



## Consumer Federation of America

August 7, 2018

Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: File Number S7-07-18, Regulation Best Interest  
File No. S7-08-18, Form CRS Relationship Summary  
File Number S7-09-18, Proposed Commission Interpretation Regarding Standard  
of Conduct for Investment Advisers

Dear Secretary Fields:

For the better part of two decades, the Consumer Federation of America (CFA)<sup>1</sup> has urged the Securities and Exchange Commission (SEC) to strengthen protections for investors who rely on broker-dealers and investment advisers for advice about their investments.<sup>2</sup> Recognizing the extent to which investors rely on those recommendations, we have identified this as the single most important thing the Commission can and should do to protect the millions of Americans who turn to securities markets to save for retirement, to fund a child's college education, or for other long-term goals. And we have, over the years, expressed a willingness to support a variety of different approaches to address the issue. We therefore appreciate that the Commission has, at long last, turned its attention to this high-priority issue and released a broad, albeit deeply flawed, proposal to address the problem. We look forward to working with the Commission to turn this regulatory package into one that we can enthusiastically support.

It is important to acknowledge at the outset, however, that we have fundamental concerns regarding the Commission's chosen regulatory approach. We believe the Commission is on shaky legal ground in proposing different standards for brokers and advisers in light of repeated statements throughout the Release suggesting that the Commission views investment advice as the primary service offered by brokers and advisers alike. We also question the Commission's assumption – critical to its bifurcated regulatory approach – that the proposed disclosures will be sufficient to alert investors to important differences between the services offered by brokers and

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<sup>1</sup> The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

<sup>2</sup> We refer to brokers' sales recommendations as advice in this context, because that is how they characterize their services to investors and that is how investors typically perceive those services.

advisers and the legal protections that apply. This would be of less concern if Regulation Best Interest proposed to create a strong and unambiguous best interest standard for brokers, backed by meaningful restrictions on conflicts of interest. But the standard as currently drafted is both too vague and too flawed to provide the assurance that investors will be adequately protected, and the Commission’s proposed Guidance on investment advisers’ fiduciary duty suffers from many of the same weaknesses. Nor has the Commission yet undertaken an even remotely credible legal and economic analysis of the issues at stake in this rulemaking to justify its proposed approach.

In light of these concerns, we caution the Commission against rushing to finalize a proposal before each of these concerns is fully addressed. In particular, the Commission must first show, through thorough and credible cognitive usability testing, that its proposed disclosures will enable even financially unsophisticated investors to make an informed choice regarding the type of account and service that will best meet their needs. If that proves not to be the case, the Commission will need to fundamentally rethink its proposed approach, whether by strengthening, and eliminating inconsistencies between, the standards for broker-dealers and investment advisers, further clarifying the distinction between brokers and advisers, rethinking the disclosures themselves, or some combination of these three approaches. Unfortunately, the Commission has not yet provided comprehensive testing results on which to base an assessment of these vitally important issues.

The remainder of this letter addresses these concerns in greater detail. The first section of the letter provides an overview of the flaws in the Commission’s proposed regulatory approach. The second section discusses Regulation Best Interest and the new Guidance regarding the Investment Advisers Act fiduciary standard. We discuss what we support in the proposed standard and Guidance as well as the extensive changes that would be needed to ensure that investors are adequately protected under both regulatory regimes. The third section of the letter discusses concerns regarding proposed Form CRS disclosures. We offer preliminary suggestions to improve the disclosures, pending publication of further testing results needed to allow a more comprehensive analysis. The fourth section discusses problems with the Commission’s proposed approach to title regulation. The fifth section discusses the questionable legal basis for the Commission’s proposed approach. The final section of the letter reviews the Commission’s deeply flawed economic analysis. We provide a redline of the best interest standard in Appendix A.

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**Appendix A: Redline of Best Interest Standard**

## **I. The Commission’s overall regulatory approach is fundamentally flawed.**

In determining how best to regulate broker-dealers’ recommendations to retail investors, the first and primary question the Commission must confront is whether it considers brokers to be mere salespeople, as industry groups argued in their successful Fifth Circuit challenge to the Department of Labor conflict of interest rule,<sup>3</sup> or advisers who just happen to offer their advice in the form of recommendations to purchase and sell securities. Although it never confronts this question directly (a glaring omission in its own right), the Commission’s discussion of its proposed Regulation Best Interest leaves no doubt that the Commission aligns itself firmly with the latter school of thought. Nowhere in the Reg BI Release does the Commission describe broker-dealers as salespeople or their services as sales recommendations.<sup>4</sup> Instead, the Commission repeatedly refers to brokers as providing advice or advice services, describing them at one point as offering a “pay as you go” model for delivering investment advice.<sup>5</sup>

If the Commission truly believes that brokers are just “pay as you go” advisers, it has an obligation to explain on what basis it continues to exclude them from regulation under the Investment Advisers Act. As we have argued at length in a previous letter to the Commission and discuss further below, nothing in the legislative record of the ‘40 Act supports the notion that Congress intended to provide brokers with a broad exclusion from the Act for any and all advisory services.<sup>6</sup> On the contrary, the record shows that Congress was aware of and sought to address the risks posed to investors by “dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice.”<sup>7</sup> It was with this concern in mind that Congress crafted a narrow exclusion from Advisers Act regulation for brokers who limit themselves to providing only that advice that is “solely incidental to” their primary function of effecting transactions in securities and who do not charge “special compensation” for that advice.

In crafting the broker-dealer exclusion, Congress clearly had a very different broker-dealer business model in mind than the one the Commission describes in this Release. The mechanical aspect of brokers’ services on which the broker-dealer exclusion was based was highlighted in an early court case, which found that a broker’s duty to the customer normally terminates with the execution of the order, “because the broker’s duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.”<sup>8</sup> If, as the Release suggests, the Commission now believes that investment advice – and not the mechanical, ministerial requirements of the purchase and sale of the security

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<sup>3</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 1, <http://bit.ly/2f4wVBW> (“The DOL seeks to...erase universally recognized distinctions between salespeople and fiduciary advisers...”); *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep’t of Labor*, et. al., No. 17-10238, at 37 (5th Cir.) (Mar. 15, 2018).

<sup>4</sup> Although the Release does discuss conflicts related to sales commissions, contests, and quotas, a broader discussion of brokers’ sales activities is largely relegated to footnotes and the economic analysis.

<sup>5</sup> Reg BI Release at 9.

<sup>6</sup> See Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2> (challenging the SEC’s reading of the legislative record).

<sup>7</sup> *Id.* at 5.

<sup>8</sup> SEC 913 Study at 55 (citing *Walston & Co. v. Miller*, 410 P.2d 658, 661 (Ariz. 1966)).

– is the primary service offered by brokers to retail customers, it has two legally acceptable options: (1) it can start regulating brokers’ advisory services under the ‘40 Act, or (2) it can adopt a uniform fiduciary standard for brokers and advisers using its authority under Section 913(g) of the Dodd-Frank Act.

Put another way, if the Commission believes brokers and advisers simply offer different payment and relationship models for providing the same service, it must hold them to the same standard when they provide advice. Only if it believes brokers and advisers are performing fundamentally different functions – selling investments versus providing advice – can it justify holding them to different standards. In that case, it must make that difference crystal clear to investors. Despite all its moving parts – a new standard of conduct for brokers, a new disclosure document for both brokers and advisers, and restrictions on use of the title “adviser” by some brokers – this is something the Commission has failed to do. It doesn’t propose a uniform fiduciary standard, on the grounds that brokers and advisers are both primarily engaged in providing advice. And it doesn’t restore a clear functional distinction between brokers and advisers, on the grounds that they are filling fundamentally different roles. By failing to engage the central question – just how far the “solely incidental” exclusion stretches – the Commission also fails to provide a coherent explanation for its chosen regulatory approach.

Instead, the Commission has proposed to adopt a new standard of conduct for brokers that it claims incorporates fiduciary principles but nonetheless isn’t a fiduciary standard. Nowhere does the Commission explain how that standard differs from, or even whether it improves upon, the existing suitability standard under FINRA rules. It also fails to make clear whether, or to what extent, a broker’s obligation to act in a customer’s best interests would differ from an adviser’s fiduciary duty (except with regard to ongoing advice, where it adopts a decidedly anti-investor interpretation). Nor does the Commission clearly explain to what extent a broker or adviser’s conflicts of interest would be permitted to influence their recommendations. Where it does fill in the details, albeit in sketchy fashion, it adopts an interpretation of best interest for brokers and advisers alike that doesn’t remotely resemble investors’ reasonable expectation regarding the meaning of that term. Meanwhile, the Commission’s proposal would continue to permit brokers nearly unchecked ability to market themselves as advisers without being regulated as such. And, despite all that, the Commission assumes that investors who struggle to understand the most basic differences between brokers and advisers will nonetheless grasp these complexities based on a vague and generic disclosure document the investor likely won’t receive until after they’ve chosen a financial professional.

Scattered here and there throughout the regulatory proposal we see individual nuggets that could form the basis of a pro-investor policy. With extensive adjustments, the Commission could turn its best interest standard into a fiduciary duty tailored to the broker-dealer business model. Given substance and clarity, its proposed requirement for brokers to mitigate conflicts of interest arising out of financial incentives could become the engine of a badly needed pro-investor transformation of the broker-dealer business model. The proposed Guidance regarding investment advisers’ fiduciary duty would need a similar overhaul in order to live up to claims that it imposes a best interest standard that cannot be satisfied through disclosure alone and to expand the concept, only hinted at currently, that not all conflicts can be adequately addressed through disclosure and consent. Finally, by working with a disclosure design expert to

completely overhaul both the content and presentation of the proposed relationship summary, the Commission could turn Form CRS into a document that helps arm investors with useful knowledge on which to base a decision among different types of providers and different types of accounts.

Absent this sort of sweeping overhaul, however, the Commission cannot reasonably claim that its proposal will strengthen protections for investors or reduce investor confusion. On the contrary, certain aspects of the Commission’s proposal have the potential to make the problem much worse, in particular by leading investors to expect protections the proposed regulations would fail to deliver. The remainder of this letter describes in detail the changes that would be needed to ensure that investors are able to make an informed choice of investment service providers and, even more importantly, that they are adequately protected regardless of the choice they make.

## **II. Proposed Regulation Best Interest and the Investment Adviser Guidance must be strengthened and clarified if they are to adequately protect investors.**

For years, investor advocates and industry lobbyists alike have called on the Commission to adopt a “best interest” standard for brokers. But that apparent agreement on the appropriate regulatory approach is illusory, masking a deep divide over how the term “best interest” should be interpreted. For investors and investor advocates, best interest is shorthand for a fiduciary standard, and the meaning is straightforward: a broker acts in a customer’s best interest when he or she recommends, from among the reasonably available suitable options, those investments that are the best match for that investor, taking into account the investor’s needs and the investments’ characteristics.<sup>9</sup> This definition draws a deliberate distinction between a best interest standard and the existing suitability standard, which can be satisfied by recommending any of what may be dozens, or even hundreds, of generally “suitable” investments.

In contrast, brokerage firms and their lobbyists appear to see little if any difference between a suitability standard and a best interest standard. In recent comments to the Commission, for example, more than one industry member characterized FINRA’s suitability standard as a “best interest standard” that is “appropriately tailored to a broker-dealer business model.”<sup>10</sup> These groups have consistently urged the Commission to adopt a best interest standard in name only, in which the duty of care is satisfied through compliance with the existing FINRA suitability rule and the duty of loyalty is satisfied through provision of some questionably effective disclosures regarding conflicts of interest.

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<sup>9</sup> See *infra* Section II.A. for a more detailed discussion of the meaning of best interest.

<sup>10</sup> See, e.g., Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, July 21, 2017, <http://bit.ly/2uRtdUA>; Letter from Dorothy M. Donohue, ICI Acting General Counsel, to the SEC, August 7, 2017, <http://bit.ly/2fhXhjU>; Letter from Mark R. Bryant, Fidelity Senior Vice President and Deputy General Counsel, to the SEC, August 11, 2017, <http://bit.ly/2wLJSKh>; Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, Feb. 5, 2018, <http://bit.ly/2EXZ5wF>; Letter from Michelle B. Oroschakoff, LPL Financial, Feb. 22, 2018, <http://bit.ly/2ouvrpe>; Letter from Kent Mason, Davis & Harman LLP, on behalf of unnamed clients, Jan. 18, 2018, <http://bit.ly/2FrF0fX>.

The question for us as we evaluate Reg BI is which of these interpretations of best interest the Commission is proposing to adopt. As Brett Redfearn, Director of the Division of Trading and Markets, has stated, “The rule seems like a Rorschach test for many. Everybody sees something different in it. And, each tends to be predisposed to see what they want to see at this stage of the game.”<sup>11</sup> That is a troubling statement about a regulatory proposal that is intended to bring clarity about broker-dealers’ obligations when making investment recommendations to retail investors. It helps to explain why, as we discuss in greater detail below, the proposed Form CRS disclosures are completely inadequate to clarify these issues for investors.<sup>12</sup>

Those who read Reg BI as simply restating the existing FINRA suitability standard can cite ample support for that view. Statements in the Release that Reg BI represents an enhancement of “existing suitability obligations under the federal securities laws” refer to suitability rules under the ‘34 Act, not the FINRA suitability standard. Tucked away in footnote 7 of the Release is a statement that “some of the enhancements that Regulation Best Interest would make to existing suitability obligations under the federal securities laws” reflect obligations that already exist under the FINRA suitability rule. Included on that list is the “requirement to make recommendations that are ‘consistent with his customers’ best interests.”<sup>13</sup>

Furthermore, FINRA itself has used virtually the exact same language as the Commission uses in Reg BI to describe brokers’ obligations under its suitability standard. In its Rule 2111 (Suitability) FAQ, for example, FINRA states: “The suitability requirement that a broker make only those recommendations that are consistent with the customer’s best interests prohibits a broker from placing his or her interests ahead of the customer’s interests.”<sup>14</sup> In enforcing that standard, however, FINRA has only rarely and very narrowly enforced the obligation to do what is best for the customer – typically in cases that involve recommending the most appropriate share class of a particular mutual fund. FINRA has not interpreted the obligation to “make only those recommendations that are consistent with the customer’s best interests” as requiring the broker to recommend those investments that are the best match for the investor from among the reasonably available investment options. Indeed, as we detailed in our July 2015 comment letter to the Department of Labor, most of the cases in which FINRA and the Commission have asserted an obligation for brokers to act in customers’ best interest have involved egregious frauds rather than questions of whether customers’ best interests were being served.<sup>15</sup>

Interpreting the intended meaning of the proposed standard is further complicated by the fact that virtually identical language has also been used to describe both the fiduciary duty that applies to investment advisers under the ‘40 Act and the DOL conflict of interest rule. The SEC’s 913 Study states, for example, that, “An investment adviser is a fiduciary whose duty is to

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<sup>11</sup> Brett Redfearn, Director, Division of Trading and Markets, SEC, Remarks at the FINRA Annual Conference, May 22, 2018, <https://bit.ly/2x5ezvR>.

<sup>12</sup> See *infra* Section III.B.4.

<sup>13</sup> Reg BI Release at 10.

<sup>14</sup> FINRA Rule 2111 (Suitability) FAQ, <https://bit.ly/2Ktkix1>.

<sup>15</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the Department of Labor, at 10-13, July 21, 2015, <https://bit.ly/2OHuR31>.



serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own."<sup>16</sup> And, in the preamble to its conflict of interest rule, DOL describes its best interest contract exemption this way: "The exemption strives to ensure that Advisers' recommendations reflect the best interest of their Retirement Investor customers, rather than the conflicting financial interests of the Advisers and their Financial Institutions."<sup>17</sup> At different points, the Reg BI Release states that the proposed standard is based on fiduciary principles from the Advisers Act fiduciary duty<sup>18</sup> and suggests it is intended to be similar to the DOL standard.<sup>19</sup> But SEC officials have also emphasized their intent to adopt a standard for brokers that is distinctly different from either.<sup>20</sup> Where those differences lie is unclear, which helps to explain why different commenters interpret the proposal in vastly different ways.

The three standards described in these virtually identical terms, and referenced by the Commission as similar to its proposed standard, impose very different requirements and afford very different levels of investor protection. As a result, the Commission can't simply adopt a requirement for brokers to act in their customers' best interests, and to refrain from putting their own interests ahead of the customer's interests, and assume that it has either strengthened or clarified the existing standard of care. Depending on how the Commission defines and interprets its proposed standard, the proposal could bring about true, pro-investor reform or create the veneer of strengthened investor protections but not the reality. Indeed, if combined with disclosures in a relationship summary describing brokers as acting in customers' best interests, a watered down interpretation that closely resembles the current suitability standard could leave investors at greater risk than they are today, expecting strengthened protections that the rule doesn't deliver. Unfortunately, it is impossible to tell from the rule text itself how the Commission intends to interpret the standard. When we look to the Release text for clarification, we find a discussion of key terms that sends a strong, pro-investor message in some areas, but falls woefully short or is ambiguous and internally inconsistent in others.

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<sup>16</sup> SEC 913 Study at iii.

<sup>17</sup> Department of Labor, Employee Benefits Security Administration, Best Interest Contract Exemption, Federal Register / Vol. 81, No. 68 / Friday, April 8, 2016.

<sup>18</sup> Reg BI Release at 160-161 ("Although we are not proposing a fiduciary duty that includes a duty of care for broker-dealers, it is important to note that we believe that the proposed care obligation under Regulation Best Interest, in combination with existing broker-dealer obligations (such as best execution), is generally consistent with the underlying principles of—albeit more prescriptive than—the duty of care enforced under the Advisers Act.”).

<sup>19</sup> Reg BI Release at 156 (“[W]e believe the proposed Care Obligation generally reflects similar underlying principles as the ‘objective standards of care’ that are incorporated in the best interest Impartial Conduct Standard as set forth by the DOL in the BIC Exemption.”).

<sup>20</sup> See, e.g. Sean Alloca, *Why ‘fiduciary’ was left out of the SEC proposal*, Financial Planning, May 22, 2018, <https://bit.ly/2H0lyVv> (“While the proposed rule is a ‘fiduciary principle,’ the commission refrained from using the term to make it easier for investors to understand the differences between broker-dealers and advisors, Clayton says. ‘Calling them both fiduciary and then defining them would not make it clear that the relationship model is different,’ Clayton says.”); Former Commissioner Michael S. Piwowar, Statement at Open Meeting on Form CRS, Proposed Regulation Best Interest and Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, <https://bit.ly/2qSddhG> (“According to the proposing release, this ‘best interest’ standard is wholly different from the well-established Investment Adviser’s Act fiduciary standard and FINRA’s suitability standard. Unfortunately, after 45 days of reviewing and commenting on this release, I am not convinced that we have clearly and adequately explained the exact differences. This lack of clarity is worrisome and could undermine our goal of preserving retail investors’ ability to access different types of financial services.”); Dalia Blass, SEC, Director, Division of Investment Management, Remarks at the PLI Investment Management Institute 2018, April 30, 2018, <https://bit.ly/2KsJN2C> (“[T]he proposal would seek to preserve the pay-as-you-go broker-dealer model by recognizing how it differs from the investment adviser model.”).

If the Commission intends to create a true best interest standard for brokers that helps to ensure investors get investment recommendations untainted by harmful conflicts, it will need to both clarify and strengthen the proposed standard. It can achieve that goal without abandoning its commitment to a principles-based approach and without dramatically increasing the length or complexity of the rule text. (We provide a redline of the proposed standard designed to achieve that goal in Appendix A.) In the process, it should also further strengthen and clarify its interpretation of the Advisers Act fiduciary duty, particularly as it pertains to the question of whether an adviser's obligation to act in clients' best interests can be disclosed away and how to deal with the multitude of conflicts of interest that dual registrants may bring into the advisory relationship. This section of the letter discusses what would be needed to turn both Reg BI and the Advisers Act fiduciary duty into a strong and unambiguous best interest standard that we could enthusiastically endorse. These changes are essential to ensure that investors are adequately protected, but they would also benefit firms by providing greater clarity regarding what they and their representatives must do to satisfy the standard.

**A. The Commission must clarify brokers' obligation under the new standard to recommend the best of the reasonably available investment options.**

Under the proposed rule, broker-dealers and their associated persons would be required to act in the best interest of the customer, and they would be prohibited from placing their financial or other interests ahead of the customer's interests, when recommending any securities transaction or investment strategy to a retail investor. The rule text identifies specific requirements brokers would have to meet to satisfy this principles-based standard. These include an obligation to provide "reasonable disclosure" of the material facts regarding the relationship, the need to follow a diligent and prudent process to determine whether the recommendation is in the customer's best interest, and the requirement to disclose or eliminate material conflicts of interest and to mitigate financial incentives. But on the central question of what is meant by "acting in the customer's best interest," the rule text is silent.

The Release makes clear that the failure to define the term was intentional. The Release states, for example, that the decision not to define "best interest" was based on a belief "that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Regulation Best Interest are satisfied."<sup>21</sup> The first part of that explanation seems to suggest that the Commission doesn't think it is possible to clarify the meaning of acting in the customer's best interests without abandoning that facts-and-circumstances-based approach. This view was recently voiced by the head of the Trading and Markets Division, who reportedly said that "it was better not to be prescriptive with the definition of best interest because 'what is in the best interest of one customer may not be in the best interest of another.'"<sup>22</sup>

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<sup>21</sup> Reg BI Release at 52 ("We are not proposing to define "best interest" at this time...").

<sup>22</sup> Rita Raagas De Ramos, *SEC Chair: Government Should Not Drive Away the Broker-Dealer Model*, Financial Advisor IQ, May 23, 2018, <https://bit.ly/2O8NxYs>.

But the Commission develops rules and guidance all the time that are facts-and-circumstances-based. A prime example is the guidance the Commission and FINRA have provided on how brokers satisfy their duty of best execution.<sup>23</sup> That guidance makes clear that there is no one-size-fits-all approach, and that the broker must take the particular needs and wishes of the customer (whether for speed, or liquidity, or anonymity) into account when deciding where to execute a trade. Similarly, the hallmark of the Advisers Act fiduciary duty is that it “follows the contours of the relationship between the adviser and its client” and that, as a result, its application “will vary with the terms of the relationship.”<sup>24</sup> In an example that is particularly pertinent to this rulemaking, an investment adviser’s ongoing duty of care is dictated by whether the adviser provides ongoing advice; an adviser who enters an agreement with a client to provide a one-time recommendation for an hourly fee would have no such ongoing duty to monitor the account. In short, there is absolutely no reason the Commission can’t clarify what it means by acting in the best interests of the customer while retaining this facts-and-circumstances-based approach. On the contrary, even as it clarifies the meaning of the term, the Commission can and should emphasize precisely this point – that the application of the standard depends on the facts and circumstances – just as it has done in its guidance on best execution and its interpretation of the Advisers Act fiduciary duty.

