What is Regulation Best Interest? - Transcript

DISCLAIMER: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinions and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions and securities discussed in this podcast.

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is Episode No. 263. Thanks for tuning in. This is Tom Mullooly, one of your co-hosts.

Joining me this week is Tim Mullooly, and Tim, I think if we were to put a headline on this, I would probably say if you're going to listen to one podcast this year, this is probably it.

Tim Mullooly: Yeah, this topic relates directly to people who work with advisors, anyone who has worked with a broker or invested money with a professional. We're going to be talking about the new regulation working its way through Washington. It's called Regulation Best Interest. We'll abbreviate it with Reg BI because that's what it's being referred to online.

Tom Mullooly: The Department of Labor actually proposed a fiduciary standard of care several years ago. This was actually rejected. It was approved, but then rejected by the Trump Administration. The White House had shot it down. And at the time, we had heard, "That's okay because the SEC is working on their own form of fiduciary rule." They actually floated this in April of 2018. It's taken a full year. When they opened it up for comments, which they always do, they received over 6,000 responses.

Tim Mullooly: Right. There was an article from Barry Ritholtz titled, The SEC's New Best Interest Rule is Far From Best For Investors, and he started out by talking about how currently, before this Reg BI would go into effect, there are currently two different standards of care that advisors and brokers need to abide by. Registered investment advisors, which is what we are here at Mullooly Asset Management, we must meet the Fiduciary Standard, whereas brokers need to abide by what is called the Suitability Standard.

Tom Mullooly: If you want to be interested in growth, you can invest in a low-cost index fund, which may be appropriate and suitable for you. On the flip side, and this is an extreme example, but if a client were working with a broker and told them that they were interested in growth, they could actually talk them into or suggest buying Bitcoin, which is very speculative. He would be protected, that broker would be protected because he's not a fiduciary; he recommended something that is merely suitable at the time of the investment.

I think what a lot of people lose sight of is that an advisor, as part of their fiduciary care, monitoring of their investments is ongoing. They have an ongoing relationship to oversee these accounts. With the broker, it's merely at the time of the transaction. "At the time, fill in the blank, looked like a suitable investment."

Tim Mullooly: The fiduciary rule from the Department of Labor was shot down. Some individual states started imposing their own fiduciary rules. I think New Jersey is one of them. There's a list in the article that Barry wrote for these states. These brokers who got the fiduciary rule shot down on a federal level are now doing the same thing on the state level; they don't want to be held to the same standard that fiduciaries and investment advisors have to.

Where this Regulation Best Interest gets kind of sketchy is that it uses the term Best Interest, which is part of the interest of what a fiduciary needs to do. It's using part of the terminology that a fiduciary acts under, but it's not coming with the same strings attached that a fiduciary needs to adhere to. So now, brokers and everyone else who aren't fiduciaries can say, "Well, I'm acting under your best interest," which is part of what the fiduciary would say.

The way Barry put it in the article, and I agree, it's almost a marketing name. It's like a branding term.

Tom Mullooly: I am not going to be surprised if next year, we see brokerage firms advertising, saying, "We have to act in your best interest. The government mandates that."

Tim Mullooly: And it's not the case. Technically, the rule would be called Regulation Best Interest, but it's not the same best interests that fiduciaries act under.

I'm confusing myself talking about it. Now individual investors are supposed to be able to identify more clearly which advisors and which brokers are actually working for them and not working for their own pockets? It just blurs the lines even more than it already was.

Tom Mullooly: And I think that's part of the premise behind this is that by blurring the distinction, saying, "Hey, it's no longer advisors who have to work in your best interest. Our brokers here also have to work in your best interest." Well, were the hell were you for the last 70 years as you were ripping off the public?

Okay, now look, in the '50s, '60s, and even up until 1975, commissions were fixed: "If you want to buy stock, here's the commission schedule." When I got started in the business, people asked me, "Send me your commission schedule." "Hey, do we have a commission schedule?" I didn't even know what that was! And that was the 1980s.

It wasn't really until the last 20 years when people started realizing the costs that are built into these products that people are buying ... I'll bring this right down to street level. Case after case after case after case comes in, new potential client opens up their books, shows us what they have as their investments right here at the conference table, and what do we see? Fat mutual funds with big sales charges. Annuity, annuity, annuity, annuity.

