Consumer Federation of America

March 15, 2018

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549-1090

Dear Chairman Clayton:

As the Commission reportedly moves closer to revising the standard of conduct for broker-dealers, a number of financial firms, trade groups, and industry lobbyists have submitted comments outlining a proposed regulatory approach that could win their support. A careful review of these letters makes clear, however, that even where they adopt the nomenclature of a fiduciary duty, these groups continue to push for a watered down suitability-and-disclosure-based standard that will not provide the protections that investors both want and need. If the Commission were to adopt their suggested regulatory framework, it would offer the appearance, but not the reality, of enhanced protections for non-retirement accounts while badly undermining existing protections for retirement accounts. This letter is intended to identify the flaws in these groups' proposed approach and the changes that would be needed to turn their framework into one that would truly put investors' interests first.

Does the standard truly require all "advisers"[1] to act in the best interests of their clients?

A number of industry commenters have written in support of a best interest standard for broker-dealers and suggested that this standard should include an explicit duty of care and duty of loyalty.[2] By adopting the nomenclature of a fiduciary standard, they create the impression that they are proposing meaningful improvements to existing investor protections. A careful review of their comments makes clear, however, that they intend for those duties to be satisfied almost exclusively through compliance with existing broker-dealer regulations. Specifically, their duty of care would

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[1] We use the term adviser in this context to include both investment advisers and broker-dealers who offer personalized investment recommendations to their customers.

[2] *See, e.g.*, Letter from Paul Schott Stevens, President and CEO, Investment Company Institute to SEC Chairman Jay Clayton regarding "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers" (Feb. 5, 2018) http://bit.ly/2EXZ5wF; Letter from Michelle B. Oroschakoff, LPL Financial, to SEC Chairman Jay Clayton regarding "Standard of Conduct for Advisory and Brokerage Accounts" (Feb. 22, 2018) http://bit.ly/2ouvrpe; Letter from Kent Mason, Davis & Harman LLP, on behalf of unnamed clients to SEC Chairman Jay Clayton regarding "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers" (Jan. 18, 2018) http://bit.ly/2FrF0fX.

be satisfied through compliance with FINRA's know your customer and suitability obligations, and their duty of loyalty would be satisfied not by minimizing or avoiding conflicts, but by disclosing and managing them.[3] Thus, the only actual "enhancement" to existing broker-dealer regulatory requirements in their best interest standard is the addition of conflict of interest disclosures, which we know to be ineffective in protecting investors from the harmful impact of those conflicts.

Notably missing from industry's proposed regulatory framework is any obligation to *act in the customer's best interests*. That is a fatal flaw that the SEC will need to fix if it is serious about safeguarding the interests of the financially unsophisticated investors who are most in need of enhanced protections. The good news is that there is an easy fix available that also advances your goal of developing consistent standards across all types of investment accounts: the SEC should adopt a best interest standard modeled on the standard in the Department of Labor's Impartial Conduct Standards for retirement accounts. Under the DOL rule, a financial firm and adviser satisfy the best interest standard when they provide investment advice "that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party."[4]

While that sounds superficially quite similar to industry groups' proposed regulatory framework, the discrepancies are significant. First, the DOL standard includes a "prudent person" component that some, but not all, industry groups include in their proposed standard of care. Inclusion of a prudent person requirement helps to make clear that the analysis supporting the best interest recommendation must meet be rigorous and based on reasonable assumptions. As drafted, the DOL standard also makes clear that the analytical process is not an end in itself; the results of that process must be reflected in the actual recommendation. Second, DOL's best interest standard includes a requirement to act "without regard to" the financial or other interests of the adviser or the firm, language that was taken directly from Section 913 of the Dodd-Frank Act. As the DOL explained, this language helps to clarify that, although the rule allows firms to earn commissions and other forms of conflicted compensation, the advice itself must not be "tainted by self-interest."[5] That is a key difference between a standard that requires advisers to act in customers' best interests and one that merely gives lip service to that concept. Contrary to what industry commenters have claimed, any standard that lacks these crucial components cannot be deemed to be consistent with either the DOL rule or Section 913 of Dodd-Frank.

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[3] *See, e.g.,* ICI letter at 4. ("A broker-dealer would be prohibited from effecting recommended transaction that raises a material conflict between the broker-dealer's interests and the customer's interests unless the broker-dealer discloses all material facts about the conflict and obtains the customer's consent.") *See, also,* Letter from Anthony Chereso, President & CEO, Investment Program Association to SEC Chairman Jay Clayton regarding "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers" (Feb. 15, 2018) http://bit.ly/2BOX1oS at 4. ("Many commenters have suggested that the Commission consider the current best interest standard applicable to broker-dealers along with enhanced up-front disclosures. The IPA believes that the appropriate approach is a flexible, principles-based approach rooted in the longstanding and widely accepted disclosure regime under the U.S. securities laws.")

