Public Investors Arbitration Bar Association

DEBUNKING THE TOP 5 BROKERAGE INDUSTRY MYTHS ABOUT FIDUCIARY DUTY

In the wake of the announcement of the Department of Labor's proposed fiduciary duty rule, the brokerage industry has worked hard to spread fear regarding the rule's potential effect. The industry has asserted that investors are well-served as things stand now and that the imposition of the proposed rule will bring about undesirable results. However, the industry's arguments are not based in fact.

The Public Investors Arbitration Bar Association (PIABA) has taken a close look at the five biggest myths about the fiduciary duty rule:

<u>**Myth #1:**</u> ***Investors understand the difference between the services they receive from a stockbroker versus those they receive from an investment adviser.***

<u>**Fact #1**</u>: ***Most brokerage firms' retail customers don't know the difference between brokers and investment advisors – and the industry is well aware of that fact.*** The simple truth is that more than three out of four investors don't understand that the current laws and rules impose different duties on brokers and investment advisors, according to a 2010 survey conducted for the Consumer Federation of America (CFA), AARP, the Investment Adviser Association, the Financial Planning Association, the CFP Board, the North American Securities Administrators Association (NASAA), and the National Association of Personal Financial Advisors.[i] More recently, a 2015 study confirmed that most retail customers think their financial advisor – regardless of which type of advisor it is – is a fiduciary.[ii] The industry is well-aware of the confusion. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said "investors don't understand the differences between brokers and investment advisers."[iii]

<u>**Myth #2:**</u> ***Investors don't need a fiduciary standard because they already are protected by the existing regulatory regime.***

<u>**Fact #2:**</u> ***Investors suffer billions of dollars in losses each year due to conflicted financial advice.*** The failure to impose a strong national fiduciary duty is costing the American public billions of dollars. As the group SaveOurRetirement.com has noted: "Every single day that passes without a strong fiduciary duty means between $57 million and $117 million of retirement savers' hard-earned money is lost due to conflicted investment advice, amounting to at least $21 billion annually. These are real financial hardships and they militate against any further delay in

the rulemaking process."[iv] The current regulatory regime allows brokers to put their own interests above those of their clients. According to a February 2015 report by the Council of Economic Advisers entitled, "The Effects of Conflicted Investment Advice on Retirement Savings," Americans are actually suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors under the existing regulatory system.[v]

Myth #3: ***FINRA's Suitability Rule is sufficient. There is no need for brokers to be forced to act as fiduciaries***.

Fact #3: ***When it comes to fighting investor claims in arbitration, brokerage firms consistently maintain that they have no obligation whatsoever to uphold anything resembling a fiduciary duty.*** "Suitability," as defined by FINRA, is simply not the same as a fiduciary duty, as commonly defined under the law. When discussing the suitability rule, FINRA itself states: "The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the 'least expensive' security or investment strategy (however 'least expensive' may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests."[vi] This is hardly the sort of unambiguous guidance one would want for those handling retirees' life savings. Perhaps the clearest evidence that a fiduciary duty places a stronger obligation upon a broker is found when investors file claims in arbitration and the industry unwaveringly denies the existence of a fiduciary duty.[vii] If the suitability and fiduciary standards imposed roughly the same duties, then brokerage firms would not so strenuously deny in arbitration that a fiduciary duty exists.

Myth #4: ***Applying a fiduciary duty to investment advice given by brokerage firms will limit investors' access to affordable financial services products and advice.***

Fact #4: ***There is no evidence that a fiduciary standard will mean fewer options for investors.*** In 2013, the overwhelming majority of participants in the fi360-ThinkAdvisor Fiduciary Survey said that extending a fiduciary standard to brokers "would not price investors out of the market for advice" and that "operating at a higher standard can save clients money over the long-term."[viii] Both academic researchers and the SEC have also concluded that investors' access to financial advisers and products will not be affected by a fiduciary duty rule.

A 2012 study conducted by Michael Finke, Ph.D. and Thomas Langdon considered the availability of brokers and financial products in states that maintain strong fiduciary duties, limited fiduciary duties, and no fiduciary duties and found: "A sample of advisers in states that have either a strict fiduciary standard or no fiduciary standard are asked whether they are constrained in their ability to recommend products or serve lower-wealth clients. We find no statistical differences between the two groups in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance." [ix]

Likewise, the SEC found that, even if a fiduciary standard was adopted for brokers, retail investors should "continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide."[x] The SEC considered the issue of whether a fiduciary standard would likely limit investors' access to advice and products and found that it could make the recommendation and still "assure that retail investors continue to have access to various investment products and choice among compensation schemes to pay for advice."[xi]

Myth #5: ***Applying a fiduciary duty to investment advice given by brokerage firms (particularly smaller ones) will increase the costs for brokers to make sales to investors.***

Fact #5: ***The brokerage industry has demonstrated that it can find a way to comply with needed investor protection rules and also continue dealing with customers of all sizes.*** The costs of compliance associated with a fiduciary duty standard are not meaningfully different from those associated with a mere suitability rule. The Finke and Langdon study addressed this issue and found that there is no statistically significant increase in compliance costs in states in which there is a clear fiduciary standard and ones in which there is no fiduciary standard.[xii] Furthermore, the SEC's study found that it was possible for it to engage in rulemaking on the subject while minimizing cost and disruption.[xiii] The impact, if any, will be felt by those firms designed to promote their own interests by offering a small menu of high-cost options to investors.