What we show clients and potential clients is, "Look, you can achieve the same returns, or possibly better, with lower cost investments where more of your money goes to work." We're just doing our job exercising our fiduciary care. "So look, Mr. Jones, here's an ETF that charges 25 basis points a year to manage this portfolio of stocks, or we could put it in an annuity where you're going to pay 2.7% per year." Are you kidding? Are you kidding!

When you think about these brokerage firms, yes, they have retail brokers. Merrill Lynch and Morgan Stanley have gigantic sales forces, but when you look at the revenue that the sales force actually generates, in comparison what the total revenue is for Bank of America Merrill Lynch – remember, they're a part of Bank of America – or Morgan Stanley, with all the investment banking, all the deals that they do, it's a fraction. It's a fraction of what they have.

When I started this business, I used to sit down with folks and tell them, "You can't serve two masters." Look, I'm either going to work for a brokerage firm, they've got their quarterly revenue and earnings that they've got to reach, I've got sales quotas that I've got to reach, or I'm going to get replaced. I've got quotas that I've got to work on, or I can work for you.

Tim Mullooly: And that's an important, I think, distinction to make too. It's the structure of these big wirehouses and the big brokerage firms that is the problem. The people working there, they're just abiding by the rules. They have to keep the-

Tom Mullooly: And they're good people.

Tim Mullooly: Right, exactly. That's the point-

Tom Mullooly: There's good brokers that are out there.

Tim Mullooly: That's the point that I'm trying to make. It's not necessarily the brokers' individual fault for doing this. They're trying to make a living, they're trying to get paid. It's the incentive structure that is all out of whack.

Fortunately though, Barry pointed out in the article that even though the fiduciary rule got shot down, there's still a blurry line between a fiduciary and who's actually working in your best interests. Over the last couple of years, they've seen billions of dollars flowing out of these expensive, active, brokerage-type accounts and into more low-cost index investing. It seems like the public has kind of started to, at least, wake up to the fact that fiduciaries are better for them; costs matter; there are better options out there.

Tom Mullooly: If you want to have someone oversee your investments, you should be working with an advisor. Now we're going to also have a distinction because brokers ... Part of this, one thing that did come out of this that it really is very good is that brokers can't use the term Advisor anymore. We'll finally get a little bit of clarity on this.

Tim Mullooly: Yeah.

Tom Mullooly: I'm an employee of blank brokerage firm.

Tim Mullooly: Yeah. It's good because there are so many different titles out there, that it kind of, in that sense, clears things up a little bit for them. One of the-

Tom Mullooly: That's done intentionally.

Tim Mullooly: Right, yeah.

Tom Mullooly: You know?

Tim Mullooly: There's a lot of intentional deception that has been happening. Things get cleared up.

Tom Mullooly: One of the things that came out of this Reg BI was that firms must have written policies in place to eliminate some sales contests. Not all sales contests. No. Such as those that promote particular securities, but they can provide financial incentives for things like total product sold, or the sale of proprietary products. What the hell? Are you kidding?

Tim Mullooly: How is that okay?

Tom Mullooly: Yeah, that's okay! Now it's going to be land grab. "Hey Mr. Jones, I know that we have your IRAs, but we want you to move your investment account, your checking account, your 529s, your Roths, your custodial accounts for your kids, and we want your whole family to move everything over. Why? Because I'm now going to get paid on the assets that I bring into whatever brokerage firm."

Tim Mullooly: Right, the assets, not necessarily the products that I put you in.

Tom Mullooly: Right.

Tim Mullooly: Is that better?

Tom Mullooly: They also created this form called a Form CRS, which stands for Client Relationship Summary. It kind of sounds like what we give our clients when we get started with them anyway. It has to be given by both brokers and advisors at the start of a client relationship that explains the services they offer, the fees that they're going to pay, and conflicts, among other things. We do all of that. We give them a Form ADV. It's got our fee schedule in it. For crying out loud, our fee schedule's on our website!

Tim Mullooly: Right. Yeah, brokers are now required to disclose more information to their clients, which ultimately sounds like a good thing, but it kind of, in a sense, covers them because now, the clients can't come back to them and say, "Well, you never disclosed this." It's like, "Well, yes I did. It was on page 473 of your 500-page client agreement."

