules apply. For example, the advisor would need to consider the account types at the broker dealer and those at the RIA and recommend the ‘best interest’ one,” Reish added.

“In theory that means that if an investor wants to buy-and-hold certain mutual funds, the advisor would use the broker-dealer. But if that same investor had a part of his investments that is advised and monitored on a continuous basis, the advisor would use the RIA,” he said.

"The dual registrants are supposed to make clear what role they are undertaking, and when they 'switch hats,' so to speak," Rhoades told *RIJ*. "The reality is that clients think that their dual registrant represents their best interests and acting under a fiduciary duty of loyalty at all times.

"In two instances over the past year, I've heard from clients that they asked their dual registrant 'Are you a fiduciary to me?' Both replied 'yes.' But, in both instances, only a small amount was in investment advisory accounts." The majority of their money was in brokerage accounts.

For the attorneys general who are suing the SEC, such ambiguity only confuses investors, who don't know which shell the fiduciary pea might be under at any given moment, or even that such a pea exists. While the SEC now requires all advisers to act in the best interest of clients—an apparent tightening of consumer protection—it leaves the definition of "best interest" up to the adviser—a loosening of consumer protection. The sum of that do-si-do is zero; almost nothing has changed except that, in the view of the states, the expression "best interest" now means something closer to "suitable" than to "fiduciary." They'd prefer that BI be closer to "fiduciary."

Consumers betrayed

Most investors don't want mere *advice* from their advisers. Advice is as common as cough drops. They can get advice from a brother-in-law, a neighbor or a robo-adviser. If truth be told, they pay advisers to *protect* them. How? By not letting them take on too much risk, by screening the fine print of contracts for them, and—ideally—by warning them before a crash. That's what they hope they'll get for the fees they pay.

That's an unrealistic but natural expectation. Advisers have a more pragmatic view of their occupation. Whether they work for a financial services firm or own their own businesses, they're trying to maximize their personal revenue. They want to grow their list of "A" clients ($1 million+), encourage their "B" clients, and minimize time spent with "C" clients.

I don't think dually registered advisers try to deceive anyone by switching hats within or between clients. Rather, they believe they're more productive if they can work on a fee-basis with high net worth clients, sell products on commission to mass-affluent clients, and mix the two strategies with clients who are in between.

In wording Reg BI as it did, the Clayton SEC supported that point of view. That's the problem. Instead of protecting consumers, the SEC chose to keep them at a disadvantage in situations where, as the ones bringing the cash to the table, they deserve more control. The state attorney generals are suing the SEC over that betrayal.