Consumer Federation of America

Testimony of Barbara Roper
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Before The

Capital Markets and Government Sponsored Entities Subcommittee
Financial Services Committee
U.S. House of Representatives

Regarding

"Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight"

September 13, 2011

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee:

My name is Barbara Roper, and I am Director of Investor Protection for the Consumer Federation of America (CFA). CFA is a non-profit association of approximately 300 national, state and local pro-consumer organizations founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the invitation to appear before you today to discuss an issue that has been the primary focus of my advocacy since I began working for CFA in 1986 – how to improve regulation of the brokers, investment advisers, and financial planners investors rely on for advice and investment services as they save for retirement and other long-term goals.

Improving regulatory oversight of these financial intermediaries is the shared focus of two SEC studies that are the topic of this hearing: the Section 913 study addresses the crucial question of what standard of conduct should apply when brokers provide personalized investment advice to retail investors, while the Section 914 study addresses the question of how best to ensure that adequate resources are devoted to oversight of investment advisers. If your goal is to protect average, unsophisticated investors, nothing is more important than how you regulate these financial intermediaries. Unfortunately, whether your measure is the quality of the regulations or the quality of the regulatory oversight, this is an area badly in need of reform.

These two studies form a foundation on which that regulatory reform can be built. The Section 913 study outlines a proposal for imposing a universal fiduciary duty on brokers and investment advisers when they provide personalized investment advice to retail investors that has won praise from investor advocates, state regulators, adviser groups, and the major broker-dealer trade associations. The Section 914 study documents the need for increased resources for investment adviser oversight and discusses the pros and cons of various approaches Congress could take to provide those resources. Appropriately implemented, the policies advocated in these studies could go a long way toward plugging two significant regulatory gaps that put retail investors at risk. The remainder of my testimony will address each of these two issues in greater depth. I will then sum up by responding to the specific questions posed in the invitation letter.

I. Raising the Standard of Care that Applies When Brokers Act as Advisers

Improving protections for investors in their dealings with investment professionals has been a priority for CFA since I joined the staff in 1986 and we issued our first report on abuses in the fast-growing field of financial planning. Our focus on this issue reflects several factors:

- Investors' lack of sophistication and heavy reliance on recommendations by investment professionals makes them vulnerable to abuse.

- Abusive conduct by investment professionals, both in compliance with and in violation of existing rules, has been a recurrent problem.

- Regulatory standards in this area are notably weak and inconsistent, promoting investor confusion and setting an unreasonably low bar for professional conduct.

There is a positive flip side to these concerns, and that is that strengthening regulatory protections in this one area has the potential to provide dramatic benefits.

The SEC's Section 913 study lays the foundation for a new, pro-investor approach to an old problem. It does so first by documenting a fundamental market failure that has been evident to industry observers for some time.

- Brokers and investment advisers offer similar, and in some cases identical, services to their retail clients, but do so under different regulatory standards and subject to different and sometimes conflicting rules.

- Investors are unable to distinguish brokers from advisers, do not understand the differences in the services they provide, and, in particular, do not understand that they are subject to different regulatory requirements.

- As a result, investors are not able to make an informed selection among the different types of financial intermediaries available to them.

- This problem cannot be eliminated through disclosure or investor education.

That forms the general basis for the study's recommendations on harmonized regulation for brokers and advisers, both with regard to the standard of conduct that applies to their recommendations to retail clients and with regard to other rules that apply to their retail business. However, each point deserves at least brief additional elaboration.

Blurring the Lines between Brokers and Advisers

When Congress adopted the Securities Exchange Act in 1934 and the Investment Advisers Act in 1940, broker-dealers and investment advisers were engaged in related but distinctly different professional activities. Brokers were in the business of effecting transactions on behalf of customers, and investment advisers were in the business of giving advice about investing in securities. Congress therefore carved brokers out of the broad definition of investment adviser that otherwise would have included them, but only so long as they met two criteria: they limited themselves to giving only that advice that was solely incidental to their primary business of effecting transactions on behalf of customers (e.g., buy this, sell that), and they didn't receive any special compensation for that advice. Brokers had to meet both criteria to qualify for the exemption. Both the legislative history and early Commission documents make clear that only a narrow broker-dealer exemption was intended.[1]

By the 1980s, the full service broker-dealer business model was coming under pressure. The deregulation of fixed commissions (and later decimalization) made significant inroads into their profit margins. Meanwhile, they were caught between two growing classes of competitors. On the one hand, discount and online brokers offered cheaper executions for the do-it-yourself investors. On the other hand, financial planners offered more comprehensive and objective

[1] The legislative record and history of the broker-dealer exclusion is described in greater detail in a February 7, 2005 letter to the Commission from CFA Director of Investor Protection Barbara Roper available here.

services for those seeking advice.[2] Full service brokers were forced to adapt in order to survive. They did so, increasingly, by transforming themselves into advisers:

- In the 1980s, they began offering financial planning among their menu of services;

- By the early 1990s, they had begun calling their sales reps financial consultants or financial advisers; and

- At the same time, they began to market their services based primarily on the advice offered.[3]

At each step along the way, the SEC enabled this transformation without reining in brokers' ability to continue to rely on the "solely incidental" exemption from the Advisers Act. Indeed, when the Commission finally defined what was meant by "solely incidental" in 2005, it did so only to define the standard out of existence – creating not the narrow exception intended by Congress but one that covered virtually any service a broker might choose to offer in conjunction with its brokerage services.

Had the Commission appropriately applied the "solely incidental to" standard over the years, brokers could have made a business decision about whether the benefits of offering advisory services justified the costs of regulation under the Advisers Act. However, because the agency gave brokers a free ride to compete as advisers without being regulated as advisers, the brokerage firms were never forced to make that choice. The result is the situation we find ourselves in today, where financial professionals who are indistinguishable to the average investor offer similar or, in some cases identical, investment advisory services to retail investors under two standards of conduct that offer very different levels of investor protection.

Same Conduct, Different Standards

The bulk of the Section 913 study is devoted to describing in extensive detail the different standards and regulatory regimes that apply to brokers and advisers when they offer personalized investment advice to retail customers. The following are among the most significant differences:

- Reflecting their origins as salespeople, brokers are subject to a suitability standard. That standard requires them to make recommendations that are generally appropriate for their customers based on a detailed understanding of the customer's financial situation and needs, but allows them to place their own financial interests ahead of those of their customers in selecting the particular investment products and strategies to recommend.

[2] The growth of the financial planning profession also served to blur the lines between brokers and advisers, since most financial planners were both investment advisers and registered reps of broker-dealers.
[3] The transformation of the broker-dealer business model is described in greater detail in a January 13, 2000 letter to the Commission from CFA Director of Investor Protection Barbara Roper available here.

- All other investment advisers, including financial planners who combine investment advice and product sales, are subject to a fiduciary duty to act in their customers' best interests that is more appropriate to that advisory role.

- Investment advisers are required to provide up-front disclosure of all material conflicts of interest and to appropriately manage those conflicts. Although their conflicts are typically greater, brokers have no such requirement.

- Investment advisers are subject to restrictions that limit their ability to engage in principal trades. Brokers are not, and indeed principal trading constitutes a significant portion of a broker-dealer's business.[4]

- Brokers are subject to regulatory oversight by an industry self-regulatory organization, FINRA. FINRA supplements oversight by the SEC and states by conducting regular routine inspections and enforcing rules of fair practice. Investment advisers are subject exclusively to state or SEC oversight, depending on the size of the firm as measured by assets under management.[5]

The report describes a number of other lower profile regulatory differences as well. These include differences in such areas as advertising rules, licensing requirements, and continuing education requirements that are the subject of separate harmonization recommendations.[6]

<u>Investor Confusion</u>

If all or even a large majority of investors clearly understood these differences, then the case for harmonizing regulation of brokers and advisers would be less urgent. One could simply trust to investors to factor the regulatory differences into their selection of provider. Indeed, brokers for years argued against tightened regulation of their advisory services on precisely these grounds – that investors understood the difference between brokers and advisers and made their choices accordingly. In recent years, however, the research refuting this argument has become conclusive, to the point that the major broker-dealer trade associations no longer make this claim.[7]

Much of that research is documented in the Section 913 study. Of particular relevance are the findings of the RAND Report, commissioned by the SEC in 2006, which included both a household survey and six focus groups of investors.[8] Both survey respondents and focus group