The other explanation given for the decision not to define the term best interest is that the specific components of the rule make that meaning sufficiently clear. But the specific components of Reg BI that make up the care obligation also refer to acting in the customer’s best interests. This sets up a tautology: brokers satisfy their obligation to act in customers’ best interests when they follow a prudent process and have a reasonable basis to believe they are acting in the customer’s best interests.<sup>25</sup> And we are no closer to knowing whether the best interest standard in question is satisfied by compliance with FINRA’s suitability standard, the DOL best interest standard, or something in between. Given the high degree of ambiguity associated with the term best interest, the failure to define it is a fatal flaw that will lead to weak and inconsistent application of the standard by firms, pose significant enforcement challenges, and, as a result, leave investors inadequately protected. It must be corrected before the rule is finalized.

In previous letters, we have described how we believe the obligation to act in the best interests of the investor should be interpreted for both broker-dealers and investment advisers. In our September 2017 letter, for example, we stated that the best interest standard must include an obligation for brokers and advisers “to seek to identify and recommend the best available investment option for the investor.”<sup>26</sup> We made clear that this does not require the broker or adviser to “look far and wide and consider every investment available in the marketplace to identify the ideal investment,” but we noted that it would require the broker or adviser to carefully consider both the investor’s personal circumstances and the characteristics of the various investment options she has available to recommend and to “recommend the option she reasonably believes best meets the investor’s needs ... even if other suitable options are available

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<sup>23</sup> See, e.g., FINRA, Regulatory Notice 15-46, Best Execution, November 2017, <https://bit.ly/2OHtTUI>.

<sup>24</sup> IA Guidance at 8.

<sup>25</sup> Reg BI Release at 141.

<sup>26</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 67, September 14, 2017, <https://bit.ly/2LSFkLg>.

that would pay the adviser more or be more profitable for the firm.” Far from suggesting that brokers and advisers must always recommend the lowest cost option, we made clear that the analysis should cover the full “range of factors relevant to such an assessment, including but certainly not limited to the risks and costs of the investment.” Finally, we stated that, “An adviser who can document that she followed a prudent process based on reasonable assumptions would generally be deemed to have complied with the best interest standard, even if the investment ultimately turned out poorly for the investor.”

We appreciate that a number of these key elements are reflected either in the rule text itself or the rule Release discussion of the best interest standard. In particular, we strongly support the inclusion of a prudence standard as part of the broker’s “care obligation” under Reg BI. Moreover, the rule Release discussion of this obligation suggests that the Commission expects brokers to conduct a robust analysis of both the client’s “investment objectives, financial situation, and needs”<sup>27</sup> and the “potential risks and rewards” of the reasonably available investment options. The Release states, for example, that, “Although the term ‘prudence’ is not a term frequently used in the federal securities laws, the Commission believes that this term conveys the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care.”<sup>28</sup> We agree. And we urge the Commission to interpret the term, as the DOL has done, as being “an objective standard of care that requires investment advice fiduciaries to investigate and evaluate investments, make recommendations, and exercise sound judgment in the same way that knowledgeable and impartial professionals would.” Moreover, we strongly agree with the DOL statement cited in the Release that financial professionals are “subject to a particularly stringent standard of prudence when they have a conflict of interest,”<sup>29</sup> and we urge the Commission to incorporate that concept into its implementation of the rule as well.

The Release elaborates on this point in its discussion of the broker’s obligation to “deal fairly” with customers, which it says, “stems from the broker-dealer’s ‘special relationship’ to the retail customer, and from the fact that in recommending a security or investment strategy, the broker-dealer represents to the customer ‘that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.’”<sup>30</sup> As part of that reasonable investigation, the Release suggests that “broker-dealers generally should consider reasonably available alternatives offered by the broker-dealer as part of having a reasonable basis for making the recommendation.”<sup>31</sup> The Release appropriately notes that “what would constitute reasonable diligence ... will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer’s familiarity with the recommended security or investment strategy.”<sup>32</sup> Finally, the Release offers helpful examples of the types of questions brokers should consider in making that evaluation, including: whether “less costly, complex, or risky products available at the broker-dealer achieve the objectives of the product;” whether the assumptions underlying the product are sound; and what the risks are, including liquidity risks, and how they relate to the investor’s profile and

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<sup>27</sup> Reg BI Release at 144.

<sup>28</sup> Reg BI Release at 134-135.

<sup>29</sup> Reg BI Release at 157.

<sup>30</sup> Reg BI Release at 135-136.

<sup>31</sup> Reg BI Release at 54.

<sup>32</sup> Reg BI Release at 139.

needs.<sup>33</sup> In doing so, the Release makes clear that its list of questions “is not meant to be comprehensive,” and that brokers must make their own assessment of what factors should be considered to determine the risks and rewards of a particular investment or investment strategy.<sup>34</sup>

While generally strongly supportive of this approach, we have two concerns with the Release’s discussion of the prudent process required under the care obligation. Our first concern is that the Commission describes this analysis as something brokers “generally should” do, rather than something they must do, to meet their care obligation. We certainly agree that the details of *how* that evaluation is conducted should vary based on a variety of factors regarding the client, the relationship, and the investment products under consideration. And we think the discussion in the Release is extensive enough that most firms will get the point that the evaluation is a necessary component of compliance with their care obligation under Reg BI. However, not all firms make the same commitment to compliance. For the firms that are inclined to test the edge of the envelope, we’d prefer a clearer declaration that, while the nature of the analysis will vary from case to case, the evaluation itself is mandatory.

Of even greater concern is the fact that, at no point in this discussion, does the Commission make clear what the outcome of that assessment should be, other than by restating the undefined obligation to act in the customer’s best interest. This leaves open the possibility that the standard could be read as strictly procedural, and that compliance will be judged based on the adequacy of the process itself rather than the outcome of that process. We strongly urge the Commission to fix this fatal flaw in Reg BI by making explicit brokers’ obligation to recommend the investments they reasonably believe, based on their reasonable assumptions and careful assessment, are the best match for the client, taking into consideration both the client’s needs and the investments’ characteristics.

We recognize that in some cases there may not be a single “best” option. Instead, a handful of the available options may be equally beneficial for the client. However, we would expect this to be a much smaller pool of investments than would satisfy a suitability standard. In these cases, brokers should be free to recommend any of the handful of “best” options. It is important to recognize, however, that this flexibility in interpreting the standard creates an opportunity for abuse. That makes the rule’s restrictions on conflicts all the more important to ensure compliance with an inherently subjective determination of best interests. Moreover, it will be incumbent on the firms, the Commission, FINRA, and the state securities regulators to provide careful oversight to ensure any flexibility in the standard is not being gamed. But the likelihood of that type of abuse would at least be minimized if the Commission made clear, as it has so far failed to do, that brokers operating under a best interest standard are required to recommend the investments they reasonably believe are best for the customer and that firms are required to minimize incentives that encourage violation of the standard.

This lack of clarity around the term best interest also arises in the Release’s discussion of how brokers are to consider costs and incentives when weighing potential investment recommendations. We greatly appreciate statements in the Release that the Commission’s “proposed interpretation of the Care Obligation would make the cost of the security or strategy,

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<sup>33</sup> Reg BI Release at 139-140.

<sup>34</sup> Reg BI Release at 140.

and any associated financial incentives, more important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy.”<sup>35</sup> That is something that we have long urged the Commission to do. This requirement would be clearer, however, if it were incorporated into the rule text, which requires the broker to consider the “potential risks and rewards associated with the recommendation,” rather than the material characteristics, including costs, of the recommended investment or investment strategy. Moreover, the Commission appears to walk back this focus on costs elsewhere in the discussion.

Taking a position that we generally support, the Release states that brokers would not be obligated to recommend the “least expensive” or “least remunerative” security or investment strategy, so long as they had otherwise complied with the rule’s disclosure, care, and conflict obligations.<sup>36</sup> And it further states that, while “cost (including fees, compensation and other financial incentives) associated with a recommendation would generally be an important factor,” brokers should also consider other factors in determining whether a recommendation is in the best interest of the customer. These include “among others, the product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions.”<sup>37</sup> The Release goes on to state, “While cost and financial incentives would generally be important, they may be outweighed by these other factors.”<sup>38</sup> This is entirely consistent with our position that brokers should be required to recommend the best of the reasonably available investment options, based on a careful assessment of both the investor’s needs and the products’ or strategy’s characteristics. Just as compliance with the best execution standard will not always be met by sending trades to the exchange where the lowest cost is displayed, compliance with a best interest standard will not always be satisfied by recommending the lowest cost option.

Where the treatment of this issue becomes potentially problematic is in its discussion regarding the conditions under which brokers are free to recommend higher cost or more remunerative investments. Here again, the discussion starts with a fundamentally sound premise: that “when a broker-dealer recommends a more expensive security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost of the security or strategy is justified (and thus nevertheless in the retail customer’s best interest) based on other factors (e.g., the product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer’s investment profile.”<sup>39</sup> Similarly, the Release suggests that when a broker recommends a product that pays him or his firm more than another reasonably available alternative, “the broker-dealer would need to have a reasonable basis to believe that—putting aside the broker-dealer’s financial incentives—the recommendation was in the best interest of the retail customer based on the factors noted above, in light of the retail customer’s investment profile.”<sup>40</sup> Finally, the Release

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<sup>35</sup> Reg BI Release at 51-52.

<sup>36</sup> Reg BI Release at 54.

<sup>37</sup> Reg BI Release at 55.

<sup>38</sup> Reg BI Release at 55-56.

<sup>39</sup> Reg BI Release at 56.

<sup>40</sup> Reg BI Release at 56.

states that the broker can recommend the higher paying alternative “if the broker-dealer determines the products are otherwise both in the best interest of—and there is no material difference between them from the perspective of—the retail customer, in light of the retail customer’s investment profile.”<sup>41</sup>

While the overall approach here appears to be sound in principle, the Commission fails to make clear how it would assess whether there is “no material difference” in this context or how it would enforce that standard. This is an important oversight given the incentive brokers will have to dismiss any differences as immaterial in order to justify their higher pay. The lack of definition regarding the meaning of “best interest” compounds the problem, rendering what otherwise appears to be a reasonable principle unacceptably vague. That’s a problem both for regulators seeking to enforce the standard and brokers seeking to comply.

Worse, the Release suggests elsewhere that restrictions on recommending the more costly option would only come into play where “the characteristics of the securities are **otherwise identical**, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.”<sup>42</sup> (emphasis added) The use of the term “otherwise identical” suggests that the Commission may intend to apply this principle very narrowly. It is not at all clear from this, for example, whether even something as basic as two different S&P 500 index funds would be considered “otherwise identical.” Footnote 106 reinforces that concern by referring to mutual funds with different share classes as an example of “identical securities.”<sup>43</sup> It notes that the Commission “has historically charged broker-dealers with violating Sections 17(a)(2) and (3) of the Securities Act for making recommendations of more expensive mutual fund share classes while omitting material facts.”<sup>44</sup> While we appreciate the Commission’s assurance that disclosure alone would not be sufficient to satisfy the care obligation under Reg BI, FINRA has already gone beyond a disclosure-based approach to share class recommendations under its suitability rule. Unless the Commission is prepared to interpret this requirement more broadly, it is unclear that Reg BI would offer *any* progress over existing FINRA practice.

In short, the prohibition on recommending the more expensive option must be extended beyond “identical” securities if it is to deliver any new protections to investors, and it would need to be applied far more broadly to be consistent with a true best interest standard. At the very least, the Commission needs to make clear that the prohibition against recommending the more costly option applies, not just between otherwise identical investments, but whenever there is “no material difference” between the investment options from the point of view of the investor. This still poses a risk that brokers could point to relatively minor differences to justify recommending the higher cost fund.

The Commission must recognize that this is an area that is likely to be prone to abuse, particularly where the more costly option is also the more remunerative option, as is often the case. The potential for abuse in this area also highlights the importance of the rule’s restrictions

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Reg BI Release at 57.

on conflicts as an absolutely essential supplement to the principles-based best interest standard. In addition, the Commission must provide clearer guidance than it has done to date on the concrete steps brokers must take to ensure that they do not place their own interests ahead of the customer's best interests. To the extent that firms take steps to levelize compensation within the same classes of securities (e.g., mutual funds, variable annuities, etc.) that would reduce this risk.

**B. The Commission must clarify that brokers are required under Reg BI to take steps to ensure their conflicts of interest don't taint their recommendations.**

As part of its requirement for brokers to act in their customers' best interest, Reg BI would prohibit firms and their associates from placing their own interests ahead of the interests of the retail customer. This suggests a recognition on the Commission's part that conflicts of interest, and financial incentives related to those conflicts, have the potential to undermine compliance with a best interest standard absent appropriate constraints on those conflicts. The Release notes, for example, that the Commission "has previously expressed long-held concerns about the incentives that commission-based compensation provides to churn accounts, recommend unsuitable securities, and engage in aggressive marketing of brokerage services."<sup>45</sup> It goes on to point out that the Commission's exam staff has found that, "[c]onflicts of interest, when not eliminated or properly mitigated and managed, are a leading indicator and cause of significant regulatory issues for individuals, firms and sometimes the entire market."<sup>46</sup> In recognition of the potentially harmful impact of conflicts, the proposed standard thus includes both the principles-based prohibition on placing the broker's interests ahead of the customer's interests and specific conflict obligations that brokers must meet to satisfy the standard.

Here again, however, inconsistencies in how the Commission describes the prohibition on placing the broker's interests ahead of the customer's interests render its intended effect on broker-dealer conduct impossible to determine. While the rule's related requirement to mitigate financial incentives seems to steer the standard in the right direction, the mitigation requirement suffers from the same lack of clarity as the term "best interest." Similarly, while the Advisers Act Guidance appears to offer progress over the status quo with its suggestion that not all conflicts can be adequately addressed through disclosure and consent, it is difficult to tell how far the Commission is prepared to go in either instance to limit common practices that have a harmful impact on investors. If the Commission wants to deliver a true best interest standard that improves protections for vulnerable investors, it must clarify that brokers and advisers alike are required to take concrete and meaningful steps to ensure that conflicts of interest present in their business model are not permitted to taint their recommendations.

1. The Commission should clarify what it means by its prohibition on placing the broker's interest ahead of the customer's interest and do so in a way that is no weaker than the "without regard to" language identified by Congress as the appropriate standard.

Confusion around the meaning of the prohibition against putting the broker's interests ahead of the customer's interests has its origins in the Commission's decision not to incorporate

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<sup>45</sup> Reg BI Release at 17.

<sup>46</sup> Reg BI Release at 18.



the “without regard to” language from Section 913(g) of the Dodd-Frank Act in its standard.<sup>47</sup> Instead, the Commission has chosen to use language comparable to that used by FINRA to describe brokers’ obligations under FINRA’s suitability rule<sup>48</sup> and used by brokerage firms and their lobbyists in comment letters to the SEC as shorthand for a disclosure-only approach to dealing with conflicts.<sup>49</sup> The Commission’s decision to use this characterization of a broker’s obligations under Reg BI, rather than the “without regard to” language that Congress identified as the appropriate standard, strongly suggests that the Commission intends to set a different, and weaker standard – one that gives brokers greater leeway to allow their conflicts to influence their recommendations. The discussion in the Release does nothing to dispel that concern. On the contrary, the nonsensical explanation the Commission offers for rejecting the “without regard to” language, along with the conflicting statements it makes about the meaning of its alternative language, only serve to strengthen that impression.

- a. The Release fails to offer a reasonable justification for the Commission’s decision not to use the “without regard to” language.

In its discussion of its proposed regulatory approach, the Commission indicates that it adopted its alternative language because it is “concerned that inclusion of the ‘without regard to’ language could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts (i.e., require recommendations that are conflict free).”<sup>50</sup> There is no rational basis for this concern in the plain meaning of the language, the context of Section 913(g), or the way in which that language has been interpreted by others that have used it, most notably the Department of Labor. At the most basic level, there is no need to act “without regard to” something that doesn’t exist. Put simply, if all conflicts were required to be eliminated, there would be no need to act “without regard to” those non-existent conflicts. Furthermore, as Section 913(g) explicitly permits conflicts in several areas, it is absurd on its face to suggest that its intent is to require recommendations that are conflict-free.

The suggestion that the “without regard to” language required the elimination of all conflicts is simply a phony argument concocted during the debate over the DOL rule by brokers and insurers anxious to preserve practices that are highly profitable for them but harmful to their

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<sup>47</sup> The Commission hasn’t even used the same language in Reg BI as it uses to describe an investment adviser’s duty of loyalty, as requiring the adviser to “to put its client’s interests first.” IA Guidance at 15.

<sup>48</sup> As we noted above, FINRA has stated that its suitability standard “prohibits a broker from placing his or her interests ahead of the customer’s interests,” but FINRA has applied that prohibition in only the narrowest and most limited of fashions.

<sup>49</sup> See, e.g., Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, July 21, 2017, <http://bit.ly/2uRtdUA> (“Given that the existing FINRA regulatory framework already contains the beginnings of a best interest standard of conduct for BDs, it would make logical sense for the SEC to direct, and as appropriate approve, FINRA rulemaking to incorporate the principles of a duty of loyalty and a duty of care, as well as enhanced up-front disclosure, into the appropriate FINRA Rules, including the Suitability Rule. Specifically, the Suitability Rule could be amended to provide that when making a ‘recommendation’ to a ‘retail customer,’ a BD shall act in the best interest of such customer at the time the recommendation is made (i.e., a duty of loyalty), and shall not have a continuing duty to the customer after making the recommendation. Further, the recommendation shall reflect the ‘reasonable diligence’ and the reasonable care, skill, and prudence that a prudent registered representative would exercise based on the ‘customer’s investment profile’ (i.e., a duty of care). The new standard of conduct should also be accompanied by appropriate principles-based rules on disclosure.” (citations omitted)).

<sup>50</sup> Reg BI Release at 48.

customers. Prior to 2015, when DOL issued its revised rule proposal, many of these same entities had voiced support for SEC rulemaking to create a uniform fiduciary standard for brokers and advisers in reliance on its Section 913(g) authority.<sup>51</sup> As these commenters were doubtless aware when making their false claims, it is ERISA itself that contains the prohibition on conflicts. The DOL’s best interest contract exemption, which incorporated the “without regard to” language, was designed specifically to outline the conditions that would apply when conflicts of interest *are* present.<sup>52</sup> Like 913(g), it allowed for the receipt of transaction-based payments, sales from a limited menu of proprietary products, and other conflicted practices. As a result, there is simply no legitimate way to read it as requiring conflict-free recommendations.

Moreover, a number of firms had developed plans for implementing the DOL rule in reliance on the BIC exemption before the rule was vacated. Many indicated in comments to the Commission that the Impartial Conduct Standards, which including the “without regard to” language, were compatible with the broker-dealer business model. For example:

- Capital Group stated, “We strongly support efforts by the U.S. Securities and Exchange Commission to adopt a uniform standard of conduct for investment advisers and broker-

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<sup>51</sup> See, e.g., Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to the SEC, Duties of Brokers, Dealers and Investment Advisers, July 5, 2013, <https://bit.ly/2KqLTiy> (“SIFMA has long supported a uniform fiduciary standard for BDs and RIAs when providing personalized investment advice about securities to retail clients....The fundamental purpose of Section 913 of the Dodd-Frank Act is to provide for the establishment of a uniform fiduciary standard that applies equally to BDs and RIAs for the benefit of retail clients when personalized investment advice is provided.”); Letter from David T. Bellaire, Executive Vice President & General Counsel, FSI, to the SEC, Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, <https://bit.ly/2KqFaVT> (“FSI supports a universal fiduciary standard of care applicable to all Financial Advisers who provide personalized investment advice to retail clients....FSI supports a standard of care that would require a Financial Adviser providing personalized investment advice concerning securities to a retail customer to: - Act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice...”); Letter from Karrie McMillan, General Counsel, ICI, to the SEC, July 3, 2013, <https://bit.ly/2vkM9e2> (“ICI continues to support the SEC staff’s 2011 recommendation that the SEC adopt a fiduciary standard of conduct for broker--dealers when they are providing personalized investment advice about securities to retail investors that is no less stringent than the fiduciary duty that applies to investment advisers. ICI agrees with these [SEC Staff] recommendations....When acting in this capacity, a broker--dealer is performing substantially the same function as an adviser, and the legal distinctions between the two types of financial professionals are often unclear and largely irrelevant to investors. And if the conduct is substantially the same, the same standard should apply.”); Letter from Christopher Gilkerson, SVP, Deputy General Counsel, Schwab, to the SEC, Duties of Brokers, Dealers and Investment Advisers, July 5, 2013, <https://bit.ly/2nazUMM> (“[T]he Commission should consider a straight-forward rule, simply tracking the language of Dodd-Frank Section 913(g)(1)...”).

