

Fi360

Regulating Conflicted Advice: Is The Rulemaking Process Working?

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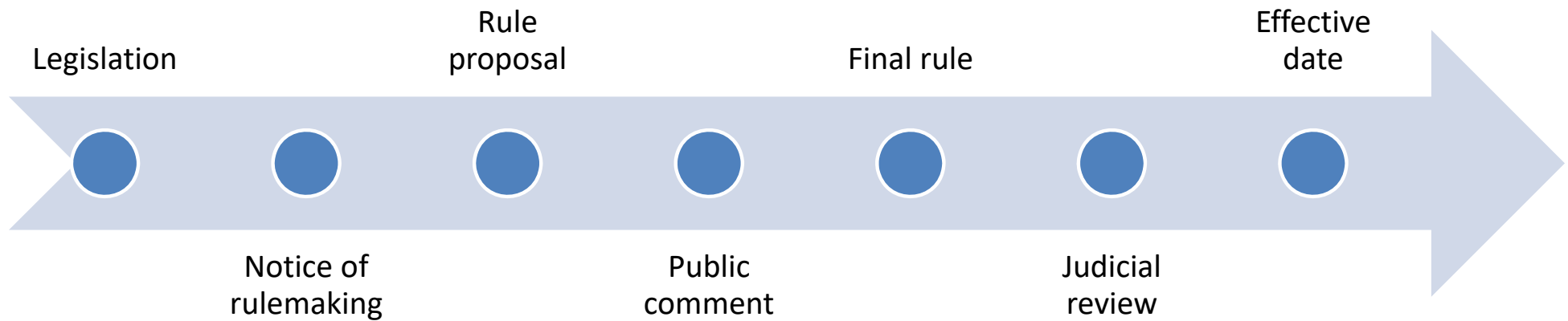
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Topics

- Rulemaking process overview
- The role of economic analysis in rulemaking
- Academic and legal challenges to Reg BI
- What to expect next

Rulemaking Process Overview



Rulemakings and Court Challenges

- Agencies accorded broad deference in interpreting the law through rulemakings
- Private parties with standing can challenge agency rules in court
- Federal courts are generally required to use the Chevron doctrine
 - Chevron doctrine is a 1 or 2-step process to analyze the scope of agency deference
 1. Step 1 requires the court to determine whether Congress spoke directly to the issue in question. If the answer is yes, there is no need to proceed to Step 2.
 2. Step 2 requires the court to determine whether the agency's interpretation was reasonable.
- An agency's economic analysis is increasingly important in a court's assessment of whether the agency's basis for rulemaking was reasonable.
- Plaintiffs can prevail if the court finds the agency's action arbitrary or capricious.

The role of economic analysis in rulemaking

- The source of rulemaking matters
 - Economic analysis is required for major rulemakings by cabinet agencies
 - Not required for independent agencies like the SEC
- Key elements of an economic analysis
 - Evident need for the rule
 - Means of assessing economic consequences
 - Examination of alternative regulatory approaches
 - Cost-Benefit analysis of the proposal and alternatives
- Major SEC rulemakings require consideration of impacts on efficiency, competition and capital formation

Economic analysis isn't always sound

“Statistics can be used in the same way that a drunk uses a lamp post – for support rather than illumination.”

- Andrew Lang



Courts Find Previous SEC Analyses Flawed

Chamber of Commerce v. SEC (Decided 2006)

- DC Circuit vacated fund independent directors rule; found SEC
 - relied on extra-record material critical to its costs estimates
 - failed to allow public input on the outside economic data

American Equity Inv. Life Ins. Co. v. SEC (Decided 2010)

- DC Circuit vacates fixed index annuity rule (Rule 151A)
 - SEC's interpretation of "annuity contract" is reasonable but
 - failed to properly consider effect of rule upon efficiency, competition, and capital formation

Business Roundtable and Chamber v. SEC (Decided 2011)

- DC Circuit vacated mutual fund proxy access rule; found SEC
 - discounted studies relying on the opposite result of its findings
 - selectively relied on two “relatively unpersuasive studies”

SEC Regroups With Staff Guidelines for Analysis

2012 Guidance on Economic Analysis

- Statement of need for proposed rule
- Baseline measurement to use for assessing economic consequences
- Identify alternative regulatory approaches
- Evaluate benefits and costs – both quantitative and qualitative – of proposal and alternatives

Academic Studies

“Much progress remains to be made before financial regulators achieve the level of cost-benefit analysis that has become the norm...” (Rose and Walker, 2013)