I talked with Dina Isola from Ritholtz Wealth Management about this on a Living With Money episode. The fact that they're required to disclose it is great, but it's not going to really help anybody because no one reads any of those things.

Tom Mullooly: No one reads this.

Tim Mullooly: And even if you do read it, it's so packed with legal and financial jargon, mumbo jumbo, we barely understand what's in there, let alone the individual. It's written by financial lawyers.

Tom Mullooly: I always ask people, when you update your computer, the computer's rebooting, and you get this page with little teeny tiny print that scrolls on for a mile and a half, and most people just go right to the button that says, "I agree."

Tim Mullooly: I accept. Next.

Tom Mullooly: Yeah.

Tim Mullooly: Right.

Tom Mullooly: You don't even read it! You don't even know what's going on. It's funny. The language in the final rule that the SEC passed said that, "Firms are not expected to disclose every material conflict of interest, and should instead consider what would be most relevant for retail investors."

Tim Mullooly: So now they get to pick what's most relevant for the-

Tom Mullooly: Yeah. "Oh, that's not relevant."

Tim Mullooly: "Oh, I just didn't think that was relevant." Dina was also talking about how, when she testified in front of the US House of-

Tom Mullooly: It was in front of the House, right?

Tim Mullooly: Yeah, yep. Their Financial Committee. One of the congressmen kept talking about how giving more choices and more options to the investors is a good thing. On the surface, you hear that, and you're like, "Yeah, I want options." You know?

Tom Mullooly: This is America!

Tim Mullooly: Right, exactly. Dina was saying that's almost the opposite of what you want to do. You want to give people fewer options, but better options. Just giving them more options but more crappy options makes it more difficult to pick the right one. If it's a blurry difference now, they're making it more difficult to determine who's a fiduciary, who isn't a fiduciary, who's working in my best interest? Well, technically, everyone now is working in your best interest, so you need to ask even more questions on top of that.

"They're leveling the playing field." No, they're not. You just have to ask more questions now, and how are people going to know to ask these questions? More choices doesn't equal better choices. It equals more confusion.

Tom Mullooly: More confusion.

Tim Mullooly: And more potential for the wrong choice.

Tom Mullooly: It's a real problem. The SEC had a great opportunity here to make it the law of the land that anyone in the investment business should exercise fiduciary care.

It's hilarious. There was an article that I found – we'll link to it in the show notes – that one of the SEC commissioners, who voted for this, her name is Hester Pierce, basically talked about how applying this Reg BI might actually make more brokers leave. I just kind of scratched my head.

Tim Mullooly: What?

Tom Mullooly: Yeah. How they said that. She said, "You know what? Broker dealers look over the fence to the advisor world," where we sit, "with its principles-based fiduciary standard, less frequent exams, predictable revenue streams. Having engaged in this comparative exercise, many firms and individual financial professionals will just say, 'Forget about FINRA. I'm going on the fiduciary bandwagon and I'm not looking back,' and Reg BI could exacerbate this."

Tim Mullooly: After reading the headline, I'm like, "What is she talking about?" But I guess I agree, and I hope that that's the case: more people will just willingly say, "You know what? The fiduciary way is better." But if you're making it easier for them not to do that, then couldn't you also argue that more people would want to stay on that side? It's like, "They're making my job easier!"

Tom Mullooly: Hey, correct me if I'm wrong, okay, on this, but I think part of this whole Reg BI package that was passed by the SEC included the ability to add annuities to 401(k)s.

Tim Mullooly: Right.

Tom Mullooly: This was in the same package.

Tim Mullooly: Yep. Barry wrapped up his article by saying that, "It's less about investor protection than it is about protecting the industry's profits." I have to agree with that. I don't think there's a good argument saying that this is in the "best interests" of the investors.

Tom Mullooly: I'm going to sound like a six-year-old kid when I use the word wish, but I wish, before clients said yes to investing in crappy, crappy products like annuities or some of these structured note products, that they ask a couple of questions like, "What's the annual cost of this investment?" I think that's a good question to ask because you can't predict what an investment's going to return, so asking, "What's my return going to be," that's-

Tim Mullooly: Let me get my crystal ball out, you know?