[4] Best Interest Contract Exemption, Employee Benefits Security Administration, U.S. Department of Labor, 81 FR 21002 (Apr. 8, 2016) http://bit.ly/2pcyi6C at printed page 21026.

[5] *Id* at 21027

Simply calling something a best interest standard does not make it so. Assuming the SEC does indeed propose a best interest standard for brokers' investment recommendations, how it interprets that standard will be critically important. In describing the impact of its best interest standard, the SEC must make clear, as the DOL has done, that its standard would permit the receipt of conflicted compensation, but it would not permit brokers "to act on their conflicts of interest to the detriment of" the customers they serve under that standard.[6] So, for example, a broker choosing between two investments could not select an investment because it is better for the broker's bottom line, even though it is a worse choice for the investor.[7] And simply disclosing its incentive to recommend the more profitable investment would not satisfy the broker's obligations in this regard.[8]

This is an area where the SEC needs to strengthen, not just the standard that applies to broker-dealers, but its enforcement of the existing fiduciary standard under the Advisers Act. For example, while we have cheered the recent series of enforcement actions and settlements reached with advisory firms over the recommendation of high-cost mutual fund share classes, we are disturbed at statements in news releases and by SEC officials that seem to suggest that disclosure of the practice would be sufficient to resolve the problem.[9] For these actions to deliver their full potential benefits, the SEC must make crystal clear that it will not tolerate actions that put the financial interests of the adviser ahead of the best interests of the investor, regardless of how clear the disclosures may be.

On the other hand, the SEC should also make clear, as DOL has done, that its best interest standard "does not impose an unattainable obligation on [brokers and their registered representatives] to somehow identify the single 'best' investment for the [investor] out of all the investments in the national or international marketplace."[10] Instead, the broker-dealer should be able to show compliance with the rule by documenting the prudent process – including the facts and reasonable assumptions – that led him or her to conclude that the investment recommended is the best fit for the investor among the options that broker has available to recommend, taking into account both the needs, characteristics, and financial condition of the investor and the characteristics of the investment products. Contrary to industry claims, this does not require firms always to recommend the lowest cost product. But it does require them to have a defensible rationale when they recommend higher cost products and not simply recommend them because the products are more profitable for the firm. This creates an achievable mechanism for compliance that, if backed by restrictions on conflicts, should result in advice that truly serves investors' best interests.

Does the standard include limits on conflicts necessary to ensure its effectiveness?

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[6] *Id* at 21007.
[7] *Id.*
[8] *Id* 21029.
[9] *See, e.g.*, Press Release, Securities and Exchange Commission, J.P. Morgan to Pay $267 Million for Disclosure Failures (Dec. 18, 2015) http://bit.ly/1PKkkjO.
[10] BICE at 21029.

To be effective, any best interest standard applied to the conflict-ridden broker-dealer business model must include meaningful steps to ensure that conflicts are not allowed to taint the advice. Industry groups suggest that this can be accomplished through a combination of conflict disclosures and policies and procedures to appropriately manage those conflicts,[11] but the SEC's recent enforcement cases against advisory firms clearly demonstrate that the traditional disclosure-based approach of dealing with conflicts under the Advisers Act does not work when those conflicts become both more complex and more opaque. From the SEC's December 2015 settlement with J.P. Morgan over its recommendation of proprietary funds to its latest settlement with Ameriprise for overcharging retirement account customers for mutual fund shares, what these actions all have in common is that the conduct put profits for the firm ahead of the best interests of investors. Recent news articles regarding incentives firms offer advisers to steer clients into managed accounts reveals the same weakness.[12] Officials at the firm cited their "internal controls" as sufficient to ensure that the best interests of the investor would always come first, but former employees indicated the pressure to recommend more profitable managed accounts was real.

If the SEC wants to promote best interest advice and not just clean up the mess after the standard has been violated, it has to get serious about tackling conflicts. While certain types of conflicts can be appropriately addressed through the disclosure and management framework outlined by industry commenters, many more cannot. An adviser's incentive to recommend strategies that maximize assets under management in order to increase fee income, for example, or a broker's incentive to transact more frequently to generate more commissions are the types of conflicts that can and should be addressed through a combination of disclosure and appropriate controls to manage those conflicts. But allowing firms to set quotas to encourage the sale of proprietary funds or deliberately create an incentive to encourage the sale of managed accounts (or some other product that is particularly profitable for the firm) and then relying on management's "internal controls" to ensure that customers are not harmed defies logic and experience. There is a reason, after all, that so many suitability violations involve sales of either annuities or non-traded REITs; the generous compensation to the seller overcomes any scruples the broker may have about the potential harm to the investor.