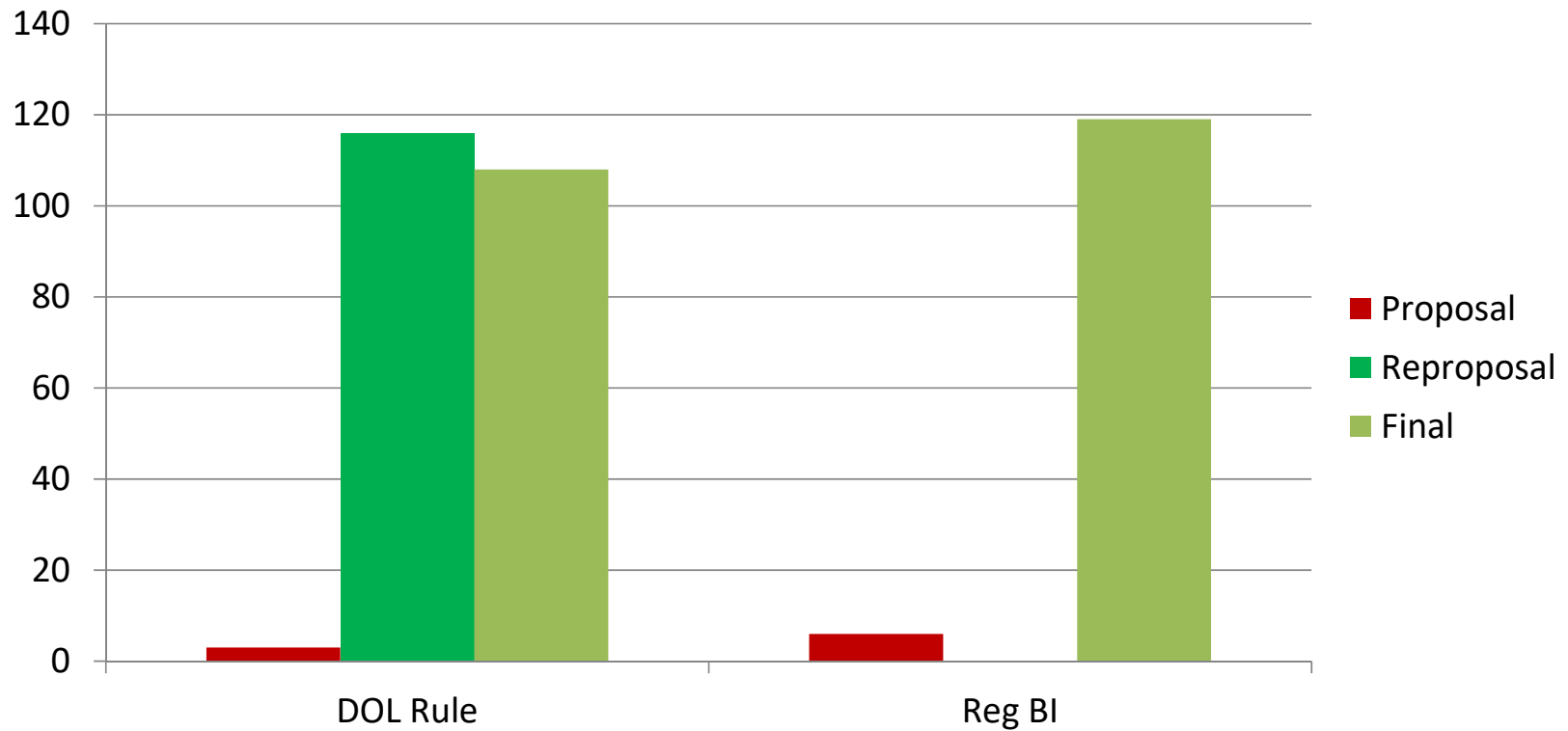
“...[S]o far the evidence [of better cost-benefit analyses] is not encouraging.” (Posner and Weyl, 2014)

“Court decisions appear to have motivated the SEC...to close the gap” with other federal agencies’ economic analysis (Ellig, 2016)

‘Honey – I Shrunk the Regulatory Impact Analysis!’



Comparison of Academic Literature – # of Papers Cited in DOL Fiduciary Rule vs. SEC’s Reg BI



Former SEC Economists' Fault Reg BI Analysis in Proposal

Economic Analysis 'weak and incomplete'

- Does not completely identify the real problem, i.e., compensation incentives
 - EA identifies main problem as brokers and customers 'misunderstanding' appropriate risk-return tradeoff
 - Instead, proposal allows 'numerous opportunities' to favor higher-paying investments
- Provides inadequate review of academic literature
- Relies 'too heavily' on disclosure to mitigate conflicts

SEC Response in Final Rule

Former SEC Economists' Concerns:

[Proposed] EA 'weak and incomplete':

