WASHINGTON INSIDER’S PERSPECTIVE

The Changing Regulatory Landscape
with Duane R. Thompson, AIFA®
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To explore the changing regulatory landscape, we sought an insider’s perspective about what has changed in recent years and what changes are on the horizon. We reached out to Duane R. Thompson, AIFA®, president of Potomac Strategies, LLC, a public policy consulting firm, who is a frequent contributor to I&WM. He has worked closely with the Investments & Wealth Institute staff and the Government Relations Committee to help the organization navigate the political landscape in Washington, DC. He also shares insights with members through the Institute’s Legislative Intelligence column and participating at numerous Institute conferences.

I&WM: Duane, you’ve seen a lot of changes over the years in regulation of wealth managers, but it seems like the pace of change is accelerating. It is often challenging for our members to understand the political climate and evolve their practices appropriately. How do you read the current regulatory landscape?

Thompson: It always seems like the pace of regulation increases every year, doesn’t it? However, if you look at new investment adviser rules, over the past 20 years the Securities and Exchange Commission (SEC or the Commission) has adopted 25, or just more than one new rule a year. However, I think the low numbers are a bit misleading because first, not all rules are made the same, and second, there are many other factors to consider.

For one, I think it’s helpful to throw in the enforcement and examination activities of the SEC along with new rules. Compliance officers should monitor both enforcement settlements and risk alerts closely because the SEC is sending not-so-subtle messages on a pattern of problems that may extend to other firms’ compliance policies and procedures. The Commission’s examination arm, the Office of Compliance Inspections and Examinations (OCIE), is a good example of this approach when it announces its annual examination priorities or issues a risk alert. Because the Investment Advisers Act of 1940 (Advisers Act) is principles-based and not rules-heavy, the SEC tends to articulate the fiduciary standard through guidance, including no-action letters, not necessarily in rules. Plus, if you’re dually registered as a broker, you know that the Financial Industry Regulatory Authority (FINRA) tends to lay on a lot of new compliance requirements in the form of notices to members. All of this tends to require more effort to comply, even if the production of new rules remains static.

One example is the recent enforcement policy of the SEC regarding disclosure of 12b-1 fees. Over the past decade and even longer, the SEC has wanted to get rid of 12b-1 fees, which technically serve as a way for investment companies to pay for marketing. But for many years 12b-1 fees have been used by advisors as a fee-offset for other services. Back in 2009, I was in a meeting with then-SEC Chair Mary Schapiro—this was in the middle of the financial crisis—and unrelated to everything else that was going on, she expressed an interest in eliminating 12b-1 fees. However, at the time a flood of new regulatory and study mandates were coming out of Congress and overwhelming the agency. Work on the 12b-1 rule was put on the back burner.

That said, advisors always have been required to disclose brokerage affiliations and commissions in Form ADV, but instead of a rulemaking the SEC turned to enforcement a couple years ago. As part of its Share Class Selection Disclosure Initiative, the SEC said that many firms had failed to provide “full and fair disclosure” of 12b-1 fees. In other words, advisors had failed to specifically disclose the conflict of interest related to compensation received based on share class selection. The result was a resource allocation to enforcement to effect a policy change. Whether intended or not to supplant a rulemaking, the enforcement program forced firms to re-think their use of higher-cost share classes. Of course, making policy through enforcement is controversial and has been criticized roundly in some circles.

My takeaway from watching the SEC interpret the fiduciary standard over the past two–dozen years is that principles-based regulation can be frustrating for advisors and compliance officers. But if advisors have due diligence procedures in place that adopt best practices and not just adhere to baseline compliance, they will not have to be as concerned with SEC risk alerts, compliance sweeps, and enforcement.
In answering your question about how I read the regulatory landscape, my approach is pretty straightforward. Because of the high level of regulatory activity, I tend to focus more on the regulators than Congress. And because the SEC is the primary regulator of wealth managers, that’s where I spend most of my time and energy. Of course, there are exceptions, such as when the Department of Labor (DOL) first proposed a fiduciary rule in 2010 that shook the entire financial services industry.