<sup>52</sup> In its implementation of the BIC exemption, DOL sought to minimize the conflicts that were most likely to be harmful and to ensure that remaining conflicts were not allowed to inappropriately influence financial professionals’ recommendations – in other words, to ensure that financial professionals acted “without regard to” the conflicts of interest present in their business model. That is the meaning the CFP Board has given the term in its recently revised Code of Ethics and Standards of Conduct, which states: “The duty of loyalty requires CFP® professionals to ... Act without regard to the financial or other interests of the CFP® professional, the CFP® Professional’s Firm, or any other individual or entity other than the Client, which means that a CFP® professional acting under a Conflict of Interest continues to have a duty to act in the best interest of the Client and place the Client’s interest above the CFP® professional’s.” CFP Board, New Code of Ethics and Standards of Conduct, <https://bit.ly/2viapNV>.

dealers.”<sup>53</sup> Capital Group continued, “We believe the existing transition rules under the Department of Labor’s (DOL) fiduciary rule accomplish this goal.”<sup>54</sup>

- LPL stated, “[W]e believe the standard of conduct should be based on the core principles that are rooted in the common law of trusts, including the duty of prudence, the duty of loyalty, and the duty to provide full and fair disclosure regarding services, fees, compensation and material conflicts of interest. A principles-based standard based on these elements would clarify and enhance the standards and protections already in place under the regulatory regimes that apply to investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”) and to broker-dealers under the Securities Exchange Act of 1934 and under FINRA regulations, and be consistent with the regulatory regime governing retirement assets under ERISA and the Fiduciary Rule.”<sup>55</sup> LPL continued, “We note that principles identified above underlie, and are consistent with, the ‘impartial conduct standards’ the Department of Labor formulated in the BIC Exemption.”<sup>56</sup>
- Stifel proposed that “the SEC adopt a principles-based standard of care for Brokerage and Advisory Accounts that incorporates the ‘Impartial Conduct Standards’ as set forth in the DOL’s Best Interest Contract Exemption.”<sup>57</sup>
- Wells Fargo stated, “In our opinion, all investors should be given protections that are consistent with the Impartial Conduct Standards. As such, we recommend that under any circumstance, the Commission formulate a best interest standard of conduct for all accounts at broker-dealers based on the DOL Fiduciary Rule’s Impartial Conduct Standards.”<sup>58</sup> Wells continued, “This formulation of the best interest standard retains the ‘without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice’ requirement of Section 913 of the Dodd Frank Act and is consistent with the fiduciary duty applicable to registered investment advisers.”<sup>59</sup>

Regardless of any other differences in opinion on what the proper standard of conduct should entail, these firms clearly found it possible to comply with the “without regard to” standard in commission accounts without eliminating all conflicts, and a number of them proposed to do so in ways that entailed clear benefits for investors.<sup>60</sup> That said, if the Commission were to adopt the “without regard to” standard, as we believe it should, it would be

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<sup>53</sup> Letter from Timothy D. Armour, Chairman and CEO, and Paul F. Roye, Senior Vice President, Capital Group, to the SEC, Standards of conduct for investment advisers and broker-dealers, March 12, 2018, <https://bit.ly/2ObsHHP>.

<sup>54</sup> *Id.*

<sup>55</sup> Letter from Michelle B. Oroschakof, LPL, to the SEC, Standard of Conduct for Advisory and Brokerage Accounts, February 22, 2018, <https://bit.ly/2ouvrpe>.

<sup>56</sup> *Id.*

<sup>57</sup> Letter from Ronald J. Kruszewski, Chairman & CEO, Stifel, to the SEC and DOL, Uniform Impartial Conduct Standards for Retirement and Non-Retirement Accounts, July 25, 2017, <https://bit.ly/2KrKpob>.

<sup>58</sup> Letter from David Kowach, Head of Wells Fargo Advisors, Wells Fargo, to the SEC, Comments on Standards of Conduct for Investment Advisers and Broker-Dealers, September 20, 2017, <https://bit.ly/2KrV5Db>.

<sup>59</sup> *Id.*

<sup>60</sup> See Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America (CFA), to the Department of Labor (DOL), April 17, 2017, <https://bit.ly/2mZITzQ>; Letter from Roper and Hauptman, CFA, to DOL, August 7, 2017, <https://bit.ly/2KeKVFY>.

free to interpret that language differently than DOL did, particularly since it is not constrained by ERISA's strict prohibition on conflicts or its "prohibited transaction exemption" regime.

In short, there are no "apparent tensions" in the phrase that would justify the Commission's decision to avoid the "without regard to" language. Moreover, the Release makes clear that the Commission understands this to be an unfounded concern. Having noted that the intent of its proposed standard is not to prohibit conflicts, the Release goes on to state, "Nor do we believe that is the intent behind the 'without regard to' phrase, as included in Section 913 of the Dodd-Frank Act or recommended in the 913 Study, as is evident both from other provisions of Section 913 that acknowledge and permit the existence of financial interests under that standard, and how our staff articulated the recommended uniform fiduciary standard."<sup>61</sup> The Release then lists a number of provisions in 913(g) that specifically allow for the existence of conflicts under the "without regard to" standard and adds: "We believe that these provisions make clear that the overall intent of Section 913 was that a 'without regard to' standard did not prohibit, mandate or promote particular types of products or business models, and preserved investor choice among such services and products and how to pay for these services and products (e.g., by preserving commission-based accounts, episodic advice, principal trading and the ability to offer only proprietary products to customers)."<sup>62</sup> We agree.

So, if the Commission knows the "without regard to" language cannot reasonably be read to require the elimination of all conflicts, and if we can safely assume that the Commission does not routinely shape its policy proposals to accommodate arguments it knows to be false, what is its real reason for adopting its proposed alternative phrasing? One possible explanation is that the reason is simply political: that the Commission is reluctant to adopt an approach that was championed by Democrats in Congress and incorporated in a rule that was a signature achievement of the previous administration. We'd like to think the Commission is above such partisan politics, but the only other reasonable explanation poses an even greater concern: that the Commission is intent on adopting a weaker standard for dealing with conflicts than the "without regard to" standard would support, but doesn't want to openly acknowledge or clearly explain the differences embodied in its chosen approach.

- b. The Commission proposes an inconsistent, weak and highly problematic interpretation of its alternative language.

Contradictions in the Release's discussion of this issue reinforce that concern. In one context, the Commission seems to suggest that brokers would be required under its proposed standard to put aside their financial interests when determining what is best for the customer. This apparently favorable interpretation is on display in the Commission's statement that a broker who recommends a product that pays him or his firm more than another reasonably available alternative "would need to have a reasonable basis to believe that—putting aside the broker-dealer's financial incentives—the recommendation was in the best interest of the retail

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<sup>61</sup> Reg BI Release at 48-49.

<sup>62</sup> Reg BI Release at 49.

customer based on the factors noted above, in light of the retail customer’s investment profile.”<sup>63</sup> Elsewhere, however, the Commission offers very different explanations of what it means by its requirement that brokers act “without placing the financial or other interest ... ahead of the interest of the retail customer.” In one place, for example, it states that, “the broker-dealer’s financial interest can and will inevitably exist, but these interests cannot be **the predominant motivating factor** behind the recommendation.”<sup>64</sup> (emphasis added) An even weaker formulation can be found in the economic analysis section of the Release, where it states, “The proposed rule would no longer make it possible for the broker-dealer to make a recommendation **solely based on** the portion of fees that flow back to the broker-dealer...”<sup>65</sup> (emphasis added)

Prohibiting brokers from being motivated primarily by their conflicts or making recommendations based solely on the fees they are likely to receive is very different from requiring them to put aside those interests or act without regard to those conflicts. This framing of the issue runs counter to the Release’s repeated assurances that there is no *scienter* requirement in its standard.<sup>66</sup> After all, it is difficult to see how the Commission could prove that a recommendation was “predominantly motivated by” the compensation received, or that compensation was the “sole basis” for the recommendation, without getting inside the broker’s head.

Moreover, both of these interpretations leave room for conflicts to continue to influence brokers’ recommendations, and neither provides clarity regarding when a broker whose actions are influenced by conflicts has crossed the line. Can they consider their own interests as long as they give greater weight to the investors’ interests? Can they give their interests and investors’ interests equal weight? If so, how does that jibe with the Commission’s earlier statement that brokers are required to put aside their own interests? It is not enough to answer that brokers can allow their conflicts of interest to influence their recommendations as long as they nonetheless act in the customer’s best interests, since acting in the customer’s best interest is also undefined.

- c. If the Commission is serious about preventing conflicts from tainting recommendations, it should either adopt the “without regard to” language or make clear that its alternative language requires brokers to “put aside” their own interests and the interests of the firm.

This degree of ambiguity on an issue of central importance to the rule’s effectiveness cannot be permitted to stand. If the Commission is serious about promoting compliance with the best interest standard, it will make clear that its intent is to ensure that the first interpretation is correct: brokers must *put aside* their own interest when determining what is best for the investor. Ideally, the Commission would achieve this by simply adopting the “without regard to” language, as intended by Congress, and interpreting it as requiring firms to take concrete and meaningful steps to ensure their conflicts of interest do not taint their recommendations. If, however, the Commission insists on retaining its alternative phrasing, it should at least make

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<sup>63</sup> As discussed above, the lack of definition regarding what it means to act in the customer’s best interests undermines what could otherwise be a reasonable approach consistent with the intended meaning of the “without regard to” language in Section 913(g) of Dodd-Frank.

<sup>64</sup> Reg BI Release at 50.

<sup>65</sup> Reg BI Release at 224.

<sup>66</sup> Reg BI Release at 42.

clear, as it has failed to do in the Release, that the prohibition on placing their own interests ahead of the customer's interest would require brokers to set aside their own interests, or act without regard to those interests, when making recommendations in order to ensure that they do what is best for the customer. That is, in our view, both the proper interpretation of the term and the right policy to ensure investors are adequately protected. Moreover, the Commission should include that same clarification in its interpretation of the Advisers Act fiduciary duty, as we discuss in greater detail below.

Instead, however, the Commission requests comment on whether the proposed rule should incorporate the “without regard to” language but “interpret that phrase in the same manner as the ‘without placing the financial or other interest . . . ahead of the interest of the retail customer’ approach set forth above.”<sup>67</sup> That is clearly not the answer, in light of the serious inconsistencies discussed above that muddle the Commission's interpretation of its alternative language. Which interpretation would apply? Would brokers be required to “put aside” their interests? Or would they be prohibited from being “predominantly motivated” by conflicts or making recommendations “based solely” on the fees they expect to receive? Given this ambiguity, and the brokerage industry's fierce determination to retain as many of its conflict-creating practices as possible, the standard would almost certainly be read as continuing to permit harmful conflicts that seriously threaten compliance with the best interest standard.

2. The Commission should strengthen and clarify the conflict obligations in the proposed standard to better ensure that conflicts are not allowed to inappropriately influence recommendations or undermine compliance with the best interest standard.

While the discussion regarding the prohibition on placing the broker's interests ahead of the customer's interest gives us cause for concern, we are encouraged that both Reg BI and the Advisers Act fiduciary Guidance include language that suggests the Commission may nonetheless be willing to take steps to reduce the harmful impact of conflicts. This includes the requirement under Reg BI for brokers to mitigate material conflicts of interest that arise from financial incentives and the discussion in the Advisers Act Guidance suggesting that disclosure and consent may not be adequate to address all conflicts. Properly interpreted and implemented, these provisions could bring about real pro-investor reform in the way that financial advice is delivered to retail investors. Here again, however, the Commission needs to strengthen the standards and clarify its intent to ensure that these provisions deliver the promised benefits.

Brokers satisfy compliance with Reg BI in part by meeting conflict of interest obligations spelled out in paragraph (a)(2)(iii). Indeed, if as appears to be the case, the Commission intends for paragraph (a)(2) to serve as a safe harbor that fully satisfies compliance with the principles-based standard in (a)(1), then paragraph (a)(2)(iii) is the only thing that gives meaning to the standard's prohibition on placing the broker's interests ahead of the customer's interests. That is because, unlike the obligation to act in the customer's best interests, which is included in both (a)(1) and (a)(2), the prohibition on placing the broker's interests ahead of the customer's interests appears only in (a)(1). In delineating the broker's obligations for dealing with conflicts, the standard draws a distinction between material conflicts of interest generally and those that

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<sup>67</sup> Reg BI Release at 50.

arise from financial incentives associated with the recommendation. The former would have to be disclosed or eliminated; the latter would have to be disclosed and mitigated or eliminated.

a. There are aspects of the proposed approach that we support.

Before we get to a discussion of our concerns, it is worth noting that there is much that we support in this proposed approach. If strengthened and clarified, it has the potential to give real heft to the prohibition on placing the broker’s interests ahead of the customer’s interests.

- First, we believe that an approach that relies on policies and procedures can be an effective means of addressing conflicts when, as is the case here, firms are responsible not just for establishing the policies and procedures, but for maintaining and enforcing them. The requirement to maintain written policies and procedures provides a paper trail the Commission, FINRA, and state regulators will be able to use in measuring compliance. The obligation for firms to enforce them helps to ensure that the policies and procedures are not just empty words.
- Second, we support the Commission’s proposed general interpretation of material conflict of interest, which turns on whether “a reasonable person” would “expect” that the conflict “might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”<sup>68</sup> Moreover, the discussion in the Release suggests that the Commission intends for the phrase “associated with the recommendation” to be broadly inclusive of conflicts that operate at the firm level as well as at the sales rep level, though we’d prefer to have that point clarified.<sup>69</sup>
- We also agree with the Commission that it is appropriate to allow firms to adopt a risk-based approach to compliance, subject to certain clarifications, as we discuss below. Focusing the firm’s compliance efforts on the areas that pose the greatest risk of non-compliance and the greatest risk of harm to investors should benefit firms and investors alike.
- Finally, we strongly support the Commission’s suggestion that not all conflicts can be adequately addressed through disclosure alone. In fact, as we noted in our September 2017 comment letter, research indicates that disclosure is generally ineffective in protecting investors from the harmful impact of conflicts and may even have a perversely harmful effect. Moreover, experience tells us that certain conflicts of interest are either

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<sup>68</sup> This is generally consistent with the definition of material conflict of interest in *SEC v. Capital Gains* (“The Advisers Act thus reflects ... a congressional intent to eliminate, or at least to expose, all conflicts of interest which **might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.**” *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963)) (emphasis added).

<sup>69</sup> See, e.g., Reg BI Release footnote 303 at 177 (“Conflicts of interest may arise from compensation other than sales compensation. For example, in the case of mutual funds, compensation for account servicing, sub-transfer agency, sub-accounting, recordkeeping or other administrative services provides an incentive for a firm to offer the mutual funds from or for which the firm receives such compensation and not offer other funds or products from or for which it does not receive such compensation.”). In addition to clarifying that firm-level conflicts are subject to the conflict requirements, the Commission should make clear that conflicts of an affiliate that could influence the recommendation would also be covered by the standard.

too complex to be adequately disclosed or are too likely to encourage non-compliance with the best interest standard to be permitted. A good rule will eliminate the most harmful practices, and put appropriate constraints on remaining conflicts, while preserving investors' ability to receive transactions-based advice.

Despite these strengths, the proposed approach also suffers from serious shortcomings that must be addressed if the standard is to succeed in raising the bar on broker-dealer conduct.

- b. The rule creates a safe harbor in which conflict obligations that would appear to fully satisfy compliance operate exclusively at the firm level.

As noted above, paragraph (a)(2) appears to provide a safe harbor that fully satisfies compliance with the principles-based prohibition on placing the broker's interests ahead of the customer's interest. One concern with this approach is the fact that the conflict obligations in (a)(2) appear to operate solely at the firm level. There is no clearly stated prohibition to prevent a natural person associated with a broker-dealer from acting on a conflict of interest in making a recommendation.

While we agree that firms should bear the responsibility for adopting, maintaining, and enforcing policies and procedures to address conflicts, the individual registered representatives actually making the recommendations to customers should also be subject to an explicit prohibition on placing their interests ahead of the customer's interests. Better yet, they should have an explicit obligation under the conflict obligations in (a)(2) to act without regard to their own interests or the interests of the firm. Otherwise, the proposed rule is unlikely to have its intended effect of protecting investors from the harmful impact of conflicts of interest.

- c. The Commission fails to draw a clear distinction between material conflicts of interest generally and those that arise out of financial incentives.

A second fundamental problem with the rule's conflict obligations is the fuzzy distinction the proposal draws between material conflicts of interest, which have to be eliminated or disclosed, and material conflicts arising out of financial incentives related to the recommendation, which, if not eliminated, have to be disclosed and mitigated. It is unclear what purpose is served by drawing a distinction between material conflicts of interest generally and those that arise out of financial incentives associated with a recommendation. The Commission fails to provide any examples of material conflicts that do not arise out of financial incentives. Nor does the Commission clearly explain what its rationale is for treating the two types of conflicts so differently. Explanations offered by Commission staff are directly contradicted in the Release.

SEC officials have indicated in discussions of the proposed rule that they cannot conceive of a material conflict that *doesn't* arise out of financial incentives associated with a recommendation. They have further indicated that the weaker disclosure-based approach for conflicts of interest that do not fit within this category was included as a backstop in case their financial incentive definition had missed anything. But the Release itself suggests otherwise. It



states, for example, that, “The Commission believes that material conflicts of interest associated with the broker-dealer relationship need to be well understood by the retail customer and, **in some cases**, mitigated or eliminated.”<sup>70</sup> (emphasis added) Even more to the point, it states: “While our interpretation of the types of material conflicts of interest arising from financial incentives is broad, we do not intend to require broker-dealers to mitigate every material conflict of interest in order to satisfy their Conflict of Interest Obligations.”<sup>71</sup>

Given the significant difference in the requirements that apply to these two different categories of conflicts, the Commission has an obligation, at a minimum, to be much clearer than it has been to date to explain this distinction and clarify what types of conflicts would not be viewed as arising out of financial incentives. Better yet, the Commission should simply eliminate this artificial distinction and require all material conflicts that are not eliminated to be mitigated, as we discuss further below.

- d. The proposed disclosure-only approach to dealing with non-financial conflicts is not adequate to protect investors.

To the degree that there are material conflicts that do *not* constitute conflicts that arise out of financial incentives, the standard does not appear to impose any requirement to ensure that those conflicts do not undermine compliance with the best interest standard. Instead, it requires only that those conflicts that are not eliminated be disclosed. Given the lack of evidence showing disclosure is effective in protecting investors from the harmful impact of conflicts (as we discussed at length in our previous letter and elsewhere in this letter), the accompanying obligation to disclose conflicts would be entirely inadequate, even if it weren’t so poorly designed. By leaving to individual firms key decisions about what form the disclosures would take and how the disclosures would be provided, the Commission all but guarantees that the disclosures will be least useful when the conflicts are most severe.

Our own view is that disclosure alone is inadequate to address *any* material conflicts of interest, though we do believe that certain conflicts can be addressed primarily through disclosure. For example, the fact that brokers are paid only when the customer completes a transaction creates an incentive for them to engage in excessive trading, while advisers who are paid an AUM fee have an unavoidable incentive to maximize assets under management. These are the types of unavoidable and relatively straight-forward conflicts that can be addressed primarily through disclosure. But, even here, firms should have supervisory programs in place to protect against churning, or reverse churning in the case of fee accounts, and to ensure that customers are not steered into a type of account that is inappropriate for them. In other words, even for these most straightforward of conflicts, disclosure should be supported by policies and procedures designed to minimize the potential for customer harm.

Although the rule text seems clear that no such obligation applies for non-financial conflicts, the commentary in the Release is ambiguous on this point. The rule text states that, for material conflicts that do not arise out of financial incentives, the broker is required only to establish, maintain, and enforce written policies and procedures “reasonably designed to identify

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<sup>70</sup> Reg BI Release at 16.

<sup>71</sup> Reg BI Release at 169-170.

and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations.” However, the Release suggests, at one point, that the Commission intends something more robust than disclosure alone “in situations where the broker-dealer determines that disclosure does not reasonably address the conflict, for example, where the disclosure cannot be made in a simple or clear manner, or otherwise does not help the retail customer’s understanding of the conflict or capacity for informed decision-making, or where the conflict is such that it may be difficult for the broker-dealer to determine that it is not putting its own interest ahead of the retail customer’s interest.”<sup>72</sup> Specifically, it suggests that, “under the proposed obligation to have reasonably designed policies and procedures to ‘at a minimum disclose, or eliminate’ all material conflicts the broker-dealer would need to establish policies and procedures reasonably designed to either eliminate the conflict **or to both disclose and mitigate the conflict.**”<sup>73</sup> (emphasis added) We would support such an approach, which would have the added benefit of being consistent with the separate Advisers Act Guidance suggesting that disclosure alone may not be sufficient to address all conflicts. However, this is simply not an accurate description of what the Reg BI rule text indicates is required for material conflicts of interest that do not arise from a financial incentive.

To begin with, the rule doesn’t make clear that conflicts that cannot adequately be addressed through disclosure have to be eliminated; it simply offers disclosure and elimination as two options for addressing non-financial conflicts. And the rule text makes no mention whatsoever of disclosure plus mitigation as an alternative means of addressing non-financial conflicts. If the Commission truly intends to require firms to mitigate non-financial conflicts that cannot adequately be disclosed, it must make that requirement explicit in the rule text. Otherwise, assuming that paragraph (a)(2) fully satisfies compliance with (a)(1), the prohibition against placing the broker’s interests ahead of the customer’s interests could be read as being satisfied exclusively through disclosure for certain types of conflicts, regardless of whether those disclosures are effective. That would render the prohibition on placing the broker’s interests ahead of the customer’s interest meaningless.<sup>74</sup>

A cleaner approach would simply be to eliminate the artificial distinction between those material conflicts that arise from financial incentives and those that do not, and to apply the same obligation to disclose and mitigate the conflict to all material conflicts, whatever their source.

- e. The Commission has proposed an appropriately broad definition of material conflicts that arise out of financial incentives. It should not be narrowed.

Given that the only concrete obligation to reduce the harmful impact of conflicts attaches to those that arise from financial incentives, we greatly appreciate that the list of practices the

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<sup>72</sup> Reg BI Release at 176.

<sup>73</sup> *Id.*

<sup>74</sup> As we discuss further below, paragraph (a)(2) can be read as providing a safe harbor that fully satisfies compliance with the principles-based standard articulated in paragraph (a)(1). In that case, the only provisions in (a)(2) that give meaning to the prohibition on placing the broker’s interests ahead of the customer’s interests are contained in the rule’s conflict provisions. For the prohibition to have any meaning, it must impose obligations beyond mere disclosure of conflicts, since disclosure of conflicts has never been shown to be effective in protecting investors from the potentially harmful impact of those conflicts.

Commission “preliminarily” believes would fall into this category is quite broad, including: “compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.”<sup>75</sup> We strongly support this broad definition of the term.

We are concerned, however, that industry groups may seek to narrow this category. The Release specifically requests comment on the scope of the term financial incentives. To the degree that brokerage firms perceive the mitigation requirement as having real teeth, they are likely to try to either narrow the category, weaken the mitigation obligations, or both. We would strongly oppose any effort to narrow this category. On the contrary, as we indicated above, we believe the obligation to disclose and mitigate the conflict should apply to *all* material conflicts of interest that are not eliminated. If the Commission were to adopt our suggested approach, it could and should make it clear that different types of conflicts can be treated differently. It could achieve this by specifying that the nature and extent of mitigation required would depend on the scope and complexity of the conflict in question, as well as its potential to undermine compliance with the best interest standard. If, as members of the rule-writing team have indicated, the intent in defining financial incentive was to be broadly inclusive, our suggested approach would be a cleaner way to achieve the desired result.

f. The requirement to mitigate conflicts needs to be clarified.

