PUTTING INVESTORS FIRST? EXAMINING THE SEC'S BEST INTEREST RULE

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS

OF THE

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PUTTING INVESTORS FIRST? EXAMINING THE SEC'S BEST INTEREST RULE

Thursday, March 14, 2019

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn B. Maloney [chairwoman of the subcommittee] presiding.

Members present: Representatives Maloney, Sherman, Himes, Foster, Vargas, Gottheimer, Porter, Casten, Ocasio-Cortez; Huizenga, Stivers, Wagner, Hill, Mooney, Davidson, and Hollingsworth.

Ex officio present: Representatives Waters and McHenry.

Also present: Representative Barr.

Chairwoman MALONEY. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Putting Investors First? Examining the SEC's Best Interest Rule."

I now recognize myself for 5 minutes to give an opening statement.

Today, we are examining the SEC's proposed Regulation Best Interest, known as Reg BI. This proposal addresses the legal standard that brokers should be subjected to when they provide retail investors with personalized investment advice.

This issue has roots going back decades. But for this rule, the story really starts in 2010 with the Dodd-Frank Act. When we were writing Dodd-Frank, there was a huge debate about whether brokers and investment advisers who provide advice to retail investors should be subject to a uniform fiduciary rule.

And in the House bill, we did subject brokers to the same exact fiduciary rule that investment advisers are already subject to. We said that the SEC shall write rules ensuring that brokers who advise retail investors are subject to the legal standard that "shall be the same as the standard of conduct applicable to an investment adviser."

But the Senate took a different approach. They said that the SEC should first conduct a comprehensive study of whether a uniform fiduciary rule is appropriate for brokers and advisers.

And then if the SEC's study found that a uniform fiduciary duty is appropriate, the SEC would be required to write a rule implementing the results of the study within 2 years. And in fact, the author of that Senate provision was Senator Crapo, who is now the Chair of the Senate Banking Committee.

The final version of Dodd-Frank required the SEC to conduct the study and then simply authorized the SEC to write a rule mandating a uniform fiduciary duty.

So the SEC staff dutifully conducted a comprehensive study. And in 2011, they submitted a 208-page report recommending very explicitly that the SEC adopt a rule subjecting brokers who provide investment advice to retail customers to the same fiduciary duty as investment advisers.

Unfortunately, despite the staff's recommendations, the SEC spent 7 years dragging its feet, refusing to even propose a uniform fiduciary duty rule. All the while, the harm to retail investors just kept mounting.

In 2015, a study from the White House Council of Economic Advisers found that investment advice tainted by conflicts of interest were costing retail investors roughly $17 billion every year.

So the Department of Labor, which has jurisdiction over retirement investing, stepped in and proposed its own fiduciary rule. The DOL rule would have subjected brokers and advisers to a very strong fiduciary duty and would have required them to eliminate harmful conflicts of interest.

But the industry filed numerous lawsuits challenging the DOL rule. And even though the rule was upheld in most courts, a single three-judge panel in the 5th Circuit in Texas struck the rule down nationwide. And the Trump Administration refused to appeal this court decision, purely out of political spite.

So after years of inaction, the SEC finally proposed its own rule in April of 2018, which is the rule we are discussing today. While the SEC's Reg BI may be an improvement on the status quo, it is still far too weak, and I still have several serious concerns with the rule.

First, despite the SEC staff's own recommendation to subject brokers and advisers to a uniform fiduciary duty, Reg BI does not subject brokers to a full fiduciary duty, like the DOL rule would have. Instead, the SEC's rule says that brokers who provide advice to retail customers have to act in the best interest of the customer, but refuses to define "best interest."

And instead of saying that brokers have to provide advice without regard to their own financial interest, which Dodd-Frank specifically required, the SEC's rule actually does allow brokers to take their own financial interests into account.

Finally, the rule relies far too much on disclosing conflicts of interest rather than simply eliminating conflicts.

Taken together, these shortcomings mean that the SEC's rule will still leave retail investors dangerously exposed to substantial losses caused by advice from hopelessly conflicted brokers. I strongly urge the SEC to strengthen its proposed rule so that retail investors get the protections they need and deserve.

We are also examining a legislative proposal from my colleague, Mr. Casten, which would simply require the SEC to conduct usability testing on their new disclosure forms before finalizing Reg BI, which I think is an excellent idea.

And I look forward to hearing from our distinguished panel of witnesses about this incredibly important topic.

And with that, I now recognize the ranking member of the subcommittee, Mr. Huizenga of Michigan, for 4 minutes for an opening statement,

Mr. HUIZENGA. I appreciate the Chair's indulgence on that. No matter what stage in life, whether it is me at 50, my kids in their early twenties, or I am looking at my adult parents, hundreds and thousands of people in west Michigan and, frankly, millions of Americans are all working to achieve financial independence and are looking to invest and save for the future.

Unfortunately, not enough of those kids, like my 20-year-olds, are doing that. That is another problem that we hope to explore at some other time. But saving for retirement takes careful financial planning and that is why hardworking taxpayers in west Michigan and all across the country are seeking out and using an investment adviser or a broker-dealer to help them plan and prepare for a prosperous future.

Now more than ever, sound financial advice has become absolutely critical, and it is Congress' job to ensure that all levels of investors have access to affordable and reliable financial advice.

In April of 2016, the Department of Labor finalized its overly complex fiduciary rule which not only denied American savers and small businesses access to investment advice and limited their choices in investment products, but also crippled them in added costs.

The courts agreed and the DOL fiduciary rule was vacated in March of 2018. It is clear that the SEC is the proper regulator to create and refine this rule. Filling that void left by the 5th Circuit's decision in April of 2018, the SEC proposed for public comment a significant rulemaking package, which included Regulation Best Interest or Reg BI.

This package is designed to better serve retail investors by improving the quality and transparency of the customer's relationship with investment advisors and broker-dealers while maintaining access and choices to the menu of different advice relationships and investment products that are out there.

At the Financial Services Committee hearing held on June 21, 2018, SEC Chairman Clayton noted that the rulemaking package from the SEC was designed to serve Main Street investors by: one, requiring broker-dealers to act in the best interest of their retail customers; two, reaffirming and in some cases clarifying the fiduciary duty owed by the investment advisers to their clients: and three, requiring both broker-dealers and investment advisors to state clearly key facts about their relationship, including their financial incentives.

By applying fiduciary principles across the spectrum of investor advice and aligning the legal requirements in mandated disclosures of financial professionals with investor expectations, the rulemaking package is intended to enhance investor protections.

So today's hearing asks the question, is the SEC's Reg BI, "putting investors first?" And the answer is a definite and resounding yes, with some refinement that needs to happen.

The proposed regulation significantly raises the standard of care by formally establishing the customer's best interest as the overarching standard of care. Consumers will be able to make more informed decisions about the types of financial professionals which will best meet their needs and allow investors greater choices and access to the products and services that they require.

Let me be clear. The proposed Reg BI is not perfect, but the SEC Chairman and the Commission are taking very meaningful steps to listen to everyone impacted by the rulemaking package.

The Commission has held seven roundtables across the country, utilized the Rand Corporation to perform investor testing of the proposed disclosure form, and are in the process of reviewing the more than 6,000 comments that were received as they work to develop the final rule recommendations.

Let us put the best interests of constituents and hardworking Americans first by letting the expert regulator, the SEC, do its job to provide all investors with the tools they need to achieve their retirement savings goals.

And with that, I yield back.

Chairwoman MALONEY. Thank you.

The ranking member of the Full Committee, the gentleman from North Carolina, Mr. McHenry, is recognized for 1 minute for an opening statement.

Mr. MCHENRY. Regulation Best Interest is a simple concept that addresses a very complex problem. Reg BI strikes a balance between investor protection and investor choice.

Forty-four percent of all U.S. households own at least one mutual fund or are in a financial product in the marketplace. And our capital markets continue to be the envy of the world, and that is a good thing.

In order for them to remain the envy of the world, though, we must ensure that we are protecting investors and giving them the tools and information they need to make informed decisions while preserving access and choice in a retail investor market.

By setting the investors' best interest as the overarching standard of conduct, Reg BI ensures that customers will not only have unfettered access and choices, but they will be protected by a significantly heightened standard of care.

Reg BI provides transparency to ensure that investors understand the nature of their relationship with investment professionals and the services that they get and provide and understand the nature of those thing. These are the simple but extremely effective tools of Reg BI, which guarantee that the best interests of Main Street investors are put first.

Thank you for holding this hearing, and I yield back.

Chairwoman MALONEY. Thank you.

Today, we welcome the testimony of our five witnesses. And in the interest of time, I am going to keep these introductions brief.

First, we have Dina Isola, an investment advisor representative at Ritholtz Wealth Management, a registered investment advisory firm located in the district I am proud to represent in Manhattan. Ms. Isola holds a Series 65 license, and prior to joining her current firm in 2016, she worked at ATI Investment Consulting for nearly 10 years.

Second, we have Susan MacMichael John, the founder and president of Financial Focus, which is a fee-only financial planning firm that provides comprehensive planning services to a wide range of professionals, retirees, and families in the New England area.

She is also the Chair of the Certified Financial Planners Board and is a member of the National Association of Personal Financial Advisors, as well as the Financial Planning Association. Welcome, Ms. John.

Third, we have Barbara Roper, the director of investor protection for the Consumer Federation of America, where she has been employed since 1986.

Ms. Roper is a member of the SEC's Investor Advisory Committee, FINRA's Investor Issues Group, and the CFP Board's Public Policy Council. Ms. Roper is a leading advocate on consumer and investor protection issues and has been the leading advocate on fiduciary duty issues for many years, so we are honored to have here today.

Next, we have Lee Baker, the owner and president of Apex Financial Services in Atlanta, Georgia, and the president of the AARP of Georgia State. Mr. Baker is a certified financial planner and is the past president of the Georgia Chapter of the Financial Planning Association. Welcome.

And last but not least, we have Harvey Pitt, the founder and CEO of Kalorama Partners right here in Washington, D.C. Prior to founding Kalorama Partners, Mr. Pitt was the 26th Chairman of the U.S. Securities and Exchange Commission, serving from 2001 to 2003, which means that this is not his first time testifying in front of this committee. So we welcome you back, Mr. Pitt.

Witnesses are reminded that your oral testimony will be limited to 5 minutes. And without objection, your written statements will be made a part of the record. And Ms. Isola, you are now recognized for 5 minutes for your testimony. Thank you.

STATEMENT OF DINA ISOLA, INVESTMENT ADVISOR REPRESENTATIVE, RITHOLTZ WEALTH MANAGEMENT

Ms. ISOLA. Thank you. Chairwoman Maloney, Ranking Member Huizenga, and other members of the subcommittee, I appreciate the opportunity to shed some light on how the lack of a strong fiduciary standard for investment advice harms retail investors.

Early in my career, some 30 years ago, I came to realize that brokers' recommendations are directly tied to compensation and incentives. At a brokerage firm I worked at, it was customary for brokers to scramble to transact business at month-end that would count toward that month's production. For some, it could mean the difference between being employed or being let go.

Top-selling brokers and managers were rewarded with gifts and trips to exotic locations like Monte Carlo, and sales quotas were often hung over broker's heads. Product-specific pushes were also a routine occurrence, with mutual fund companies paying to be included at the firm's recommended list.

The firm expected 75 percent of sales to come from its in-house funds, which increased the firm's revenues. Branch managers pressured brokers to comply, regardless of the fact that many of the firm's products were inferior to available alternatives which would have been better for investors.

With these perverse incentives, brokers routinely would make sales recommendations in order to win contests and trips, hit quotas and get to the next rung on the payout grid, regardless of whether their recommendations were in investors' best interests.

Since I have left the brokerage industry nothing has changed in this respect. The brokerage business model, with all these and other perverse incentives, is set up to pit broker against client. These incentives reward bad advice that harms investors.

What is truly shocking is that brokers are allowed to engage in harmful conflicts of interest all while leading investors and policymakers to believe they are trusted financial advisors who will do what is best for investors.

The non-ERISA 403(b) market is a living, breathing case study as to why a lack of a strong fiduciary standard for investment advice results in harm to investors.

These teachers are trying to do the right thing by saving for their retirement. They want, need, and expect that they are getting advice that puts their interests first, not sales recommendations that will enrich the financial professional at their expense.

Instead, they are typically sold high-cost, low-quality investments that tie up their money for years. In fact, 76 percent of assets in non-ERISA 403(b)s are in annuities.

This despite the fact that both the SEC and FINRA have warned investors that these products can be extremely complex, have high costs, and may not provide meaningful value to them. What they do provide are huge commissions to the financial professional firm selling them. I often get asked, "How is this legal?" And I have no answer. I can feel investors' embarrassment at having been too trusting. They behave like abuse victims who then blame themselves for the abuse.

When reality sinks in, they get angry and want to take action, but what can they do? It is perfectly legal to give conflicted advice. Investors' intentions to be responsible and save for their retirement with the guidance of a professional has left them feeling double-crossed, duped, and set up to fail.

And countless investors have no idea they are being harmed by their trusted advisor and they would be so much better off if they had received advice not tainted by conflicts of interest.

No one asks for complicated, expensive products that will drain their hard-earned savings and investments. No one asks to be shackled to an investment for years before surrender fees disappear. No reasonable person would consent to being given bad advice.

Why are these products sold to them? It is not because financial professionals are bad people. It is because they are caught up in a web of toxic incentives. There has never been greater access to low-cost, high-quality investment opportunities, yet the lack of fiduciary protections leaves many investors paying excessive fees and suffering poor outcomes.

Professionals who are referring to themselves as trusted advisors or providing what anyone would reasonably believe is investment advice, must be willing to deliver on that implied promise and put investors' needs first; otherwise, they should clearly be identified as salespeople. And if that title seems too distasteful, perhaps they should reevaluate their business model.

Supporting a warmed-over suitability standard by pretending sales tactics is sound advice is damaging to the investor and puts them at risk for needing government assistance in retirement when they have tried to be self-sufficient. It also casts doubt on those who are in a position to change the situation but choose not to do so.

In this case, not being part of the solution is being a large part of the problem. I truly hope you have the courage to act genuinely to protect investors' best interests. Thank you.

[The prepared statement of Ms. Isola can be found on page 49 of the appendix]

Chairwoman MALONEY. Ms. John, you are now recognized for 5 minutes to give your oral presentation.

STATEMENT OF SUSAN MACMICHAEL JOHN, FOUNDER AND PRESIDENT, FINANCIAL FOCUS

Ms. JOHN. Good morning. Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee, thank you for the invitation to appear here today regarding the SEC's Regulation Best Interest package of proposed rules.

CFP Board is a nonprofit organization whose mission is to benefit the public by granting CFP certification and upholding it as the recognized standard for competent and ethical personal financial planning.

Today, more than 83,000 CFP professionals already provide fiduciary level services across business and compensation models as investment advisors collecting fees or as broker-dealers and insurance agents charging commissions. We bring this unique perspective to your consideration about the proper standard of conduct for investment advice.

CFP Board first adopted a fiduciary standard in 2007 requiring a CFP professional to act as a fiduciary when providing financial planning. Last year, CFP Board adopted a revised code of ethics and standards of conduct which will become effective this October. The new standards provide clarity for the public by extending the application of fiduciary duty from financial planning services to all financial advice.

The standards are responsive to today's complex financial marketplace where consumers seek investment advice and find that it is virtually impossible to distinguish a salesperson from an advisor.

Against the new standards, we evaluated the Regulation BI package. And while we appreciate the opportunity the rule proposals represent, our concern is that they offer the appearance but not the reality of increased investor protection. However, if the proposed rules are strengthened, we believe that the Commission may realize its goal of increasing investor protection.

Although there are similarities between the SEC's Regulation BI and the CFP Board's new standards, there are also major differences, the most significant of which I will highlight now.

The first is best interest. CFP Board standards unambiguously defined best interest as fiduciary, including both a duty of care and a duty of loyalty. Under Regulation BI, "best interest" is not defined.

Second, duty of loyalty. Strikingly, Regulation BI does not contain a distinct, well-defined, standalone duty of loyalty whereas the duty of loyalty is prominently featured in CFP Board standards.

Third, disclosure. Our experience is that disclosure has little impact on changing or informing investor behavior. Disclosures should not be considered a substitute for clear and effective regulation. We believe that disclosures must be qualitatively tested for investor comprehension and effectiveness.

As such, we strongly support the draft SEC Disclosure Effectiveness Testing Act. Each of these issues and still others are discussed in greater detail in my written statement.

I want to leave you with what I have learned in 30 years of practice as a financial planner and investment advisor. Many smart, educated, accomplished individuals don't do even the basic work to check out the financial advisor they choose to work with, and they trust their advisor to work in what they believe is their best interest.

Even clients who came to me after experiencing considerable financial harm at the hands of their previous advisor, believed that that advisor had their best interest at heart. And despite substantial financial harm, I estimate that fewer than one in ten of these investors is at all interested in pursuing a remedy that may be available to them. The client, it seems, is loyal to the advisor no matter what.

The financial service industry is changing. We are in a period of substantial change. And as the industry moves away from transactions and towards service and advice, it is more important than ever for consumers to be able to distinguish whether their advisor is bound to act in their best interests and in a fiduciary manner. The Reg BI package should reflect this reality. Thank you.

[The prepared statement of Ms. John can be found on page 53 of the appendix.]

Chairwoman MALONEY. Ms. Roper, you are now recognized for 5 minutes.

STATEMENT OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

Ms. ROPER. Thank you, Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee for inviting me to testify today on an issue that has been a priority for the Consumer Federation of America and a focus of my own work for many years.

Since the 1990s, I have reached out to every incoming SEC Chair urging them to strengthen the protections that apply when vulnerable Americans turn to financial professionals for advice about their investments. Instead, the SEC has unleashed broker-dealers to market themselves as trusted advisors while continuing to regulate them as mere salespeople.

It has adopted a weak disclosure-based approach to enforcement of the Investment Advisors Act fiduciary duty that provides few meaningful protections. And even after Congress gave the SEC explicit authority to adopt a strong, uniform fiduciary standard for brokers and advisors, it failed to act.

So when SEC Chairman Jay Clayton announced that he planned to make rulemaking in this area a priority, we responded with a sense of cautious optimism. And at first glance, Regulation Best Interest seemed to offer at least modest progress.

So why am I here testifying today that with Reg BI, the SEC is, once again, proposing a regulatory approach that does more to weaken investor protections than to strengthen them?

So let us start with Reg BI's so-called best interest standard, which doesn't even require brokers to recommend the investments that they reasonably believe represent the best available options for their customers. In fact, as others have pointed out, best interest isn't even defined in the rule text or the 408-page proposing release.

And this is a big omission because the exact same—virtually identical—best interest language has been used to describe everything from the existing FINRA suitability standard to the now defunct Department of Labor fiduciary rule.

And as the State Securities Regulators recently pointed out, industry groups are taking this lack of clarity as, "confirmation that pretty much anything and everything will be considered acting in the client's best interest where disclosure occurs."

The proposed prohibition on placing the brokers' interests ahead of the customers' interest is, if anything, even more problematic. First, in articulating this obligation, the Commission has deliberately chosen language that is weaker than the standard specified by Congress in Section 913(g) of the Dodd-Frank Act.

Second, the prohibition doesn't even appear in the operational provisions of the rule that fully satisfy compliance with the best interest standard. So it is essentially unenforceable.

One provision of the rule that does have the potential to reform harmful broker-dealer conduct is the requirement for firms to mitigate financial conflicts of interest.

But here again the SEC has failed to give any indication of how it would measure whether firms' policies and procedures to mitigate conflicts are adequate, and they don't even clearly ban firms from artificially creating incentives of the kind Dina described that encourage and reward advice that is not in customers' best interest.

As a result, a rule that appeared at first glance to offer promise is revealed to do little more than simply codify the existing requirements under FINRA suitability rules. And in some important areas, the rule would actually deprive investors of protections they currently receive under common law fiduciary standards when they enter long-term relationships of trust and confidence with their brokers.

The good news is that it would still be possible for the Commission to fix Reg BI and to do it without restarting its regulatory process from scratch.

And my written testimony details the basic changes that we believe are needed to ensure that the best interest standard truly does raise the bar on the FINRA suitability standard and that it really does require brokers to put their customers' interests first.

Finally, we strongly support the SEC Disclosure Effectiveness Testing Act. Had it been enacted before the SEC proposed this regulatory package, it might have helped to avoid the disclosure disaster that is Form CRS.

Ultimately, unless the Commission is prepared to adopt substantial improvements to Reg BI along the lines that we have indicated in our testimony, it is likely to do more harm than good by misleading investors into expecting protections that the rule simply does not provide. Thank you.

[The prepared statement of Ms. Roper can be found on page 77 of the appendix.]

Chairwoman MALONEY. Thank you.

Votes have been called, and I intend to recognize the remaining two witnesses for their testimony and then adjourn for the votes and then come back after the votes.

So Mr. Baker, followed by Mr. Pitt.

STATEMENT OF LEE BAKER, PRESIDENT, AARP GEORGIA STATE

Mr. BAKER. On behalf of our 38 million members and Americans saving for retirement, AARP thanks Chairwoman Maloney, Ranking Member Huizenga, and the members of the subcommittee for the opportunity to testify today.

My name is Lee Baker and I am the volunteer president for AARP Georgia. I am also a certified financial planner. Growing up, I recall one of my mother's earliest jobs was as an insurance agent. My parents and I lived in a middle-class area in Jacksonville, Florida, where I later fell in love with a girl who would become my wife, Veronica.

The relevance of this to today's hearing is that Veronica was in many ways my very first financial planning client. Due to tragic circumstances, Veronica became the de facto head of household for a family at the age of 19.

At that time, I was still in college and employed with Lindeman Insurance, and was able to help when she was given bad advice that could have resulted in their losing 10 percent of their investment. Since those early days, my passion for helping people achieve financial security has simply grown.

AARP has long advocated for policies that strengthen Americans' ability to save and manage their retirement assets. Nearly half of our members work full- or part-time, with many of their employers providing retirement plans.

The dramatic shift from employer-managed defined benefit plans to individual account plans such as 401(k) plans and IRAs has transferred significant responsibility to individuals for investment management.

AARP applauds the SEC's work to develop a higher standard than the suitability standard. We believe a strong, clear, and enforceable standard, coupled with a robust client relationship summary, or CRS, could provide invaluable investor protections.

Both broker-dealers and investment advisors play an important role in helping Americans manage their financial lives. Unfortunately, the SEC's proposal does not impose an explicit fiduciary obligation and does not define the new best interest standard. This concerns us.

There should be a strong and clear standard and this is critical. Investors close to retirement are especially vulnerable as they make significant and often one-time decisions such as rolling retirement savings out of more protected employer-based plans.

First, the assets they have to invest are larger. Second, many lack strong financial literacy. And finally, some face reduced cognition that may affect financial decision-making.

In order to mitigate this risk, AARP recommends the SEC adopt the state trust definition of best interest. A financial professional would have to make recommendations both solely in the interest of the consumer and with the care, skill, prudence, and diligence a prudent person acting in a like capacity would use.

Research shows investors typically rely on recommendations they receive from B.D.s and investment advisors alike. This trust is encouraged by industry marketing, leaving consumers exposed to fraud and unscrupulous advisors who exploit that trust in order to profit.

At AARP, we hear countless bad stories, like the one Anna Duressa shared. Anna, a retired librarian, contributed to her employer-provided retirement account for 20 years before retiring. Upon retiring, she rolled her savings into a Roth IRA and was deceived twice by her advisors. Anna states, "I want people to know that investors often don't know what is happening with their accounts until something goes wrong."

Even with the information at one's disposal it can be hard to fully comprehend. Ensuring all advisors who provide investment advice to retail investors are subject to a fiduciary standard is needed to ensure a level and transparent market for investors.

Second, the proposed CRS form should be simplified. Investors should be empowered to make informed decisions. AARP has undertaken two rounds of testing of the CRS, and we found that many participants had difficulty distinguishing the standards. They did not understand how conflicts of interest could affect them and struggle with the CRS. Therefore, additional revisions and testing of the CRS are necessary.

Third, disclosure alone is not enough. Simply disclosing conflicts does not provide adequate protection and does not shield investors from potential financial harm of conflicted advice. A standard that does not require firms to prohibit incentives that reward and encourage advice that is not in an investor's best interest is likely to be a best interest standard in name only.

And we know that disclosure may even have unintended consequences and effects, such as making a consumer more confident that an adviser is meeting a higher standard than he may actually be meeting.

In conclusion, we would like to thank you again for the opportunity to share AARP's views. We stand ready to serve as a resource and partner in developing an effective standard and appropriate disclosure that will promote and protect the financial and retirement security of American families. Thank you.

[The prepared statement of Mr. Baker can be found on page 34 of the appendix.]

Chairwoman MALONEY. Mr. Pitt?

STATEMENT OF HARVEY L. PITT, CEO AND MANAGING DIRECTOR, KALORAMA PARTNERS; AND FORMER CHAIRMAN, SEC

Mr. PITT. Thank you, Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee. It is good to be back in front of the subcommittee.

I appreciate the opportunity to testify this morning on Reg BI, the Commission's package of proposals and interpretations regarding the standards of professional conduct to which security professionals should adhere for the benefit of their clients.

One thing that I think comes through from the testimony is this is not an easy subject. There are widely disparate views and they are all held quite forcefully and firmly, which is a good thing because eventually it will produce the right results.

As Chair Maloney indicated in her opening statement, the Commission's rule does improve the existing law. We should start with that, and also recognize, as General von Clausewitz said centuries ago, the worst enemy of a good proposal is a perfect one. We will never achieve perfection.

Where we are in the process is that the Commission has put out a thoughtful and creative proposal designed to improve investor protections, but that proposal is still in the process of being finalized. And today's hearings and all of the comments, the studies, for example, that Mr. Baker referred to, all will be useful to the Commission in finalizing its rule.

But I think that what the Commission has done is put forward something that is impressive. Under Chairman Clayton, in only 2 years, the Commission has come forward with a very substantial, thoughtful proposal and a well-planned effort. And the proposed regulation should be seen as an initial step, not as the final step or even necessarily the current step.

Unlike other rules that the SEC has adopted, it is also important to realize that experience here will be the best determinant. While the survey that the AARP conducted found some confusion, the Rand Corporation study found very good results, although results that can be improved with a much broader sample than the AARP used.

So all we are saying is the Commission has done the right thing. It has sought investor views on this and it is continuing to refine those issues.

Most of the criticisms that have been raised, both outside this hearing and today at this hearing, reflect a misunderstanding of the actual terms of the proposal, as well as an understanding of the study and efforts that went into the creation of the proposal.

In that regard, the proposed draft requirement that the SEC do investor surveys, while having real value in some circumstances, is a poorly worded and ill-advised piece of legislation in its current form. It would effectively engender only one real pragmatic result if it were passed at the present, which is preventing the SEC from implementing the needed reforms that we all agree Regulation BI should serve.

In short, I think that the Commission's efforts are laudatory. I think there is room for improvement, and I think this process, as well as 6,000 comment letters, will help produce a final rule that will get things started in the right format and fashion with additional tweaking after actual experience. Thank you.

[The prepared statement of Mr. Pitt can be found on page 68 of the appendix.]

Chairwoman MALONEY. Thank you.

I thank all of you for your testimony.

The subcommittee stands in recess until after Floor votes. Thank you very much.

[recess]

Chairwoman MALONEY. The subcommittee will come to order. And I will now recognize myself for 5 minutes for questions.

My first question is for Ms. Roper. You have probably been working on this issue for longer than anyone here, and I want to applaud you for everything you have done on behalf of investors. You have been very critical of Reg BI and I share your concerns.

I think we both agree that the SEC should make significant changes to the rule in order to strengthen it.

But my question for you is, what do you think are the most important changes that the SEC should make? Is it a change to the substantive standard for brokers, greater restrictions on conflicts of interest, better disclosures, or are these changes inseparable?

Ms. ROPER. I think the changes are indeed inseparable. The SEC chose to adopt an approach, not a uniform standard, so chose to adopt an approach where investors are still going to have to figure out whether they are dealing with an advisor or broker and what the significance of that is.

So the disclosures, while they have not been the primary focus of our comment, are nonetheless extremely important. One of our changes is we think the Form CRS needs to be completely rewritten, retested, and re-proposed.

But looking at Reg BI itself, I think the good news is that it is fixable. The Commission didn't adopt the approach that we would have preferred of uniform rulemaking under 913(g), but it is fixable.

And you start by making the best interest standard meaningful. It has to require some kind of narrowing of the acceptable options beyond what currently satisfies the FINRA suitability standard. And it currently doesn't do that. There is a footnote that says it simply codifies the existing FINRA suitability standard on best interest.

If you just say brokers have to act in their customers' best interest but you leave in place all of the kind of toxic incentives that Dina talked about in her testimony, you are going to have, at best, just gross noncompliance with the rule.

You have to do things under Reg BI to try to rein in those conflicts. That doesn't mean eliminating every conflict. It means that you eliminate the most egregious conflicts, the conflicts that firms create to incentivize their brokers to act in ways that are harmful to investors, like creating a sales quota for sale of proprietary products, where brokers fear for their job if they don't meet it.

The rest have to be appropriately managed to prevent the broker from placing their interests ahead of the customer's interest. Just including that language in the mitigation requirement of the rule would be a significant improvement because right now there is nothing in the rule's safe harbor that actually includes that requirement to place the customer's interest first.

You could include that in mitigation. And then we didn't talk about it today, but to the degree that the SEC has reduced inconsistencies between the standard for brokers and advisors, they have done that more by adopting the weakest possible interpretation of the Advisers Act fiduciary standard that you can possibly imagine.

Not using 913(g) makes that harder to solve than it should be, but there are things that the SEC could do to ensure that investment advisors really do have to live up to the standard they describe in their guidance but do not enforce.

Chairwoman MALONEY. Thank you very much. And I would like to follow up and hear what the other witnesses think about this, too. And let us just go down the line starting with Ms. Isola, then Ms. John, right down the line.

Ms. Isola?

Ms. ISOLA. I think a real issue that I hope you all will realize by the end of this is that the average investor doesn't understand very much, and that is the truth. They don't understand disclosure. They don't read it. They don't understand the difference between a broker and a fiduciary.

They don't understand that the person giving them advice isn't representing their best interest. So anything that is done that keeps that murky and unclear is just going to create confusion and leave the door wide open for gross abuses.

And again, getting back to those incentives, most people aren't aware of that. Had I not worked at that brokerage firm 30 years ago, I wouldn't have known it either. How would I have known it? And that is the reality.

Chairwoman MALONEY. Ms. John?

Ms. ISOLA. If someone is making a recommendation because they are getting something from it—

Chairwoman MALONEY. Yes. I have very limited time and I would like to hear from—

Ms. ISOLA. Oh, sorry, I am sorry. Go ahead.

Chairwoman MALONEY. —Ms. John and others.

Ms. John?

Ms. JOHN. Thank you. I think there are three things that could be done to improve the rule. The first would be to actually provide a definition for best interest. The second would be to include a duty of loyalty.

And third, I agree there needs to be further testing on the CRS form. It is totally incomprehensible to most people. We talk about fees, costs and charges and the customer wants to know what exactly does that mean?

Chairwoman MALONEY. Okay. My time has expired. So I would like to ask the other panelists to submit their answers in writing.

I now recognize the distinguished ranking member for 5 minutes for questions.

Mr. HUIZENGA. Thank you, Madam Chairwoman, and let us dive right into this.

Mr. Pitt, there has been some criticism, obviously, that Reg BI, and we have just been hearing some of this, is a weaker standard because it is different than the standard proposed by the Department of Labor. But the Department of Labor covered only a portion of the actual retirement funds, correct?

Mr. PITT. That is correct.

Mr. HUIZENGA. And maybe you can describe what it covered?

Mr. PITT. I think that the standard is actually superior and it picks up from the experience that the Department of Labor had. The Department of Labor had a very narrow jurisdictional predicate, but it effectively was covering the universe of brokerage firms that they had no jurisdiction over. And that is why their rule was struck down.

Mr. HUIZENGA. In the courts—

Mr. PITT. Yes.

Mr. HUIZENGA. As we—this proposed rule goes across all investor retail accounts, correct?

Mr. PITT. Yes, it does.

Mr. HUIZENGA. And it seems to me that that would be a stronger standing. I did a little quick, brief research. We have a couple of firms here. They appear to be fee-for-service firms, and I just—that is correct? Right? Both of your firms are fee-for-service?

All right, so recently a study showed that a fee-based advisory firm account minimums vary greatly, but typically range between $50,000 and $3 million. It is widely accepted that brokers—and I would imagine between New Hampshire and Manhattan there is maybe a little difference between your average sizes.

And I noticed on the website for Ms. John, you have a header: "No cookie cutter here. Each client is unique." I think I would wholeheartedly agree with that, but it is widely accepted that brokerages typically can offer much lower account minimums than fee-based advisory services.

And based on the SEC Form ADV filings, the Ritholtz Wealth Management requires a minimum account of $750,000. So I am kind of curious. What do we do with that $2,000 a year investor?

And Ms. Roper, you have been at this a long time. There is some real benefit to that. There are a few negatives. In September 2011, you testified to this subcommittee that $2,000 a year investors are, "not that enticing a market and there are not a lot of fee-only financial planners or fee-only advisors who are going to step in and provide those services."

So I am curious, Mr. Pitt, from your experience, how do we get to those lower-income, and moderate-income working families who are trying to go and scrape and save and try to have some sort of a better future for themselves?

I mean, a 1.18 percent ongoing fee for a $50,000 account versus 0.5 percent for a $30 million account, that seems a little different, too. So I just—describe the landscape for us, if you would?

Mr. PITT. Well, I think the crucial thing is first to ensure that lower income and middle income investors have the protections that are so necessary, that their securities professionals understand their obligation is to act in the best interest of that customer.

I think the second important thing is to permit lower income investors to have access to a wide range of service. We don't want to force them into a pigeonhole where they can only get one type of service.

Mr. HUIZENGA. So, like a robo-advisor?

Mr. PITT. Yes.

Mr. HUIZENGA. All right. I think that is what we are seeing a lot of this being driven towards, and some, not any of our panelists today, but some have talked about how that should be the preferred method of investing for most people is just robo-investors. I for one am not a real fan of mathematical algorithms deciding what my future looks like, but care to—

Mr. PITT. I am not a fan of them either and I have to say I don't understand most of the algorithms anyway. So it wouldn't work for me.

[laughter]

Mr. HUIZENGA. Well, I think we have some common goals here. First of all, let us acknowledge that there is a need for greater transparency and sunlight. That absolutely there have been abuses in the past. There still are ongoing abuses. Man is depraved, sinful, fallen, and evil. That is proven every day.

But that is why the SEC is doing this and it seems to me that a Rand study with an 1,800-person sample, 1,400 respondents, versus an 18-person study by AARP might be a little more clarifying as to how this is actually going to function. I am committed to working with the SEC to improve these. I think this is a very good start.

And with that my time is up, and I yield back.

Chairwoman MALONEY. Thank you.

And now the gentleman from Illinois, Mr. Casten, is recognized for 5 minutes.

Mr. CASTEN. Thank you.

I have some prepared questions, but before I do that, I am just curious, is there anyone else on the panel who would like to briefly respond to the last question since we only got one response?

Ms. John?

Ms. JOHN. I totally disagree about a lack of investor choice. New business models are coming on all the time. I will say that throughout the financial services industry, regardless of what business model you are working under, we could all do a better job of serving the general public than we do now.

Mr. CASTEN. Okay. Thank you. I suspected you would say that. I would encourage you all to submit in your written comments any other responses you may have.

I am focused on the—I am delighted that the SEC sought input on Form CRS before taking it out, before taking it to the Federal Register and seeking public comment. They proactively engaged in investor testing. I think that investor testing is a useful tool for the Sec, particularly for disclosures to help retail investors make informed decisions.

I am pleased they engaged in investors usability testing on Form CRS, but I am concerned that they over-relied on surveys as opposed to in-depth interviews. Now, I need to take a little aside here.

I am a huge fan of competitive markets. I also still remember the first chapter of my freshman economics textbook about how for competitive markets to work you need no barriers to entry, no barriers to exit, and a whole lot of transparency.

It is not lost on me that there is not a business in the world that wants to be in a competitive market. It is really hard. And so we have an obligation for those tasked with consumer protection to increase transparency, not to reduce it.

And in that context, the fact that the SEC's 1,800-person survey, the vast majority of those believe that the form would, "help them make more informed decisions about investment accounts and services."

But when they dove a little deeper and interviewed 31 individuals in Denver and Pittsburgh, they found that there were areas of confusion for participants, including differences between types of accounts or financial professionals.

My first question is for all of you. Does anyone here believe that only 31 qualitative interviews is sufficient to understand the usefulness of the disclosure?

Ms. ROPER. I think it is more useful than a survey that tells you whether investors like it, but doesn't tell you whether they understand it. Investors routinely answer to surveys that they like disclosures, but testing of the kind that Rand did indicates they don't understand them. So if I have to choose between their survey and their qualitative interviews, limited as they are, I would take the qualitative.

Mr. CASTEN. Sure. And I am really just asking whether 31 is sufficient to form a judgment before we roll the rule out.

Mr. Baker, what did the divergent test results between the 1,800 and the 31 suggest to you?

Mr. BAKER. It suggested there is more work to be done. It is clearly a difficult issue. Experience through the years has told us this is complex. One of the things that I would like to point out is I am unaware of anything that says that you can't act in a client's best interest in a commission environment. Okay?

Quite frankly, there is a gentleman down the hall from me in my office, I won't talk about the firm he works for, but to the best of my knowledge, he does a good job. And so when I think about my background, the people that I grew up with were those kind of $2,000 investors. And personally, in my day job, I don't have an asset minimum.

When I talk to clients, I take the time to go through that process, to explain it. And I will be candid with you, the documents that we have to provide clients are confusing, and the simpler the better. You know, this kind of makes me think of Occam's Razor.

Mr. CASTEN. Thanks.

Ms. Roper, do you believe that investor testing by the SEC is or can be effective in understanding and enhancing the quality and transparency of investors' relationships with investor advisors, broker-dealers?

Ms. ROPER. Absolutely. I think the SEC has known since it did its financial literacy study that the disclosures it currently relies on aren't well-understood by investors. Instead of treating that as an urgent problem, it has failed to address it.

If it were required to conduct real qualitative usability testing of those disclosures, they could get information on whether the disclosures work or not, what changes are needed to make them more effective. And they could work with disclosure design and drafting experts to get the disclosures right.

Mr. CASTEN. Thanks.

With the little bit of time I have left, and again, with Ms. Roper, my final concern is that the SEC's investor testing doesn't seem to be an iterative process. And, where the SEC would retest periodically, retest the disclosures. Should the SEC republish and retest its proposed disclosure prior to issuing a final rule?

Ms. ROPER. Absolutely.

Mr. CASTEN. Thank you.

I yield back my time.

Chairwoman MALONEY. The gentleman from Ohio, Mr. Stivers, is recognized for 5 minutes.

Mr. STIVERS. Thank you, Madam Chairwoman, for holding this hearing. I think we all would agree that what we want is to give investors access to financial advice, transparency, and protection where their best interest is at heart.

Mr. Pitt, are you familiar with what happened in the United Kingdom when they put a fiduciary standard-like rule in effect? And what happened especially to investors of lower means who didn't have the ability to have those big account balances?

Mr. PITT. Yes.

Mr. STIVERS. Can you tell my colleagues what happened?

Mr. PITT. Yes. One of the problems was that trying to import a fiduciary standard which has certain contexts into the context of a broker-dealer relationship doesn't work. And the U.K. found that that was a difficulty.

One of the experiences the U.K. took advantage of, however, was to adopt a standard for brokerage firms, put the customer first, and they have had very good success with that kind of standard.

Mr. STIVERS. So when they originally adopted a fiduciary standard, it is my understanding about 750,000 British folks lost access to their advisor. Then they changed their rule to a best interest-type of standard and people got access again.

Mr. PITT. Yes.

Mr. STIVERS. I just want to make sure when we do this, we don't have people lose access. I will say, I was very concerned when Secretary Perez at the Department of Labor a few years ago said that those people of lower means could just get access to robo-advice. Basically, a computer could tell them what to do.

Mr. Pitt, are you familiar with what happens when people actually don't get investment advice, what will they do? Will they sell at the highest price or will they end up selling at the wrong time and losing money? And will it affect their total return?

Mr. PITT. They wind up losing money in virtually all cases unless they just hit it lucky, like the lottery. So the goal is to get them professional counseling and professional advice that puts their interests first.

Mr. STIVERS. And that is why I talked about access being so important. If they don't get advice, actually, I have seen that they lose about 100 basis points on average of a return, which is significant.

And I also do think protection is important. Do you believe the best interest standard under this rule will make sure that investors get the protections they need?

Mr. PITT. I do. I think that this is an important standard, and it is also a prudential standard which will make it possible for the SEC to apply it broadly and to achieve its purposes, not in a narrow vein, which would be the result with a more prescriptive rule.

Mr. STIVERS. And can you talk about how broker-dealers under this rule would have to handle conflicts of interest when making recommendations?

Mr. PITT. Yes. In the first place, broker-dealers and investment advisors would be required to identify material conflicts.

They would also be prevented from using what I refer to as grammatical fraud. That is, they won't be allowed to say we might have a conflict with such and such. If they have it, they are required to say it.

Third, in cases where the conflict cannot be remediated, the transaction would not go forward. That is one of the misunderstandings about this rule.

So I believe that what the Commission has done is come up with a flexible approach that will provide the greatest amount of protection to investors.

Mr. STIVERS. Great. Under this proposal do you think it is possible for a broker-dealer to make a recommendation that is not in the customer's best interest, even after they mitigate the disclosure of a conflict of interest?

Mr. PITT. No.

Mr. STIVERS. Thank you.

I yield back the balance of my time.

Chairwoman MALONEY. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. In the world of ideology, a half a loaf must be discarded. The good is the enemy of the best, and no matter what benefit there is from a partial step, it must be rejected. If we want to help people the most we can, we have to realize that half a loaf is better than no loaf.

We passed Dodd-Frank. I co-sponsored it. Many other people in this room did, as well. It gave the authority to the SEC to promulgate rules that would apply to all investment accounts. Well, the SEC failed to do anything. We need to applaud this SEC for at least doing something.

The Department of Labor had authority only over well less than half the accounts. It did something. A lot of people in this room thought that they had done a pretty good job. And then the 5th Circuit pulled the plug.

So the Department of Labor effort is not going anywhere, is not effective now. At a maximum, it could affect less than half the accounts and less than half the investment money and is unlikely to be re-promulgated by the current Secretary of Labor.

So we can pine for the DOL rule or we can examine the choice that we have now, the SEC rule or nothing, or the SEC rule and then a chance to make the SEC rule better.

There is an argument that the average investor needs to be in an index fund. That is clearly at the lowest cost possible. And that is not a bad approach.

If you had to pick one flavor of ice cream and everybody bought vanilla ice cream, people would get the most ice cream for the least money. But Baskin-Robbins decided it has demonstrated to us, that if the goal is to get people to eat more ice cream, you give them 31 flavors.

And our goal—you can argue this rule, that rule. The number one thing we have to do is to encourage people to save for their retirement and for the education of their children.

And if the only way to get them into the ice cream store is to offer them tutti-frutti—and after all, that is a terrible ice cream—that is better than decreeing that everything has to be plain vanilla.

I have no idea why the SEC didn't do something in its first 7 years of authority. So I want to ask everybody here, is this rule better than no rule?

Let us go down the line.

Ms. ISOLA. I think if you adopt a lowest common denominator standard, that is what you are going to get. And I don't—

Mr. SHERMAN. Yes. It is clearly not the rule you want.

Ms. ISOLA. No.

Mr. SHERMAN. Is it better than nothing?

Ms. ISOLA. No. No, it is not. In a perfect world, I would want your Thrift Savings Plan offered to everyone in this country. That would be—

Mr. SHERMAN. Our what?

Ms. ISOLA. The Thrift Savings Plan—

Mr. SHERMAN. Yes.

Ms. ISOLA. —that you all are privileged to have—

Mr. SHERMAN. I am not asking you to—

Ms. ISOLA. That would be in the perfect world.

Mr. SHERMAN. Look, I got Donald Trump as President of the United States and in control of the Executive Branch of Government. The choices are, pretty much, this rule or no rule for now. I look forward to better choices in the future.

Ms. ISOLA. That is a horrible choice. I abstain.

Mr. SHERMAN. I am not sure—

Ms. ISOLA. I abstain. That is a horrible choice.

Mr. SHERMAN. —that you think we have a great President. Okay. So it is a horrible choice.

Ms. ISOLA. It is a horrible choice.

Mr. SHERMAN. You can't make a decision.

Ms. John?

Ms. ISOLA. It won't do the job.

Ms. JOHN. It is easier for me. No rule rather than this rule.

Mr. SHERMAN. No rule. Is that because you would aspire to a better rule later or you think that this rule actually undercuts what existed before?

Ms. JOHN. I think this rule undercuts what existed before. And I am hopeful that there will be a better rule later.

Mr. SHERMAN. Go on. I hope for good things, too. Go ahead.