At a high level, I compare the whole process to a kitchen funnel. Congress is at the top of the funnel, pouring things into it when it is able to enact legislation. Typically, the new laws come with broad mandates for agencies to carry out congressional intent. Moving down the funnel, the regulators translate the legislative mandates into rules. And when the law or rules are silent on a specific advisory activity, at the bottom of the funnel are the compliance professionals. They and the advisors are left to sort out the gray areas that sometimes can be confounding for an advisor just trying to do his job. And in a worst-case scenario, the sorting out may end up in an arbitration forum or the courts if the firm or rep is careless.

I find that policy analysts like me are somewhere down there in the funnel, too—somewhere between the policymakers and the compliance folks. We do our best to interpret the hundreds, sometimes thousands of pages of a rule, a risk alert, or enforcement action, and we also try to read the tea leaves in public statements by SEC commissioners, in order to distill the results into a bottom line for practitioners. But it is the compliance professionals who have the ultimate responsibility for providing bright-line guidance to the wealth manager.

Being a policy consultant is not that different from what SEC staff does on the policy level. An attorney in the SEC’s Division of Investment Management once told me that when he prepared presentations for industry groups, he would call someone at OCIE to get some real-life examples of what was happening on the ground that prompted the SEC to undertake a new rulemaking. So, I think if there is any area that needs improvement to assist the advisor community, it’s the gap between an SEC rulemaking and implementation at the street level. I have a short list of compliance folks who I check with on an intermittent basis, and I always get an earful on numerous unanswered questions that are the consequences of something that was decided at the top of the regulatory funnel or somewhere inside.

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It’s not that the regulators are blind or don’t care about the consequences of a rulemaking. When you think about it, it would be impossible to anticipate everything that might occur as a result of a new rule, which is why the actual text of the Regulation Best Interest rule is only seven pages, but the SEC used 750 pages to explain it. And by giving firms flexibility to adopt policies and procedures across business models, the SEC tries to avoid putting firms in a straitjacket.

Of course, given the scope of services provided by wealth managers, they must be cognizant of many other laws and regulations ranging from federal and state tax codes to oversight of pension plans by the DOL. It’s a big job. I am still in awe of all the regulatory dynamics that investment professionals must stay on top of besides the ultimate responsibility of helping clients meet their financial goals and objectives. When I switched from lobbying on franchise sales regulation some 25 years ago, I was staggered by the amount of regulatory minutiae that I encountered in the securities industry. At the time I thought: “Oh well. It will take a while to get a handle on everything.” Today I still find myself on a never-ending learning curve. When you handle other people’s money, the regulatory thicket is pretty dense.

**I&WM:** The fiduciary standard has been a focal point for state and federal regulators over the past decade or more. First the DOL offered a rule, and later the SEC offered its version. Now we have Regulation Best Interest (Reg BI), courtesy of the SEC. Will we ever have true harmonization of these rules? Are there more changes and regulation to come?

**Thompson:** I would say the debate goes back much further than a decade. In 1999 the SEC proposed a rule exempting fee-based advisory programs by broker-dealers; it was called the Merrill Lynch Rule or Rule 202. The SEC eventually was sued for exceeding its regulatory authority, and the rule was overturned by an appeals court in 2007. I know all about this history firsthand because I managed the Washington, DC, office of the Financial Planning Association (FPA) during this period. The FPA was concerned about the delivery of financial planning services under two different standards, one fiduciary, the other a lower suitability standard. Literally from 2000 onward we saw independent advisors and consumer groups line up on the pro-fiduciary side and industry groups on the other. The Obama administration came out in support of a fiduciary standard for retail investment advice by brokers in 2009, and the DOL intensified the debate the next year by proposing a strong conflict of interest or fiduciary rule for investment advice to retirement plans and accounts. Of course, readers know the rest of the story. The DOL rule was overturned in March 2018 by the
Fifth Circuit Court of Appeals at a time that the incoming Trump administration was pushing a sweeping de-regulatory agenda.

As a consequence, the DOL deferred to the SEC to create an alternative approach to regulating retail investment advice, so now we have Reg BI. However, that's not the end of the story. What was once a backwater issue, the fiduciary standard has morphed into a political football in Congress as well as at the SEC, dividing the agency into two camps from the commissioner level down to individual staff. On top of that, blue states have begun to push fiduciary rules that are much stronger than Reg BI, so the debate goes on with no clear end in sight. If the states' fiduciary battle is prolonged, we could end up with a patchwork set of fiduciary standards, one on the state level, and another on the federal level, somewhat like the patchwork regulation of investment advisers and fund companies we had before Congress passed a law in 1996 preempting some of the states' authority.