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[4] This issue, in particular, has been an impediment to efforts to close the loophole that has allowed brokers to escape regulation under the Advisers Act when they act as advisers.
[5] Issues related to SRO oversight are discussed in the section of the testimony that deals with the Section 914 Report and the draft legislation to create and investment adviser SRO.
[6] This testimony will not go into those issues in any detail as concrete proposals in this area have not yet been put on the table. As a general matter, however, we support the notion of adopting uniform standards where the conduct is the same.
[7] To our knowledge, only the insurance broker-dealer trade associations continue to make this now completely discredited argument.
[8] Both the survey and the focus groups included experienced and inexperienced investors, with about twice as many experienced investors included in the sample.

participants reported that they did not understand the differences between investment advisers and broker-dealers and that they found the common job titles used by brokers (e.g., financial advisor, financial consultant) and investment advisers to be too similar and therefore confusing. Focus group participants offered the additional insight that the "we do it all" advertisements added to the confusion. This should hardly be surprising. That is precisely the result the brokerage firms intended when they adopted those titles and that marketing strategy – a strategy that was specifically designed to enable them to compete more effectively with financial planners offering more comprehensive and objective advisory services.

One finding of the RAND Report sheds particular light on the policy responses available to address that investor confusion. In their focus group interviews, RAND found that investor confusion was not simply generic. Most participating investors could not identify whether their own provider was a broker or investment adviser, and that confusion persisted even after the investors were provided with fact sheets on investment advisers and brokers that included a description of their common job titles, legal duties, and typical compensation practices. Moreover, the RAND Report was commissioned after previous efforts by the Commission to address confusion through enhanced disclosure had also failed.[9] The SEC's experience in this area along with the RAND Report findings offer conclusive evidence, in our view, that neither disclosure alone nor disclosure in combination with investor education would be effective in eliminating investor confusion.

Investor Expectations

Survey data demonstrates not only that investors are confused about the differences between broker-dealers and investment advisers, but also that investors expect their financial adviser to act in their best interests. That was the overwhelming conclusion of a survey conducted by ORC International for CFA, AARP, the North American Securities Administrators Association, the Certified Financial Planner Board of Standards, Inc., the Investment Adviser Association, the Financial Planning Association, and the National Association of Personal Financial Advisors. Virtually all (91 percent) of the survey's 2,012 respondents indicated that, if a stockbroker and investment adviser provide the same kind of services, they should have to follow the same investor protection rules. And 97 percent (including 85 percent who agreed strongly) agreed that "when you receive investment advice from a financial professional, the person providing the advice should put your interests ahead of theirs and should have to tell you upfront about any fees or commissions they earn and any conflicts of interest that potentially could influence that advice."

Our survey also found investors confused about the legal obligations of different types of investment services providers. Specifically, survey respondents were as likely to think financial advisors, a title commonly used by brokers for their sales reps, had a fiduciary duty (76 percent) as they were to think financial planners (75 percent) and investment advisers (77 percent) had such a duty. That is consistent with the findings of the RAND Report that investors expected brokers and investment advisers alike to act in their best interests when giving advice. Other

[9] The Commission had proposed to require fee-based brokers to provide disclosures in advertisements and other account documents as a condition of relying on their exception from the Investment Advisers Act. When they tested those disclosures with investors, however, they found they were not effective in conveying the desired information.

surveys over the years have reached similar conclusions. These are, after all, reasonable expectations, since the key characteristic that distinguishes advice from a sales pitch is that it is designed with the recipient's interest in mind.

The Need for Consistent Standards

If, as the survey data overwhelmingly suggests, investors cannot distinguish between brokers and investment advisers (even after the differences are explained to them), if they expect anyone offering advice to act in their best interests, and if disclosures and education cannot clear up their confusion, the case for regulatory reform in this area becomes undeniable to all but the most hardened anti-regulation cynics. But there are additional reasons for regulatory harmonization to be found in the extensive overlap between these two once largely distinct populations. As of October 2010, fully 88 percent of investment adviser representatives were also registered representatives of a FINRA-registered broker-dealer. Given the extent of that overlap among the individuals providing retail advisory services, it makes no sense to apply different standards of conduct to those services. Moreover, the brokerage firms that offer fee-based accounts are already complying with the Advisers Act for those accounts after a court decision overturned the SEC rule exempting them from the Act.[10] This has two implications for policy in this area. On the one hand, it means these firms already have the procedures in place to comply with a fiduciary duty. On the other, it actually makes it more difficult for the customers of these firms to know when they are dealing with a broker and when they are dealing with an adviser, making harmonization of the standards more important, not less.

The SEC's Proposed Approach Regarding the Standard of Conduct for Advice

Based on its findings, the Commission staff reached what we believe is the only logical conclusion: that brokers and investment advisers alike should be subject to a fiduciary duty when they render investment advice to retail customers. As it approached the issue, the Commission had at least three options available to it for imposing a fiduciary duty on brokers when they give investment advice.

- Having created the regulatory discrepancy through its failure to appropriately enforce the brokers' "solely incidental to" exception from the Advisers Act, the Commission could at any time have eliminated the discrepancy by adopting a narrowed definition of solely incidental to that is consistent with the statutory language of the Advisers Act and with clearly documented congressional intent at the time the Advisers Act was adopted. This is the approach that CFA advocated for many years prior to the passage of the Dodd-Frank Act.[11]

[10] In March 2007, the U.S. Court of Appeals for the District of Columbia Circuit ruled that the SEC had exceeded its authority when it created an exemption from the Advisers Act for brokers that charge asset-backed fees. (FPA v. SEC)

[11] For years, CFA urged the Commission to take one of two actions. If brokers had indeed transformed themselves into advisers, as their titles and marketing campaigns suggested, they should lose their solely incidental exclusion from the Advisers Act and be regulated accordingly. If they had not fundamentally changed the nature of their business to be primarily advisory in nature, then the SEC should stop permitting them to misrepresent themselves to investors. This argument fell on deaf ears at a Commission that often over the years appeared more concerned with

- Alternatively, the Commission could have proposed to adopt a fiduciary standard for brokers using the broad grant of authority under Subsection (f) of Section 913, subject only to a requirement that the rules be "necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide)" and consistent with the findings of its Section 913 Report.

- Instead, the Commission has proposed to exercise its authority under Subsection (g) of Section 913 to adopt parallel rules under the '34 Act and the Advisers Act imposing a uniform fiduciary duty on brokers and advisers when they give personalized investment advice about securities to a retail customer.[12] That subsection provides more detailed direction to guide the SEC rulemaking than Subsection (f). It specifies that the standard cannot be weaker than the existing standard for advisers and that the standard for advisers and brokers must be the same. It also makes clear that the receipt of commissions does not by itself violate the fiduciary duty, and that the fiduciary duty does not automatically entail an ongoing duty of care where there is no ongoing advice. Finally, where a broker sells proprietary products or sells from a limited menu of products, it authorizes the Commission to require notice and consent, but it clarifies that the practice is not by itself a violation of the fiduciary duty.

In its Section 913 Report, the staff recommends that the Commission adopt the third approach, with the addition that it will simultaneously address the issue of how best to regulate principal trading under a revised standard. The goal in the latter case is to preserve brokers' ability to engage in principal trading while ensuring that these trades are subject to appropriate investor protections.[13] While we are concerned to see how the Commission will interpret certain aspects of the proposed rulemaking, we believe the staff has recommended the right approach – one that appropriately balances the need for enhanced investor protections with the desire to minimize market disruptions and preserve investor choice.

That balance is reflected in the praise that greeted the Commission's release of its Section 913 study. That praise came not only from long-time advocates of a fiduciary standard, such as CFA, AARP, state securities regulators, and investment adviser groups, but also from the two leading broker-dealer trade associations. SIFMA, for example, specifically praised the agency for recognizing "that any fiduciary standard should not pick business model winners and losers." The Financial Services Institute issued the following favorable comment: "The Study acknowledges the importance of investor choice and access to services. It proposes a means to reduce the costs associated with the proposed regulatory changes and avoids picking winners and losers thereby leaving the choice of provider to investors. These were major concerns for FSI and we are satisfied to see that the Study addresses them."