The answer here again is for the SEC to work hand-in-hand with DOL to force firms to eliminate extraneous conflicts, such as these, that encourage advisers to base their recommendations on their own financial interests, or the interests of the firm, rather than the client's best interests. The SEC has already taken an important step toward creating a less conflicted broker-dealer business model, with its approval of clean shares. But investors have largely been denied the benefits of that decision, as firms sit on the sidelines hoping for a watered down, disclosure-based standard out of the SEC that would also allow them to circumvent the DOL rule's tougher restrictions. The SEC must not fall prey to this pressure to back down on a reform that, more than

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[11] *See, e.g.,* LPL letter at 5. ("As the Commission considers adopting a standard of conduct that incorporates a duty of loyalty, we believe it should ensure that a duty of loyalty be implemented through a principles-based approach that preserves financial institutions' flexibility to avoid or manage conflicts in which they have a competing financial interest, provided they fully and fairly disclose the nature of such conflicts to investors and take such additional steps as may be necessary to ensure that conflicts do not adversely affect the impartiality and prudence of the advice they provide to investors.")

[12] Jason Zweig and Anne Tergesen, "Advisers at Leading Discount Brokers Win Bonuses to Push Higher-Priced Products," Wall Street Journal (Jan. 10, 2018) http://on.wsj.com/2EwdZGu.

any other, has the potential to turn the broker-dealer business model into one that can truly benefit investors.

Does the proposed standard cover the full range of services investors perceive and rely on as advice?

With a few exceptions, industry commenters have generally proposed an appropriately broad definition of recommendation to which the best interest standard would apply.[13] Their support for applying their "best interest" standard broadly to all personalized recommendations appears to stem, at least in part, from their adamant opposition to any proposal that would limit their ability to market themselves to customers as advisers. It is worth noting, however, that support could quickly evaporate, as it did in the context of DOL rulemaking, if the SEC proposes a sufficiently rigorous best interest standard. We understand, however, that the SEC is considering an approach that would preserve some ability for brokerage firms to offer certain services outside the reach of its best interest standard. While we are willing to consider such an approach in principle, it is important to recognize that it is extremely difficult to get right, and getting it wrong risks perpetuating the problems this rulemaking is intended to address.

The following are the minimum requirements necessary, in our view, to make such an approach workable:

- Any services that are marketed in ways that create the reasonable expectation on the part of the customer that they constitute personalized investment advice, and any individual who offers such services, must be subject to the best interest standard.
- All the factors that contribute to the consumers' reasonable expectations, and not just titles, must be taken into account.
- All titles designed to create the impression that the services are advisory in nature, and not just the specific title of "adviser," must be included.
- To the degree that services are excluded from the standard because they constitute arm's length commercial sales transactions, they must be clearly labeled as such and those providing such services must be clearly labeled as salespeople.
- Care must be taken to ensure that dual registrants are not able to engage in hat switching to avoid the reach of the best interest standard.

Finally, given the difficulty of conveying these distinctions to investors, the Commission should first test any such titles- or holding-out-based approach to ensure that investors clearly understand the limitations of the services being offered.

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[13] One notable exception is the letter from industry lobbyist, Kent Mason, on behalf of a group of unnamed clients in which he proposes that the SEC limit its best interest standard to instances in which there is a "mutual agreement" between the broker and the customer that the standard should apply. This approach would simply recreate, using different words, the existing broker-dealer exclusion from the Advisers Act that is the source of the problem the current rulemaking is intended to cure. (Letter from Kent Mason, Davis & Harman LLP, to SEC Chairman Jay Clayton regarding "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers" (Jan. 18, 2018) http://bit.ly/2FrF0fX.)

The Commission has an opportunity to adopt a clear and consistent best interest standard for all types of securities accounts. The good news is that such a standard is achievable. Unfortunately, the proposed regulatory approach being pushed by industry lobbyists and financial firms falls well short of achieving that goal. With the critical changes we have outlined above, however, industry's framework can be transformed into a true best interest standard for broker-dealers and investment advisers alike. That, and nothing short of that, is what investors expect and deserve. Thank you for considering our comments. If you have any questions about these comments, please feel free to reach out to us directly.

Respectfully submitted,

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Micah Hauptman

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cc: Commissioner Kara M. Stein
Commissioner Michael S. Piwowar
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