Ms. ROPER. No rule, because as law professor Jill Gross explained in a letter to the SEC, and she literally wrote the book on broker-dealer law and regulation, this rule deprives investors of protections they get now under common law fiduciary standards.

Mr. SHERMAN. Okay.

Mr. Baker?

Mr. BAKER. Yes. I agree with the concept, basically, that you don't want to let the perfect be the enemy of the good. However, I think we should all know that when you get better, you do better. And so we have been down this road before. And it is incumbent upon all of us to do better.

Mr. SHERMAN. Mr. Pitt?

Mr. PITT. I think this rule is an enormous improvement over current standards and therefore it is better than nothing. Although, I do think there will be opportunity for it to be improved.

Mr. SHERMAN. I don't think any—if this rule came with a tag that said we can never do anything to improve it in the future, it would be the worst possible rule. Why do you think it is better?

Mr. PITT. Well, I would think that was very narrow-minded and short-sighted and ill-advised. But I still think this is better than the current status quo.

Mr. SHERMAN. For what technical reasons? What investor is going to benefit from this rule that would not do well under the status quo?

Mr. PITT. I think all investors will do better, because their interests must be put first. And that is crucial.

Mr. SHERMAN. I know there is a huge debate here between best interest on the one side and fiduciary standard on the other. I think you would have to go to law school for at least 3 years to be able to determine the difference.

But I believe my time has expired.

Chairwoman. MALONEY. Yes, the gentleman's time has expired.

The gentlewoman from Missouri, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Madam Chairwoman.

Since taking on this fight against the Department of Labor's fiduciary rule over 6 years ago, through my introduction of RIPA, the Retail Investor Protection Act and the PASS Act, Protecting Advice for Small Savers, I have maintained that oversight of the broker-dealers must protect Main Street. This is about Main Street Americans and their access to sound financial advice.

The Department of Labor rule lacked sufficient economic analysis to even be taken seriously and was already hurting low and middle income retirement saving.

The new proposed rule by the SEC, which is the proper jurisdictional agency—I think we all agree on that—is an important first step in overturning years of misguided policy and lifting up the low- and middle-income families.

I applaud Chairman Clayton and look forward to a finalized SEC rule very soon that will create a best interest standard for broker-dealers that benefits the most vulnerable consumers and restores their choice and access to financial products and affordable cost.

Chairman Pitt, we are going to go quickly here, the median household income in my State of Missouri is around $56,000. Let us say a young family that I represent earns around that amount each year and wants to start investing for their future.

Initially, they have $1,500 to invest, and are only willing to pay someone around 100 bucks for help. They don't want to do a lot of trading in their account. But they would like to get in the habit of investing a little each paycheck.

Chairman Pitt, if this family wanted to sit down, one-on-one, with someone to ask questions and get help, are they typically going to be better off, from a cost perspective, working with a broker who charges by the transaction or an advisor who charges an ongoing fee?

Mr. PITT. I think they will be better off with a broker who charges by the transaction.

Mrs. WAGNER. Chairman Pitt, under the proposed regulation, will there be a specific obligation on the broker to make recommendations to this family that are in their best interest?

Mr. PITT. Absolutely.

Mrs. WAGNER. Absolutely. One of the criticisms that has been voiced of the SEC's proposed rule is that it does not define best interest.

However, Chairman Pitt, isn't it true that the core function of the proposed rule requires broker-dealers and their registered representatives to act in the best interest of their retail customers, and expressly forbids these financial professionals from placing their own interest ahead of the customer's interest?

Mr. PITT. Yes.

Mrs. WAGNER. Chairman Pitt, isn't it true that the standard in the proposal lays out three affirmative duties for these financial professionals to comply with, including various new disclosures, a new standard of care, and a new requirement to mitigate or limited financial conflicts of interest?

Mr. PITT. Yes, it does.

Mrs. WAGNER. To me, it would appear that the proposal does define a best interest standard, clearly, with at least three specific, new and increased affirmative duties that financial professionals would have to comply with. Chairman Pitt, is that correct?

Mr. PITT. That is correct. And it avoids pigeonholing conduct the way a prescriptive rule would do.

Mrs. WAGNER. Chairman Pitt, what current FINRA rule applicable to all brokerage products requires that a customer receive a written disclosure of any conflicts relating to a recommendation before or at the time of the recommendation? Is there any right now?

Mr. PITT. Yes. And it is a crucial provision to require this, which the rule does, but which is not part of the current set of regulations applying to broker-dealers.

Mrs. WAGNER. So the current rule in Regulation Best Interest it has at least a four-page disclosure that has to be signed and an agreement. So it is not too long or onerous, but it is a four-page or less disclosure agreement between the two parties. Is that correct?

Mr. PITT. That is correct.

Mrs. WAGNER. Doesn't Reg BI also clarify titles to make it very clear, so we don't have any fuzziness about financial advisors versus broker-dealers versus wealth managers versus whatever? Is it clear?

Mr. PITT. Yes. It prohibits the use of those misleading titles.

Mrs. WAGNER. So Regulation Best Interest has taken care of disclosures, titles, and still allows low- and middle-income investors to get the advice they need from a broker-dealer in a cost-effective way?

Mr. PITT. Yes. Your couple in your home State would do much better under this rule.

Mrs. WAGNER. Thank you very much. I appreciate it.

I yield back.

Chairwoman MALONEY. Thank you.

And the gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank you, Madam Chairwoman. Thanks for convening this hearing. It is good to have a discussion in this Congress on seeing what the SEC's proposal is on a best interest standard.

We had so much discussion the last two Congresses about the DOL fiduciary rule, and all along that time in those 4 years I thought the Commission was the right place to handle this discussion because it dealt with both retirement assets and non-retirement assets and did that in a uniform way.

And I think everybody in the financial services industry has more clarity, if that is where this issue is dealt with and adjudicated.

And I am certainly for consumers having more information and more specific information, which is why Dr. Foster and I co-sponsored in the last Congress, our exchange-traded fund research bill that allowed independent research on exchange-traded funds since so much of the world has moved to that form of lower-cost investing. But it has embedded in that a lot of procyclical risks that are very different than past investment standards.

And I am also pleased that starting back in 2010, FINRA took the annuity issue seriously in making sure every exchange or sale of a variable annuity required an extensive background review of the client, their needs, why this fit in their portfolio, what the fees were, and that it was signed off on personally by a supervisor at each of those firms. Because that is clearly a place where it is an expensive product that does not fit every investor.

So in my view, we have been working to improve consumer protection in this industry.

My assessment in reading this is that this is certainly better than the current suitability rule and certainly better than the status quo. And the conflicts are certainly more proactively disclosed and outlined.

Mr. Baker, you have been in this business a long time. I know you support maybe some other stance, but do you agree that that is the case from seeing it over the years?

Mr. BAKER. One of the things that I would like to clarify, and, with all due respect, Mr. Pitt, it is not necessarily the case that a fee-for-service model is going to harm that $50,000-a-year family, that is my background, and, quite frankly, lower than that.

All financial advisors, including myself, don't have asset minimums. Everybody in here can do basic math, okay? I am going to make less money working with that family in the model that I use.

Mr. HILL. Right. I understand that.

Mr. BAKER. That 1 percent, I am going to make less money than if I chose the brokerage stance, did a transaction that was 5 percent.

Mr. HILL. Yes. I understand that. But I deal with—I have been in this business for 35 years.

I have been in the brokerage side of the business. I have run two different commercial bank trust departments. I have been all of our open architecture for the people who were talking about proprietary products. We didn't have proprietary products.

So I am familiar with the business. But many, many retired people want to minimize embedded expenses in the funds that you recommend to them—

Mr. BAKER. Absolutely.

Mr. HILL. Minimize fees on a quarterly basis, regardless of whether you are in alignment with them. It is just a cost.

Mr. BAKER. Absolutely.

Mr. HILL. And so really for an older person who is fully allocated in an investment account, they don't have to have any transaction fees because they don't need to change their account very much.

Therefore, that is the lowest cost. And I had many, many senior investors over my career, certainly in deep retirement, say, in their late seventies and eighties, reject any form of fee management.

They wanted their portfolio allocated on a commission basis and to be left alone then and not have any reoccurring fees. And if you look at the time value of money on that, I really do think many of them come out ahead.

But we are not going to debate that today.

Ms. Isola, you run a wealth management business, I noticed in your background material. And you do fee planning and then you put them into an account—I mean, in an allocation, I assume, in your firm. Is that right?

Ms. ISOLA. Well, my husband and I actually head up a new division there which focuses on non-ERISA 403(b)s.

Mr. HILL. I see. Okay.

Ms. ISOLA. There are no minimums for these teachers.

Mr. HILL. Right.

Ms. ISOLA. The fees are low, 0.62 percent.

Mr. HILL. And does—I understand.

Ms. ISOLA. So all in, that is the all-in fee.

Mr. HILL. Thank you. Do do your funds pay a 12b-1 fee?

Ms. ISOLA. No.

Mr. HILL. Okay. Do people in your firm earn 12b-1 fees?

Ms. ISOLA. No.

Mr. HILL. Okay.

Ms. ISOLA. The thing is, that is the issue. If you are saying low-cost advice, that means if they are not going to be paying these exorbitant sales charges and fees that factors in.

Mr. HILL. No, I understand that.

Ms. ISOLA. If the account is low—

Mr. HILL. I understand that.

My time has expired. I yield back.

Ms. ISOLA. Sorry.

Chairwoman MALONEY. Thank you.

The gentlewoman from California, Ms. Porter, is recognized for 5 minutes.

Ms. PORTER. Thank you for being here, Mr. Pitt. It would seem to me that the SEC Chairman should be here as he is responsible for the Commission's current approach. And he should be the one that we are holding accountable for failing to follow Congress' clear directive in Dodd-Frank to establish a higher standard for brokers and dealers.

But in his absence, I hope you can answer a few questions about Regulation BI that I think investors will want to know.

I only have 5 minutes, so I am asking for affirmative yes-or-no answers. And if you cannot give one, please just say pass. Do you agree that incentives are an influence on broker-dealer behavior?

Mr. PITT. I'm sorry, do I believe—

Ms. PORTER. Do you agree that incentives are an influence on broker-dealer behavior?

Mr. PITT. Yes.

Ms. PORTER. If a broker gets paid more to recommend one mutual fund company over another mutual fund company, do you agree that creates an incentive to recommend the higher paying fund company?

Mr. PITT. It could, but not under this rule.

Ms. PORTER. If a broker gets paid more to recommend a proprietary fund over a non-proprietary fund, do you agree that creates an incentive to recommend a proprietary fund?

Mr. PITT. I don't believe it is per se a problem if the investment is a better one.

Ms. PORTER. If a broker—but it could create an incentive.

Mr. PITT. It could definitely create an incentive.

Ms. PORTER. Because when I get paid more, I usually feel more incentivized.

Mr. PITT. Yes.

Ms. PORTER. If a broker gets paid significantly more to recommend an annuity or a non-traded REIT over a basic, ordinary mutual fund, do you agree that could create an incentive to recommend a higher paying investment?

Mr. PITT. It could create an incentive.

Ms. PORTER. If a broker is pressured to hit monthly sales quotas for the sale of proprietary products, do you agree that that creates an incentive to make enough sales to hit that quota?

Mr. PITT. Under some circumstances, yes.

Ms. PORTER. If a brokerage firm offers trips to exotic locations for hitting certain sales thresholds, do you agree that that trip creates an incentive to make enough sales?

Mr. PITT. It could.

Ms. PORTER. Does Reg BI outright prohibit any of the incentives that we just talked about?

Mr. PITT. Yes. In my view, it would prohibit all of them if it involved not putting the investor's best interest first.

Ms. PORTER. Do you think these incentives that we just talked about result in the best quality advice for investors, as opposed to a world in which these incentives did not exist?

Mr. PITT. I think it would depend on the individual case. It could, but it might not.

Ms. PORTER. So you don't know?

Mr. PITT. We would have to look at the specific circumstances to come to a real conclusion on that.

Ms. PORTER. So before Reg BI was released, SIFMA, the lobbying industry for the broker-dealer industry, took the position that FINRA's existing suitability standard effectively was consistent with the best interest of the customers.

And so Fidelity stated, for instance, "We view FINRA's existing suitability standard as an already highly effective best interest standard of conduct that protects investor interests." How is it better to have a rule that doesn't change anything?

Mr. PITT. I believe this rule changes everything and therefore it is better.

Ms. PORTER. You disagree with SIFMA, which had stated that suitability already constrained broker-dealers to engage in consumers' best interests. That was SIFMA's longstanding position and SIFMA members' longstanding position prior to the rollout of the so-called best interest rule.

Mr. PITT. I think the suitability requirement is a very crucial one, but I believe it is not sufficient. And I do believe that is SIFMA's position with respect to Reg BI.

Ms. PORTER. Well, I am sure they love Reg BI because it doesn't do anything. It actually weakens from where they already are. So I find that entirely self-obvious.

They obviously prefer a rule that weakens the existing rule. To me, this so-called best interest standard, is really just a regurgitation of the existing self-interest standard.

Madam Chairwoman, I yield back.

Mr. HUIZENGA. Will the gentlelady yield?

Ms. PORTER. Yes.

Mr. HUIZENGA. I do want to correct the record that it is my understanding that the SEC and Chair Clayton were actually not invited to this panel. That was not part of today. So that is why they were not here.

Chairwoman MALONEY. Okay. The gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Madam Chairwoman. And I thank our witnesses for your testimony today and your written testimony in advance. And I will thank you in advance for your follow-up to any questions that are submitted afterwards into the record.

You know, when I listen to some of the dialogue talking about how broker-dealers might behave and how earning a commission might motivate bad behavior, I wonder if there is an industry where these benevolent people who aren't motivated by the payroll function exist.

Payroll is one of the most popular features of every place of employment. I find it hard—there are a lot of good charities and everything else, but most people need to make a living. And people have found that charging commissions are a variable cost way of doing it.

In general, it can align interests. For example in real estate, your buyers and sellers have an incentive to come to a deal. And while it is not established in code anywhere that 6 percent is the sacred number, it is fairly common when you read the disclosure statements that you are going to pay 6 percent.

It is fairly common that attorneys are rewarded, particularly in class-action lawsuits, for being successful in bringing their case. Does that motivate bad action? Certainly in some cases one would assume it might tempt people to engage in fraudulent activity.

But to somehow say that every lawyer who brings a lawsuit and earns a commission on the back end because there is a settlement or earns a percentage of the settlement is somehow only doing it for their own self-interest, but not to advance their clients, I think is tainted.

And if we look at that, applying similar behaviors, I have seen almost monolithically from my colleagues from the other side of the aisle, I think you are arguing against a straw man.

And Mr. Pitt, I applaud you for trying to provide context to questions that were meant to knock down strawman arguments. Small businesses, of which I came from that background, are often challenged to find products that provide access to the same types of things that bigger businesses do.

And part of the reason is you can't move as big of a book of business in a 401(k) program, for example, as a large employer. So while I had a couple hundred employees, I did find it hard to get the same level of service from my retirement plan that Proctor & Gamble in the area probably gets for their retirement plan, for obvious reasons.

But as broker-dealers navigate things like the best interest rule or other proposed schemes, I just wonder how do we balance access with consumer protection with the best interest of the invested people?

Mr. Pitt, doesn't the SEC's proposed Reg BI prevent something that would make it more difficult for employers to even offer these benefits to their employees?

Mr. PITT. Yes. I think the Commission's approach is to try to preserve choice on the part of all investors for the types of services that will best serve those investors but require the same high-level of professionalism, no matter who is assisting those investors.

And if there is a disclosure requirement that notices the consumer, or in this case, the small business owner who is required by ERISA to have some level of due diligence on the plans, how is the intersection of that with the best interest rule taken into account?

Investors would be required, whatever their size, to be given the kind of information that would precisely and surgically highlight what conflicts of interest exist and enable them to question their professionals and to make judgments based on recommendations that they might receive.

Mr. DAVIDSON. In the real estate realm, we have a disclosure scheme where the real estate agent discloses, am I working on behalf of the buyer, or am I working on behalf of the seller. Is this analogous to this type of disclosure?

Mr. PITT. Yes, but it goes beyond that by requiring a delineation of all of the material conflicts that might exist in the type of advice that would be given.

Mr. DAVIDSON. Thank you.

I yield back.

Chairwoman. MALONEY. Okay.

The gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. Well, good morning. I appreciate everybody being here, and I appreciate the great comments that have been talked about already in this hearing.

This is really important work. I have the honor of representing a very diverse district in Indiana's 9th district, rural America, small town America, suburban America and a little bit of urban America, as well.

And one thing that unites those individuals all the way across the district is their rage against Washington, a Washington that they continue to feel is empowering certain individuals over other individuals, continuing to help certain individuals and not empower rural America, empower the small business, empower low- and middle-income America.

This is exactly what is going on. And I am very upset that we continue to talk about polls that ask, do you believe that this fiduciary rule is a good idea, question mark?

People say yes. What is not disclosed in that is that you, lower- and middle-income America, won't get the benefit of that because you don't have an account size that is enough to ensure that those people will continue to give you advice. You will be pushed to robo-advisors. Meanwhile, upper-income America will get that extra level of trust in their financial advisor.

I just want to read some of the statistics of the many, many studies that have talked about how lower- and middle-income America will no longer have access to retirement products and to genuine advice. And by the way, to your exact point that you have been talking about over and over and over again, these are the individuals who need that advice the most.

If you have $1 million in investable assets, there are a lot of places you can go to get advice. And I would venture to say you might be more financially sophisticated than an individual who has $2,000.

I want that individual who has $2,000 to be able to save for their retirement, to get appropriate advice and have access to a real advisor, just like that account with $1 million in it.

I want to read some of these studies and the results of these studies. Deloitte study, 53 percent of study participants reported limiting or eliminating access to brokerage advice for retirement accounts, which firms estimate to impact 10.2 million accounts, $900 billion in assets under management, roughly $88,000 account.

Further, roughly 95 percent of study participants indicate they have reduced access to choices, reduced access to brokers directly, and have had to make hard decisions about who they will cut and who they will keep in terms of their accounts.

Harper Polling: only 10 percent of certified financial planners report that the rule is helping them serve the best interest of their clients; 55 percent report the rule is restricting them from serving their clients' best interest; 75 percent of respondents say, typical clients have starting assets under $25,000.

That 25-year-old who just got a job where they can finally start saving a little bit, and they walk into that financial advisor's office and say, "I want to start putting away a little bit of money. I can't do a lot, but I want to start putting away a little bit of money."

What I continue to hear back home is financial advisors are excited about that opportunity to serve that Hoosier and to ensure that they get the advice, just like the person with the $1 million under asset.

Sixty-three percent reported that the fiduciary standard will definitely/probably or already has limited investment options in products they can provide their clients. So now government is deciding which products you can and can't invest in.

American Action Forum, up to 7,000,000 individual retirements would fail to qualify for an advisory account due to the balance too low to be sustainable for the advisor. Or as written will result in over $1,500 in duplicative fees charged per household retirement account. That is startling. I have a lot of Hoosiers back home whose entire account is worth $1,500.

They are trying to save. They are trying to get ahead. But again, Washington is deciding who will get this good advice and who won't get this good advice, instead of my Hoosier financial advisors back home making those decisions.

Then, this is from AAF's further research. The rule will result in additional charges to retirement investors of approximately $816 annually.

Now, I know in Washington D.C., here with a lot of financial institutions, a lot of financial advisors and big money up here, $816 doesn't sound like a lot. But to my Hoosiers back home, that makes a huge difference. That may be the entire amount that they can save after taxes in a year.

To me, as I continue to delve into this, as I continue to talk to so many Hoosier savers back home, so many individuals who are nearing retirement, have so many roundtables with financial advisors, what they continue to say is, I won't be able to serve those who need it most.

And that rage in—that exists there, that Washington is deciding and giving the best advice, giving more opportunities to those who already have higher income levels, already have higher levels of financial sophistication, that will further enrage them.

And so I applaud the SEC for the work that they are doing here in finding a balance that will empower my lower and middle-income Hoosiers back home.

Thank you so much.

Chairwoman MALONEY. The gentleman from Kentucky, Mr. Barr, is recognized for 5 minutes.

Mr. BARR. Thank you, Madam Chairwoman. And thank you for allowing me to participate in this hearing. I don't serve on this subcommittee, but this is an issue of intense interest to me. We all want our retail investors to get the best advice and to have access to professional advice.

I want to unpack or explore this issue, this idea that Reg BI is just simply a regurgitation of the status quo. I am a little stunned to hear that.

Chairman Pitt, what current FINRA rule explicitly requires broker-dealers to establish, maintain, and enforce written policies and procedures designed to identify each material conflict of interest and disclose, mitigate or eliminate each material conflict?

Mr. PITT. There is no specific rule to that effect.

Mr. BARR. Does the Reg BI provide that?

Mr. PITT. Yes, it does.

Mr. BARR. And Chairman Pitt, what current FINRA rule requires an upfront disclosure to educate retail customers on the differences between a brokerage and advisory relationship, including types of conflicts and differences in fees?

Mr. PITT. There is no current rule that does that.

Mr. BARR. Does the Reg BI impose that requirement?

Mr. PITT. Absolutely.

Mr. BARR. And Chairman Pitt, what current FINRA rule, applicable to all brokerage products, requires that a customer receive a written disclosure of material conflicts related to a recommendation before or at the time of a recommendation?

Mr. PITT. There is no express rule.

Mr. BARR. And yet, the Reg BI proposal does have that. Is that correct?

Mr. PITT. Absolutely.

Mr. BARR. And so the claim that this is simply a regurgitation of suitability, that it is a regurgitation of the status quo, doesn't really hold up. Is that correct?

Mr. PITT. That is correct.

Mr. BARR. One other question for you, Chairman Pitt. How important is it for retail investors' access to affordable investment advice and retail investors' access to advice that maximizes optimal returns for them? How important is it to prevent plaintiff's lawyers from bringing frivolous claims against investment professionals?

Mr. PITT. I think any frivolous claims should be absolutely prohibited. And it is crucial that frivolous claims be stopped in their tracks.

Mr. BARR. We did hear from Ms. Roper the argument that this rule would eliminate common law claims or common law fiduciary claims. Is that accurate based on your interpretation of the Reg BI rule?

Mr. PITT. I have great respect for Ms. Roper, but I respectfully disagree with that interpretation.

Mr. BARR. Yes. And in reviewing Reg BI, I don't see any preemption of common law claims.

Mr. PITT. No.

Mr. BARR. Let me ask you one other question. The Majority has proposed legislation, the SEC Disclosure Effectiveness Act. That legislation would require the SEC to conduct investor testing when developing rules and regulations dealing with disclosures to retail investors.

I am concerned that this bill would result in the SEC becoming stuck in an infinite loop of investor testing and they would never be able to finalize rules and regulations. Could this bill actually result in harming investors if the SEC is prevented from finalizing Reg BI?

Mr. PITT. Absolutely, in my view.

Mr. BARR. Yes. I think the idea that we should just stick with the status quo and not move forward with the SEC is ludicrous.

This statement that there is no rule is better than this rule, I just don't get it. Even if you are dissatisfied with this, the idea that it is the same as the status quo is patently untrue.

Ms. John, final question to you. The Certified Financial Planners Board is comprised almost exclusively of financial planners and fee-only investment advisors. It has virtually no broker-dealer representation or broker-dealer regulatory expertise.

Yet, the CFP Board—we need CFPs and CFPs do a very important service to the public—seeks to extend its financial planning standard to brokerage activity unrelated to financial planning.

Couldn't you argue that registered investment advisors stand to benefit if broker-dealers eliminate services or raise costs for Main Street investors like we saw following the DOL fiduciary rule?

Ms. JOHN. I would respectfully request that you look at the current roster of board members, and I think you will find some broker-dealer people prominently featured there and that the CFP Board is business model neutral. We have worked on our new code and standards for over 3 years and all industries have participated in putting those code and standards together.

Mr. BARR. Well, my time has expired. And I think fee-based services are perfectly appropriate in the marketplace. But I think preserving access to commission-based services is also very important, particularly for those seniors that my colleague, French Hill, was referring to.

Thank you, I yield back.

Chairwoman. MALONEY. Thank you. And before we wrap up, I would like to recognize the ranking member for administrative matters.

Mr. HUIZENGA. Yes, Chairwoman Maloney, I would like to ask for unanimous consent to submit the following statements for the record.

First, a letter from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness; a written statement from the American Council of Life Insurers; and an op-ed from Investment News by the American Securities Association titled, "The SEC Reg BI Strengthens Investor Protections."

Chairwoman MALONEY. Without objection, it is so ordered.

I would also like to take care of some administrative matters.

Without objection, I would like to submit letters and statements for the record from the following organizations: the North American Securities Administrators Association; SIFMA; the Institutional Limited Partners Association; Consumer Reports; the Insured Retirement Institute; the CFA Institute; and the Massachusetts Secretary of the Commonwealth.

I would like to thank all of our witnesses for your testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

A P P E N D I X

March 14, 2019

AARP Real Possibilities

STATEMENT FOR THE RECORD

SUBMITTED TO THE

HOUSE FINANCIAL SERVICES COMMITTEE, SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP AND CAPITAL MARKETS

"PUTTING INVESTORS FIRST? EXAMINING THE SEC's BEST INTEREST RULE"

March 14, 2019

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On behalf of our 38 million members and all Americans saving for their retirement, AARP thanks Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets for tackling this important issue and hosting today's hearing. We appreciate the opportunity to testify on the Security and Exchange Commission's (Commission) proposed Regulation Best Interest (BI) and Customer Relationship Summary (CRS) disclosure form.

AARP is the nation's largest nonprofit, nonpartisan organization dedicated to empowering Americans 50 and older to choose how they live as they age. With nearly 38 million members and offices in every state, the District of Columbia, and the U.S. territories, AARP works to strengthen communities and advocates for what matters most to families with a focus on financial security, retirement planning, healthcare, and protection from financial exploitation.

A priority for AARP is to assist Americans in accumulating and effectively managing adequate retirement assets to supplement Social Security. Nearly half of our members are employed full or part-time, with many of their employers providing retirement plans. The shift from defined benefit plans to defined contribution plans has transferred significant responsibility to individuals for investment decisions that directly impact the adequacy of the assets available to fund future retirement needs. Unfortunately, the state of America's retirement landscape is cause for great concern. According to calculations by the Center for Retirement Research at Boston College, only about half of households have retirement savings and the "retirement income deficit" for American households continues to grow.[1] According to recent analysis by EBRI, 47 percent of workers in 2017 reported that the total value of their household's savings and investments, not just for retirement, was less than $25,000 and 24 percent had less than $1,000.[2] Given these trends, it is critical to do all we can to help Americans keep as much of their hard-earned nest egg as possible and AARP has historically supported the development of rules and regulations that protect savers when they make investment decisions concerning their retirement monies. We believe that without such protections, it is difficult for individuals to effectively plan for a secure and adequate retirement.

All financial professionals should act in the best interest of the savers they are serving -- they should put the client's best interest first and ahead of their own. AARP members and the public have generally demanded and supported the protections of a fiduciary standard. In survey after survey, we have found that retirement savers overwhelmingly want advice that is in their best financial interest. In a 2018 poll, almost 70 percent of respondents agreed that the government should establish a rule that would require financial professionals to give advice that is in the best interest of the account holders when giving advice about retirement accounts.[3] In addition,

[1] Alicia H. Hummell, *401(K)/IRA Holdings in 2013: An Update from the SCF* (Sept. 2014), http://crr.bc.edu/wp-content/uploads/2014/09/IB_14-151.pdf.
[2] Lisa Greenwald et al., *The 2017 Retirement Confidence Survey: Many Workers Lack Retirement Confidence and Feel Stressed About Retirement Preparations* (Mar. 21, 2017), https://www.ebri.org/pdf/briefspdf/EBRI_IB_431_RCS.21Mar17.pdff. This figure refers to the total value of their household's savings and investments, excluding the value of their primary home.
[3] AARP 2018 Mid-Term Voter Issues Survey (2018), https://www.aarp.org/content/dam/aarp/politics/ advocacy/ 2018 /08/aarp- national- multi-issue-voter-survey-Q21.pdf.

in a 2013 AARP survey of over 1,400 adults who had money saved in either a 401(k) or a 403(b) plan, more than nine in ten (93 percent) respondents favored requiring retirement advice to be in their sole interest, and fewer than four in ten (36 percent) respondents indicated they would trust the advice from an adviser who is not required by law to provide advice that is in their best interests.[4] A survey taken after the Department of Labor's (DOL) Fiduciary Rule was promulgated demonstrated that an overwhelming percentage of respondents were in favor of the rule and believed it was important for financial professionals to give advice in a client's best interest.[5] Among those individuals who have received professional financial advice, the support was the deepest, with nearly 8 in 10 (78 percent) strongly agreeing with a fiduciary rule.

In April 2018, AARP applauded the Commission's important first step to tackling this issue and developing rules aimed at helping retail investors make informed investment decisions. We believe that the Commission can play a critical role in ensuring that all financial industry professionals, who provide retail clients with advice about securities, are held to a clear and uniform standard of conduct where the advice is solely in the interest of the investor. AARP also appreciates the opportunity to respond to the Commission's request for public comment on standards of conduct for registered investment advisers (IA) and broker-dealers (BD) and we have done so on a number of occasions both in writing, as well as at local town halls and meetings with many of the Commissioners and Chairman.

We have also undertaken a couple of rounds of independent testing of the Commission's proposed disclosure, the Customer Relationship Summary (CRS), most recently in December 2018. Recognizing the important role the CRS plays in the Commission's proposed regulatory approach to Regulation Best Interest, AARP hired Kleimann Communications Group, a non-affiliated third party, for two separate research projects. The first project was concluded in September 2018 and the findings were filed with the Commission.[6] That research was centered on testing the combined BD and IA services disclosure with typical consumers using the Commission's Dual Registrant Mock-up of Form CRS. In that study we found that overall participants had difficulty distinguishing the standards of conduct between different financial professionals, they did not understand how conflicts of interest could affect them, and they struggled with the language used on the form, especially with respect to fees and conflicts of interest.

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[4] AARP, *Fiduciary Duty and Investment Advice: Attitudes of 401(k) and 403(b) Participants* (Sept. 2013), http://www.aarp.org/research/topics/economics/info-2014/fiduciary-duty-and-investment-advice---attitudes-of-401-k--and-4.html.
[5] S. Kathi Brown, *Attitudes Toward the Importance of Unbiased Financial Advice* 4, 6 (May 2016), http://www.aarp.org/content/dam/aarp/research/surveys_statistics/econ/2016/attitudes-unbiased-fin-advice-rpt-res-econ.pdf.
[6] Letter from AARP, the Financial Planning Coalition, and the Consumer Federation of America to the SEC, dated Sept. 11, 2018, available at https://www.sec.gov/comments/s7-08-18/s70818-4341455-173259.pdf.

In December 2018, and much like our first round of testing, our findings clearly indicated the need for the Commission to rethink, revise, and retest the content, language, and format of the CRS, as well as its underlying policy. During this testing, we found multiple opportunities to amend the CRS and improve the experience of the retail investor. Most significant was the challenge retail investors experienced when trying to understand the underlying best interest standard, which continued to cause confusion and ultimately rendered retail investors unable to make informed decisions about which type of account or service would be best for them.[7]

This finding has amplified for our organization the reality that adoption of a uniform standard -- that would apply to both BDs and IAs when providing personalized investment advice to retail customers, as contemplated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 913) -- is of critical importance and long overdue. The standard should be based on the core principle that when providing personalized investment advice to retail customers, a financial professional must always act in the best interest of those customers regardless of their marketing strategy, business model, or registration status. Ensuring that all financial professionals who offer investment advice to retail investors are subject to a fiduciary standard is needed to ensure a level and transparent market for consumers seeking investment advice.

As we have in the past, we continue to urge the Commission to continue developing and testing its regulatory package until it can clearly communicate the meaning and scope of the new best interest standard, and be certain that the disclosures that form the centerpiece of its regulatory package function to support informed investor decision-making.

I. Despite The Commission's Best Effort, The Proposed Regulation Best Interest Undercuts Retail Investors' Ability To Distinguish Between The Standards Of Care Applicable To Financial Professionals.

Both BDs and IAs play an important role in helping Americans manage their financial lives, and accumulate and manage retirement savings. Retail investors receiving investment advice should get a consistent standard of care that is solely in their best interest, regardless of whether the advice comes from a BD or an IA. In 2011, AARP supported the SEC staff recommendation in its Section 913 Study to adopt parallel rules under the Advisers Act and the Securities Exchange Act of 1934 establishing an over-arching fiduciary duty that is identical for BDs and IAs but only if, as the Dodd-Frank Act mandates, it is no less stringent than the existing standard under the Advisers Act. We believe that such an approach, if properly implemented, could both enhance

[7] Letter from AARP and CFP Board to the SEC, dated Dec. 7, 2019, available at https://www.sec.gov/comments/s7-07-18/s70718-4729850-176771.pdf.

investor protections and preserve key beneficial elements of the transaction-based BD business model.

AARP appreciates that the Commission's proposal under discussion today seeks to impose a higher standard than the existing suitability standard on BDs. AARP has long supported advice in the best interest of individuals saving and investing. To that end, AARP was very supportive of the DOL's fiduciary rule, which required that retirement investment advice be in the best interest of the client saving for retirement -- that means advice that minimizes conflicts of interest, is solely in the interest of the client, and which is provided with the care, skill, prudence and diligence that a prudent person would use. Unfortunately, in its current form, the Commission's proposed Regulation Best Interest rule does not impose a fiduciary standard and further fails to define the contours of the "best interest" standard. Absent a full fiduciary standard, investors will continue to be vulnerable and will not receive the protections they need and deserve. AARP has long stated that a suitability standard does not protect investors from the potentially detrimental impact of conflicted advice. AARP recommends that the Commission amend its proposal and adopt the state trust definition of best interest (which the Employee Retirement Income Security Act (ERISA) also adopted). Such a definition is of long-duration and understandable to industry stakeholders and consumers. A financial professional would have to make recommendations both "solely in the interest" of the consumer and with the "care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use." Quite simply, it is not enough for the financial professional to solely rely on their own opinion. The professional must assess what a prudent expert would recommend and document their decision-making process.

a. The Proposed Regulation Best Interest leaves investors confused and at risk.

AARP commends the Commissions' effort to restrict the use of the terms "adviser" and "advisor" by a BD in its CRS. The regulatory imbalance between the duties of BDs and IAs has persisted for many years, even as evidence demonstrating that brokers have transformed themselves from salesmen into advisers has grown. Many BDs today call themselves "financial advisers," offer services that clearly are advisory in nature, and market themselves based on the advice offered. For example, one firm advertises that it "proudly strive[s] to embrace [its] own fiduciary responsibilities" and that its "highest value is to 'always put the client first,'"[8] even though its Form ADV brochure (a regulatory filing that the SEC requires to be given to clients after a transaction is completed) demonstrates otherwise, noting that "[d]oing business with our affiliates could involve conflicts of interest if, for example, we were to use affiliated products and services when those products and services may not be in our clients' best interests."[9] As a result of such marketing and misleading statements, the average investor

[8] Letter from Robert Reynolds, President and CEO of Putnam Investments, to U.S. Dep't of Labor (July 20, 2015), *available at* https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-ZA25/00077.pdf.

[9] Putnam Advisory Company, LLC, SEC Form ADV Part 2A at 25 (Mar. 30, 2016), *available at* http://www.adviserinfo.sec.gov/IAPD/Content/Common/crd_iapd_Brochure.aspx?BRCHR_VRSN_ID=375046. (Putnam Investments wholly owns Putnam Advisory Company through various subsidiaries.)

cannot distinguish between BDs and IAs and does not recognize that their "financial adviser" operates under a lower legal standard than that to which an investment adviser is held. Nor is it surprising that investors expect that those who advertise themselves as a trusted adviser will provide financial advice in the best interest of the investor.

Federal regulations have not kept pace with changes in business practice, and BDs and IAs continue to be subject to different legal standards when they offer advisory services. According to the Commission's 2011 Study on Investment Advisers and Broker-Dealers, as of the end of 2009, FINRA-registered BDs held over 109 million retail and institutional accounts and approximately 18 percent of FINRA-registered BDs also are registered as IAs with the Commission or a state.[10]

Consumers and regulators face a fundamental problem – there are tens of thousands of financial products, many of which contain complex rules, requirements, and fees. Regulators face the enormous challenge of ensuring that these products are fairly structured and sold, and that consumers understand all of the key terms and conditions of these products. Where there are different standards of conduct dependent merely upon which investment and for what purpose the investment will be used, the result can be not only continued investor confusion and reduced personal savings but also an unfair system which only the most sophisticated investors can navigate.

Ensuring all securities professionals who offer investment advice to retail investors are subject to a fiduciary standard is needed to ensure a level and transparent market for investors seeking advice. Investors deserve a regulatory system that is designed to promote their best interests and imposes comparable standards on investment professionals who are performing essentially the same functions. Research has found that investors typically rely on the recommendations they receive from BDs and IAs alike. The trust most investors place in financial professionals is encouraged by industry marketing, leaving investors vulnerable not only to fraud but also to those who would take advantage of that trust in order to profit at their expense. Investors who place their trust in salespeople who market services as acting in their best interest can end up paying excessively high costs for higher risk or underperforming investments that only satisfy a suitability standard but not a fiduciary standard. That is money most middle-income investors cannot afford to lose.[11]

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[10] S.E.C., *Study on Investment Advisers and Broker-Dealers* (Jan. 11, 2011).

[11] See Craig Copeland, *2015 Update of the EBRI IRA Database: IRA Balances, Contributions, Rollovers, Withdrawals, and Asset Allocation*, EBRI ISSUE BRIEF NO. 437, at Figures 2, 4, 6, 19 (Sept. 2017), https://www.ebri.org/pdf/briefspdf/EBRI_IB_437_IRAs.12Sept17.pdf (finding that the average IRA account balance in 2015 was $99,017, but 45% of those owning IRAs had less than $25,000 in their accounts at year-end 2015; accounts were largest closest to retirement age); Alicia H. Munnell & Anqi Chen, *401(k)/IRA Holdings in 2016: An Update from the SCF* (Issue Brief No. 17-18),Ctr. for Retirement Research at Boston College (Oct. 2017), http://crr.bc.edu/briefs/401kira-holdings-in-2016-an-update-from-the-scf/ (households approaching retirement had approximately $135,000 in 401(k) and IRA assets which provides only $600 per month in retirement).

These are not theoretical issues and the risk includes direct harm to the retirement savings of retail investors. For example, AARP recently spoke with Anna Duressa Pujat, a retired university librarian who contributed to her employer provided retirement account for 20 years before retiring.[12] When Anna retired, she rolled her savings into a ROTH IRA and was ultimately deceived twice by unscrupulous advisers. Anna states, "I want people to know that investors often don't know what is happening with their accounts until something goes wrong... even with the information at one's disposal, it can be hard to fully comprehend." Anna and her husband shared that outside of their home, her retirement accounts were their greatest financial assets and they depend on this money for their basic needs and financial security. After suffering the financial losses from exorbitant service fees and inappropriate and risky investments with her retirement funds from previous advisers, Anna recently shared, "Having the fiduciary rule would give me confidence that I am receiving the financial guidance I know I need."

Retiree Janice Winston also testified at a Senate briefing on the importance of unconflicted advice and in her testimony she shared, "I thought that anyone I paid to advise me would be guided only by my best interests. This is important, because I really have no good way to evaluate whether my investments are performing well or whether I am paying too much in fees. Imagine my surprise when I learned that my investment adviser was not necessarily required to act in my best interest."[13]

b. The duties of brokers must be clearly defined.

The Commission's proposal does not define a best interest standard. Instead the question of whether a BD acted in the best interest of its retail investor is left to be determined by consideration of the facts and circumstances surrounding the recommendation. However, AARP's research indicates that investors do not understand the different legal standards that apply to different types of financial professionals. Investors believe that financial professionals are required to act in the investor's best interest. Further, older Americans may not be able to tell you the precise legal definition of fiduciary but they have clear views on what they expect from financial professionals.

In six state specific opinion polls conducted by AARP, AARP asked residents age 50 plus questions related to the various investor and consumer reforms.[14] Respondents overwhelmingly favored requiring financial professionals to put the consumer's interest ahead

[12] *See* Declaration of Anna Duressa Pujat, attached to AARP's Motion to Intervene in Chamber of Commerce v. U.S. Dep't of Labor, Case No. 17-10238 (5th Cir. filed Apr. 26, 2018).
[13] Pension Rights Center, Retiree Janice Winston speaks out in support of strong fiduciary regulations (September 13, 2013), http://www.pensionrights.org/newsroom/speeches-statements/retiree-janice-winston-speaks-out-support-strong-fiduciary-regulation-0
[14] To view the state-specific surveys go to http://www.aarp.org/money/scams-fraud/info-04-2010/finprotect_states.html.

of their own when making recommendations. In addition to a fiduciary duty of care, respondents favored upfront disclosure of fees, commissions, and potential conflicts that could bias advice. The level of support for this commonsense reform ranged from a low of 88 percent (Arkansas) to a high of 95 percent (Indiana).[15] Moreover, not only do investors believe that investment advice should be provided in their best interests, but the financial services industry generally agrees. See, e.g., SIFMA Comment Letter 506 to DOL ("The industry ... shares that goal" "to ensure financial services providers are looking out for their customer's best interest").[16] For decades, registered IAs and certified financial planners have successfully and profitably provided fiduciary advice. Expanding that model to the BD space would provide consistency across the regulatory landscape as well as much need consumer protection.

II. Failure To Impose A Fiduciary Standard Undermines The Financial Security Of Americans Saving For Retirement.

As consumers move closer to retirement, they may be more vulnerable to the negative impact of advice that is not in their best interests for three reasons: (1) the assets they have to invest are larger; (2) they may lack strong financial literacy skills;[17] and, (3) reduced cognition may affect financial decision-making.[18] In addition, the detrimental effects of advice that is not in the investors' best interests may have the most negative potential impact on individuals with modest balances[19] as they have fewer economic resources -- any additional costs or losses diminish what little savings they have. For all these reasons, investors close to retirement are especially vulnerable as they make significant and often one-time decisions such as moving retirement savings out of more protected employer-based plans.

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[15] *Id.*

[16] https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00506.pdf.

[17] Annamaria Lusardi, et al., *Financial Literacy and Financial Sophistication in the Older Population: Evidence from the 2008 HRS* (Sept. 2009), http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp216.pdf ("In view of the fact that individuals are increasingly required to take on responsibility for their own retirement security, this lack of [financial] knowledge has serious implications."); see also Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement* Wellbeing, Nat'l Bureau of Econ. Research Working Paper 17,078, at 6 (May 2011), http://www.nber.org/papers/w17078.pdf (one-third of survey respondents did not understand compound interest, one-quarter did not understand inflation implications and half did not know about risk diversification).

[18] E.g., Keith Jacks Gamble, et al., *How Does Aging Affect Financial Decision Making?* (Issue Brief No. 15-1), Ctr. for Retirement Research at Boston College, at 1, 6 (Jan. 2015), http://crr.bc.edu/wp-content/uploads/2015/01/IB_15-1-508.pdf (declining cognition begins to accelerate after age 60 and has a noticeable effect on financial literacy; "given the increasing dependence of retirees on 401(k)/IRA savings, cognitive decline will likely have an increasingly significant adverse effect on the well-being of the elderly."); see generally Tara Siegel Bernard, *As Cognition Slips Financial Skills Are Often the First to Go*, NEW YORK TIMES (Apr. 24, 2015), http://www.nytimes.com/2015/04/25/your-money/as-cognitivity-slips-financial-skills-are-often-the-first-to-go.html?_r=0 ("A person's financial decision-making ability peaks at age 53, or more generally, in their 50s").

[19] *See* n. 1, *supra*.

Increasingly, the way that most Americans save and invest is through their employer sponsored retirement plans, most typically a 401(k) type savings plan. The Government Accountability Office (GAO) has estimated that $20,000 in a 401(k) account that had a one percentage point higher fee for 20 years would result in an over 17 percent reduction in the account balance, a loss of over $10,000.[20] We estimate that over a 30-year period, the account would be about 25 percent less. Even a difference of only half a percentage point — 50 basis points — would reduce the value of the account by 13 percent over 30 years. Conflicted advice resulting in higher fees and expenses can have a huge impact on retirement income security levels.

Lower and middle-income retirement investors need every penny of their retirement savings. "Among the 48 percent of households age 55 and older with some retirement savings, the median amount is approximately $109,000 — commensurate to an inflation-protected annuity of $405 per month at current rates for a 65- year-old."[21] DOL likewise reported that "small investors" (that is, those with low balances or those with modest means) are most negatively impacted by the detrimental effects of conflicted advice. Those with small accounts have fewer economic resources, and consequently any additional costs or losses diminish what little savings they have worked so hard to amass.

III. The Proposed CRS Form Should Be Simplified In Order To Better Meet The Needs Of Investors And Facilitate Informed Decision-making.

