ISTONISH

From Disclosure to Comprehension: Mitigating Risk in a Fiduciary World

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Introduction

Ever since the enactment of the Investment Company Act and Investment Advisers Act, the U.S. Securities and Exchange Commission has required organizations engaged primarily in investing and trading stocks to provide full disclosure about their investment objectives, while minimizing conflicts of interest. Since then, disclosure has been a prominent tool in the investor-protection arsenal of regulators around the world.

Unfortunately, as many regulators have found, clear and proper disclosure doesn't always produce the desired result of protecting retail investors as they navigate a world of increasingly complex financial products. Other factors, such as suitability of the investment, adviser compensation, firm culture, and incentives can also contribute to mis-selling. Further, an imbalance of knowledge, in which investors possess less material knowledge than their advisers or product sellers, places investors at risk for making decisions that may not be in their best interests. Increasingly, regulators are considering a fiduciary standard, along with strict requirements for transparency and disclosure, to improve the quality of advice to consumers.

In this paper, we discuss proposed new disclosure requirements under the U.S. Department of Labor's (DOL) Fiduciary Rule, and then address the concept of disclosure itself. Finally, we introduce a way to document evidence of comprehension by investors that could reduce the risk of litigation for financial services firms while helping them identify training gaps that could expose them to additional risk. The method has been used successfully by the telecommunications and mortgage-lending industries to satisfy regulatory requirements, and could also be used as education tool to increase financial literacy among investors.

The DOL Fiduciary Rule

The U.S. Department of Labor, which regulates the quality of financial advice related to retirement under the Employee Retirement Income Security Act of 1974, or ERISA, focused on aligning the interests of retirement plan advisers with those of their clients when it introduced its Fiduciary Rule in 2016. The reform came after four decades in which retirement products shifted from traditional, employer-funded pensions to employee-funded individual account plans, such as 401(k), 457, and 403(b) plans, and self-directed or broker-managed individual retirement arrangements (IRAs). Both participants and the employer-sponsors of plans bore responsibility for understanding the fine-print complications, risks, and trade-offs of many retirement investments, including investment expenses, fees, commissions and restrictions and limitations. Financial professionals, working for individual retirement investors, have added value through their expertise by helping identify investors' propensity for risk when selecting investments, allocating assets, contributing to retirement plans, and developing income solutions.

Under the Fiduciary Rule, the DOL defines who is a fiduciary of an employee benefit plan under ERISA as a result of giving investment advice to a plan or its participants and beneficiaries. As part of the rule, the DOL grants a new prohibited transaction class exemption called the Best Interest Contract Exception (BICE). The rule affects virtually all broker-dealer firms and their registered representatives, registered investment advisers and their individual adviser representatives, as well as insurance companies and their agents. The Fiduciary Rule and BICE:

1. Broaden the scope of retirement advisers who are deemed to be fiduciaries under ERISA and the Internal Revenue Code.
2. Establish a standard of conduct by which fiduciary investment advice providers must provide such advice in the "best interests" of the client in an unconflicted manner and without regard to the interests of the firm or the representative.
3. Require that prior to, or commensurate with, the execution of the recommended transaction, voluminous disclosures, including web-based disclosures, must be provided to the investor client about the fiduciary status of the firm and its representative, its standard of conduct (one element of which is that compensation for the service provided will be reasonable), material conflicts of interest, and its anti-conflict policies and procedures. For investor clients that are non-ERISA plans, such as Keogh plans, solo 401(k) plans, IRAs and arrangements such as health savings accounts, delivery of fiduciary investment advice must be made according to a written contract. The reasons for recommending a rollover must be internally documented to provide evidence of compliance with the "best interest" standard of care.

The BICE increases the litigation risk for financial services firms and their advisers and insurance brokers.

While the Fiduciary Rule was slated to take effect April 10, 2017, and many financial services firms had begun plans to comply with the rule, President Trump issued a memorandum in February asking the DOL to examine whether the rule could adversely affect Americans' ability to gain access to retirement information and financial advice. The DOL delayed implementation of the rule until June, when it expected to complete its review and determine if a revision or repeal is necessary.

Even if Fiduciary Rule were rescinded, however, the controversy surrounding it has enlightened some consumers who were previously unaware that not all financial advisers place their interests first. In fact, Vanguard founder John Bogle, in an opinion piece for the *New York Times*, predicts "the principle of 'clients first' is here to stay." If market demand for a fiduciary standard of care does increase, it's possible that more broker-dealers and insurance providers could embrace a fiduciary approach on their own to differentiate themselves from their competition, increasing their need to demonstrate that they have disclosed potential conflicts, compensation models, and the like.