The Consumer Federation of America found: "While firms of all sizes will have to adjust their business practices to comply with the rule, there is no valid basis for the claim that small firms would be put out of business. For small firms, the key to compliance will be the initial selection of the product menu they offer to retirement savers to ensure that it comports with a best interest standard. Firms that already offer a mix of reasonably priced, high-quality investment options that allows for creation of a diversified portfolio should see relatively little impact from the rule. They would have to enter into a contract with clients, make best interest recommendations, and provide disclosures with regard to costs and conflicts, but their business could otherwise continue largely unchanged. Those whose business is built around the sale of a few high-cost, low-quality products will face a more significant change to come into compliance, but that is appropriate. Either the sponsors of the investment products they recommend will have to adjust their products to make them more competitive under a best interest standard, or the firm will have to consider changing its product mix or, in the case of high-cost products, rebating fees that don't meet the reasonableness standard. While firms are likely to see some increase in compliance cost, including the cost associated with new disclosures, investment advisers who serve the small saver market under a fiduciary standard have shown that it is possible to serve this market affordably."[xiv]

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[i] *See* http://bit.ly/1Npodra.

[ii] *See* "Fiduciary – Do Investors Know What It Means" a Whitepaper on a new study issued by Spectrem Group (http://349ab54c3b58919c6638-ff70f51d4942f2bbd11ba0e41cfec577.r51.cf2.rackcdn.com/Fiduciary%20Whitepaper.pdf).

[iii] *See* "Trustworthy Advice and Individual Investors: Will Regulators Act in Investors' Best Interest?" issued in August 2013 to report the findings of the 2013 fi360-ThinkAdvisor Fiduciary Survey; *see also* "Seeking Trustworthy Advice for Individual Investors – Financial Intermediaries Indicate Strong Support for Fiduciary Standard" issued in February 2015 to report the findings of the 2015 fi360 Fiduciary Standard Survey (http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf); and "Fiduciary Duty and Investment Advice: Attitudes of 401(k) and 403(b) Participants," a report published by the AARP in September 2013 (majority of participants concerned investment advice by plan providers not held to fiduciary standard) (for all related documents, go to http://www.aarp.org/research/topics/economics/info-2014/fiduciary-duty-and-investment-advice---attitudes-of-401-k--and-4.html).

[iv] *See* http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf

[v] *See* https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf. "Conflicted advice" refers to advice given on particular investment products where the financial advisor is compensated in fees and commissions that depend on which investment product the customers buys.

[vi] *See* FINRA Rule 2111 (Suitability) FAQ, available at: http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

[vii] *See* PIABA's March 25, 2015 Report, "Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty" (https://piaba.org/piaba-newsroom/report-major-investor-losses-due-conflicted-advice-brokerage-industry-advertising-cre). PIABA's report gave multiple examples of actual Answers filed in FINRA arbitrations with customers in which broker-dealers denied having a fiduciary duty, and even included one Answer that included an Affirmative Defense that the firm's duties to Claimants were limited to "transactional duties." *Id*. In other words, the broker-dealer disavowed liability because it was only an order taker doing what the customer wanted.

[viii] *See, supra,* Findings of the 2013 fi360-ThinkAdvisor Fiduciary Survey. Specifically, 83 % of the fee only, 72% of the fee/commission, and 66.67% of the commission-only respondents agreed that a fiduciary standard would not price investors out of the market for advice.

[ix] *See* "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice," Michael Finke and Thomas P. Langdon (March 9, 2012), available at: https://www.onefpa.org/journal/Pages/The%20Impact%20of%20the%20Broker-Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx

[x] *See* "Staff Study Recommending a Uniform Fiduciary Standard for Conduct for Broker-Dealers and Investment Advisers" (2011), available at: https://www.sec.gov/news/press/2011/2011-20.htm.

[xi] *Id*.

[xii] *See* "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice," *supra*.

[xiii] *See* "Staff Study Recommending a Uniform Fiduciary Standard for Conduct for Broker-Dealers and Investment Advisers" (2011), available at: https://www.sec.gov/news/press/2011/2011-20.htm

[xiv] *See* "DOL Delivers on its Promise: Conflict of Interest Rule Proposal Provides Needed Protections for Retirement Savers, Flexibility for Financial Firms." Available at: http://www.consumerfed.org/pdfs/150507_DOL-revised-rule_QandA.pdf