AARP believes that the CRS combined with a strong and enforceable best interest standard could provide invaluable investor protections to Americans saving for retirement. We applaud the Commission's objectives in proposing a CRS that seeks to "fill the gaps" between investor expectations and legal requirements by "mandating clear disclosures" about how financial professionals describe the customer relationship to retail investors.[22]

However, AARP encourages the Commission to amend and continue testing its CRS in order to ensure a more easily used and valuable resource for retail investors. AARP conducted two rounds of usability testing in 2018. What we found was that a short, plain language, user-friendly form with key information, enabling retail investors to evaluate BDs' and IAs' obligations to them are essential characteristics of a useful tool. In our testing, the overall level of comprehension of the complex disclosure among participants was poor; most participants did not understand disclosures regarding legal obligations; participants understood the

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[20] U.S. Gov. Accountability Office, *GAO-07-21, Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees* 7 (Nov. 2006).
[21] U.S. Gov't. Accountability Office, *GAO-15-419, Retirement Security: Most Households Approaching Retirement Have Low Savings* 11 (May 2015), http://www.gao.gov/assets/680/670153.pdf.
[22] https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking

existence but not the import of conflicts of interest; and participants were deeply confused by the disclosure of fees and costs -- both the many types and number of fees described in the CRS' Costs and Fees section.

To be effective, it is imperative that the CRS provide information in a manner that is clear, understandable, and not overwhelming in order to facilitate the retail investor's ability to make informed decisions about their investments. Retail investors should be empowered to make informed decisions. They should understand their choices and what they are selecting -- especially when their hard earned savings are on the line. Numerous surveys have shown that consumers need and want complete disclosures concerning their investment options in order to help them make informed decisions about their investments.[23] Financial professionals should be required to tell prospective and engaged retail investors the applicable standard of care and nature of their relationship. The more consistent the standards of care available, the less confusion we can anticipate on the part of retail investors. In addition, clarity is key to breaking through investor confusion -- especially around complex financial investment instruments. During the April 18, 2018, open meeting on Standards of Conduct for Investment Professionals, Chairman Clayton stated:

> Misalignment between reasonable investor expectations and actual legal standards can cause investor harm. For example, retail investors may be harmed if they do not understand when BDs and IAs may have conflicting financial interests. In addition, without sufficient clarity, retail investors may be more deferential to, or place greater reliance on, their BD or IA than they otherwise would. I believe that clarifying the legal standards of conduct that apply and reducing investor confusion through disclosure can significantly mitigate these potential harms as well as increase investor protection.[24]

Chairman Clayton further stated, "Put bluntly, we want investors to understand who they are dealing with, i.e., what category — IA, BD, or dual-hatted — their investment professional falls into and, then, what that means and why it matters."[25] This intent, as described by Chairman Clayton, is exactly the right one and would benefit retail investors. In order to meet that objective, however, the CRS should be updated to meet a number of critical core components.

[23] The report is titled *401(k) Participants' Awareness and Understanding of Fees, available at* https://assets.aarp.org/rgcenter/econ/401k-fees-awareness-11.pdf.
[24] https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking
[25] *Id.*

First, the standard of care should be clear, concise, and defined. Distinctions between different standards of care should be clear and easy for "Mr. and Mrs. 401(k)"[26] -- the average retail investor -- to understand. The standard of care should be explained in plain language and terms like "fiduciary" and "best interest," which are used in the three iterations of the relationship summary currently available, must be well-defined.

In addition, the CRS should be reformatted. The forms should be short, with a layered approach and/or supplemental pages included in order to allow access to information while avoiding information overload. The information disclosed should be written plainly and concisely, for the purpose of informing the investor, not simply to meet a legal standard. The fee structure should be straightforward and should avoid technical jargon. Finally, the forms should be shared with retail investors in a timely manner, prior to any decisions or actions that may be taken.

a. Standards of Care must be clearly defined.

The Commission's hypothetical, four-page relationship summary forms are intended to explain and clarify whether retail investors are working with an IA, BD, or dually registered representative. Unfortunately, we believe the intended clarity is lost in the forms as currently drafted.

For example, under "Obligations to You," the relationship summary forms fail to distinguish between the BD's new "best interest" standard and the investment adviser's existing "fiduciary" obligation.[27] The duty of IAs is explained as, "We are held to a fiduciary standard that covers our entire investment advisory relationship with you." Nowhere in the relationship summary is the technical term "fiduciary standard" defined. The BD obligation is illustrated as "We must act in your best interest and not place our interest ahead of yours when we recommend an investment strategy involving securities." However, the practical definition and application of acting in the" best interest" is not articulated in the standalone relationship summary for BDs.[28] This leaves many open questions – particularly, what is the meaning of best interest, and how does it differ from a fiduciary standard, if at all. Even an expert would struggle to understand the difference and a retail customer would surely be confused. Because of this lack of clarity, AARP is concerned that the CRS will further confuse investors, or worse, provide them with a false sense of security.

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[26] Chairman Clayton has a well-documented record of referring to Main Street investors as "Mr. and Mrs. 401K" beginning with his first public speech as SEC Chair before the Economic Club of New York (July 12,2017) See https://www.sec.gov/news/speech/remarks-economic-club-new-york; see also https://www.sec.gov/news/testimony/testimony-clayton-2017-09-26.
[27] https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf
[28] https://www.sec.gov/news/statements/2018/annex-b-2-bd-registrant-mock-up.pdf.

Another example of where the CRS can be improved is on the dual registrant's disclosure. In that form, the CRS attempts to provide useful guidance on dual registrants, including tabular formatting that illustrates advisory and brokerage services side-by-side. However, although the visual formatting is helpful, the substantive information laid out within the table remains technical and is likely to be confusing to the average retail investor -- someone who does not have expertise in complex financial products. In addition, the relationship summary does not explain how and when these financial professionals must notify investors if they are switching hats. Such information is critical and should be included in order to assist the retail investor with understanding the potential fluidity of the relationship.

b. The CRS should be reformatted to ensure accessibility to key information.

Clear information is essential for making informed decisions, understanding how investments and financial relationships operate, and preparing for retirement. Based on our experience, the format of disclosure forms as well as the vocabulary used can have a significant impact on the comprehension of and value of the information being shared with retail customers. We encourage the Commission to strike a balance between sharing concise, non-technical information in as short a form as possible.

We believe that the current four page relationship is too long, technical, and therefore too onerous for the average investor and household to process. The text of the CRS should be simply written and should avoid technical terms like "asset-based fee" unless such complex terms are clearly defined. Behavioral science has shown that when faced with a complicated choice, people often simplify by focusing on only two or three aspects of the decision.[29] The less they are able to frame the decision in narrow terms, the more likely they will end up overwhelmed, undecided, or procrastinating. A good disclosure statement will be concise and will highlight the information most important to the consumer.

AARP commissioned a report in 2007 to determine the extent to which 401(k) participants were aware of fees associated with their accounts and whether they knew how much they actually were paying in fees. The report revealed participants' lack of knowledge about fees as well as their desire for a better understanding of fees. In response to these findings, the report suggested that information about plan fees be distributed regularly and in plain English,

[29] Daniel Read et al., *Choice Bracketing*, 19 J. Risk & Uncertainty 171, 171–73 (1999).

including a chart or graph that depicts the effect that the total annual fees and expenses can have on a participant's account balance.[30]

A form that is perceived as easy to understand and helpful is more likely to be used to weigh the advantages and disadvantages of available options and to make informed decisions than one that is more confusing. Layout and design elements can be used to enhance understanding of key information in the relationship summary. Side by side comparisons can be helpful, but the information should be simplified and reduced to the key elements. For example, using bold type, underlining, bullets, and borders to highlight important information may enhance comprehension by drawing attention to it. Furthermore, while tables are a viable way to convey information, additional testing to ensure retail investors think the specific tables contained in the form are helpful would be beneficial.

c. The delivery of the CRS should allow adequate time for review and questioning.

Of particular importance to AARP is when the CRS will be delivered to the retail investor. When a retail investors fails to receive accurate and complete information regarding the financial professionals' potential conflicts then they are seriously disadvantaged and unable to make an informed decision about their financial security. Given the importance of these forms and potential actions by retail investors, the timing and method by which they receive this information is significant. Investors should have clear and reasonable opportunities to protect their interest and discuss conflicts that may place them at a disadvantage.

As currently drafted, retail investors would receive the CRS at the beginning of a relationship with a firm, and would receive updated information following a material change. AARP recommends that such information be made available upon the first interaction with a prospective retail investor with time allowed for review. Furthermore, the CRS should also include information like the timing of when, and if, the financial professional has an obligation to notify the investor if a conflict arises.

d. Disclosure alone is not enough. Evidence shows that disclosures can do more harm and may add confusion.

AARP agrees that all financial professionals should disclose and mitigate or eliminate material conflicts of interest. The Commission should require financial professionals to eliminate practices that directly conflict with the best interest standard appropriate for personalized

[30] The report is titled *401(k) Participants' Awareness and Understanding of Fees, available at* http://www.aarp.org/research/financial/investing/401k_fees.html.

advice such as bonuses, competitions, and rewards. A best interest standard that does not require firms to prohibit incentives that reward and encourage advice that is not in investors' best interests is likely to be a best interest standard in name only.

Recent behavioral science studies have shown that disclosures are largely ineffective because they tend to increase conflict in advisers and make the investor more likely to trust the adviser and thus follow biased advice.[31] Indeed, simply disclosing conflicts does not provide adequate protection and does not shield investors from potential financial harm of conflicted advice. Disclosure may even have unintended effects, such as making a consumer more confident that a financial professional is meeting a higher standard than he or she actually may be meeting. In fact, the less substantive protection there is in the Regulation Best Interest, the more critical the need for a strong relationship summary that discloses the critical components of the investor-financial professional relationship.

Furthermore, the CRS should include a duty on the financial professional's part to document key aspects of the client relationship. This should include precise capturing of what the client wanted, what the financial professional recommended and why. The financial professional should also be required to document not only if conflicts exist, but also how they will be mitigated or minimized, and when and how this conflict was disclosed to the retail investor. The financial professional should acknowledge his/her standard of care, agree to adhere to the standard of care, and document steps taken to comply with that standard. This acknowledgement should be disclosed and delivered in writing to the retail investor and with adequate time for the investor to review (and follow up with questions) prior to engagement.

IV. The financial services industry agrees that a fiduciary standard is the appropriate standard for providing retirement investment advice.

The financial services industry repeatedly states that investment advice should be provided in the best interests of the participant and retirement investor. Registered IAs and certified financial planners have for decades successfully provided fiduciary advice. Noting that the public demand for fiduciary advice has increased dramatically and that the market continues to move in the direction of providing fiduciary advice, in 2018 the Certified Financial Planner (CFP) Board of Standards approved revisions to its *Standards of Professional Conduct*, which sets forth the ethical standards for CFP® professionals. The revision broadens the application of the

[31] Sunita Sah, *Gray Matter: The Paradox of Disclosure*, NEW YORK TIMES, July 8, 2016, https://www.nytimes.com/2016/07/10/opinion/sunday/the-paradox-of-disclosure.html?_r=0; Sunita Sah and George Loewenstein, *Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest*, 25(2) PSYCHOL. SCI. 575 –584 (2014); cf. Sunita Sah, Angela Fagerlin, and Peter Ubel, *Effect of physician disclosure of specialty bias on patient trust and treatment choice*, http://www.pnas.org/content/113/27/7465.full.pdf.

fiduciary standard, effectively requiring CFP® professionals to put a client's interest first at all times.

V. Conclusion

We thank the Committee for the opportunity today to share AARP's views on the Commission's proposed rule and required disclosures. AARP remains committed to the strongest possible fiduciary standard for investment advice. For this package to be truly effective, it must reflect an underlying clear and strong rule that protects the best interest of investors. AARP stands ready to serve as a resource and partner in developing an effective standard for investment advice that will promote and protect the financial and retirement security of American families.

Testimony of

Dina Isola, Investment Advisor Representative
Ritholtz Wealth Management

Before

Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives

On

Putting Investors First? Examining the SEC's Best Interest Rule

March 14, 2019

Chairwoman Maloney, Ranking Member Huizenga and other members of the Subcommittee, I appreciate the opportunity to shed some light on how the lack of a strong fiduciary standard for investment advice harms retail investors.

Early in my career, some 30 year ago, I came to realize that brokers' recommendations are directly tied to compensation and incentives. At a brokerage firm I worked at, it was customary for brokers to scramble to transact business at month-end that would count towards that month's production. For some it could mean the difference between being employed or let go.

Top-selling brokers and managers were rewarded with gifts and trips to exotic locations like Monte Carlo and sales quotas were hung over brokers' heads. Product-specific pushes were also a routine occurrence, with mutual fund companies paying to be included on the firm's recommended list. The firm expected 75% of sales to come from the firm's own funds, which increased the firm's revenue. Branch managers pressured brokers to comply, regardless of the fact that many of the firm's products were inferior to available alternatives, which would have been better for investors.

With these perverse incentives, brokers routinely would make sales recommendations in order to win sales contests, hit quotas, and get to the next rung on the payout grid, regardless of whether their recommendations were in investors' best interest. Since I've left the brokerage industry, nothing has changed in this respect.

The brokerage business model, with all of these and other perverse incentives, is set up to pit broker against client. These incentives reward bad advice that harms investors. What's truly shocking is that brokers are allowed to engage in harmful conflicts of interest, all while leading investors and policymakers to believe they are "trusted financial advisors" who will do what's best for investors.

My path to becoming a fiduciary investment advisor came from a jarring personal experience after my father was diagnosed with Alzheimer's. My mother was caring for him and could not focus on finances, which he had handled. She went to a broker, who recommended a full liquidation of their holdings. No provisions were made to manage two complexities of their situation - the onerous tax implications of selling all the positions and the escalating out-of-pocket costs of my father's health care. Instead, the advice centered on product sales. I was appalled. If she had followed the broker's recommendation, there is the very real possibility that funds needed for my father's care would have been squandered on high fees and a manufactured tax bill. My husband, Tony, and I knew what was at stake and, with her urging, took over to keep fees low and make changes in a tax-efficient manner so they could afford the care he required.

This very personal experience made us worried for those who don't have experts in their family who ensure their loved ones aren't taken advantage of. It drove us to start our own investment advisory firm. We wanted to provide others the same advice that we would give our loved ones and that we would want to receive if we were in their same situation.

We began advising teachers - colleagues of my husband's – on their non-ERISA 403(b) plans.

And we joined our firm with Ritholtz Wealth Management in 2015 to begin a program specifically for teachers. We have been able to educate them on the importance of low fees and diversification. We have delivered a low-cost fiduciary option with all-in annual fees of 0.62% and no account minimum requirements.

The non-ERISA 403(b) market is a living, breathing case study as to why the lack of a strong fiduciary standard for investment advice results in harm to investors. These teachers are trying to do the right thing by saving for their retirement. They want, need, and expect that they are getting advice that puts their interests first, not sales recommendations that will enrich the financial professional at their expense. Instead, they are typically sold high-cost, low-quality investments that tie up their money for years. In fact, 76% of assets in non-ERISA 403(b) plans are in annuities – this despite the fact that both the SEC and FINRA have warned investors that these products can be extremely complex, have high costs, and may not provide meaningful value to them. What they do provide are huge commissions to the financial professionals and firms selling them.

For example, one young teacher we worked with was paying 3% a year to own the market with a guarantee that he would get his original investment at the end of 20 years, despite the fact that there has never been a 20-year period in the stock market's history when it has lost value.

Another teacher we worked with was paying $2,418 a year on an $80,000 account. To get out of that account, she needed to pay $3,000 in surrender fees. The purpose of surrender fees of course is to reimburse a firm for the commission they shell out to the salesperson. We were able to provide a solution that would cost her under $500 a year, so she paid the surrender fee.

We also worked with our son's former teacher, who barely understood what the S&P 500 is, but who was sold a complicated alternative mutual fund that had exposure to a variety of different complex derivatives and employed hedge fund strategies. Annual fund fees were just under 2% and every paycheck contribution was hit with a 3.75% sales charge, making it pretty impossible to earn a positive return after inflation.

Another teacher we worked with had more than half of his account in a single, illiquid REIT that would pay him 40 cents on the dollar if he endured an onerous liquidation process, which included applying for permission to liquidate during one of the few tender offer periods and waiting to see if see if permission is granted. Overwhelmed by the process and the potential loss, he is resigned to holding the investment for now.

And yet another teacher who inherited money from her mother and thought she had a conservative investment to generate income for her upcoming retirement, was instead invested in a portfolio of risky junk bonds that lost more in principal than it paid out in income. She ended up liquidating the portfolio and losing tens of thousands of dollars. Scarred from this experience, she is terrified to invest to recoup her losses.

I can go on and on.

I get asked: How is this legal? And I have no answers. I can feel investors' embarrassment at having been too trusting, they behave like abuse victims who then blame themselves for the abuse. When reality sinks in, they get angry and want to take action. But what can they do? It is perfectly legal to give conflicted advice. Investors' intentions to be responsible and save for their retirement with the guidance of a professional has left them feeling double-crossed, duped and set up to fail. And countless investors have no idea they are being harmed by their "trusted advisor" and that they would be so much better off if they received advice not tainted by conflicts of interest.

No one asks for complicated, expensive products that will drain their hard-earned savings and investments. No one asks to be shackled to an investment for years before surrender fees disappear. No reasonable person would consent to being given bad advice. Why are these products sold to them? It's not because financial professionals are bad people. It's because they're caught up in a web of toxic incentives.

There has never been greater access to low-cost, high-quality investment opportunities, yet the lack of fiduciary protections leaves many investors paying excessive fees and suffering poor outcomes.

Professionals referring to themselves as trusted advisors or providing what anyone would reasonably believe is investment advice must be willing to deliver on that implied promise, and put investors' needs first. Otherwise they should clearly be identified as salespeople. If that title seems too distasteful, perhaps they should reevaluate their business model.

Supporting a warmed-over suitability standard by pretending sales tactics are sound advice is damaging to investors and frankly puts them at risk for needing government assistance in retirement, when they have tried to be self-sufficient. It also casts doubt on the intentions of those in a position to change the situation, but choose not to. In this case, not being part of the solution is being a large part of the problem.

I truly hope you have the courage to act to genuinely protect investors' best interests.

CFP BOARD

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

Testimony of Susan MacMichael John
Founder and President, Financial Focus
Chair, Certified Financial Planner Board of Standards, Inc.

Before the Financial Services Subcommittee on Investor Protection,
Entrepreneurship and Capital Markets
U.S. House of Representatives

"Putting Investors First? Examining the SEC's Best Interest Rule"
March 14, 2019

Executive Summary

CFP Board of Standards, Inc. ("CFP Board") is a non-profit organization whose mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard for competent and ethical personal financial planning. Today, CFP® certification is held by more than 83,000 professionals in the United States. Consistent with our mission to benefit the public, CFP Board supports a fiduciary standard for financial advice.

Importantly, CERTIFIED FINANCIAL PLANNER™ professionals provide fiduciary-level services across business models – as investment advisers, broker-dealers, and insurance agents – and across compensation models – including commission and fee models. It is this unique perspective that we bring to your consideration about the proper standard of conduct for personalized investment advice.

On public policy-related issues, CFP Board works in collaboration with the two membership organizations representing CFP® professionals – the Financial Planning Association[1] and the National Association of Personal Financial Advisors[2] – as the Financial Planning Coalition.[3]

The Financial Planning Coalition has long advocated in support of a fiduciary standard of conduct for personalized investment advice. We supported Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and for more than a decade have urged the SEC to move forward in rulemaking to accomplish what that provision contemplated. While we waited for the SEC to act, the Coalition supported the Department of Labor's fiduciary rule for retirement investment advice.

Faced with an increasingly complex universe of financial products and services, Americans today depend on competent and ethical advisors to help them make decisions critical to their financial security. When they seek financial advice, however, they face a marketplace in which it is virtually impossible to distinguish a salesperson from an advisor, or between those advisors who are legally obligated to provide advice in the investor's best interest versus those who are not. A clear fiduciary standard applied equally to all financial professionals who provide personalized investment advice, including broker-dealers, would help clarify the investment decisions Americans face every day. The expanded fiduciary obligation in the revised CFP Board *Code of Ethics and Standards of Conduct* ("CFP Board *Standards*"), adopted in March 2018, reflects the simple and unambiguous principle that CFP® professionals operating under all business models must, at all times when providing Financial Advice to a Client, act as a fiduciary.

[1] FPA® is the largest membership organization for CFP® professionals and those who support the financial planning process in the U.S. with 23,000 members nationwide. With a national network of 88 chapters and state councils, FPA® represents tens of thousands of financial planners, educators and allied professionals involved in all facets of providing financial planning services. FPA® works in alliance with academic leaders, legislative and regulatory bodies, financial services firms and consumer interest organizations to represent its members.

[2] NAPFA is the nation's leading organization of fee-only comprehensive financial planning advisors with more than 3,500 members nationwide. NAPFA members are highly trained professionals who adhere to high professional standards. Each NAPFA advisor annually must sign and renew a Fiduciary Oath and subscribe to NAPFA's Code of Ethics.

[3] The Financial Planning Coalition is a collaboration of the leading national organizations representing the financial planning profession. Together, the Coalition seeks to educate policymakers about the financial planning profession, advocate for policy measures that ensure financial planning services are delivered in the best interests of the public, and enable the public to identify trustworthy financial advisers. *See*, http://financialplanningcoalition.com.

It is against this backdrop that CFP Board and our partners in the Financial Planning Coalition evaluated the Securities and Exchange Commission's ("Commission" or "SEC") package of rule proposals[4] intended to: (i) raise the standard of conduct for broker-dealers; (ii) reaffirm the fiduciary obligation of investment advisers; (iii) enhance investor understanding by requiring both broker-dealers and investment advisers to deliver a relationship summary document to retail investors; and (iv) reduce investor confusion by restricting the use of certain titles by broker-dealers.

This package of proposals provides the SEC the long-awaited opportunity to raise the standard of conduct applicable to broker-dealers who provide personalized investment advice from the current "suitability" standard to a fiduciary standard of conduct. We are concerned, however, that the rule proposals offer the appearance, but not the reality, of increased investor protection. A final rule must include robust and explicit fiduciary protections for retail investors, regardless of the business model under which that advice is provided. Without these critical safeguards, Reg BI not only will fail to increase protections for retail investors, it may unintentionally mislead the public by implying that compliance with the final rule will cause financial firms and professionals to recommend only those investments that are truly in a retail investor's "best interest."

In comments[5] submitted to the Commission last year, the Coalition recommended that the Commission consider the framework set out in CFP Board's practical approach to a fiduciary standard that accommodates various business models, as described in CFP Board *Standards*. If the proposed rules are improved and strengthened, as recommended by the Financial Planning Coalition[6] and others, and with appropriate implementation, we believe the Commission will realize its goal of increasing investor protection and enhancing the quality of investment advice provided to the public.

Finally, CFP Board strongly supports the draft "SEC Disclosure Effectiveness Testing Act." Research conducted on behalf of the SEC and others has shown how difficult it is to convey even the most basic concepts in a way that investors understand. And, it is not enough to simply survey investors or use other informal input to determine whether proposed disclosures would be effective at achieving their regulatory purpose. For this reason, we are particularly pleased that the draft legislation includes a requirement for qualitative testing in the form of one-on-one cognitive interviews of retail investors.

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[4] U.S. Securities and Exchange Commission, Proposed Regulation Best Interest ("Proposed Regulation Best Interest"), 83 Fed. Reg. 21574 (May 9, 2018), *available at* https://www.federalregister.gov/documents/2018/05/09/2018-08582/regulation-best-interest ("Reg BI"); Proposed Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg. 21203 (May 9, 2018), *available at* https://www.federalregister.gov/documents/2018/05/09/2018-08679/proposed-commission-interpretation-regarding-standard-of-conduct-for-investment-advisers-request-for ("IA Interpretation"); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, 83 Fed. Reg. 21416 (May 9, 2018), *available at* https://www.federalregister.gov/documents/2018/05/09/2018-08583/form-crs-relationship-summary-amendments-to-form-adv-required-disclosures-in-retail-communications ("proposed Form CRS").

[5] Financial Planning Coalition, Letter to Brent J. Fields regarding "Regulation Best Interest" (dated Aug. 7, 2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4186652-172763.pdf; Financial Planning Coalition, Letter to Brent J. Fields regarding "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (dated Aug. 7, 2018), *available at* https://www.sec.gov/comments/s7-09-18/s70918-4185807-172700.pdf; Financial Planning Coalition, Letter to Brent J. Fields regarding "Form CRS Relationship Summary" (dated Aug. 7, 2018), *available at* https://www.sec.gov/comments/s7-08-18/s70818-4185790-172672.pdf.

[6] *Id.*

I. CFP Board *Standards*: A Business-Model Neutral Fiduciary Standard

CFP Board is a professional body that sets and enforces education, examination, experience and ethics requirements for CFP® professionals. As a professional standard-setting organization, CFP Board develops and enforces business conduct standards that are consistent with, and in certain instances may exceed, existing legal and regulatory requirements. Today, more than 83,000 CFP® professionals agree to abide by high standards for competency and ethics, which CFP Board periodically reviews and updates to maintain the value, integrity and relevance of CFP® certification.

A. CFP Board *Standards* Adopted in 2007 Limited the Fiduciary Obligations To Financial Planning Services

CFP Board first adopted a fiduciary standard for CFP® professionals in 2007, when it issued revised *Standards* providing that a CFP® professional owes to the client a fiduciary duty when providing financial planning or material elements of financial planning.[7] Notably, "CFP Board's embrace of the fiduciary standard in 2007 wasn't greeted with fanfare."[8] At that time, major financial services firms, as well as industry organizations representing the brokerage and insurance industries, raised significant concerns, asserting that CFP Board's fiduciary requirement was unworkable with their business models and that CFP® professionals would be forced to rescind their certification if required to operate under a fiduciary standard of conduct.[9]

Contrary to these dire predictions, the number of CFP® professionals has grown by nearly 50 percent since that time, to more than 83,000 today. CFP® professionals, many of whom work at large financial services firms that represent a cross-section of business models, proudly promote that they deliver fiduciary-level services when providing financial planning.

A 2013 Aité survey found that most registered representatives and registered investment advisers agree that a fiduciary standard of conduct is appropriate for financial services providers who deliver personalized investment advice.[10] This finding cuts across a multitude of business models subject to different regulatory provisions. The Aité study surveyed financial professionals at various firm types, including broker-dealers, wirehouses, independent registered investment advisers, and online brokerage firms. Those surveyed cited greater alignment among provider and investor interests as the primary benefit of a uniform fiduciary standard.

In July 2015, Princeton Survey Research Associates International (PSRAI) surveyed[11] 1,852

[7] COMMENTARY TO CODE OF ETHICS AND STANDARDS OF CONDUCT, at p. 3 (March 2018), *available at* https://www.cfp.net/docs/default-source/for-cfp-pros---professional-standards-enforcement/CFP-Board-Code-and-Standards-with-Commentary ("COMMENTARY").
[8] Kevin R. Keller, "A fiduciary standard is good, old-fashioned common sense," Investment News (Oct. 10, 2011), *available at* https://www.cfp.net/docs/press-kit/investmentnews-(oct2011).pdf?sfvrsn=2.
[9] Coalition Letter to the Department of Labor, Regarding "Proposed Conflict of Interest Rule and Related Proposals, RIN-1210-AB32" (July 21, 2015), *available at* https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00702.pdf.
[10] Aité, "Fiduciary Study Findings for CFP® Board" (June 2013), *available at* https://www.cfp.net/docs/public-policy/fp-coalition-sec-rfi-comments-july-2013.pdf.
[11] Financial Planning Coalition, "Fiduciary Standard Survey," Prepared by Princeton Survey Research Associates International (Revised July 2015), *available at* http://financialplanningcoalition.com/wp-content/uploads/2015/07/Princeton-Research-Fiduciary-Study-Final.pdf.

stakeholders from Coalition organizations, including professionals from broker-dealers, registered investment advisers, and insurance companies. The study found that almost nine out of 10 respondents agree with the statement that "a fiduciary standard of care is appropriate for all financial professionals who deliver personalized investment advice to retail investors" and two-thirds believe that a change to extend the fiduciary standard of conduct to broker-dealers would have a positive impact on investors.[12]

B. Revised CFP Board *Standards* Expands the Fiduciary Obligation

In December 2015, CFP Board announced the formation of a Commission on Standards to review and recommend to the Board of Directors of CFP Board proposed changes to the *Terminology, Code of Ethics and Professional Responsibility, Rules of Conduct,* and *Financial Planning Practice Standards* sections of the CFP Board *Standards.* Commission members included CFP® professionals and other financial services professionals operating under diverse business models, regulatory experts, an investor advocate, and a public representative.

Before the Commission on Standards began its work, CFP Board sought input from CFP® professionals and the public on the issues that should be addressed in the process of updating the CFP Board *Standards.* Public forums were held across the country to gather comments. The Commission then met to review the initial comments and to begin the process of developing updated and revised CFP Board *Standards* to be presented to the Board of Directors of CFP Board.

CFP Board released a draft of the proposed revisions on June 20, 2017, and announced a 60-day public comment period. In addition to accepting written comments, CFP Board received comments during eight public forums held across the country. In November 2017, CFP Board announced a second comment period on the proposed revisions. In addition, CFP Board met with FPA, NAPFA, the Securities Industry and Financial Markets Association ("SIFMA"), the Financial Services Institute ("FSI"), CFP Board's Business Model Council (which is comprised of firm representatives from various business models), and many other stakeholders, including CFP® professionals and the firms at which they work. CFP Board also considered more than 1,500 written comments and hundreds of oral comments.

In March 2018, the Board of Directors of CFP Board updated the CFP Board *Standards* by adopting revisions which become effective on October 1, 2019. Consistent with CFP Board's vision and mission, and in furtherance of its strategic plan committed to a fiduciary standard, the newly revised CFP Board *Standards* extends the application of the fiduciary duty to all "Financial Advice"[13] provided by a CFP® professional. This is in contrast to the current CFP Board *Standards* (which remain in effect until October) that impose a fiduciary duty on CFP® professionals only when providing "Financial Planning" services.

The expanded fiduciary obligation effective in October is "the crown jewel" that animates a CFP® professional's commitment to high professional standards. Under CFP Board *Standards,* the public will know that a CFP® professional is committed to acting as a fiduciary at all times

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[12] *Id.*, at p. 6.
[13] CODE OF ETHICS AND STANDARDS OF CONDUCT, adopted March 2018, and COMMENTARY, *available at* https://www.cfp.net/docs/default-source/for-cfp-pros---professional-standards-enforcement/CFP-Board-Code-and-Standards and https://www.cfp.net/docs/default-source/for-cfp-pros---professional-standards-enforcement/CFP-Board-Code-and-Standards-with-Commentary, respectively.

when providing Financial Advice.[14] As a result, CFP® professionals will owe their clients the same fiduciary duty both when providing Financial Planning services and when providing Financial Advice, thereby eliminating potential client confusion about the CFP® professional's obligations when providing both types of services.

This development enjoys strong support among CFP® professionals and their membership organizations. More than 96 percent of CFP® professionals who responded to a recent survey agreed that a CFP® professional should be required to act in the client's best interest when providing "Financial Advice."[15] Likewise, FPA and NAPFA support the expanded CFP Board fiduciary obligation. FPA applauded CFP Board "for taking the bold and necessary step in expanding the fiduciary standard for CFP® professionals."[16] NAPFA commented that the proposal "supports CFP Board's efforts to [broaden] fiduciary requirements for CFP® professionals. Working under fiduciary principles is the most transparent – and we believe the most objective – way of serving the public. Consumers have come to expect advice delivered in their best interest and will now be able to count on a CFP® professional to provide it at all times when giving financial advice."[17]

II. CFP Board *Standards*: A Roadmap for SEC Rulemaking

The Coalition has compared the Commission's proposed Reg BI to the revised CFP Board *Standards*. While there are important similarities, there are significant differences as well. Key similarities and differences are discussed below.

A. Similarities

1. Duty of Care

Both Reg BI and the revised CFP Board *Standards* describe the duty of care in terms of acting with care, skill, prudence and diligence. These are common concepts found in traditional trust law, case law under the Advisers Act, and existing self-regulatory regimes. Together, care, skill, prudence, and diligence signify that a financial professional must use reasonable efforts in gathering information about the retail investor. The duty of care, as described by both Reg BI and CFP Board *Standards,* echoes elements found in the common law "prudent person rule" which can serve to measure the reasonableness of a prudent professional's actions concerning the funds with which he or she is entrusted.

It is important to note that Reg BI does not establish a fiduciary standard of conduct and therefore does not include a clear, stand-alone duty of loyalty, unlike the fiduciary obligation under CFP Board *Standards.* In that respect, CFP Board *Standards* more closely reflects the scope and spirit of the prudent person rule.

2. Providing Firms Leeway in Developing and Implementing Policies and Procedures

[14] Financial Advice is defined broadly and includes recommendations as to non-securities-based financial assets, such as bank instruments, real estate, and insurance products. *See* "Financial Advice" and "Financial Assets" in CFP BOARD CODE OF ETHICS AND STANDARDS OF CONDUCT (March 2018), *available at* https://www.cfp.net/docs/default-source/for-cfp-pros---professional-standards-enforcement/CFP-Board-Code-and-Standards.

[15] COMMENTARY, at p. 4.

[16] *Id.*

[17] *Id.*

Both Reg BI and CFP Board *Standards* acknowledge the importance of firms' policies and procedures. In addition to having duties to their clients, CFP® professionals have duties to their firms, one of which is complying with internal firm policies and procedures, so long as the policy or procedure does not conflict with CFP Board *Standards*.

Firms' written policies and procedures play a large part in Reg BI's conflict of interest obligations. Under proposed Reg BI, firms would be required to establish, maintain, and enforce written policies and procedures reasonably designed to comply with Reg BI's framework of dealing with conflicts of interest. The SEC believes "there is no one-size-fits-all framework, and broker-dealers should have flexibility to tailor the policies and procedures to account for, among other things, business practices, size and complexity of the broker-dealer, range of services and products offered and associated conflicts presented."[18]

As with the CFP Board *Standards*, Reg BI gives firms and associated persons some latitude to tailor and depend on their own written guidelines that fit their business, so long as certain required parameters are met. Firms' written policies and procedures must be reasonably designed to comply with the conflicts of interest obligations of Reg BI. In drafting and applying these written policies and procedures, broker-dealers would be permitted to exercise their judgment to account for unique aspects of their business. The SEC envisions a risk-based compliance and supervisory system to accommodate a variety of different business models and to allow for a facts-and-circumstances evaluation of any given situation. CFP Board envisions the same business model-neutral, risk-based approach in its *Standards*, in particular by examining the conflict's potential for harm in determining whether there was informed consent to the conflict.

3. Similar Approaches to Documentation of the Decision-Making Process

Both CFP Board *Standards* and Reg BI allow for principles-based documentation of the process leading up to the final advisory decision. There is no specific documentation standard that applies to all financial advice in the revised CFP Board *Standards*. However, during the financial planning process, the CFP Board *Standards* requires "a CFP® professional to act prudently in documenting information as the facts and circumstances require, and expressly takes into account the [firm's] policies and procedures."[19] Gathering and maintaining documents to evidence the formation of a basis for decisions made during the financial planning process is a flexible activity. Because this is a facts-and-circumstances-based inquiry, the process already may be covered by the firm's own internal policies and procedures. Consistent with the letter and spirit of the CFP Board *Standards*, CFP® professionals must use sound judgment to determine whether a specific situation warrants the keeping of documentation related to their decision-making process. CFP Board will issue guidance materials to more clearly illustrate how the CFP Board *Standards* will be applied in certain situations with differing fact patterns.

Similarly, Reg BI does not prescribe hard-and-fast rules on creating and maintaining documents on a registered representative's decision-making process. Rather, it requires that the broker-dealer or registered representative have a "reasonable basis" for recommending a transaction that would be in the best interest of at least some customers, or of a particular customer, or that a series of recommendations would be in the customer's best interest.

[18] Reg BI, at p. 21618.
[19] COMMENTARY, at p. 19.

4. Educational Materials Exception

Reg BI and CFP Board *Standards* appropriately carve out exceptions to the best interest requirement for educational materials and other client-facing documents that do not provide specific recommendations or advice. For example, the definition of "Financial Advice" under CFP Board *Standards* "excludes the provision of services or the furnishing or making available of marketing materials, general financial education materials, or general financial communications that a reasonable CFP® professional would not view as 'Financial Advice.' "[20] Reg BI excludes from the meaning of "recommendation" communications that would include "providing general investor education (e.g., a brochure discussing asset allocation strategies) or limited investment analysis tools (e.g., a retirement savings calculator)."[21]

B. Differences

While Reg BI and the CFP Board *Standards* share important similarities, certain obligations outlined under each are quite different. CFP Board *Standards* provides a consistent and robust set of fiduciary principles that translate into an effective investor protection standard. In contrast, certain components of proposed Reg BI remain ill-defined and overly reliant on disclosure. CFP Board is concerned that these key differences will result in a diluted investor protection standard under Reg BI that will not meet the Commission's objectives with respect to retail investors.

1. Definition of "Best Interest"

Under CFP Board *Standards,* "best interest" clearly and unambiguously means a fiduciary duty. The fiduciary duty encompasses both a duty of loyalty and a duty of care. The duty of loyalty and duty of care flow directly from traditional fiduciary duty concepts applicable to investment advisers under the Advisers Act. The fiduciary duty is clearly stated and defined, and must be satisfied through the management of conflicts, and not simply through disclosures, policies or procedures. All CFP® professionals owe the fiduciary duty to their clients whenever providing Financial Advice, regardless of the business model under which they operate. By contrast, under Reg BI only a duty of care is required and the SEC notes in the rulemaking package, it "[is] not proposing to define 'best interest' at this time."[22]

The Commission overcomplicates the regulations applying to broker-dealers providing investment advice by establishing yet another conduct standard to this activity. During consideration of the DOL Fiduciary Rule, it was suggested that only a uniform and consistent standard would cure investor confusion about the different roles that different professionals play and the different standards of conduct to which they are held. We agree that the goal should be a consistent investment advice conduct standard across account types and advice providers. This is particularly important in an environment where services provided by broker-dealers and investment advisers are indistinguishable to the average investor. As such, Reg BI fails to accomplish its purported investor protection goals.

Moreover, by failing to clearly define "best interest", it is not clear what standard is being

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[20] COMMENTARY, at p. 3.
[21] Reg BI at p. 21593.
[22] Reg BI, at p. 21587. The SEC went on to say, "Instead, we preliminarily believe that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Reg BI are satisfied." *Id.*

applied. The proposed rule text, which requires brokers to act in the best interests of their customers and prohibits them from placing their interests ahead of their customer's interests, is the same language that has been used to describe a broker's obligation under FINRA's suitability rules, an investment adviser's fiduciary duties under the Advisers Act, and the requirements under the DOL Fiduciary Rule. All of these standards are different in significant ways and it is not clear how the proposed standard is similar to and different from each of these established standards.

2. CFP Board *Standards*' Fiduciary Duty Includes a Distinct and Separate Duty of Loyalty

CFP Board *Standards* prominently features a duty of loyalty that incorporates "without regard to" language originally found in Section 913(g) of Dodd-Frank, thereby placing an affirmative requirement on the CFP® professional to act in the best interest of the Client when conflicts arise. This requirement mandates that the CFP® professional be proactive in placing the Client's interests above his or her own interests or the firm's interests. These interests may be financial or non-financial. If a conflict cannot be avoided, the CFP® professional must fully disclose the material conflict, obtain the Client's informed consent, and properly manage the conflict. This step-by-step process is similar to what is required under the Advisers Act and makes clear that disclosure alone is insufficient to satisfy the duty of loyalty under CFP Board *Standards*.

In contrast, Reg BI lacks a separate, distinct, and well-defined duty of loyalty. Instead, Reg BI attempts to incorporate the concept of loyalty in the requirement to put customers' interests "ahead of" those of the broker-dealer. But the term "ahead of" is likewise undefined. It appears that "best interest" will be satisfied *primarily* through disclosures, firms' written policies and procedures as to conflicts of interest, and the duty of care."[23]

The duty of loyalty, along with the duty of care and the duty to follow client instructions form the three-part fiduciary duty under CFP Board *Standards*. It brings clarity to what is expected of the CFP® professional and aligns with retail investors' reasonable expectation that they should always receive advice that is "in their best interests."

3. Conflicts of Interest

CFP Board *Standards* has a single, uniform method of dealing with conflicts of interest, regardless of how they originate. Reg BI, however, distinguishes between different types of conflicts of interest and applies different approaches to handling them, depending on whether they stem from financial incentives or the recommendations themselves.

Rather than relying solely on firms' written policies and procedures, CFP Board *Standards* directs CFP® professionals to take affirmative steps and concrete actions to rein in conflicts of interest. All CFP® professionals must "avoid or disclose and **manage** conflicts of interest." CFP® professionals have two choices when it comes to handling conflicts: either (i) avoid the conflict or (ii) fully disclose the material conflict to the client, obtain the client's informed consent, and properly **manage** the conflict. This applies to all Financial Advice and remains true whether

[23] The SEC explained that its choice of the term "ahead of" stemmed from its concern that "inclusion of the 'without regard to' language [as mandated by Section 913(g) of Dodd-Frank] could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts (i.e., require recommendations that are conflict free)." Reg BI, at p. 21586.

the conflict originates from a recommendation or the advice itself, or an incentive linked to that recommendation or advice.

Reg BI provides different avenues for handling conflicts related to recommendations and conflicts linked to financial incentives. If the material conflict has to do with the recommendation itself, then it either must be eliminated or disclosed. Material conflicts relating to financial incentives must be eliminated or disclosed and mitigated. Mitigation is undefined because the SEC does not seek a one-size-fits-all solution and gives firms the flexibility to develop their own mitigation procedures. Financial incentives are undefined but broadly interpreted to cover compensation incentives, sales of proprietary products, sales contests, and transactions in a principal capacity. Reg BI's conflict of interest obligations are anchored to the written policies and procedures that the broker-dealer reasonably designs, establishes and maintains, rather than on the words, actions, and behaviors of associated persons.

It should be recognized that the requirement for firms to mitigate conflicts of interest that arise from financial incentives has the potential to be one of the most beneficial provisions in Reg BI. However, it is unclear what conflict mitigation practices are required and what practices are restricted.

4. "Client" v. "Retail Customer" v. "Retail Investor"

CFP Board *Standards*' definitions capture a broader segment of the population seeking investment advisory services. A "Client" is defined as "Any person, including a natural person, business organization, or legal entity, to whom the CFP® professional provides or agrees to provide Professional Services pursuant to an Engagement."[24] This definition encompasses a variety of individuals and organizations, regardless of their accredited investor or similar status, and regardless of the purpose for which they seek the services of a CFP® professional. It is more comprehensive than either the "retail customer" definition in proposed Reg BI or the "retail investor" definition in the proposed Form CRS.

Reg BI would not apply to business organizations or legal entities. It would also be limited to personal, family, or household purposes. We believe this coverage gap potentially leaves smaller businesses' employee benefit plans without viable options to ensure that they receive sound and unbiased advice. We fundamentally disagree with a "purpose test" (i.e., personal, family or household purpose) and believe that those smaller organizations that are, in turn, responsible for the welfare of their retail beneficiaries should also have the benefit of robust investor protections.

III. The Need for a Bright Line: The Broker-Dealer Exclusion of the Advisers Act

When the federal securities laws were enacted, Congress drew a distinction between broker-dealers, who were regulated as salespeople under the Securities Exchange Act of 1934, and investment advisers, who were regulated as advisers under the Investment Advisers Act of 1940. Brokers were excluded from regulation under the Advisers Act only to the extent that they limited themselves to a sales function and provided advice "solely incidental" to such sales without receiving "special compensation" for such advice.[25]

Over the last several decades, however, the roles of broker-dealers and investment advisers

[24] *Standards*, at p. 13.
[25] Investment Advisers Act, Section 202(a)(11)(C).

have largely converged. While differences remain, many broker-dealers today offer advisory services, such as investment planning and retirement planning that are similar to the services offered by investment advisers. In addition, many broker-dealers use titles such as "financial adviser" for their registered representatives and market themselves in ways that highlight the advisory aspect of their services. The original broker-dealer exclusion from the Advisers Act has broadened beyond its original intent to allow incidental advice to include a wider range of investment services.

Because federal regulations have not kept pace with changes in business practices, broker-dealers and investment advisers are subject to different legal standards when they offer advisory services. Those legal standards – a suitability standard for broker-dealers and a fiduciary duty for investment advisers – afford different levels of protection to the investors who rely on those services.

Investors, on the other hand, typically make no distinction between broker-dealers and investment advisers, and most are unaware of the different legal standards that apply to advice and recommendations. Although many investors don't understand the meaning of "fiduciary duty," or know whether it or suitability represents the higher standard, investors generally treat their relationships with both broker-dealers and investment advisers as relationships of trust and expect that the recommendations they receive will be in their best interests.

Given the realities of the financial markets today, CFP Board and the Financial Planning Coalition support a uniform fiduciary standard for personalized investment advice. This would ensure that, regardless of who provides advice, a fiduciary standard would apply. How the duty is applied would vary based on the differences in the two business models. This would follow the will of Congress by treating functionally equivalent activity the same by applying a fiduciary standard that is no less stringent than the Advisers Act standard to investment advice, no matter who provides that advice.