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protecting the full service broker-dealer business model than with protecting investors. It is very much to the credit of the current leadership of the Commission that they have reversed priorities in this area.

[12] This subsection also permits the Commission to apply the standards to additional non-retail customers, though it is not expected to do so.

[13] We believe this is an achievable goal and have supported the Commission's decision to extend its temporary principal trading rule in order to deal with the issue more comprehensively in the context of a fiduciary rulemaking.

Like us and other long-time supporters of a fiduciary standard, the broker-dealer groups are understandably interested in the details of how the Commission moves forward to implement the proposed standard. We have had an opportunity in recent months to discuss a number of those implementation issues with members of the broker-dealer community – issues such as what does and does not constitute personalized investment advice, how a fiduciary duty would be applied in different contexts, and what role disclosure would play in satisfying a fiduciary standard. While it is unlikely that we will ever get to the point of complete agreement, the differences that divide us are less dramatic than many might expect. SIFMA has, for example, suggested an excellent general definition of personalized investment advice that we support. We and SIFMA have both attempted to identify activities that would fall in our outside the definition of personalized advice, and there are far more points of agreement between those two lists than there are points of disagreement. Indeed, the differences in our approaches are at a level of detail that could appropriately be worked out through negotiations during the rulemaking process. Certainly, they are not of a magnitude to warrant stopping the rulemaking proposal in its tracks.

Criticism of the Commission Proposal

Although the Section 913 Report has garnered widespread praise, it is not without its critics. Some, including two SEC Commissioners, have criticized the study on the grounds that it "does not identify whether retail investors are systematically being harmed or disadvantaged under one regulatory regime as compared to the other" and have argued that, as a result, the Commission "lacks a basis to reasonably conclude that a uniform standard or harmonization would enhance investor protection."[14] Echoing that concern, Chairman Garrett and thirteen other Members wrote in a March 17, 2011 letter to Chairman Schapiro that, "the Commission has not identified and defined clear problems that would justify a rulemaking and does not have a solid basis upon which to move forward."

The Need for More Empirical Data

Obviously, we strongly disagree with that conclusion. The Commission has made a strong case based on investor confusion, clearly documenting that the assumptions underlying the previous regulatory policy were unfounded. But we do agree that the Commission could have done more in its Section 913 Study to document the harm that investors suffer when they put their trust in "financial advisors" who are not required to act in their best interests. Our concern is not that regulatory action is unjustified without it. Rather, we feel it is important for the Commission to arm itself against a possible legal challenge, and the best way to do that is to make a strong economic case for the proposed rulemaking.

In our comment letter to the agency at the outset of the study, we suggested a number of approaches the Commission could take to document investor harm when "advice" is offered

[14] This statement from the dissent by Commissioners Casey and Paredes was quoted in an August 2, 2011 letter from House Financial Services Committee Chairman Spencer Bachus to SEC Chairman Mary Schapiro. A March 17, 2011 letter from Chairman Garrett and Republican members of this Subcommittee made a similar reference to the Casey-Paredes dissent.

under a suitability standard.[15] Under a pressing six-month deadline for completion of the report, and with limited staff resources for conducting the kind of economic analysis called for, the Commission did not heed our suggestions. The Commission has since established a team to collect additional data with an eye toward further documenting the need for a fiduciary rulemaking and analyzing the potential impact of such a rulemaking on the industry.[16] Of course, should the agency move forward, the rulemaking process itself would provide an additional opportunity for the Commission to solicit and analyze data specific to its proposed regulatory approach.

While we believe there is a strong economic argument to be made for raising the standard of care when brokers act as advisers, it is important to acknowledge that gathering economic data to support that case is extremely challenging. First, it is not possible to gain meaningful information from investors through the type of survey Commissioners Casey and Paredes suggest in their dissent since, as previous research has shown, investors cannot reliably identify whether their provider is a broker or investment adviser. Second, unsophisticated investors often do not realize that they have been taken advantage of, since they do not have the sophistication to recognize, for example, that a variable annuity rarely if ever belongs in a tax-advantaged account, that a different annuity than the one they were recommended offers significantly higher guaranteed benefits, or that the mutual fund they purchased has above average costs that are eating into their investment returns. Thus, they are unlikely to report any dissatisfaction even when they are being disserved. Third, much of the conduct that is harmful to investors is legal under a suitability standard and thus not subject to enforcement action or regulatory recordkeeping, making it difficult to gather data on those practices. Finally, potentially the biggest benefit to investors from a fiduciary duty – the sweeping benefits that could result if product sponsors were forced to compete for business based on benefits to the investor rather than by offering more generous compensation to the provider – are impossible to quantify. But it is reasonable to suppose that harnessing market forces to benefit rather than disadvantage investors has the potential to bring about truly revolutionary changes.

Recognizing the difficulty of the task, our comment letter to the Commission nonetheless suggested that the Commission attempt to gather evidence related to three basic points of difference between a fiduciary duty and the suitability standard:

- differences in the quality of advice or product recommendations investors receive from brokers and investment advisers;

- differences in investor complaint levels or arbitration filings with regard to brokers and investment advisers; and

[15] See August 30, 2010 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Elizabeth M. Murphy, available here.

[16] Although the Commission requested data from industry on the potential costs of a fiduciary rule, the only marginally substantive data submitted was a report commissioned by SIFMA that did not analyze the approach the Commission has since proposed and thus does not offer valid insights into the likely effect of the Commission's proposed approach. (See, "Standard of Care Harmonization, Impact Assessment for SEC," prepared by Oliver Wyman for SIFMA, October 2010 and CFA's response, available here.)

- whether one standard provides regulators with a better means of holding financial professionals accountable than the other.

While we recognized that it would not be possible for the Commission to produce definitive information, particularly with regard to the quality of recommendations, we felt it would be possible to collect information that would help to document the difference in investor protection provided by the two standards.

In documenting the harm to investors, a key point to focus on is conduct that is permissible under the suitability standard that nonetheless results in harm or lost benefits to the investor. One way to think about this is that a suitability standard essentially allows a broker to recommend the least suitable of the various suitable options, while a fiduciary duty requires the broker to have a reasonable basis for believing his or her recommendation is the best of the available options for that client.[17] One factor a broker would have to look at in making that analysis under a fiduciary duty that is too often ignored under a suitability standard is the cost to the client of the various suitable options. We have long known that even small differences in cost can have a huge long-term impact on investor returns, and recent Morningstar research has reinforced that message, concluding that mutual fund costs are the single best predictor of long-term fund performance.[18] Thus costs, while certainly not the only relevant factor, are clearly an important factor in determining what's best for the client. This cost analysis is particularly important for middle income investors, who cannot afford to pay too much for an investment just so the broker can enjoy a more generous payday.

Although it would be approximate at best, one way to begin to quantify the potential economic benefit of a fiduciary duty would therefore be to analyze the menu of investment options offered by various broker-dealers, identify the range of options that would satisfy a suitability standard under a particular scenario, and determine whether there are significant economic differences for the investor between the "best" and "worst" or highest cost and lowest cost of the suitable options. If there are, then it stands to reason that there would be significant economic benefits for investors from holding brokers to a best interest standard. Mutual funds would be suitable for such an analysis, since they are widely recommended and the costs are highly transparent. Even better would be an analysis of variable annuities, since their often high costs, opaque contract terms, and questionable sales practices make them an area where imposition of a fiduciary duty is likely to bring the greatest benefits. Because the Commission has limited resources with which to conduct this sort of analysis, it may be necessary to look to academics and other outside groups to supplement the record in this area.