Even if the Commission were to eliminate the disparity in its treatment of conflicts related to financial incentives and other non-financial conflicts, the proposed standard would still suffer from a lack of clarity regarding the obligation to mitigate conflicts. The Commission never defines what it means by mitigate and provides only vague guidance on how that obligation should be applied. This leaves open the possibility that the term will be interpreted to require few if any changes in even the most harmful broker-dealer practices. One recent example is particularly relevant. Confronted with reports regarding their practice of paying their brokers financial bonuses for steering customers into higher-priced managed accounts, some firms defended the practice by saying they have policies and procedures in place to ensure that brokers nonetheless act in their customers’ best interests. But brokers employed at the firms say the pressure to push the more profitable products regardless of the customer’s interests can be intense.<sup>76</sup> If the new standard’s requirement that firms mitigate conflicts can be met through these sorts of empty claims, it will not deliver its promised protections.

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<sup>75</sup> Reg BI Release at 169.

<sup>76</sup> Jason Zweig and Anne Tergesen, *Advisers at Leading Discount Brokers Win Bonuses to Push Higher-Priced Products*, The Wall Street Journal, January 10, 2018, <https://on.wsj.com/2EwdZGu>.

The concern is not simply hypothetical. Some brokerage firms' actions since the demise of the DOL rule suggest that they expect the Commission to be far more lenient in its treatment of harmful conflicts than the DOL rule would have been, had it been fully implemented. Pro-investor products developed in response to the DOL – most notably mutual fund clean shares – have languished since it became clear that the rule's fate was in question.<sup>77</sup> Practices that increase conflicts are once again on the rise. For example, Wells Fargo, which was reportedly under investigation by the DOL for pushing participants in low-cost 401(k) plans to roll over into higher cost IRAs,<sup>78</sup> recently announced that it was expanding revenue sharing and sub-TA fees to mutual funds held in IRA wrap accounts, introducing new costs and conflicts into the accounts that had historically been exempt from the fees.<sup>79</sup> Bank of America announced a new compensation program in May that punishes its Merrill Lynch brokers who fail to meet sales targets for cross-selling the bank's products, such as mortgages and credit cards.<sup>80</sup> And, since the DOL announced in March that it would no longer be enforcing the fiduciary rule, both Morgan Stanley<sup>81</sup> and Stifel<sup>82</sup> have reintroduced higher back-end recruiting bonuses, and applied the bonuses to IRA, SEP, and other retirement account revenue. Wells Fargo announced a year ago that it was increasing signing bonuses for veteran brokers.<sup>83</sup> The Tully Commission identified these sorts of recruiting bonuses as creating troubling conflicts of interest roughly two decades ago, but the Commission has failed to take effective action to prevent the practice.<sup>84</sup> Firms' recent actions seem to suggest that they expect that leniency to continue despite the Commission's claims to be raising the bar for broker-dealer conduct and reducing the harmful impact of conflicts of interest.

In order to send a strong signal that it intends to crack down on the most harmful conflicts, even as it preserves access to transaction-based advice, the Commission needs to be much clearer than it has been thus far regarding the substance of the obligation to mitigate conflicts and the standard against which it will measure compliance. The Commission should start by making clear that it interprets the obligation to mitigate conflicts consistent with the dictionary definition of that term as to lessen in force or intensity, to moderate, or to make less severe.<sup>85</sup> Moreover, it is important to place the requirement to mitigate in the appropriate context, as a necessary component of a broker's compliance with the best interest standard. In other words, the goal of mitigation should be to reduce the intensity of conflicts of interest, or to

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<sup>77</sup> See Bradley Saacks, *Raymond James Asks Wholesalers to Stop Bringing Up Clean Shares*, Ignites, April 16, 2018, <https://bit.ly/2AG3Iub>; Bradley Saacks, *Fund Shops, Distributors Buy DOL-Inspired Products Alongside Rule*, Ignites, June 29, 2018, <https://bit.ly/2O8Utom>.

<sup>78</sup> Gretchen Morgenson and Emily Glazer, *Wells Fargo's 401(k) Practices Probed by Labor Department*, The Wall Street Journal, April 26, 2018, <https://on.wsj.com/2HTI7Ri>.

<sup>79</sup> Bradley Saacks, *Wells Lumps Fee-Based IRAs into Revenue-Sharing, Sub-TA Deals*, Ignites, June 5, 2018, <https://bit.ly/2KqMLnk>.

<sup>80</sup> Lisa Beilfuss, *Merrill Lynch Brokers Face Pay Clawbacks*, The Wall Street Journal, May 24, 2018, <https://on.wsj.com/2kmuSeP>.

<sup>81</sup> Mason Braswell, *Farewell Fiduciary Rule? Morgan Stanley Sweetens Recruiting Bonuses*, AdvisorHub, May 1, 2018, <https://bit.ly/2FzbALq>.

<sup>82</sup> Mason Braswell, *Stifel Restores Back-End Recruiting Bonuses Following DOL Rule's Demise*, AdvisorHub, July 2, 2018, <https://bit.ly/2nhuyQ5>.

<sup>83</sup> Michael Wursthorn, *Wells Fargo Sweetens Broker Recruitment Bonuses*, The Wall Street Journal, May 25, 2017, <https://on.wsj.com/2rnHWe4>.

<sup>84</sup> Report of the Committee on Compensation Practices, April 10, 1995, <https://bit.ly/2nwNb0E> ("Tully Report").

<sup>85</sup> Dictionary.com Unabridged, Based on the Random House Unabridged Dictionary, 2018, <https://bit.ly/2MjUWnh>.

lessen their impact, in order to ensure that brokers act in their customers' best interests and do not place their own interests ahead of their customers' interests. In some cases, the only way to achieve that would be to require the incentive to be eliminated. The Commission needs to make clear, preferably in the text of the rule itself, that it is against this standard that it will determine whether policies and procedures are reasonably designed.

Toward this end, the Commission should redraft its mitigation requirement to state that policies and procedures must be reasonably designed to ensure that broker-dealers and their associated persons comply with the requirement to provide investment recommendations in the customer's best interests and to ensure that they do not place their own interests or the interests of the firm ahead of the customer's interests. This would have the added benefit of including the prohibition on placing the broker's interests ahead of the customer's interests in paragraph (a)(2), a necessary addition if the Commission continues to recognize paragraph (a)(2) as a safe harbor that fully satisfies compliance with the principles-based standard.

Under such an approach, whether the policies and procedures are reasonably designed would clearly and explicitly turn on whether they are reasonably sufficient to prevent violations of the best interest standard. As currently drafted, the rule text fails to provide that clarity, and the commentary in the rule Release is once again ambiguous. Clarity is essential on this point since, under the proposed rule, broker-dealers would be permitted to exercise broad judgment regarding the types of conflict mitigation methods that may be appropriate. We agree that some degree of flexibility is necessary, since "there is no one-size-fits-all framework" that would be appropriate for all broker-dealers. We further agree, within limits, that firms "should have flexibility to tailor the policies and procedures to account for, among other things, business practices, size and complexity of the broker-dealer, range of services and products offered and associated conflicts presented."<sup>86</sup>

However, that flexible approach also comes with the considerable risks. The Release suggests that this "principles-based approach provides broker-dealers the flexibility to establish their supervisory system in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted."<sup>87</sup> But it is just as likely that some firms will resist adopting mitigation methods that are reasonably likely to prevent violations of the best interest standard. And those firms that lack a strong compliance culture, and where conflicted practices are most deeply entrenched in the business model, are least likely to develop rigorous mitigation methods. As the Commission notes in the rule Release, FINRA found that, even after its publication and promotion of best practices to address conflicts, "some firms continue to approach conflict management on a haphazard basis, only implementing an effective supervisory process after a failure event involving customer harm occurs."<sup>88</sup> Only a clearly articulated standard against which compliance can be measured, backed by tough enforcement of that standard, will be sufficient to overcome that predictable resistance.

The Release includes some helpful guidance on elements that firms "should consider including" when designing their policies and procedures. These include policies and procedures:

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<sup>86</sup> Reg BI Release at 171.

<sup>87</sup> Reg BI Release 179.

<sup>88</sup> Reg BI Release at 19.

to clearly identify all material conflicts of interest and specify how the broker-dealer intends to address each conflict;<sup>89</sup> “robust compliance review and monitoring systems; processes to escalate identified instances of noncompliance to appropriate personnel for remediation;” clearly designating the staff responsible for supervision of functions and persons, including determining compensation; processes for periodic review and testing of the adequacy and effectiveness of procedures; and training on the policies and procedures.<sup>90</sup> Indeed, we fail to see how a firm could claim to have reasonably designed policies and procedures if they do not address each of these factors in designing their system. We urge the Commission to make clear that, while firms are free to decide how to address each of these issues, in light of their business model, these are things all firms are required to consider in reaching those decisions. Moreover, in deciding what mitigation methods to use, firms should be required to consider these factors in light of the risks of non-compliance with the best interest standard present in their business model and the likelihood that their policies and procedures will be effective in reducing that risk.

In addition to its general guidance on factors firms should consider when designing their policies and procedures, the Commission also provides a more detailed list of “practices firms should consider incorporating” when developing their policies and procedures to mitigate material conflicts of interest that arise out of financial incentives.<sup>91</sup> It is a good list that focuses on common industry practices that encourage brokers to make recommendations based on their own financial interests, rather than the customer’s best interests, such as: compensation practices that “disproportionately increase compensation through incremental increases in sales” (e.g., retroactive ratcheted payout grids); compensation incentives that “favor one type of product over another” (e.g., paying more for the sale of proprietary products); “eliminating compensation incentives within comparable product lines” (e.g., leveling compensation to the salesperson for comparable mutual funds); “implementing supervisory procedures to monitor recommendations” that are near compensation thresholds or thresholds for firm recognition, that involve higher compensating products, proprietary products or transactions in a principal capacity, or that involve the rollover or transfer of assets from one type of account to another or from one product class to another; and “adjusting compensation for registered representatives who fail to adequately manage conflicts of interest.”<sup>92</sup>

The Release also suggests that “heightened mitigation measures, including enhanced supervision, may be appropriate in situations where the retail customer displays a less sophisticated understanding of securities investing generally or the conflicts associated with particular products involved, where the compensation is less transparent (for example, a payment received from a third-party or built into the price of the product or a transaction versus a straight commission payment), or depending on the complexity of the product.”<sup>93</sup> But this scenario – complex products with non-transparent payment mechanisms sold to financially unsophisticated investors – is so pervasive that the Commission would be better to recognize this as the norm, rather than as an exception that calls for exceptional measures. In other words, it is because one

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<sup>89</sup> Assuming the Commission maintains its separate treatment of conflicts arising out of financial incentives and non-financial conflicts, it should include an assessment of what category the conflict falls into.

<sup>90</sup> Reg BI Release at 172.

<sup>91</sup> Reg BI Release at 181-183

<sup>92</sup> Reg BI Release 182-183.

<sup>93</sup> Reg BI Release at 179-180.

or more of these elements is so often present that rigorous mitigation of conflicts is needed across the board.

- g. The Commission needs to make clear that certain practices are inconsistent with a best interest standard.

Where the proposal falls short is in failing to make clear that certain practices are by definition inconsistent with the best interest standard and cannot be adequately mitigated. They must be eliminated. The Release hints at this, when it states that “certain material conflicts of interest arising from financial incentives may be more difficult to mitigate, and may be more appropriately avoided in their entirety for retail customers or for certain categories of retail customers (e.g., less sophisticated retail customers). These practices may include the payment or receipt of certain non-cash compensation that presents conflicts of interest for broker-dealers, for example, sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management.”<sup>94</sup> But the Release fails to state that such practices – where firms artificially create conflicts of interest that are not inherent to the transaction-based business model – are inconsistent with a standard that is designed to ensure that the broker does not place his own interest, or the interests of the firm, ahead of the customer’s best interests. It is frankly absurd to suggest that firms should be able to create incentives that are clearly designed to encourage sales based on the firm’s interest rather than the customer’s interest, then dismiss the risk because they have policies and procedures in place designed apparently to ensure that the incentive doesn’t work as intended.

We urge the Commission to explicitly state, as part of its mitigation requirement, that firms are prohibited from creating financial incentives, such as sales quotas for the sale of proprietary products or financial bonuses for recommendations of managed accounts, that would reasonably be expected to encourage recommendations based on factors other than the customer’s best interests. After all, the justification the Commission offers for not banning conflicts – that it “could mean a broker-dealer may not receive compensation for its services”<sup>95</sup> – simply doesn’t apply in such cases. Moreover, there is simply no basis to conclude that sales quotas or financial payments to reward recommendations of products that are especially profitable for the firm has any benefit for investors to outweigh the potential harm. We appreciate that the Release hints at this, but the Commission needs to say so clearly and unequivocally.

Finally, we agree that “it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance with Regulation Best Interest, rather than conducting a detailed review of each recommendation of a securities transaction or security-related investment strategy to a retail customer.”<sup>96</sup> And we agree, moreover, that such a system should “focus on specific areas of their business that pose the greatest risk of noncompliance with the Conflict of Interest Obligations, as well as the greatest risk of potential harm to retail customers through such noncompliance.”<sup>97</sup> Indeed, a well-designed risk-based system that is

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<sup>94</sup> Reg BI Release at 183.

<sup>95</sup> Reg BI Release at 175.

<sup>96</sup> Reg BI Release at 171.

<sup>97</sup> Reg BI Release at 171.

focused on the greatest risk of noncompliance with the best interest standard will be both more efficient and more effective in preventing customer harm. In assessing risks, firms should look both at practices that have the greatest potential to cause severe harm, even if only a small number of investors is affected, and practices that have the greatest potential to harm a large number of investors, even if the degree of harm is more modest. Another focus should be the risk of harm to populations that are least able to recover from that harm, either because of their age or because of their lack of financial sophistication or both. Firms that take their risk assessment seriously are likely to conclude, as we do, that certain practices pose too great a risk of noncompliance to be permitted.

**C. The Commission should similarly strengthen and clarify its proposed Guidance regarding investment advisers' fiduciary duty under the Advisers Act.**

The Commission's proposed Guidance regarding investment advisers' fiduciary duty under the '40 Act suffers from some of the same weaknesses and inconsistencies as proposed Regulation Best Interest. In discussing key obligations, such as the duty to act in clients' best interests, the Release fails to clarify what it means by best interest, and the Guidance is inconsistent on this point. The proposed Guidance is equally unclear with regard to the prohibition on subordinating the client's interests to the adviser's interests. And, while aspects of the discussion seem to suggest that the Commission may be prepared to go beyond its past practice of allowing conflicts to go unchecked as long as they are disclosed, others seem to lock in place its current tightly circumscribed enforcement of the Advisers Act fiduciary duty. The result is a missed opportunity to meaningfully strengthen protections for clients of investment advisers. This is highly problematic in light of the growing presence of dual registrant firms that bring a host of toxic conflicts of interest into the advisory relationship, where an ill-defined and poorly enforced fiduciary standard will be inadequate to prevent abusive practices.

The Guidance starts with a strong declaration that, "An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its client."<sup>98</sup> The Release goes on to state that this fiduciary duty requires an adviser "to adopt the principal's goals, objectives, or ends," which "means the adviser must, at all times, serve the best interest of its clients and not subordinate its clients' interest to its own."<sup>99</sup> In describing the investment adviser's duty of loyalty, it further states that, "an adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship." And, where the adviser chooses to disclose rather than avoid the conflict, "The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest."<sup>100</sup>

This is the description of the Advisers Act fiduciary duty that we have been hearing for years and that we strongly support. Moreover, we have no doubt that many investment advisers

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<sup>98</sup> IA Guidance at 3.

<sup>99</sup> IA Guidance at 7.

<sup>100</sup> IA Guidance at 15-16.



embrace this high fiduciary standard and follow it in their practice.<sup>101</sup> Unfortunately, this description of the Advisers Act fiduciary duty bears little resemblance to the duty as actually enforced by the Commission. In reality, the Commission's enforcement actions almost never turn on whether the adviser acted in the client's best interest or subordinated the client's interests to their own. Instead, such actions almost always turn on whether the adviser fully disclosed the practice that was inconsistent with clients' best interests. So, while the proposed Guidance states that advisers, as fiduciaries, must always act in their clients' best interests and must never subordinate the client's interests to their own, and that "the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty,"<sup>102</sup> the Commission's enforcement of that duty suggests that advisers *can* disclose away their obligation to act in the client's best interest and *can* subordinate the client's interests to their own as long as they "fully disclose" that fact. That is a problem this rulemaking should seek to fix but does not.

1. The Commission fails to take advantage of this opportunity to ensure that the Advisers Act fiduciary duty, as enforced, lives up to its principles.

In discussing this disparity between how the Commission describes the Advisers Act fiduciary duty and how it enforces that duty, we've been told that the Commission views itself as constrained by the fact that the Advisers Act duty is implied rather than stated and arises out of the antifraud provisions of the Act. Disclosure, we've been told, is almost always a defense against fraud claims. That renders it all the more inexplicable to us that the Commission refuses to take advantage of its authority under Section 913(g) to adopt an explicit requirement under the Advisers Act for advisers to act in the best interests of the customer, without regard to the adviser's own interests, and to impose restrictions on certain conflicts. This is particularly bewildering when the proposed Guidance makes clear that the main reasons the Commission has offered for that decision – a contorted discussion of the meaning of "without regard to" (see above) and an equally unpersuasive argument that separate standards are necessary to preserve the broker-dealer business model as distinct from the advisory model – have no basis in fact. A fiduciary duty that "follows the contours of the relationship," and where the terms of that duty can be tailored to the relationship, could easily be applied to broker-dealers' "advice services" without putting brokers' ability to offer transaction-specific recommendations at risk.

Regardless of whether the Commission reconsiders its decision not to rely on Section 913(g) for this rulemaking, as we hope it will, it should use this rulemaking to clarify that for investment advisers, as well as broker-dealers, the requirement to act in the client's best interest and the prohibition on subordinating the client's interests to the adviser's interests has a real meaning that is not just procedural in nature and cannot be disclosed away. We agree with much of the proposed Guidance regarding the process advisers must follow when determining whether a particular security or investment strategy is in the client's best interests. For example, we agree that the advice "must be evaluated in the context of the portfolio that the adviser manages for the

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<sup>101</sup> See, e.g., IA Guidance at 8, footnote 21, quoting the August 31, 2017 letter from the Investment Advisers Association ("While disclosure of conflicts is crucial, it cannot take the place of the overarching duty of loyalty. In other words, an adviser is still first and foremost bound by its duty to act in its client's best interest and disclosure does not relieve an adviser of this duty.").

<sup>102</sup> IA Guidance at 8. We believe the use of 'hedge clauses' is inconsistent with the Advisers Act fiduciary duty and we urge the Commission to reconsider its position, which appears to show a greater acceptance of such clauses. See Heitman Capital Mgmt., LLC, SEC No-Action Letter, February 12, 2007.

client and the client's investment profile."<sup>103</sup> Moreover, we believe this requirement to assess recommendations in the context of the portfolio as a whole should apply to brokers and advisers alike, regardless of whether they are actually managing an investment portfolio for the client. How could they know whether a particular recommendation is in the client's best interest if they don't know how it fits within the portfolio as a whole?<sup>104</sup>

2. The Commission adopts an interpretation of an adviser's obligations to consider the costs of its recommendations that is so narrow as to be essentially meaningless.

We also agree with the general discussion about factors advisers should consider in order to determine whether the advice is in the client's best interest, including that cost is an important factor, but only one of many factors the adviser should weigh.<sup>105</sup> Here again, however, as in its discussion regarding brokers' obligations to consider costs under Regulation BI, the Release frames the issue much too narrowly to offer meaningful protections to investors. It states: "We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is **otherwise identical**, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance."<sup>106</sup> (emphasis added) This suggests that the adviser would be free to recommend the higher cost product or strategy in circumstances where they are not otherwise identical, even perhaps in instances where there is no material difference from the point of view of the investor.

The universe of "otherwise identical" securities is so narrow, it could be construed as excluding anything but different share classes of the same mutual fund. That makes the obligation to consider costs as part of a best interest evaluation all but meaningless. Instead, the Commission should make clear that, in considering various different strategies to achieve the same investment goal (e.g., providing income in retirement through mutual funds, an annuity, or a bond ladder), the adviser must include a consideration of the costs of those strategies along with other relevant factors, such as risk, liquidity, and volatility. Having considered those factors, the adviser should be required to have a reasonable basis for concluding that the recommended strategy is the best match for the investor, taking all of those factors, including costs, into account.

Worse, the Guidance suggests that even this narrowest of interpretations of the role that cost considerations should play in determining whether a recommendation is in a client's best interest could be addressed through disclosure alone. It states: "For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other

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<sup>103</sup> IA Guidance at 11.

<sup>104</sup> The only circumstances we can envision in which this obligation would not apply is where the client, for whatever reason, refuses to provide information to the broker or adviser about the entirety of their portfolio.

<sup>105</sup> IA Guidance at 11-12 ("The cost (including fees and compensation) associated with investment advice would generally be one of many important factors—such as the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client. Accordingly, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy.").

<sup>106</sup><sup>106</sup> IA Guidance at 12.

available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict."<sup>107</sup> Under this interpretation, the adviser wouldn't have to do what is best for the client by recommending the lower cost share class and would be free to put its own interests ahead of the client's by recommending the more remunerative share class, as long as the adviser provided full disclosure and obtained the client's "informed consent." In short, it appears from this discussion that the only aspect of the fiduciary duty that the Commission believes can't be "disclosed away," is the obligation to disclose. This interpretation also makes a mockery of the concept of informed consent, since no rational investor would consent to being forced to pay more when a lower cost and "otherwise identical" option is available.

3. The Commission suggests that disclosure alone is not adequate to address all conflicts, but it fails to adequately address the extent to which disclosure does not result in "informed consent."

Elsewhere, the Release seems to suggest that, "Disclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act."<sup>108</sup> In making this statement, the Release cites to the *Capital Gains* decision, which, in its discussion of the legislative history of the Advisers Act, referenced "the ethical standards of one of the leading investment counsel associations, which provided that an investment counsel should remain 'as free as humanly possible from the subtle influence of prejudice, conscious or unconscious' and 'avoid any affiliation, or any act which subjects his position to challenge in this respect.'"<sup>109</sup> We strongly support this interpretation of the Advisers Act fiduciary duty, which, properly implemented, could help give substance to the obligation to avoid conflicts and has the potential to help ensure that the standard lives up in actual practice to its theoretical protections.