The goal of Reg BI is an attempt to fix the inequities that exist in the standards that apply to broker-dealers and investment advisers, both of whom are providing personalized investment advice. However, it falls short of ensuring that investment advice – whether provided by a broker-dealer or investment adviser – is subject to the same high fiduciary standard.

IV. Other Issues

A. Rollovers

Reg BI appears to apply to Individual Retirement Account (IRA) rollovers[26] and therefore would have a substantial impact on billions of dollars in the retirement savings accounts of U.S. retail investors. However, the SEC is encouraged to better define the parameters around the application to IRA rollovers. Given the trend towards self-directed retirement planning, it is critically important that additional regulatory guidance be provided.

Reg BI implies, but never clearly codifies in the text of the proposed rule, that it may apply to

[26] Reg BI, at p. 21595 ("We are not proposing at this time that the duty extend to recommendations of account types generally, unless the recommendation is tied to a securities transaction (e.g., to roll over or transfer assets such as IRA rollovers)."); *See also* Fred Reish, "Interesting Angles on the DOL's Fiduciary Rule #97" (July 10, 2018), *available at* http://fredreish.com/interesting-angles-on-the-dols-fiduciary-rule-97/ (With respect to recommendations to retail customers, as defined by Reg BI, "[b]oth the rollover recommendation and the recommended IRA investments would be covered by the best interest standard.").

IRA rollovers if the rollover recommendation is tied to a securities transaction. The sheer impact of IRA rollovers on the U.S. economy and retail investors' retirement savings warrants an additional provision in Reg BI specifically for IRA rollovers. Given that IRA rollovers represent a primary way workers save for retirement, the SEC should clearly and affirmatively state that IRA rollovers are covered by Reg BI and clearly explain the precise framework in the rule text.

B. Dual Registrants

CFP Board *Standards* addresses the issue of dual registrants and "hat switching" with a clean and elegant solution: a fiduciary standard that applies to all financial advice, and not simply investment advice. Investors are unlikely to understand that a single financial advisor operates under a fiduciary standard in one context and under a suitability standard in another context.

The Coalition believes that the Commission's proposal to restrict the use of the titles "adviser" or "advisor" to registered investment advisers is a limited step in the right direction. However, the restriction is limited in its effectiveness because of its narrow application and failure to account for "holding out." A firm's dual registration status, as both a broker-dealer and investment adviser, should not be the basis upon which representatives of the firm hold themselves out to the public as "advisors."

V. Disclosure-Related Issues

Disclosure is a key component of the securities regulatory scheme. Yet, research conducted on behalf of the SEC and others has demonstrated how challenging it is to develop clear, understandable disclosures in this area, both because the issues to be disclosed are often complex and technical in nature, and because the level of investor understanding of these concepts is typically poor.

A decade ago, for example, RAND Corporation concluded in research conducted on behalf of the Commission that most investors, including those who had employed financial professionals for years, "do not have a clear understanding of the boundaries between investment advisers and broker-dealers."[27] An October 2018 focus group study conducted jointly by RAND Corporation and the SEC's Office of Investor Advocate confirmed that this lack of understanding persists today.[28] Moreover, just as in the 2008 study, researchers in 2018 found that presenting participants with fact sheets describing key differences between broker-dealers and investment advisers did little to dispel that confusion.[29] This is the challenge when trying to develop a disclosure that will enable investors to make an informed choice between different types of investment accounts and service providers.

A 2016 RAND Corporation study examined the academic literature related to effective disclosures in financial decision-making and concluded that, "disclosure, particularly disclosure used in isolation, may not provide sufficient support in helping investors make more informed decisions." Looking specifically at disclosures related to conflicts of interest, the RAND

[27] Angela A. Hung, et al., "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," at p. 87 (RAND, 2008), *available at* http://bit.ly/1OrrZ3v.
[28] *See generally,* Brian Scholl, Ph.D., SEC Office of the Investor Advocate and Angela A. Hung, Ph.D., RAND Corporation, et al. "Re: Investor Testing Regarding Standards of Conduct for Investment Professionals" (Oct. 12, 2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf.
[29] *See generally,* Angela A. Hung, et al., "Investor Testing of Form CRS Relationship Summary" (November 2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4628415-176399.pdf.

researchers found that "many consumers fail to adjust their behavior sufficiently, if at all"[30] when conflicts are disclosed. Research has shown, moreover, "that the longer, more detailed disclosure documents have not been effective at helping consumers make informed choices in selecting mortgages, credit cards, and mutual funds, due to either limited attention or limited understanding of the material itself."[31] Lengthy, detailed disclosures necessary to convey the relevant information would be unlikely to be read or understood by investors.

Based on this real world experience, CFP Board strongly supports the draft "SEC Disclosure Effectiveness Testing Act." As noted above, research conducted on behalf of the SEC and others has shown how difficult it is to convey even the most basic concepts in a way that investors understand. And, it is not enough to simply survey investors or use other informal input to determine whether proposed disclosures would be effective at achieving their regulatory purpose. For this reason, we are particularly pleased that the draft legislation includes a requirement for qualitative testing in the form of one-on-one cognitive interviews of retail investors.

A. Why Qualitatively Test Disclosure?

Simply surveying investors about how they feel with regard to a particular disclosure form or whether they can point to specific information in the form is not enough to determine whether the proposed disclosures would be effective at achieving their regulatory purpose. A deeper look into the way investors analyze and synthesize information is necessary to determine the usefulness of the disclosure document in the investor's decision-making process.

For example, despite the fact that investors say they like the proposed Form CRS disclosure and believe that it is helpful, the 2018 RAND report[32] for the SEC provides compelling evidence that the proposed summary relationship disclosure fails to achieve its intended purpose. The results of that research – and, in particular, the significant discrepancy between the survey results, which document investor opinion, and the findings from the in-depth interviews, which test investor comprehension – highlight just how vitally important qualitative testing is to a determination of whether the disclosures actually support informed investor decision-making.

B. Qualitative Testing of the Proposed Form CRS

Recognizing the important role Form CRS plays in the Commission's proposed regulatory approach to Regulation Best Interest, the Financial Planning Coalition joined with AARP and Consumer Federation of America to engage Kleimann Communications Group, Inc. ("Kleimann"), a non-affiliated third party, for two separate research projects.

The first project was concluded in September 2018 and the findings were filed with the Commission.[33] That research was centered on testing with typical investors the SEC's Dual Registrant Mock-up of Form CRS, which combined disclosures about Broker-Dealer and Investment Adviser in a side-by-side format. That research found that overall, participants had difficulty distinguishing the standards of conduct between different financial professionals, they did not understand how conflicts of interest could affect them, and they struggled with the

[30] Angela A. Hung, et al., "Effective Disclosures in Financial Decisionmaking," at p. 9 (2015), *available at* file:///C:/Users/aratner/Downloads/Effective%20Disclosures%20in%20Financial%20Decisionmaking%20(1).pdf.
[31] *Id.*, at p. 24.
[32] *See* n. 28, *supra*.
[33] AARP, et al., Letter to The Hon. Jay Clayton (dated Sept. 11, 2018), *available at* https://www.sec.gov/comments/s7-08-18/s70818-4341455-173259.pdf.

language used on the form, especially with respect to fees and conflicts of interest.

In a second round of testing,[34] Kleimann, directed by AARP and CFP Board, developed and tested alternate language and design for a suggested Form CRS used by the dually registered Investment Adviser and Broker-Dealer. Within that task, three overarching goals were set for the alternative Form CRS:

1) Enable retail investors to understand the basic services offered by an Investment Adviser, Broker-Dealer, and dual registrant, and the terms under which those services are offered;
2) Enable retail investors to compare the services of an Investment Adviser and a Broker-Dealer; and
3) As a result of improved comprehension and comparability, enable retail investors to make informed decisions about the types of accounts and services that are most appropriate for them.

Toward that end, alternative language and formatting was adopted based on lessons learned in the first round of research. This included shortening the document from four pages to the front and back of one page, reordering the topics, simplifying and clarifying the language in plain English, and adopting a question-and-answer format. The purpose of these changes was to improve the usability of Form CRS, reinforce the differences between the two types of accounts, and thereby facilitate a retail investor's ability to make an informed decision.

Despite extensive revisions to the disclosure document based on investor testing, the inescapable conclusion of this second round of testing, like the previous round, was that many, if not most, investors failed to understand many of the key points illustrated in Form CRS and, therefore, could not use it to make an informed choice of accounts.

For example, participants understood the existence, but not the import, of conflicts of interest. Participants struggled to define "conflicts of interest" although they had a vague and general intuitive sense that it would not be good for them. As previously found, most participants were able to understand, based on Form CRS, that conflicts of interest were present in both the brokerage and the advisory accounts. They understood, moreover, that these conflicts took the form of payments that created incentives to recommend certain products. For most participants, however, that is where their understanding ended, and some did not even demonstrate that level of comprehension.

In addition, participants could not adequately explain what it meant to consent to a conflict. Some participants wondered to what they were giving consent, finding the definition and the timing unclear. Other participants mistakenly assumed that having to give consent implied that they would be giving explicit consent for any transaction that included a conflict of interest. Across testing, few participants knew what the word "mitigate" meant and, thus, were confused about how exactly conflicts of interest were to be handled, some even wondering if they would know if a conflict existed. Finally, some investors were confused by what they considered to be contradictory statements: (1) that the financial professional would work in their best interest; and (2) that same professional would have conflicts of interest. Regardless of whether they saw the conflicts as a threat or simply as business as usual, they want their interests to come first.

[34] AARP, et al., Letter to The Hon. Jay Clayton (dated Dec. 7, 2018), *available at* https://www.sec.gov/comments/s7-07-18/s70718-4729850-176771.pdf.

Too often, mandated disclosures, as in the proposed Form CRS, are too technical, wordy and lengthy to be useful to investors. The danger on the other end is that the disclosures are nothing more than marketing tools. Conducting thorough one-on-one cognitive testing is the only way of determining if a proposed disclosure document will meet its intended purpose.

VI. Conclusion

We believe that the Reg BI package of proposals presents an opportunity to strengthen investor protection for retail investment advice. We encourage the Commission to improve the rule proposals, as suggested by the Financial Planning Coalition and others, so that it lives up to its promise.

Written Statement of Harvey L. Pitt
Founder, CEO and Managing Director
Kalorama Partners, LLC and Kalorama Legal Services, PLLC

Before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House Committee on Financial Services,

"Putting Investors First? Examining the SEC's Best Interest Rule"

KALORAMA PARTNERS

KALORAMA LEGAL SERVICES

March 14, 2019

Written Statement of Harvey L. Pitt
Founder, CEO and Managing Director
Kalorama Partners, LLC and Kalorama Legal Services, PLLC
Before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House Committee on Financial Services, "Putting Investors First? Examining the SEC's Best Interest Rule"

(March 14, 2019)

Chair Maloney, Ranking Member Huizenga, Members of the Subcommittee:

I. Introduction

I am Harvey Pitt, the Founder, CEO and Managing Director of the global strategic business consultancy, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC. Prior to founding the Kalorama firms, I was privileged to serve as the twenty-sixth Chairman of the Securities and Exchange Commission ("SEC" or "Commission"), from 2001-2003; I had previously served as the first Chief Counsel of the SEC's then Division of Market Regulation (today, the Division of Trading & Markets), from 1973-1974, and as the SEC's General Counsel, from 1975-1978.[1]

I am grateful for the opportunity to testify this morning on a subject of vital importance—the SEC's package of regulatory proposals regarding the standards of professional conduct to which securities professionals should adhere, for the benefit of their clients and customers.[2] At the request of the Committee's Chair,

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[1] My full curriculum vitae is attached to this Written Statement, as requested by the full Committee's Chair, and I do not repeat my background and experience here.

[2] In April 2018, the SEC issued a package of three proposed rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers, while preserving access to a variety of types of advice-obtaining relationships and investment products: Proposed Regulation Best Interest, Securities Exchange Act Rel. No. 83062 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf; Proposed Form CRS Relationship Summary; Amendments to SEC Form ADV; Required disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, Securities Act Rel. No. 83063 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf; and a Proposed Commission Interpretation Regarding the Standard of Conduct Applicable to Registered Investment Advisers, Inv. Advisers Act Rel. No. 4889 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf (collectively, "Reg BI").

I also will offer my views with respect to draft legislation, with the short title of the "SEC Disclosure Effectiveness Testing Act" ("DETA").

I am appearing here today in my personal capacity, not on behalf of my Kalorama firms, their clients, or any of my Kalorama colleagues.[3] In addition, the views I present to this Subcommittee this morning have not been influenced, directly or indirectly, by any clients the Kalorama firms currently represent, or may have represented in the past.

II. Summary of Views

My views on the topics under review by this Subcommittee can be summarized as follows:

- Proposed Reg BI is an impressive, creative and well-planned effort by the Commission to put the interests of main stream investors first, by clarifying the standards of conduct expected of market professionals, and enhancing the quality of service investors have a right to, and should, receive from their securities professionals;

- The proposed Regulation should be seen as an initial step in bringing securities professionals into the twenty-first century, by placing a premium on substance, rather than labels;

- Unlike other rules the SEC has, in the past, adopted, the package of rules and interpretations constituting proposed Reg BI will warrant regular monitoring and, presumably, subsequent tweaking, as experience is gained in how Reg BI operates in actual practice;

- Reg BI creates a strong addition to the arsenal of protections already applicable to securities broker-dealers and investment advisers, and will materially raise the quality of service investors receive from their securities professionals, without sacrificing the ability of investors to choose which professionals, and what services, they seek to obtain;

- There are major differences in certain of the functions performed by securities broker-dealers, on the one hand, and SEC-registered investment advisers, on the other, which make it sensible for the Commission to avoid becoming mired in legal terminology; rather, the

[3] This written testimony reflects solely my own views, and was prepared and written solely by me, with research assistance from my Kalorama colleagues, working solely under my supervision. I have not received any compensation, in any form, either directly or indirectly, for my appearance here, or the views I express.

SEC has embraced a pragmatic and effective standard—putting the best interests of customers ahead of any potential significant profit interests of the firms that employ these securities professionals;

- Most of the criticisms that have been raised against Reg BI reflect one or more of the following unfortunate deficiencies:
  - A misunderstanding of the actual terms of the proposal;
  - A misunderstanding of the study and efforts that went into the creation of the proposal;
  - Competitive concerns by investment-adviser only operations; and
  - The failure to recognize that the worst enemy of a good proposal is a "perfect one;" and
- The draft DETA is poorly-worded, and ill-advised; it would effectively engender only one result if passed at present—preventing the SEC from implementing the needed reforms incorporated within Reg BI.

III. Reg BI[4]

As proposed, Reg BI would establish a standard of conduct for broker-dealers (and their associated account executives) who make recommendations to retail customers of any securities transaction or investment strategy involving securities to act in the "best interest" of the retail customer at the time the recommendation is made. Although there has been some criticism of the fact that the term "best interest" is not formally defined as part of the SEC's rulemaking, the Regulation makes clear that both the broker-dealer and any natural person interacting with the retail customer (usually, the "account executive" or "financial advisor") must make these recommendations without placing the financial or other interests of the firm, or the individual account executive, ahead of the interest of their retail customer.[5]

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[4] There are many useful summaries of the package of rules and proposed interpretations that comprise Reg BI. *See, e.g.*, Y. Lee, S. Nicolas & J. Toner, "*SEC's Standards of Conduct for Investment Professionals Rulemaking Package*, WILMERHALE (Apr. 2018), prepared for the Securities Industry and Financial Markets Association ("SIFMA"), available at https://www.sifma.org/wp-content/uploads/2018/04/WilmerHale-Summary-re-Reg-BI.pdf ("*WH Analysis*").

[5] *See* Securities Exchange Act Rel. No 83602, *supra* n. 2, at p. 8.

Moreover, the Regulation expressly provides that this obligation of putting the retail investor's best interest ahead of those of the brokerage firm or its account executive are satisfied if

- The firm and its account executive reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, as well as all material conflicts of interest implicated by specific recommendations;[6]
- The firm and its account executive exercise reasonable diligence, care, skill, and prudence in making the covered recommendations;[7]
- The firm establishes, maintains and enforces written policies and procedures reasonably designed to identify and, at a minimum disclose, or eliminate, all material conflicts of interest that may be associated with the recommendations;[8] and
- The firm establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest that arise from the financial incentives applicable to such recommendations.[9]

Significantly, and in my view appropriately, nothing in the proposed Regulation requires broker-dealers to recommend the least expensive or least remunerative securities or investment strategies, as long as the firm and its associated individuals comply with the disclosure, care and conflict of interest obligations that would be created by the Regulation. This is significant, because the mere fact that a brokerage firm, or an account executive, receive additional remuneration for pursuing certain strategies or securities does not, *ipso facto*, make the recommendation improper, unsuitable, or contrary to the best interests of the retail customer.

On the other hand, if a recommendation were primarily motivated by a broker-dealer or its individual account executive's self-interest, it would violate both the care and the conflict of interest obligations set forth in the

6 *Id.*

7 *Id.*, at p. 9.

8 *Id.*

9 *Id.*

proposed Regulation.[10] The advantage of this structure is that it wisely avoids prohibiting transactions that may be financially advantageous to a retail customer, notwithstanding the fact that it could permit the brokerage firm and/or its individual account executive to receive additional remuneration from the remuneration that would be generated by alternative possible recommendations.

The proposed Regulation fits carefully into the existing panoply of regulations governing the conduct of broker-dealers and their individual account executives and, concomitantly, differs from recommendations of the SEC Staff Study regarding the obligations of brokers, dealers and investment advisers, undertaken in response to Dodd-Frank Act ("DFA") §913(b).[11] Instead of creating either a new standard for broker-dealers, or adopting wholesale the obligations and duties that have arisen under a separate regulatory regime that addresses a different type of advice relationship, the proposed approach adds to the current broker-dealer regulatory regime.[12] On the other hand, the proposed Regulation draws upon the similar duties of loyalty and care applicable to registered investment advisers, as those have been interpreted under the Investment Advisers Act of 1940 "(IAA").[13]

IV. Proposed Form CRS Relationship Summary

As part of its package comprising Reg BI, the SEC also would require both investment advisers and broker dealers to deliver a "relationship summary" to retail investors (Form CRS), in addition to current disclosures and requirements.[14] The new rules would require broker-dealers and investment advisers to file a proposed form CRS with the Commission as well as delivering it to new customer

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[10] *Id.*, at p. 58.

[11] The DFA was enacted and signed into law on July 21, 2010. *See* Pub. L. No. 111-203 (2010). Section 913 was codified at 15 U.S.C. §§78o, 80b-11. *See, e.g.*, T. Hazen, "*Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*," 15 N.C. BANKING INST. 47, 48 & n. 7 (2011). *See* SEC Staff, "*Study on Investment Advisers and Broker-Dealers*" (Jan. 2011), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf ("*Staff Study*"). The *Staff Study* had recommended a uniform standard for investment advisers and broker-dealers when providing personalized investment advice to retail investors. *See Staff Study*, at pp. v-vi, 109-110.

[12] In proposing Reg BI, the Commission stated that it was not eliminating existing broker-dealer obligations. *See* Securities Exch. Act Rel. No. 83062, *supra* n. 2, at p. 42. *See, e.g.*, *WH Analysis*, *supra* n. 4, at p. 3.

[13] *See* IAA §§206(1) and (2), 15 U.S.C. §§80b-6(1) and 80b-6(2). *See, e.g.*, *WH Analysis*, *supra* n. 4, at p. 5.

[14] *See* Securities Exch. Act Rel. No. 83063 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

or advisory client, and, when the nature of the relationship changes or involves different accounts, deliver it to existing customers and advisory clients. The generic forms must also be posted on each firm's website. To facilitate understanding of the new requirements, the Commission also provided sample disclosures, both for dual registrants and for standalone broker-dealers and investment advisers. In addition, the SEC proposed to bar registered broker-dealers and individual account executives from using the term "adviser" or "advisor" as part of the name or title, unless there is coverage for the firm or the account executives under the IAA.[15]

V. Proposed Interpretation of the Standard of Conduct for Investment Advisers[16]

As part of its Reg BI package, the SEC proposed to "reaffirm," and in some cases "clarify," certain aspects of a registered investment adviser's fiduciary duties.[17] The proposal noted that an investment adviser's fiduciary duties are not explicitly included or defined under the IAA, or in any of the SEC's rules, but have evolved under common law, and also are dependent on the precise nature of the relationship spelled out in the adviser's advisory contract.[18]

Among other things, the Fiduciary Duty Interpretation Release indicated that investment advisers owe their customers both a duty of care and a duty of loyalty, which include:

- An obligation to provide advice that is in the adviser's client's best interest;
- A duty to seek best execution when the adviser is responsible for selecting the executing broker-dealer;
- A duty to provide advice and monitoring over the course of the

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15 This would, presumably, preclude the use of the very popular current title for individuals employed by brokerage firms of the title "financial advisor," unless there was dual registration for the firm or the individual as a registered investment adviser.

16 *See* IAA Rel. No. 4889 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf ("Fiduciary Duty Interpretation Release").

17 *Id.*, at p. 5. The proposed interpretation would apply to all investment advisers, including those who are exempt from SEC registration. *WH Analysis*, *supra* n. 4, at p. 18.

18 Fiduciary Duty Interpretation Release, *supra* n. 16, at p. 6.

relationship;

- A proscription of favoring its own interests ahead of those of its clients;
- A bar against favoring certain clients over others;
- Avoiding conflicts and fully disclosing the conflicts that do exist;
- Eliminating "grammatical fraud"—that is, if a conflict *does* exist, advisers cannot say that it *may* exist;
- Obtaining meaningful informed consent to potential conflicts, not including consent merely by inference; and
- Noting that, in some cases, disclosure may not be sufficient to cure a conflict.

VI. Draft DETA Legislation

As part of the Subcommittee's consideration of Reg BI, the Chair of the full Committee attached a copy of the Draft DETA legislation. While the appropriateness of investor/consumer testing in appropriate cases is a valuable adjunct to agency rulemaking efforts, this legislation is wholly unnecessary here, and in any event is poorly worded and would serve to obstruct legitimate efforts at SEC rulemaking.

In connection with its proposed Form CRS, the SEC's Office of the Investor Advocate engaged the RAND Corporation to conduct a nationwide survey and qualitative interviews of investors to gather feedback on a sample Relationship Summary.[19] Thus, whatever merits a disclosure effectiveness testing requirement might otherwise have, this legislation is superfluous here, since the Commission caused such testing to be performed in connection with these rules.

Beyond this, the proposed legislation is poorly worded, and would likely be used by those with different objectives to hamstring almost any rulemaking effort involving investor disclosures that the Commission may consider. The rules that are the focus of the Subcommittee's hearings today are an enormous and important step forward, and they do not deserve to be hamstrung by procedural

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[19] *See* A. Hung, K. Carman, J. Cerully, J. Dominitz & K. Edwards, "*Investor Testing of Form CRS Relationship Summary*," RAND CORP. RESEARCH REPORT (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf.

questions regarding potential claims that, whatever investor testing occurred was inadequate or insufficient for some spurious reason.

Finally, I think it is important to note that, while consumer testing may be a useful adjunct to rulemaking, singling out the SEC as the sole financial services regulator that would be subject to this type of requirement is a poor way, in my opinion, to elevate the general standards of federal agency rulemaking. If these requirements make sense, they should be applicable to all financial services federal agencies, and not solely the SEC.

VII. Misguided Criticisms of the Commission's Rulemaking Package

As noted, many of the criticisms of the Commission's proposals reflect a fundamental misunderstanding of the substance of the Commission's proposals. For example, some have suggested that the proposed regulation does not do enough to *prevent* a broker's conflicts from tainting its recommendations, and the rule does not prevent brokers from creating incentives that put the firm's interests ahead of its clients' interests. In fact, if a recommendation were primarily motivated by a broker-dealer's self-interest, it would directly violate the Care and Conflict of Interest Obligations set forth in the proposed rule. Disclosure would not be enough, and conflicts arising from financial incentives must be mitigated or even eliminated completely.

Similarly, it has been suggested that the Commission's economic analysis was lacking, and therefore does not support its regulatory proposals. This claim misperceives the fact that the Commission had been studying this issue for almost eight years before it issued Reg BI, and the Commission evaluated each of the issues set forth in DFA §913. The resulting proposal reflects a remarkable effort to utilize all the information at the Commission's disposal to craft a rule that would surely benefit all investors.

VIII. Conclusion

As I noted at the outset, I appreciate this opportunity to address the Commission's Reg BI. I believe the Commission has done an outstanding job in crafting its proposed Regulation, and that, with the benefit of the thoughtful comments it has received, it will fine-tune its proposal and provide all investors with the kinds of protection they surely deserve.

Consumer Federation of America

Testimony of

Barbara Roper, Director of Investor Protection
Consumer Federation of America

Before

Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives

On

Putting Investors First? Examining the SEC's Best Interest Rule

March 14, 2019

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee:

Thank you for inviting me to testify today. I am Barbara Roper, director of investor protection for the Consumer Federation of America (CFA). CFA is a non-profit organization that was founded in 1968 to advance the consumer interest through research, advocacy, and education. For more than three decades, CFA has sought to strengthen the safeguards that apply when individuals turn to financial professionals for help with their investments. Because investors rely heavily on the recommendations they receive from financial professionals, and because they suffer very real financial harm when those financial professionals place their own interests ahead of their customers' interests, we have identified strengthening the standard of care that applies to broker-dealers and investment advisers as the single most important step policymakers could take to improve protections for the millions of average working Americans who turn to our financial markets to fund an independent and secure retirement, a child's college education, or other long-term goals.

Accordingly, CFA was a strong supporter of language in Section 913(g) of the Dodd-Frank Act that provides a framework for Securities and Exchange Commission (SEC) rulemaking to adopt a uniform fiduciary standard for broker-dealers and investment advisers. Since the Dodd-Frank Act's enactment nearly a decade ago, we have repeatedly urged the SEC to use this authority to adopt rules to ensure that broker-dealers and investment advisers alike act in their customers' best interests, and without regard to their own conflicting financial interests, when providing personalized investment advice to retail investors. That is what investors reasonably expect when they turn to a financial professional for advice about their investments, and that is what the SEC claims to have achieved with its proposed Regulation Best Interest regulatory package.[1]

Unfortunately, we and others who have closely examined the SEC proposal have concluded that the reality is quite different.[2] Regulation Best Interest (Reg BI), as drafted and interpreted in the proposing Release, falls far short of the standard Congress identified as appropriate when it enacted the Dodd-Frank Act. For example:

- **It does not create a uniform standard for broker-dealers and investment advisers.** As a result, investors would still bear the burden of understanding differences in the standards that apply to different types of securities accounts and how those differences might affect the advice they receive.

- **It does not create an unambiguous obligation for brokers to do what is best for their customers.** As a result, investors would be misled into expecting protections the rule does not provide and relying on advice tainted by conflicts of interest.

[1] The regulatory package has three parts: Regulation Best Interest, which outlines a new standard of care for broker-dealers, Investment Advisers Act Guidance, which details the Commission's interpretation of the Advisers Act fiduciary standard, and the Customer Relationship Summary, or Form CRS, which broker-dealers and investment advisers would be required to provide to clients at the outset of the relationship.

[2] CFA issued a press release when we submitted our comment letter to the SEC on Reg BI highlighting the most serious problems with the proposal and identifying where in our comment letter a more detailed discussion of the issues can be found. A copy of the press release is available in **Appendix A**.

- **It does not prevent brokers from placing their own interests ahead of customers' interests in most circumstances.** As a result, brokerage firms would remain free to engage in common industry practices that encourage and reward conduct that is harmful to their customers.

- **It does not provide investors with the tools they need to distinguish between broker-dealers and investment advisers or to understand key differences in the services they provide.** As a result, investors will continue to struggle to determine which type of account would best suit their needs.

Because of these and other shortcomings in the proposed rule, it is not clear to what extent, if at all, Reg BI improves on protections already afforded under the FINRA suitability standard that currently governs brokers' sales recommendations. Indeed, to the degree that the Commission has reduced inconsistencies in the advice standards for broker-dealers and investment advisers, it has achieved that more by adopting a weak interpretation of the Investment Advisers Act fiduciary standard than by raising the standard of conduct for broker-dealers. That helps to explain why support for the proposal has come almost exclusively from the brokerage industry, whose members would benefit from being able to claim they act in customers' best interests without actually having to do so. In contrast, state securities regulators, investor advocates, and fiduciary advisers have all raised serious concerns regarding Reg BI's failure to deliver the strong protections that vulnerable investors need and expect when they entrust their financial future to an investment professional.

The good news is that it is still possible for the SEC to adopt sufficient changes to Reg BI for the regulation to earn its "best interest" label. The SEC could do this without having to start its rulemaking process from scratch, by adopting a handful of changes to the regulatory text and then supporting the standard in the final Rule Release with appropriate interpretative language.[3] Toward that end, we have had, and continue to have, an open dialogue with Chairman Clayton, members of the Commission, and SEC staff about the changes needed to ensure that Reg BI strengthens, rather than weakens, existing investor protections. However, it is too early to say whether those changes will be incorporated in a final rule. Today's hearing sends a welcome message that this Committee continues to view adoption of a rule that truly puts investors' interests first as a priority.

For the remainder of this testimony, I will provide a brief overview of the key changes and clarifications that are needed to turn Reg BI into a true best interest standard. I will also discuss the draft disclosure testing legislation under consideration by the Committee. Had that legislation been in place before Reg BI was proposed, the SEC might have avoided the disclosure disaster that is Form CRS. If enacted, this bill would help to ensure that the disclosures that investors rely on today as well as the ones that the Commission develops in the future are designed and drafted to convey information in a way that investors are more likely to read and better able to understand, with the result that investors should be able to make better informed investment decisions.

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[3] Many of the problems in Reg BI result from a combination of vagueness in the rule text and harmful language in the proposing Release. Accordingly many, though not all, of the necessary changes could be accomplished by revising the interpretive language in the proposing Release.

Changes Needed to Turn Reg BI into a Standard that Puts Investors' Interests First

While we would have strongly preferred that the Commission follow the will of Congress and adopt a rule based on Section 913(g) of the Dodd-Frank Act, we do believe it is still possible for the Commission to adopt a pro-investor rule based on its current regulatory approach.[4] However, doing so will require some fundamental changes to and clarifications of the proposed standard. Problems with the Commission's proposed rule are too numerous to detail here. The following are among the most pressing priorities to ensure that the standard truly puts investors' interests first and reins in harmful practices. Without these changes, the proposal will have the unintended effect of putting investors at even greater risk, by misleading them into placing their trust in conflicted advice that exposes them to unnecessary costs, substandard performance, or inappropriate risks.

1) "Best interest" must be defined to provide meaningful protections.

Reg BI theoretically requires brokers to act in the best interests of their customers when making a recommendation, but nowhere in either the regulatory text or the 408-page proposing Release does the Commission explain what it means by "best interest." This is a glaring omission, since the same language has been used to describe three very different standards: the existing FINRA suitability standard governing broker-dealer sales recommendations,[5] the Investment Advisers Act fiduciary duty,[6] and the Department of Labor's now defunct fiduciary rule.[7] FINRA has indicated that Reg BI would simply make "explicit" an obligation to act in the best interests of the customer that is "implicit" under its suitability standard.[8] This interpretation is reinforced by the Release's inclusion of the "requirement to make recommendations that are 'consistent with his customers' best interests'" on a list of Reg BI's enhancements to the Securities Exchange Act suitability standard that are already reflected in FINRA rules.[9] Nowhere does the Release specify how the proposed best interest standard would actually enhance FINRA suitability in any tangible way.

[4] **Appendix B** includes a redline of the proposed standard showing how it could be revised to truly put investors' interests first.
[5] FINRA Rule 2111 (Suitability) FAQ, https://bit.ly/2Ktkix1. ("The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests.")
[6] SEC 913 Study at iii. ("An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own.")
[7] Department of Labor, Employee Benefits Security Administration, Best Interest Contract Exemption, Federal Register / Vol. 81, No. 68 / Friday, April 8, 2016. ("The exemption strives to ensure that Advisers' recommendations reflect the best interest of their Retirement Investor customers, rather than the conflicting financial interests of the Advisers and their Financial Institutions.")
[8] Letter from Robert W. Cook, FINRA President and Chief Executive Officer, to Senators Elizabeth Warren, Sherrod Brown, and Cory Booker, August 3, 2018, at 4.
[9] Release at 10, footnote 7. ("Some of the enhancements that Regulation Best Interest would make to existing suitability obligations under the federal securities laws, such as the collection of information requirement related to a customer's investment profile, the inability to disclose away a broker-dealer's suitability obligation, and a requirement to make recommendations that are "consistent with his customers' best interests," reflect obligations that already exist under the FINRA suitability rule or have been articulated in related FINRA interpretations and case law... Unless otherwise indicated, our discussion of how Regulation Best Interest compares with existing suitability obligations focuses on what is currently required under the Exchange Act.")

At the very least, if the meaning of this critically important term is left ambiguous, investors won't know what protections they can reasonably expect when dealing with a broker-dealer, and brokers won't know what they need to do to comply with the standard. Worse, as state securities regulators noted in a recent letter to the Commission, in the absence of clarity, industry groups have interpreted the term in a way that minimizes any benefits the rule might otherwise offer. As NASAA states in its letter: "Industry groups have seized upon the SEC's emphasis to 'preserve – to the extent possible – investor choice and access to existing products, services, service providers, and payment options' as an invitation to continue business as usual, subverting the Commission's goal of championing the best interests of retail clients."[10] NASAA adds that, "These groups point to the Commission's 'interpretive nuances' as confirmation that pretty much anything and everything will be considered 'acting in the client's best interest' – where disclosure occurs. To these industry groups, no abusive product or practice appears to be off limits."[11] That is a serious charge, coming as it does from the state securities regulators who are the front line in protecting Main Street investors from all-too-common predatory industry practices. We share NASAA's concern over industry lobbyists' apparent confidence that they have succeeded in getting the best interest standard in name only that they asked for in comments they submitted to the Commission as it was drafting the rule proposal.[12]

In challenging the idea that Reg BI simply rebrands the existing suitability standard as a best interest standard, Chairman Clayton has stated that Reg BI would require brokers to give greater consideration to costs when determining what investments to recommend.[13] But that requirement does not appear in the rule text. And the proposing Release suggests that, to the degree this obligation exists at all under Reg BI, it would only apply when the broker is considering "otherwise identical" securities, such as different share classes of the same mutual

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[10] Letter from Michael Pieciak, President of the North American Securities Administrators Association and Commissioner, Vermont Department of Financial Regulation, to SEC Secretary Brent J. Fields, Supplemental Comment Letter to NASAA's 2018 Consolidated Comments to SEC Proposed Rulemakings: Regulation Best Interest (File No. S7-07-18), Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles (File No. S7-08-18), and Standards of Conduct for Investment Advisers (File No. S7-09-18), February 19, 2019, https://bit.ly/2IytBAa, at 2.

[11] *Id.* at 3. NASAA makes clear that it believes this is a misinterpretation of the proposal, but one that is likely to result in significant non-compliance if the Commission does not clarify its meaning.

[12] In comment letters to the SEC before it issued its proposed rule, several industry members characterized FINRA's suitability standard as a "best interest standard" that is "appropriately tailored to a broker-dealer business model" and urged the Commission to adopt this as its model. Their positive reaction to Reg BI suggests they believe that is what the SEC has done. *See, e.g.*, Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, July 21, 2017, http://bit.ly/2uRtdUA; Letter from Dorothy M. Donohue, ICI Acting General Counsel, to the SEC, August 7, 2017, http://bit.ly/2fhXhjU; Letter from Mark R. Bryant, Fidelity Senior Vice President and Deputy General Counsel, to the SEC, August 11, 2017, http://bit.ly/2wLJSKh; Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, February 5, 2018, http://bit.ly/2EXZ5wF; Letter from Michelle B. Oroschakoff, LPL Financial, February 22, 2018, http://bit.ly/2ouvrpe; Letter from Kent Mason, Davis & Harman LLP, on behalf of unnamed clients, January 18, 2018, http://bit.ly/2FrF0fX.

[13] *See, e.g.*, Testimony of SEC Chairman Jay Clayton before the U.S. Senate Committee on Banking, Housing, and Urban Affairs regarding Oversight of the Securities and Exchange Commission, December 11, 2018, https://bit.ly/2QSBV0M. ("Among other things, the obligations under proposed Regulation Best Interest would put greater emphasis on costs and financial incentives as factors in evaluating the facts and circumstances of a recommendation.")

fund.[14] But FINRA has long brought enforcement actions under its suitability standard against brokers who fail to recommend the mutual fund or annuity share class that is most favorable to the customer, rather than the one that is most remunerative to the broker. So, even in the one area the Chairman emphasizes as enhancing existing protections, the Rule Release's interpretation of Reg BI appears to simply codify existing FINRA requirements.

If the goal behind Reg BI truly is to enhance protections for investors, and not simply to preserve the status quo, the Commission must start by clarifying what it means by "best interest," and it must do so in a way that offers protections beyond those already afforded under FINRA rules. The good news is that this can be achieved by building on the foundation of the existing proposed rule and without abandoning a principles-based approach. For example, the proposed Rule already requires brokers to exercise reasonable diligence, care, skill, and prudence. And the proposing Release makes clear that, in order to satisfy this standard, the broker must consider reasonably available alternatives in order to arrive at a recommendation that is in the customer's best interests.[15] These aspects of the proposed rule should be preserved.

What the Commission must additionally make clear is how it will weigh whether a particular recommendation is, in fact, in the customer's best interests. Specifically, the Commission must adopt a principles-based definition of best interest clarifying that a broker acts in a customer's best interest when she recommends, from among the reasonably available suitable options, those investments, investment strategies, services, or accounts that she reasonably believes are the best available match for that investor, taking into account both the investor's needs and the investments' material characteristics.[16] While there will often not be a single "best" option, satisfying a best interest standard should require the broker to narrow down the acceptable options beyond the dozens or even hundreds of investments that would satisfy the existing suitability standard in a given situation. This approach would offer the enhanced protections for investors that Reg BI promises but fails to deliver, while retaining sufficient flexibility to make the standard workable for firms of all sizes, operating under a variety of business models.

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[14] Reg BI Release at 56-57. ("We preliminarily believe that under the Care Obligation, a broker-dealer could not have a reasonable basis to believe that a recommended security is in the best interest of a retail customer if it is more costly than a reasonably available alternative offered by the broker-dealer and the characteristics of the securities are otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance." The accompanying footnote 106 states: "An example of identical securities with different cost structures are mutual funds with different share classes.")

[15] Reg BI Release at 54 ("While to satisfy proposed Regulation Best Interest, a broker-dealer would not be required to analyze all possible securities, other products or investment strategies to find the single 'best' security or investment strategy for the retail customer, broker-dealers generally should consider reasonably available alternatives offered by the broker-dealer as part of having a reasonable basis for making the recommendation, as required under the Care Obligation.")

[16] In advocating this approach, we have made clear that compliance with the standard should be judged based on whether the broker had a reasonable basis for the recommendation *at the time it was made*, not on how it ultimately performed for the investor. We have also made clear that brokers should not be required to consider every investment available in the marketplace in arriving at this determination, but simply those their firm includes on its product menu. Firms, on the other hand, should have an obligation to ensure that they maintain a product mix that is sufficient to enable their registered representatives to comply with their best interest obligations. In its recent recommendation regarding Reg BI, the SEC Investor Advisory Committee also called on the SEC to clarify the meaning of best interest and to do so along these lines, https://bit.ly/2XuF2MI.

If it isn't prepared to require brokers to recommend the investments they reasonably believe are the best match for the investor, the Commission should stop calling this a best interest standard. It is deceptive.

2) The prohibition on placing the broker's interests ahead of the customer's interests must be strengthened and incorporated into the obligation to mitigate conflicts.

The question at the heart of this hearing is whether Reg BI requires brokers to put investors' interests first. It does not. If you want proof, search for the standard's prohibition on placing the broker's interests ahead of the customer's interest in the safe harbor provisions that fully satisfy compliance with the rule. It isn't there. This is a remarkable omission, given the emphasis that Chairman Clayton and members of the rule-writing team have placed on this prohibition in touting the benefits of the rule.[17] Without a clear requirement to place the customer's interests first in the compliance safe harbor, there is little reason to expect that firms will comply.[18]

The broker-dealer business model is rife with conflicts of interest that have the effect, and in some cases the intent, of encouraging recommendations based on the financial interests of the firm and the individual representative rather than the best interests of the customer.[19] This goes far beyond the simple, and relatively benign, conflict of interest that results because brokers get paid through commissions and only get paid when they complete a transaction. The accompanying incentive to recommend transactions regardless of whether they are appropriate can largely be mitigated through supervisory procedures designed to detect and deter excessive trading. Other conflicts of interest are more complex and opaque. The following are examples of the types of conflicts of interest that can be present in a single brokerage transaction:

- If a brokerage firm has a contest underway to reward production goals, the individual sales rep may qualify for lavish trips or prizes if he hits certain production targets.[20] This creates an incentive for that rep to recommend a rollover from a 401(k) plan or a cash withdrawal from a pension plan even if the customer would be better off leaving that money put.
- If the firm is a dual registrant firm offering both brokerage and advisory accounts, the individual rep might get an extra reward from the firm for steering customers into the

[17] See, e.g., Transcript of Miami Investor Roundtable, at 13 https://bit.ly/2BBvjx3 (Chairman Clayton: "We then raise the standard of care that broker-dealers owe their clients to embody what I would call a true fiduciary concept, that a broker can't put their interests ahead of the client's.") See, also, Transcript of Denver Investor Roundtable, at 72 (Chairman Clayton responding to a question from INVESTOR 4 about the meaning of best interest: "It's the fiduciary obligation not to put your interests ahead of the clients', and it's the care obligation to have a series of policies and procedures such that you are exercising care in the recommendations you're making."
[18] NASAA letter at 3. ["In the industry's view, not even conflict-ridden sales practices involving cash and non-cash prizes are being taken off the table as they conjure up carve-outs for 'product-neutral' rewards (as if it matters which high-commission product a broker pulls off the shelf to meet a production target or qualify for some type of cash or noncash award)."]
[19] CFA Fact Sheet, If Financial Firms Support a Best Interest Standard Why do they Encourage Harmful Advice? https://bit.ly/2H8pCJ0.
[20] *See, e.g.*, Corrie Driebusch, Wall Street Revives Reward Junkets for Top Brokers, The Wall Street Journal, July 30, 2014, https://on.wsj.com/2NPNBgB.

type of account that is most profitable for the firm rather than the one that is best for the customer.[21]

- Because certain classes of investments (e.g., non-traded REITs,[22] structured products,[23] or variable annuities[24]) offer significantly higher compensation than other classes of investments (e.g., a mutual fund or ETF), the rep has a strong financial incentive to advise the customer to invest in the higher-cost, less liquid investments that typically offer the most generous compensation.
- In addition, the firm may offer the individual rep extra compensation if he recommends funds that make revenue sharing payments to the firm or impose a sales quota to encourage the sale of proprietary funds, since those are more profitable for the firm, even if the firm has other options available with lower costs or better performance.[25]
- And if the firm uses a retroactive ratcheted payout grid to compensate its reps, a rep who is approaching the next rung on the grid has an added incentive to recommend the products that will get him over the threshold more quickly, since hitting that target will increase his payout not only on future transactions, but on all the transactions he has already completed in that pay period.[26]

Firms that are sincere in wanting their sales reps to act in customers' best interests wouldn't artificially create such powerful incentives for them to do otherwise. If the SEC is sincere in wanting to improve protections for investors, it will rein in avoidable conflicts of interest such as these that clearly undermine the best interest standard.

Ideally, the Commission would revise its standard to incorporate the language from Section 913(g) of the Dodd-Frank Act requiring brokers and advisers alike to act "without regard to" their own financial interests or the interests of their firm when determining what investments to recommend. Under this approach, conflicts of interest would be permitted to exist, but they would not be permitted to taint the recommendations. By willfully disregarding the standard that Congress set out, and in particular by adopting language that mirrors FINRA's interpretation of its suitability standard, the Commission strongly suggests that its intent is to adopt a standard that is weaker than the 913(g) standard, one that leaves some room for conflicts to influence recommendations.[27]

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[21] *See, e.g.*, Gretchen Morgenson, The Finger-Pointing at the Finance Firm TIAA, The New York Times, Oct. 21, 2017, https://nyti.ms/2BIFu1z. *Also* Jason Zweig and Anne Tergesen, Advisers at Leading Discount Brokers Win Bonuses to Push Higher-Priced Products, The Wall Street Journal, Jan. 10, 2018, https://on.wsj.com/2HB35lh.
[22] Craig McCann, Fiduciary Duty and Non-Traded REITs, Investments and Wealth Monitor, July/August 2015, https://bit.ly/2H7YvxK.
[23] Matt Levine, Wells Fargo Brokers Loved Structured Notes, Bloomberg, June 26, 2018, https://bloom.bg/2UrpMyl. *Also,* Bloomberg News, Structured notes offer too-good-to-be true returns, Investment News, Jan. 21, 2013, https://bit.ly/2tUda7d.
[24] FINRA Investor Alert, Variable Annuities: Beyond the Hard Sell, https://bit.ly/2VSmowP.
[25] Testimony of Mercer Bullard, MDLA Distinguished Lecturer and Professor of Law at the University of Mississippi School of Law, before the House Financial Services Committee Subcommittees on Capital Markets and Government Sponsored Enterprises and Oversight and Investigations regarding Preserving Retirement Security and Investment Choices for All Americans, Sept. 10, 2015, https://bit.ly/2H80ceA.
[26] *Id.*
[27] *See* CFA Comment at 12-15 for an explanation of the tortured logic the Commission uses to justify its proposed approach.

