

Comment to DoL Fiduciary Rule Proposal

RIN 1210-AB32

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July 21, 2015

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Prudent and skilled management of individual retirement funds is of crucial importance not just for retirees but also for the future of our country. The national wealth represented by these growing pools of assets should be managed with prudence, skill and efficiency to fuel new economic growth and prosperity for younger generations while providing a comfortable retirement for savers. People who are entrusted to make investment decisions or provide advice should have a high level of both expertise and ethics while also understanding the social implications of their actions.

Overwhelmingly, activities of financial intermediaries who are in conflicted situations tend to reduce return for investors as a group, increase risk or both. This is especially true for those lacking expertise and ethics, those not interested in long relationships with clients and those motivated primarily by personal profits. Therefore, I support the new Fiduciary Rule proposal from DoL as it can help reduce conflicts of interest.

However, even with the implementation of the new rule, the financial industry and the investment management sector would still be a long way off from having what would be considered normal consumer protection safeguards in other industries of similar importance such as accounting, medicine or architecture.

Reliance on the traditional approach of more disclosures and more regulations may address some issues but can potentially exacerbate the problems in the current framework by adding even more complexity. What is needed is an emphasis on professionalism and professionals. In the investment management industry there is a need for different types of professionals with different skills. Within each profession, there is often a need for specialization.

The “professionalization” of investment management would succeed where regulation fails. By definition, professions require a high degree of education, training and conduct conforming to a rigorous code of ethics. Professionals who are “fiduciaries” must act in the best interest of the client. They should not receive compensation from those selling products or wishing to influence the advice given.

Being a fiduciary necessarily means being a member of a formal profession. The current definition of a fiduciary for investment advisers is incomplete as it mentions only prudence and loyalty. Acting in the best interest of the client as a fiduciary must require a high level of professional competence and the existence and adherence to a code of ethics.

By definition, salespeople cannot be fiduciaries. Therefore, the idea of imposing a uniform fiduciary standard for broker-dealers and investment advisers is impossible and, if implemented, doomed to create widespread institutionalized deception.

A rational approach would be to follow the model of the healthcare industry where performing medical procedures or recommending treatment with drugs that can be potentially harmful is done only by licensed physicians. In the investment management industry, investment advisers should be highly qualified professionals, compensated solely by clients, making prudent recommendations based on the best professional practices and a code of ethics. Lawmakers and regulators should apply this model by recognizing certain professions, setting up accreditation organizations, administering or monitoring the examinations, issuing licenses and ensuring that those who practice are only licensed professionals. In the end, this would result in a higher quality of service, less regulation and less litigation. It would also contribute to an increase of trust in the industry and in the government regulators.

Background

Consumer protection is generally a government function that relies on regulation and enforcement. It covers both products as well as services but the approach is different for each. In the case of products, regulation typically attempts to prevent the sale of those that are harmful or unsafe. For some categories of products such as automobiles and other durable goods, laws also ensure a level of quality by mandating warranties or recalls.

For services, the main consumer protection tools are licensing, mandatory insurance, bonding and litigation. The first line of defense for ensuring a proper quality of service and preventing harm done by service providers is professional licensing. There are many formal professions such as physicians, lawyers, accountants, architects, engineers, plumbers, etc. In cases where customers are still harmed, litigation, bonding and insurance provide an additional safety net.

The investment management industry offers both products and services. Unlike the regulation of normal products, investment products such as securities, funds, etc., due to their nature, have no government-mandated safety or quality requirements. A strong emphasis and reliance on disclosure produces long and complex documents that are virtually impossible for individual investors to understand and analyze. This automatically creates the need for a competent, unconflicted and ethical advisor who is a service provider.

However, when it comes to investment management services, government's approach to consumer protection is vastly weaker than other industries. Whereas licensing requirements for other professions are very high and rigorous, investment management is not even recognized as a formal profession. This is evident from the fact that, depending on state, nearly anyone can be a licensed "Registered Investment Adviser" or RIA.

Some states have certain education requirements. For example, in NY, an RIA representative must have either a Series 65, a Series 7 and 63 or have a designation such as CPA, CFP or CFA. Other states such as Georgia have no education or testing requirements. Wyoming does not even require registration at all. Most states allow investment advisers to operate without being registered if they have less than six clients. We must wonder if it would be acceptable to practice medicine without a physician license if someone had less than six patients in each state. College level education, or any level of education, is not necessary in all 50 states. This is because even requiring Series 65 does not require having a college diploma.

To make matters worse, investment advice is often given by salespeople such as broker-dealer representatives or insurance agency reps presenting themselves and acting as financial advisers. Typically licensing for the sales-side only requires passing a Series 7, Series 8 or Life&Health Insurance examination. This poses several important problems related to consumer protection. First and foremost, the advice is inherently conflicted. Second, the costs tend to be either obscured or hidden making comparison-shopping difficult or impossible. Lastly, salespeople typically have no special qualifications to act as investment managers. Again, a college degree of any kind is not a requirement.

Asking consumers to protect themselves by carefully selecting an “adviser” is a utopian idea that fails in real life. We know that to be the case when we find that most investors are unaware of the most basic facts, which include understanding the difference between a salesperson versus an adviser and being able to identify who they are dealing with. Having dually-registered representatives blurs the line even more for clients as it becomes difficult to know the capacity in which the agent operates at any given time.

Another potential tool at the consumer’s disposal is the existence of professional designations. However, this also poses problems in practice for the consumers. As evidence, there is a list of about 150 designations as published by FINRA and making sense of them is difficult if not impossible. Very few designations rise to the level of profession by having extensive education requirements, a prior college degree, rigorous examinations and a code of ethics. Others are little more than the equivalent of a safe-driving course where the requirement is simply attendance in person or remotely. Interestingly, FINRA refers to all designations as “professional designations” when in fact the vast majority would not be even remotely seen as formal professions.

Putting all designations on an equal footing not only adds to the confusion but diminishes the value of any true professional designations. A consumer might be further misled by the name of the designation. For example, a designation name including the words “retirement specialist” would probably sound more powerful and relevant than another one that has the words “chartered” or “analyst”.

Furthermore, even the most valuable designations are not an indication of whether a person is acting as a fiduciary or not and therefore qualified to give advice. Often, individuals holding designations work in a sales capacity being inherently in a situation of conflict of interest. Still, not being a fiduciary doesn’t mean that the person is acting without ethics.

Increasingly various types of companies and different kinds of professionals are branching into the investment management business by leveraging their existing client base and their trust relationship with those clients. With low or non-existent barriers of entry, depending on the state, it is very easy

for an accountant or a lawyer to register as investment adviser. This is further evidence that currently investment management is not a profession and that fiduciary standard for investment management is flawed.

Accounting as a true profession does not permit non-professionals to give accounting advice. The same is true for legal advice or other types of professional advice. The mere fact that someone is a professional in one field should not be a qualification to practice in a different field. In fact one professional code of ethics of plumbing engineers is specific in stating that its members should not work outside their own area of expertise.

Current regulatory framework ignores the first line of defense in consumer protection by relying on professionalism and instead seeks to strengthen the liability and litigation aspects. This is not only the most inefficient and expensive form of consumer protection, it is also extremely unreliable as it can leave many victims without the means of possibility for redress.

In conclusion, both government and industry need to start fundamentally rethinking their approach by moving towards professionalization. Ultimately, this would benefit not only the public but also the industry itself.