We agree, moreover, that advisers should be precluded from inferring or accepting client consent to a conflict "where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed."<sup>110</sup> And we further agree: that, "in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duty;" and that, in other cases, "disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive."<sup>111</sup> Finally, we share the view that, where full and fair disclosure and informed consent is insufficient, advisers should be required either to eliminate the conflict or "adequately mitigate the conflict." However, the goal of that mitigation should not simply be to ensure that the conflict can be adequately disclosed, as the Guidance suggests, but to ensure that it does not undermine compliance with the adviser's fiduciary obligation to act in

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<sup>107</sup> IA Guidance at 12.

<sup>108</sup> IA Guidance at 17.

<sup>109</sup> IA Guidance at 17, footnote 44.

<sup>110</sup> IA Guidance at 18.

<sup>111</sup> *Id.*

the client's best interests and to place the client's interests first.

It seems apparent to us that, at least in the context of large, dual registrant firms that bring to the advisory relationship all of the conflicts that pervade the broker-dealer business model, much of the ADV Form disclosures that are currently deemed to satisfy the obligation to obtain informed consent to conflicts would not meet this standard. Indeed, it is incumbent on the Commission to engage in usability testing of these conflict disclosures, not just in the context of Form CRS but also more generally, to determine to what extent the conflicts disclosed are well understood by investors. If, as we expect, the Commission were to find that investors rarely read the dense and legalistic disclosures and do not understand them when they do, that would suggest that the Commission needs to go much farther than it has to date to reduce the reliance on disclosure alone to satisfy the Advisers Act fiduciary standard.

4. The Commission needs to do more to give meaning to advisers' fiduciary obligation to "avoid" conflicts.

As an initial step to reduce reliance on disclosure to address conflicts, the Commission should revise the Guidance to give more meaning to the obligation to "avoid" conflicts. Consistent with what we've recommended above with regard to Reg BI, advisers who, as fiduciaries, are obligated to avoid conflicts, should not be permitted to artificially create incentives that are reasonably likely to cause them to give advice that is not disinterested and not in their clients' best interests.

Here again, we draw a distinction between the unavoidable conflicts associated with getting paid, and other conflicts that can easily be avoided and are well within the advisory firm's control. So, for example, the conflicts inherent in a firm that includes proprietary products among its offerings can be disclosed (and managed), but imposing a sales quota or otherwise pressuring advisers to implement their advice with proprietary products should be prohibited. Similarly, the fact that certain products and services are more profitable for the firm could be addressed through disclosure, but offering financial bonuses to encourage advisers to steer customers into those products and services should be prohibited. And, in the case of dual registrant firms, paying advisers bonuses to steer customers into the account type that is most profitable for the firm, rather than the one that best matches the customer's needs and preferences, should likewise be prohibited. Otherwise, if firms are free to create conflicts that wouldn't otherwise exist, there is no real obligation to "avoid conflicts," as that phrase is likely to be understood by investors, and the Commission should stop saying there is.

The Commission has an opportunity to ensure that the Advisers Act fiduciary standard lives up to its billing. To do that, however, it must move beyond a disclosure-only interpretation of those fiduciary duties and truly require that advisers act in their clients' best interests and place their clients' interests first. We believe that is best achieved through rulemaking under Section 913(g) of the Dodd-Frank Act. But, even if the Commission sticks with its current approach, it can and should strengthen its interpretation of the Advisers Act fiduciary duty to make clear: that the obligation to act in the client's best interests and to put the client first cannot be disclosed away; that advisers who seek to adopt practices that are not consistent with the client's best interest will be deemed, by definition, not to have obtained informed consent, since

no rational investor would consent to be harmed; and that advisory firms are prohibited from artificially creating incentives that would reasonably be expected to result in advice that is not disinterested.

**D. The disclosure obligations under Regulation Best Interest are completely inadequate and should be extensively revised.**

While it can be difficult to determine exactly how the core requirements of the best interest standard for brokers and the fiduciary duty for advisers differ, and where they are the same, one clear difference involves the disclosures brokers and advisers are required to provide. As part of their obligations to satisfy Regulation Best Interest, brokers would be required, prior to or at the time of their recommendation, to “reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation.”<sup>112</sup> In contrast, investment advisers are required to provide “full and fair” disclosure of all material facts.<sup>113</sup> The Commission offers no explanation for why broker-dealers should be subject to less rigorous disclosure obligations than investment advisers when providing “advice services.” This is particularly troubling since: (1) the potential for investor confusion is at its greatest when dealing with broker-dealers and dual registrants that routinely market their services as advisory in nature;<sup>114</sup> and (2) broker-dealers and dual registrants typically operate with conflicts of interest that are far more extensive, complex, and intense than the conflicts typically present in a stand-alone investment adviser practice.

1. The Commission gives firms too much discretion to determine how the disclosures will be presented under its “reasonable” disclosure standard.

We therefore found it laughable when SIFMA suggested in its earlier comment letter that the Commission should give brokerage firms discretion to “elect the timing and content, form (whether paper, electronic, web-based, or otherwise), and manner of delivery (whether hard copy or electronic delivery or access) of disclosure, including any updates to disclosure and notices thereof, based on the BD’s particular business model.”<sup>115</sup> As we indicated in our September 2017 comment letter, it seemed obvious to us that giving firms discretion to choose the delivery mechanism would all but ensure that many investors would never see the disclosures, and “giving firms discretion to determine the content of the disclosures would undermine comparability and clarity, providing no assurance that the disclosures effectively conveyed the required material, indeed virtually guaranteeing that in many cases they would not.”<sup>116</sup> Yet, what

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<sup>112</sup> Reg BI Release at 97.

<sup>113</sup> IA Guidance at 4.

<sup>114</sup> See Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, January 18, 2017, <http://bit.ly/2jKUbFD>.

<sup>115</sup> Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, at 7, July 21, 2017, <http://bit.ly/2uRtdUA>.

<sup>116</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 79, September 14, 2017, <https://bit.ly/2LSFkLg>.

we found laughable, the Commission has, with only minimal changes, branded as “reasonable” disclosure.<sup>117</sup>

The Commission lays out a series of principles against which it will measure whether disclosures are “reasonable.” These include such basic principles as that disclosure “must be true and may not omit any material facts necessary to make the required disclosures not misleading,”<sup>118</sup> that they should be “concise, clear and understandable to promote effective communication between a broker-dealer and retail customer,”<sup>119</sup> and that they “be provided in writing in order to facilitate investor review of the disclosure, promote compliance by firms, facilitate effective supervision, and facilitate more effective regulatory oversight to help ensure and evaluate whether the disclosure complies with the requirements of Regulation Best Interest.”<sup>120</sup> While we support these and other basic principles outlined in the Release, experience tells us that they are likely to be enforced, if at all, only for the most egregious of violations. And the Commission undermines these and other sound principles of disclosure at every step when it provides a more detailed discussion of how it is likely to interpret the requirements.

As a result, the Commission cannot reasonably assume that these general principles will result in disclosures that are provided to investors at a time when it is useful to them, in a form they can readily understand, and with a clear focus on issues of greatest importance to them. On the contrary, experience tells us that, left to their own devices, most firms will provide disclosures that may well meet their obligations to incorporate basic principles of effective design and plain language, but that nonetheless sugarcoat or obscure key issues related to their conflicts of interest and the potentially harmful impact those conflicts could have on investors. Similarly, firms are likely to make it extremely difficult for investors to determine exactly how much they are paying and for what, a perennial problem this proposal does nothing to solve. The simple fact is that firms often have a strong incentive to obscure this information, and the Commission’s proposed approach to disclosure leaves them plenty of room to do so.

2. The proposed approach would allow disclosure of crucial information to be delayed until it is too late to benefit the investor.

On the crucial issue of disclosure timing, the Release sends decidedly mixed messages. It states, on the one hand, that, “Investors should receive information early enough in the process to give them adequate time to consider the information and promote the investor’s understanding in order to make informed investment decisions, but not so early that the disclosure fails to provide meaningful information (e.g., does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with disclosures related to a

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<sup>117</sup> Reg BI Release at 114 (“In lieu of setting explicit requirements by rule for what constitutes effective disclosure, the Commission proposes to provide broker-dealers with flexibility in determining the most appropriate way to meet this Disclosure Obligation depending on each broker-dealer’s business practices, consistent with the principles set forth below and in line with the suggestion of some commenters that stressed the importance of allowing broker-dealers to select the form and manner of delivery of disclosure.”).

<sup>118</sup> Reg BI Release at 115.

<sup>119</sup> Reg BI Release at 117.

<sup>120</sup> *Id.*

number of potential options that the retail customer may not be qualified to pursue).”<sup>121</sup> However, it also suggests that providing disclosures “at the point of sale” would, at least in some circumstances, satisfy this standard.<sup>122</sup> But point of sale disclosures will almost never provide “adequate time to consider the information,” and the Commission should make that clear.

Worse, the Release suggests that post-sale disclosure, such as in a trade confirmation, might satisfy the standard if coupled with initial disclosure explaining that practice. Under this approach, investors could expect to get boilerplate disclosures on the front end, with more detailed and specific information not coming until after it is too late to incorporate that information into their investment decision. The Commission states that it believes “that including in the general disclosure this additional information of when and how more specific information will be provided would help the retail customer understand the general nature of the information provided and alert the retail customer that more detailed information about the fact or conflict would be provided and the timing of such disclosure.”<sup>123</sup> We do not share that belief, nor do we believe there is any research on disclosure effectiveness that would support the Commission’s assumption. On the contrary, it seems patently obvious to us that this interpretation provides a loophole of such enormous proportions that investors would rarely if ever receive specific information about the costs and conflicts of a particular recommendation at a time when it would be useful to them in assessing the recommendation.

If the Commission is serious about wanting investors to have time to consider the information and make an informed choice, the general rule of thumb should be that any information that can be provided before the transaction is entered into should be provided. Furthermore, transaction-specific information should be provided, whenever possible, at the point of recommendation, rather than at the point of sale. Otherwise, investors will be unlikely to have or take time to consider information that is directly relevant to their investment decision. To counteract that concern, the Commission should include as one of its principles for disclosure that detailed information should be provided as soon as reasonably feasible and, when possible, no later than at the point of recommendation.

3. The proposed cost disclosures are likely to lead to generic and opaque information of little value to investors.

The Release appropriately suggests that a broker-dealer’s “fees and charges that apply to retail customers’ transactions, holdings, and accounts” would “generally” be considered to be “material facts relating to the scope and terms of the relationship.”<sup>124</sup> It goes on to state that the Commission would “generally expect” brokers to build on their Form CRS disclosures “by disclosing additional detail,” including quantitative information about those fees and costs.<sup>125</sup> In other words, it would not be enough to describe the types of fees that would apply; the broker would also need to provide information on the amount of those fees. But, what it gives with one hand, it takes with the other. Rather than requiring clear, unambiguous dollar amount

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<sup>121</sup> Reg BI Release at 119.

<sup>122</sup> *Id.*

<sup>123</sup> Reg BI Release at 120-121.

<sup>124</sup> Reg BI Release at 107.

<sup>125</sup> Reg BI Release at 108-109.

disclosures, which is the clearest way to convey cost information to investors, the Commission would permit brokers to disclose that cost information as “percentages or ranges.” Many if not most brokers can be expected to provide the cost information in the least transparent way possible, particularly when the costs are highest. Here again, the “flexibility” that the Commission provides is all but certain to result in opaque disclosures that do little to enlighten investors about the true costs of brokers’ “advice services.” And many brokers can be expected to use the added “flexibility” the Commission provides on the timing of disclosures to delay providing even these limited details until after the transaction.

4. The Release’s discussion of required conflict disclosures raises unanswered questions regarding the types of conflicts that would have to be disclosed.

There are similar problems with the Commission’s proposed approach to conflict of interest disclosures. The Commission takes the position that material conflicts of interest, rather than all conflicts of interest, would have to be disclosed. We support that approach. However, the Release’s discussion raises as many questions as it answers with regard to what the Commission would consider to be a material conflict of interest. It states, for example, that the Commission preliminarily believes that “a material conflict of interest that generally should be disclosed would include material conflicts associated with recommending: proprietary products, products of affiliates, or limited range of products; one share class versus another share class of a mutual fund; securities underwritten by the firm or a broker-dealer affiliate; the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction); and allocation of investment opportunities among retail customers (e.g., IPO allocation).”<sup>126</sup>

Noticeably missing from this list is any mention of compensation differences within and across different product lines. While the Commission does not state that the list is intended to be comprehensive, this omission, when considered in the context of the Release’s earlier discussion of a broker’s best interest obligations regarding cost considerations, sends a troubling message. Specifically, it suggests that the Commission considers conflicts of interest related to cost and compensation through only the narrowest of lenses. Also missing from the list is any mention of back-end recruiting bonuses, retroactive ratcheted payout grids, sales contests or sales quotas, and the financial incentives a dual registrant firm may have when determining whether to steer the customer toward a fee or commission account. At the very least, the Commission should make clear that its list represents only a tiny fraction of the material conflicts of interest that would need to be disclosed to retail investors under Regulation Best Interest.

5. The Commission needs to make clear that an “access equals delivery” approach would not satisfy the proposal’s delivery requirements.

The Commission also needs to provide greater clarity with regard to the means by which brokers could satisfy their disclosure delivery obligations. The Release states that documents that broker-dealers are required to provide under Regulation Best Interest could be delivered electronically “consistent with the Commission’s guidance regarding electronic delivery of

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<sup>126</sup> Reg BI Release at 112-113.



documents.”<sup>127</sup> And the Release specifically cites to the 1995 and 1996 guidance on electronic delivery which require not just notice and access, but also evidence to show actual delivery.<sup>128</sup> This would seem to suggest that the Commission would not deem the reasonable disclosure requirement to be met where the broker simply posted the information on a publicly accessible website (e.g., “access equals delivery”). If true, this would be a welcome improvement over SIFMA’s proposed approach to disclosure. But the Release is not sufficiently clear on this point.

We urge the Commission to state clearly that reasonable disclosure requires notice, access *and* delivery and that customers, rather than firms, should choose how they prefer to receive disclosures. Where the customer has affirmatively consented to electronic delivery, disclosure obligations could reasonably be satisfied by delivery of a url or hyperlink in a text or email that provides notice of the disclosure’s availability.<sup>129</sup> But simply making the information accessible on the company website, or sending a text or email notice without specifying where the information can be found, would not satisfy the broker’s obligations.

6. Shortcomings in the proposed “flexible” approach to disclosure are likely to be exacerbated in the dual registrant context.

On virtually every point – including timing, presentation, delivery, and content – the “flexibility” the Commission provides is likely to result in disclosures that do not effectively convey the key information in a usable form at a time when it can be incorporated into the investment decision. These shortcomings are all exacerbated in the context of dual registrant firms where a customer maintains both brokerage and advisory accounts, which we’ve been told is common. The Commission states that it “would expect a broker-dealer that is a dual-registrant to do more to meet the Disclosure Obligation.”<sup>130</sup> But it would be left to the dual registrant to determine “how best to assist its retail customers in understanding the capacity in which it is acting.”<sup>131</sup>

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<sup>127</sup> Reg BI Release at 117-118.

<sup>128</sup> Use of Electronic Media for Delivery Purposes, Exchange Act Release No. 36345 (Oct. 6, 1995) (“Providing information through postal mail provides reasonable assurance that the delivery requirements of the federal securities laws have been satisfied. The Commission believes that broker-dealers, transfer agents, and investment advisers similarly should have reason to believe that electronically delivered information will result in the satisfaction of the delivery requirements under the federal securities laws. . . . Broker-dealers, transfer agents, and investment advisers may be able to evidence satisfaction of delivery obligations, for example, by: (1) obtaining the intended recipient’s informed consent to delivery through a specified electronic medium, and ensuring that the recipient has appropriate notice and access, as discussed above; (2) obtaining evidence that the intended recipient actually received the information, such as by an electronic mail return-receipt or by confirmation that the information was accessed, downloaded, or printed; or (3) disseminating information through certain facsimile methods.”).

<sup>129</sup> While we strongly oppose allowing firms to meet their disclosure delivery obligations simply by posting the required information on a website, we do believe there is a strong public benefit from having information regarding accounts, particularly with regard to costs and conflicts, readily available on company websites. The two positions are not inconsistent. The key difference is that information that is intended for a particular client should have to be delivered to that client, particularly when actual delivery in the electronic age is cheap, easy and virtually instantaneous.

<sup>130</sup> Reg BI Release at 106.

<sup>131</sup> *Id.*

The limited guidance the Release offers on this point is completely inadequate to ensure that customers understand not just what capacity the dual registrant is acting in at a particular time, but what significance that has for the investor. Telling the investor that their “financial advisor” is currently acting in his brokerage capacity won’t convey significant meaning to the millions of investors who do not fully grasp the differences between brokers and investment advisers, particularly when they use the same titles. Nor will it alert the customer to the different types of conflicts of interest that may be present in that relationship or the fact that the recommendation will not be subject to ongoing monitoring. Investors will have no basis to understand what incentives the dual registrant may have to make certain recommendations in the brokerage account rather than the advisory account, or vice versa, since both the regulatory standard and disclosure obligations apply to the specific account rather than to the relationship as a whole. In short, the proposed disclosures are likely to be least effective when they are most needed to resolve customer confusion.

7. The disclosure requirements are too weak to deter harmful conduct.

One of the benefits often attributed to disclosure is that it can provide an incentive for firms to abandon harmful practices rather than disclose them. Perhaps with this in mind, the Release requests comment on whether the proposed disclosure obligations under Reg BI would “cause a broker-dealer to act in a manner that is consistent with what a retail customer would reasonably expect from someone who is required to act in his or her best interest?”<sup>132</sup> The answer is an emphatic no. In designing the disclosure obligations under Reg BI, the Commission appears to have ignored every scrap of evidence from academic studies and even its own past disclosure testing regarding what does and doesn’t work to convey key information to often financially unsophisticated retail investors. Indeed, as currently designed, it is difficult to see how the proposed disclosures would provide any meaningful benefit to offset their costs.

But even if the Commission were to adopt clearer and higher standards for the timing, form, and content of the required disclosures, there would still be reason to be skeptical. The Commission already has ample evidence, for example, that dual registrant firms engage in conduct within their fee accounts that is not in investors’ best interests despite having to disclose it. This is likely explained at least in part by their ability to bury their disclosures in dense, legalistic documents that few investors read and fewer still understand. And, as we discussed in our earlier comment letter, some academic research indicates that conflict of interest disclosure, in particular, can have a perverse effect. That is not a reason to abandon the disclosure obligations entirely, but it does have two clear implications: (1) the Commission must do much more to ensure that the disclosures are as clear and timely as possible; and (2) rather than relying so heavily on disclosures to protect investors, the Commission should strengthen the underlying standards for brokers and advisers alike and eliminate remaining inconsistencies between the two standards.

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<sup>132</sup> Reg BI Release at 125.

**E. A broker’s ongoing obligations to the client under the best interest standard, like an adviser’s fiduciary duty, should follow the contours of the relationship.**

Courts have previously determined that broker-dealers, unlike investment advisers, generally do not have an ongoing duty to their customers, and the Commission has chosen to maintain that approach in Reg BI. It is instructive, in this regard, that courts adopted that interpretation on the grounds that, “The agency relationship between customer and broker normally terminates with the execution of the order because the broker’s duties, unlike those of an investment advisor or those of a manager of a discretionary account, **are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.**”<sup>133</sup> (emphasis added) That view of brokers’ limited duty was upheld in 1975 in a court decision that found that a broker-dealer that “merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer.”<sup>134</sup> In other words, the lack of an ongoing duty for brokers that the Commission retains in its proposed standard is premised on the notion that broker-dealers do not provide ongoing advice. While that may have accurately reflected the nature of the broker-customer relationship when the securities laws were written, it is a far cry from the “pay as you go advice” relationship described by the Commission in the Reg BI Release.

1. The Commission has proposed an approach to ongoing duty of care that doesn’t reflect the variation in brokers’ relationships with their customers.

The Commission clearly recognizes that the relationship between broker-dealers and their customers today can vary greatly in terms of the “frequency and level of advice services provided (i.e., one-time, episodic or on a more frequent basis).”<sup>135</sup> The economic analysis explicitly states that the advice can be provided on an “episodic, periodic, or ongoing basis.”<sup>136</sup> And yet, instead of proposing a standard that, like an investment adviser’s fiduciary duty, “follows the contours of the relationship,”<sup>137</sup> Reg BI treats even long-term relationships as if they consisted of a series of one-time sales recommendations that can be assessed in isolation for compliance with the best interest standard.<sup>138</sup> It adopts this approach without doing anything meaningful to limit brokers’ ability to hold themselves out as providing advisory services in the context of long-term relationships. As such, it weakens existing protections for investors, who currently can at least argue in arbitration that they had a reasonable expectation that the broker would provide ongoing account monitoring. If Regulation Best Interest is adopted, such cases will be significantly less likely to succeed.

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<sup>133</sup> 913 Study at 55, footnote 248, citing *Walston & Co. v. Miller*, 410 P.2d 658, 661 (Ariz. 1966).

<sup>134</sup> *Id.*, citing *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff’d*, 512 F.2d 484 (5th Cir. 1975).

<sup>135</sup> Reg BI Release at 118.

<sup>136</sup> Reg BI Release at 225.

<sup>137</sup> IA Guidance at 8.

<sup>138</sup> As we discuss below, the language in the standard regarding a series of transactions is narrowly focused on prevention of churning. Although it could be adapted to provide more meaningful protections in the context of long-term relationships, that is not currently either its intent or its effect.

The Commission justifies its approach by claiming it will benefit brokers and investors alike. The Release states, for example, that “taking an approach that is driven by each recommendation would appropriately capture and reflect the various types of advice broker-dealers provide to retail customers, whether on an episodic, periodic, or more frequent basis and help ensure that customers receive the protections that Regulation Best Interest is intended to provide.”<sup>139</sup> But it fails to address the contrary evidence, in the form of arbitration claims, that many investors are confused about the extent to which brokers in long-term relationships will monitor past recommendations to determine whether they need to be updated. Instead, the Release states, again without supporting evidence, that the Commission believes “that by applying Regulation Best Interest to a ‘recommendation,’ as that term is currently interpreted under broker-dealer regulation, we would provide clarity to broker-dealers and their retail customers as to when Regulation Best Interest applies and maintain efficiencies for broker-dealers that have already established infrastructures to comply with suitability obligations.”<sup>140</sup>

## 2. Disclosure will not adequately address the gap in regulatory protections.

It is certainly true that this approach would benefit brokers. It would do so by scaling back their obligations to customers in circumstances where they represent their services in ways that create a reasonable expectation of ongoing monitoring but they fail to provide that monitoring. But there is simply no basis for the Commission’s claim that it will also provide clarity to retail customers. To make that claim, the Commission would need to believe not only that investors will read and understand disclosures regarding limitations on the brokers’ account monitoring, but also that those disclosures will outweigh million-dollar marketing campaigns designed to send precisely the opposite message. To our knowledge, nothing in either the academic literature on disclosure effectiveness or the Commission’s own past studies supports that assumption, and the Commission offers no new evidence to support its claim.