If, for whatever reason, the Commission is not willing to adopt the "without regard to" language, it should at the very least revise its standard to require brokers to place the customers' interests first at all times when providing personalized investment advice. Moreover, for this requirement to have any practical effect, the Commission must incorporate it in the provisions of the rule that, as currently drafted, fully satisfy compliance with the standard.[28] The best way to do that, in our view, is to require firms to adopt and enforce policies and procedures to mitigate conflicts of interest that are reasonably designed to ensure that the broker-dealer and its individual reps place the customer's interests first and act in the customer's best interests when making recommendations. This is a flexible approach that would give firms extensive freedom to develop policies and procedures appropriate to their business model. Under no circumstances, however, should the Commission give in to industry pressure to allow Reg BI's conflict mitigation requirement to be satisfied through disclosure alone. (CFA has developed a framework for how firms could manage conflicts of interest to meet this standard, which I have included in Appendix C.)

Unless the Commission is prepared to make this change, it should stop claiming that its rule would prohibit brokers from placing their interests ahead of their customers' interests. It is deceptive.

3) Brokers in ongoing advice relationships with their customers should have an ongoing duty to monitor customers' accounts.

Courts have deemed that broker-dealers owe fiduciary duties to their customers, including an ongoing duty to monitor the account, in certain circumstances where there is an ongoing relationship and a high degree to reliance by the customer on the broker's recommendations. Reg BI would weaken those protections by artificially declaring that brokers have no such ongoing duty to their customers after the completion of a transaction, regardless of the nature of their relationship. (Appendix D includes a legal analysis of this issue prepared by Professor Jill Gross, who is Associate Dean for Academic Affairs and Professor of Law at the Elisabeth Haub School of Law at Pace University.)

The SEC has proposed to adopt this arbitrary limitation on brokers' duties to their clients without doing anything to rein in brokers' ability to market their services as long-term relationships of trust and confidence. Such marketing is commonplace:[29]

- "Selecting a financial advisor and firm when seeking a long-term financial relationship built on trust and experience is one of the greatest decisions you will make." (Janney)
- "The ongoing relationship between you and your advisor is at the heart of what we do, to help you track your progress and adapt to changes in your life." / "We regularly reach out to you with meaningful information and ideas." (Ameriprise)
- "We are committed to establishing and maintaining long-term relationships based on integrity and trust and delivering long-term results based on deep research and independent thinking." (Stephens)

[28] To better protect investors, these provisions should establish the minimum steps brokers must meet to satisfy the standards rather than a safe harbor that fully satisfies compliance in all circumstances.
[29] See Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, Consumer Federation of America, January 18, 2017, https://bit.ly/2qKIhmO.

- "You'll build an ongoing, one-on-one relationship as your advisor gets to know you and your situation, and you can work together to tailor financial advice specifically to meet your needs." (Voya)
- "[I]t's developing a long-term relationship built on understanding and trust. Your advisor is there for you throughout the planning and investing process, giving you objective and unbiased advice along the way." (Raymond James)
- "If this sounds to you like a fairly close relationship, you're right. Many people develop lifelong friendships with their financial advisors. After all, these are people that you entrust with your financial future." (Securian Financial)[30]

There is a simple solution to repair this mismatch between the Commission's rule proposal and common industry practices. The Commission should adopt a principles-based approach in which the nature and extent of the broker's ongoing duties to the customer follow the contours of the relationship, just as they do for investment advisers. Under such an approach, brokers who truly do offer a one-time sales recommendation to a customer with no suggestion that the recommendation is being offered as part of an ongoing relationship would have no ongoing duty. In such circumstances, however, the broker should not be permitted to recommend investments that the customer is not capable of monitoring on her own. On the other hand, a broker that has an ongoing relationship with the customer that includes periodic recommendations should have an ongoing duty appropriate to that role. This might include an obligation to review the customer account once a year, for example, to make sure that everything continues to perform as expected, to ascertain whether the customer's circumstances have changed, and to ensure that the investments continue to be in the best interests of the customer based on that evaluation. This approach is consistent with both the transaction-based broker-dealer business model and investors' reasonable expectations based on brokerage firms' marketing of their services as ongoing relationships of trust and confidence.

If the Commission is not willing to impose any ongoing duties on brokers' ongoing customer relationships, it should stop claiming that Reg BI raises the standard of conduct for brokers when it actually weakens protections investors currently receive. It is deceptive.

4) The Advisers Act guidance must be strengthened.

For years, we have pointed to the Investment Advisers Act fiduciary duty as the standard to which all personalized investment advice should be held. Unfortunately, the interpretation of the Advisers Act standard included as part of the Reg BI regulatory package is so weak and limited in scope that it would leave investors virtually devoid of meaningful protections when dealing with a conflicted adviser. In one place, for example, the guidance states that an adviser *may* violate his fiduciary duty if he recommends a higher cost share class of a mutual fund because it pays him more without disclosing that practice to the investor.[31] If this interpretation

[30] Securian, When to hire a financial advisor, https://bit.ly/2XMLzT1 (last visited March 9, 2019).

[31] IA Guidance at 12 ("For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict.") Traditionally, the Commission has accepted disclosure in the ADV Form as satisfying the adviser's obligation to obtain informed consent.

of the Advisers Act fiduciary duty is allowed to stand, advisers would be free to subordinate their clients' interests to their own and make recommendations that are clearly not in their clients' best interests, as long as they provide "full and fair" disclosure of their anti-investor practices.

That is far from the level of protection investors have been led to expect when they deal with a "fiduciary" adviser. Indeed, it is directly at odds with other statements in the Advisers Act guidance, where the Commission suggests that investment advisers have a fiduciary duty to place the client's interests first at all times that cannot be negotiated or disclosed away.[32] Just as the Commission's interpretation of Reg BI in the proposing release contradicts the protections the rule seems to offer, the further discussion of the Advisers Act fiduciary duty in the proposed guidance document contradicts its initial strong statement of fiduciary principles. At best this is confusing. At worst, it suggests that both Reg BI and the Advisers Act fiduciary standard, as interpreted and enforced by the SEC, fall far short of the best interest, client first standard they are purported to be.

This weak interpretation of the Advisers Act fiduciary duty might be of less concern if stand-alone, fee-only advisers continued to represent the dominant advisory business model, since that business model is relatively free from complex and opaque conflicts. But the Commission's weak interpretation of the Adviser's Act fiduciary standard cannot begin to adequately address the complex web of conflicts often present in advisory accounts at dual registrant firms. This is one of the most serious harmful consequences of the Commission's decision not to rely on its rulemaking authority under Section 913(g) of the Dodd-Frank Act, which would have created an explicit obligation under the Advisers Act for investment advisers to act in the best interests of their clients, without regard to their own financial interests. Had it exercised its authority under 913(g), the Commission would not have had to rely exclusively on the implied fiduciary duty arising out of the Advisers Act's anti-fraud provisions, which it cites as justification for its disclosure-based approach.

While we continue to believe 913(g) rulemaking would be far better for investors, there are steps the Commission could and should take under its chosen approach to better protect the clients of investment advisers. First, the Commission should do far more to ensure that investors' "consent" to conflicts of interest is truly informed. Burying pages of legalistic conflict disclosures deep within an ADV form many investors will never read and fewer still will understand does not lead to informed consent, if that term has any meaning. Unfortunately, testing of the proposed Form CRS suggests that its more abbreviated conflict disclosures are also poorly understood by many investors. Therefore, if the Commission chooses to continue to rely primarily on disclosure to protect investment adviser clients, it must radically revise its approach to disclosure in order to ensure that: 1) advisers clearly and prominently alert investors to any conflicts that may influence their recommendations; 2) help them to understand the scale and impact of the conflict; and 3) obtain consent to that conflict that is truly informed.

Second, and even more important, the Commission must acknowledge that investors do not give informed consent to be harmed. Put a different way, an investor may reasonably consent

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[32] IA Guidance at 7 (As a fiduciary, an investment adviser is required "to adopt the principal's goals, objectives, or ends," which "means the adviser must, at all times, serve the best interest of its clients and not subordinate its clients' interest to its own.")

to the existence of conflicts of interest, but an investor does not knowingly consent to be harmed as a result of those conflicts. For example, there is an important difference between a standard that permits an adviser to offer proprietary products and one that permits an adviser to favor recommendations of poorly performing, high-cost proprietary products when they have better options available to recommend. The first is consistent with a fiduciary duty, assuming the conflict of interest is appropriately managed to ensure that it doesn't inappropriately influence recommendations; the second, which clearly subordinates the client's interests to the adviser's interests, is not.

Accordingly, in implementing this approach, the Commission must make clear that investment adviser firms, like broker-dealer firms under our proposed framework for mitigating conflicts, are prohibited from artificially creating incentives that would reasonably be expected to result in customer harm. Similarly, conflicts of interest that either cannot be avoided, or are not avoided but are consented to by the investor, must still be appropriately managed to ensure that they do not undermine the adviser's fiduciary duty to act in the client's best interests. Simply disclosing those conflicts, however clearly, would not satisfy this obligation. If the Commission were to adopt this standard, it would more closely match the protections investors have been led to expect from a fiduciary adviser. It is, moreover, an interpretation of the Advisers Act fiduciary standard that many investment advisers embrace.[33]

If the Commission fails to adopt improvements to the standard along these lines, the Commission should stop claiming that investment advisers are required to place the client's interest first, and are prohibited from subordinating the client's interests to their own. It is deceptive.

5) The Form CRS disclosures must be completely redesigned, retested, and reproposed.

Instead of establishing a strong, uniform fiduciary standard consistent with Section 913(g), the Commission has chosen to maintain separate regulatory standards for broker-dealers and investment advisers. It relies on a pre-engagement Customer Relationship Summary (Form CRS) to enable investors to make an informed choice regarding which type of relationship or account would be the best option for them. The Commission adopted this approach despite the fact that its own prior testing had showed it was unlikely to be successful in allaying investor confusion.[34] And, despite giving disclosure a central role in its regulatory approach, the Commission didn't even bother to work with disclosure design experts or engage in investor testing in developing that critically important disclosure document to ensure it effectively conveyed the desired information. Even after the disclosure document was released for public

[33] *See, e.g.,* CFP Board, Code of Ethics and Standard of Conduct, Effective Date October 2019, https://bit.ly/2ToTEir at 2 (A CFP® professional must … Act without regard to the financial or other interests of the CFP® professional, the CFP® Professional's Firm, or any individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interests of the Client and place the Client's interests above the CFP® professional's.) *See, also,* Committee for the Fiduciary Standard, Five Core Principles, https://bit.ly/2HmD4bG.

[34] *See, e.g.,* Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005, https://bit.ly/1MkdujW. *See, also,* Angela A. Hung, et al., RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, (2008), https://bit.ly/2LSDOsr.

comment, the Commission chose to rely primarily on investor surveys and roundtables, rather than rigorous qualitative testing, to evaluate the disclosure.[35]

Certainly, we appreciate the Commission's extensive outreach to investors regarding Reg BI and the Form CRS disclosures. The extent of their efforts to get input from retail investors is unprecedented in my more than 30 years of experience working on Commission rulemakings. And there are undoubtedly valuable insights to be gained from surveys and roundtables about investor preferences and opinions. But what those methods don't tell you with any degree of reliability is whether the disclosure document actually works. In other words, surveys and roundtables alone cannot tell us whether investors are able to use the Form CRS disclosure to make an informed decision about the selection of a financial professional to rely on for investment advice. For that, you need to conduct rigorous qualitative testing, in the form of one-on-one interviews.

Ultimately, the qualitative testing that we and others conducted of proposed Form CRS clearly showed that it is more likely to mislead than to inform investors.[36] In the testing we conducted with AARP and the Financial Planning Coalition, for example, testing participants who reviewed the Form CRS far more thoroughly and carefully than investors would be likely to do under real world circumstances still:

- did not understand key differences in the legal standards for broker-dealers and investment advisers, including the meaning of the term fiduciary;
- assumed that the two standards were different ways of expressing the same thing;
- struggled to articulate a clear distinction between the services offered as part of brokerage and advisory accounts;
- did not understand critical distinctions between different payment models;
- could not determine which type of account was likely to cost them more; and
- did not understand how conflicts of interest might impact them.

In short, measured by the standard the Commission itself has identified – does the CRS, as proposed, reduce investor confusion and enable informed choice – the answer is clearly no, it does not. It would be possible, in our view, for the Commission to make dramatic improvements in the CRS, though whether it can ever bear the full regulatory weight that the Commission has placed on it remains to be seen. Under the circumstances, the only responsible way forward is for the Commission to work with disclosure design experts to completely revamp the document to make it more readable and more comprehensible for typical retail investors and then to retest it to ensure it has achieved its goal. In light of the dramatic changes we believe this would entail, the Commission should then repropose that revised version to allow all interested stakeholders to comment.

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[35] Ultimately, the Commission conducted qualitative testing as a part of a new RAND Study evaluating the CRS disclosures. *See* Angela A. Hung et. al., Investor Testing of Form CRS Relationship Summary, prepared by the RAND Corporation for the Securities and Exchange Commission, November 2018, https://bit.ly/2QxcRfj. In response to this study, CFA filed a comment letter with the SEC December 7, 2018 urging it to revise and retest the CRS disclosures, https://bit.ly/2BhQlh2.
[36] AARP, CFA, Financial Planning Coalition Press Release, "Independent Testing Shows SEC's Proposed Customer Relationship Summary Form May Add to Investor Confusion," September 12, 2018, https://bit.ly/2Mv4efu.

If the Commission is not prepared to take the time to get Form CRS right, it should stop claiming that its regulation would reduce investor confusion. It is deceptive.

6) CFA strongly supports the draft SEC Disclosure Effectiveness Testing Act.

The shortcomings we've identified with proposed Form CRS are hardly unique. On the contrary, problems with the language, content, and format of Form CRS are common to many disclosure documents that the Commission relies on to inform and protect investors, as was well-documented in the Commission's Dodd-Frank-mandated financial literacy study.[37] These problems occur despite the best intentions of Commission staff, who have extensive market and legal expertise but lack the disclosure design and drafting expertise necessary to translate that knowledge into clear communications for a financially unsophisticated retail audience. The SEC Disclosure Effectiveness Testing Act would tackle that problem head-on, by requiring the Commission to incorporate disclosure testing into the rulemaking process when developing disclosures relied on by retail investors.

Had this legislation been in effect when the Commission was developing its Regulation Best Interest regulatory package, it would have put the Commission on notice much earlier in the rulemaking process that its proposed Form CRS disclosures did not serve their intended purpose. By requiring the findings to be made public, it would also have held the Commission accountable for addressing those findings in its rulemaking proposal. The Commission would then have had the choice of revising the disclosures to make them more effective, revising its regulatory approach to be less reliant on disclosure, or some combination of the two. Facing that decision earlier in the regulatory process, before it raised concerns about the need to repropose the rule and the associated delays, might have reduced the Commission's continuing resistance to revising this deeply flawed document and testing those revisions to ensure they achieve their intended effects.

Toward this end, we are particularly pleased that the legislation includes a requirement for qualitative testing in the form of one-on-one cognitive interviews of retail investors. This form of testing is essential to determining whether proposed disclosures effectively convey the desired information. Unfortunately, it has often gotten short shrift from the Commission, which prefers to rely on surveys and roundtables for investor input. While surveys and roundtables can add value, particularly on questions related to such issues as delivery methods and timing, they do not answer the central question of whether a particular disclosure document works. After all, investors often provide responses on surveys indicating that they "like" disclosure approaches that qualitative testing shows they do not understand.[38] Similarly, surveys and roundtables do not typically provide the kind of detailed, specific information needed to guide decisions about how to revise a particular disclosure to make it easier for investors to comprehend.

[37] SEC Staff, Study Regarding Financial Literacy Among Investors, as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, August 2012, https://bit.ly/2C9d145. *See also,* Siegel + Gale, Investor Research Report, (submitted to the SEC July 26, 2012), https://bit.ly/1MfBbss.

[38] This was the case in the RAND Study commissioned by the SEC to evaluate Form CRS. *See, e.g.,* Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to Brent J. Fields, SEC Secretary, regarding File No. S7-08-18, Form CRS Relationship Summary, (December 7, 2018), https://bit.ly/2BhQlh2.

We also strongly support the provisions in the draft bill that would require the Commission to conduct effectiveness testing of existing disclosure documents. The Commission has had evidence at least since it conducted its financial literacy study in 2012 that many of the disclosure documents we currently rely on are not well understood by retail investors. This includes cost disclosures that don't clearly convey costs, risk disclosures that don't clearly convey risks, and conflict disclosure that do not clearly convey the nature or impact of those conflicts. Yet the Commission has failed to incorporate the lessons of that study into its approach to retail disclosures. Instead, Form CRS as well as two other recent disclosure initiatives undertaken by the Commission – one focused on mutual fund disclosure effectiveness[39] and one to create a summary prospectus for variable annuities[40] – are likely to result in the development of disclosures that largely perpetuate fundamental failings in our existing disclosure system.

All these proposals would benefit greatly from the type of testing that would be required under this draft bill. It will be important for Congress, as this legislation moves forward, to provide the Commission with funding necessary to fulfill these responsibilities, either by hiring the staff with the necessary expertise or contracting with outside experts. The long-term benefits to investors, in the form of improved investment decision-making, will be significant.

Conclusion

In analyzing the failings of Reg BI, one can't help wondering why the Commission has proposed a regulatory package designed to benefit average, middle income investors that falls so far short of what is needed. After all, the Commission has been considering the issue, in one form or other, for decades. It has conducted studies and issued requests for comment and obtained extensive input from all interested stakeholders.[41] It also has the benefit of extensive peer-reviewed academic research addressing important issues relevant to the rulemaking, including both the effectiveness of disclosure as an investor protection tool and the harmful impact of conflicts of interest.

One obvious problem is the Commission's failure to clearly define what regulatory problem it was seeking to solve. This failure to "identify the specific problem(s) needing attention" was highlighted in a recent letter from 11 former SEC senior economists outlining serious shortcomings in the economic analysis backing the regulatory proposals.[42] This

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[39] Securities and Exchange Commission, Request for Comment on Fund Retail Investor Experience and Disclosure, File No. 27-12-18, available at: https://bit.ly/2XOJbuW. *See also,* Letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Brent Fields regarding File No. S7-12-1, "Request for Comment on Fund Retail Investor Experience and Disclosure," October 31, 2018, https://bit.ly/2FVrS5H.

[40] Securities and Exchange Commission, Request for Comment on Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, File No. S7-23-18, available at: https://bit.ly/2EKJsq6. *See also,* Letter from CFA Director of Investor Protection Barbara Roper and Financial Services Counsel Micah Hauptman to SEC Secretary Brent Fields regarding File No. S7-23-18, "Request for Comment on Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts," February 27, 2019, available at: https://bit.ly/2UxrMVT.

[41] **Appendix E** lists and links to previous CFA letters relating to this topic dating back to 1999.

[42] Letter from Charles Cox, et. al. to SEC Secretary Brent J. Fields regarding SEC File Number 57-07-18, February 6, 2019, https://bit.ly/2XOofob. CFA raised similar concerns regarding the inadequacy of the economic analysis in our comment letter on Reg BI at 105-161.

fundamental analytical oversight doesn't just lead to a deeply flawed economic analysis, however, it also leads to a deeply flawed rule.

Views differ regarding the specific regulatory problem the Commission should focus on solving. Some believe regulations should be targeted at eradicating investor confusion. They tend to gravitate toward solutions that rely on disclosure or title restrictions. Others, including CFA, believe the regulations should be designed to reduce the financial harm that investors suffer when they rely on conflicted advice. Accordingly, we believe the best approach is to adopt a strong, uniform standard of care backed by restrictions on harmful conflicts, so that investors are appropriately protected regardless of who they rely on for investment advice. Rather than choose between these two camps, and without carefully analyzing the root causes of either problem, the Commission has adopted a hybrid approach in Reg BI that doesn't effectively address either.

The Commission seems particularly reluctant to rein in pervasive conflicts of interest out of a misplaced concern that doing so would destroy the broker-dealer business model. But if the Commission truly believes, as we do not, that the broker-dealer business model can only be preserved if brokers are permitted to create toxic conflicts of interest and profit unfairly at customers' expense, it should reconsider whether this is a business model worth preserving. But this is a false choice. In reality, it is clearly possible to adopt a rule that eradicates the most toxic conflicts, and ensures that remaining conflicts are appropriately managed, without eliminating brokers' ability to charge for their services through transaction-based payments or restricting investors' access to commission accounts. Indeed, if the Commission were to adopt such an approach, it would make the broker-dealer model a far more attractive option for investors than it is currently. This would doubtless come at a cost to broker-dealer profits. But eliminating the excess profits that come from placing the broker's interests ahead of customer interests should be a goal of the rulemaking, not an excuse for maintaining the status quo.

A final glaring problem with the Commission's approach to this rulemaking is its failure to recognize fundamental market changes that render its artificially bifurcated regulatory approach obsolete. This is ironic, since no one has done more to blur the distinctions between broker-dealers and investment advisers than the Commission itself. Over a period of several decades, it has given brokers virtually unrestrained ability to rebrand themselves as advisers and market themselves primarily on the advisory nature of their services without regulating them accordingly. The result is a marketplace in which both brokers and advisers offer a range of services that include varying levels of advice, and the dividing line between brokerage and advisory services is all but impossible to detect. The Commission's regulatory approach, which adopts an antiquated, one-size-fits-all picture of the broker-dealer business model, simply doesn't reflect modern day market realities. At the same time, an increasing percentage of customer accounts are held at dual registrant firms, where customers may maintain both brokerage and advisory accounts serviced by the same financial professional. A regulatory approach that relies on investors to understand when their "financial advisor" is acting as a broker and when he is acting as an investment adviser is completely unworkable.

In short, flaws in the Commission's regulatory approach have their roots in flaws in its regulatory analysis. This suggests that a major change in mindset will be needed for the Commission to rectify the rule's myriad shortcomings. There is still time for the SEC to fix Reg

BI so that it truly puts investors' interests first. Doing so would have the added benefits of increasing the likelihood that the rule would survive in a new Administration and reducing the incentive for states to step in to adopt their own, stronger broker-dealer standards. With the Commission reportedly putting the finishing touches on this regulatory package, however, that time is running out.

CFA appreciates the past efforts of Members of this Committee to ensure that investors are adequately protected when dealing with financial professionals, and we look forward to continuing to work with you to advance that goal.

Appendix A: CFA News Release Regarding Reg BI Comment Letter

CFA **Consumer Federation of America**

SEC Proposal Fails to Live Up to its "Best Interest" Label

Without Extensive Revisions, Inadequate Protections Would Leave Investors Vulnerable to Bad Advice; Proposed Disclosures Would Perpetuate Investor Confusion

August 7, 2018 | Press Release

WASHINGTON, D.C. – In the guise of strengthening protections for retail investors, the Securities and Exchange Commission (SEC) has proposed a regulatory package that, despite its name, doesn't clearly require brokers to do what is best for their customers, doesn't clearly prevent them from placing their own interests ahead of their customers' interests, enshrines as policy the Commission's weak and ineffective approach to enforcing the Investment Advisers Act fiduciary standard, and requires disclosures by brokers and advisers that are more likely to mislead investors than to dispel investor confusion.

CFA outlined these and other weaknesses in the SEC proposal in a comment letter filed with the agency earlier today. The letter responds to the Commission's request for comment on three related regulatory proposals: (1) Regulation Best Interest, which purports to raise the standard of conduct that applies when brokers make securities recommendations (Reg BI); (2) a new interpretive release regarding the standard of conduct for investment advisers (IA Guidance); and (3) a proposal to create a new relationship summary disclosure document for brokers and advisers (Form CRS).

"It is easy to be beguiled by the rhetoric surrounding Regulation Best Interest into thinking the SEC has done something meaningful to improve protections for average mom and pop investors, but a look beneath the surface quickly dispels that illusion," said CFA Director of

Investor Protection Barbara Roper. "Unless the SEC undertakes extensive revisions, the proposal will put investors at greater risk, misled into expecting protections the proposed standard doesn't provide."

"Last year, SEC Chairman Jay Clayton set out principles to guide this rulemaking, his '4 Cs' – consistency, clarity, choice, and coordination. Unfortunately, this rulemaking fails to live up to his guiding principles," said CFA Financial Services Counsel Micah Hauptman. "It establishes different advice standards for different financial professionals, and many of the key differences are hazy at best. It preserves bad choices for investors but very profitable choices for the brokerage industry. And there's no evidence that the SEC coordinated with the Department of Labor or learned from experts who have extensively studied conflicts of interest in securities markets."

The following are among the most serious of the proposal's shortcomings detailed in CFA's comment letter.

1. **Reg BI is not a true "best interest" standard.** (Section II.A., pages 3-12)

- The new standard does not define the term "best interest" at all, let alone in a way that matches investors' reasonable expectations.
- It does not require brokers to recommend, from among the reasonably available investments, those that are the best match for the investor.
- Brokers would remain free to recommend higher cost investments that pay them more, except in the narrowest of circumstances.
- As a result, it is not clear that the so-called "best interest" standard imposes any obligations, except disclosure, that go beyond existing requirements under FINRA's suitability standard.

"There's a huge gap between what investors expect when they hear the term 'best interests' and what this rule actually delivers," Roper said. "If the SEC isn't prepared to require brokers to recommend the best of the reasonably available investments, they should stop calling this a best interest standard. It's misleading."

2. **Reg BI doesn't do enough to prevent brokers' conflicts from tainting their recommendations.** (Section II.B., pages 12-28)

- The rule includes a compliance safe harbor that doesn't contain the prohibition on placing the broker's interests ahead of the customer's interests.

- Some conflicts could be addressed through disclosure alone, with disclosures likely delayed until after the recommended transaction.
- Even where conflicts would have to be "mitigated," the Commission doesn't make clear that mitigation has to be designed to support compliance with the best interest standard.
- It doesn't even prevent brokers from artificially creating incentives – like sales quotas and bonuses for recommending certain products – that encourage recommendations that put the firm's interests ahead of the customers' interests.

"Instead of cracking down on toxic incentives that firms use to encourage and reward brokers for giving bad advice, such as sales quotas and contests, it defers to the firms. As long as they go through the motions of mitigating conflicts, that appears to be good enough under the proposed standard," Hauptman said.

3. **The standard applies too narrowly.**

- Even brokers in long-term relationships with their customers would have no obligation to monitor the account to ensure that past recommendations continue to perform as intended and to be in the customer's best interests. (Section II.E., pages 39-43)
- Because recommendations regarding account type are not included, the rule wouldn't prevent dual registrant firms from steering customers toward the type of account that is most profitable for the firm, rather than the account that is best for the investor. (Section II.G., pages 44-45)

"Brokers market their services as ongoing relationships, but the rule applies only episodic protections. And for customers of dual registrant firms, those protections only kick in after the all-important recommendation of account type has been made," Roper said.

4. **The IA Guidance enshrines as policy the Commission's historically weak and ineffective enforcement of the Advisers Act fiduciary standard.** (Section II.C., pages 28-33)

- The guidance says investment advisers must always act in the client's best interests and put the client's interests first, but it goes on to make clear that this obligation could generally be satisfied through disclosure.
- It says advisers must "avoid" conflicts, but it doesn't even prohibit them from adopting incentives that conflict with their clients' best interests, as long as those incentives are disclosed.
- While it does suggest that disclosure alone might not to be adequate to address all conflicts, a positive step, it needs to apply that standard far more broadly than it does here for the standard's promised protections to be realized in practice.

"The SEC had an opportunity to strengthen the Advisers Act standard to match the rhetoric used to describe it, but it failed to do so," Roper said. "Instead, to the degree that the regulatory package reduces inconsistencies in the treatment of brokers and advisers, it achieves that primarily by adopting the weakest possible interpretation of investment advisers' fiduciary duty rather than by raising the standard of conduct for brokers. Ironically, it adopts that approach despite broad support within the adviser community for a much stronger interpretation of their fiduciary obligations."

5. **The Form CRS disclosures are more likely to mislead investors than to reduce investor confusion.** (Section III, pages 50-81)

- The proposed disclosures would generally come only after the investor has chosen a provider, much too late to be factored into the choice of providers or accounts.
- The information firms would be required to provide about the nature of their services and the conflicts of interest present in their business model is too vague and generic to be useful.
- The information on the standard of conduct that applies would lead investors to expect protections that the standards do not, in practice, provide.

"The proposed Form CRS disclosure document for brokers and advisers fails every test of disclosure effectiveness. It is too dense and technical to be understood, too generic to be meaningful, and in some areas it is downright misleading. It needs to be totally revamped based on the results of cognitive usability testing and in consultation with disclosure design experts," Roper said.

6. **The Commission hasn't conducted an even remotely credible economic analysis to support its proposed regulatory approach.** (Section VI, pages 105-161)

- The Commission bases its "analysis" on a false characterization of the broker-customer relationships and fails even to acknowledge that a serious market failure exists that requires a regulatory response.
- It fails to consider the rich body of evidence suggesting that conflicts of interest have a harmful impact on investors, including evidence from its own regulatory oversight of the market, academic research, and audit studies.
- Instead, it draws unsupported conclusions based on unfounded assumptions, often simply echoing brokerage industry talking points designed to support adoption of the weakest possible standard.

- Because it provides no analysis of the tangible impact the proposed regulations would have on broker-dealer conduct, it doesn't clearly explain what regulatory problem it is attempting to solve or how its proposed approach would address that problem.

"Simply put, this is not serious economic analysis," Hauptman said.

7. **The Commission conducted a superficial and incomplete analysis of regulatory alternatives.** (Section V, pages 81-105, and Section VI.E., pages 147-150)

- Even though the Release makes clear that the Commission views brokers as just a different type of investment adviser, it doesn't even consider a regulatory approach based on regulating brokers' advisory activities under the Investment Advisers Act.
- It provides only a cursory analysis of the approach favored by Congress – adopting a uniform fiduciary standard for broker-dealers and investment advisers in reliance on the authority in Section 913(g) of the Dodd-Frank Act.

"This appears to be nothing more than a check-the-box exercise to justify the SEC's chosen approach," Roper said. "It doesn't include any serious analysis of regulatory alternatives that reflect the will of Congress and have broad support in the investor community."

8. **The Commission should not finalize this deeply flawed proposal without extensive revisions.**

"The brokerage industry asked the SEC for a best interest standard in name only, and that is what the SEC has delivered. Investors deserve better," Roper said. "The SEC needs to go back to the drawing board to get this right."

"The strongest supporters of this proposal come from the brokerage industry. That tells you everything you need to know about it," Hauptman said. "The question is whether the SEC is willing to make the necessary changes to protect and serve investors or whether it is content with an approach that protects and serves the brokerage industry."

Appendix B: Redline of Necessary Changes to Proposed Regulation Best Interest

As I indicated in the above testimony, CFA believes it is possible to develop a principles-based best interest standard that, unlike the standard proposed by the Commission, would create a clear obligation for brokers to do what is best for the investor and impose meaningful restrictions on practices that undermine compliance with that standard. Working within the parameters of the Commission's proposed approach, we offered this redline of the best interest standard as part of our comment letter to the Commission. It reflects the changes that would be needed to turn the Commission's proposal into a true best interest standard that meets investors' reasonable expectations regarding the legal protections they should receive when receiving investment advice from a broker-dealer.

§ 240.15l-1 Regulation Best Interest.

(a) *Best Interest Obligation.* (1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction, ~~or~~ investment strategy involving securities, securities account, or investment service to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without regard to the financial or other interest ~~placing the financial or other interest~~ of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ~~ahead of the interest of the retail customer~~.

(2) To satisfy the best interest obligation in paragraph (a)(1) ~~shall be satisfied if~~ the broker, dealer, or natural person who is an associated person of a broker or dealer must, at a minimum, comply with the following duties:

(i) Duty to Disclose ~~ure Obligation~~. The broker, dealer, or natural person who is an associated person of a broker or dealer, as soon as reasonably practicable prior to ~~or at the time of~~ such recommendation, must provide full and fair disclosure ~~reasonably discloses~~ to the retail customer, in writing, of all ~~the~~ material facts relating to the ~~scope and terms of the relationship with the retail customer~~ recommendation, including all material costs, risks, and conflicts of interest that are associated with the recommendation.

(ii) Duty of Care ~~Obligation~~.

(A) The broker~~,~~ or dealer shall make available a menu of investment options sufficient to reasonably ensure that it and its associated persons can satisfy their best interest obligations.

(B) The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, shall exercise~~s~~ reasonable diligence, care, skill, and prudence to:

~~(A)~~1. Understand the material facts, including potential risks and rewards, associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

~~(B)~~2. Have a reasonable basis to believe that the recommendation is ~~in~~ the best option, from among the reasonably available options, for ~~interest of~~ a particular retail customer based on that retail customer's investment profile and ~~the potential risks and rewards associated with~~ the material characteristics of the recommended securities transaction, investment strategy, securities account, or investment service ~~recommendation~~; and

~~(C)~~3. Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

(C) The broker, dealer, or natural person who is an associated person of a broker or dealer who provides periodic, episodic, or ongoing recommendations to a customer shall, throughout the duration of that relationship, periodically monitor the customer's account to determine whether investments in the account continue to be in the customer's best interests.

(iii) ~~Conflict of Interest Obligations~~ Duty of Loyalty.

(A) The broker or dealer shall establish~~es~~, maintain~~s~~, and enforce~~s~~ written policies and procedures reasonably designed to prevent violations of the best interest standard by identifying and at a minimum ~~disclose~~ disclosing and mitigating, or ~~eliminate~~ eliminating, all material conflicts of interest that are associated with such recommendations.

(B) The broker or dealer may not create incentives (including but not limited to sales quotas, contests, or special awards) that are intended or would reasonably be expected to encourage recommendations based on factors other than the customers' best interests.

(C) ~~The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.~~ When recommending a securities transaction, investment strategy, securities account, or investment service, natural persons who are associated persons of a broker or dealer shall comply with the written policies and procedures of the broker or dealer and act without regard to their own financial or other interests or the financial or other interests of the broker or dealer.

Appendix C: CFA's Proposed Framework for Addressing Conflicts of Interest

CFA | **Consumer Federation of America**

A Framework for Addressing Broker-Dealer and Investment Adviser Conflicts of Interest When Providing Retail Investment Advice

Conflicts of interest are present in both the broker-dealer and investment adviser business models. Some conflicts are inherent to each business model, the natural outgrowth of commission- and fee-based compensation structures. Other conflicts result from the investment products brokers and advisers recommend and the various payments product sponsors make to encourage their sale. Still other conflicts are artificially created by firms to encourage financial professionals to recommend the products and services that are most profitable for the firm. All have the potential to inappropriately influence recommendations, to the detriment of investors, but the nature and severity of those conflicts varies greatly. How the Commission addresses conflicts of interest will largely determine whether investors benefit from the proposed Regulation Best Interest as well as the Commission's accompanying interpretation of the Investment Advisers Act fiduciary duty.

The good news is that there is a workable framework for addressing conflicts of interest that can be adapted to both brokerage and advisory business models. Under this approach, firms would be required to adopt conflict mitigation practices that are tailored to the nature and scope of conflicts of interest present in their particular business. Conflicts that are more likely to result in serious investor harm would be subject to more stringent mitigation requirements. This framework for addressing conflicts would preserve the ability of brokers to receive transaction-based compensation, minimize the risk that misaligned incentives present in both brokerage and advisory business models would result in investor harm, and create an incentive for brokers and investment advisers alike to adopt consumer-friendly practices.

I. Conflicts that are inherent to the business model

A. Explanation of the problem

Conflicts of interest are inherent to both the broker-dealer and investment adviser business models. Brokers and advisers alike have an interest in maximizing their compensation, creating incentives that may not always align with investors' interests.

- **Commission compensation creates an incentive to maximize transactions.** In the brokerage model, the firm and financial professional get paid only if a recommendation results in the completion of a transaction. Therefore, a broker-dealer has an incentive to recommend that an investor complete a transaction, regardless of whether doing so is in the best interest of the customer. This incentive can result in recommendations to roll over a 401(k) to the firm, even when that results in increased costs to the investor, or to churn an account in order to increase the number of transactions, for example.

- **AUM fees create an incentive to gather assets.** Investment advisers who charge a fee based on assets under management get paid only if they are managing a client's money. The more of the client's money they manage, the more they get paid. As with brokers, this incentive can result in recommendations to roll over a 401(k) to the firm, regardless of the benefits to the client. It can also cause advisers to avoid financial recommendations, such as paying off debts or investing in real estate, that would reduce assets under management. Because an adviser compensated through AUM fees gets paid the same amount regardless of the level of service provided, that adviser also has an incentive to do the least amount of work necessary to maintain the account (a practice known as reverse churning).
- **Other payment methods also create conflicts.** While AUM fees represent the most common compensation method among investment advisers, some advisers charge hourly fees while others charge engagement or monthly fees. Each comes with its own set of conflicts. When the client pays by the hour, for example, the adviser has an incentive to maximize the time it takes to complete the job. The opposite is true when the adviser is paid by the engagement, and the incentives associated with monthly fees resemble the incentives under AUM fees to engage in reverse churning.
- **Dual registrants have an additional layer of conflicts.** Firms that offer both brokerage and advisory accounts, or different accounts with different payment models, have an incentive to recommend the type of account that is most profitable for the firm, rather than the type of account that is best for the investor.

Conflicts of interest that are inherent to the business model are typically fairly simple and straightforward. They boil down to the fact that the firms and financial professionals have an incentive to maximize compensation, whatever their compensation structure, that may not always result in recommendations that are in investors' best interests.

B. Framework to appropriately address this problem

Addressing conflicts that are inherent to the business model starts with disclosure and informed consent. The disclosure must be sufficient to ensure that the investor understands the nature of the conflicts of interest associated with the particular business model and how the recommendations they receive could be affected, since without such understanding consent cannot truly be "informed." It is critically important to recognize, however, that when investors consent to the existence of conflicts, they do not consent to be harmed as a result of those conflicts. Firms and financial professionals must still have an obligation to provide advice that is in the investor's best interest, even after the conflicts have been disclosed and consented to.

To ensure that conflicts of interest that are inherent to the business model do not taint the advice they offer, firms must adopt strong policies and procedures tailored to the conflicts specific to their business model. So, for example, broker-dealers must have policies and procedures in place to ensure that their reps do not engage in excessive and unnecessary transactions. Advisers who charge AUM fees must have policies and procedures in place to ensure they do not neglect the account. To achieve this, firms must have surveillance mechanisms to identify and curtail recommendations that are the natural result of the business model's conflicts and that are not in the investor's best interest. At dual registrant firms, this should include supervisory procedures designed to ensure that their financial professionals recommend the type of account that is best for the investor, rather than the type of account that is most profitable for the firm.

All three types of firms must have policies and procedures in place to ensure that rollover and asset transfer recommendations are in the best interests of the customer, and not just the firm. Under such an approach, firms must require rigorous analysis and documentation showing why their advice or recommendation is in the investor's best interest. For example, to ensure that any recommendation to roll over a workplace retirement account into an IRA is in the investor's best interest, a firm's policies and procedures must require that the professional undertake a rigorous analysis comparing the customer's current account with reasonably available options at the firm. This analysis would include a comparison of the relative costs, available investments, and different level of services, for example, in order to make an ultimate assessment of the value of the recommended transaction. Further, the firm's policies and procedures must require that the financial professional document this analysis so that the firm's compliance department and regulators can review whether the recommendation was in the investor's best interest and confirm that it was not inappropriately influenced by the desire to charge a commission or capture assets.

Firms that prepared to implement the Department of Labor fiduciary rule before it was overturned in court should already have designed compliance programs that meet this standard. Moreover, numerous technological tools were brought to market in response to that rule to support such a requirement. In some cases, an objective analysis is going to demonstrate that a rollover is improper, and firms need to be prepared to refrain from recommending a rollover in such instances. For example, few firms can compete with the low costs available to participants in the Thrift Savings Plan (TSP) and thus would find it difficult to justify a rollover that could easily increase the investor's annual costs by 30 to 40 times for similar products. In other instances, the firm will be able to document the benefits to the investor of a rollover, particularly when the firm has an attractive suite of retirement account options or the 401(k) plan in question is a substandard plan. This approach has the added benefit of creating an incentive for firms to compete based on the cost and quality of their products and services, which in turn has the potential to deliver significant benefits to investors.

II. Investment product-related conflicts

A. Explanation of the problem

Conflicts of interest can also arise as a result of payments investment products make, and practices product manufacturers engage in, to encourage firms and financial professionals to recommend their products rather than those of their competitors. Some of those conflicts, such as payments made to get on a firm's investment menu, may be present in advisory as well as brokerage accounts, particularly at dual registrant firms. Others are directly tied to transaction payments, and thus are associated exclusively with brokerage accounts. When financial professionals' pay and firms' profits vary significantly based on what investments they recommend, conflicts of interest are multiplied and magnified, and the policies and procedures firms adopt to address those conflicts must be adjusted accordingly.

These product-specific conflicts arise because of the stiff competition that exists among product manufacturers, who seek to encourage sales of their products over their competitors' by offering the most attractive compensation arrangement to the selling brokers. Such conflicts tend to be much more complex than the basic compensation-related conflicts discussed above, making them difficult for even financially sophisticated investors to understand or guard against. To illustrate, when a product manufacturer creates an investment product, the manufacturer decides whether to embed certain distribution-related costs in the product and how those costs should be structured. With a broker-sold mutual fund, for example, the mutual fund company decides both the amount of the sales load to be charged and how to structure that load; whether and how much to charge in 12b-1 fees; whether and how much to charge for recordkeeping through sub-transfer agency fees; whether and how much the fund's adviser should pay different broker-dealers in revenue sharing arrangements; and how much to pay to brokers in gross-dealer concessions for distributing their fund. It only gets more complicated from there. Different mutual fund companies adopt different distribution cost structures and varying levels of compensation paid to brokers who sell their products. And other investment products – such as annuities, structured products, and non-traded real estate investment trusts (REITs) and business development companies (BDCs) – have different cost structures from mutual funds, typically with even higher levels of compensation paid to broker-dealers who sell them.

The result is that brokers have a strong incentive to recommend the products that pay them the most, regardless of whether they are the best option for the investor. In practice, this means, for example, that a broker-dealer has an incentive to recommend a mutual fund that pays a higher share of the load rather than an available alternative that offers a lower payout, even if the alternative has a history of better performance or is otherwise a better match for the investor. Similarly, a broker-dealer has an incentive to recommend a variable annuity or structured product instead of a mutual fund, because those products pay so much more, even if a portfolio of mutual funds would achieve the same investment goal at lower cost and with greater liquidity and fewer risks.

Conflicts such as these are a major source of investor harm. Because costs associated with product-specific incentives are ultimately born either directly or indirectly by the investor, the products that are most lucrative for the broker are also typically those that are most expensive for the investor. Similarly, products that are hardest to sell, because they are less liquid or higher risk or suboptimal for other reasons, can overcome those disadvantages by offering higher compensation. As a result, these incentives can expose investors not just to higher costs, but also to higher risks or inferior performance. Because of the complexity of such conflicts, and the potential for investor harm, particularly rigorous policies and procedures are needed to reduce the likelihood that these incentives will taint recommendations.

B. Framework to appropriately address this problem

It should be patently obvious that conflicts of interest of this complexity cannot adequately be addressed through disclosure alone. Experience, and disclosure testing, tell us that most investors will never gain a sufficient understanding of such conflicts to give informed consent. And brokers who have strong incentives to act against their customers' interests are less likely to comply with a best interest standard. More rigorous policies and procedures are needed to ensure that these product-specific conflicts do not taint investment recommendations.

The good news here is that, while firms do not create these product-specific conflicts of interest, it is possible for them to eliminate or at least significantly reduce such conflicts. Some firms had begun that process in response to the DOL rule through the adoption of "clean shares" and other more product-neutral approaches to broker compensation. By removing all distribution-related costs from the products, clean shares in particular have the potential to eliminate incentives for broker-dealer reps to recommend funds based on their own financial interests rather than the investor's best interest. (Though some clean shares appear to be "cleaner" than others.) Other approaches to levelizing compensation across products, and basing broker compensation on the nature and extent of services provided rather than on the products sold, have the potential to provide a similar benefit at the individual rep level, though firms may continue to face compensation-related conflicts.