Tom Mullooly: Yeah, there's no way of knowing that. But asking, "How much is this going to cost per year?" I think is a very good question for individuals to ask before you go into something.

Tim Mullooly: Yeah.

Tom Mullooly: The other question, which I have believed since the '80s, it's the old roach motel idea: how do we get out of this? We get into this investment, how do we get out? Don't die with an annuity on your hands. It's one of the worst things that could ever happen. How do we get out of a structured note? How do we get out of some of these products?

I think it's kind of fruitless to ask how much a broker's getting paid; he's getting paid. He's getting paid.

Tim Mullooly: Yeah. We're recording this on June 25th. This morning, there was an article that came out. Maxine Waters from California has, essentially, blocked Regulation BI for the time being. She submitted an amendment that went through that says, the language wasn't specific, but that SEC can't use its funds to enforce Reg BI.

Tom Mullooly: Right.

Tim Mullooly: So now, the whole regulation has to go back to the House for a new vote, which the article said, could be as early as Tuesday. It could be a very quick delay. For now, it seems like it's been blocked. She's been very vocal, kind of echoing the points that we've talked about, and what Barry had said in his article, highlighting all of the negatives about this regulation.

The one thing that crossed my mind, and this might not be the right line of thinking, but if for some reason, they go back and vote on this in the House, and then it passes, then we would have Regulation BI, Best Interest, and the SEC would have no money to enforce it. How is that a good thing?

Tom Mullooly: That means that, at some future Congress, the next wave after the election, we have a new Congress comes in, they decide, "We're going to fund this thing," and then it's on.

Tim Mullooly: Right. So up until that point, brokers and advisors wouldn't have to operate under Regulation BI?

Tom Mullooly: That's a good question. I mean, they should do it anyway.

Tim Mullooly: Right because it seems like a win, I think, in my mind for the brokers, so they can start operating and saying, "I'm working in your best interests under Regulation BI," and whether they're doing that or not, the SEC can't enforce it.

Tom Mullooly: Yeah.

Tim Mullooly: Yeah. I understand where the amendment is coming from. I hope that it's just to put up a roadblock for the time being and give people more time to think, "Hey, this probably isn't a good idea." Hopefully there are more changes along the way, but it seems like it'll probably end up passing again anyway.

Tom Mullooly: It's very confusing. That's a sad commentary because the Department of Labor came out with their set of regulations, and when they started getting into the nitty-gritty, the details, people got lost in the weeds. "Well, if we can do this, why can't we do that?" That got shot down, then the SEC cooked up their own version of it, which we disagree with, some people agree with. The states are now coming up with their own issue of this. I heard the Department of Labor is now talking about resurrecting this thing.

For God's sake people, there are people out there who want to take advantage of investors who don't know any better. Ask questions. It's okay to say, "Let me get back to you," and call someone, and find out before you buy something or before you sign on the dotted line. Just be careful about this because not everybody has your best interests in mind.

Tim Mullooly: Right. The most telling thing for me is the question, why is it so difficult to get a law or a bill passed to work in people's best interests, to put client's best interests ahead of their own? Why is that so hard? Think about the answer to that question.

Tom Mullooly: Yeah, maybe it's-

Tim Mullooly: Who's fighting this and why?

Tom Mullooly: Right.

Tim Mullooly: To me, I think the one question, if you're interviewing a new investment professional, is "Are you a fiduciary?" We talked about this. I talked about this, again, with Dina. She said, "It's a yes or no question."

Tom Mullooly: It is.

Tim Mullooly: She said one client came back and said, "I asked my current advisor if they were a fiduciary. They sent me this three-page response." And she was like, "That's a no." Because if they are a fiduciary, they're going to want to scream it at you from the rooftops.

Tom Mullooly: Yeah. No, it's not, "Yes, I'm a fiduciary." Hell yes. It's, "Hell yes, of course I am."

Tim Mullooly: If you ask them one question, that's the question I would ask.

Tom Mullooly: That is the question, yeah.

Tim Mullooly: Yep.

Tom Mullooly: Way to wrap up Episode 263. Tim, thanks for chiming in with your comments on this. Very important and confusing bit of news.

Tim Mullooly: Yeah, of course.

Tom Mullooly: Thanks for listening and we will catch up with you on the next episode.