This is one more reason the Commission cannot reasonably adopt its proposed regulatory approach without first completing independent usability testing of its proposed Form CRS disclosures, making those testing results available for public comment, and including an evaluation of comments received in its evaluation of not just Form CRS but also Regulation Best Interest. If, as we expect, testing shows that many investors will not carefully read a disclosure document they do not receive until account opening, and that even those who do read it may not understand its significance with regard to ongoing monitoring of past recommendations, then the Commission would need to completely rethink its proposed approach to this issue. Indeed, we think there are good reasons for the Commission to rethink its proposed approach, regardless of the outcome of any disclosure testing. The protections in Regulation Best Interest simply do not match the reasonable expectations of investors who have a long-term relationship with their broker. Moreover, as we explain further below, the problem could easily be fixed without imposing the same obligations on broker-dealers who provide episodic sales recommendations that would apply in the context of ongoing portfolio management.

It is instructive, in this regard, that the Commission mischaracterizes its very different approach as being generally “consistent with the DOL’s approach under the DOL Fiduciary Rule

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<sup>139</sup> Reg BI Release at 72.

<sup>140</sup> *Id.*

and the BIC Exemption.”<sup>141</sup> While it is true that the DOL rule did not “mandate an ongoing or long-term advisory relationship, but rather [left] the duration of the relationship to the parties,”<sup>142</sup> DOL also made clear that “the obligation to monitor the investment on an ongoing basis would be a function of the reasonable expectations, understandings, arrangements, or agreements of the parties.”<sup>143</sup> In other words, brokers would have been free under the DOL rule to limit the scope of the relationship with the customer, but where they entered into an ongoing relationship, an ongoing duty would apply. In contrast, the Commission proposes to arbitrarily limit the broker’s duty to act in the customer’s best interests to the point of recommendation, even in the context of what may be a decades-long relationship in which the broker makes regular recommendations and receives ongoing compensation (e.g., 12b-1 fees). Those are two very different things.

3. The Commission can and should adopt an ongoing duty for long-term brokerage relationships that reflects the nature of that relationship.

Ironically, the Commission’s claim that its limitation on brokers’ ongoing duty is needed to preserve differences in the broker-dealer and investment adviser business models is directly contradicted in the proposed Advisers Act Guidance. The proposed Guidance states, for example, that an adviser’s fiduciary duty, including the duty to provide ongoing monitoring and account management, “follows the contours of the relationship between the adviser and its client.”<sup>144</sup> Moreover, the adviser and its client “may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent,” and that “ability to tailor the terms means the application of the fiduciary duty will vary with the terms of the relationship.”<sup>145</sup> Under this approach, an investment adviser who provides “continuous advice” in the form of ongoing portfolio management has an ongoing duty that reflects the nature of that relationship.<sup>146</sup> But an investment adviser who contracts with a client to provide one-time advice for an hourly fee would have no ongoing duty to that client, as long as the limitations on that relationship had been fully and fairly disclosed and consented to by client.

This view is clearly reflected in the text of the proposed Guidance. It states: “An adviser is required to provide advice and services to a client over the course of the relationship at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client. The duty to provide advice and monitoring is particularly important for an adviser that has an ongoing relationship with a client (for example, a relationship where the adviser is compensated with a periodic asset-based fee or an adviser with discretionary authority over client assets). Conversely, the steps needed to fulfill this duty may be relatively circumscribed for the adviser and client that have agreed to a relationship of limited duration via contract (for example, a financial planning relationship where

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<sup>141</sup> Reg BI Release at 81.

<sup>142</sup> *Id.*

<sup>143</sup> Reg BI Release at 81, footnote 148.

<sup>144</sup> IA Guidance at 8.

<sup>145</sup> *Id.*

<sup>146</sup> Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 *Villanova Law Review* 701, 728 (2010) (“If an adviser has agreed to provide continuous supervisory services, the scope of the adviser’s fiduciary duty entails a continuous, ongoing duty to supervise the client’s account, regardless of whether any trading occurs.”).

the adviser is compensated with a fixed, one-time fee commensurate with the discrete, limited-duration nature of the advice provided).”<sup>147</sup>

In other words, the Advisers Act fiduciary duty, including the duty to monitor the account, is the opposite of a one-size-fits all standard. It could easily be adapted to accommodate the transactional nature of the typical broker-customer relationship, and few if any changes would be needed in applying this principle to brokerage accounts. For example, the Commission could make clear that brokers are permitted to limit the scope of their relationship with customers, but not the ongoing nature of their duties in the context of a long-term relationship. Under this approach, the nature of the relationship, the reasonable expectations of the investor, and the representations of the broker would all be key factors in determining whether the broker has an ongoing duty to monitor the account. In this context, a broker’s disclosures that there is no ongoing monitoring would have to be weighed against both other representations by the broker that create the opposite expectation and the degree of reliance by the investor on the broker’s advice. But, if the nature of the interaction is truly one-time advice, and that is made crystal clear and consented to by the customer, there would be no ongoing duty. If nothing else, such an approach might at least help to rein in some of the most egregiously misleading broker-dealer marketing practices.

In the context of an ongoing relationship, the nature and extent of the ongoing duty that would apply would depend on the nature of the relationship. Specifically, the Commission could and should take the position that a broker-dealer in a long-term relationship with a customer is required to provide advice and services to a customer over the course of the relationship at a frequency that is both in the best interest of the customer and consistent with the scope of the brokerage services agreed upon between the broker-dealer and the customer. Instead of requiring the kind of continuous monitoring appropriate for an adviser who is providing portfolio management, however, the Commission might determine that brokers would be required to review their past recommendations at least annually or semi-annually to ensure that investments remain on track. The more frequent the interactions and the greater the customer’s reliance on the broker’s recommendations, the greater the obligation to monitor would be. However, even in circumstances where obligations to monitor the account are minimal (e.g., because the recommendations are infrequent and the customer is sophisticated), the broker should be required to assess each new recommendation against the account or portfolio as a whole when determining whether the recommendation is in the customer’s best interests.

It would be ironic indeed if the Commission were to weaken existing protections for customers of broker-dealer in a regulation that is supposed to promote their best interests. But in its treatment of brokers’ duties in the context of a long-term relationship, that is precisely what the proposed rule would do. Moreover, the Commission proposes to weaken these essential protections without providing any evidence that their proposed approach is adequate to protect investors or needed to preserve brokers’ ability to provide transactional accounts at an affordable cost. Fixing this badly deficient provision in the proposed rule should be a top priority for the Commission.

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<sup>147</sup> IA Guidance at 14-15.

**F. The Commission should clarify that the principles-based standard in Reg BI is independently enforceable and that the requirements in (a)(2) of the rule do not constitute a safe harbor.**

As discussed at length above, we have serious concerns regarding both the ambiguous wording of the principles-based “best interest” standard articulated in paragraph (a)(1) of the rule proposal and with the specific requirements to meet that requirement outlined in paragraph (a)(2). Shortcomings in the rule’s specific requirements are particularly troubling, since compliance with the best interest standard appears to be fully satisfied by compliance with (a)(2)’s specific disclosure, care, and conflict obligations. While paragraph (a)(2) does include a specific, albeit undefined, requirement intended to capture the broker’s obligation to make recommendations that are in the best interest of the customer, there is no similar language in (a)(2) to give meaning to the prohibition on placing the broker’s interests ahead of the customer’s interest. And the disclosure and conflict obligations, as currently drafted and interpreted, are completely inadequate to ensure that conflicts are not permitted to influence recommendations.

As a result, simply fixing the wording of the principles-based standard in (a)(1) would not resolve problems with the proposed rule, although it is a necessary first step. Instead, shortcomings in the rule’s specific requirements must also be fixed, as outlined above, to clarify and give substance to the obligation to act in the customer’s best interest and to ensure that conflicts of interest are not permitted to taint the broker’s recommendations. In revising the rule to achieve this goal, the Commission should make clear that (a)(2) does not constitute a safe harbor designed to protect the broker from liability and that, on the contrary, the principles-based duty expressed in (a)(1) has “residual force and effect apart from the obligations in (a)(2).”<sup>148</sup> Without that change, the Commission is proposing to adopt, not an enforceable, principles-based best interest standard, as we have consistently advocated, but a procedures-based rule that will not be adequate to reform harmful broker-dealer business practices or rein in the toxic incentives that undermine compliance with a true best interest standard.

**G. The focus of the Reg BI standard is too narrow, giving rise to a host of problems and limiting its potential benefits.**

Above we discuss our concerns with regard to the proposed standard itself, which we believe must be extensively revised if it is to achieve the Commission’s stated goal of requiring brokers to make recommendations in the best interest of their customers. But we also have concerns with the narrow focus of the standard, which as proposed would apply only on a transaction-by-transaction basis and only to recommendations to retail customers. One problem, discussed above, is that this transaction-based approach doesn’t allow for an appropriate application of the standard in the context of an ongoing broker-customer relationship involving regular recommendations over the course of many years. But this transaction-based focus also poses other problems, particularly in the context of dual registrants. In particular, it means that the standard does not apply to recommendations regarding account type. It also means the standard may not apply consistently across an entire customer relationship, where a customer has multiple accounts with a dual registrant firm. Meanwhile, by limiting the standard’s protections

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<sup>148</sup> Reg BI Release at 210.

to recommendations to retail investors, the Commission also misses an opportunity to benefit millions of Americans who invest through small retirement plans and badly need improved plan investment options.

1. The standard should be revised to cover recommendations regarding account types by dual registrants.

Last October, we wrote to the Commission, as well as to Secretary Acosta at DOL and Robert Cook at FINRA, in response to claims by industry groups opposed to the DOL rule that, in order to avoid complying with the best interest contract exemption, some dual registrant firms were inappropriately steering customers into fee accounts when they would be better off and face lower costs in a commission account.<sup>149</sup> We wrote: “In light of brokerage firms’ incentive to maximize their fee income, industry groups’ claims that investors are being inappropriately shifted to fee accounts should be investigated. If verified, the Commission must act to end the practice. It should start by sending a clear message that it takes the requirement that firms recommend the type of account that is best for the investor seriously and that it is prepared to hold firms accountable for complying with this requirement.” We noted, moreover, that firms that engage in such practices were violating the DOL rule, which clearly required firms that have both fee and commission accounts available to recommend the type of account that is best for the customer and further required that fees be reasonable in light of services offered.

Since that time, we’ve heard SEC officials cite this problem as evidence of the DOL rule’s harmful impact and something the Commission was anxious to avoid with its own regulatory proposal. Instead of addressing this problem head on, however, the Commission allows it to persist by excluding recommendations regarding the type of account from Reg BI’s coverage. This is a problem, since the evidence clearly suggests that the practice, which predates the DOL rule, is driven primarily by firms’ incentive to maximize revenue by steering customers toward the accounts that are most profitable for the firm, rather than those that are best for the customer. The demise of the DOL rule is therefore unlikely to cause the problem to go away.

Moreover, the problem should be relatively easy to solve. The issue arises primarily in the context of dual registrant firms. We certainly would not suggest, for example, that a stand-alone broker should be required to send away a customer who would be better served working with an investment adviser, or vice versa. But where a firm has both options available, or even an assortment of different types of brokerage or advisory accounts, and where they recommend a particular account type to the customer, that recommendation should have to be in the customer’s best interests. (The concept here is comparable to what we recommend regarding best interest recommendations of investments; brokers should be required to recommend the best of the options they have reasonably available to recommend.) The customer would, of course, be free to make a different choice than that recommended by the broker. In this, as in all other aspects, Reg BI affects the recommendations brokers can give, not the choices investors can make. But firms should not remain free to steer investors toward accounts that are most beneficial for the firm, and they certainly shouldn’t be free to incentivize their registered reps to do so.

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<sup>149</sup> Letter from Barbara Roper and Micah Hauptman, CFA, to Chairman Clayton, Brokerage Firms Shifting Investors to Fee Accounts, October 3, 2017, <https://bit.ly/2MkhHHF>.



To correct this problem, the Commission should apply the best interest standard, not just to recommendations of investments, but also to recommendations of accounts and services. While our primary focus is on ensuring that recommendations regarding brokerage versus advisory accounts are made in the investor's best interest, this approach has added benefits. Where stand-alone brokerage firms have more than one type of brokerage account available (e.g., full-service, online, or serviced by a call center), our suggested approach would have the added benefit of capturing those recommendations as well. For this reason, we believe this is a better approach than simply adding a specific requirement to the rule that dual registrant firms recommend the account type that is best for the investor. However, either approach would be a significant improvement over the rule proposal, as drafted, which does nothing to address a practice that the Commission itself has identified as a concern.

2. The standard should be revised to apply consistently to advice offered by a dual registrant firm to a particular customer across multiple accounts.

In developing its proposed regulatory approach, the Commission has failed to give adequate consideration to how its proposed approach would, or more likely would not, work in the context of dual registrant firms. This is a significant oversight since, according to the Release, “nearly 90 million (68% of) customer accounts” are held by dual registrant firms, and an even larger percentage of firms are affiliated with an investment adviser.<sup>150</sup> The Commission's proposed bifurcated regulatory approach is likely to pose significant implementation challenges for dual registrant firms and be particularly ineffective in protecting the millions of Americans whose accounts are held at such firms.

For years, we have been hearing from the brokerage industry how important it is to have a uniform standard for all investment accounts, both to prevent investor confusion and to ease compliance. A comment letter from Fidelity is fairly typical, claiming that, “The DOL Fiduciary Advice Rule has increased investor confusion, rather than reduce it. Many investors and regulated entities are now faced with standards of conduct, disclosure requirements, and enforcement mechanisms for their retirement accounts that are different than for their non-retirement accounts. The outcome is confusing to retail investors who reasonably question why certain products, services and fees are not the same across their accounts, even if the provider is the same.”<sup>151</sup> If this was a concern with regards to the DOL rule, it is all the more likely to be a problem where a customer has a variety of accounts with a financial services firm, some of which are brokerage accounts and some of which are advisory accounts, but all of which are served by the same “financial advisor.”

Industry's answer to this perceived problem of investor confusion has for years been adoption by the SEC of a uniform standard that would apply to all securities accounts. In a 2015 comment letter to the DOL, for example, the Financial Services Institute (FSI) touted its long support for “a carefully-crafted, uniform fiduciary standard of care applicable to all professionals

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<sup>150</sup> Reg BI Release at 226.

<sup>151</sup> Letter from Mark R. Bryant, Fidelity Senior Vice President and Deputy General Counsel, to the SEC, August 11, 2017, <http://bit.ly/2wLJSKh>.

providing personalized investment advice to retail clients.”<sup>152</sup> FSI explained its support for a uniform fiduciary standard this way: “While broker-dealers are already subject to a robust regulatory and enforcement regime designed to protect investors, we recognize that the differing standards of care between broker-dealers and registered investment advisers may lead to unnecessary client confusion.” More recently, SIFMA’s Asset Management Group expressed strong support for a uniform best interest standard because it “would have the benefit of applying a single standard of care across all investment recommendations made to retail investors, whether for retirement savings or otherwise.”<sup>153</sup> Indeed, the SEC’s ability to provide a uniform standard across all securities accounts has long been a leading talking point in industry’s argument that the SEC, rather than DOL, should take the lead in setting policy in this area.

In advocating uniformity in the context of the DOL rule, the brokerage industry cynically supported an approach that would actually reduce uniformity. Specifically, under their preferred approach, different standards would have applied to different products sold within retirement accounts and to different types of advisers to retirement accounts. SIFMA’s July 2017 letter to the Commission demonstrates that same inconsistency between their stated support for a uniform standard and their actual preferred regulatory approach.<sup>154</sup> In that letter, SIFMA both argued the need for uniformity and proposed an approach that directly undermined uniformity. In this case, they suggested that different regulators should act independently to adopt standards for the individuals and entities for which they serve as primary regulator and they proposed a standard for broker-dealers that is different from the standard for investment advisers.

While the industry’s arguments in favor of uniformity may be cynical, the fundamental principle is sound. Adopting a uniform standard for all securities accounts would: (1) reduce the potential for investor confusion regarding the duties they are owed by their adviser in different contexts, and (2) ease compliance for dual registrant firms that offer both brokerage and advisory accounts. Unfortunately, the Commission has chosen instead to follow the industry’s lead in proposing a standard for brokers’ “advice services” that is different in important ways from the standard that applies to investment advisers and assuming despite all past evidence that disclosure will be sufficient to clarify those differences.

This is particularly unlikely to be the case when an investor is working with a “financial advisor” at a dual registrant firm and has multiple accounts that include both advisory and brokerage accounts. Investors cannot reasonably be expected to understand what incentives the firm may have to conduct certain transactions within the brokerage account and others within the advisory account or to recognize that the investor would be better off under a different approach. Under the Commission’s bifurcated regulatory approach, where Reg BI applies only at the transaction level, the individual recommendations may be able to satisfy a best interest standard even where the customer would be better served if the transaction were conducted instead in the advisory account or even a different brokerage account (e.g., an IRA rather than a taxable

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<sup>152</sup> Letter from David T. Bellaire, Executive Vice President and General Counsel, FSI, to DOL, Regulatory Definition of the Term “Fiduciary” and Related Exemptions, at 2, July 21, 2015, <https://bit.ly/2Mh1frr>.

<sup>153</sup> Letter from Laura Martin and Joseph Cox, SIFMA Asset Management Group, to DOL, Regulatory Definition of the Term “Fiduciary” and Related Exemptions, at 2-3, April 17, 2017, <https://bit.ly/2naK004>.

<sup>154</sup> Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, July 21, 2017, <http://bit.ly/2uRtdUA>.

account). The narrow focus of the standard thus does not ensure that the customer's portfolio as a whole will be managed in the customer's best interests.

As we have noted elsewhere, we believe the cleanest solution to this problem would be for the Commission to adopt a uniform standard that applies consistently across different types of accounts. Alternatively, the Commission could and should make clear that the requirement to act in the customer's best interest must operate at the relationship level, and not just on a transaction by transaction basis. Furthermore, each recommendation should have to be weighed in the context of the customer's entire portfolio to determine whether the transaction is, in fact, in the customer's best interest, and transactions should have to be executed in the account that is best for the customer. This is relevant in any instance where a customer has multiple accounts with the same firm, but it is particularly important where the customer has both brokerage and advisory accounts with the same firm.

3. The standard should be expanded to apply to advice to small retirement plans.

GAO studies, the DOL's Regulatory Impact Analysis, and independent research have all documented the fact that small retirement plan sponsors often rely on conflicted financial services firms, including broker-dealers, for investment recommendations regarding their retirement plan offerings, often in the mistaken belief that they are receiving fiduciary investment advice.<sup>155</sup> As a result, "plan sponsors may not be aware that service providers can have a financial incentive to recommend certain funds that would be prohibited if they were ERISA fiduciaries."<sup>156</sup> The problem is particularly acute for smaller plan investors, the DOL concluded, because smaller plans are less likely than larger plans to receive investment assistance from a service provider that is acting as a fiduciary.<sup>157</sup> The DOL further concluded that plan sponsors and plan officials that rely on biased advice "may make poor investment decisions," which can in turn compromise participants' retirement security.<sup>158</sup>

As we documented at length in our April 2017 letter to the DOL, retirement savers are paying billions of dollars a year in excess costs as a result of conflicted advice to small company retirement plans.<sup>159</sup> Holding service providers to a fiduciary standard has the potential to reduce those costs.<sup>160</sup> By limiting Reg BI to advice to retail customers, the Commission misses an opportunity to help fix this problem. Its proposed approach is also likely to result in confusion for small business owners who get recommendations from a broker in both their individual capacity and in their capacity as plan sponsors.

Respected ERISA attorney Fred Reish discussed the issue in a recent column. "Based on my reading of the SEC proposal, and on my conversations with securities lawyers, a 'retail customer' includes individual investors, family and personal trusts, IRA owners, and plan

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<sup>155</sup> DOL Regulatory Impact Analysis at 189, quoting GAO Publication No. GAO-11-119, 401(K) PLANS Improved Regulation Could Better Protect Participants from Conflicts of Interest, <http://bit.ly/2p3UIZk>.

<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> See Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America (CFA), to the Department of Labor (DOL), DOL Fiduciary Reexam, at 44-60, April 17, 2017, <https://bit.ly/2mZITzQ>.

<sup>160</sup> *Id.* at 59-60.

participants. However, it does not include businesses, retirement plans, and tax-exempt organizations,” he wrote.<sup>161</sup> “Unfortunately, the SEC did not explain why they excluded some of those investors, who may be relatively unsophisticated. For example, if a small business owner has a 401(k) plan, advice about the business owner’s personal account would be protected by the best interest standard of care; advice about the investments in the plan would not be; advice to the owner about investing his participant account would be; and advice about investing the corporate account would not be. It seems difficult to imagine that the small business owner—who has the same level of sophistication regardless of which account he or she is investing—would understand that the protections under the securities laws varied depending on which ‘hat’ the business owner was wearing. This will, undoubtedly, lead to confusion.”<sup>162</sup> We strongly agree.

While a wholesale change to address this problem would require a new proposal, the Commission could and should take an interim step to help reduce the potential for confusion and abuse. It could achieve this by making clear that, while Reg BI applies only to retail investors, it applies across all of those investors’ accounts, including certain non-retail accounts. Specifically, the Commission could and should make clear that, where a broker serves clients both in their individual capacity and in their capacity as small business owners, all of the broker’s advice to that client would be covered by Reg BI’s best interest standard. Ultimately, once the Commission has repaired this and other shortcomings in the rule proposal, it should act to expand the rule’s protections to a broader set of customers – similar to the broad coverage of the Advisers Act fiduciary standard – with a particular eye toward the need for improved protections in the small plan market. Unfortunately, as we discuss further below in the legal analysis, the Commission never seriously considered whether to extend the standard to other customers, as authorized under the statute.

#### **H. The enforcement regime for Regulation Best Interest is unclear.**

As currently drafted, it’s not really clear what the enforcement regime will be for Reg BI and the Commission provides no analysis on this critical issue. Does the Commission intend to enforce the standard itself, does it intend for FINRA to enforce it, or some combination of the two? These are important issues that will help to determine the rule’s effectiveness.

