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Beyond a Culture of Compliance: Securities Regulators Emphasize Disclosure

Recent statements by securities regulators emphasize that financial firms need to move beyond a "culture of compliance" to ensure that investors have a better understanding of risk and the investments they are purchasing. During his keynote address at FINRA's Annual Conference, held in Washington, D.C., May 20-22, FINRA Chairman and CEO Richard Ketchum recommended firms focus on the quality of the disclosures they provide to their customers.

Disclosure of Conflicts of Interest

Ketchum stated that FINRA is completing its review of industry practices regarding identification and disclosure of conflicts of interest and plans to issue a report that outlines some strong conflict management practices. The quality of disclosure provided to customers is likely to be a major focus of the report, which will be published this summer. "How do we change the dynamic so investors truly understand what they're buying and, likewise, that financial advisers understand what they are selling?" Ketchum asked. He stated firms must provide comprehensible, plain-English risk disclosure to customers and suggested that some of the compelling images that appear on the marketing pages of firm websites might be better employed on the legal and disclosure pages. Ketchum noted that FINRA is particularly focused on conflicts pertaining to (1) firms' controls around the sale of structured products both to their own private wealth divisions and to other firms; and (2) firms' controls around compensation, regarding their own efforts to design more product-agnostic commission grids and with respect to third-party incentives.

FINRA has already taken action to address compensation disclosure. In January, FINRA proposed a rule requiring disclosure of recruitment compensation packages. The rule would require a broker-dealer that recruits representatives using enhanced compensation (including signing bonuses, up-front or back-end bonuses, loans, accelerated payouts, transition assistance, and similar arrangements) to disclose such compensation to customers solicited to transfer with the representative. The comment period expired in March, and Ketchum announced the rule will be discussed at FINRA's July board meeting.

Disclosure of Risks of Complex Products

Ketchum voiced concern about the sale of complex and speculative products with low liquidity to unsuitable customers by financial advisers who often don't fully understand the risks of the products. He cited the fixed-income market as an example, noting that in this zero-yield environment, many investors are taking on more risk by moving to longer-duration or high-yield fixed income products. Ketchum urged firms to ensure that investors better understand the risks and possible negative scenarios of concentrated holdings in these types of securities. Firms that make illiquid investments available to retail customers would be well-advised to explain to clients the features of the product, how the product is expected to perform under different market conditions and the possible negative scenarios that can impact this investment. Ketchum noted, "It is a great time to remind clients that bond funds are not the same as directly owning fixed securities," and he suggested firms also provide better risk disclosures relating to investments in funds that invest in leveraged loans, private REITs, closed-end funds and private placements.

Ketchum's concerns about investor disclosure were echoed by SEC Commissioner Elisse Walter during a question-and-answer session at the FINRA Annual Conference, where she encouraged firms to educate bond investors about how rising interest rates would negatively impact their bond portfolios.

Disclosure and the Uniform Fiduciary Standard

During the question-and-answer session, Walter stated she would like the SEC to move forward with shaping a uniform fiduciary standard for broker-dealers and investment advisers, noting that she believes "the cost of brokers becoming fiduciaries is very low." Ketchum also called upon the SEC to finalize a uniform fiduciary standard. Enhanced disclosure obligations for broker-dealers are likely to be part of any rule making. The SEC staff study required by Section 913 of the Dodd-Frank Act recommended the SEC facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest. These disclosures could take the form of a general relationship guide similar to Form ADV Part 2A, and firms could provide more specific disclosures when they give their clients personalized relationship advice. Walter expressed hope that the comments submitted in response to the SEC's request for data and economic analysis on the costs and benefits of alternative approaches regarding the standards of conduct will assist the agency. The comment period ends on July 5.

Conclusion

Although the culture of compliance continues to be a buzzword in financial regulatory circles, it appears that disclosure?-- in plain English rather than legalese?-- is primed to be a new regulatory focus. To stay ahead of the curve, financial firms should take a close look at how they communicate with their investors and consider enhancing their disclosures to make them easier to understand.