False Claims that Middle Market Investors Will Be Harmed

Although the Commission has bent over backward to propose an approach on fiduciary duty that accommodates legitimate industry concerns, and the major broker-dealer groups have

[17] In making that assessment, the broker doesn't have to consider every product available in the marketplace, but simply those that he or she has available to recommend, as the SEC has made clear it would permit sales from a limited menu of products.
[18] Jeff Brown, "Low-Cost Funds Out Perform High-Cost Options," *The Main Street Newsletter*, August 11, 2010, available here.

acknowledged that fact, the Commission has not succeeded in silencing all its industry critics. Most vocal in opposition have been the insurance broker-dealers, whose sale of variable annuities would come under the heightened standard of care. Award-winning personal finance writer Liz Pulliam Weston has called variable annuities "the worst retirement investment you can make."[19] Another industry commentator has called them "one of the most overhyped, most oversold, and least understood investment products."[20] And one analyst, who each year compares the performance of variable annuities to an alternative approach using low-cost index funds, estimates that variable annuities transfer approximately $25.6 billion a year "of spendable investment returns" from vulnerable investors to the insurance industry and its sales force.[21]

Given the billions of dollars at stake, it is hardly surprising that brokers whose business model is heavily dependent on the sale of variable annuities would fear application of a fiduciary duty to those sales. In making their case that the fiduciary duty proposal would harm Main Street investors by increasing their costs or denying them access to valued products and services, however, the main insurance broker-dealer groups have so far chosen to ignore the actual approach the Commission has proposed. Earlier this year, I wrote to members of this Committee refuting these arguments.[22] Rather than repeat those arguments in detail here, I have included a copy of that letter as an appendix to my testimony. The main point to keep in mind is that these arguments are based on a series of false claims, including that: the suitability standard is a more robust standard than the fiduciary duty,[23] that investors are able to make an informed choice among different types of service provider, that the fiduciary duty would prohibit brokers from charging commissions, that it would force them to charge fees, and that it would therefore force them to serve only wealthy clients. They also make completely unsupported claims about compliance costs that directly conflict with what they say elsewhere about the rigorous procedures their members follow in complying with the suitability standard. They similarly exaggerate the potential increase in legal liability under a fiduciary duty, ignoring the fact that violation of fiduciary duty is already the most common claim brought against brokers in arbitration. Worst, their argument is cynically presented as a defense of middle market investors – the very investors who can least afford to pay the high commissions for substandard performance that the suitability standard all too often allows.

<u>The SEC Approach Offers Investors the Best of Both Worlds</u>

Contrary to these criticisms from the insurance broker-dealers, the Commission's proposed approach to imposing a fiduciary duty on brokers when they offer personalized investment advice to retail customers offers investors the best of both worlds. It preserves their ability to choose from a variety of different business models – to choose on-going account management vs. transactional recommendations, for example, and to pay through fees or to pay through commissions – without having to give up the right to receive recommendations in their

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[19] Liz Pulliam Weston, *The Basics: The worst retirement investment you can make*, updated January 2008.
[20] InvestSense, LLC, *Common Sense InvestSense™ … Variable Annuities*, 2002.
[21] Scott Burns, "Variable Annuity Watch, 2008," *AssetBuilder – Registered Investment Adviser*.
[22] See May 9, 2011 letter from CFA Director of Investor Protection Barbara Roper to Chairman Spencer Bachus, Ranking Member Barney Frank, Chairman Scott Garrett, and Ranking Member Maxine Waters, available here.
[23] NAIFA and others make this false claim by conflating the standard of care that applies to advice – suitability vs. fiduciary duty – with the degree of regulatory oversight of brokers and advisers. These are separate issues that require separate solutions.

best interest from those who claim to be acting as their adviser. For these reasons, we strongly support the Commission's recommendation in its Section 913 Study. We believe it has the potential to deliver dramatic and long-overdue benefits to investors who need to make every dollar count in these tough economic times.

II. Improving the Quality of Investment Adviser Oversight

For almost as long as we have been advocating improved regulation of securities salespeople who hold themselves out as advisers, CFA has also been advocating for increased resources for oversight of investment advisers. This problem began to emerge in the late 1980s at a time when both mutual funds and investment advisers serving retail clients were growing at an extremely rapid pace, and agency staffing to oversee these areas was growing slowly if at all. By the early 1990s, the problem had reached crisis proportions, with inspections so infrequent that a small adviser might reasonably expect to set up shop and reach retirement without ever seeing an SEC inspector.[24]

This issue of investment adviser oversight received heightened attention as a result of the unraveling of the Madoff Ponzi scheme in the early days of the financial crisis. This is ironic, since Madoff was a broker-dealer regulated exclusively as a broker-dealer up until just two years before his fraud was uncovered. If the Madoff scandal was an indictment of anything, therefore, it was an indictment of the effectiveness of broker-dealer oversight.[25] That said, the problem of inadequate investment adviser oversight is quite real and the need for a solution is urgent.

Over the years, CFA has supported a variety of approaches to solve this resource problem, including increased appropriations to the SEC, self-funding for the agency to free it from the appropriations process, and user fees on investment advisers to pay for increased oversight. None has been adopted.[26] Instead, Congress chose to "solve" the resource problem by delegating more responsibility to the states, an approach that simply divided up the existing regulatory resources differently without doing anything to address the basic funding short-fall.

While the resource problem ultimately rests with Congress to resolve, Section 914 of the Dodd-Frank Act required the SEC to conduct a study assessing the need for additional resources for investment adviser examinations and options available to Congress to address this issue, including by delegating this responsibility to a self-regulatory organization (SRO). Earlier this year, the SEC issued its Section 914 study.[27] In it, the staff documented a decline in the number and frequency of inspections of registered investment advisers over the past six years and described new challenges the Commission will face as it takes on responsibility for registration and oversight of private fund advisers.

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[24] At the time, SEC staff members estimated that small advisers were on a once every 40 years inspection cycle.
[25] A group of independent FINRA board members, led by Charles Bowsher, has since conducted a very credible examination of FINRA's failure to uncover both the Madoff and the Stanford frauds, and FINRA has reportedly begun to implement the recommendations of that study to improve the quality of its broker-dealer oversight.
[26] User-fee legislation that twice cleared the House with overwhelming bipartisan support in the early 1990s died in the Senate Banking Committee. The funding increases that were provided to the SEC in the wake of the Enron scandal were used to shore up equally pressing funding short-falls in corporate finance and enforcement.
[27] "Study on Enhancing Investment Adviser Examinations," by the staff of the Division of Investment Management of the Securities and Exchange Commission, January 2011. The study is available here.

- The study indicates, for example, that the number of investment advisers registered with the Commission has grown 38.5 percent in the past six years, from 8,581 advisers on October 1, 2004 to 11,888 advisers on September 30, 2010.

- The assets managed by investment advisers registered with the Commission have grown even faster, increasing 58.9 percent, from $24.1 trillion to $38.3 trillion, during the same period.

- During that period, the number of Office of Compliance Inspections and Examinations (OCIE) staff dedicated to examining registered investment advisers decreased 3.6 percent, from 477 staff to 460 staff, falling as low as 425 staff at certain points during the period from September 30, 2007 to September 30, 2008.

- Because of increased funding for the agency from 2008 through 2010, the reduction in OCIE staff dedicated to investment adviser examinations was not as severe as it otherwise would have been.

- As a result, the number of examinations of registered investment advisers conducted each year between 2004 and 2010 decreased 29.8 percent, from 1,543 examinations in 2004 to 1,083 examinations in 2010.

- The percentage of investment advisers examined each year declined accordingly, from 18 percent in 2004 to just 9 percent in 2010, with the number of years on average between examinations rising from 6 to 11.

- Because of changes in Dodd-Frank, the staff predicts a 28.2 percent near-term decrease in federally registered advisers as some smaller advisers migrate to state registration and some previously exempt advisers, such as hedge fund managers, are newly required to register.

- Other obligations under Dodd-Frank, such as new requirements to examine municipal advisers and swap entities, could force the Commission to divert resources from investment adviser examinations if the increased funding provided for in Dodd-Frank is not forthcoming.

As a result of all these factors, we share the study's conclusion that "the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency" and that "The Commission's examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers."

The study outlines three options for Congress to consider adopting to address this "capacity constraint:"

- imposing user fees on SEC-registered investment advisers to fund their examinations by SEC inspection staff;

- authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or

- authorizing FINRA to examine dual registrants for compliance with the Advisers Act.

We believe the user-fee approach outlined in the SEC report offers the best option for funding enhanced inspections in a way that promotes investor protection while minimizing added costs to industry. As a general principle, we believe in funding government agencies to do their jobs rather than farming out those responsibilities to private entities. Moreover, as a government agency, the SEC is more transparent and more accountable than a private regulator is likely to be. Funding increased investment adviser oversight through user fees also has the benefit of being supported by the investment adviser community, at least in part because they believe it would impose lower costs, particularly for small advisers.