The proposed rule is likely to be difficult to enforce. The Commission states repeatedly throughout the Release that it “preliminarily believe[s] that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Regulation Best Interest are satisfied.”<sup>163</sup> The “facts and circumstances” of each recommendation will differ, which will make it exceedingly difficult to examine individual registered representatives’ recommendations to determine compliance.

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<sup>161</sup> Fred Reish, Interesting Angles on the DOL’s Fiduciary Rule #96, FredReish.com, June 25, 2018, <https://bit.ly/2KwPNGu>; See also Fred Reish, Interesting Angles on the DOL’s Fiduciary Rule #97, FredReish.com, July 10, 2018, <https://bit.ly/2LOBZgd>.

<sup>162</sup> *Id.*

<sup>163</sup> Reg BI Release at 52.

The Commission fails to discuss how it intends to address this issue. For example, does the Commission believe that performing such “facts and circumstances” inquiries at a firm level is possible and would shed sufficient light on individual representatives’ behavior? If so, on what basis does it reach that conclusion? Absent a plan for effective enforcement, even the strongest standard is likely to deliver only limited benefits. A vague and ill-defined standard that is not backed by strong enforcement is doomed to ineffectiveness.

The Release also sends mixed messages regarding what rights individual investors would have under Regulation Best Interest when they believe the standard has been breached. On the one hand, the Release states that, “[W]e do not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result.”<sup>164</sup> Elsewhere, however, it states that, “Broker-dealers may also face increased costs due to enhanced legal exposure as a result of a potential increase in retail customer arbitrations.”<sup>165</sup> The issue is further complicated by the fact that FINRA arbitration panels are not required to follow the law, and the most common claim retail investors bring against brokers today is violation of fiduciary duty. The Commission fails to either clearly explain or seriously analyze how the proposal would affect investors’ ability to protect themselves. Yet this issue, like the related issue of regulatory enforcement, is critical to determining the extent to which the proposal is likely to reform harmful industry practices.

## **I. Other provisions**

The Commission requests comments on a broad range of issues related to Reg BI, not all of which we have the capacity to address here. The above comments address the issues that we believe are of primary importance, where significant changes are needed in order to deliver a true best interest standard backed by meaningful restrictions on conflicts of interest for broker-dealers and investment advisers alike. The following represent areas where we believe additional, albeit less extensive, comment is warranted regarding issues raised in the rule Release.

1. The Commission should clarify firms’ obligations with regard to ensuring that their associates can meet their best interest standard by recommending “reasonably available alternatives.”

We support an approach to the best interest standard that recognizes that all firms limit their product menus in some way and that associates of the firm should be able to meet their best interest obligations recommending the investments from the firm’s product menu. However, we believe this general approach should come with a caveat: firms should have some obligation to ensure that they maintain a product menu reasonably sufficient to enable their associates to meet their best interest obligations for the customers the firm serves. In other words, a broker that maintains a limited menu of decidedly subpar investment options shouldn’t be deemed to be in compliance with a best interest standard, simply by recommending the least bad of the available uniformly bad options. Similarly, where a firm specializes in a narrow range of investment options, it shouldn’t be able to satisfy its best interest obligations to an investor for whom none

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<sup>164</sup> Reg BI Release at 42.

<sup>165</sup> Reg BI Release at 279.

of the options is a good match by recommending the option that comes closest to matching the investor's needs. This may be implied in the Commission's proposed care obligations under Reg BI, but it is not made clear. The Commission should provide the necessary clarification.

2. CFA supports the Commission's position that discretionary accounts should be regulated as advisory accounts.

The Commission has for more than a decade generally taken the position that accounts where a broker exercises more than temporary or limited discretion are appropriately regulated under the Investment Advisers Act because, "the quintessentially supervisory or managerial character of investment discretion warrants the protection of the Advisers Act and its attendant fiduciary duty."<sup>166</sup> Unfortunately, the 2005 interpretative rule that classed discretionary accounts as advisory accounts was later vacated over provisions exempting fee accounts from the Advisers Act, and the Commission has not since taken formal action to reaffirm that position. The Release suggests, however, that most financial firms treat discretionary accounts as advisory accounts.

CFA has generally been supportive of the Commission's proposal to regulate all discretionary accounts under the Advisers Act.<sup>167</sup> Our one concern was with the length of the exemption for temporary discretion, which we have argued is indicative of a degree of reliance that should be subject to fiduciary protections. If the Commission were to adopt a uniform fiduciary standard for all accounts, that concern would be alleviated. As long as the Commission resists taking that approach, however, accounts in which the broker-dealer exercises "unfettered" discretion must continue to be regulated under the Advisers Act fiduciary standard. Only limited discretion – e.g., occasional, of short duration, or of limited scope, such as using an automated platform to carry out an agreed upon strategy – can reasonably be viewed as solely incidental to the firm's conduct as a broker-dealer.

A financial firm that exercises limited discretion in its capacity as a broker should have an explicit fiduciary obligation to act in the best interest of the customer for the purposes of and throughout the duration of the period in which it exercises discretion. This would be consistent with court cases finding that brokers are fiduciaries when exercising discretion. Moreover, to the degree that brokers exercise such limited discretion, firms should have a heightened obligation to supervise the account to ensure that conflicts of interest are mitigated and that the discretionary authority is not being misused. We would encourage the Commission to adopt an interpretive rule formalizing this interpretation.

### **III. The proposed Form CRS disclosures are inadequate to enable investors to make an informed choice among different types of providers, accounts, and services.**

CFA has long advocated improved pre-engagement disclosure to help investors make better informed decisions about who to rely on for investment advice and sales recommendations. For many investors, this is the last investment decision they will make. In

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<sup>166</sup> Reg BI Release at 202.

<sup>167</sup> See Letter from Barbara Roper, CFA, and Mercer Bullard, Fund Democracy, to the SEC, Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, November 2, 2007, <https://bit.ly/2vjxnEp>.

working with a financial professional, they expect to rely on that professional's recommendations, without doing additional research to determine whether the recommendations are in their best interest or better options are available. There are good reasons for this. Many investors lack the financial expertise necessary to evaluate the advice they receive, which is a key reason they choose to work with a financial professional in the first place. And they assume that all "financial advisors," like all doctors and all attorneys, are legally bound to act in their clients' best interests. It is these investors the Commission should have in mind in designing its new relationship summary for broker-dealers and investment advisers.

Developing a relationship summary that can be readily understood by typical investors is no easy task. Previous research, including research conducted on behalf of the Commission, has demonstrated how challenging it is to develop clear, understandable disclosures in this area, both because the issues to be disclosed are often complex and technical in nature and because the level of investor understanding of these concepts is typically poor. We have therefore cautioned against placing too much reliance on disclosure to protect investors and have instead urged the Commission to tackle the underlying problem – that broker-dealers have been permitted to market themselves as trusted advisers without being held to the fiduciary standard appropriate to that advisory role. As we wrote in our September 2017 comment letter, "unless and until the Commission is prepared to prevent brokers from misrepresenting their sales representatives as advisers and their arm's length sales recommendations as advice, even the best designed disclosures aren't going to be sufficient to prevent investor confusion."<sup>168</sup>

Unfortunately, the Commission has chosen instead simply to tweak its decades-old approach of maintaining different standards of conduct for broker-dealers and investment advisers without doing anything meaningful to rein in brokers' ability to market their sales recommendations as advice. Indeed, to the degree that the Commission has taken steps to minimize differences between the two standards, it appears to have achieved this as much by adopting the weakest possible interpretation of the Advisers Act standard as by strengthening the standard that applies to brokers' "advice services." As we discuss at length in the previous section, that fundamental failure of the proposed standard to live up to investors' reasonable expectations cannot be fixed through disclosure alone.

The Commission nonetheless proposes to rely on Form CRS to ensure that investors can understand key differences between brokers and advisers. In adopting this approach, the Release acknowledges that investors are confused about these differences. The purpose of Form CRS, according to the Release, is "to assist investors in making an informed choice when choosing an investment firm and professional, and type of account" by providing them with "clear and sufficient information in order to understand the differences and key characteristics of each type of service."<sup>169</sup> In particular, the Release suggests that Form CRS will play a central role in helping investors to understand the different standards of conduct that apply. It states: "While Regulation Best Interest would enhance the standard of conduct owed by broker-dealers to retail customers, it would not make that standard of conduct identical to that of investment advisers, given important differences between investment advisers and broker-dealers. The requirements

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<sup>168</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 37-38, September 14, 2017, <https://bit.ly/2LSFkLg>.

<sup>169</sup> Form CRS Release at 8.

we are proposing in this release would help an investor better understand these differences, and distinguish among different firms in the marketplace, which in turn should assist the investor in making an informed choice for the services that best suit her particular needs and circumstances.”<sup>170</sup>

Given the mountain of research showing how challenging it is to develop effective disclosures in this area, as well as the central role disclosure plays in the Commission’s proposed regulatory approach, one would have expected the Commission to devote considerable effort, before issuing its proposal, to developing the clearest and most effective disclosures possible. But this does not appear to have been the case. On the contrary, the proposal appears to have been rushed out the door, without first consulting disclosure experts on the design, content, or presentation of the information and without incorporating commonly recognized principles of effective disclosure. The result is a proposed disclosure document that suffers, as disclosure expert Susan Kleimann said in a recent presentation to the SEC Investor Advisory Committee (IAC), both from “the curse of knowledge,” i.e., an expectation that investors will have a level of understanding of the issues they are unlikely to have, and from some very basic design flaws.<sup>171</sup> As a result, although the document focuses on important topics that we agree are critical to an informed choice among different types of financial professionals and different types of investment accounts, we believe its discussion of those topics is unlikely to be understood by typical investors, and is least likely to be understood by the financially unsophisticated investors most in need of enhanced protections. Indeed, in some areas, we believe the disclosures are likely to increase, rather than reduce, investor confusion.

Though the Commission cannot expect to redress the fundamental problems with its proposed regulatory approach through disclosure alone, it can and must do more to ensure that the Form CRS disclosures are as clear and informative as possible. We are, therefore, encouraged by reports that the Commission is undertaking independent usability testing of the proposed disclosures. That is an essential first step in order to determine whether the disclosures clearly convey, in a way that typical, financially unsophisticated investors can understand:

- Differences between the sales recommendations offered by broker-dealers and the advice offered by investment advisers;
- What protections they can expect to receive from the proposed best interest standard for brokers and the fiduciary duty for investment advisers, and how those standards differ;
- That, for investors who work with a broker, it is the investor and not the broker who will be responsible for monitoring the account to ensure that their investments remain on track and continue to be appropriate for their needs;
- How the financial professional charges for their services; and

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<sup>170</sup> Form CRS Release at 13.

<sup>171</sup> Susan Kleimann, Making Disclosures Work for Consumers, Presentation to the SEC’s Investor Advisory Committee, Kleimann Communication Group, June 14, 2018, <https://bit.ly/2M064sp>.



- The nature and extent of conflicts present in the business model and how they might influence the recommendations the investor receives.

Testing should also seek to determine when and how investors would need to receive the disclosures in order to incorporate the information provided into their selection of firms and accounts.

We are disappointed that the Commission has not yet made the results of that usability testing available and that it has, so far, failed to respond to requests to allow an opportunity for public comment on those testing results before moving to finalize a rule. Because we view the issue of usability testing as of critical importance, we have joined with other organizations to engage Kleimann Communication Group to conduct such testing on our behalf. We expect to have results from that testing to submit to the Commission within 45 days. While we recognize that our submission will fall outside the formal comment period on the regulatory proposal, we are counting on the Chairman’s repeated assurances that the Commission will continue to accept and consider comments received after the comment deadline has passed, as has traditionally been the Commission’s practice.

While our own testing is not yet complete, initial results raise serious concerns regarding the likely effectiveness of Form CRS. Others have raised similar concerns. Man on the street interviews typically find that few if any individuals understand the term fiduciary, as these examples from the Investment Adviser Association<sup>172</sup> and Federated<sup>173</sup> illustrate. Recently, when *Ignites* sent a crew to Wall Street to conduct similar interviews, they consistently found at best a hazy understanding of the term, confusion at the idea that there was a difference between fiduciary and best interest, and skepticism that they would read the proposed disclosures.<sup>174</sup> As one woman said, in response to a question about whether she would read the disclosures, “I honestly don’t think I would, and I understand the importance of it. I’m an economist so I get it, and I don’t think I’d do it.”<sup>175</sup> That’s a sobering message the Commission must take seriously as it considers the central role disclosure plays in its proposed regulatory approach.

Assuming the Commission’s usability testing also demonstrates that many investors either will not read the proposed disclosures or cannot make an informed choice based on Form CRS as currently proposed, the Commission must, by its own logic, rethink its proposed regulatory approach. As we and others have previously commented, if the proposed disclosures fail to dispel investor confusion regarding differences between broker-dealers and investment advisers, particularly with regard to the nature of services offered and the standard of conduct, the Commission would need to: (1) do more to help investors distinguish brokers from advisers, for example, through much tighter restrictions on titles and marketing practices; (2) dramatically improve its proposed disclosures, including by working with disclosure design experts to refine the format and content of Form CRS; (3) hold brokers and advisers alike to a fiduciary duty that includes a true best interest standard and real restrictions on conflicts of interest, in order to

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<sup>172</sup> Investment Adviser Association, What’s a Fiduciary, YouTube, November 1, 2017, <https://bit.ly/2ACUMWI>.

<sup>173</sup> Federated, What is a Fiduciary? YouTube, August 6, 2012, <https://bit.ly/2OIheAB>.

<sup>174</sup> Jill Gregorie, What is “Best Interest”? “I Have No Idea”: Investors, Ignites, July 19, 2018, <https://bit.ly/2OL3NOa>.

<sup>175</sup> *Id.*

minimize the potential for investors to be harmed as a result of making an uninformed choice of service providers; or (4) some combination of the three.<sup>176</sup> Our own view is that extensive improvements to both the proposed standard of conduct and the proposed disclosures will be needed, as discussed in more detail below. We will further refine these views based on the results of our usability testing.

#### **A. The Form CRS disclosures, as proposed, are unlikely to be widely read.**

A crucial factor in whether the Form CRS disclosures serve their intended purpose is whether they actually get read by investors. Timing, as well as format and presentation, influence readership, and Form CRS suffers from serious deficiencies in both areas. The Commission allows for delivery of Form CRS so late in the process of choosing an account or a firm that the disclosures are unlikely to factor in the selection. The information is presented in a format that is dense and unappealing and does not reflect the way people review disclosures, further reducing the likelihood that investors will read, let alone understand, the information provided. The Commission must fix both, particularly if it continues to rely on the disclosures to alert investors to important differences between brokerage accounts and advisory accounts and the differing standards of conduct that apply.

1. The proposed timing of the disclosures comes too late to be useful to investors when choosing whom to hire or what type of account to open.

The Commission “encourages” delivery of Form CRS “far enough in advance of a final decision to engage the firm to allow for meaningful discussion between the financial professional and retail investor, including by using the Key Questions, and for the retail investor to understand the information and weigh the available options.”<sup>177</sup> The Release states that the proposed approach is “intended to make the relationship summary readily accessible to retail investors at the time when they are choosing investment services,”<sup>178</sup> and it notes that one point of the disclosure is to “facilitate comparisons across firms that offer the same or substantially similar services.”<sup>179</sup> Having provided that rationale for the Form CRS disclosures, however, the Commission doesn’t actually require the disclosures to be provided at a time when the information could readily be factored into the investor’s choice of firms and accounts. Instead, under the Commission’s proposed approach, delivery of the disclosures could be delayed until “the time the retail investor first engages the firm’s services,” in the case of a broker, and “the time the firm enters into an investment advisory agreement with the retail investor,” in the case of an investment adviser, or whichever comes earlier in the case of dual registrants.<sup>180</sup>

As a result, delivery of Form CRS will in many, if not most, cases come only *after* the investor has already made a decision about which firm to engage and which type of account to open. Most egregious in this regard is the Commission’s failure to require disclosure at the time a broker-dealer makes a recommendation to a retail investor, if that recommendation does not

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<sup>176</sup> Letter from AARP et al., to Chairman Clayton, Request to Delay Comment Deadline for Best Interest Proposal, May 21, 2018, <https://bit.ly/2Jkc7ay>.

<sup>177</sup> Form CRS Release at 139.

<sup>178</sup> Form CRS Release at 141-142.

<sup>179</sup> Form CRS Release at 16.

<sup>180</sup> Form CRS Release at 138-140.

lead to a transaction with the broker-dealer.<sup>181</sup> This makes a mockery of the Commission's claims that the disclosures will aid investors to compare firms and accounts and make an informed choice of providers. In adopting this approach, the Commission is explicitly forgoing an opportunity to require the disclosure at a point when it could be incorporated into the investor's decision regarding whether to accept the recommendation and work with the firm. Instead, it proposes to delay delivery until after the decision to work with the firm and enter into the transaction has already been made. It is frankly incomprehensible to us that the Commission, even as it acknowledges the importance of timely disclosure, would nonetheless propose to adopt an approach that all but guarantees investors will not receive the information at a point when it is useful to them in making a decision about who to hire and what type of account to open.

If the Commission is sincere in wanting to encourage delivery of Form CRS early enough that it can be incorporated in the investor's choice of firms and accounts, it should require the disclosures to be provided, whenever possible, at the point of first contact or inquiry between the investor and the broker or adviser. For dual registrants, the disclosure should have to be provided no later than the point at which a recommendation is made regarding which type of account to open. It is at this point, when the investor shows interest in possibly hiring the firm, or when the firm reaches out to solicit the investor's business, that the information is most likely to be incorporated into the investor's decision. The only acceptable reason not to provide the disclosure at this point is if the firm doesn't have contact information for the investor and the investor, for whatever reason, chooses not to provide contact information. In such cases, firms should be required to provide the disclosure promptly if and when the firm receives any follow-up inquiry or contact from the investor.

Under our suggested approach, the disclosure should routinely be provided well in advance of the broker's making a recommendation to the customer. But, where this is not the case – presumably where brokers are cold calling potential customers with specific investment recommendations before conducting even a minimal know-your-customer review – the disclosure should be provided no later than the time of recommendation, and the investor should be encouraged to review the disclosure before making a decision. After all, this is likely to be a situation that poses particular risks to investors and one where they would benefit greatly from making an informed choice of providers.

Only if the Commission fixes this critical weakness in the timing of the initial disclosure can it reasonably claim that the disclosures will help to support more informed investor decisions regarding whom to hire and what type of account to open. As such, as we discuss in greater detail in our discussion of the Commission's economic analysis below, the Commission could claim little if any benefit to offset the proposal's costs.

2. We support other aspects of the proposed approach to delivery and filing of the forms.

While we have grave concerns about the proposed timing of the initial Form CRS disclosures, there are other aspects of the proposed approach to delivery and filing of the forms that we support. These include: the proposed approach to follow-up disclosures when clients are

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<sup>181</sup> Form CRS Release at 143.

encouraged to shift money between accounts or open new accounts; the requirement for firms to post the Form CRS disclosures on the firm website; the requirement to file the forms with the Commission in text-searchable format; and the proposed approach to electronic delivery.

Disclosures to Existing Customers: In addition to requiring point-of-engagement delivery of Form CRS, the Commission also proposes to require firms to provide the disclosures to existing clients and customers “before or at the time (i) a new account is opened that is different from the retail investor’s existing account(s); or (ii) changes are made to the retail investor’s existing accounts that would materially change the nature and scope of the firm’s relationship with the retail investor.”<sup>182</sup> We support this proposal and agree with the Commission that, in these instances, “retail investors are again making decisions about whether to invest through an advisory account or a brokerage account and would benefit from information about the different services and fees that the firm offers to make an informed choice.”<sup>183</sup> We appreciate, moreover, that, in contrast to its requirements with regard to the initial disclosure, the Commission would require the disclosure to be provided “before or at the time a recommendation is made.”<sup>184</sup> We urge the Commission to make clear that the disclosures should be provided as soon as practicable before or at the time the recommendation is made, and that investors should be given an opportunity to consider the information before being asked to take action on that recommendation.

Website Disclosure: The Commission proposes to require firms “that maintain a public website to post their relationship summaries on their websites in a way that is easy for retail investors to find.”<sup>185</sup> For the many investors who are likely to do their initial research on the Internet, this requirement should be particularly beneficial. Moreover, requiring the document to be posted on the company website provides an opportunity to enhance the quality of the disclosures by incorporating pop-up text boxes with explanations of key terms, links to more detailed information (e.g., the firm’s fee schedule, or fact sheets explaining the features of specific types of accounts, or a more detailed explanation of the firm’s conflicts of interest than would be possible within a four-page document), and greater use of graphics and even video to make the information more understandable for investors. The risk, of course, is that some firms may try to use these bells and whistles to distract from the essential content of the form, but we believe the potential benefits are significant. We therefore encourage the Commission to work closely with Internet disclosure experts to develop, and test, an approach to Form CRS online disclosure that truly delivers the benefits of a layered and more interactive approach to disclosure possible on the Internet.

Filing Requirement: The Commission proposes to require investment advisers to file Form CRS on the Investment Adviser Registration Depository (IARD), brokers to file the form on the Commission’s Electronic Data Gathering, Analysis and Retrieval System (EDGAR), and dual registrants to file the form in both databases. The forms would have to be filed electronically in a text-searchable format.<sup>186</sup> As the Commission explains in the Release, this

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<sup>182</sup> From CRS Release at 140-143.

<sup>183</sup> From CRS Release at 143-144.

<sup>184</sup> From CRS Release at 140-143.

<sup>185</sup> From CRS Release at 139.

<sup>186</sup> From CRS Release at 137.

filing requirement helps to ensure that, even for firms that do not maintain a company website, the forms will be available to the public in an electronic form.<sup>187</sup> We agree that providing “[e]asy access to various relationship summaries through one source may facilitate simpler comparison across firms.”<sup>188</sup> Once the disclosures are refined and the regulatory package is finalized, the Commission should promote access to the disclosures on its website through a public education campaign.