- Does not completely identify 'numerous opportunities' to favor higher-paying investments
- Proposed EA provides inadequate review of academic literature
- Reg BI relies 'too heavily' on disclosure to mitigate conflicts

SEC Response in Final Release

Final economic analysis addresses those concerns:

- More in-depth analysis of potential problems with BD recommendations
 - Final EA 'engages more fully' with economic literature on advice
 - Final EA provides discussions on effectiveness of Reg BI disclosure requirements
- Separately, Reg BI release claims one limitation of academic literature was staff's inability to distinguish whether investor was seeking advice from broker or adviser

Study: Fiduciary duties improve investor outcomes

- *Fiduciary Duty and the Market for Financial Advice* (National Bureau of Economic Research, May 2019)
 - Study of state-registered brokers
 - Contrasts behavior in states where brokers are accountable versus those where they are not
 - Finds that extending fiduciary duty to broker-dealers causes:
 - Clients to “purchase products with lower fees”, and
 - Broker-dealers to “steer customers towards products with a larger and more diverse set of investment options that ... lead to improved mean returns.”
- The Reg BI approach is at odds with this study and the preponderance of evidence
 - Form CRS dismisses “fiduciary” as “technical jargon”
 - Reg BI fails to extend fiduciary accountability consistent with Dodd-Frank Section 913

Study: Hat switching has harmful side effects

- *The worst of both worlds? Dual-registered investment advisers* (Nicole Boyson, Northeastern University, May 2019)
 - Compares investment practices of dual registrants versus those of independent RIAs
 - Finds that dual registered advisors have more frequent regulatory actions, have more conflicts, higher fees, and worse investment performance
 - Concludes that lower suitability standards regarding costs, conflicts, and due diligence spillover to the behavior of dual registrants when they switch hats from brokerage to advisory relationships
- The Reg BI approach is at odds with this study and adds to investor confusion
 - SEC investor education videos fail to mention the difference in accountability; focusing only on costs and services
 - Dual registrants are permitted to use the title “advisor”

Reg BI is inconsistent with the 5th Circuit Decision

- In the decision vacating the DOL Fiduciary Rule, the 5th Circuit Court of Appeals said:
 - “Stockbrokers and insurance agents are compensated only for completed sales (directly or indirectly), not on the basis of their pitch to the client. Investment advisers, on the other hand, are paid fees because they ‘render advice.’”
 - “Only in the DOL’s semantically created world do salespeople and insurance brokers have ‘authority’ or ‘responsibility’ to ‘render investment advice.’”
- The Court noted that if salespeople provide personalized advice, or misrepresent their role by implying that they do, an appropriate regulator should address that issue (e.g. by requiring them to refrain from providing advice or to register with the SEC).

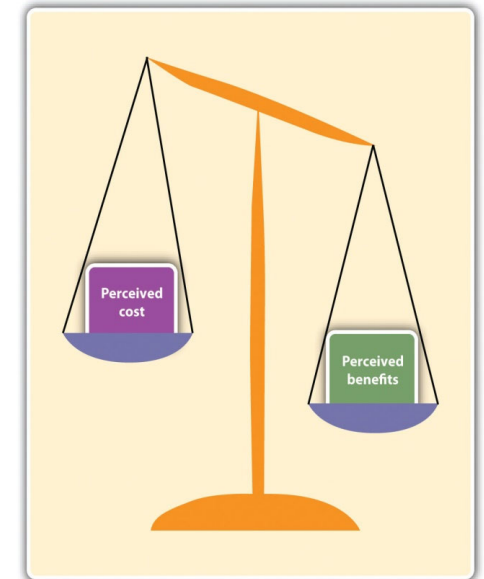
States, Planners Sue to Overturn Reg BI

- Seven states and DC file 1st administrative challenge Sept. 9
- XY Planning Network files 2nd suit next day
- Suits moved from district to appellate court Sept. 27
- Both suits filed in 2nd Circuit; likely to be consolidated
- Suits are similar, claim that Reg BI:
 - Exceeds SEC’s statutory authority by ignoring sec. 913(g) of Dodd-Frank Act, which requires
 - Brokers to provide advice “without regard” to their own financial interests
 - Broker-dealer standard “shall be the same as” the standard for investment advisers
 - Violates Administrative Procedure Act (APA)
 - SEC conducted and relied on a flawed cost-benefit analysis for final rule



Economic Analysis a Secondary Issue?

