Best Interest?!

“IT’S THE TRUMPIFICATION OF THE SEC”: AS STANDARDS ARE LOWERED FOR INVESTMENT PROS, “MR. AND MS. 401(K)” COULD BE SCREWED

An Orwellian new rule, dubbed “Regulation Best Interest,” gives investment advisers the freedom to sell stuff they wouldn’t buy themselves.

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Without a whole lot of fanfare—or wisdom—the Securities and Exchange Commission voted Wednesday morning to change dramatically, and not for the better, the way investment professionals interact with their clients. About half of Americans invest in the stock and bond markets, and most of them use either a “broker” at a Wall Street firm, such as Goldman Sachs or Morgan Stanley, or an investment professional at a money-management firm, such as BlackRock, Fidelity, or Vanguard (and Hughes Capital Management). By one estimate, investors lose “tens of billions of dollars” a year as a result of Wall Street brokers acting in their self-interest, as opposed to their clients.’ That’s a lot of money.

The new rule, dubbed “Regulation Best Interest,” passed on a 3-1 vote, lowering the standards for investment professionals down to the standards of the brokers, instead of trying to raise up the standards of the brokers to those of the investment professionals. Instead of ending up with a higher standard of care, we will end up with a lower standard of care.

It’s an Orwellian turn of events, and unnecessarily upends much of the calculus that has been around for decades between people who manage other people’s money for a living and their clients. “It’s the Trumpification of the SEC and of **[Jay] Clayton,** [the SEC chairman],” says **Carter Dougherty,** the communications director for Americans for Financial Reform, an organization that opposes the change, “where we’re going to say, ‘Up is down and right is left, and two plus two equals five.’ They have imported this disdain for the truth into the commission now, and this has a very real implication on a day-to-day basis for your average investor, or what Clayton likes to call ‘Mr. and Ms. 401(k).’ It’s that your broker will be able to look you in the eye and say, ‘I am complying with Regulation Best Interest of the SEC,’ but in fact [they] are not creating a relationship here that requires that your broker acts in your best interests in the manner that, say, a doctor or a lawyer is obligated to act in your best interests.”

For decades, brokers and investment professionals played by different rules. Investment professionals were required to be “fiduciaries” for their clients, meaning that they had to not only put their clients’ interests ahead of their own, but they basically could not put their clients into an investment that they themselves would not also make. That way, the professional’s interests were exactly aligned with their clients. Generally speaking, investment advisers acting as a “fiduciary” charged more than a broker—say an annual fee of assets being managed—but they also held themselves, and were held by others, to a higher standard of professionalism.

Wall Street brokers are different. They don’t operate under the “fiduciary” rule. They don’t have to put your interests ahead of theirs. They can get away with a lower standard, known as “suitability,” which is Wall Street speak for doing their best to meet their clients’ goals, given a set of risk parameters. They often get paid after each trade and are rewarded for churn. A Wall Street broker can also be compensated by their firm to sell some sort of crazy structured note or security, whether or not they think it's a worthy investment or not. You are of course free to say no, and challenge their recommendation, but that requires a level of financial sophistication that few outside of Wall Street possess.

It's not a great system, since clients of Wall Street brokerage firms can end up getting sold a lot of crap that your Wall Street broker gets rewarded to sell to you, and you may not be the wiser. Now of course it's ridiculous to generalize about such things as individual brokers, because there are many, many brokers at Wall Street firms who are decent and honorable and only want the best for their clients. They would never sell you anything that they were not themselves proud to own. But if the shit were to hit the fan—as say happened in 2008—then the level of liability for a Wall Street broker in that situation is lower than it would be for an investment adviser.

Barack Obama tried to change the rules for the Wall Street brokers. After much study, his Labor Department introduced a so-called "fiduciary rule" for brokers. (**Mary Jo White,** the chair of Obama's SEC and a once and present Wall Street attorney, reportedly wanted no part of the debate, which was why the Labor Department ran with the ball.) But Wall Street didn't like, or want, the new fiduciary rule. Wall Street did not want to be held to the same high standard as the investment advisers at Fidelity and Vanguard. It wanted to be able to still sell its customers whatever securities Wall Street cooked up, bad or good, without risking liability if things went wrong, as they inevitably do.

Wall Street sued the Labor Department to strike down the new rule. Wall Street won. After the 2016 presidential election—and to prove the old adage that elections have consequences—**Donald Trump** decided he wanted nothing to do with resurrecting a new version of the fiduciary rule.

This is where more politics enters the fray. To head the SEC, Trump chose Jay Clayton, a former partner at Sullivan & Cromwell, which for decades has been Goldman Sachs' preferred law firm. (His wife worked at Goldman.) As his "senior policy adviser," Clayton selected **Alan Cohen,** a former head of compliance at Goldman Sachs for 13 years. Trump appointed new commissioners to the SEC, including **Robert Jackson,** a law professor at NYU and previously Columbia; **Hester Peirce,** a senior research fellow at the Mercatus Center at George Mason University; and **Elad Roisman,** who served as a top adviser to two Republican senators, **Mike Crapo** and **Richard Shelby.** Generally speaking, Clayton, Peirce, and Roisman have voted more "conservatively" than has Jackson. (Jackson was the lone vote in opposition to Regulation Best Interest.)

Last year the SEC proposed a new rule, essentially a watered-down version of the Obama rule, that would require Wall Street brokers to stop putting their own interests ahead of their clients—not quite the "fiduciary" standard, but better than the "suitability" standard. In other words: a baby step toward protecting Americans and their money from wayward Wall Street brokers. The investment advisers would still have been subject to the higher "fiduciary" standard.

That's when things got interesting. According to a source with knowledge of the discussions, lobbyists for the investment advisers—among them the Investment Company Institute and the Investment Adviser Association—threatened a lawsuit if the Wall Street brokers got to have an SEC-sanctioned lower standard than the investment advisers, even though that is already the case. "And Jay needed a way out," said the source, who is a Wall Street lawyer. "He needed a way to adopt a rule that would not get him in a lawsuit he couldn't win." So that's when Clayton proposed to *lower* the standards for the investment advisers to the already low standard of the Wall Street brokers. Instead of raising the standards for everyone who manages money, whether at a Wall

Street firm or at a money-management firm, the SEC has now lowered the standards across the board. (Spokesmen for both the Investment Company Institute and the Investment Adviser Association denied that their organizations threatened the SEC with a lawsuit; the ICI spokesman said the organization “publicly, consistently, and affirmatively advocated preserving the fiduciary duty standard for investment advisers.”)

Of course, Clayton will likely say he’s just changing the rule to reflect the reality of what investment advisers actually do, as opposed to what they are supposed to do. And Wall Street will say it’s great to be less regulated. The investment advisers and their lobbyists will say it’s a wonderful deal that everybody should like and be happy about.

But this is Trumpworld, where truth is often the first casualty. The bottom line is that the lobbyists won. The new SEC rules will not be good for anyone who has professional help investing their money, unless you know the people who are doing that task ....

Our thoughts

It is hunting season on Wall Street, and you are on the menu. The SEC is giving the green light to all sorts of predatory behavior. After this ruling, you can no longer rely on the fact that someone is a Registered Investment Advisor as some measure of protection. If your Advisor (or Broker) does not explicitly mention that they have a Fiduciary responsibility (which HCM has), you need to run (and no, acting in "Best Interest" is not the same thing, and is a significantly lower standard). Another way to verify that an investment professional is held to a sane standard of care is to verify that they have a CFA Charter (as I do) or CFP designation, as those programs require a Fiduciary responsibility to clients.