- **Levelizing compensation for similar products can better align interests of brokers and investors.** Where investment products have similar features and serve similar functions, broker-dealer firms could reduce product-specific conflicts by taking steps to ensure that the compensation that flows to the individual rep does not depend on the product recommended. For example, a broker-dealer would ensure that there is no incentive for the rep to recommend one mutual fund over another by providing level compensation for all mutual fund recommendations. One option would be to apply a level commission to load-waived A shares, as LPL announced it planned to do with its Mutual Fund Only Platform, an approach that reduces conflict-related incentives at both the firm and individual rep level. Another option is for firms to continue to distribute products that offer variable compensation, but to offer level compensation at the individual rep level for all similar products. In such cases, the firm neutralizes the conflict at the rep level but retains the conflict at the firm level, as well as the differences in cost to the investor. This approach to levelizing compensation for similar investments would apply equally to recommendations of annuities, for example, or any other class of investments. If firms are required to design policies and procedures to mitigate conflicts that are reasonably designed to ensure that the customer's interests come first, they may come up with additional approaches that achieve the same objective of minimizing product-specific conflicts.
- **Ensuring that variations in compensation are justified based on an objective analysis can help to reduce compensation-related conflicts of interest across different product lines.** While levelizing compensation for similar products can reduce incentives to recommend one mutual fund over another or one annuity over another based on compensation considerations, it doesn't eliminate the incentive to recommend those classes of investment products (e.g., variable annuities, non-traded REITs, and structured products) that offer the most generous compensation. Brokers have argued that differences in compensation are warranted by differences in the time it takes to analyze the products and explain their features to investors. But it is unquestionably the case that the higher compensation provided by these products largely explains why they feature so prominently in stories of abusive sales practices. To counteract this problem, broker-dealer firms should take steps to ensure that any variations in the level of compensation for different types of investments that flow to the individual representative are justified based on an objective analysis, in writing.
- **To the extent firms do not eliminate compensation-related conflicts, recommendations of higher compensating products must be backed by rigorous analysis documenting the basis for concluding that such recommendations are in the customer's best interest.** Firms that retain significant variations in compensation at the individual rep level will need to adopt particularly rigorous policies and procedures to ensure those conflicts don't inappropriately influence recommendations. Where the rep recommends higher paying products, particularly when those products also impose additional costs on the investor, this must include written documentation of the basis on which the rep determined that a particular recommendation is in the customer's best interest. The rep should have to explain, for example, how the particular product meets the investor's goals and needs, why the imposition of any additional costs provides value to the investor, and why the same objective cannot be accomplished more efficiently through other reasonably available investment products or strategies. For example, if a broker-dealer

recommends that an investor purchase a variable annuity or a non-traded REIT, the broker-dealer should be required to provide an objective analysis documenting the investor's need for that particular type of investment and why it is a better option for the investor than other reasonably available investment products and strategies. If the rep can't support the recommendation, including why any added costs are justified, he should not be permitted to make the recommendation. And the firm should adopt supervisory procedures to ensure compliance.

The benefits to investors of a more product-neutral approach to broker compensation are obvious. If investment products were forced to compete based on their own merits (cost and quality), rather than by compensating the broker, the best products would thrive, to investors' benefit. And, in a commission account based on clean shares, for example, the costs of brokerage services would be transparent and subject to market forces. These factors have historically led to much lower costs for investors, which likely explains why firms have been so reluctant to adopt clean shares now that the DOL rule no longer provides them with an incentive to do so. But there are benefits to firms as well from approaches that reduce product-specific conflicts. Firms that adopt such approaches are likely to face fewer compliance headaches under a best interest standard if incentives for non-compliance are reduced or eliminated. And firms that minimize product-specific conflicts should find it easier to justify their recommendations and easier to defend against claims that their reps placed their own financial interests ahead of the customer's best interests.

C. Conflicts that firms artificially create to drive specific conduct

A. Explanation of the problem

Conflicts of interest also arise when firms themselves create incentives to encourage and reward very specific behavior that is profitable to the firm, but harmful to investors. These types of conflicts aren't inherent to the broker-dealer or investment adviser business models, nor are they created by outside parties, as product-specific conflicts typically are. Rather, these conflicts arise when firms make a conscious decision to inject a variety of perverse incentives into a business model that, in all too many cases, is already rife with conflicts of interest in order to maximize their profits at customers' expense.

Artificially created incentives include, but are certainly not limited to, contests, quotas, bonuses, trips, or other special awards that firms use to reward individual reps for meeting certain sales targets. Such incentives may be used, for example, to encourage financial professionals to sell proprietary products over non-proprietary products or, at dual registrant firms, to steer prospective clients to high-cost managed accounts when they would be better served by a brokerage account. Artificially created incentives also include retroactive ratcheted payout grids, which disproportionately increase compensation for incremental increases in sales, creating enhanced risks for investors when reps approach the next level on the grid. What these incentives have in common is that none exist naturally or inevitably within the broker-dealer business model, and all are fully within the control of the firm. While not every such incentive is harmful, these incentives create problems for investors when the conduct that is most profitable for the firm is not in investors' best interest, because it inappropriately increases their costs, for example, or exposes them to unnecessary risks.

Moreover, these types of incentives are not limited to the broker-dealer business model. They may also arise in advisory accounts in the dual registrant context, where investment adviser affiliates often artificially create many of the same conflicts that are so prevalent in the broker-dealer space. In such cases, the investment adviser affiliate typically buries their various conflict disclosures deep in their Form ADV in legalese that few if any investors will read and even fewer will understand. As discussed above, that type of disclosure does not lead to informed consent and cannot substitute for a true best interest obligation.

B. Framework to appropriately address this problem

As with product-specific conflicts, an approach to these artificially created incentives that relies on disclosure alone would be totally ineffective at protecting retail investors from harm. Research has shown that simply disclosing conflicts does not enable investors to protect themselves from the harmful impact of those conflicts, particularly when the conflicts are complex and opaque, as is often the case here. Moreover, the whole point of many of these incentives is to drive specific behavior that benefits the firm, regardless of whether it harms investors. Where that is the case, the easy, logical solution is simply to eliminate the incentive.

The specific standard that the SEC should adopt to guide firms when deciding what artificially created incentives they must eliminate is whether the incentive would reasonably be expected to encourage recommendations based on factors other than the customer's best interest. If an objective analysis shows that an incentive would reasonably be expected to encourage recommendations that are not in the customer's best interest, it must be eliminated. The good news is that, because these incentives are not intrinsic to either the broker-dealer or investment adviser business models, they are the easiest of conflicts to eliminate. All it takes is the will to do so.

* * *

In conclusion, the only way to ensure compliance with a meaningful best interest standard is to rein in harmful incentives that would otherwise taint advice. This requires firms to adopt strong anti-conflict policies and procedures that are tailored to the specific risks that different types of conflicts pose to investors' well-being. This framework for addressing common conflicts of interest among both broker-dealers and investment advisers is rigorous enough to protect investors' interests and flexible enough to work across a variety of business models.

Appendix D: Legal Analysis of How Reg BI Would Weaken Protections Investors Currently Receive

Position Paper on the SEC's Proposed Regulation Best Interest

Jill I. Gross*

I have reviewed the Securities and Exchange Commission's proposed Regulation Best Interest, released for public comment in April 2018 ("Reg BI").[43] Reg BI, if approved, would "establish an express best interest obligation: that all broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as "broker-dealer"), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer."[44]

Regulation Best Interest vs. Current Law

One of the premises of the proposal is that the new Regulation will *strengthen* the regulation of broker-dealers in their dealings with their customers. Indeed, when releasing the proposed rule, the Commission stated "we believe it is appropriate to make *enhancements* to the obligations that apply when broker-dealers make recommendations to retail customers."[45] However, according to my analysis of current law, Reg BI offers *less protection* than is available under the current law governing a broker-dealer's duties to its customers.

The leading case setting forth the obligations of broker-dealers to their customers under the common law is *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[46] In *Leib,* the U.S. District Court for the Eastern District of Michigan reiterated the well-established rule that, if a broker-dealer has trading discretion in a customer's account, that broker-dealer is in a fiduciary

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[43] SEC Regulation Best Interest, Release No. 34-83062; File No. S7-07-18 (Apr. 18, 2018). Reg BI details how a broker can satisfy the requirements of the new regulation. *Id.* at 8-9.

[44] *Id.* at 8. For purposes of this position paper, as in Reg BI and unless otherwise indicated, the term "broker-dealers" include the firm as well as natural persons who are associated persons of a broker-dealer.

[45] *Id.* (emphasis added).

[46] 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd mem.*, 647 F.2d 165 (6th Cir. 1981). Many federal and state courts across the country still follow the framework of broker-dealers' obligations set forth in *Leib.*

relationship with the customer and owes broad duties of care to customers.[47] The *Leib* court further held that, even a broker-dealer for a nondiscretionary account, although not a fiduciary "in a broad sense," owes his customer six specific duties of a fiduciary nature[48]:

> (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis ...; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests ...; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security ...; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security ...; (5) the duty not to misrepresent any fact material to the transaction ...; and (6) the duty to transact business only after receiving prior authorization from the customer....[49]

The distinction made in *Leib* between a nondiscretionary account, in which the broker's duties end upon the completion of each transaction, and a discretionary account, in which the broker has a continuing duty to further and protect his customer's interests, has been widely followed by courts.[50] However, even the *Leib* court pointed out that there is a "hybrid-type account" between the purely nondiscretionary account and the purely discretionary account, in which the "broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer *the same fiduciary duties* as he would have had the account been discretionary from the moment of its creation."[51]

Thus, in addition to when the customer has granted discretion to the broker, in most states, brokers owe enhanced duties to their customers if the broker has control over the customer's

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[47] *Id.* at 952-53.
[48] *Id.* at 953.
[49] *Id.* at 952-53.
[50] *See* de Kwiatkowski v. Bear Stearns & Co., Inc., 306 F.3d 1293, 1302 (2d Cir. 2002) ("It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis ... The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention."); McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766 (3d Cir. 1990); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987); Berki v. Reynolds Sec., Inc., 560 P.2d 282, 286 (Or. 1977).
[51] *Leib*, 461 F. Supp. at 954 (emphasis added); *see also* Hecht v. Harris, 430 F.2d 1202 (9th Cir. 1970); Burns v. Prudential Secs., Inc., 857 N.E.2d 621, 635-36 (Ohio Ct. App. 2006) ("if a nondiscretionary broker assumes control of his clients' accounts and performs transactions *at his own discretion* with the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients") (emphasis in original); Crook v. Shearson Loeb Rhoades, Inc., 591 F. Supp. 40, 50 (N.D. Ind. 1983) (a broker-customer relationship is a fiduciary one, but where the broker "exercised de facto discretionary control over the account [he] had an even stronger fiduciary responsibility toward [the client]").

account,[52] sometimes referred to as "transformative circumstances."[53]

De Facto Control/ Transformative Circumstances

In a more recent leading case, the U.S. Court of Appeals for the Second Circuit recognized that in "transformative 'special circumstances,'" a broker may owe a broader duty to a client than a purely transactional one to prevent the brokers from taking "unfair advantage of their customers' incapacity or simplicity."[54] Such circumstances "that render the client dependent" include "a client who has impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker."[55]

A broker typically acquires *de facto* control over an account in one of two ways. First, the broker, without receiving discretionary authority from the customer, treats the account as if he had been given discretion, initiating trades for the account without obtaining the prior approval of the customer.[56] Second, the customer, without conferring discretionary authority on the broker, nevertheless permits his broker to exercise control over the account. This typically occurs where the broker recommends investments to the customer and the customer, lacking the experience or sophistication to exercise his own judgment concerning his investments, routinely approves the broker's recommendations.[57] In both types of situations, the broker has the same fiduciary duties as he would if the customer had given him formal discretion over the account.[58] To determine whether a broker controls an account, courts consider factors such as whether the broker has acted as an investment advisor and whether the customer almost invariably followed the broker's advice, the sophistication of the customer, whether the broker and customer communicated frequently concerning the status of the account or the prudence of particular transactions, and whether the

[52] Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1216-17 (8th Cir. 1990) (applying South Dakota law and stating that, when analyzing breach-of-fiduciary-duty claims arising from unauthorized trading of securities, the "crucial question is who exercised actual control over the account"); Caravan Mobile Home Sales v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561 (9th Cir. 1985); Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128-29 (D.C. Cir. 1990); Holmes v. Grubman, 691 S.E.2d 196, 201–02 (Ga. 2010) (answering questions certified from the Second Circuit and stating that "the broker will generally have a heightened duty, even to the holder of a non-discretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest").

[53] De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1308 (2d Cir. 2002).

[54] *Id.* at 1308-09.

[55] *Id.* at 1308.

[56] *See* Anwar v. Fairfield Greenwich Ltd., 891 F.Supp.2d 548, 555 (S.D.N.Y. 2012) (when a broker "undertakes a substantial and comprehensive advisory role with respect to nondiscretionary accounts, ongoing duties may be triggered, such as a duty to monitor") (internal quotations and citations omitted); Burns v. Prudential Secs., Inc., 857 N.E.2d 621, 635-36 (Ohio Ct. App. 2006) ("if a nondiscretionary broker assumes control of his clients' accounts and performs transactions at his own discretion with the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients");

[57] Paine Webber v. Adams, 718 P.2d 508, 517 (Colo. 1986) ("proof of practical control of a customer's account by a broker will establish that the broker owes fiduciary duties to the customer with regard to the broker's handling of the customer's account.")

[58] Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 460 (9th Cir. 1986); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); *Leib*, 461 F. Supp. at 954; Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 515-16 (Colo. 1986).

customer placed trust and confidence in the broker, with the broker's knowledge, to manage the account for the customer's benefit.[59]

Fiduciary Duties

Under the common law, if a broker is in a fiduciary relationship with a customer, the broker "must (1) manage the account in a manner directly comporting with the needs and objectives of the customer ...; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests ...; (3) keep his customer informed as to each completed transaction; and (4) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged."[60] Notably, a broker may have a duty to monitor a customer's account, especially where the broker expressly assumes such a duty, even though the broker may not have discretion or otherwise control the account.[61]

Reg BI Weakens Existing Investors' Rights

As demonstrated by the authorities above, courts already recognize that a broker-dealer making recommendations to a customer may have enhanced obligations to that customer to act in the client's best interest, give ongoing advice, and even monitor the account in between transactions, depending on the nature of the account. The notion set forth in proposed Reg BI that a broker does not have such obligations currently is simply not supported by the courts.

Moreover, the circumstances that create a fiduciary duty under the existing case law are present in the typical broker-dealer relationship. While customers may not explicitly grant discretion or control to their broker-dealers, many do hand over implicit control to the individual listed on the account. Many retail investors are incapable of evaluating recommendations on their own, rely on those individuals as "trusted advisors" (in fact they are told by broker-dealers' marketing materials to rely on them), and follow their advice without questioning what is best for them. They reasonably believe they are in long-term relationships of trust and confidence and that their "advisor" will monitor their account and keep them apprised of any changes that should be made. Based on how these relationships are marketed and work in practice, it is entirely understandable why investors expect that they will receive ongoing services from broker-dealers.

Additionally, Reg BI applies a mechanical approach to recommendations, such that there is *never* an ongoing duty. This approach defeats, rather than matches, retail investors' legitimate expectations. If the issue of whether a broker-dealer owes its customer an ongoing duty is adjudicated in court or in arbitration, it is reasonable to assume that a court or panel of arbitrators would look to the SEC standard for the applicable legal principles (the brokerage industry will certainly argue that it should). This would increase the risk that, despite the fact that the *case law*

[59] *Adams,* 718 P.2d at 516-18; *see also* David K. Lindemuth Co. v. Shannon Fin. Corp., 660 F. Supp. 261, 265 (N.D. Cal. 1987) ("The key in determining control of the account is whether the customer can independently evaluate his broker's suggestions, based on the information available to him and his ability to interpret it"); Wallace v. Hinkle Northwest, Inc., 717 P.2d 1280, 1282 (Or. App. 1986) ("A stockbroker is a fiduciary if his client trusts him to manage and control the client's account and he accepts that responsibility").

[60] *Leib*, 461 F. Supp. at 953-54; Rupert v. Clayton Brokerage Co. of St. Louis, 737 P.2d 1106, 1109 (Colo. 1987).

[61] *See Vucinich*, 803 F.2d at 460-61 (California law); Khan v. BDO Seidman, LLP, 948 N.E.2d 132, 152 (Ill. App. 2011), *aff'd sub nom.* Khan v. Deutsche Bank AG, 978 N.E.2d 1020 (Il. 2012).

would apply a fiduciary duty to circumstances described above, *the SEC's standard* would not. To the extent a court or arbitration panel determines that the SEC standard should control rather than existing case law, investors' rights would be significantly weakened.

For all of the foregoing reasons, it is my opinion that Reg BI, if approved as currently drafted, will reduce current investor protections, rather than enhance them.

Appendix E: CFA's Prior SEC Comment Letters on Issues Related to the Standard of Care for Broker-Dealers and Investment Advisers

Letter from Barbara Roper, CFA Director of Investor Protection, to Securities and Exchange Commission Chairman Arthur Levitt, urging him to strengthen regulation of broker-dealers' investment advice, October 1999, http://bit.ly/2eXC5T4.

Letter from Roper to SEC, commenting on fee-based brokerage account rule proposal, January 2000, http://bit.ly/2eMqEhg.

Letter from Roper to SEC Chairman Harvey Pitt urging him to reconsider the Commission's anti-investor approach in the fee-based brokerage account rule, December 13, 2001, https://bit.ly/2SYLUyz.

Letter from Roper to SEC, commenting on renewed proposal to adopt a fee-based brokerage account rule, September 2004, http://bit.ly/2wZ3xHw.

Letter from Roper to SEC Chairman William Donaldson, rebutting SIA arguments regarding the fee-based brokerage account rule and offering a pro-investor alternative, October 2004, http://bit.ly/2vVbiKP.

Letter from Roper to SEC, CFA letter challenging the SEC's interpretation of solely incidental to exemption for broker-dealers, including its mischaracterization of the legislative history on which that interpretation is based, February 2005, http://bit.ly/1T6xNS2.

Letter from Fund Democracy, CFA, Consumers Union and Consumer Action to SEC, commenting on the revised fee-based brokerage account rule proposal, February 2005, http://bit.ly/2xc8M7i.

Letter from CFA and Fund Democracy to SEC Chairman Christopher Cox, challenging the staff interpretation of the applicability of the Investment Advisers Act to financial planning services offered by broker-dealers, February 2006, http://bit.ly/2xQ5I36.

Letter from Roper to SEC, commenting for the staff study regarding the standard of conduct for broker-dealers and investment advisers, August 2010, http://bit.ly/2f7gcBf.

Letter from Roper to SEC, commenting on the RFI on the standard of conduct for broker-dealers and investment advisers, July 2013, http://bit.ly/2veGjfw.

Letter from AARP, CFA, Fund Democracy, CFP Board of Standards, Financial Planning Association, and NAPFA in response to the Request for Information regarding the standard of conduct for broker-dealers and investment advisers (with a particular focus on evidence of investor harm), April 2014, http://bit.ly/2gPXyhx.

Letter from Roper and CFA Financial Services Counsel to SEC Chairman Jay Clayton responding to his request for input on the standard of conduct for broker-dealers and investment advisers, September 14, 2017, https://bit.ly/2LSFkLg.

Letter from Roper and Hauptman to SEC Chairman Clayton urging the agency not to simply rebrand suitability as a best interest standard, March 15, 2018, https://bit.ly/2TKwfY9.

Letter from 24 organizations to SEC Chairman Clayton urging him to conduct qualitative testing of the Form CRS disclosure and delay the comment period on Reg BI until 90 after the test results are made public, May 21, 2018, https://bit.ly/2Jkc7ay.

Letter from AARP, CFA and the Financial Planning Coalition to SEC Chairman Clayton providing the results of our qualitative testing of Form CRS and urging the Commission to revise and retest the proposed disclosure, September 12, 2018, https://bit.ly/2CXfz6W.

Letter from Roper and Hauptman to SEC Secretary Fields commenting on the RAND Study of Form CRS, December 7, 2018, https://bit.ly/2BhQlh2.

Additional letters are available on the Investment Professionals page of the CFA website at: http://consumerfed.org/issues/investor-protection/investment-professionals/

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CFA Institute Views on SEC's Proposed Regulation Best Interest Proposals

Regulation Best Interest

CFA Institute[1] has long advocated for a uniform fiduciary standard for all who provide personalized advice to retail investors. While proposed Regulation Best Interest (Reg BI) does not accomplish this, it is a step in the right direction. But, to be fully effective in its objectives for *clarity and investor protection, Reg BI requires substantial changes.*

Suggested Revisions

- ***Definition***. The BI standard needs to be defined to distinguish for investors the difference between the BI (proposed for brokers) and fiduciary (applicable to advisers) standards.
- ***Conflicts.*** Conflicts of interest that provide financial incentives to brokers should be prohibited (e.g., sales contests, bonuses based on sales levels).
- ***Disclosure***. Brokers should provide "full and fair disclosure" of material conflicts of interest, particularly with respect to recommendations involving proprietary products and all conflicts involved in rollover recommendations.

Form Customer Relationship Summary

CFA Institute supports providing information to investors that help them in investment decision-making, including choosing the service provider most appropriate for their investment objectives. We thus support the objective of Form Customer Relationship Summary (CRS), which is to educate investors in choosing an adviser or broker dealer.

But as written, the form fails in its format and substance to compare the proposed best interest and fiduciary standards in a meaningful manner. In particular, it continues to blur the distinctions between financial "sales people" and "fiduciary advisers."

We strongly support the use of experts who are skilled in consumer communications to conduct investor testing and to provide input on both the presentation of substance and format that will

[1] CFA Institute is a global, not-for-profit professional association of nearly 169,000 investment analysts, advisers, portfolio managers, and other investment professionals in 164 countries, of whom more than 162,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 154 member societies in 77 countries and territories.

result in the best investor experience. *As drafted, the format is outdated, does not engage the investor, and fails to clearly convey critical information.*

Suggested Revisions

- ***Substance.*** The CRS tries to convey too much information and on a too-technical level for investors to understand.
- ***Clarity—standard and services.*** The CRS needs to clarify the differences between a best interest and fiduciary standard. As drafted, it implies that best interest is the higher standard. It also needs to better distinguish services provided by broker-dealers and investment advisers, and particularly that the broker does not provide continuous monitoring of client accounts.
- ***Fees.*** The CRS should provide examples of costs illustrative of what investors may pay under the different providers so that investors to apply them to their actual situations.
- ***Availability.*** CRS information should be made available to investors *prior to* meeting with a broker or adviser, so that investors have the information to first choose the service provider that is most appropriate. Receiving the information at the time of engaging with the provider will not to allow the needed evaluation.

Restrictions on the Use of Certain Names or Titles

CFA Institute strongly supports the proposed restrictions on the use of "adviser" or "advisor" to those who are registered investment advisers.

The prevalent and ongoing misuse of titles has perpetuated mis-selling and contributed to investor confusion as the activities of certain broker-dealers and investment advisers have been allowed to blur. Restricting the use of these names/titles to those who are required to operate under the higher fiduciary standard serves an important investor protection mandate.

Suggested Revisions

- ***Marketing activities as an adviser.*** The restriction on the use of titles should also extend to broker-dealers who may not expressly refer to themselves as "advisors/ers" but nonetheless hold themselves out as offering investment advice. This approach will provide added investor protections for those marketing themselves in ways that imply adherence to a fiduciary standard, when that is not the case.

INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

March 14, 2019

The Honorable Carolyn Maloney
Chairman
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga
Ranking Member
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives
Washington, D.C. 20515

Re: March 14, 2019 Hearing Entitled "Putting Investors First? Examining the SEC's Best Interest Rule"[1]

Dear Madam Chair and Ranking Member Huizenga:

I am writing on behalf of the Institutional Limited Partners Association (ILPA) to express our appreciation for holding the above referenced hearing and to provide you with our views on the impact on private equity fund advisers ("PE Advisers") and their investors, of the *Proposed Interpretation Regarding Standard of Conduct for Investment Advisers*[2], a component of the Best Interest Rule, which we understand may be discussed at the hearing. We would respectfully request that this letter be made a part of the hearing record.

ILPA is the voice of institutional investors invested in the private equity ("PE") asset class, known as Limited Partners ("LPs"). Our 500+ member institutions represent over $2 trillion in PE assets under management and include U.S. and global public and private pension funds, insurance companies, university endowments, charitable foundations, family offices, and sovereign wealth funds, all of which invest in the U.S.

[1] Hearings, United States House of Representatives, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (March 14, 2019), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402388
[2] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, SEC Rel. IA-4889, File No. S7-09-18 (Apr. 18, 2018). ("Proposed Interpretation")

PE market.[3] LPs provide the capital that fuels private equity and venture capital investment, generating economic growth and job creation, across America and around the world. In addition to providing this critical capital for economic growth, LPs are the trusted financial stewards investing the assets of average Americans in a class of investments consistently providing high investment returns so that they may enjoy financial security and comfort. Limited partner beneficiaries include teachers, first responders, students receiving university scholarships, and charity recipients, among others.

Strong fiduciary duties are the foundation of the relationship between LPs and the PE Advisers they invest with. These duties of care, loyalty, and good faith foster the trust that gives investors confidence to invest with investment managers, particularly in private markets; markets that by their very nature exhibit less transparency. Unfortunately, LPs are facing significant resistance in their efforts to retain meaningful fiduciary protections while investing in the PE market, ultimately raising the risk of harm to beneficiaries. The loss of certain fiduciary protections is magnified due to the illiquid nature of these investments, which often last for 10-15 years in duration. Addressing these challenges will require both action by the SEC while finalizing their Proposed Interpretation, and legislative solutions in Congress to address the reduction of fiduciary duties in the investment contracts of PE Advisers.

The primary sources of fiduciary obligations owed by PE Advisers to LPs are found in two places: the Investment Advisers Act of 1940 ("Advisers Act") and those included in the investment contract between the LP and the PE Adviser, generally governed under the laws of the state of Delaware.[4] ILPA believes that the SEC could and should improve their final Proposed Interpretation in a variety of ways, which are outlined below. ILPA also encourages Congress to take action to address the problem of federally registered PE Advisers reducing or eliminating their fiduciary duties under their investment contracts with investors. Addressing these issues will only become more critical should retail investors gain the ability to invest in PE, as we understand is being evaluated by the Commission.[5]

Overview of Fiduciary Duties under the Advisers Act & ILPA's Suggested Improvements to the SEC's Proposed Interpretation:

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[3]As an illustration of the members we represent, the ILPA Board of Directors includes representatives from: Guardian Life Insurance Company, Teacher Retirement System of Texas, Oregon State Treasury, Washington State Investment Board, California State Teachers Retirement System (CalSTRS), Tufts University Investment Office, and the Alaska Permanent Fund Corporation, among others: https://ilpa.org/who-we-are/board-of-directors/

[4] Most private equity funds in which U.S. LPs invest are formed under the Limited Liability Company and Limited Partnership laws of the State of Delaware. *See* Michael Hong, *Fiduciary Duties under the Advisers Act vs. Delaware Law*, LAW360, April 7, 2017, *available at:* https://www.law360.com/articles/896627/fiduciary-duties-under-the-advisers-act-vs-delaware-law

[5] "Mr. Clayton said the SEC is now weighing a major overhaul of rules intended to protect mom-and-pop investors, with the goal of opening up new options for them." Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals*, WALL STREET JOURNAL, August 30, 2018.

As members of this Subcommittee are likely aware, the Advisers Act fiduciary obligations of investment advisers are not expressly stated in the statute passed in 1940, but instead were interpreted to exist under the anti-fraud provisions of the law (by the U.S. Supreme Court in the case *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963). This case (and subsequent case law) set out that investment advisers, including those advising private equity funds, have both a duty of loyalty (i.e. they must act in the best interest of their investors), and a duty of care (i.e. they must not act negligently in their duties).[6] Most importantly for LPs, the fiduciary duties under the Advisers Act are **only** enforceable by the SEC, and only apply to the fund as a whole, not the individual LPs within it.[7] LPs are most concerned with the provisions in the Proposed Interpretation that discuss the duty of loyalty and the obligations of the PE Advisers to disclose conflicts of interest and achieve "informed consent" from the investors. We encourage the Commission to do more to make clear the obligations of PE Advisers.

This duty of loyalty is particularly critical to LPs, given the increased diversity of GP services that has accompanied the growth and maturation of this asset class. As the private equity industry has grown, many GPs have dramatically expanded their business lines, effectively becoming large asset managers. The increased scale and breadth of PE Advisers' activities, as well as the varying types of clients and funds they advise, has resulted in a concurrent rise in potential and actual conflicts of interest[8], and therefore greater risk of breaching their duty of loyalty.

Since 2014, there have been at least 18 SEC enforcement actions against private fund advisers that were found to have breached their fiduciary duties.[9] Many of these

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[6] "An investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty." *See* Proposed Interpretation at P. 7.

[7] *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006).

[8] "Conflicts of interest are a particularly important challenge for large financial institutions and asset managers with complex structures. Due to these firms' extensive affiliations and the dynamic nature of their businesses, conflicts are constantly arising and changing." *See* Michael Sakala and Daniel New, *Managing conflicts of interest in the alternative investment industry,* Ernst & Young, September 2013, *available at:* https://www.ey.com/Publication/vwLUAssets/EY_-Conflicts_of_interest_in_alternative_investment/$FILE/EY-conflicts-of-interest.pdf

[9] The cases where private fund advisers were found to have breached their fiduciary duties by the SEC include: *In the Matter of THL Managers V, LLC and THL Managers VI, LLC* (June 29, 2018) (Failed to disclose accelerated monitoring fees); *In the Matter of Aisling Capital, LLC* (June 29, 2018) (Failed to offset consulting fees charged to investors); *In the Matter of WCAS Management Corp.* (April 24, 2018) (Failed to disclose conflicts of interest between adviser & clients); *In the Matter of TPG Capital Advisers, LLC,* (December 21, 2017) (Failed to disclose accelerated monitoring fees); *In the Matter of Capital Dynamics, Inc.,* (August 16, 2017) (Inappropriately charged management expenses to the fund/investors); *In the Matter of SLRA Inc., as successor to Liquid Realty Advisors III, LLC and Scott M. Landress,* (February 7, 2017) (Failure to disclose fees and expenses); *In the Matter of Centre Partners Management, LLC* (January 1, 2017)(Failure to disclose potential conflicts of interest and omission of material facts); *In the Matter of New Silk Route Advisors, LP* (December 14, 2016)(failure to obtain LPAC consent for co-investments); *In the Matter of Apollo Management V, VI, VII and Apollo Commodities Mgmt, LP.* (August 23, 2016) (Failure to disclose accelerated monitoring fees, failing to disclose accrued allocation of accrued interest from a loan would benefit only one fund); *In the Matter of JH Partners, LLC* (November 23, 2015) (Favoring one client over another, failure to disclose conflicts of interest, failure to obtain consent from LPAC on investments outside LPA coverage); *In the Matter of Cherokee Investment*

enforcement actions were against well-known and significant PE Advisers, managing billions of dollars in assets. Most of these actions highlighted the breach of the duty of loyalty, and most significantly the *failure to disclose* either real or potential conflicts of interest or inappropriately charged fees & expenses. While these actions are believed to have deterred other advisers from engaging in similar breaches of fiduciary duty, they have also resulted in a "mountain" of disclosures in the limited partnership agreements ("LPAs") and Private Placement Memorandums ("PPMs") drafted by investment advisers. These complex and opaque documents do not present these disclosures in a standardized way, and often fail to ensure that LPs are clearly informed about the various conflicts that an adviser has or may have, or the fees and expenses that will be charged. As a result, it is often difficult for an LP, even a sophisticated LP, to truly give informed consent when confronted with written LPA terms and PPM disclosures that are broad, opaque, voluminous, inclusive of comprehensive possibilities or potential conflicts that are not thought to be relevant, complex, and sometimes contradicted by the oral statements of the investment adviser.

ILPA has suggested several specific and targeted improvements that should be made to the final Proposed Interpretation in letters sent to the SEC on November 21, 2018[10], and in a follow-up letter signed by 35 of the largest institutional investors in the United States on February 12, 2019.[11] The goal of these suggestions was to improve the disclosure received by investors and ensure they are truly giving informed consent to the PE Adviser. These suggestions included:

- Private fund advisers should be required to explicitly and clearly disclose the standard of care under both state law and the Advisers Act owed to LPs and the fund.

Partners, LLC and Cherokee Advisers, LLC, (November 5, 2015) (Failure to disclose funds would be charged for GP legal and compliance expenses); *In the Matter of Fenway Partners, LLC et. al.,* (November 3, 2015) (Failure to disclose conflicts of interest regarding use of outside consultants and application of fee offsets); *In the Matter of Blackstone Management Partners LLC, III and IV,* (October 7, 2015) (Failure to disclose accelerated monitoring fees, failure to disclose disparate legal fee discount between GP and Fund); *In the Matter of Guggenheim Partners Investment Management, LLC* (August 10, 2015) (Failure to disclose that an executive received a loan to personally participate in a Guggenheim acquisition, inadvertently billing a client for management fees on non-managed assets); *In the Matter of Kohlberg Kravis Roberts & Co, LP,* (June 29, 2015)(Failing to allocate broken deal expenses to co-investors rather than fund); *In the Matter of Alpha Titans LLC et. al.,* (April 29, 2015) (Using fund assets to pay expenses without clear authorization in the LPA); *In the Matter of BlackRock Advisors, LLC,* (April 20, 2015) (Failing to disclose conflict of interest involving the outside business activity of a portfolio manager); *In the Matter of Lincolnshire Management, Inc.,* (September 22, 2014) (Failing to follow expense allocation policy in LPA).

[10] Follow up letter from the Institutional Limited Partners Association to the Securities & Exchange Commission regarding the "*Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18*", November 21, 2018.

[11] *Institutional Investor Letter on Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18*", February 12, 2019.

- The SEC should clearly state that the standard of care owed to the clients of private fund advisers under the Advisers Act is a "negligence" standard.

- "Pre-clearance" of conflicts of interest should be limited, and specific details of each conflict must be presented to the LPs to receive true "informed consent."

- The SEC should indicate that for private fund advisers, having a Limited Partner Advisory Committee (LPAC) is best practice, and all perceived conflicts should be presented to the committee for resolution.

- The SEC should provide more clarity surrounding hedge clauses, including the limits of their scope, and the facts and circumstances in which they can be used.

- The SEC should issue a statement indicating that any settlements of an enforcement action with a private fund adviser will be conditioned upon that adviser itself assuming those costs (including attorneys fees), rather than seeking indemnification from investors.

We ask members of the Subcommittee to encourage the Commission to make these changes to ensure that investors truly can give "informed consent" to actual and prospective conflicts of interest that would otherwise violate a PE Adviser's fiduciary obligation.

Overview of Fiduciary Obligations under the Investment Contract with PE Advisers

The contractual fiduciary obligations under the Delaware limited partnership and LLC laws are slightly different than those under the Advisers Act, but currently more critical to LPs. In 2004, the Delaware legislature enacted laws that permitted General Partners and LLC Managing Members[12] to disclaim their fiduciary duties of care, loyalty and good faith owed to LPs and LLC members.[13] Prior to 2004, Delaware, where many partnerships and LLCs are domiciled, required fundamentally the same fiduciary duty obligations for PE Advisers as those under the Advisers Act. After 2004, PE Advisers were permitted to contract away their duties of care and loyalty under Delaware law. "By contractually waiving fiduciary obligations, a fund manager 'has almost no extracontractual constraints on it'...the limited partners are left to rely upon the 'implied covenant of good faith and fair dealing, which is explicitly protected within the Delaware statutes, but seldom found by the Delaware courts as a source of protection."[14]

[12] Under partnership or LLC laws, the PE Adviser is structured into serving as the General Partner or Managing Member of the LLC, directing the investment activities of the private equity fund, while the Limited Partners or LPs are the passive investors in the fund.
[13] Courtney Nowell, Matthew Cohen and Brooke LoCoCo, *A Call to Duty: Waivers of Fiduciary Duty under Delaware Law,* Squire Patton Boggs, Vol. 22, No. 7, July 2015, *available at:* www.squirepattonboggs.com/~/media/files/insights/publications/2015/07/a-call-to-duty-waivers-of-fiduciary-duty-under-delaware-law/a_call_to_duty_waivers_fiduciary_duty_under_delaware_law.pdf
[14] *Id.* at 2.

Fiduciary duties under Delaware law, if they have not been contracted away under the LLC agreement or LPA, apply to the fund as a whole, and each individual LP. They also are enforceable in court by the LPs and provide a remedy in the case of breach by PE Advisers.

Given that the Advisers Act duties can only be applied in an SEC enforcement action, only apply to the fund as a whole (rather than the individual investors), and usually do not result in a financial recovery of the full LP losses if they are triggered, they are generally less protective than those found in the investment contract under Delaware law. Unfortunately, federally registered PE Advisers with fiduciary duties under the Advisers Act are permitted to contract away those same exact duties under their investment contracts with their investors. This is becoming an increased concern due to market trends.

PE Advisers Are Actively Reducing Their Fiduciary Obligations in Their Investment Contracts with Investors

Federally-registered PE Advisers are increasingly reducing or diminishing their fiduciary obligations to their investors under Delaware law. While the impact of the change in Delaware law permitting this to occur was not immediately felt in the private equity marketplace due to the Great Recession, as the market has rebounded, the legal terms have becoming immensely more challenging. This has been exacerbated by the current fundraising environment, which is characterized by unprecedented fund raising levels and speed, where GPs have significant leverage in negotiations, and many LPs, particularly public pensions, are forced to deploy capital under disadvantaged terms in order to achieve allocations in the sorts of high performing funds that will help them to attain certain actuarial performance thresholds necessary to meet their pension and other disbursement requirements.[15] LPs, including even the nation's largest public pensions, with correspondingly reduced leverage in negotiations, have continued to face a market where they are forced to accept these reductions in the applicability of basic duties of fairness, loyalty and good faith owed to them by the investment advisers they invest with. This was evidenced in an October 2018 poll of over 80 LP organizations conducted by ILPA, in which 69% of LP organizations indicated they had been faced with reduced fiduciary duties in the LPAs they were required to sign to invest, with 54% seeing an increased frequency in reduced fiduciary duties in LPAs. Out of the 89 LP organizations responding to the poll, 42% of LP organizations had been forced to walk away from an investment because these duties could not be restored in negotiation.

[15] "While many in the industry anticipated 2017 would be another strong year for private equity fundraising, I suspect few would have predicted that 2017 would witness the largest amount of capital ($453 bn) raised in any year." *See* Christopher Elvin, *Private Equity in 2018,* 2018 Preqin Global Private Equity & Venture Capital Report, 15, *available at:* http://docs.preqin.com/reports/2018-Preqin-Global-Private-Equity-Report-Sample-Pages.pdf

Some of the largest LPs have been forced to walk away from investment opportunities because the PE adviser was requiring them to accept terms permitting the manager to think of its own interests (i.e., permitting the manager to act in its "sole discretion") before the interests of the institutions providing the PE Advisers with their capital. As the poll evidences, the ability of LPs to retain basic protections has been substantially undermined in recent years. This challenge is magnified for U.S. public pension plans. Their ongoing commitments to PE are critical in order to generate sufficient investment returns for beneficiaries, but they may be unable to invest with managers that have reduced or eliminated their fiduciary duties due to their own fiduciary obligations to pensioners. This results in capital being left out of the marketplace and harms the ability of pensioners to achieve the returns they need.

We believe Congress should take action to ensure that these federally registered PE Advisers are not able to avoid their full fiduciary obligations by reducing or eliminating them in their investment contracts with LPs. The Advisers Act could be amended to prevent federally registered PE Advisers from contracting to a lower fiduciary standard than that in the Advisers Act in their investment contracts. Taking this action will ensure there are basic, minimum standards in the asset class that require PE Advisers to truly act in the best interest of their investors.

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If we can answer any questions or provide additional information that would be helpful to you or the Subcommittee, please do not hesitate to contact me at (202) 871-9367 or chayes@ilpa.org.

Sincerely,

Christopher Hayes
Senior Policy Counsel
Institutional Limited Partners Association (ILPA)

NAIFA National Association of Insurance and Financial Advisors

March 12, 2019

The Honorable Maxine Waters	The Honorable Patrick McHenry
Chairwoman	Ranking Member
House Committee on Financial Services	House Committee on Financial Services
2129 Rayburn House Office Building	2129 Rayburn House Office Building
Washington, DC 20515	Washington, DC 20515

RE: NAIFA Statement for the Record
Hearing of the Subcommittee on Investor Protection
Putting Investors First? Examining the SEC's Best Interest Rule
March 14, 2019

Chairwoman Waters, Ranking Member McHenry, and Members of the Committee:

The National Association of Insurance and Financial Advisors (NAIFA) appreciates this opportunity to share our perspective on the Securities and Exchange Commission's (SEC) proposed Regulation Best Interest[1] (the "proposal") and how, if finalized, it will protect and advance the interests of investors. We commend the Committee for taking up this important issue and welcome future opportunities to work with you on consumer protection initiatives and measures to improve Americans' financial security.

Founded in 1890 as The National Association of Life Underwriters (NALU), NAIFA is the oldest, largest and most prestigious association representing the interests of insurance professionals from every Congressional district in the United States. NAIFA members assist consumers by focusing their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, retirement planning, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members.

NAIFA supports a best interest standard of conduct for securities-licensed firms and individuals. With its proposal, the SEC went to considerable effort to establish such a standard *without*

[1] SEC, Proposed Rule, Regulation Best Interest, 83 Fed. Reg. 21574 (May 9, 2018); SEC, Proposed Rule, Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, 83 Fed. Reg. 21416 (May 9, 2018).

imposing unduly prescriptive or burdensome implementation or compliance requirements that ultimately could disadvantage low- and middle-income savers. The SEC's general approach, we believe, significantly strengthens the standard of conduct for financial services professionals while preserving choice and access to advice and investment products for consumers at all income levels and account sizes.

The SEC's principles-based proposal strengthens investor protections and will not discourage saving by low- and middle-income families.

The SEC's proposal contains a robust, substantive regime to protect investors by making sure the advice they receive is in their best interest, reducing confusion about financial professionals' obligations and potential conflicts of interest, *and* preserving all investors' access to financial professionals and products that will help them save. Notably, the proposal:

- Clearly requires that clients' interests be placed above firms'/advisors' interests when investment recommendations are given, and requires individualized and thorough analyses of the appropriateness of a recommendation to a particular client;
- Is product- and compensation-neutral, which allows for the recommendation and sale of diverse products under compensation arrangements that make sense for all types of investors;
- Contains simple and meaningful disclosure obligations, including disclosure of all material conflicts of interest, types of compensation involved, and the best interest standard to which the advisor must adhere;
- Calls for policies and procedures to be established at the firm level to address conflicts of interest; and
- Utilizes existing federal enforcement mechanisms, rather than the private plaintiffs' bar and state courts, to enforce and interpret the new standard and attendant requirements.

The focal point of the SEC's new structure—the best interest standard—enhances the professional standard of conduct for broker-dealers (BDs) and registered representatives (RRs) who advise retail customers. This heightened standard *requires* BDs and RRs to act in the best interest of their clients when making recommendations without placing their own interests ahead of their customers' interests. It also sets forth clear supporting obligations to ensure fulfillment of the standard:

- Disclosure Obligation – requires concise upfront disclosures regarding conflicts of interest and the nature and terms of the advisor-client engagement;
- Care Obligation – requires advisors to exercise reasonable diligence, care, skill, and prudence in evaluating recommendations and conducting individualized analyses on whether a recommendation is in the best interest of a particular client; and

- Conflict of Interest Obligation – requires firms to maintain *and enforce* policies and procedures to disclose, mitigate and/or eliminate conflicts of interest.

The SEC's proposed Form CRS also would require *additional* disclosures to address potential consumer confusion about the financial professionals with whom they are working. Form CRS would require financial professionals to provide a description of the relationship and services provided (including a plain-English explanation of whether brokerage or advisory services, or both, will be offered), as well as applicable standards of conduct, fees and costs, and potential conflicts of interest. All disclosures under the proposal are required to be concise, easy-to-understand descriptions of the important features of the financial professional-client relationship and the services and products being offered.[2]

NAIFA members serve Main Street investors who deserve advice that is in their best interest <u>and</u> choice and affordability in the marketplace.

NAIFA members work primarily with lower and mid-market clients – the average "Janes and Joes" who are often referred to as "Main Street America" – to help these consumers build a safe and sound financial future for their families. Vital to achieving this goal is maintaining consumer choice and access by small account holders to products they want to buy, professional advice and investment education, and advisor compensation arrangements that are realistic for and beneficial to the client. Consequently, while we support a strong best interest standard for licensed firms and individuals, it is important that regulations *not* impose unnecessary costs and burdens on businesses or consumers, be more prescriptive than necessary, or artificially force the market toward regulator-preferred (not consumer-driven) business models, products, or compensation arrangements that simply do not work for many American families.