With regard to regulatory harmonization, we already are seeing the fiduciary standard take root across the securities and insurance sectors, although there will be many more bumps in the road before a robust uniform standard is embedded across the country. Let me explain.

The fiduciary standard comprises twin duties of loyalty and care, and it has been around for centuries. Under FINRA rules and insurance regulation governing annuity transactions, products were sold at arms-length, the only modification a duty to recommend suitable investments. Investment advisers have a similar obligation to make only suitable investment recommendations under a rule that was proposed but never adopted by the SEC in 1994. But that's where the similarities end.

Today, the major point of contention involves the duty of loyalty, under which fiduciaries are obligated to avoid or mitigate conflicts in the best interest of the client. Investment fiduciaries to trusts, foundations, ERISA pensions, and investment advisers with retail advisory clients have always had a fairly robust duty to avoid or manage conflicts in the interest of the client and not the firm. However, the duty of loyalty is not clear under Reg BI. And with respect to fixed-annuity and life insurance transactions, the duty of loyalty is clearly missing. All of this comes out of the old business models in which the agent was identified as a salesperson facilitating arms-length transactions with a customer. After Congress repealed Glass-Steagall in 1999, allowing affiliations of banks with broker-dealers and insurance companies, cross-selling was rampant and still is today. But that creates new conflicts—and new problems if a firm is subject to a fiduciary standard while selling products that can impair its objectivity.

The SEC asserts that Reg BI draws from fiduciary principles, but it's still puzzling to me why fiduciary terms such as “duty of loyalty” are absent from the rule itself. As the old saying goes, if it walks like a duck then it is a duck, but it seems to me that Reg BI struts like a fiduciary rule but under the mask is a beefed-up suitability standard. SEC Chairman Jay Clayton insists the key to the rule’s success is firms adopting tough policies and procedures that will result in a broker acting in a retail customer’s best interest. Only time will tell. And depending on your point of view, the question of whether Reg BI is a “duck” will depend upon whether the SEC and FINRA aggressively enforce Reg BI for violations. Reg BI takes effect in July 2020, so it probably will be several years before we see results.

**I&W M:** As a Washington insider, what are you hearing about the new retirement legislation that has passed the House of Representatives? Is it likely we'll see sweeping reform or just modest changes for retirement plans?

**Thompson:** I think modest changes are more likely. One would think the retirement legislation you are referring to, called the SECURE Act, would pass the Senate easily after a 417-3 vote in the House in May 2019. However, several senators are reported to have placed holds on the bill, which makes it extremely difficult under Senate procedural rules to bypass the committee process and move it quickly to the Senate floor for a vote. The principal objector is reportedly Senator Ted Cruz (R-TX), who objected to the removal of a proviso in the bill by House Speaker Nancy Pelosi (D-CA) that allowed for the use of 529 plan assets to pay for home-schooling. I think there is slightly better than a 50-50 chance the SECURE Act could be attached to a must-pass bill before the end of the year, but there are no guarantees.

The reason I call the bill a modest, and not sweeping, reform bill is that in comparison to the Pension Protection Act of 2006 (PPA), it’s small potatoes. The PPA dramatically increased the savings rate of workers through its automatic enrollment provision and ability to default participants into target-date and other equity funds as opposed to into a default cash account. The SECURE Act, in contrast, contains a whole bunch of tweaks to the tax code that most advisors will be delighted to add to their toolkits. Still, if it becomes law, the SECURE Act will be the biggest reform initiative since the PPA.

On the downside, the new tax deductions and credits would be paid for, at least in part, by limiting the use of stretch individual retirement accounts as an estate planning tool. But overall, there is a lot to like in the proposal.