We should note that Registered Investment Advisers must already act as fiduciaries, and provide a written disclosure statement to prospective and current clients as required by the Investment Advisers Act of 1940, as well as provide full and fair disclosure of material facts and conflicts of interest that cannot be avoided. But how does disclosure impact the decision-making process of consumers, and how could it be improved?

Blah, Blah, Blah: Why Disclosure Protects No One

In a March 10, 2017 article in the *Wall Street Journal*, columnist Jason Zweig made the case for a revolution in investor disclosure, and highlighted a new initiative by the U.S. Securities and Exchange Commission (SEC) to discuss strategies for helping retail investors better understand key investment concepts, such as risk, return, fees and conflicts of interest. Zweig quoted the SEC's investor advocate, Rick Fleming, as saying, "The SEC does a good job of providing disclosure of all information that the most sophisticated investors would find useful, but with this new program we're looking to do a better job of making disclosure more useful to the average person."

Fleming's point is a good one, assuming people regularly read disclosures. But research finds that most people don't read the fine print. A study by NYU law professor Florencia Marotta-Wurgler, who examined software licensing agreements, found that only one or two in 1,000 consumers read the agreement for the product they were purchasing, and of those who did review the agreement, most only read a small portion. Further research has shown that consumers are limited on the amount of information that they can pay attention to at any point in time. Now imagine the likelihood of retail investors reading a prospectus or periodic financial reports for every investment they own!

Disclosure as a Cure-All

As Loewenstein, Sunstein and Golman point out in their paper, "Disclosure: Psychology Changes Everything," disclosure has long been advocated as a proper response to many different social and economic problems. On the positive side, they write that an important advantage of disclosure requirements is their flexibility and respect for the operation of free markets. However, the authors point out, mandatory disclosures may have unintended adverse effects, such as consumers overreacting to the disclosure, which could prevent them from receiving good advice. Others may be even more trusting of the advice they receive, just because the disclosure is there.

Regulators have traditionally turned to disclosure as a low-cost tool to protect consumers. But at the same time, many have advocated for, or in some ways mandated a culture change at financial services firms to incentivize fiduciary behavior. In Europe, for example, the original Markets in Financial Instruments Directive (MiFID) already required investment firms to consider and manage potential conflicts by creating a detailed policy and disclosing it to clients. MiFID II, however, recognizes that firms are relying too heavily on disclosure, instead of focusing on mitigating or eliminating potential conflicts. It includes even more detail and direction to push firms toward a client-centric culture.

In the U.S., former SEC Chairman Christopher Cox acknowledged the role that corporate culture plays in protecting consumers. "[T]he tone at the top is a major factor in determining the effectiveness of internal controls to prevent fraud, in treating customers, employees, investors and other stakeholders fairly, and in contributing to the long-term success of the organization," he said.

What does treating customers fairly look like to advisers? In their book, "Conceptions of Professionalism: Meaningful Standards in Financial Planning," authors Ken Bruce and Abdullahi D. Ahmed interviewed a group of U.S. CERTIFIED FINANCIAL PLANNER™ professionals about what it means to serve the client. Their answers included the following:

- "…professionalism is a **basic respect** for other people."
- "Treat people with respect and make sure that you are **not tainted by any kind of conflict** of interest or anything like that."
- "I have a **moral obligation** to do what's right for my clients at all times."
- "To do the right thing by the client. To **make a difference in their lives professionally and personally**."
- "It means I work for the clients. It's not choosing financial products and making investment decisions, insurance decision – it's not a game. It's not a numbers game. It's about service – providing a service and the service is **helping people make good financial decisions** for their families."
- "What it means to me is that I need to take a look at my clients and **put their interests first**."
- "I just try and **put myself in their shoes**. If it was me I would want everything to be fair and people that were assisting me to be not on either side but to be fair as well."

While placing a client's interests first may involve "helping people make good financial decisions" and "doing the right thing," the education provided by many advisers does not necessarily contemplate ensuring that clients understand the advice or products involved in a specific transaction. Similarly, standards set by the International Organization for Standardization (ISO) or certifiers who use ISO's standards tend to focus on competence, consistency of processes, and impartiality by the adviser or firm, not whether a client actually understands or comprehends the advice provided or the products sold.

ERISA addresses the core duties of a fiduciary – loyalty, prudence, the duty to diversify plan assets, and the duty to administer a plan in accordance with its terms. However, it does not discuss the fiduciary duties required under the common law of trusts, which have sometimes been imposed by the courts as part of the common law of ERISA. One of these duties involves the duty to disclose or inform. While several legal cases have addressed the need to provide complete and accurate information even in situations where the beneficiary did not inquire, generally, in the absence of any inquiry by a plan participant, a fiduciary has no duty to disclose except when the fiduciary knows that silence may be harmful.

Shifting Paradigms to Reduce Risk

If plan fiduciaries have a legal obligation to disclose or inform beneficiaries about a plan and its related documents – particularly in situations where failure to explain could be detrimental to plan participants – why not mitigate risk by taking one extra step: ensuring or confirming that the beneficiary comprehends the information being provided?

While evidence of comprehension is not an ERISA requirement, DOL regulations do state that summary plan descriptions should be "written in a manner calculated to be understood by the average plan participant." That particular phrase, or a variant, also appears in the Internal Revenue Code section 432, and in Department of Treasury regulation. It's then reasonable to consider that the issue of "understandability" could surface if a DOL auditor finds a summary plan description to be too complex, or too sophisticated to be understood by the average plan participant.

In other industries, regulators have, for years, sought to confirm that consumers understood and approved the services for which they were paying. For example, in 1996, the Federal Trade Commission (FTC) and the Federal Communications Commission (FCC) enacted rules (see Section 258 of the Telecommunications Act of 1996) requiring all providers of wired voice communications lines to obtain reliable proof that a consumer requested a change of service or ordered new service. This was in response to a practice called "slamming and cramming," whereby operators could illegally switch a consumer's phone service or add charges for services without a consumer's permission.

Acquiring this proof proved quite difficult, given that most change-of-service requests occurred (and continue to occur) via phone. As a result, the FTC and FCC allowed phone verifications to be legally binding provided that recordings are: captured by a third party who does not have interest in the transaction, are available for audit for a minimum of 24 months, and that the identity of the authorizing person must be verifiable (i.e., by Social Security number, driver's license number, date of birth, or other means).

Third-party verification (TPV) is now a standard in the telecom industry. Service providers using TPV are able to confirm and track whether a customer understands or has approved charges for a new service. Could the same compliance solution prove transferable to the financial services industry as it faces the possibility of increased litigation under the DOL Fiduciary Rule? We believe so.

Introducing Aprisi Assure™

For more than 15 years, Istonish has worked as a third-party verification provider to the telecom industry. Our new compliance solution for the financial services industry, Aprisi Assure™, is designed to help fiduciary advisers:

- Secure legally admissible proof of compliance – or what we call “evidence of Fiduciary Rule comprehension” – from retail consumers;
- Store evidentiary records for easy, on-demand retrieval;
- Improve sales confidence and operational efficiency;
- Ensure compliance throughout client companies; and
- Build trust with retail customers.

Aprisi Assure helps protect advisory firms and robo-advice platforms by eliciting a clear response from clients to a series of questions that can be customized by company, service and/or product. For convenience, companies can choose multiple communication channels for verification – including a live agent, interactive voice response, email or text. The client’s answers produce an “artifact” that can be archived in a secure, cloud-based storage system for 10 years by Istonish, and retrieved immediately in the event of litigation.

Aprisi Assure complements, but does not replace, disclosure documents required for compliance under the DOL Fiduciary Rule; however, it provides an additional confirmation of contractual representations and disclosures using an independent third party, offering another layer of legal protection.

An added benefit of Aprisi Assure is its ability to identify gaps in comprehension, or misunderstanding by clients, requiring that the financial adviser reconfirm the terms conditions and disclosures with the client under the DOL’s best-interest contract provisions. Feedback from Aprisi Assure includes statistics that can provide compliance departments, sales supervisors or advisers with information to improve training.

Finally, Aprisi Assure enables firms to administer compliance rules consistently across the enterprise. The third-party reporting helps compliance officers monitor client feedback and solve problems before they get to the litigation stage.

Evidence of Comprehension: The Next Step in Fiduciary Care

A 2016 article in Bloomberg highlights what some have long known in the financial services arena: that information asymmetry – in which the adviser or seller knows more than the client – plays a major role in how financial services firms make money, and how well markets operate (or don't). Growing complexity of financial products can add further to the perception of market opacity by consumers.

Publicity surrounding the DOL's Fiduciary Rule – including an entire television broadcast devoted to the topic by comedian John Oliver – has helped propel the idea of fiduciary care to the forefront. Experts predict consumer demand for fiduciary care will increase regardless of regulation, and some firms have begun to embrace the concept ahead of the Fiduciary Rule's implementation to help differentiate their services.

For more information on Aprisi Assure, or to request a demonstration, visit www.istonish.com/home/industries/financial-services, or call us at 800-728-6821.