Identifying the Issues an SRO Proposal Must Address

In the past, CFA has categorically opposed delegating investment adviser oversight to an SRO, particularly one dominated by broker-dealer interests and particularly if that SRO were given rule-making authority. However, having spent the better part of two decades arguing for various approaches to increase SEC resources for investment adviser oversight with nothing to show for our efforts, we have been forced to reassess our opposition to the SRO approach. Specifically, we have concluded that a properly structured SRO proposal would be a significant improvement over the status quo. Too often, however, the SRO approach is presented as an easy solution by individuals who have not adequately confronted the many thorny issues it presents. The SEC study does an excellent job, in our view, of laying out the issues that would need to be addressed if Congress were to pursue this approach. Only by answering the following questions can Congress develop an SRO proposal that adequately protects investor interests while avoiding imposing undue costs on small advisers.

- How should such an approach be structured in light of the diversity in the investment adviser community?

- How can the risks of industry capture be avoided?

- What would the costs of effective SRO oversight be, and how would they be borne by the many small investment adviser firms?

- What resources would the SEC need in order to provide effective oversight of any such SRO or SROs to which this responsibility might be delegated?

- Should an SRO be an inspection-only SRO, or should it also have broader rule-making authority?

- What entity (or entities) is best suited to this task?

Ultimately, whatever approach Congress chooses to take, we share the view expressed by SEC Commissioner Elisse Walter in her statement on the study, “that the current resource problem is severe, that the problem will only be worse in the future, and that a solution is needed now.” We urge you to act to resolve this problem sooner rather than later.

The Draft Investment Adviser SRO Legislation

Late last week, the Subcommittee released a draft bill to create an investment adviser SRO. The legislation, which is closely modeled on the SRO registration requirement for broker-dealers serving retail customers, is obviously a serious attempt to address this issue. The following section of this testimony will provide our initial assessment of that bill in terms of the previously identified principles for effective self-regulation. Given the short time we’ve had to review the legislation, however, our assessment will of necessity be only preliminary.

- How should such an approach be structured in light of the diversity in the investment adviser community?

The draft legislation deals with this issue at least in part by exempting those investment advisers that primarily serve institutional clients of various types – advisers to mutual funds, hedge funds, and venture capital funds, for example, as well as those where 90 percent or more of the investors are qualified purchasers.[28] Because of the way the exemptions are drafted, using percentage of assets rather than percentage of clients as the basis for the exemption, the legislation could end up exempting a number of advisers with a significant retail investor clientele. The sponsors may therefore want to look at whether this approach would actually have the intended effect of subjecting advisers with largely retail clientele to SRO oversight. The draft legislation also allows for more than one investment adviser SRO. Thus, if fee-only investment advisers or another subset of advisers wanted to form a separate SRO, they would be able to do so, provided they could find a way to do so that was not cost prohibitive.

While this approach of singling out retail-oriented advisers for SRO oversight will make for a more homogenous population of advisers subject to SRO oversight, it may not do much to reduce the resources needed at the SEC to provide effective investment adviser oversight. Under this approach, after all, many of the largest advisers and those with the most complex operations would remain under the SEC’s jurisdiction. According to the Section 914 study, these are the advisers whose examinations are the most labor intensive and require the most sophisticated expertise for staff conducting those examinations.

- How can the risks of industry capture be avoided?

The draft bill includes two mechanisms to limit industry capture. It requires, as a condition of recognition as an investment adviser SRO, that the association have rules that “assure a fair representation of the public interest and the investment adviser industry in the

[28] That, at least, is how we read exemption (c), although the drafting is somewhat ambiguous and needs clarification.

selection of its directors and the administration of its affairs." It elaborates on this point by requiring that a majority of the SRO's directors "shall not be associated with any member of the association or any investment adviser or broker-dealer." While it may be appropriate to further clarify who would qualify as an independent board member, the Commission could do so under the bill's grant of rulemaking authority. That Commission oversight, both in approving the registration of an SRO and in overseeing its operations and approving its rules, provides additional protection against industry capture, if effectively implemented and adequately funded. While these provisions help to reduce the risk of industry capture, they do not eliminate entirely a risk that is inherent in the notion of an industry self-regulatory organization.

- What would the costs of effective SRO oversight be, and how would they be borne by the many small investment adviser firms?

The bill seeks to ensure an "equitable allocation of reasonable dues, fees, and other charges." It remains unclear, however, that the SRO approach is a more cost-effective approach to oversight that funding SEC oversight through user fees. This is of particular concern for the many small investment advisers who would be affected by this proposal. Before moving forward with legislation, sponsors should seek to better understand the likely fees these advisers would face and whether those fees would exceed the user fees necessary to fund a more robust SEC oversight program.

- What resources would the SEC need in order to provide effective oversight of any such SRO or SROs to which this responsibility might be delegated?

As we noted above, it is not clear that delegating oversight of smaller, retail-oriented advisers to an SRO would significantly reduce the resources the SEC needs to provide effective investment adviser oversight since the most labor intensive inspections would remain under the SEC's jurisdiction. In addition, as the draft bill makes clear, the SEC would also have extensive responsibilities associated with oversight of the new adviser SRO. That oversight responsibility would be magnified if there were more than one SRO. By creating the potential for a race to the regulatory bottom between associations anxious to attract members, having multiple SROs would necessitate strong Commission oversight to prevent that outcome. It would therefore be a dangerous fallacy for supporters of this approach to assume that it would reduce the pressure on SEC resources significantly if at all.

One anomaly of the proposed approach is that it would put the Commission in charge of overseeing an SRO whose members include state-registered advisers. In order to ensure that SRO and state oversight of these state-registered advisers is consistent, it may be appropriate to provide state regulators with a more formal role in overseeing the agency. We have not had a chance to think through how that could be structured. However, it seems only appropriate that state securities regulators would have some say in ensuring that SRO rules affecting state-registered investment advisers would be consistent with state law.

- Should an SRO be an inspection-only SRO, or should it also have broader rule-making authority?

The sponsors have chosen to give the proposed investment adviser SRO a full range of rulemaking authority, subject to oversight and approval by the Commission. If the bill results in creation of more than one SRO, this would create a potential for inconsistency in the rules – and, under the worst case scenario, a competition between the SROs to attract members by adopting less rigorous rules. This would place a premium on effective SEC oversight of the SRO or SROs to ensure that any rules adopted are strong, reflect the public interest, and are consistent, which would require adequate agency funding to permit that oversight.

- What entity (or entities) is best suited to this task?

The legislation is neutral as to who would serve as the investment adviser SRO, and leaves open the possibility that there might be more than one such entity. While having more than one SRO creates challenges in terms of SEC oversight, the potential for regulatory oversight, and consistency of rules and enforcement, we believe the benefits of this approach outweigh the risks. While it seems certain that FINRA would serve this role for dual registrants, those advisers who are registered exclusively as advisers may prefer to establish an alternative SRO oriented toward their fee-only business model. It would be important to ensure that any such alternative SRO had adequate resources to regulate effectively. The legislation appears to give the Commission adequate authority to ensure that any such entity would have the necessary capacity to perform the required functions.

III. Responses to Questions from the Subcommittee

The invitation to testify from the Subcommittee poses a series of specific questions with regard to these issues. While the above testimony includes a detailed discussion related to certain of those questions, this section of my testimony will provide brief additional responses to each of those questions.

1) Is there sufficient empirical data to support a new standard of care for broker-dealers?

As we discuss in greater detail above, we believe there are a number of reasons the new standard for brokers is justified.

- First, brokers should never have been allowed to transform themselves into advisers without being regulated as advisers. The new standard is needed to rectify a past regulatory failure that permitted brokers to offer investment advice that was more than solely incidental to their role as brokers without subjecting them to regulation under the Advisers Act. The Commission has gone out of its way to propose the least disruptive approach possible to correct that regulatory error.

- Second, there is extensive evidence that investors cannot make an informed choice among investment professionals and expect all financial advisers to act in their best interests. Because investors cannot factor the difference in legal standards into their choice of investment professional, regulators must step in and ensure that all advisers meet the appropriate standard.

- Third, there is a strong economic case for imposing a fiduciary duty on brokers when they provide personalized investment advice to retail investors. While the data is difficult to compile, particularly given the Commission's limited resources for economic analysis, the evidence can be found in harmful conduct that is permissible under the suitability standard that would be prohibited under a fiduciary duty. A focus should be on practices that increase costs to investors or deprive them of benefits.