- Lawsuits focus primarily on sec. 913 violations
- State AGs' standing claim focuses on
 - Residents economically harmed by Reg BI
 - Fails to impose a fiduciary standard
 - Likely to exacerbate confusion over broker's duties
 - Two studies (including NBER paper) show savings for investors with a fiduciary standard
- XYPN likely has stronger standing as competitor in marketplace
 - Suit claims cost-benefit analysis 'deeply flawed'
 - Purported benefits lack 'evidentiary foundation'
 - True costs of regulation not adequately considered
 - No other details in original complaint



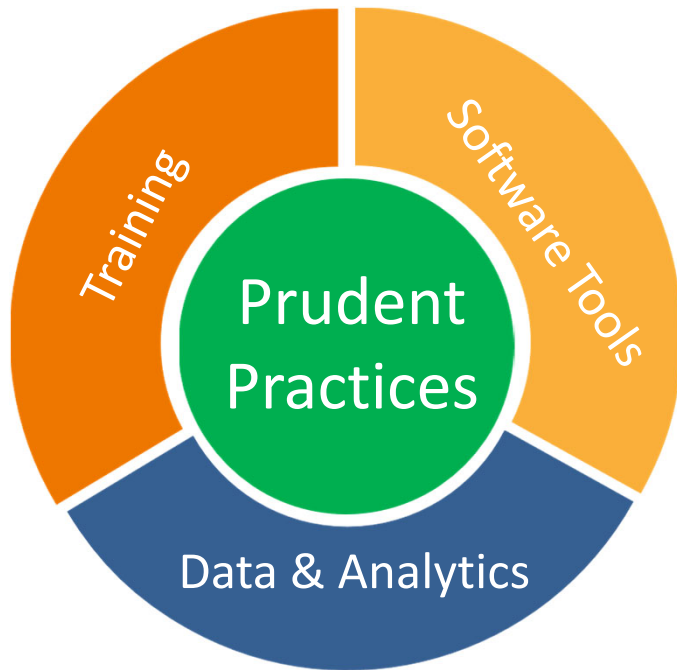
Will SEC's Analysis Stand Up in Court?

- Since 2012, SEC paying more attention to economic analysis
- Reg BI 'beefed up' academic cites from six to 119 in final release BUT
- SEC must explain why it rejected studies showing costs of conflicted advice
 - 42% of academic studies in Reg BI cited in DOL's economic analysis
 - DOL found "wide body of economic evidence" supporting rule
 - Reg BI, States' lawsuit drew difference conclusions from NBER study
 - Court may consider whether SEC discounted studies it disagreed with and selectively relied on 'unpersuasive' studies
- Court could ignore economic analysis claims and make finding on separate grounds as 5th Circuit did in *Chamber v. DOL*

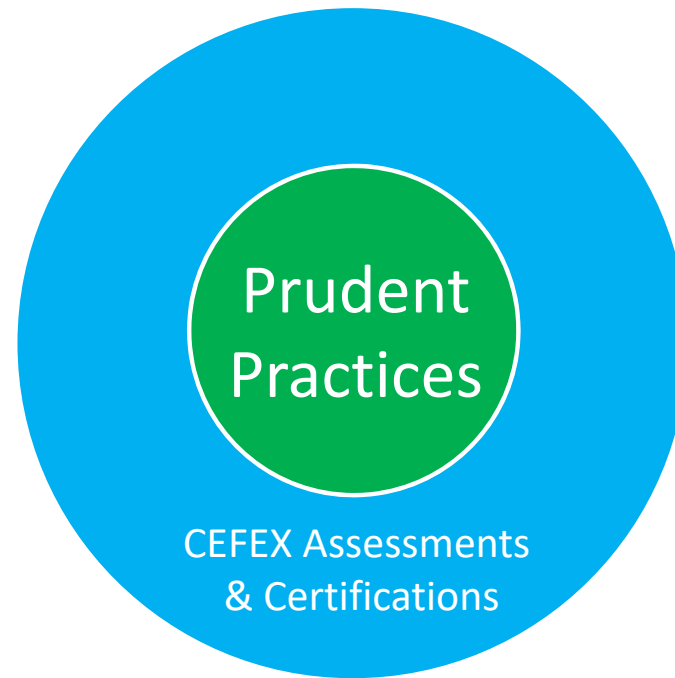
What to expect next

1. Firms have little choice but to comply with Reg BI requirements
2. Despite its many shortcomings, Reg BI does raise the suitability standard and promote fiduciary principles
3. Reg BI faces an uncertain future (lawsuits, changing political climate, etc.)
4. In the absence of fiduciary accountability for advice, the “Wall Street vs. Main Street” climate will continue, and the profession’s reputation will suffer
5. Firms that embrace fiduciary accountability enjoy a competitive advantage to attract both investors and breakaway brokers
6. As the gap between fiduciary and suitability narrows, more firms are likely to separate objective advice from directed brokerage
7. “Compliant” is not brandable; firms will strive to differentiate based upon demonstrated excellence

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Q & A



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