According to a recent survey of NAIFA members, 83% of NAIFA members reported that a majority of their clients have household incomes of less than $150,000, while nearly one-third of NAIFA members reported that most of their clients have household incomes of $100,000 or

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[2] NAIFA has encouraged the SEC to revise its proposed titling restrictions (i.e., restricting the use of the words "advisor/adviser" for BDs and RRs) because that piece of the proposal, we believe, is unnecessary and actually has the potential to *add* consumer confusion. The proposed restrictions, for instance, would apply only to BDs and RRs and not the numerous other professionals using those words and delivering advice on a wide variety of financial topics (e.g., various insurance products, college funding, home ownership and real estate, risk management, estate planning, tax, charitable giving, etc.). Barring ubiquitous words for a particular segment of the financial services sector does *not* enhance consumers' understanding of the specific obligations and standards that apply to their advisor(s). Straightforward disclosures, which already are included in the proposal, are a far better and more direct way for consumers to gain such an understanding, as well as the products and services offered under what terms, regardless of title.

less.[3] With respect to liquid assets (including cash, stocks, bonds, and mutual funds, but excluding real estate and vehicles), more than two-thirds of NAIFA members said that a typical client's amount of liquid assets totals less than $250,000, while over 40% of our members reported that a typical client's liquid assets totals less than $100,000[4] -- an amount well short of current account minimums for many fee-based investment accounts.

Indeed, traditional commission-based compensation models typically *benefit* low- and middle-income investors like NAIFA members' clients. Unlike for high-wealth consumers, the alternatives to commission-based compensation arrangements – upfront advisory fees with ongoing asset management fees, and wrap account arrangements – are not workable or palatable for many of our members' Main Street clients. In fact, a 2011 survey of 25.3 million IRA accounts found that a large majority of IRA investors opted for commission-based arrangements over fee-based arrangements, and low-balance account holders favored commission-based arrangements at an even higher rate – for good reason.[5]

As a fundamental matter, clients who are deciding whether they have the resources to save at all will be unable or unwilling to pay a substantial out-of-pocket fee that represents a significant portion of the assets they may have to invest. Further, fee-based arrangements are often not available to and/or do not make economic sense for many non-wealthy investors. An internal survey of NAIFA members revealed that for 78% of our members, *more than half* of their current clients would experience increased costs if their accounts were shifted from commission-based to fee-based arrangements; and for about 41% of our members, *more than 80%* of their clients would see such an increase (a strong argument against all advisors moving to an investment advisor (IA)/investment advisor representative (IAR)/fee-based platform).

Generally, under a brokerage model, investors pay a one-time commission when an asset is purchased or when "new money" is invested in the account. Under a fee-based model, on the other hand, investors pay regular (e.g., annual) fees for account "management" services based on the total amount of assets under management, not just "new money." Thus, for some investors, the fee-based arrangement will likely result in unnecessary or excessive charges – for example, investors who buy and hold assets for a long period and do not require any real level of "management" (e.g., annuity and target fund purchasers) or investors who simply transfer money between investments in the same fund family (a move for which many commission-based advisors receive no additional compensation).

[3] NAIFA Survey: NAIFA Members Serve Main Street Americans, Feb. 2019, available at https://www.naifa.org/News-Publications/Research/NAIFA-Survey-NAIFA-Members-Serving-Main-Street-Am.

[4] *Id.*

[5] Milloy, Meghan, American Action Forum, *The Consequences of the Fiduciary Rule for Consumers* (Apr. 10, 2017), available at https://www.americanactionforum.org/research/consequences-fiduciary-rule-consumers/.

There simply is no one-size-fits-all investment scenario that is appropriate for all Americans. Flexibility and diversity of options are essential and attempting to drive all consumers toward particular products and/or business models via overly costly, prescriptive regulations is counterproductive. As described above, the SEC's proposal represents a principles-based approach with a high standard of conduct and clear obligations for financial professionals, but with a commonsense implementation framework that will allow diverse products and compensation arrangements to be offered in the marketplace.

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Ultimately, the entire SEC proposal is designed and has the substantive components necessary to minimize consumer confusion and harm, and to promote smart saving by all Americans. For the foregoing reasons, NAIFA supports the proposal and looks forward to a finalized Regulation Best Interest as soon as possible.

Sincerely,

Jill M. Judd

Jill M. Judd, LUTCF, FSS
NAIFA President

Written Statement of Michael S. Pieciak

President, North American Securities Administrators Association

and

Commissioner, Vermont Department of Financial Regulation

to the

U.S. House of Representatives Committee on Financial Services;

Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

"Putting Investors First? Examining the SEC's Best Interest Rule."

March 14, 2019

Washington DC

Good Morning, Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee. I'm Michael Pieciak, Vermont Commissioner of Financial Regulation and President of the North American Securities Administrators Association ("NASAA").[1]

NASAA members include state securities regulators who for more than 100 years have served on the frontlines of investor protection, safeguarding the financial futures of hardworking Americans, and assisting local businesses and entrepreneurs seeking to raise investment capital. Our unique position as the regulators closest to the investing public provides a window into the concerns of Main Street investors and small businesses.

My colleagues and I are responsible for enforcing state securities laws including investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs to your constituents.

States are leaders in civil and administrative enforcement actions, as well as criminal prosecutions of securities violators. Our most recently compiled enforcement statistics reflect that in 2017 alone, state securities regulators conducted nearly 4,790 investigations, leading to more than 2,000 enforcement actions, including 255 criminal actions. Moreover, in 2017, among licensed financial professionals, NASAA members reported 150 enforcement actions involving broker-dealer agents, 187 actions involving investment adviser representatives, 120 involving broker-dealer firms, and 190 involving investment adviser firms.

I appreciate the opportunity to submit this written statement for inclusion in the record of today's hearing to examine the U.S. Securities Exchange Commission's ("SEC" or "Commission") Regulation Best Interest Proposal ("Proposed Rule" or "Reg. BI").

<u>Elevating the Standard of Care for Broker Dealers</u>

NASAA has long advocated for raising the standard of care applicable to broker-dealers. In the debate over legislative proposals that were ultimately enacted under Sec. 913 of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act ("Dodd-Frank Act"), NASAA supported the enactment of a fiduciary duty standard for broker-dealers when providing investment advice to customers.[2]

Unfortunately, eight-and-a-half years after the enactment of the Dodd-Frank Act, the suitability standard remains in place and broker-dealers are still not required to act in their client's best interest when making investment recommendations. This problem persists despite overwhelming evidence that many retail investors do not understand the differences between investment advisers and broker-dealers, find the different standards of care confusing, or are

[1] The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] For example, see: NASAA's Letter to the House Financial Services Committee regarding the Investor Protection Act (Oct. 26, 2009), http://www.nasaa.org/wp-content/uploads/2011/07/10-27-09-NASAA_IPA_Letter102609.pdf.

uncertain about the meaning of the various titles and designations used by investment advisers and broker-dealers.[3] In fact, retail investors expect that financial services professionals - both investment advisers and broker-dealers - will act in their best interests, or incorrectly believe that their financial advisers, including broker-dealers, are acting in a fiduciary type relationship.[4]

It is necessary to raise the standard of care applicable to investment professionals, to reflect the evolution of how financial advice is delivered to customers, where broker-dealers are acting as *de facto* investment advisers to such customers. Further, as a practical matter, such reforms stand to protect Main Street investors to the tune of $17 billion or more in unnecessary costs annually.[5]

As I noted earlier, we are now eight-and-a-half years since the enactment of Section 913 of the Dodd-Frank Act and the SEC has published a proposal that, while not extending a fiduciary duty to broker-dealers, is aimed at raising the current suitability standard. As explained further in my statement, the benefit of a heightened standard of care should be a regulatory paradigm that enacts meaningful reform for the benefit of investors. It cannot be a conflicts disclosure regime, but should be one where the provider of advice must act in the best interest of the investor. While disclosing and managing conflicts of interest is an important component of any professional relationship, to truly raise the broker-dealer standard of care, the Proposed Rule must recognize that significant conflicts of interest cannot simply be disclosed. To this end, NASAA continues to emphasize that significant conflicts of interest must be prohibited.

Proposed Regulation Best Interest

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[3] Section 913 of Title IX of the Dodd-Frank Act required the Commission to conduct a Study regarding the obligations of brokers, dealers, and investment advisers. The required Study was completed by the SEC Staff and published in January 2011. The Study concluded that: "*The foregoing comments, studies, and surveys indicate that, despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities. This lack of understanding is compounded by the fact that retail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals. Retail investors are relying on their financial professional to assist them with some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations.*" (See: Section 913 Report. P. 103. https://www.sec.gov/news/studies/2011/913studyfinal.pdf).

[4] Ibid. P. 93-113.

[5] According to a 2015 analysis by the White House Council of Economic Advisers, "*Investment losses due to conflicted advice result from the incentives conflicted payments generate for financial advisers to steer savers into products or investment strategies that provide larger payments to the adviser but are not necessarily the best choice for the saver. Conflicted advice leads to lower investment returns. Savers receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent return to a 5 percent return) ... Thus, we estimate the aggregate annual cost of conflicted advice is about $17 billion each year.*" See: https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

NASAA supports and appreciates the SEC's effort to raise the standard of conduct for broker-dealers. NASAA also supports the SEC's efforts beyond the Proposed Rule itself, including the SEC's proposals to address conflicts of interest, improve fee transparency, restrict the use of potentially misleading professional titles, and clarify investment adviser conflict of interest obligations.

We agree that the Commission should act to address investor confusion regarding the different roles of investment advisers and broker-dealers and should raise the current standard of care applicable to broker-dealer recommendations from suitability to a standard akin to the fiduciary duties owed by investment advisers.

Further, NASAA agrees that the Commission's approach of raising the standard for broker-dealers, while not weakening the current standard applicable to investment advisers, is the correct one. In essence, the Proposed Rule itself says that brokers have an overarching obligation to act in the best interests of their clients, which is very similar to the fiduciary duty that investment advisers owe to their clients. Fundamentally, that obligation should lead both brokers and investment advisers to recommend the best, most cost-effective investment options for their clients that are tailored to those clients' individual needs. This is not the case today, especially in the brokerage industry where financial incentives often rule the day.

Thus, NASAA believes that the Proposed Rule itself represents a first big step forward, and with some key modifications, forms the basis for a strong and effective final rule.[6]

NASAA recommends the following modifications, among others, to the Proposed Rule: (1) define the "best interest" standard, rather than allow the industry to comply with their own interpretation; (2) apply the standard to all investors with only minor exceptions; (3) apply the standard to recommendations regarding account type, since such decisions are part of an overall investment strategy; and (4) explicitly include the word "cost" as a factor that must be evaluated when making a recommendation, since costs have an adverse impact on investor returns.

Additional information about NASAA's perspective on the Proposed Rule, including how we believe the Commission should define the "best interest standard," as well as related SEC proposals,[7] can be found in our comment letters to the SEC.[8]

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[6] The scope of this testimony does not include Form CRS. Congress should look to the comment file for our views. NASAA discussed its preliminary concerns with Form CRS in our first comment letter and suggested that the Form could be improved by, most preferably, overhauling and streamlining existing registration and disclosure forms for both broker-dealers and investment advisers rather than through an entirely new form. Unlike Reg. BI, however, CRS is a form that should be easier to change over time; our main priority right now is getting Reg. BI right.

[7] Related proposals include the SEC's Proposed Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles (File No. S7-08-18), and Standards of Conduct for Investment Advisers (File No. S7-09-18).

[8] See: NASAA's Letter from President Michael Pieciak to Secretary Brent Fields (Feb. 19, 2019); and NASAA's Letters from then-NASAA President Joseph Borg to SEC Secretary Brent Fields (Aug. 7, 2018 and Aug. 23, 2018).

Proposed Guidance

NASAA's main concern at this stage relates to the SEC's interpretive guidance in the proposing release for Reg. BI and whether this guidance will be part of any adopting release. Industry participants rely on proposing and adopting releases in implementing SEC rules; these releases (sometimes referred to as "guidance" or "interpretive guidance") generally provide additional information and gloss for practical application of a rule. Therefore, it is paramount that the adopting release language supports the strongest interpretation of Reg. BI. The guidance in the proposing release appears to send conflicting messages and the wrong overall message to the brokerage industry regarding how industry participants should read the rule and ultimately change their practices to better serve investor interests.[9] This is exactly the wrong message to send to such industry participants if the goal is to develop a standard that eliminates and mitigates conflicts such that investors receive the maximum benefit of their investments.

The SEC's Reg. BI guidance must be firm and unequivocal in that it intends to place investor interests first and recommendations to investors must be made without placing the financial or other interest of the broker-dealer ahead of their client. The message should be clear that self-serving incentives and conflicts are prohibited, and investors must be steered toward products that serve their best interest, which will most often be the best-performing, cost-effective products. Given that the text of the Proposed Rule contemplates meaningful reforms that benefit all investors, the SEC should close any misinterpretation that could allow the industry to continue business-as-usual and yet comply with the rule. Such an outcome would undermine the agency's rulemaking.

The following are examples of how such clarity could be better achieved for Reg. BI:

1. The adopting release should specify that sales contests, the most obvious of self-serving financial incentives for a broker, are inconsistent with the standard. The problem posed by these types of contests are blatantly self-evident; other countries recognize that and have banned them outright.[10] Sales contests are a pernicious feature of brokerage sales activities, and by their very nature, require agents, consciously or not, to put their own interests ahead of customers. NASAA can envision no circumstances under which *any* sales contest would ever be consistent with a broker-dealer's duty under the Proposed Rule. Therefore, the SEC should declare such contests *per se* impermissible under its best interest conduct standard.

2. If not outright prohibited, revenue sharing arrangements between brokers and product manufacturers must be highly scrutinized for compliance with the final rule. Such agreements encourage brokers to offer and recommend to their clients more costly and poorer performing products as a result of higher payouts to the firm.

[9] See: NASAA's Letter from President Michael Pieciak to Secretary Brent Fields (Feb. 19, 2019).

[10] For example, the United Kingdom and Australia; see: https://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1269/RAND_RR1269.pdf.

3. Reg. BI should leave no room for preferential treatment of customers in the allocation of investment opportunities, such as initial public offerings. It should be clear that broker-dealers have no freedom to favor their richest or best-connected customers when allocating investment opportunities. Investment allocations should instead be made based upon objective, fair criteria that is immune from a broker-dealer's own business self-interest.

4. NASAA strongly disagrees that a broker-dealer could satisfy its "best interest" requirements by recommending securities from a limited menu of products without any comparison whatsoever to alternatives beyond such limited menu. Such an interpretation of a "best interest" standard is contrary to the standard of care articulated in the text of the proposed rule, which requires broker-dealers and associated persons to "exercise reasonable diligence" and "prudence" in recommending products.[11] We have urged the SEC to revise the language in the proposing release to make clear that broker-dealers and associated persons need to look outside the firm in considering factors such as cost, complexity, liquidity, and risk of readily available products and investment strategies that meet the customer's investment profile for purposes of making a best interest recommendation.

5. NASAA is also very concerned with language in the proposing release that appears to limit an investor's recovery rights under the new standard, and we believe the SEC should clarify that investors retain all their rights and remedies to seek redress for alleged violations of the conduct standard.

6. In all instances, moreover, the SEC should also provide clear fact pattern illustrations to demonstrate how Reg. BI will address and resolve the issues of conflicted advice.

Conclusion

Proposed Reg. BI is centered on the notion that broker-dealers will only make recommendations that are in the best interest of their client, and that such recommendations will be made without placing the broker-dealer's financial or other interest ahead of the interests of their client. This is what Main Street investors expect and want from their investment professionals – regardless of whether they are a broker-dealer or investment adviser.[12] Therefore, should the SEC adopt a final rule, it must ensure the final rule is true to its promise. Among other things, this means that the SEC must be explicit in both the text of any final rule and the adopting release about its expectation for meaningful reforms that benefit investors by requiring

[11] Proposed Regulation Best Interest, at 53-54.

[12] Congress should also be mindful of the likelihood that if the Proposed Rule is finalized, broker-dealers will undertake marketing campaigns heralding their obligation to act in the "best interest" of clients when recommending securities. This underscores the imperative that any such best interest standard be true to its label.

investment professionals to truly and consistently act in the best interest of their clients and customers.

Ultimately, Reg. BI is meant to better protect investors and align their expectations for the services and advice they receive from broker-dealers. Investors have waited nearly a decade for the SEC to enact a strong standard of care for investment professionals. The SEC can and should seize the present opportunity to align the promise of the Proposed Rule with results for investors.

Statement for the Record by the
Public Investors Arbitration Bar Association
Hearing before the House Financial Services Committee; Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets:
Putting Investors First? Examining the SEC's Best Interest Rule

March 14, 2019

Chairwoman Maloney
Ranking Member Huizenga
U.S. House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship,
and Capital Markets
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairwoman Maloney and Ranking Member Huizenga:

The Public Investors Arbitration Bar Association (PIABA)[1] appreciates the opportunity to submit this statement for the record in connection with the March 14, 2019 hearing, "Putting Investors First? Examining the SEC's Best Interest Rule."

PIABA has long advocated for a true fiduciary standard for brokers who provide investment advice to their clients. Consistent with numerous studies, including the Securities and Exchange Commission's ("SEC") findings in 2011, we believe that a uniform fiduciary duty applicable to all financial intermediaries who provide investment advice would best protect customers.[2] We therefore believe that the fiduciary duty should apply to all forms of financial advice, and should last throughout the duration of

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[1] PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules which govern the conduct of those who provide advice to investors.

[2] SEC, *Study on Investment Advisers and Broker-Dealers* ("SEC Study") (Jan. 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. The SEC reviewed two studies which it sponsored (the "Seigel & Gale Study" and the "RAND Report"), and a study conducted by Consumer Federation of America. The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors did not understand the differences between investment advisers and broker-dealers. The SEC determined that this misunderstanding is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals." *Id.* at 101.

the advisor-customer relationship. We also believe that disclosure should be used to inform investors, and not to absolve firms of responsibility.

Brokers and Investment Advisers should be held to a true fiduciary standard

Most retail investors think their financial advisor – regardless of whether that advisor is a broker or an investment adviser – is a fiduciary.[3] The industry is well aware of this misimpression. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said: "investors don't understand the differences between brokers and investment advisers."[4]

Many firms and their personnel are also "dually-registered," meaning that they operate simultaneously as broker-dealers and as registered investment advisers. Investors working with such firms often open both "brokerage" accounts and "investment advisory" accounts with the same person at the same time. The investors are typically given a sheaf of paperwork, much of it in small print, in which the firm attempts to disclaim any duties related to the brokerage accounts. Investors rarely read these materials; rather they rely on the representations made by their financial advisor about the scope of the relationship. They do not understand that their financial advisor may claim to have one duty with respect to their brokerage account, and a separate and different duty with respect to their advisory account.

Investors are further misled about the scope of brokers' duties by firm advertising. In a study conducted by PIABA in 2015, PIABA examined the websites of nine different brokerage firms (the "PIABA Report").[5] PIABA examined Allstate, UBS, Morgan Stanley, Berthel Fisher, Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab and found that the firms' advertising presents the image that firms are acting in a fiduciary capacity.[6] Those firms have continued to promote themselves as offering all-encompassing financial advice with no differentiation between the firms' investment adviser services and brokerage services.

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[3] *See* Spectrum Group, *Fiduciary – Do Investors Know What it Means* (2015), available at http://spectrum.com/Content_Whitepaper/fiduciary.aspx.
[4] *See* fi360-ThinkAdvisor, *Trustworthy Advice and Individual Investors: Will Regulators Act in Investors' Best Interest?* (Aug. 2013), available at http://www.fi360.com/uploads/media/fiduciarysurvey_resultsreport_2013.pdf; *see also* fi360-ThinkAdvisor, *Seeking Trustworth Advice for Institutional Investors – Financial Intermediaries Indicate Strong Support for Fiduciary Standard* (Feb. 2015), available at http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf.
[5] *See* PIABA, *Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard* (Mar. 25, 2015) (the "PIABA Study"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf.
[6] *Id.* at 1.

Investors have been misled to believe that financial advisors, whether brokers or investment advisers, are acting as fiduciaries when providing investment advice. Firms should be required to meet the expectations they have set with investors. Both brokers and investment advisers should be held to a fiduciary duty that encompasses both a *duty of care* and a *duty of loyalty*.

Duty of Care: The duty of care should require brokers to act with the care, skill, prudence and diligence, that a reasonably prudent person acting in a like capacity would use in connection with providing investment advice, based on the investment objectives, risk tolerance, financial circumstances, and needs of the investor, without regard to the financial or other interests of the broker. This duty would require the investment advice to not only be suitable, but to also be the best possible advice given the circumstances. Investment costs must be a factor in determining what investment is best for a client, as well as investment objectives, risk and liquidity.

Duty of Loyalty: The duty of loyalty should require the mitigation or elimination of conflicts of interest, not just the disclosure of such conflicts – which the industry knows very well are almost never read. Incentives which encourage brokers to engage in conduct that they would not otherwise engage in should be prohibited. Brokers should not be paid differential compensation that is dependent on the product recommended. Commissions should be leveled so that the incentive to recommend one product over another is eliminated.[7] This will ensure that a broker considers the needs of his or her clients, rather than his or her own pecuniary interest. In addition, sales contests should be eliminated because they encourage financial advisors to put their own interests ahead of their clients'.

A true fiduciary standard should apply to all forms of investment advice and should last throughout the duration of the broker-investor relationship

Brokerage firms create the impression that they provide comprehensive advice on a continuous basis. First, brokerage firms give their "registered representatives" titles that sound trustworthy, like "Financial Advisor," "Retirement Consultant," and "Wealth

[7] This is not to say that commission based accounts need to be eliminated to comply with a fiduciary standard, as the industry often attempts to suggest. There are times when a commission based account is the account in the best interests of an investor (as opposed to a fee based account). However, commissions cannot be used to incentivize brokers to sell one financial product over another as that creates a conflict of interest that will encourage fiduciary violations.

Manager."[8] Next, as shown in PIABA's research of brokerage firm marketing, financial services firms tell prospective clients that they can assist investors in planning and managing their wealth and investment goals over the course of their relationship. Brokers encourage investors to *trust* them, saying they will provide *advice* and *guidance*. For example, UBS describes its services as follows, "Advice that's all about you and what you need is what UBS does best. It starts with a plan that we develop together—as part of a strategy for managing your wealth and pursuing your personal goals for every part of your life, at every stage of your life. It's what we call: Advice. Beyond investing."[9] Wells Fargo advertises that "Our Financial Advisors are committed to providing you with top-notch service and attention that you expect and deserve."[10] Merrill Lynch says, "Your advisor will help guide you, making adjustments as your needs change."[11]

Because of the impressions created by the brokerage industry, investors rightly expect that brokers will advise them when a change in strategy is appropriate. Investors often maintain their accounts with a broker for years and, at times, decades. During that time, an investor's investment profile will change, sometimes dramatically. Investors may retire, or marry and have children. Investors look to their broker to advise them as to how these life changes impact their investment strategies. Similarly, the characteristics of investments change over time. While an investment in a particular security may be suitable at a time when it has certain characteristics, it may become unsuitable over time as those characteristics change, e.g., an investment in a bond that is investment grade when sold to the investor, but, over time, becomes a "junk bond" because of a change in financial circumstances of the company. While arguably suitable when sold, over time, that same investment is likely unsuitable and the investor may not realize the difference unless the changes in characteristics are properly explained to the investors. Investors will not always recognize that they should seek out this advice.

Additionally, brokers are often compensated for investment transactions and investment advice after the sale has occurred. For example, variable annuities and mutual funds continue to pay commission trails to brokers and their firms for years after the investments are sold. The broker's fiduciary duties to a customer should

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[8] *See* Consumer Federation of America and Americans for Financial Reform, *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways* (January 18, 2017), available at https://consumerfed.org/wp-content/uploads/2017/01/1-18-17-Advisor-or-Salesperson_Report.pdf.

[9] UBS, *Wealth Planning*, available at https://www.ubs.com/us/en/wealth/planning.html (last visited Mar. 13, 2019).

[10] Wells Fargo Advisors, *Why Choose Wells Fargo Advisors*, available at https://info.wellsfargoadvisors.com/form.aspx?type=wellsfargoadvisorspacket&cid=WFA140043903&intcid=WFA140043903 (last visited Mar. 13, 2019).

[11] Merrill Lynch, *Working with Us*, available at https://www.ml.com/working-with-merrill-lynch-financial-advisor.html (last visited Mar. 13, 2019).

continue for as long as the broker or the firm is continuing to be compensated for that recommendation.

Brokers use the language of fiduciaries to gain the trust and confidence of investors.[12] As a result of decades of the above type of advertising, investors rightfully believe they are doing business with individuals who will work with them along their financial journey. Investors do not believe that their financial advisor is there to make a recommendation, and then disappear. Representations like the ones above are clearly meant to tell potential clients that investment advice beyond the "transactional advice" that brokerage firms want the SEC and other regulatory bodies to judge them by is what will be provided if an investor entrusts their savings to the firm. These firms have purposely create an impression that they will be providing a fiduciary service, but then ask not to have to live up to that standard when the advice they give does not meet the standard.[13]

Disclosure should inform the investor, not absolve the financial services firm of any obligations

While disclosure is always an important part of any fiduciary relationship, it is vitally important that such disclosure be used to benefit and inform the customer, not as a shield against misconduct, as it is often used and could be used under the current Regulation Best Interest standard.

As part of Regulation Best Interest, the SEC has proposed the use of a Client Relationship Summary ("CRS") form.[14] PIABA has concerns about whether the CRS form can or will provide effective disclosure to investors, whether such a form will be lost in the voluminous written materials which investors typically receive when making a securities transaction, and whether investors will be able to reasonably understand and synthesize the information on the form.

Recent studies show that disclosures do not lead to greater understanding, even when read. For example, a Rand Corporation study commissioned by the SEC revealed that,

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[12] *See supra* n. 5.
[13] This is an example of the type of situation that mere disclosure cannot resolve. Brokerage firms have spent decades and billions of dollars to create an impression of trustworthy financial professionals providing unbiased and continual advice to their clients. A boilerplate disclosure in a document handed to new clients, along with many other documents when opening an account, will not undue this perception that the brokerage industry has been instilling in the minds of the public for so long. Rather, the only real solution is to make brokerage firms live up to the standard they have been advertising towards for decades.
[14] The proposed Rule provides that a broker's required disclosure relating to the scope and circumstances of its relationship with the customer would be made through the CRS form, provided to customers at the opening of a new account. 17 CFR Part 240, 249, 275 and 279, Release No. 34-83063 (April 18, 2018).

after reviewing disclosures regarding the differing duties of investment advisers and brokers, many individuals still remained confused about when firms owed them fiduciary duties and when they did not.[15] This finding was confirmed by another study of the effect of such disclosures which was conducted by the American Association of Retired Persons, the Consumer Federation of America, and the Financial Planning Coalition.[16] In short, disclosure of differing duties does not adequately put investors on notice that they should not trust their broker, or that a "buyer beware" standard applies.

Providing greater disclosure also does not appropriately mitigate the conflicts of interest inherent in the relationship between brokers and investors. Instead, it places the burden on the investors to fully understand the impact of those conflicts on the future of their retirement savings. However, the brokers have held themselves out to be professionals who are there to offer guidance to investors on important life decisions. They should accept the responsibility that comes with the profession and with the trust they have sought to earn by managing the life savings of an individual.

Thank you for your attention to this issue. We appreciate the opportunity to provide a statement. Please do not hesitate to contact us if you have any questions or would like any additional information.

Respectfully submitted,

Christine Lazaro
President

cc: Chairwoman Waters; Ranking Member McHenry

[15] SEC, *Investor Testing of Form CRS Relationship Summary*, 46 (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationshipsummary.pdf.
[16] AARP, Consumer Federation of America, and Financial Planning Coalition, *Final Report on Testing of Proposed Customer Relationship Summary Disclosures*, 12 (Sept. 10, 2018), available at https://consumerfed.org/reports/report-on-testing-of-proposed-customer-relationship-summary-disclosures/.

Response to Questions for the Record
Susan John
Chair, Board of Directors, CFP Board of Standards
Before the House Financial Services Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
"Putting Investors First? Examining the SEC's Best Interest Rule"
March 14, 2019

Question #1: ***How do you address the claim that stronger fiduciary standards decrease access to advice for moderate-income investors and those living in rural areas, specifically?***

Answer: It is inaccurate to say that a stronger fiduciary standard decreases access to advice for moderate-income investors, especially those living in rural areas. In 2007, CFP Board adopted its current *Standards of Professional Conduct*, which established a fiduciary duty when a CERTIFIED FINANCIAL PLANNER™ (CFP® professional) provides financial planning or material elements of financial planning. In March 2018, CFP Board issued the *Code of Ethics and Standards of Conduct*, which requires a CFP® professional to act as a fiduciary at all times when providing financial advice, with "financial advice" defined broadly.

Since 2007, the number of CFP® professionals has increased by more than 52%, to more than 84,000 certificants across all 50 states, as well as U.S. territories and the District of Columbia. These certificants are not deterred by a strengthened fiduciary standard and many of them work in sparsely populated areas of the country. Certainly, there are CFP® professionals who primarily serve high net worth individuals. But, increasingly CFP® professionals work with clients of more modest means under non-traditional, fee-for-service remuneration systems, such as hourly fees or monthly retainers or project-based charges. In fact, different compensation models are emerging every day. For example, CFP® professionals in the Garrett Planning Network are hourly-based, fee-only financial planners who serve many middle-income investors and follow a fiduciary standard of care. Schwab Intelligent Portfolios Premium offers comprehensive financial planning with guidance from a CERTIFIED FINANCIAL PLANNER™ professional and access to online planning tools for a one-time planning fee of **$300** and just a **$30**/month advisory fee after that.

In my own firm, which is based in the small community of Wolfeboro, NH, and serves people in small towns across various states, we are fiduciaries and we have options for people of more modest means. We have taken the position that we have no asset minimums. Additionally, we offer different types of payment plans for people with smaller accounts, such as Smart Start, or for those wishing to do only one-time projects that are smaller in scope.

Question #2: ***How do you address the assertion that financial planners are only providing financial advice to well established investors and upper income individuals, as opposed to a broader market, including younger people in earlier stages of their careers?***

Answer: As detailed in Question #1, above, the compensation models for how retail investors pay for financial advice is rapidly changing. Although the traditional payment model calls for fees to be paid as a percentage of assets under management (AUM), new payment methods are on the rise in order to help younger cohorts save for their goals, including paying off student loan debt, buying a home, having children, and even retirement. It is becoming more common to see alternative fee arrangements, such as hourly fees based on salary, not AUM; or a one-time, all-inclusive fee for a limited project. For instance, CFP® professionals in the XY Planning Network are fee-only, no-minimum-assets financial advisors who specialize in serving the financial needs of Gen X-ers and Millennials, many of whom do not have significant investable assets that are the key to more traditional AUM-based payment structures. The same evolution in fee arrangements also is occurring with respect to investors of more means. This evolution is democratizing access to fiduciary level financial advice.

We are of the opinion that everyone deserves fiduciary level advice – especially those of more modest means where the harm done can be more devastating.

Question #3: ***How do you address the assertions that changing Reg BI will lead to a lack of investor choice and reduce retail investors' access to financial advice in general?***

Answer: Fears that strengthening Reg BI will lead to a lack of investor choice and reduce retail investors' access to financial advice are misplaced. Through CFP Board's own experience with a fiduciary standard of conduct that is business model-neutral, we have seen that a fiduciary duty is not an impediment to the provision of advice, whether the certificant is serving clients at a broker-dealer, investment adviser, or insurance agency. As stated previously, CFP Board first addressed a fiduciary standard for CFP® professionals in 2007 when it issued revised CFP Board *Standards* providing that a CFP® professional owes to the client a fiduciary duty when providing financial planning or material elements of financial planning. At that time, major financial services firms, as well as industry organizations representing the brokerage and insurance industries, raised significant concerns, asserting that CFP Board's fiduciary requirement was unworkable with their business models and that CFP® professionals would be forced to rescind their certification if required to operate under a Fiduciary Standard of Conduct. Yet, contrary to these predictions, the number of CFP® professionals has grown by over 52% to more than 84,000 certificants since 2007. CFP® professionals, many of whom work at large financial services firms that represent a cross-section of business models, proudly promote that they deliver fiduciary-level services when providing financial planning. In fact, a 2013 Aité survey[1] found that most registered representatives and registered investment advisers agree that a fiduciary standard of conduct is appropriate for financial services providers who deliver personalized investment advice. This finding cuts across a multitude of business models subject to different regulatory provisions. And in July 2015, a Princeton Survey Research Associates International (PSRAI) survey[2] found that almost nine out of 10 respondents agree with the statement that "a Fiduciary Standard of Conduct is appropriate for all financial professionals who deliver personalized investment advice to retail investors."

Brokerage firms business models are changing. More are offering the types of services and transparency that consumers are demanding – or losing employees to more open platforms. The flight of big firm personnel to more independent firms is in the news every day. With

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[1] Aité, "Fiduciary Study Findings for CFP® Board" (June 2013), *available at* http://www.cfp.net/docs/public-policy/aitefiduciary-study-june-2013.pdf.

[2] Financial Planning Coalition, "Fiduciary Standard Survey," Prepared by Princeton Survey Research Associates International (Revised July 2015), *available at* http://financialplanningcoalition.com/wp-content/uploads/2015/07/Princeton-ResearchFiduciary-Study-Final.pdf.

potentially less supervision in smaller firms, it is even more important that a fiduciary standard be a requirement for dealing with individual investors.

Question #4: ***Is it accurate to say that CFP Board's certificant population consists almost exclusively of fee-only planners, and that there are virtually no broker-dealers in this population? If so, then why does CFP Board extend its Standards to broker-dealer accounts?***

Answer: I appreciate the opportunity to clarify this misconception. No, it is not accurate to say that CFP Board's certificant population consists almost exclusively of fee-only planners. In fact, the CFP® professional population at broker-dealers is the fastest growing segment of certificants. CFP Board's Board of Directors, which I chair, also includes broker-dealer representatives, as do other advisory panels at CFP Board, ensuring their views and concerns are equally addressed. Moreover, the *Standards* is business-model neutral, as stated above, and compensation type-neutral. The *Standards* reflects CFP Board's experience with certificants who represent all types of business models, whether it be broker-dealer, investment adviser, or insurance, and utilizing various types of compensation models

Question #5: ***It was suggested that the November 2018 RAND study provided "very good results" as to Form CRS, in part because of a larger, "much broader" sample size than the AARP testing. How do you respond to that? Why is it important to ensure that in-depth interviews are conducted, in addition to the surveys?***

Answer: There is a vast difference between what retail investors "like" and what they "understand." RAND's 1,800-person survey tested opinions about each section of Form CRS, format and delivery preferences, and attitudes of survey-takers in general. RAND's one-on-one interviews, however, delved into more granular questions on retail investor's comprehension of the information being conveyed in the form. It appears from RAND's November 2018 testing that even if retail investors "like" Form CRS, many of them are unable to connect the idea that conflicts exist and can harm them even if the financial professional owes them certain obligations. Likewise, many exhibited confusion or misunderstanding between different account types and fees, and still others were unfamiliar with financial terms, such as "fiduciary." So, far from "very good" results on Form CRS, the Rand study actually proves the point we are making.

AARP's testing showed results that were similar to those found by RAND in the interviews. Kleimann Communication Group, the third-party, neutral disclosure testing expert engaged in AARP's research, employed a combination of question types in its testing of both the SEC mock-up and a revised version of Form CRS. "This combination of question types allowed us to elicit responses that could demonstrate two levels of cognitive skills. One is the ability to locate information within the disclosure (a fairly low-level cognitive skill). The other is the ability to integrate information and synthesize it into a rational evaluation (a more complex and higher-level cognitive skill)."[3] Just like RAND's interviews, Kleimann's results showed that investors were confused by certain terms, couldn't connect the idea that conflicts of interest are inherent in every relationship and could harm them even if the professional is subject to a standard of conduct, and couldn't understand the fees and costs associated with services provided.

Kleimann also pointed out that "According to Robert Virzi, an experimental psychologist and usability expert, five participants uncover 80% of usability problems and ten participants uncover

[3] See page 8 of https://www.sec.gov/comments/s7-07-18/s70718-4729850-176771.pdf.

90%."[4] So even though a sample size may be much smaller than 1,800, one-on-one cognitive testing may still reveal comprehension problems and disclosure shortfalls at a relatively high level of reliability.

[4] Id.

By Christopher A. Iacovella | February 14, 2019

Each day, America's financial advisors go to work in communities across the country to help their neighbors develop plans to save for retirement, send their kids to college, buy a house, or meet other financial and family goals. In this business, relationships are everything. Trust and confidence between advisors and their clients must exist for a strong relationship to flourish.

Main Street financial firms have always sought to maintain the trust and confidence of their clients by acting in the best interest of those clients - not only to remain in business, but because it's the right thing to do. That is why the American Securities Association (ASA) has supported efforts by the Securities and Exchange Commission (SEC) to take regulatory action that codifies a "best-interest standard" into law. This enhanced level of accountability is necessary to weed-out the bad actors that tarnish the industry's reputation and harm the confidence of retail investors.

We strongly support Chairman Jay Clayton moving the SEC forward to finalize its Regulation Best Interest (Reg BI) proposal. While the debate has unfortunately been hijacked and purposely misrepresented by political extremes, the fact is that Reg BI will strengthen investor protections, protect retirement savers, and preserve investor choice.

The SEC Reg BI proposal improves investor protection by requiring financial firms and professionals to:

1. Put their customers interest first by not placing their own interests ahead of clients;

2. Disclose key facts about relationships, including fees and compensation related to financial products;

3. Exercise diligence, care and skill when making recommendations of investment products to make certain they are in the client's best interest; and

4. End high-pressure sales practices.

Importantly, Reg BI forces advisors to identify, disclose, and mitigate conflicts of interests. Mitigation significantly improves upon existing requirements, which merely require the disclosure of conflicts. Make no mistake, all of Reg BIs improvements are in the best interests of America's retirement savers and Main Street retail investors.

Those who question the merits of this proposal by suggesting that this rule does not adequately improve investor protection are playing fast and loose with legal words in order to create confusion among the investing public and delay the SEC's work. This is especially true of certain groups who continue to support the invalidated Department of Labor-backed approach, which would generate wealth for the politically-connected plaintiff bar, force Americans to only invest in passive index funds, and cut millions of Americans off from access to financial professionals. Unlike that outcome, Reg BI preserves the relationship between individuals planning for retirement and their advisors.

At the end of the day, ASA members have been and will continue to put our clients first. We believe this is the only way to earn and maintain their trust and confidence. We know that if we fall short of this guiding principle, then clients will rightly choose to work with someone else. We remain committed to working with the SEC to finalize Reg BI and we applaud the Commission's work to strengthen investor protections, improve accountability, and increase transparency. Not only is this smart public policy, it's the right thing to do.

Christopher A. Iacovella is the chief executive officer of the American Securities Association.

Statement for the Record

Submitted to the

U.S. House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

"Putting Investors First? Examining the SEC's Best Interest Rule"

March 14, 2019

On Behalf of

Susan K. Neely
President and CEO
The American Council of Life Insurers

The American Council of Life Insurers (ACLI) appreciates the opportunity to submit this statement for the record on "Putting Investors First? Examining the SEC's Best Interest Rule."

The insurance industry supports a best interest standard of care for all financial professionals. When recommending an annuity, financial professionals should be required to act with care, skill, diligence and prudence and avoid or reasonably manage conflicts of interest. Consumers should know the range of products and services financial professionals offer, how they will be compensated and whether the financial professional has any material conflicts of interest. These obligations are consistent with important regulatory initiatives now under way at the National Association of Insurance Commissioners and the Securities and Exchange Commission (SEC).

THE AMERICAN COUNCIL OF LIFE INSURERS

ACLI is the leading trade association driving public policy and advocacy on behalf of the life insurance industry and the 90 million American families relying on life insurers' products for financial protection and retirement security. ACLI's 280 member companies represent 95 percent of industry assets and are dedicated to promoting consumers' financial well-being with products that reduce risk and increase their financial security, including life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision insurance and other supplemental benefits. The core business of the life insurance industry is financial security, and retirement security is a critical mission. As society and work change, the industry is committed to solutions that protect all Americans, regardless of where and how they work, their life stage, or the economic status of their household. Life insurers seek to expand the availability, accessibility, and affordability of financial protection and retirement security products for all.

ACLI SUPPORTS A BEST INTEREST STANDARD OF CARE FOR ANNUITIES

ACLI is committed to a uniform, harmonized best interest standard of care for annuity and securities transactions across all state and federal regulatory platforms for financial services firms and financial professionals. This standard would benefit retirement savers and, indeed, all consumers planning and saving for the future.

Experience with the Department of Labor's now-vacated investment advice fiduciary regulation showed the regulation's actual harm to consumers. When faced with a fiduciary standard, many financial firms moved to a fee-for-service-only model, eliminating choice and access for small and moderate balance savers and typical buy-and-hold investors who rely on commission-based advice for their retirement needs. As a product that is designed as a long-term retirement solution, most annuities are sold on a commission basis. According to a LIMRA survey, if the Labor Department's fiduciary regulation had remained in-force, 54 percent of advisors might have dropped or turned away small investors, resulting in as many as 4 million middle class households losing access to information they need to ensure a secure retirement. Further, according to independent research by the American Action Forum, the DOL fiduciary regulation had the potential to increase consumers costs by $46 billion, or $813 per individual retirement account (IRA). LIMRA also states that consumers who work with a financial professional are more likely to be contributing to their employers' retirement plans (86% vs. 77%) than those who don't work with one and consumers who work with a financial professional are more likely to be saving for retirement (92% vs. 70%) than those who don't. Finally, pre-retirees who work with a financial professional are significantly more likely to have calculated the amount of assets and investments they will have available in retirement (58% vs. 35%).

ACLI supports rules requiring all financial professionals, when making a recommendation, to act in the consumer's best interest – with care, skill, prudence, and diligence – based on the consumer's financial needs and objectives. ACLI also supports rules requiring financial professionals to avoid or reasonably manage conflicts of interest through increased transparency. This is consistent with National Association of Insurance Commissioners (NAIC) and Securities and Exchange Commission (SEC) initiatives underway.

These efforts for increased transparency include the disclosure of all material conflicts of interest; the types and scope of services provided; and the types of compensation to be received by the financial professional. In short, consumers should know whether a financial professional, in making a recommendation, has a material conflict of interest.

These requirements would build on and enhance the strong protections in place today. Strong consumer protections and a long history of integrity and commitment to retirement savers help explain why Americans rely on life insurers and the financial professionals who distribute their products to help them achieve financial security in retirement. Adoption of fiduciary standards - and differing standards from state to state – will cause adverse consequences for consumers.

According to the latest available data, the median annual household income of annuity owners is $64,000. Eighty percent have total annual incomes below $100,000 and more than a third (35 percent) have household incomes less than $50,000. The best interest standard that life insurers support will enable retirement savers at all income levels to maintain access to, and information about a full range of products, including annuities, the only financial products in the private marketplace that can guarantee lifetime income.

Life insurers are offering a better alternative to provide retirement savers and all consumers with certainty that financial professionals are acting in their best interest when recommending annuity and securities products, while preserving consumer choice. We also seek a uniform approach to consumer protection. A patchwork of state and federal laws and regulations will spread uneven protections across the country and across the retirement plan marketplace, jeopardizing savers' ability to obtain long-term financial peace of mind.

ACLI has filed four submissions with the SEC on its Proposed Regulation Best Interest, Proposed Form CRS, Investment Adviser Interpretations and the Proposed Summary Disclosure Initiative. These SEC initiatives were designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products. In sum; the SEC's

- Proposed Regulation Best Interest "requires a broker-dealer to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer."
- Proposed Form CRS "would provide retail investors with simple, easy-to-understand information about the nature of their relationship with their investment professional and would supplement other more detailed disclosures."
- Proposed investment advisers' interpretations "reaffirm SEC positions about the fiduciary duty investment advisers owe to their clients." Through the reconfirmed interpretations, "investment advisers and their clients would have greater clarity about advisers' legal obligations."
- Proposed Summary Disclosure Initiative for variable insurance contracts is simplified, plain-English information through a layered process with access to more detailed information

through supplemental web-based or paper distribution on request.

SUMMARY OF ACLI'S POSITION ON REGULATION BEST INTEREST ("Reg. BI")

ACLI supports a best interest standard that would require financial professionals to put a consumer's interest first by (i) acting with reasonable care, skill, prudence, and diligence in gathering and evaluating information regarding the consumer that is used to make the recommendation; (ii) making no misleading statements; (iii) providing full and fair disclosure of the recommended product's features, fees, and charges; (iv) fairly disclosing how and by whom the financial professional is compensated; and (v) avoiding, disclosing, or otherwise reasonably managing material conflicts of interest. Reg. BI fully fulfills these objectives.

The SEC's years of experience regarding investment adviser and broker-dealer regulation dovetails with developing a constructive best interest standard that can be uniformly applied across all regulatory platforms, including state insurance regulations. As a result, consumers will enjoy a consistent level of protection and will be able to obtain access to a wide range of retirement products and advice. To meet their financial and retirement security needs, retirement savers deserve standards ensuring continued access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest. Clarity, consistency and coordination across all regulatory platforms will best serve investors, and thwart regulatory arbitrage. The SEC's inclusive outreach to state regulators and the National Association of Insurance Commissioners (NAIC) as partners in the development of a best interest standard is an essential element of effective oversight and regulation. Life insurers strongly support protections serving the best interests of customers, which can be meaningfully safeguarded with disclosure about services and material conflicts of interest. This approach provides an effective means to shield consumers and facilitate informed purchase decisions.