While the SEC did not include that empirical data in its Section 913 Study, it has since appointed a study team to collect that data. We believe it is proceeding appropriately.

2) Should a rulemaking for a new standard of care for broker-dealers be undertaken at the expense of other statutorily-mandated rulemakings?

Retail investors suffered devastating losses as the collateral damage of a financial crisis that otherwise had little to do with them. They desperately need federal regulators, including the SEC, to adopt tough regulations required under Dodd-Frank to restore the market integrity on which all our financial security depends. But individual investors suffer equally devastating effects every day when they are victimized by a "financial advisor" who preys on their financial naiveté. For the investor whose ability to retire in comfort is put at risk, it doesn't really matter whether the harm was the result of a failure to protect against systemic risks or a failure to protect against predatory brokers. In short, this question poses a false choice based on an artificially created limitation on SEC resources. Investors' need for protection from both types of investment risks shouldn't be sacrificed because Congress has chosen to deprive the Commission of the resources necessary to do its job. That some would force the Commission to make such choices is particularly cynical, since it is within Congress's power to fully fund the SEC at the level authorized under Dodd-Frank without adding a dime to the deficit and while still allowing for a reduction in industry-paid fees. Should the Commission find it necessary to make trade-offs in order to free up the staff resources to proceed with the fiduciary rulemaking, it would be far better for it to do so by delaying its recently announced review of existing regulations, which will eat up agency resources without adding any new investor protections.

3) If a rulemaking on a new standard of care for broker-dealers should be undertaken, what should the new standard of care be?

As we discuss in detail above, we believe the Commission has proposed an approach in its Section 913 Study that simultaneously strengthens investor protections, minimizes the disruption to industry, and maintains investor choice. That approach has won the praise of a wide range of interested parties, including investor advocates, state securities regulators, investment adviser and financial planning groups, and the major broker-dealer trade associations. As such, we believe it is the best approach for the Commission to adopt in pursuing a rulemaking in this area.

4) What potential problems could arise if the Securities and Exchange Commission moves forward with a standard of care rulemaking for broker-dealers in light of the standard rulemaking proposed by the Department of Labor?

While we have concerns about the Department of Labor's proposed fiduciary rulemaking, they are entirely unrelated to the SEC's fiduciary proposal. Indeed, one concern we have with the DOL's proposed definition is that it contains an overly broad seller's exemption that threatens to create precisely the same problem in the pension market that the SEC is trying to fix with its proposed fiduciary duty for brokers acting as advisers. Moreover, the difficulties raised by the DOL proposal are the result of restrictions in the ERISA statute and have nothing to do with the proposed SEC rulemaking. For example, we believe industry concerns are probably justified that brokers might abandon the individual retirement account market if they were subject to ERISA's restrictions on third-party compensation and its tough sanctions for violations. The answer, however, is to ensure that the DOL proposal is implemented in a way that more closely resembles the approach advocated by the SEC. In short, while there may be good reasons to request further clarification from DOL on how it expects to implement its proposal before its rule is finalized, there is absolutely no reason that controversies over the DOL approach should impede progress on the SEC's fiduciary rulemaking.

5) Is increased oversight over investment advisers or a new standard of care for broker-dealers more essential to investor protection?

As we discuss in detail above, we believe both a new standard of care for broker-dealers and increased oversight over investment advisers are needed. And we see no reason why these priorities should be mutually exclusive. If forced to choose a higher priority, however, it would clearly be the new standard of care for brokers providing investment advice. Once the economic harm resulting from "advice" offered under a suitability standard is measured, we believe the resulting excess costs and lost returns will measure in the tens of billions of dollars a year, if not more. In contrast, while we believe examinations can serve an important investor protection function by detecting and deterring fraud, there is actually no evidence that the current system, despite its inadequate resources, is resulting in anything like that level of harm.

The most commonly cited example, the Madoff Ponzi scheme, is simply not pertinent. Madoff was a broker, regulated exclusively as a broker, throughout the vast majority of the fraud. There was no Madoff "investment adviser" until 2006, when the SEC began regulating commission-based discretionary accounts as advisory accounts. So the story line that FINRA and its predecessor NASD missed the fraud because they did not have the necessary authority over Madoff's advisory activities simply does not hold water. The truth is that Madoff lied about what his business consisted of, and the regulatory oversight provided by NASD and FINRA was insufficient to detect that lie. As we noted above, FINRA has since conducted a very credible independent board examination of its failure in the Madoff and Stanford cases and appears to be working to resolve the short-comings in its regulatory oversight uncovered in that investigation.

Meanwhile, the SEC's regulatory failure in the Madoff case had relatively little to do with the inadequacy of its investment adviser oversight, and a great deal to do with failings in its handling of whistleblower complaints. The agency is working to fix the latter problem, which was also addressed in the Dodd-Frank Act. The one exception to the above characterization is that, once the agency required Madoff to register as an investment adviser in 2006, it should have done more to carefully inspect that operation. With greater resources at its disposal, it might have done so, though we can never know for sure.

6) What are the positives and negatives about the options presented in the Section 914 study for increased oversight of investment advisers?

As we noted above, we prefer the user fee approach, which provides a stable and secure funding source to support a vigorous oversight program. This approach is not without its risks, however. One risk of this approach is that Congress would reduce appropriations to off-set any increase from user fees, though legislation could be drafted in a way that would guard against that risk. The biggest negative of this approach is that Congress seems to be dead set against adopting it. The biggest positives of the SRO approach are that it allows for a stable and sufficient source of funding and that it allows for pay levels for SRO employees that are sufficient to attract and retain highly qualified staff. While the SEC has long been successful in attracting qualified staff, it has been less successful in retaining them over the long-term. The biggest risk of the SRO approach is that Congress will not provide adequate resources for the SEC to provide effective oversight of the SRO and to maintain an effective investment adviser oversight program where it retains jurisdiction. Whichever approach Congress chooses to take, it must ensure that it allows for secure and robust funding and strong oversight.

7) What are your comments on the draft legislation to create an investment adviser SRO?

As we have described in greater detail above, we believe the draft bill represents a reasonable approach should Congress choose to move forward with creation of an investment adviser SRO. Before moving forward, however, we urge the sponsors to more carefully assess the potential costs of this approach for the many small investment adviser firms, to get additional input from other members of the investment adviser and financial planning community who would be directly affected by this proposal, and to ensure that this offers the most cost-effective means of enhancing investment adviser oversight.

IV. Conclusion

In a market that appears to have gone mad, investors are more dependent than ever on advice from trusted investment professionals. But neither the standard of care governing investment advice by brokers nor the quality of regulatory oversight of investment advisers provides adequate protections for vulnerable investors. The Section 913 and Section 914 studies mandated by Dodd-Frank provide a strong foundation for a new, more pro-investor approach to regulation of the brokers, investment advisers, and financial planners investors rely on for advice. The reforms they call for are long overdue. We urge Congress to support the Commission in making these reforms a reality without further delay.

Appendix A

Consumer Federation of America

May 9, 2011

The Honorable Spencer Bachus
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Barney Frank
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Scott Garrett
Chairman
Capital Markets and Government
Sponsored Entities Subcommittee
Financial Services Committee
U.S. House of Representatives

The Honorable Maxine Waters
Ranking Member
Capital Markets and Government
Sponsored Entities Subcommittee
Financial Services Committee
U.S. House of Representatives

Dear Chairman Bachus, Ranking Member Frank, Chairman Garrett and Ranking Member Waters:

I am writing on behalf of the Consumer Federation of America (CFA) in response to concerns expressed by some members of this Committee regarding the Securities and Exchange Commission's proposal to impose a fiduciary duty on brokers when they offer personalized investment advice to retail investors. While CFA has long advocated a universal fiduciary duty for personalized investment advice, we understand that Members of Congress are likely to be concerned when they hear claims that imposing a fiduciary duty on brokers could increase costs to middle income and rural investors or cause them to lose access to valued products and services. The SEC proposal, as outlined in the Section 913 study, should lay those fears to rest.

