

New fiduciary standard cultivates consumer confusion

What do a rutabaga and a turnip have in common with your investments? Quite a lot, as it turns out.

For the past hundred years or so, as agricultural science progressed and found new ways to grow food more efficiently via the use of chemicals, a small organic food movement has persisted. Proponents of the movement argued that chemically or genetically adulterated food was unhealthy and potentially dangerous.

Over time—and as more non-natural ingredients found their way into our food—the organic movement grew. What was once relegated to the confines of small, local farmers markets was now available in grocery stores. Interestingly, this occurred despite significantly higher prices for organic food.

Consumer demand for organic food grew so much that conventional farms and food producers took notice. Not only were they losing market share, but they also got excited about the much higher margins that could be achieved with organic food. As economic theory tells us, higher margins lead to more competitors. Many new players, including conventional food producers, jumped on the organic bandwagon.

Inevitably, some bad apples entered the organic space. Some producers continued to use conventional farming methods that relied on chemical pesticides and fertilizers but passed off their produce as organic in order to reap higher prices.

Ultimately, the government decided that it needed to get involved in order to regulate the use of the word “organic.” This was ostensibly done in order to protect true organic farmers as well as consumers. While that may sound like a good idea, there are often unintended consequences.

The larger players in the food industry lobbied to get the rules changed so that they could use the organic label without significantly changing their practices. It seems to have worked. While the USDA now defines organic food as that grown without synthetic pest controls for a minimum of three years, it allows some synthetic pesticides to be used by organic farmers. It even also allows a small amount of



ON INVESTING

Mark Armbruster

banned pesticides to be present in foods it deems to be organic.

The result is that there is now confusion within the organic food industry. In fact, in a study the USDA released in 2012, it found that over 40 percent of organic food it sampled tested positive for synthetic pesticides. So, quite a bit of what consumers pay higher prices for is not actually organic at all, if organic is defined as free of chemicals.

The government regulations ultimately watered down the definition of organic, helped the largest players in the industry, hurt small farmers and confused consumers.

The same thing seems to have occurred recently in the investment industry.

The Department of Labor last month enacted a new regulation that imposes a fiduciary duty on all advisers to retirement plans. That means that the adviser has to always act in the client’s best interest. While that may seem logical, it has not been the industry norm.

Registered investment advisers, or RIAs, have always been fiduciaries, but brokers and insurance reps have been held to a lesser standard known as suitability. As long as an investment was suitable, it was permitted for the broker to recommend it to a client. This was true even if it really wasn’t that great an investment, or incurred high costs that benefited the broker at the expense of the client.

This resulted in some practices that were less than altruistic. Bad apple brokers would charge commissions on transactions and then trade frequently; they would recommend high-commission products like non-traded REITs or variable annuities. They also would sell mutual funds

sponsored by their employers—so-called proprietary funds—because it would result in more revenue for their employer.

These aggressive tactics generally favored the broker, but disadvantaged the client. The White House estimates that these types of practices cost retirement investors \$17 billion annually in lost performance. I’m not sure I agree with that estimate, but it is clear that investors were being harmed in many cases.

With the new DOL standard, these practices will be a thing of the past, right? Not so much. It seems optics and nomenclature are more important to the regulators than effecting actual change. After industry lobbyists were done pressuring the regulators, the final DOL rule looked virtually nothing like the original proposal. In fact, as long as brokers sign a “best interest contract” assuring their clients that they will act in their best interests, they are allowed to use many of their previous tactics that many thought were unscrupulous.

For example, brokers may continue to charge commissions for trades, recommend high-commission products like non-traded REITs or variable annuities, and sell mutual funds sponsored by their employers. While it is hard to imagine whether these practices are truly in clients’ best interests, they are now legally allowed and with a “fiduciary” stamp of approval.

You may wonder if anything has actually changed. The new regulation will probably make it easier to prosecute brokers who are truly bad actors. Aside from that, I don’t see much difference between the new environment and the old. In fact, the real impact of the rule change may be additional confusion among consumers, just as in the organic food industry. Prior to the rule change, RIAs were clearly defined as fiduciaries, and brokers and insurance reps were not. For investors wanting advice from a true fiduciary, that service was fairly easy to find and define. Now, the waters will be muddied.

That is particularly true since brokers are only required to act in a fiduciary capacity for retirement accounts. For tradi-

tional brokerage accounts, the old suitability standard still applies. It is possible that clients who have both brokerage and retirement accounts will find that their brokers serve them in a split capacity, creating further confusion.

Investors are now saddled with an addi-

tional due diligence burden when selecting an investment adviser to ensure they are being represented in the capacity they desire. While traditional brokerage practices may have their place, clients who truly want their best interests served will probably still be better off with a traditional

registered investment adviser. However, comparing apples with apples just became more complicated.

Mark Armbruster is president of Armbruster Capital Management Inc. He can be reached at (585) 381-4180 or marmbruster@armbrustercapital.com.