If the SECURE Act doesn’t pass this year or in 2020, I think there’s a decent chance Congress eventually will bundle various savings options into a legislative package that can be signed into law. As a rule of thumb, it often takes five or six years for major legislation to pass Congress, as occurred with the PPA.
I&W: We hear a lot of noise from the SEC about such diverse issues as allowing private equity in 401(k) plans to allowing firms to launch bitcoin exchange-traded funds (ETFs). What is the SEC’s focus over the next couple years? Will we see private equity in retirement plans? Will the SEC loosen the accreditation standards?

Thompson: The current leadership of the SEC is very interested in broadening access to investment opportunities in a variety of areas that you mention, although there is obviously less enthusiasm for bitcoin ETFs as well as significant concerns with cryptocurrencies. In June 2019, the SEC published for comment a concept release asking questions about private equity in 401(k) plans, other crowdfunding initiatives, and loosening the definition of accredited investor (AI) to include other potential investors. I think the SEC will follow-up with a series of rule proposals. Whether they can get it done before the next general election is another question. But if wealth managers haven’t tested the political winds already, I think it is very possible that new, alternative investments will be increasingly available to their clients, either by adding advisors to the AI definition, through a qualifying exam, or some other way. This will create new opportunities for alpha and diversification of risk, but for fiduciaries with an obligation to evaluate novel, unconventional investments through a prudence filter, alternatives will present new and difficult challenges, particularly with regard to monitoring frequency, liquidity needs of the client, and product valuations.

I&W: In recent years, we’ve seen explosive growth in ETFs, numerous launches of robo-advice offerings, and alternative investments becoming more readily available to Main Street investors. What's on your radar of things to watch in the coming years? What are some of the regulatory implications of these changes?

Thompson: Product innovations are probably more top of mind to advisors than to policy wonks like me. The marketplace is always ahead of the regulators and Congress. I mentally take note of what is going on so I'll be prepared to see how the SEC and other policymakers react. The SEC is charged with facilitating capital formation, maintaining fair and orderly markets, and protecting investors. As we’ve seen with the debate over cryptocurrencies, the Commission staff still is trying to wrap its policy thinking around the best approach to meeting its mission of promoting capital formation while also facilitating orderly markets and protecting investors. It is a constant balancing act in which the emphasis often shifts depending on who’s in the White House.

On top of that, the SEC is restricted to regulating securities, and some of the new alternative investments may not meet the definition of a security, thereby relegating the agency to the sidelines. It’s certainly possible we could see some regulatory gaps fester over time. As James Madison wrote in the Federalist Papers, “If men were angels, no government would be necessary.” Unfortunately, the same holds true with regulation. If the tilt toward investing in unregulated investments leads to abusive practices, Congress may respond by broadening the SEC’s or some other agency’s oversight authority to include the new alts.

Because I have been focused on advisor regulation for most of my time in the industry, I use a fiduciary filter for assessing new products and investment practices. For example, I take notice of public statements such as a speech by former SEC Commissioner Kara Stein questioning whether robo-advisors are able to meet their suitability obligations under the Advisers Act. The following year OCIE issued robo guidance and later made digital advice an examination priority, stating it would look specifically at algorithms that generate recommendations, robo marketing materials, data protection, and conflicts of interest. I don’t know if Ms. Stein’s remarks prompted the review, but they certainly help observers trying to read the tea leaves.

Similarly, when the DOL re-proposed its fiduciary rule in 2015, the agency asked in the rulemaking whether certain alternative investments should be banned under its Best Interest Contract Exemption, such as security futures, puts, calls, straddles, and options, as well as non-publicly traded equity securities. However, it later backed off from specific product restrictions in the final rule. Recall that back in the 19th and early 20th centuries state legislatures actually dictated what stocks were prudent for use in trusts, and they placed greater emphasis on capital preservation than inflation risk. But I don’t foresee any backtracking, given more recent developments in trust law and academic research that encourage the use of equities in trust portfolios and to allow delegation of a trustee’s investment responsibilities to a prudent expert.

So, it’s nice having the trade press telegraph far in advance the new products coming out, but I tend to wait and see how Congress and the regulators react before I begin to actively monitor on behalf of the Institute.

All in all, I really enjoy what I’m doing. Although my family and friends don’t fully understand the nature of my work—admittedly it’s pretty dry stuff—I love it. I like to think that at the end of the day, it helps make life just a little easier for advisors and affords them a little more time to concentrate on what they like doing best, and that’s helping clients.

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