



**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.<sup>1</sup>

Unfortunately, we and others who have closely examined the SEC proposal have concluded that the reality is quite different.<sup>2</sup> 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.

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<sup>1</sup> 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.

<sup>2</sup> 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.<sup>3</sup> 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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<sup>3</sup> 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.<sup>4</sup> 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,<sup>5</sup> the Investment Advisers Act fiduciary duty,<sup>6</sup> and the Department of Labor's now defunct fiduciary rule.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup> Nowhere does the Release specify how the proposed best interest standard would actually enhance FINRA suitability in any tangible way.

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<sup>4</sup> **Appendix B** includes a redline of the proposed standard showing how it could be revised to truly put investors' interests first.

<sup>5</sup> 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.")

<sup>6</sup> 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.")

<sup>7</sup> 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.")

<sup>8</sup> 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.

<sup>9</sup> 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."<sup>10</sup> 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."<sup>11</sup> 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.<sup>12</sup>

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.<sup>13</sup> 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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<sup>10</sup> 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.

<sup>11</sup> *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.

<sup>12</sup> 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>.

<sup>13</sup> *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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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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<sup>14</sup> 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.")

<sup>15</sup> 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.")

<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup>

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.<sup>19</sup> 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.<sup>20</sup> 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

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<sup>17</sup> 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.")

<sup>18</sup> 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)."]

<sup>19</sup> CFA Fact Sheet, If Financial Firms Support a Best Interest Standard Why do they Encourage Harmful Advice? <https://bit.ly/2H8pCJ0>.

<sup>20</sup> 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.<sup>21</sup>
- Because certain classes of investments (e.g., non-traded REITs,<sup>22</sup> structured products,<sup>23</sup> or variable annuities<sup>24</sup>) 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.<sup>25</sup>
  - 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.<sup>26</sup>

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.<sup>27</sup>

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<sup>21</sup> 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>.

<sup>22</sup> Craig McCann, *Fiduciary Duty and Non-Traded REITs*, *Investments and Wealth Monitor*, July/August 2015, <https://bit.ly/2H7YvxK>.

<sup>23</sup> 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>.

<sup>24</sup> FINRA Investor Alert, *Variable Annuities: Beyond the Hard Sell*, <https://bit.ly/2VSmowP>.

<sup>25</sup> 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>.

<sup>26</sup> *Id.*

<sup>27</sup> 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.<sup>28</sup> 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:<sup>29</sup>

- “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)

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<sup>28</sup> 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.

<sup>29</sup> 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)<sup>30</sup>

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.<sup>31</sup> If this interpretation

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

<sup>31</sup> 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.<sup>32</sup> 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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<sup>32</sup> 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.<sup>33</sup>

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 repropose.

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.<sup>34</sup> 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

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<sup>33</sup> 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>.

<sup>34</sup> 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.<sup>35</sup>

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.<sup>36</sup> 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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<sup>35</sup> 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>.

<sup>36</sup> 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.<sup>37</sup> 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.<sup>38</sup> 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.

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<sup>37</sup> 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>.

<sup>38</sup> 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<sup>39</sup> and one to create a summary prospectus for variable annuities<sup>40</sup> – 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.<sup>41</sup> 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.<sup>42</sup> This

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<sup>39</sup> 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>.

<sup>40</sup> 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>.

<sup>41</sup> **Appendix E** lists and links to previous CFA letters relating to this topic dating back to 1999.

<sup>42</sup> 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.



**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** ~~are 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 exercises 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 establishes, maintains, and enforces 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



**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 leveling 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.

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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").<sup>43</sup> 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."<sup>44</sup>

#### 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."<sup>45</sup> 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.*<sup>46</sup> 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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<sup>43</sup> 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.

<sup>44</sup> *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.

<sup>45</sup> *Id.* (emphasis added).

<sup>46</sup> 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.<sup>47</sup> 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<sup>48</sup>:

(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....<sup>49</sup>

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.<sup>50</sup> 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.”<sup>51</sup>

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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<sup>47</sup> *Id.* at 952-53.

<sup>48</sup> *Id.* at 953.

<sup>49</sup> *Id.* at 952-53.

<sup>50</sup> 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).

<sup>51</sup> *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,<sup>52</sup> sometimes referred to as “transformative circumstances.”<sup>53</sup>

### **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.”<sup>54</sup> 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.”<sup>55</sup>

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.<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup> 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

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<sup>52</sup> *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”).

<sup>53</sup> *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1308 (2d Cir. 2002).

<sup>54</sup> *Id.* at 1308-09.

<sup>55</sup> *Id.* at 1308.

<sup>56</sup> *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”);

<sup>57</sup> *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.”)

<sup>58</sup> *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.<sup>59</sup>

### **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.”<sup>60</sup> 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.<sup>61</sup>

### **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*

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<sup>59</sup> *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”).

<sup>60</sup> *Leib*, 461 F. Supp. at 953-54; *Rupert v. Clayton Brokerage Co. of St. Louis*, 737 P.2d 1106, 1109 (Colo. 1987).

<sup>61</sup> 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 (Ill. 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/2xQ5l36>.

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/>