With the release of its Section 913 study, the SEC made clear that it is very sensitive to the need to preserve the broker-dealer business model and, with it, investor access to affordable, transaction-based advice paid for through commissions on product sales. With those concerns in mind, the SEC proposed to impose the fiduciary duty through parallel rules under the '34 Act and the '40 Act, rather than regulating brokers directly under the Advisers Act, and to do so in a way that preserves brokers' ability to charge commissions, sell proprietary products, sell from a limited menu of products, and offer transaction-based advice. While issues remain to be worked out regarding exactly how the fiduciary duty would be applied in various situations, they are precisely the type of issues that are appropriately resolved during the rule-making progress.

Moreover, our own discussions with members of the broker-dealer community suggest that these issues are imminently resolvable.

For these reasons, the SEC proposal has engendered a significant, if not unprecedented breadth of support. Most remarkably, the proposal has won praise not just from the traditional advocates of a fiduciary duty – investor advocates, state securities regulators, and investment adviser and financial planning groups – but also from the major broker-dealer groups. In its official statement on the report, for example, SIFMA praised the agency for recognizing "that any fiduciary standard should not pick business model winners and losers." The Financial Services Institute was, if anything, even more positive, noting that the study had addressed its concerns regarding the fiduciary duty proposal by acknowledging "the importance of investor choice and access to services" and proposing "a means to reduce the costs associated with the proposed regulatory changes."

Unfortunately, a relatively small but highly vocal portion of the broker-dealer community continues to attack the SEC proposal on the grounds that it would harm middle income and rural investors. In doing so, as the attached document is intended to show in greater detail, proponents of this view ignore serious short-comings in existing investor protections as well as the significant steps the SEC proposes to take to ensure that the fiduciary duty would be applied in a way that is consistent with the broker-dealer business model. We are concerned that arguments with so little basis in fact appear to be persuading some Members to advocate a go-slow approach on this top investor protection priority for retail investors.

We recognize that some Members share the concern, expressed by SEC Commissioners Casey and Paredes in their dissent, that the SEC has failed to provide sufficient economic justification for moving forward with a rule. We view this argument with mixed sentiments. On the one hand, we believe the SEC report clearly documents a serious market failure in need of a regulatory solution: that brokers and investment advisers offer personalized investment advice under two very different regulatory standards; that investors are unable to make an informed choice between the two types of service providers because they cannot tell them apart and do not realize they are subject to different standards; and that disclosure alone cannot resolve this investor confusion.

On the other hand, we believe there is a powerful economic argument to be made in favor of holding brokers to a fiduciary duty when they give investment advice. Specifically, an effectively enforced fiduciary duty could save investors tens of billions of dollars a year in excess costs and reduced payouts by forcing brokers to make recommendations based on the best interests of the investor rather than their own bottom line. While it may be impossible to precisely quantify this economic benefit, we believe the best way for the SEC to satisfy the demands to provide a stronger economic basis for rulemaking is to document the significant costs that investors bear and the benefits they lose as a result of conduct that is permissible under a suitability standard but unacceptable under a fiduciary duty.

In its study, the SEC has proposed a way to move forward on fiduciary duty that maximizes investor protections while minimizing industry disruption. In doing so, it was won broad support from industry and investor advocates alike. It would be tragic if opposition from a few industry members intent on maintaining the status quo were able to derail that progress. Despite the self-interested claims of certain industry members, it is the middle income investors who must make every dollar count who are most in need of these enhanced protections.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

cc: Members of the Committee

Response to Arguments about Fiduciary Duty "Unintended Consequences"

During congressional consideration of legislative proposals to impose a fiduciary duty on brokers when they give investment advice, a concern was raised that doing so may have the effect of denying middle-income and rural investors access to valued products and services. The Section 913 report mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and released earlier this year by the Securities and Exchange Commission (SEC) should lay those fears to rest. With its proposal to impose the duty through parallel rules under the Investment Advisers Act and the Securities Exchange Act, the agency has made clear its intention: to apply the fiduciary duty only to brokers' personalized investment advice to retail customers and not to a broader range of brokerage services; to continue to permit brokers to charge commissions for their services; to continue to permit brokers to sell proprietary products and to sell from a limited menu of products; and to develop a workable approach to principal trading consistent with a fiduciary duty.

The approach advocated by the SEC has won strong support from those groups that have long advocated a fiduciary duty: investor advocates, state securities regulators, and investment adviser and financial planning groups. But it has also won praise from leading members of the broker-dealer community. In particular, both of the two major broker-dealer trade associations – SIFMA and the Financial Services Institute – have endorsed the regulatory approach proposed by the SEC. SIFMA, for example, specifically praised the agency for recognizing "that any fiduciary standard should not pick business model winners and losers." FSI issued the following favorable comment: "The Study acknowledges the importance of investor choice and access to services. It proposes a means to reduce the costs associated with the proposed regulatory changes and avoids picking winners and losers thereby leaving the choice of provider to investors. These were major concerns for FSI and we are satisfied to see that the Study addresses them."

Despite this important progress, a relatively small segment of the broker-dealer community, particularly the brokers whose business model depends on the sale of often high-cost variable annuities, continue to argue that imposing a fiduciary duty on brokers would harm Main Street investors by increasing their costs or denying them access to valued products and services.[29] We recognize that Members of Congress are understandably concerned by claims that middle income or rural investors could be harmed by the fiduciary duty proposal, and as such have attempted to analyze the basis for this claim. In doing so, we have found that those expressing this concern fail to recognize or acknowledge serious short-comings in regulatory protections under the existing standard, ignore those aspects of the SEC proposal designed to protect the broker-dealer business model, and fail to provide any facts to support their claims regarding the effect of a fiduciary duty on compliance costs. Given the lack of substantiation offered, and the support for the SEC approach expressed by other members of the broker-dealer community, we can only conclude that these concerns are unfounded.

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[29] See, for example, the National Association of Insurance and Financial Advisors (NAIFA) issue brief on this topic and earlier fact sheet on a LIMRA International survey of NAIFA members.

I. Critics ignore serious short-comings in existing regulatory protections.

A basic premise of the argument against extending a fiduciary duty to brokers offering personalized investment advice is that the current system is working well, providing investors with both adequate protection and the ability to choose whether to work with a broker or an adviser. To arrive at that conclusion, however, one would need to ignore, deny, or gloss over serious short-comings in the current system.

A. For example, it has been suggested that the suitability standard governing broker-dealers is a more robust standard than the fiduciary duty. This is factually untrue.

- A fiduciary duty requires extensive up-front disclosures of information important to investor decision-making, particularly with regard to conflicts of interest. Brokers operating under a suitability standard are not subject to comparable disclosure requirements, though their conflicts of interest are typically greater.

- Certain recommendations that satisfy the suitability standard would not be permissible under a fiduciary duty. The following is a simplified example of how this can harm investors.

  A broker operating under a suitability standard and choosing between two variable annuities to recommend would be free to recommend the one that pays him the highest compensation as long as both were considered appropriate investments for the customer. He would not have to disclose that conflict to the customer.

  A broker operating under a fiduciary duty would have to analyze the two options to determine which of the two annuities would be best for the customer, for example by determining which has the features most suited to the client's situation and would offer the highest payout. The broker would then have to recommend that option. In addition, he would have to disclose all material information about the recommendation, including conflicts that could affect his judgment.

  The difference in costs or payouts to the investor can amount to many thousands of dollars, potential returns middle-income investors can ill afford to forego.

- Those who are best able to judge the extent of the investor protections afforded by the two standards – the federal, state, and industry self-regulators who enforce those standards – all have stated repeatedly that the fiduciary duty affords important protections not offered by the suitability standard. All have advocated extending the fiduciary duty to brokers' advisory activities.

B. In addition, it has been suggested that any differences in the two standards don't matter since investors are able to choose whether to work with a broker or investment adviser. However:

- Numerous surveys have shown that investors cannot distinguish between brokers and advisers. The RAND Study found, for example, that focus group participants could not tell whether their own financial professional was a broker or adviser, even after the differences between the two had been explained to them.

- Surveys have also shown both that investors are unaware that brokers and advisers are subject to different standards of conduct when providing investment advice and that they expect advisers to act in their best interests.

- Absent an understanding of these most basic differences, investors cannot make an informed choice of whether to work with a broker or adviser.

- Lacking financial sophistication, investors may be slow to recognize when they are being taken advantage of, if that recognition comes at all.