A full assessment about the current regulatory framework is important to the SEC's thorough evaluation of potential approaches under Reg. BI and should include the comprehensive network of state insurance regulation. Joint collaborative efforts between the SEC, FINRA, DOL and state insurance regulators will generate a uniform best interest standard across all regulatory platforms that properly protects consumers while advancing financial and retirement security. It's important that any proposal works in harmony with the standards set by other regulators. Conscientious evaluation of the many different business models operating in this space and the economic impact of potential modifications will contribute to efficient, effective regulation. Cost-benefit and competitive impact analysis will help achieve this objective.

Disclosure required under Reg. BI will need careful coordination to properly mesh with amendments to Form CRS. A single disclosure fulfilling Reg. BI and Form CRS would reduce disclosure burdens and increase the likelihood consumers will read the required information. The application of Reg. BI's obligations should dovetail with FINRA requirements governing non-cash compensation practices.

SUMMARY OF ACLI'S POSITION ON FORM CRS

The disclosure obligation under Reg. BI provides an important means for consumers to understand the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation. The SEC's approach properly advances informed consumer decision making, and rightfully allows broker-dealers to create disclosure tailored to their specific business model, product line, and operation. ACLI supports a flexible standard which this framework provides.

ACLI is concerned, however, that the disclosure standards in Form CRS do not mesh well with the disclosure proposed in Reg. BI. Further, the creation of two new disclosure events may frustrate the worthwhile goals of consumer understanding by enlarging the already significant number of disclosures documents a consumer would face. The volume of disclosure currently delivered can, unfortunately, dilute the value of meaningful disclosure essential to understanding and informed decision making. A single disclosure fulfilling Reg. BI and Form CRS would reduce disclosure burdens and increase the likelihood consumers will read the required information. ACLI encourages the SEC to clarify that broker-dealers can appropriately elect to merge required disclosure under Reg. BI and Form CRS in a single document.

The disclosure standards and objectives should be consistent and parallel in Form CRS and Reg. BI to avoid confusion and to promote clear understanding. A more flexible approach to required disclosure is preferable and would better serve consumers. In addition, greater flexibility in content and length of Form CRS will allow life insurers to describe products which are often more complex than those offered by full service broker-dealers.

SUMMARY OF ACLI'S POSITION ON PROPOSED INVESTMENT ADVISER INTERPREATIONS

The SEC must consider the impact of any future proposals on the unique business models of life insurers. Life insurers with associated investment advisers and broker-dealers are subject to multiple layers of regulation from state insurance commissioners, state securities regulators, the SEC, and FINRA. In lieu of any proposed new regulation, the SEC should continue to provide interpretative guidance and rely upon the extensive existing guidance and case law regarding the duties of investment advisers, rather than attempting to codify this body of existing law. Additional licensing and continued education under review would be duplicative of existing state securities licensing and continuing education requirements for investment adviser representatives. Such proposed "enhancements" are aiming to fill a perceived gap that does not exist. ACLI looks forward working with the SEC on this issue.

SUMMARY OF ACLI'S POSITION ON SEC'S SUMMARY DISCLOSURE INITIATIVE

ACLI strongly supports the SEC's summary disclosure initiative and its layered delivery of information about variable annuities and variable life insurance. These products, among others provided by life insurers' help American families achieve financial and retirement security. The summary disclosure initiative greatly advances these important national priorities.

The summary disclosure proposal is a constructive development beneficial to consumers, life insurers, and the environment. Because of the high correlation between summary disclosure, financial literacy and retirement and financial security, the proposal's layered disclosure approach can help alleviate financial literacy challenges in a functional manner and enhance American families' retirement and financial security. With broader exposure to variable contracts through user-friendly summary disclosure, the proposal dovetails with the SEC's capital formation priorities by enlarging the marketplace and broadening the scope of life insurers' investments;

The summary disclosure initiative creates a more balanced regulatory and disclosure environment for financial products competing in the same markets. Careful awareness and coordination about the cumulative disclosure under proposed Regulation Best Interest, Form CRS, the summary disclosure initiative, and required disclosure under state insurance laws will help prevent information overload that thwarts the noble objectives of the proposal. ACLI supports the SEC's desire to "future proof" the rule, keep it from becoming rapidly outdated, and to get it right because "it will be on the books for a long time."

CONCULSION

ACLI is committed to a uniform, harmonized best interest standard of care for annuities and securities transactions across all state and federal regulatory platforms for financial services firms and financial professionals. This standard will ensure customers will retain access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest- including lifetime income products. In contrast, as evidenced by the now-vacated Department of Labor fiduciary regulation, applying a strict fiduciary standard to all financial professionals in all circumstances would limit or eliminate access to and information about lifetime income products, harming low and moderate balance retirement savers. Additionally, ACLI supports rules to require all financial professionals, when making a recommendation to act with care, skill, prudence, and diligence based on the consumer's financial needs and objectives.

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
EXECUTIVE VICE PRESIDENT

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March 13, 2019

The Honorable Carolyn Maloney
Chair
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
U.S. House of Representatives
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
U.S. House of Representatives
Washington, DC 20515

Re: Hearing on the Securities and Exchange Commission's Best Interest Rulemaking Package

Dear Chair Maloney and Ranking Member Huizenga:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and is dedicated to promoting, protecting, and defending America's free enterprise system. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to advance the United States' global leadership in capital formation.

The SEC's proposed Best Interest Regulations promote investor choice and improve investor protection.

CCMC has been engaged with the Securities and Exchange Commission ("SEC") throughout the development of its three proposals and submitted comments regarding the standards of conduct for investment advisers and broker-dealers – "Regulation Best Interest,"[1] "Form CRS Relationship Summary,"[2] and "Proposed Commission Interpretation Regarding Standard of Conduct of Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation"[3] (collectively, the "Proposals").

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[1] 83 Fed. Reg. 21574 (May 9, 2018).
[2] 83 Fed. Reg. 21416 (May 9, 2018).
[3] 83 Fed. Reg. 21203 (May 9, 2018).

Ms. Maloney and Mr. Huizenga
March 13, 2019
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CCMC believes the SEC is the proper agency to approach this rulemaking in the aftermath of the Department of Labor's ("DOL") failed "Fiduciary Rule."[4] Finalized in April 2016, the Fiduciary Rule sought to broadly define who is a "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") and to treat individuals who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as "fiduciaries" in a wider array of advising relationships. The Chamber consistently argued that DOL overstepped its legal authority in issuing the Fiduciary Rule. The U.S. Court of Appeals for the Fifth Circuit ultimately agreed with the Chamber and other organizations that challenged it, vacating the rule on March 15, 2018 on the grounds that a "perceived 'need' [for the rule] does not empower DOL to craft *de facto* statutory amendments or to act beyond its expressly defined authority" under ERISA.[5] The decision leaves the SEC as the appropriate agency to develop standards of conduct that serve all investors across all types of accounts.

We support the SEC's goal of maintaining different business models and appreciate that Regulation Best Interest accounts for different structures and avoids applying a one-size-fits-all regulatory approach. Investors have different needs. Some need ongoing, regular investment advice and comprehensive financial planning. Others need only episodic assistance in purchasing a particular financial product for a specific purpose.[6]

The various types of financial professionals and the different ways in which they are compensated and regulated allow consumers to select providers that best meet their different needs. Imposing one-size-fits-all regulation would impose requirements incompatible with differing business models, making it extremely difficult for financial professionals to offer certain services, such as brokerage accounts. Newer investors or those only investing a small amount tend to benefit most from the brokerage model. The SEC's rules will protect small and new investors and ensure they continue to have access to investment advice through the brokerage model.

The SEC's proposed rules will also protect investors from bad actors. The proposed rules would specifically require broker-dealers and investment advisers to act in the best interest of

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[4] Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice, 81 Fed. Reg. 20945 (Apr. 8, 2016).

[5] Chamber of Commerce of the U.S. v. U.S. Dep't. of Labor, No. 17-10238 (5th Cir. Mar. 15, 2018) at 30.

[6] CCMC compiled profiles of different types of investors in various stages of the investment lifecycle to illustrate investors' varying needs:
https://www.uschamber.com/sites/default/files/ccmc_sixprofiles_v13nomarks.pdf

their clients by mitigating or eliminating conflicts of interest, providing enhanced disclosures, and adhering to existing regulatory obligations. Investment professionals providing misleading advice or recommending products in their own self-interest will be penalized. For example, the SEC has made clear that they will eliminate sales contests that reward financial professionals for promoting a specific product. These types of contests have the potential to incentivize financial professionals to recommend a product to an investor even if the product is not the most suitable for that particular investor. Investors will now be protected from receiving product recommendations that may not be in their best interest.

Investors will also benefit from enhanced disclosure requirements, particularly through the SEC's proposed Form CRS. CCMC commissioned a poll of more than 800 investors to examine their perspectives on working with financial professionals and to gauge their priorities regarding new regulatory requirements.[7] In general, we found that investors are happy with their financial professionals. However, there is room for improvement, particularly relating to communication. To that end, when the SEC's proposed Form CRS was described in the survey, 72% of investors said they believe the Form will improve transparency.

CCMC also commissioned a survey of financial services companies,[8] including broker-dealers and firms dual-registered as broker-dealers and investment advisers to gain perspective on the SEC's Proposals' impact on investors, the financial services industry, and the marketplace. The firms surveyed are responsible for managing over 78.5 million investment accounts and nearly $23 trillion in assets. While the firms surveyed believe there are opportunities for streamlining, clarifying, and improving certain aspects of the proposals, they also believe investors will be better served because of the Proposals. Regarding impacts to the industry, most firms feel that implementation costs of the Proposals may be higher at first, but will lessen over time. Firms also noted that these costs will be offset by the business modernizations made over the past several years.

States should let the SEC take the lead to avoid a patchwork of regulatory requirements.

Several states have moved forward with legislation or regulation to promulgate their own fiduciary rules. However, strong and efficient regulation cannot be achieved on a state-by-state

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[7] "Working with Financial Professionals: Opinions of American Investors," 2018: http://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/CCMC_InvestorPolling_v5-1.pdf

[8] "SEC Regulation Best Interest Rule Proposals: Request for Information Analysis," July 25, 2018: https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/08/Reg-BI-Rule-Proposal-Research_8.7.18_FTI-Updated_final.pdf

basis through a patchwork of conflicting state regulations that differ materially with respect to one another as well as to Federal regulations. The reality is that no state can take such action in a vacuum—financial professionals simply cannot efficiently serve their clients if they are subject to material differences in regulation in every state regarding their legal obligations, documentation requirements, and legal risks. Indeed, financial transactions, at some point, must be completed through the use and the means of interstate commerce. Federal rules, rather than varying state standards, will protect investors from regulatory arbitrage and ensure each investor receives equal treatment, no matter where they live.

Conclusion

CCMC supports the SEC's efforts to modernize the standards of conduct for investment advisers and broker-dealers and believe the Proposals enhance investor protection, while maintaining investor access to different types of financial advice. We look forward to working with the SEC, the Subcommittee, and all parties interested in the SEC's work to ensure that the Proposals are effectively implemented to protect and preserve choice for the benefit of Main Street investors.

Sincerely,

Tom Quaadman

U.S. House of Representatives Financial Services Committee

Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

Hearing entitled:

"Putting Investors First? Examining the SEC's Best Interest Rule"

Testimony of Wayne Chopus President and CEO, Insured Retirement Institute

March 14, 2019

Chairwoman Maloney and Ranking Member Huizenga, and Members of the United States House of Representatives Financial Services Committee Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, my name is Wayne Chopus, President and CEO of the Insured Retirement Institute (IRI). On behalf of our members, I want to express our appreciation for this opportunity to provide testimony to the Subcommittee with our perspective about the proposed U.S. Security and Exchange Commission's Regulation Best Interest (Reg BI) proposal as part of today's hearing.

Summary of Testimony

My testimony will address two key points:

1. IRI supports the SEC's proposed Reg BI because it establishes a new, clear, consistent and workable best interest standard of conduct for financial professionals that will serve as a platform to help consumers make informed decisions and preserve investor choice.
2. To avoid unintended consequences associated with Reg BI, the SEC should provide additional guidance and clarity regarding certain provisions.

About IRI

As you may know, for nearly three decades, the Insured Retirement Institute (IRI) has vigorously worked to promote consumer confidence in the value and viability of insured retirement strategies by bringing together members of the insurance industry, financial advisors and consumers to engage in a dialogue and advance all parties' interest. IRI is the leading association for the entire supply chain of insured retirement strategies, including life insurers, asset managers, and distributors such as Broker-Dealers, banks and insurance marketing organizations. IRI members account for more than 95 percent of annuity assets in the U.S., include the top 10 distributors of annuities ranked by assets under management, and are represented by financial professionals serving millions of Americans. IRI champions retirement security for all through leadership in advocacy, awareness, research, and the advancement of digital solutions within a collaborative industry community.

Our members support common sense, bipartisan policies to help Americans achieve their retirement goals by expanding opportunities to save for retirement by enhancing savers' access to workplace retirement plans while also seeking to improve the quality of existing workplace retirement options. To accomplish these goals, our members advocate to improve access to professional financial guidance, extend greater access to lifetime income products in workplace retirement plans, and preserve the current tax treatment of retirement savings plans. At the same time, our members understand that managing and insuring hard-working Americans' money also requires robust consumer protection efforts. For that reason, IRI has also supported consumer education and safeguards to protect Americans from financial exploitation. IRI and our members seek to constructively engage in a dialogue with federal and state policy makers to achieve these objectives which will help provide sustainable strategies to address the challenges Americans face to achieve a secure and dignified retirement.

SEC Proposed Best Interest Standard

Background

Americans face many challenges and obstacles when saving and planning for retirement. To help understand and mitigate these risks many Americans seek out financial professionals for guidance and advice. For nearly a decade, policymakers have been working to formulate appropriate enhancements to the standards of conduct for financial professionals who provide personalized advice about investments and/or insurance to retail consumers.

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, Section 913 of that law empowered the SEC to impose a fiduciary standard on Broker-Dealers. Although empowered by this statute to move forward to promulgate a fiduciary standard, the section was not written as a mandate and gave the SEC discretion to formulate a standard of conduct for Broker-Dealers that would best serve the twin goals of investor protection while maintaining the robust and diverse market for financial advice.

Instead of allowing the SEC to formulate a standard to accomplish these twin aims, the Department of Labor ("DOL") decided to adopt its fiduciary rule during the administration of President Barack Obama. The Department of Labor's fiduciary rule significantly expanded the universe of "investment advice fiduciary," as the term is defined under the

Employee Retirement Income Security Act of 1974 ("ERISA"), and elevated all financial professionals who work with retirement plans or provide retirement planning advice to the level of a fiduciary.

The DOL rule proved difficult and costly to implement and was plagued by inaccurate underlying assumptions. Given these problems, the ultimate rule would have been devastating for the investment advice community, especially investors, who would have lost access to the financial advice they need to achieve a secure retirement. According to research, the proposed rule would have denied access to a financial professional for 18 million lower and middle income investors, resulting in $240 billion lost from the system and 900,000 fewer IRA accounts.[1]

The Fifth Circuit's decision[2] to vacate the fiduciary rule gave the SEC an opportunity to engage in their own rulemaking and investigate how to provide proper consumer protections while preserving the market for financial advice. Subsequent to the court decision vacating the DOL rule, the SEC proposed a new rule known as Reg BI, under the Securities Exchange Act of 1934. The proposal would enhance the standard of conduct for Broker-Dealers and their registered representatives when they make a recommendation to a retail customer for any securities transaction or investment strategy. The proposed standard of conduct requires Broker-Dealers to act in the retail customers' best interest at the time a recommendation is made and prohibits the Broker-Dealer or their registered representative from placing their own interests ahead of the interest of the retail customer.

The SEC's proposed rule was open for public comment for several months and more than 3800 comments were filed regarding the rule proposal. IRI filed a comment letter[3] in which we urged the SEC to advance a proposed regulation to require financial professionals to act in their clients' best interests. IRI's comments emphasized that the proposed SEC rule will help investors make informed decisions about the type of financial professional that would best meet their needs while preserving investors' choice and access to the products and services they need to achieve their financial

[1] Cathy Weatherford, *Department of Labor Fiduciary Rule: Major unintended consequences*, The Hill, August 8, 2011, https://thehill.com/blogs/congress-blog/economy-a-budget/176473-department-of-labor-fiduciary-rule-major-unintended-consequences.
[2] *Chamber of Commerce of United States of Am. v. United States Dep't of Labor*, 885 F.3d 360, 365 (5th Cir. 2018).
[3] Insured Retirement Institute, Comment Letter on Proposed Regulation Best Interest, Form CRS, and the Proposed Commission Interpretation Regarding Standard of Conduct of Investor Advisors (Aug. 7, 2018), https://www.sec.gov/comments/s7-07-18/s70718-4185630-172656.pdf.

goals. In addition, IRI's comments also offered several recommendations to enhance the effectiveness of the SEC's proposed regulation by providing additional clarity or guidance to help IRI members understand and meet the obligations imposed under the proposal.

The SEC is still in the process of reviewing and digesting the comments it has received. As such, the rule remains a proposal now when this hearing is being conducted. The rule has not been made final, and no one knows what, if any, changes, edits or additions may be made by the SEC before the rule is published as final. It is therefore critical that all interested parties continue to engage with the SEC to ensure the final rule accomplishes all of its goals.

Why does IRI support Reg BI?

IRI and its members have long supported the principle that financial professionals should be required to act in their clients' best interest. IRI has been among the leaders of the financial services industry's efforts to advocate for adoption of a clear, consistent and workable best interest standard that will provide meaningful and effective consumer protections without depriving Americans of access to valuable financial products and services.

IRI supports the SEC proposed rule because it will:

- Provide a solid foundation for an enhanced standard of conduct for financial professional providing investment advice while appropriately preserving investor choice and access to the products and services they need to achieve their financial goals;
- Preserve the important and valuable distinctions between Broker-Dealers (BDs) and investment advisers (IAs), focusing instead on helping investors understand the differences between BDs and IAs so they can make informed decisions about the type of financial professional that would best meet their needs;
- Formulate a best interest standard that provides a clear and straight-forward compliance roadmap for firms and financial professionals; and
- Encourage the development of innovative disclosure techniques to improve the investor experience.

<u>How Can Reg BI be Improved?</u>

IRI's comments filed with the SEC offered several recommendations to enhance the effectiveness of the SEC's proposed regulation. The recommendations made by IRI would provide additional clarity and guidance to help financial professionals understand and meet the obligations imposed under the proposal.

IRI's comments request for the final rule to include:

- Guidance to help firms identify and evaluate the factors that should be considered when deciding how to manage material conflicts of interest, including the extent to which a conflict would directly impact a financial professional's behavior;
- Greater clarity as to the disclosure requirements (including the use of incorporation by reference for information that is already disclosed under other rules) without mandating the use of specific verbiage; and
- An opportunity for the SEC to send a strong signal to advisors – including the many new advisors joining the industry every day – that longevity risk and retirement income needs are important factors that must be part of any discussion with clients about retirement saving and planning.

<u>What Concerns Have Been Raised About Reg BI?</u>

Although the SEC Reg BI proposal has not been finalized into a rule yet, critics are voicing concerns about the effectiveness of the proposed rule. To respond to some of the concerns, we are highlighting those concerns below and providing a response to address them.

Concern: Reg BI does not define "Best Interest".

Reg BI does define "Best Interest." The core function of the proposed rule requires Broker-Dealers and their registered representatives to act in the best interest of their retail customers and forbids these financial professionals from placing their own interests ahead of the customers' interest. To ensure that Broker-Dealers and their registered representatives are meeting this standard, the proposal lays out three affirmative duties for these financial professionals to comply with:

the disclosure[4], care[5], and managing conflicts of interest[6] obligations. In formulating the rule in this way, the SEC has brought some clarity to financial professionals in how they will meet the best interest standard while also providing consumers expectations about how their Broker-Dealer should act.

Concern: A "fiduciary standard" for Broker-Dealers would be stronger than "Best Interest."

A fiduciary standard imposes duties at specific points in time (duty of care) and on an ongoing basis (duty of loyalty). The imposition of a fiduciary standard would severely limit the services Broker-Dealers can effectively offer and, in turn, limit the ability of millions on Americans to access financial professionals who can offer advice commensurate with an individual's investment goals and risk tolerance. Ongoing duties are incompatible with the transactional nature of brokerage relationships since Broker-Dealers generally provide investment advice and assistance on a transactional basis. These services are commonly more affordable and are heavily utilized by low and middle-income Americans who use these services to obtain tailored investment advice.

Concern: Reg BI has no teeth to prosecute bad actors.

Unlike the DOL fiduciary rule, which would have deferred to the plaintiffs' bar for enforcement, Reg BI relies on rigorous SEC and FINRA enforcement mechanisms to protect consumers and resolve conflicts in a timely and efficient manner. The SEC has statutory authority to protect investors and to enforce the provisions of the rule through its Division of Enforcement as well as through FINRA. They are authorized to conduct investigations into possible violations of the federal securities laws and prosecute the Commission's civil suits in the federal courts as well as its administrative proceedings. The Division has the authority in civil suits to seek injunctions to prohibit future violation and if violated is subject to fines or imprisonment for contempt. In addition, the Commission often seeks civil money penalties and the disgorgement of ill-gotten gains. In certain circumstances, the Commission also may seek, among other things, a court order barring or suspending individuals from acting as corporate officers or directors.

[4] Regulation Best Interest, 83 Fed. Reg. 21574, 21599-21608 (May 9, 2018) ("Reg BI").
[5] Reg BI, 83 Fed. Reg. 21574, 21608-17 (May 9, 2018).
[6] Reg BI, 83 Fed. Reg. 21574, 21617-28 (May 9, 2018).

The Division also has the authority to bring a variety of administrative proceedings including cease and desist order against any person who violates the federal securities laws. With respect to regulated entities (e.g., brokers, dealers and investment advisers) and their employees, the Division may institute administrative proceedings to, among other things, revoke or suspend registration, or to impose bars or suspensions from employment. In both cease-and-desist proceedings and administrative proceedings against regulated persons as well as order the payment of civil penalties and disgorgement of ill-gotten gains. Certain industry, associational, and conduct-related bars may also be available.

Concern: Reg BI preserves the status quo.

The SEC's proposal would significantly strengthen consumer protections by establishing a best interest standard for those providing personalized advice. While the current standard only requires Broker-Dealers to establish that a financial product is suitable for the client. The SEC's proposed rule enhances that standard and forbids Broker-Dealers from considering their own interest over their clients' interest. In addition, Reg BI requires several new requirements for Broker-Dealers including:

- Disclosure: The Broker-Dealer must reasonably disclose to the retail customer the material facts relating to the scope and terms of the relationship, including material conflicts of interest associated with the recommendation;
- Care: The Broker-Dealer must exercise reasonable diligence, care, skill and prudence to (A) understand the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (C) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest;

- Conflicts of Interest: The Broker-Dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and then to (A) at a minimum disclose, or eliminate, material conflicts of interest associated with the recommendation; and (B) disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation.[7]

Conclusion

The Subcommittee has posed a question about the SEC Reg BI proposal which is the subject of the hearing for which we are submitting testimony, asking whether it puts the investor first? IRI's response to that question is yes, it does put the investor's interest first.

The SEC's proposed Reg BI presents a platform to enact a national standard of conduct for Broker-Dealers. With Reg BI, consumers will be able to make informed decisions about the types of financial professionals which will best meet their needs and allow investors greater choice and access to the products and services they require.

The SEC proposed rule reflects the realities of the long—standing relationships between financial advisors and their clients. Although IRI and our members believe that the vast majority of Broker-Dealers already act in their clients' best interest and are intensely committed to helping their clients reach their retirement income objectives, we also understand that many consumers are dubious about seeking out assistance from financial professionals. Therefore, we believe the SEC rule effectively establishes a baseline for all Broker-Dealers to adhere to and provides consumers confidence that their financial professional is working first and foremost on their behalf.

With its proposed Reg BI, the SEC is properly taking the lead on this critically important initiative. IRI and our members generally support the proposal, and we have offered feedback focused on avoiding unintended consequences and helping firms and advisors understand and meet the obligations that would be imposed under the proposal. The SEC

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[7] Chairman Jay Clayton, "Overview of the Standards of Conduct for Investment Professionals Rulemaking Package," April 18, 2018, https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking.

should move expeditiously to finalize the proposal in collaboration with its fellow regulators to ensure consistency across jurisdictions.

Thank you for the opportunity to present this testimony. It is our hope you will find it useful, and IRI welcomes the opportunity to work with the Subcommittee in the future.

The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

March 13, 2019

The Hon. Maxine Waters, Chairwoman
The Hon. Patrick McHenry, Ranking Member
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Hon. Carolyn B. Maloney, Chair
The Hon. Bill Huizenga, Ranking Member
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
2129 Rayburn House Office Building
Washington, DC 20515

Re: Hearing of the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets: Putting Investors First? Examining the SEC's Best Interest Rule Proposal

Dear Chairwoman Waters, Ranking Member McHenry, Subcommittee Chair Maloney, and Subcommittee Ranking Member Huizenga:

I write in my capacity as the chief securities regulator for Massachusetts. The Office of the Secretary of the Commonwealth administers and enforces the Massachusetts Uniform Securities Act, M.G.L. c.110A, through the Massachusetts Securities Division. We welcome this opportunity to comment on the Securities and Exchange Commission's (the "SEC" or the "Commission") Regulation Best Interest ("Regulation BI") proposal, the related Form CRS proposal, and the proposed Commission interpretation regarding investment adviser conduct (together, the "Proposals").

The Proposals address the most fundamental investor protection issue: the duties that providers of investment advice owe to customers and clients. Main Street investors too often suffer grievous harm when they rely on the kind of conflicted investment advice permitted under current conduct rules. To protect these investors, we urge Congress and the SEC to upgrade the standard of care for financial advice to a true fiduciary standard.

Pursuant to the mandates in the Dodd-Frank Act, the SEC has the opportunity of a generation to protect retail investors and savers. Unfortunately, the Proposals fail to provide that protection. We urge the Commission to replace the current Proposals with a strong fiduciary standard, comparable to the standard applicable under the Investment Advisers Act of 1940 (the "'40 Act" or the "Advisers Act"), that will apply uniformly to advice provided to retail investors by both investment advisers and broker-dealers.

I. To Protect Investors, Broker-Dealers Must Provide Advice under a True Fiduciary Standard

Not only do the Proposals fall short of providing the protection that retail investors demonstrably need, it is likely that they will exacerbate the current widespread confusion about securities advice, particularly when that advice is provided by a broker-dealer.

My Office strongly supports the principle set out in Section 913 of the Dodd-Frank Act, which authorized the SEC to establish a standard of conduct for broker-dealers providing investment advice about securities to retail investors that is "no less stringent than" the fiduciary duty standard under the Advisers Act." In 2011, the SEC's Section 913 Study, which was required under Dodd-Frank, specifically recommended that broker-dealers provide advice pursuant to the same fiduciary standard that applies to investment advisers.[1]

While we were encouraged that SEC Chairman Clayton has stated that there should be "no daylight" between the conduct standards applicable to investment advisers and broker-dealers who provide advice and recommendations to retail investors,[2] the Proposals and the SEC proposing releases will not accomplish that goal. Instead, the SEC's so-called "best interest" conduct standard for broker-dealers will foster confusion and will fail to protect vulnerable investors. For all intents and purposes, there is no daylight between the current broker-dealer suitability standard and the best interest rule described in the Proposals.

Under current law, a broker-dealer is a merchant that is subject to fair dealing and suitable recommendation requirements when it deals with customers. Too often, we have

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[1] Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011) at page (v): "The Commission should exercise its rulemaking authority to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that: 'the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.'" (emphasis added)

[2] David Armstrong, *SEC's Clayton: "No Daylight" Between Advisor, Broker/Dealer Duties in Proposed Rules*, WEALTH MANAGEMENT, May 23, 2018, https://www.wealthmanagement.com/regulation-compliance/sec-s-clayton-no-daylight-between-advisor-brokerdealer-duties-proposed-rules.

seen broker-dealer firms assert in enforcement actions and in customer lawsuits that their obligations to customers are limited, and are not fiduciary in nature. When customers are harmed, it is a typical strategy for broker-dealers, who formerly had portrayed themselves as trusted advisers, to make every possible legal argument to limit their liability exposure based on the weak suitability standard.

a) Adopt a Clear and Uniform Fiduciary Standard for All Investment Advice

To ensure clarity and accountability, broker-dealers should provide advice pursuant to a contract with the customer that includes a clear statement that the broker-dealer stands in a fiduciary relationship with the customer and that advice and recommendations will be in the best interest of the customer. "Best interest" must be defined as a standard no less stringent than that standard under the '40 Act. Investors should be able to sue to enforce this contract, to assure that it will provide meaningful protection.

The best interest obligation of broker-dealers should require that:

- The broker-dealer must take every reasonable measure to avoid conflicts of interest,
- Advice be provided solely in the interest of the customer/client,
- Advice be provided with the care, skill, prudence and diligence that a prudent person would use,
- Direct and indirect compensation to the broker-dealer, the financial institution, or any of their affiliates or related entities must be reasonable,
- The broker-dealer not make any materially misleading statements regarding the applicable fees, conflicts of interest, or any other matters relevant to the investment decision, and
- The investor has a private right of action for violation of the conduct standard.

In contrast to the above, the Proposals lack clarity and fall below a true fiduciary standard.

b) A Fiduciary Standard Can and Should Apply to Episodic Advice

We understand the Commission's aim to design standards that will apply to advice that is provided to customers on an episodic, or pay-as-you-go, basis. We agree that any new rule should accommodate episodic advice, but we urge that such advice must be provided under a fiduciary standard, taking into account the time-limited nature of the engagement of the broker-dealer.

The rules on episodic advice should be drafted to avoid creating a loophole in the broker-dealer's fiduciary obligation to monitor accounts when that would be appropriate. For example, the payment of ongoing compensation, such as a trail commission, indicates an ongoing relationship, and so must carry ongoing duties to monitor the investment.

II. Fundamental Problems with the Proposed "Best Interest" Standard

The Proposals do not define what "best interest" means under the new conduct standard. This places the standard, and the Proposals overall, on a path for failure. SEC Commissioner Kara Stein correctly focused on this problem in April 2018, when the Commission released the Proposals:

> [T]he lack of a definition of best interest, the use of similar terms to mean different things, the use of different terms to mean the same things, and the possibility that the SEC and FINRA interpret the same language in their suitability standards differently. All of these concerns would make it difficult for the industry to discern a clear compliance path. Any resulting confusion may well result in higher compliance costs for broker-dealers, which will likely be passed onto the investor. What's more, the lack of a clear standard is not likely to give investors more confidence in the broker-dealer business model. [3]

The Best Interest nomenclature used in the Proposals will promote confusion. The fiduciary standard under the '40 Act is often defined as a "best interest" standard, but the SEC's Proposals use the same words to designate a weaker conduct standard.

It is evident that the Commission has abandoned a fiduciary standard to preserve the current broker-dealer advice model, based on spurious claims that this will preserve investor choice. As a result, the Proposals present the veneer of a fiduciary standard without providing the substance needed to protect retail investors.

a) The Proposals Place Improper Emphasis on "Reasonable" Procedures to Satisfy the Best Interest Standard

We note that the Proposals state in numerous places that a broker-dealer will meet the proposed best interest standard if it has acted "reasonably." This includes requirements that broker-dealers should "reasonably" disclose conflicts, establish policies "reasonably designed" to identify and at a minimum disclose all material conflicts, exercise "reasonable" diligence, care, and prudence . . . , and have a "reasonable basis to believe" a recommendation is in the customer's best interest. Taken together, this softening language fundamentally weakens the best interest standard.

Currently, when disputes arise between brokers-dealers and customers, a key defense will be that the broker-dealer acted "reasonably" under the rules, even if the customer was harmed by bad advice or recommendations. The Securities Division has seen broker-dealers raise this kind of defense under the current suitability conduct standard. In a case that was the subject of a Securities Division enforcement action, a broker-dealer sold millions of dollars' worth of speculative, privately-placed notes to a

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[3] Public Statement, *Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers. Commissioner Kara M. Stein, April 18, 2018*, . https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818.

large segment of its retail customers.[4] When the value of the notes collapsed, the firm attempted to justify those sales based on its adherence to its investment screening procedures and based on language in the subscription agreements that imposed upon customers responsibility for selecting the investment.

Based on our experience, we foresee that brokerage firms will raise the same kinds of defenses under the Regulation Best Interest conduct standard when inappropriate recommendations are alleged. If anything, the Proposals will give broker-dealers more opportunities to argue that they fully complied with the requirements of Regulation Best Interest because they provided disclosures and their procedures were reasonable and defensible under the rules. Capable corporate counsel will have ample tools to decimate investors' claims under an amorphous "reasonableness" standard.

b) The Proposals Should Designate Practices that are Inconsistent with the Best Interest of Customers

It is telling that the Proposals do not designate any brokerage practices that tend to be so harmful to investors that they will not meet the best interest standard, even when steps are taken to mitigate and disclose conflicts.

Brokerage industry practices that are fundamentally contrary to the requirement for broker-dealers to provide advice that is in the true best interest of customers, include:

- Sales contests,
- Sales quotas (especially for in-house products), and
- Incentives to sell high-cost and high-risk products.

The SEC's discussion of how sales contests should be addressed under Regulation Best Interest uses notably bland language: "Broker-dealers that make recommendations to retail customers that may involve such compensation practices [sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management] should carefully assess the broker-dealer's ability to mitigate these financial incentives and whether they can satisfy their best interest obligation."[5] (emphasis added)

The Securities Division has repeatedly seen sales contests and incentives that have harmed investors. An investor's life savings should not be caught up in a contest to win a trip or other award. These practices must be prohibited. Under the Proposals, it is not clear what conflict mitigation would be required, and in some parts of the discussion it sounds like mere disclosure of financial conflicts could be enough to satisfy the mitigation requirement.

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[4] Massachusetts Securities Division, Docket No. E-2009-0085 (Jan. 26, 2010) (Consent Order filed on May 23, 2011).

[5] Regulation Best Interest Proposing Rel. at 183-184.

A supplemental comment letter that the North American Securities Administrators Association ("NASAA") filed with the SEC in February 2019 describes comments and arguments submitted to the SEC by members of the investment industry and trade groups in support of preserving practices such as sales contests, the promotion of in-house financial products, and the payment of high selling compensation for risky and expensive investments.[6] Retail investors often lack the experience, expertise, and bargaining power to fend for themselves when a broker-dealer makes recommendations influenced by such incentives and conflicts. These products and practices impose great costs and detriments on retail investors and savers, so these are areas where a true fiduciary conduct standard would provide substantial benefits.

It is dangerous not to squarely address these issues now. Failing to do so will imply that even the worst brokerage conflicts can be adequately addressed under the new conduct standard if the brokerage makes disclosures and can demonstrate that it has observed "reasonable" procedures. Retail investors deserve clear protection against severe conflicts.

c) The Proposals Improperly Rely on Disclosure in an Attempt to Remedy Conduct Standard Problems

The provisions of the Proposals are directly contrary to years of data reflected in past studies and reports on disclosure and the conduct standards applicable to broker-dealers. The Proposals disregard the findings of the 2008 RAND Report[7] as well as the specific recommendation by the SEC Staff in the Section 913 Study that a uniform fiduciary standard should apply to both investment advisers and broker-dealers when they make recommendations to retail customers.

The empirical studies supporting the RAND Report found that investors were fundamentally confused about the differences between broker-dealers and investment advisers.[8] An array of industry practices has fostered such confusion (especially through misleading professional titles and firm advertising campaigns).[9] A key finding of the 2008 RAND Report is that most investors mistakenly believed the intermediary (whether it is a broker-dealer or an investment adviser) is acting in the investor's best interest.[10] The RAND Report concluded that investors do not have the education and background to understand and effectively use disclosures such as Form ADV, Part 2. Long, formulaic documents are not useful in practice because investors do not read them.

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[6] North American Securities Administrators Association, Supplemental Comments to NASAA's 2018 Consolidated Comments to SEC Rulemakings, pages 2 - 3 (February 19, 2019). http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Reg-BI-Supplemental-Comment-Letter-021919.pdf

[7] Investor and industry perspectives on investment advisers and broker-dealers / Angela K. Hung ... [et al.]. "RAND Report" (2008).
[8] RAND Report at 19.
[9] RAND Report at p. 19, "Questionable Value of Disclosures."
[10] RAND Report at 19.

We agree with the SEC that relationship disclosure is important for all investors. However, it cannot replace a clear fiduciary standard of conduct. Disclosure is not the answer to the conflicts the brokerage industry has created by trying to benefit from calling themselves advisers.

III. Massachusetts Securities Division Enforcement Actions Demonstrate the Need for a Uniform Fiduciary Standard

As the Commission knows, retail investors are suffering severe financial harm under the current "suitability" conduct standard for broker-dealers. The following enforcement cases may have been avoided if a true uniform fiduciary standard had been in place:

a. Conflicts of Interest Cases
    i. Sales Contests
        1. 2016-0055: Sales contests at a large broker-dealer firm involving cross-selling.
        2. 2017-0045: Sales contests at a large broker-dealer firm involving sales in violation of internal policies and procedures.
    ii. Churning
        1. 2012-0118: Churning in senior citizen's brokerage account involving covered securities.
        2. 2016-0085: Churning in brokerage accounts and unsuitable sales of alternative investments.
b. Suitability Cases
    i. Broker-dealers on Bank Premises
        1. 2015-0103: Unsuitable sales of securities products to a senior citizen by a representative working out of the offices of a large state chartered bank.
        2. 2016-0060: Representatives of a mid-sized independent broker-dealer working out of state chartered bank premises made unsuitable sales of alternative investments including structured CDs, non-traded REITs and BDCs.
        3. 2016-0095: Failure to supervise by large independent broker-dealer of their agents working out of Massachusetts based credit unions.
    ii. Failure to Supervise and Alternative Investments
        1. 2012-0036: Failure to supervise by a large independent broker dealer of their agents in the sale of non-traded REITs.
        2. 2015-0178: Failure to supervise by a large broker-dealer firm of their agent, who made unsuitable recommendations of warrants, REITs and covered securities to investors,

including many seniors - specifically, this involved warrants of exchange-listed securities

iii. Failure to Supervise and Unsuitable Investments

1. 2016-0039: Failure to supervise by large independent broker-dealer of its agent who made unsuitable recommendations involving sales of the exact same financial product carrying a very high commission, to more than 80 customers.

Under a true fiduciary standard, these kinds of activities will be constrained by strong regulation and industry's concerns about investors' private rights of action.

IV. The Flaws in the Best Interest Standard Will Prevent Form CRS from Achieving its Purpose of Reducing Investor Confusion

Done right, a form to educate retail investors on the duties owed to them by broker-dealers and investment advisers should help them make educated decisions on what is right for their needs. However, we cannot support the proposed Form CRS because it will promote investors' current confusion about conduct standards.

The Proposals are built around a confusing and vague best interest conduct standard for broker-dealers. Then, the form attempts to summarize the proposed standards of conduct owed by broker-dealers and investment advisers in brief descriptions for the sake of comparison. The result is a complex and vague form that reflects the flaws in the proposed conduct standard.

The resulting standard comparison will look somewhat like this, based on the required language as pulled from the Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer found in Appendix C:

Broker-Dealers	Investment Advisers
"We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities." "When we provide any service to you, we must treat you fairly and comply with a number of specific obligations."	"We are held to a fiduciary standard that covers our entire investment advisory relationship with you."

While lawyers and securities industry professionals may understand these differences, retail investors are likely to be confused or misled. It would not be clear to the average retail investor what the difference between these standards is or what this means for them when making important decisions regarding their finances. This flaw cannot be fixed by simply redrafting the form because it goes to the core of the Best Interest standard proposal.

To make matters more confusing, the fiduciary standard is often defined as a "best interests" standard. This is clearly not enough to help investors understand which standard is stronger or in what way.

Further, the length of Form CRS reduces its potential. Form CRS should be a shorter form of 1-2 pages that will be easier to use and understand given that investors are unlikely to read a long and complicated form.

The evident problems with Form CRS shine a glaring light on the flaws in Regulation Best Interest. The Best Interest standard remains unclear and how this standard of conduct differs from the fiduciary duty standard for investment advisers remains muddled as well. A uniform fiduciary standard that applies to both investment advisers and broker-dealers would resolve these issues since it would be easier for financial firms to disclose and for investors to understand.

a) Restrictions on the Use of Titles, including "Adviser" and "Advisor," Provide Greater Clarity, but More is Needed

The SEC's proposal to reform professional titles should provide investors with clarity on the precise role, and associated standards, of their financial professionals.

As a threshold issue, investors should be able to identify, when speaking with a registered person, what standard of conduct covers the relationship. Preventing standalone broker-dealers from using the title "advisor" and "adviser" is a small but important step towards distinguishing broker-dealers from investment advisers. This reform is overdue but welcome. This labelling issue will diminish in importance if a uniform fiduciary standard is adopted.

We also ask the Commission to prohibit the use of other titles that improperly suggest an advisory-type relationship, including, financial consultant, investment consultant, and wealth manager by those who are not subject to a fiduciary standard.

When a uniform conduct standard applies, what brokers or investment advisers call themselves will no longer be crucial.

V. The Commission's Proposed Interpretation of the Fiduciary Standard is Ineffective Due to the Problems of Regulation Best Interest

We support the Commission's effort to improve investor protection by offering guidance on the fiduciary duty under the Advisers Act. However, the Commission's proposed interpretation will only cause more confusion when read alongside Regulation Best Interest.

The Commission says it is proposing different standards of conduct for broker-dealers and investment advisers but it is really fusing the two standards in substance while distinguishing them by name. The proposal incorporates components of the investment adviser fiduciary duty into the broker-dealer standard of conduct, and vice versa. The Commission insists that the standards are different and serve different relationship dynamics. In reality, many broker-dealers and their agents hold themselves out as proving the kinds of advice and guidance that have traditionally been offered by investment advisers. Accordingly, broker-dealers and investment advisers should be held to the same standards of care, loyalty, and conduct, and we urge the Commission to adopt a uniform fiduciary standard for both broker-dealers and investment advisers.

a) More and Clearer Guidance is Needed on the Fiduciary Duty

The Commission's interpretation fails to clarify the fiduciary duty under the Advisers Act because it fails to offer real guidance in terms of how investment advisers can satisfy their fiduciary duty. More and clearer guidance is necessary in three key areas:

First, more guidance is necessary on the best interest obligation under the fiduciary duty. Investment advisers will wonder whether the best interest obligation under the fiduciary duty is the same as that set out in Regulation Best Interest. In using the term "best interest" to describe both the investment adviser and broker-dealer standards of conduct, the Commission's interpretation dilutes the fiduciary standard by attempting to bring investment advisers in line with broker-dealers. Instead, we urge the Commission to bring broker-dealers in line with investment advisers and hold both to the higher fiduciary duty standard of conduct.

Second, more guidance is needed on the factors that determine whether an investment adviser has an ongoing relationship with a client because this determination impacts the investment adviser's duty to provide advice and monitoring to the client. The Commission implies but does not clearly state that investment advisers that earn asset-based fees have ongoing client relationships. The Commission should clarify the degree to which an investment adviser's fee structure impacts the scope of its relationship with a client. We urge that the payment of a trailing commission indicates that the relationship is something other than episodic, so a duty to monitor the investment should apply.

Finally, more guidance is needed on full and fair disclosure of conflict of interests. The Commission suggests that in certain circumstances an investment adviser cannot rely on disclosure of conflicts to satisfy its fiduciary duty. However, the Commission fails to shed light on any such circumstances. The Commission illustrates how an investment adviser may handle conflicts but uses only innocuous examples, which leads to an oversimplification of the fiduciary duty. Investment advisers would benefit from examples of how to satisfy the fiduciary duty in less mundane situations.

b) Additional Investment Adviser Regulation Proposals Should Mirror Existing State Regulation

If the Commission puts forth proposals regarding licensing and qualification requirements for investment adviser representatives, we would advocate for requirements that mirror those already in place at the state level. Uniform qualification requirements would ease the transition for investment advisers on the cusp of federal-state registration without hampering business or client service. Similarly, we would advocate that any future proposals for additional investment adviser regulations are in harmony with those already in place at the state level.

c) In the Absence of Meaningful Action by the Commission, Massachusetts is Prepared to Adopt a Fiduciary Standard for Broker-Dealers

My Office has repeatedly seen the harm caused by broker-dealers that provide conflicted investment advice to their customers, and we see the need to act to protect our citizens. Due to the Commission's long delay in addressing these issues and the serious problems with the current Proposals, we are prepared to adopt a requirement that broker-dealers must provide advice and make investment recommendations under a fiduciary conduct standard comparable to investment advisers' under the '40 Act.

We urge the Commission to withdraw the current Proposals and replace them with a set of proposals built around a uniform fiduciary standard, as recommended in the Dodd-Frank Section 913 Report. Retail investors demonstrably need the protection of a uniform fiduciary standard. The Commission should propose revised rules to address that need.

If you have questions about this letter or we can assist in any way, please contact me or Diane Young-Spitzer, Director of the Massachusetts Securities Division, at (617) 727-3548 or diane.young-spitzer@sec.state.ma.us.

Sincerely,

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts