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5 Big Regulatory Changes Coming in 2014.

Want to prepare your practice for potential changes in the year ahead? Keep your eye on these five areas

As I attempt to look at what's on the 2014 horizon in terms of regulation, compliance and other best practices, I can't overcome the feeling of déjà vu. Or perhaps I am just repeating myself.

Many of the topics here — a fiduciary standard, industry reorganization, arbitration methods — are not new. Yet, after years of effort, the months ahead might finally lead to changes in these hotly debated areas. Or not. Here are my predictions:

1. FIDUCIARY STANDARD

Sticks and stones may break my bones, but a fiduciary will never hurt me.

Acting in the best interest of the client does not have to be to the detriment of the financial advisor. A commission-based product may be in the best interest of the investor. A fee-based product may be in the best interest of the investor. Whether a financial advisor makes a fee or a commission, the financial professional is being compensated for services.

Fiduciaries can break laws and steal client money. Commissioned reps can have the highest of ethics. (And vice versa.) So it is not the label or the law that makes one honest; it is if one is actually honest that counts.

Let's get beyond the in-fighting. The SEC should adopt a fiduciary standard for all financial services professionals, albeit with allowances for differences between investment advisor representatives and broker/dealer representatives. All financial advisors should have full disclosure of services, fees, conflicts of interest, and act in the best interest of the client. Send the lawbreakers to jail.

2. HARMONIZATION

Brokerage and advisory services are indistinguishable to investors.

Here is my ideal futuristic shape of the industry: We will be under one regulatory regime. No longer will we have the broker/dealer and registered investment advisor industries. There will be one registration for the company, one fee, one filing. One registration for reps, one fee, one grand-slam exam. One full-disclosure document used by all to replace the Form ADV.

Wealth management, life planning, financial planning, asset management, or simple buy-and-sell securities recommendations will be done under one roof. There will be a choice of fee structures, based on client suitability. Some specialist firms will continue to exist — with wealth management on one side of the spectrum and traditional brokerages on the other — but they will all fall under one regulatory scheme. The Financial Advisory and Investment Transaction Services Act of 2023 (FAITS Act) and its rules and regulations will be streamlined. Under this imaginary FAITS Act, some rules will apply for transactional trades, and other rules will apply for services that are advisory in nature

— but all under one coordinated act.

Hmmm … I actually made this prediction 10 years ago. So I am adding on another 10 years to my dream regime.

3. ARBITRATION CLAUSES

You may believe arbitration is the civil way to resolve a dispute, but it could bring on the wrath of the state regulators.

When your client wants to pick a fight with you, would you rather get your day in court in front of a jury, or face a panel of arbitrators? It is not uncommon to see mandatory pre-dispute arbitration agreements in broker/dealer and investment advisor contracts.

It is not my job, in the space of this article, to counsel you on your choice of forum. Broker/dealers utilize arbitration clauses under the good graces of FINRA. Federally covered registered investment advisors will find the SEC sitting on the fence on this matter. State registered investment advisors may find that these clauses are (or soon will be) prohibited in some states.

The North American Securities Administrators Association (NASAA) announced its strong support for the Investor Choice Act of 2013 (H.R. 2998), which would (if passed) prohibit the use of mandatory pre-dispute agreements by broker/dealers and registered investment advisors.

The Investor Choice Act would not in any way prevent investors from voluntarily electing to resolve a dispute through arbitration or mediation after the facts and circumstances of the dispute have been discovered. The Investor Choice Act may die in committee.

The SEC has authority, under the Dodd-Frank Act, to either ban arbitration clauses in advisory contracts or, at a minimum, commence a study of the use of pre-dispute arbitration. The SEC has not acted in the three years since the Dodd-Frank Act was passed, much to the dismay of NASAA.

4. BUSINESS CONTINUITY PLANS

How will you get back up and running if your office becomes uninhabitable? Your files disappear? Your staff can’t get to work? Your phone lines go down?

It has been approximately 10 years since both the SEC and FINRA adopted rules for investment advisors and broker/dealers to implement a business continuity plan (BCP). The BCP addresses events that could cause a significant business disruption and how the business will regain functionality within the shortest possible time span.

Yet, year after year, disaster after disaster (think Katrina and Sandy), financial advisors are still getting caught off guard without a viable BCP in place. The SEC, CFTC and FINRA recently issued a joint advisory to suggest effective practices. The SEC Office of Compliance Inspections and Examinations issued a separate risk alert for investment advisors.

5. IDENTITY THEFT

Can you spot the red flags for identity theft and prevent losses from your client accounts?

The Federal Trade Commission’s (FTC) Red Flags Rule implemented obligations imposed by the Fair and Accurate Credit Transactions Act of 2003 (FACT Act). Many firms are already in compliance based on this original FTC rule; others firms hesitated to adopt policies, believing the FTC rule did not apply to them.

SEC Regulation S-ID recently implemented provisions in the Dodd-Frank Act, which amended the FACT Act and directed the SEC (and the CFTC) to adopt rules for identity theft red flags. For those firms that now need to come into compliance with the SEC rule, it was effective May 20, 2013, with a final compliance date of Nov. 20, 2013.

The Red Flags Rule requires specified firms to create a written identity theft prevention program (ITPP) that is designed to identify, detect and respond to red flags — patterns, practices or specific activities — that could indicate identity theft.

The Red Flags Rule requires firms to prepare an ITPP if they are either a “financial institution” or a “creditor” and offer “covered accounts.” It’s important to look closely at how the rule defines “financial institution” and “creditor” because the terms apply to groups that might not typically use those words to describe themselves.

An investment advisor who directly or indirectly holds transaction accounts and is permitted to direct payments or transfers out of those accounts to third parties is an example of an SEC-regulated entity that could fall within the meaning of the term “financial institution.”

Investment advisors who have the ability to direct transfers or payments from accounts belonging to individuals to third parties upon the individuals’ instructions — or who act as agents on behalf of the individuals — are susceptible to the same types of risks of fraud as other financial institutions. And individuals who hold transaction accounts with these investment advisors bear the same types of risks of identity theft and loss of assets as consumers holding accounts with other financial institutions. If such an advisor does not have a program in place to verify investors’ identities and detect identity theft red flags, another individual may deceive the advisor by posing as an investor.

By Nancy Lininger

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