II. Critics ignore specifics of the SEC proposal when suggesting that the broker-dealer business model would be harmed.

The argument that middle-income investors would be harmed by adoption of a universal fiduciary duty for investment advice is based on the idea that doing so would require a dramatic change in the way brokers operate and charge for their services. This was never a persuasive claim, as investment advisers have adopted a wide variety of practice models consistent with a fiduciary duty, including sale of securities for commissions. Now that the SEC has issued its report clarifying its intent to preserve the ability of brokers to charge commissions, sell proprietary products, sell from a limited menu of products, and offer transaction-based advice, this argument has gone from being unpersuasive to being outright deceptive. The following discussion briefly examines and refutes each component of this argument.

A. Some fiduciary opponents imply that, because most investment advisers typically charge fees, imposition of a fiduciary duty would either prevent brokers from charging commissions or force them to charge fees. Neither is true.

- The SEC has proposed to rely on Section 913(g) of the Dodd-Frank Act to impose the fiduciary duty on brokers' investment advice. To the degree that there was any doubt about the ability to charge commissions under a fiduciary duty (a questionable claim to begin with since many fiduciary financial planners charge commissions), that subsection makes clear that fees and commissions are equally acceptable forms of compensation.

- Since the SEC proposal would not require brokers to charge fees, statements that most investors would choose to go without advisory services if their advisor charged up-front fees of $2,500 are completely irrelevant to the question of whether investors would be harmed by imposition of a fiduciary duty.

- Similarly, statements that consumers want to be able to choose whether to pay for advisory services through fees or commissions are also irrelevant, since there is nothing in the SEC proposal that would deny them that choice.

B. Similarly, some fiduciary opponents falsely imply that, because many investment advisers serve wealthy clients, imposition of a fiduciary duty would force brokers to limit the availability of their services to wealthy clients.

- Investment advisers typically offer on-going account management services, comprehensive financial planning, or a combination of the two, services that are more likely to be attractive to wealthier clients and for which they typically set account minimums and charge up-front planning and/or on-going account management fees.

- The SEC proposal and the legislative provision on which it is based recognize the benefit to investors of maintaining the availability of transaction-based advice. Toward this end, it makes clear that there would be no on-going fiduciary duty where there is no on-going advice.

- By preserving the ability of brokers to offer transaction-based advice, the proposal preserves their ability to offer advisory services on terms that are more affordable for middle-income investors.

- At the same time, the proposal would raise the standard that applies to those transaction-based recommendations, ensuring that they serve the best interest of the investor rather than primarily serving the bottom line of the broker.

C. By focusing solely on fees and ignoring commissions, some fiduciary opponents falsely imply that services offered by brokers are more "affordable" than those offered by typical investment advisers.

- Fees are not the only costs paid by investors, although they are the most visible. Commissions also impose significant costs on investors by subtracting from the amount that goes toward the investment.

- Consider, for example, variable annuities. These are considered to be among the more expensive investment products marketed to average investors. As a recent *Smart Money* article noted: "Variable annuities are notorious for the fees they charge. Indeed, the average annual expense on variable annuity subaccounts (including fund expenses plus insurance fees) is typically more than a full percentage point more than on the average open-ended mutual fund. Unfortunately, variable annuity fees don't stop there. Many variable annuities act like B shares of mutual funds, paying commission from the ongoing fees; the average contract fee is $30 to $35."[30]

- These costs are exacerbated when brokers are free to recommend the variable annuity (or other investment product) that pays them most, rather than the one that is in the best interest of the investor.

- A fiduciary duty would bring those costs, and the conflicts of interest associated with them, out into the open and require brokers to consider costs to the investor, among other factors, when making their recommendations.

III. Fiduciary opponents have offered no data to substantiate claims about increased costs under a fiduciary duty.

Some fiduciary opponents have suggested that adopting a universal fiduciary duty for investment advice would significantly raise compliance and liability costs for brokers and that this could cause them to stop serving middle-income investors, reduce services to those investors, or raise their costs. We are not aware, however, that those making this claim have offered any hard data to support the contention that compliance and liability costs would increase significantly under a universal fiduciary duty for investment advice. There are a number of reasons to doubt this claim.

A. Some fiduciary opponents have suggested, for example, that compliance costs would increase by as much as 15 percent if a universal fiduciary duty for investment advice were adopted, but they have offered no factual basis to justify this figure.

   - However, these fiduciary opponents simultaneously maintain that they already follow "know-your-customer" procedures adequate to satisfy a fiduciary duty, including: spending a great deal of time getting to know their clients; requiring customers to fill out detailed suitability questionnaires and to provide extensive documentation to support their responses; reviewing this information and considering additional factors to narrow the selection of financial products from the thousands available to a narrower group of financial products that they believe are most appropriate for the client's objectives.

   - If this is an accurate description, there should be little additional compliance cost associated with determining which of those products is best for the customer.

   - Moreover, a LIMRA survey of NAIFA members calls into question these concerns about compliance costs. According to that survey, NAIFA members are more likely to have dropped their broker-dealer registration primarily because of existing compliance burdens (18 percent) than to have dropped their investment adviser registration for the same reason (9 percent). This suggests that the compliance

[30] "What's Wrong With Variable Annuities," *Smart Money,* August 1, 2010.

burdens associated with being an investment adviser have proven no more onerous to NAIFA members than regulation as a broker-dealer and indeed that the opposite may be true.

B. Claims about increased liability costs associated with a fiduciary duty are equally unsupported and ignore the legal environment in which brokers currently operate.

- Some fiduciary opponents have suggested that brokers would be exposed to greater liability under a fiduciary duty because fiduciary duty is an inherently "amorphous" or ill-defined standard. But fiduciary duty is no more amorphous a concept than suitability. Both are principles-based, facts-and-circumstances specific standards.

- The SEC proposal makes clear that it intends to provide extensive guidance to assist brokers in implementing the fiduciary duty.

- Brokers already face liability under a fiduciary standard, since violation of fiduciary duty is the leading claim filed by investors in FINRA arbitration, and arbitrators are not required to follow the law in reaching their decisions and thus are free to make awards based on a perceived violation of fiduciary duty.

- Some state courts have also held brokers to a fiduciary standard in circumstances where they determined that there was a relationship of trust and reliance.

IV. Middle-income investors are among those most in need of the protections afforded by a fiduciary duty.

Fiduciary opponents often cite concern over its potential impact on middle income investors who may have only a few thousand dollars a year to invest. While it is true that such investors cannot typically afford the account minimums or management fees charged by many investment advisers, it is equally true that they cannot afford to pay the high commissions charged by many brokers when lower cost options are readily available. The SEC proposal protects the interest of these investors by preserving their access to commission- and transaction-based services while simultaneously ensuring that those services are delivered with the investor's best interests in mind.

CFA

Consumer Federation of America

Barbara Roper
Director of Investor Protection

Barbara Roper is director of investor protection for the Consumer Federation of America, where she has been employed since 1986. CFA is an alliance of approximately 300 pro-consumer organizations, which in turn represent more than 50 million individual consumers.

A leading consumer spokesperson on investor protection issues, Roper has conducted studies of abuses in the financial planning industry, state oversight of investment advisers, state and federal financial planning regulation, financial planning software, financial education needs of low income older persons, the need for audit reform in the wake of the Enron scandal, the need for mutual fund reform in the wake of trading and sales abuse scandals, the information preferences of mutual fund shareholders, systemic risk regulation, and securities law weaknesses as a cause of the financial crisis. She has testified before Congress and has supported federal and state legislative and regulatory initiatives on a broad range of investor protection issues.

Roper is a member of the Public Company Accounting Oversight Board's Standing Advisory Group as well as its Investor Advisory Group. She has previously served on the SEC's Investor Advisory Committee, the Investors Working Group, the board of Fund Democracy, and the national advisory board of AARP's Money After Fifty program. She is the 1991 recipient of the National Association of Personal Financial Advisors' Distinguished Service Award, the 1992 recipient of a Distinguished Service Award from the North American Securities Administrators Association, and a 2004 recipient of Consumer Action's Consumer Excellence Award. She graduated in 1977 from Princeton University with a degree in art history.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Barbara Roper	Consumer Federation of America
3. Business Address and telephone number:	
1620 I Street, N.W., Suite 200 Washington, D.C. 20006 (202) 387-6121	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	
Barbara L. N. Roper	

Please attach a copy of this form to your written testimony.