However, past experience regarding investors’ limited use of existing databases, such as IARD and BrokerCheck, cautions against placing too much reliance on investors’ accessing the documents directly. We therefore urge the Commission to require that the documents be filed, not just in a text-searchable format, but in a machine-readable format. We can envision a time when third parties could develop online tools to help investors search for a firm or account that meets their preferred parameters, much like the tools Kelly Blue Book or Edmunds provide to help car buyers narrow their selections. Investors could fill out a questionnaire covering both features they want in a provider – e.g., how they prefer to pay, whether they want ongoing monitoring of the account, whether they want a one-time investment recommendation or ongoing portfolio management – and features they want to avoid, such as certain types of conflicts or disciplinary issues, and receive a list of possible candidates in their area. This would achieve the Commission’s stated goal of allowing easy comparisons across firms in a way that the Commission’s current proposal does not. The Commission should seek to ensure that its proposed disclosures are provided in a form that would support such an approach.

Electronic delivery: The Commission has proposed to allow firms to satisfy their disclosure obligations by delivering them electronically. We greatly appreciate that, in discussing this issue, the Release specifically references the obligation to provide “evidence to show delivery.”<sup>189</sup> This should help to clarify that firms could not meet the disclosure requirement simply by making the disclosures accessible on a public website and providing notice of their availability, under an “access equals delivery” model, as industry has requested. We also support allowing firms to deliver the relationship summary “in a manner that is consistent with how the retail investor requested information about the firm or financial professional,” as long as the delivery method in question allows for actual delivery of the written disclosure document and as long as the investor has not specifically requested receiving the information through a different delivery method. In other words, delivery of a message that includes a hyperlink or URL that would take the investor directly to the disclosure document would clearly satisfy this standard, as long as the investor had not specifically requested to receive the information through the mail. A text indicating the document is available on the website, without a URL or hyperlink, would not. We also agree that brokerage and advisory firms that offer only online account openings and transactions should be able to make global consent to electronic delivery a condition of account opening, for purposes of delivering the relationship summary. Finally, we appreciate that the Commission has taken the position that, with respect to existing clients or customers, firms would be required to deliver Form CRS “in a manner consistent with the firm’s existing

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<sup>187</sup> From CRS Release at 138.

<sup>188</sup> *Id.*

<sup>189</sup> From CRS Release at 144.

arrangement with that client or customer,”<sup>190</sup> which should reflect the customer’s delivery preference.

While we appreciate these features of the Commission’s proposed filing and delivery requirements, they are overshadowed by problems with the timing of the initial disclosures, discussed above, and problems with the presentation and format of the disclosures, discussed below. These other aspects of the proposal must be fixed if the goal is informed investor decision-making.

3. The format and presentation of the Form CRS disclosures ignores basic principles of clear and effective disclosure, reducing the likelihood that the disclosures will be read and understood.

In developing the format and presentation of the Form CRS disclosures, the Commission starts with a series of sound principles. It proposes to keep the document short on the grounds that doing so “would help retail investors, many of whom may not be sophisticated in legal or financial matters, to understand the information in the relationship summary.”<sup>191</sup> It proposes to require firms to present the required information under prescribed headings and in the same order in order to promote comparison across firms, “promote consistency of information presented to investors,” and allow retail investors to focus on information the Commission believes “would be particularly helpful in deciding among firms.”<sup>192</sup> It proposes to require firms to “use ‘plain language’ principles for the organization, wording, and design of the entire relationship summary, taking into consideration retail investors’ level of financial sophistication.”<sup>193</sup> It proposes to allow for both paper and electronic formatting of the document and seeks input on how to incorporate the relationship summary within a layered approach to disclosure.<sup>194</sup>

We support all these requirements. Moreover, we believe the Commission has identified the appropriate topics for inclusion in a relationship summary. And we appreciate that the Commission has provided mock-ups of the proposed forms to aid in assessing the proposals. Because, more than anything else, those mock-ups demonstrate how good principles don’t necessarily result in good disclosures. For example, in the interest of ensuring that the Form CRS is “as short as practicable” and that it covers key topics investors need to understand when choosing a financial professional, the Commission proposes to cram a discussion of five meaty topics, along with an introduction and a list of questions for investors to ask the firm’s financial professionals, into no more than four pages. The result is a dense and difficult-to-read document, particularly for dual registrant firms, that seems destined to turn people off. Similarly, what a group of securities law experts view as plain language does not necessarily match what typical investors are likely to view as plain language, resulting in disclosures that are unlikely to be understood by those who need the information most. That is why it is so important for the Commission not just to engage in usability testing of the disclosure, but also to work with disclosure design experts to improve the formatting and presentation of those disclosures.

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<sup>190</sup> From CRS Release at 145.

<sup>191</sup> Form CRS Release at 17-18.

<sup>192</sup> Form CRS Release at 23.

<sup>193</sup> Form CRS Release at 18-19.

<sup>194</sup> Form CRS Release at 19-20.

a. Form CRS needs a complete design makeover.

While we do not purport to be disclosure design experts, the following comments represent our initial views on changes the Commission should consider to improve the disclosures. Our suggestions are premised on the expectation that, before it finalizes a disclosure rule, the Commission will test these and other changes it may consider to ensure that they would have the intended beneficial effect of improving the readability of Form CRS and, thus, increase the likelihood that investors could use the form to make an informed choice among different types of providers and different types of accounts. In the following section of this letter, we also suggest changes to the content of the proposed disclosures that we believe would make them easier to understand for financially unsophisticated investors.

In her presentation to the SEC IAC in June, disclosure design expert Susan Kleimann discussed four principles that could be used to improve the Form CRS disclosures. The first is to recognize that people typically skim documents “looking for answers to questions.” Kleimann suggested that Form CRS could be improved by refashioning the questions at the end of the document into headings that would guide the reader through the document. The form would end up disclosing essentially the same information, but with a very different impact on the reader, she said. When the document is “focused around the consumer and the questions the consumer has,” that helps the consumer “to feel, ‘this document is there for me.’ If that were the only change that were made to this disclosure, it would be a far more powerful disclosure and would potentially encourage the consumer to read this disclosure as opposed to maybe not read it,” she said.

We urge the Commission to adopt this question-and-answer format. Possible questions might include: What services do you offer? (For dual registrants: What are the key differences in those services? How do I know which type of account is best for me?) What is your legal obligation to me? What conflicts of interest do you have that could bias your recommendations? How will I pay for your services? How can I find out more about my actual costs? Have you or your firm ever had disciplinary problems? Where can I find additional information about those disciplinary problems? Here again, however, we encourage the Commission to work with disclosure experts to determine the right way to frame these questions to increase the likelihood that the investor will understand why the information could be important to them.

Kleimann also warned that the disclosure design needs to take people’s short attention spans into account. “We have this concept of cognitive fluency,” she explained, “which means that when we look at something and it doesn’t look like we should read it, it looks hard, we go, ‘maybe I won’t.’ And so, it is our obligation as designers of disclosures to make the reader want to read it.” Framing the disclosure around questions could help make it more inviting, and it is also important to keep sentences short and coherent, Kleimann said. But she said it is even more important to “build context, because we can have words that are simple, we can have sentences that are simple, but we have to have context because what we’re trying to get the reader to do is to understand implications. And you can have simple words and simple sentences but if we don’t give them some context, we’re not going to help them build to understanding the implications.”

As we discuss in greater detail in the following section on the disclosure content, we believe one of the most serious shortcomings in the proposed disclosures is their failure to provide that context and, thus, their failure to make clear to investors why they should care about the information being disclosed. Some of that can be fixed by adjusting the order of the disclosures. In particular, we agree with Kleimann that it is important that information about the broker or adviser's legal duty is juxtaposed with information about their conflicts. Understanding the nature and extent of conflicts should help the investor to understand why they should care about the financial professional's legal obligations. We also believe that the introduction can and should be rewritten to put the entire topic into context and better convey the implications of the information being provided, as we discuss in greater detail below.

Kleimann's third principle is that design matters. In our view, the Form CRS disclosures are a design disaster – dense, cluttered, and visually off-putting, particularly for dual registrant firms. This is probably the easiest problem with the Form CRS disclosures for the Commission to fix, by working with a design expert, which we strongly encourage. Finally, Kleimann emphasized the importance of testing, which, as we discuss above, we agree is critical. Testing is important to determine “performance,” not “preference,” she said. “You want to test that [investors] can understand it. So, when you're doing this kind of testing, you're not doing focus groups. You're doing cognitive usability testing.” The goal is to determine whether investors can answer basic questions that show they understand the information presented in the document, can “synthesize information,” and can “articulate rational reasons for why they make a choice” based on that information.

Before it can reasonably conclude that its proposed disclosures will, in fact, support informed investor decisions regarding the type of investment professional and account that is best for them, the Commission must conduct this type of cognitive usability testing, incorporate the findings of that testing into a revised disclosure document, and test again (and perhaps several times) to ensure the changes adopted had the intended effect of improving investor understanding. We are encouraged that Kleimann said she thinks it is possible to develop clear and understandable Form CRS disclosures, but this document as currently conceived falls far short of meeting that goal.

b. Additional issues related to format and presentation.

Cross-References: One of the Commission's stated aims in proposing to keep the document brief is that it would “facilitate a layered approach to disclosure in which firms would include certain information in the relationship summary, along with references and links to other disclosure where interested investors can find additional information.”<sup>195</sup> In keeping with that approach, firms would be required to “include cross-references to where investors could find additional information, such as in the Form ADV Part 2 brochure and brochure supplement for investment advisers or on the firm's website or in the account opening agreement for broker-dealers.”<sup>196</sup> As part of its usability testing, the Commission should seek to determine the extent to which investors are willing to take advantage of those cross references, and the hyperlinks in an electronic version of the document, to explore issues in greater detail. This is particularly

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<sup>195</sup> Form CRS Release at 20.

<sup>196</sup> Form CRS Release at 20, footnote 48.



important with regard to issues, such as costs, conflicts, and disciplinary history, where firms will have a strong incentive to minimize and sugarcoat the information they include in Form CRS.

Similarly, the Commission assumes that investors are likely to use the document to “seek additional information in other ways, including through suggested questions for retail investors to ask their financial professional.”<sup>197</sup> A focus group conducted by AARP and the CFP Board and presented to the SEC IAC at its December 7, 2017 meeting, raised serious questions about the validity of that assumption. Focus group participants indicated almost no willingness to ask further questions of someone they had already engaged. This experience suggests that the Commission should seek to better understand investors’ likely behavior in this regard before finalizing its proposal. If, as we suspect, a significant percentage of investors would be unlikely to use the provided questions to gain more information, the Commission would need to carefully consider whether there are any issues raised in those questions that ought to be directly addressed in the disclosure document itself. And it should reconsider whether to devote so much of the document’s limited space to those questions.

Combined Form for Dual Registrants: The Commission seeks comment on its proposal to require dual registrant firms to discuss all of the firm’s advisory and brokerage services in one summary document. We initially found the idea of separate forms attractive, because of its potential to reduce the clutter of the dual registrant forms and provide information that is more specific and less generic. However, we are persuaded that our instinctive reaction in support of independent documents may be misguided. In response to a question on precisely that point, Kleimann told the IAC that one of the things her firm has seen when it has tested disclosures “is that consumers do need to be able to see the whole as well as the part.” If they only see information on one option, they are likely to choose that option, she said, and they can’t be relied on to look for information on the other options. It is, therefore, important that investors “see what the other option is” in order to make an informed choice. So, here again, we suggest that the Commission both consult with disclosure design experts and test the different options to see which is most likely to result in an informed investor choice. A different approach would be to supplement the Form CRS disclosure that covers both types of accounts, but in a somewhat generic fashion, with individual fact sheets for each account type that contains information that is less hypothetical and generic. But that would come with considerable additional costs, so it would only be an attractive option if it also was shown, through testing, to provide considerable additional benefits.

Definition of Retail Investor: The Commission proposes to require that Form CRS be provided to retail investors, which it defines as all natural persons. It requests comment on whether the disclosure obligation should be expanded to include certain other types of investors, “such as individuals representing sole proprietorships or other small businesses, or institutional investors that are not natural persons, including workplace retirement plans and funds,” or narrowed to exclude “certain categories of natural persons based on their net worth or income level, such as accredited investors, qualified clients, or qualified purchasers?” CFA would strongly oppose narrowing the definition to exclude groups, like accredited investors, where net worth and income has been used as a flawed and inaccurate proxy for financial sophistication. In

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<sup>197</sup> Form CRS Release at 21.

our experience, even investors that would be deemed financially sophisticated by any reasonable measure often struggle to distinguish brokers from advisers and do not fully understand the different legal standards that apply. On the other hand, we encourage the Commission to conform the definition of retail investor to the definition of retail customer as proposed in Reg BI. Investors who need the protections of a best interest standard would likely also benefit from improved disclosures regarding service providers.

**B. Form CRS focuses on the right topics, but its discussion of those topics fails to provide the clear, straightforward information investors need.**

The Commission has, in our view, done a good job of identifying the key topics that should be included in a brief relationship summary. But that is where the positive news about Form CRS ends. In each case, the proposed discussion of the topic fails to draw the clear distinctions or force the clear discussions needed to truly inform investors. The proposed language throughout is generic, vague, and technical, assuming at every turn that investors have knowledge that testing indicates most lack. In some cases, the problem seems to go deeper. The Commission appears reluctant to require broker-dealers, in particular, to provide a clear, unvarnished picture of sales-focused nature of their business model, and the conflicts of interest present in that model, perhaps out of fear that doing so might turn off investors.

In other words, Form CRS reflects that same fundamental problem that pervades this entire regulatory package: a reluctance on the part of the Commission to acknowledge that there is a meaningful difference between sales recommendations and advice or a problem, beyond investor confusion, that needs to be solved. It is this same reluctance that has made the Commission a willing partner in brokers' decades-long campaign to erase the distinction between brokers and advisers and a reluctant regulator when it comes to reining in conflicts that are the source of so much investor harm. Unless and until the Commission overcomes this reluctance, it will not be able to adopt a standard of conduct that matches investors' reasonable expectations, nor will it be able to design a disclosure document that supports an informed decision between different types of providers and different types of accounts. Indeed, unless the Commission is willing to strengthen its interpretation of both brokers' obligations under Reg BI and investment advisers' obligations under the Advisers Act, some of the proposed disclosures would be misleading, leading investors to expect protections that the Commission has so far been unwilling to provide.

The following are our specific suggestions for how the content of the document could be improved. As with our suggestions regarding disclosure design and presentation, these reflect our preliminary recommendations, which may evolve based on the results of our own usability testing and the testing we understand the Commission is conducting. And we urge the Commission to engage an independent disclosure expert to assist in revising the content of the document. Specifically, we urge the Commission to work with an expert to conduct cognitive usability testing to hone the messages so that they clearly convey the key information in a way that financially unsophisticated investors are most likely to understand. That testing should be designed to determine whether investors can use the disclosures to understand key differences between the services offered by brokers and advisers, relate that information to their own

situation, and make a rational, informed choice regarding which type of account is the best match for them.

1. The proposed introduction and description of services need to be completely revised.

Form CRS gets off to a poor start, with an introduction and a section on relationship and services that, between them, fail to clearly convey basic information about the differences between services offered by broker-dealers, investment advisers, and dual registrants in a way that average investors would be expected to understand. Indeed, the introduction *requires* firms to use language to describe their services that the Commission's own previous testing indicates many investors find confusing or uninformative. Its required description of the document's content fails to highlight important issues related to conflicts of interest and legal obligations, missing an opportunity to focus investors' attention on important issues they might otherwise fail to consider. If the Commission truly wants investors to be able to make an informed choice based on these disclosures, these sections must be completely rewritten and reconfigured.

- a. The introduction needs to be rewritten to provide more insight into the types of choices investors have and to engender more eagerness to read the disclosures.

Problems with Form CRS start with the first few lines: "There are different ways you can get help with your investments. You should carefully consider which types of accounts and services are right for you."<sup>198</sup> This bland and content-free statement fails to create any sense of urgency on the part of the investor to review the document. It also fails to provide any insight into what the various options are for "getting help with your investments," let alone how those options differ or why the investor should care. The subsequent statement about the purpose of the document – "This document gives you a summary of the types of services we provide and how you pay" – exacerbates the problem by failing to highlight important issues related to conflicts of interest and legal obligations that, effectively communicated, could help to alert investors to the fact that there is information here they need to pay attention to.<sup>199</sup>

If the Commission is going to overcome investors' general reluctance to read disclosure documents, it needs to do a better job at the outset of grabbing investors' attention and showing how the document can be useful to them. We think this is best achieved by highlighting the ways in which accounts can differ, in terms of: the type and amount of assistance the investor will receive (e.g., episodic sales recommendations versus ongoing portfolio management versus financial planning, etc.); who will bear responsibility for monitoring the account to ensure that investments continue to serve the customer's needs; the costs of the services and how the investor pays; what conflicts of interest could influence recommendations; and what legal

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<sup>198</sup> Form CRS Release at 34.

<sup>199</sup> When Siegel & Gale, LLC conducted focus groups on behalf of the Commission in 2005 to test investor reactions to its proposed disclosure for fee-based brokerage accounts, they found that: "Terms such as *duties*, *rights*, and *obligations* increased the perceived importance of the statement. These terms in part 'raised red flags' and would prompt investors to ask questions." Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005, <https://bit.ly/1MkdujW> ("Siegel & Gale Study").

obligation the firm and its employees owe to the investors. Obviously, we are not proposing that the introduction discuss any of these issues in any depth, simply highlight them as examples of the factors that will determine whether one type of account or provider is the better match for the investor. The introduction could then conclude with a statement along the following lines: “This document discusses each of these issues. It is designed to help you determine whether our services are right for you.”

Such an approach would be more consistent than the Commission’s own proposed introductory language with the Release’s stated goal for the introductory paragraph, which it says is to set up “a key theme of the relationship summary – helping retail investors to understand and make choices among account types and services.”<sup>200</sup> In discussing its proposed approach, the Release provides a few examples of areas in which investor preferences and account options differ: “For example, some retail investors want to receive periodic recommendations while others prefer ongoing advice and monitoring. Some retail investors wish to pursue their own investment ideas and direct their own transactions, while others seek to delegate investment discretion to the firm.”<sup>201</sup> We certainly agree that, “Emphasizing that there are different types of accounts and services from which a retail investor may choose would help the retail investor make an informed choice about whether the firm provides services that are the right fit for his or her needs and help the retail investor to choose the right firm or account type.”<sup>202</sup> In fact, however, the Release does a far better job than the disclosure itself in emphasizing this point, even with its limited array of examples. As a result, we cannot agree with the Commission’s conclusion that the proposed disclosures, as “intentionally simplified and generalized” as they are, “would help retail investors to obtain more detailed information.”<sup>203</sup>

In proposing a more specific discussion of the types of choices investors have before them, our hope is that, if we illustrate up-front how much investors have riding on their selection of providers, they might be more willing to take the time to read the disclosure in order to better understand their options. However, as with all our recommendations in this section, we do not purport to be disclosure experts. We urge the Commission to work with a disclosure specialist to recast the introduction to achieve that result.

b. A new section should be added, “What services do you offer?”

We propose following the revised introduction with a new paragraph titled, “What services do you offer?”<sup>204</sup> Its purpose would be to begin to answer the questions set up in the introduction with more detailed information. As such, it would incorporate some of the information from the current introduction, as well as some of the information from the proposed Relationships and Services section. But we believe it also needs to include a much clearer and more descriptive explanation of the nature of those services. Our latter point is consistent with

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<sup>200</sup> Form CRS Release at 35.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> We weren’t sure whether it made more sense to ask these questions from the investor’s point of view (What services do you offer?) or the firm’s (What services do we offer?). We view this as the type of question disclosure experts can answer. For the purposes of consistency, we have framed all of our suggested new subheads as questions posed from the investor’s point of view.

previous research conducted on behalf of Commission when it was testing a proposed disclosure for fee-based brokerage accounts.

In 2005, Siegel & Gale, LLC conducted focus groups to test a brief disclosure that began with a statement that is virtually identical to the required statement in the introduction to Form CRS: “Your account is a brokerage account and not an advisory account...”<sup>205</sup> When Siegel & Gale asked investors for their reaction, they reported that, “In general, investors found the statement communicates that differences might exist, but did not do enough to explain those distinctions.”<sup>206</sup> Because the statement was viewed as lacking sufficient detail, “investors were confused as to the differences between accounts and the implications of those differences to their investment choices.”<sup>207</sup> An area of particular concern for focus group participants was that the proposed disclosure did not include any definition of the actual differences between brokerage and advisory accounts.<sup>208</sup> And one of the focus group participants’ suggested changes was to “specify the actual differences between *brokerage accounts* and *advisory accounts*.”<sup>209</sup> (emphasis in original)

We believe the Commission should learn from its past research and require firms to be crystal clear about the nature of the services they offer. Simply telling them that the account is a brokerage account or an advisory account doesn’t necessarily convey useful information. We appreciate that the Commission has sought to provide more details with its section on Relationships and Services. The Release states, for example, that, “Each firm would discuss specific information about the nature, scope, and duration of its relationships and services, including the types of accounts and services the firm offers, how often it offers investment advice, and whether the firm monitors the account.”<sup>210</sup> But it fails to include a clear and simple definition of brokerage account or advisory account. The mock-ups provided by the Commission fail to provide the necessary clarity or precision and fail to follow a logical order in how they present the information they do include. Moreover, there’s reason to believe that, without better guidance from the Commission, many firms’ descriptions will be considerably less informative.<sup>211</sup>

Our preliminary view is that this section should start with a clearer definition of what a brokerage account or advisory account is and what services are included in that account. In their 5th Circuit challenge to the DOL rule, industry groups described the “distinction between selling products and giving advice that has been fundamental to the securities laws for nearly 80

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<sup>205</sup> Siegel & Gale Study.

<sup>206</sup> *Id.* at 4.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> Form CRS Release at 36.

<sup>211</sup> The draft alternative approach to Form CRS presented by Joe Carberry, Senior Vice President, Head of Corporate Communications, for The Charles Schwab Corporation at the June 2018 meeting of the SEC’s Investor Advisory Panel, fails to include any discussion of the account features, perhaps assuming (mistakenly in our view) that these are well understood by investors. And, when it comes to disclosure, Schwab can be expected to do a far better job than many other firms. Disclosures from small firms without a compliance department or in-house disclosure experts, and particularly those with a business model built on the sale of high-cost annuities, non-traded REITs and private investments, are likely to be particularly problematic. <https://bit.ly/2Od62uF>.

years.”<sup>212</sup> It is that distinction that the Form CRS disclosures should make clear. To achieve that, the Commission needs to add an initial definition of a brokerage account as a sales account. And each of the key statements the Commission proposes to include needs to be sharpened and clarified. For a brokerage account, the description might read something like this:

We offer brokerage accounts. These are sales accounts in which you can buy and sell investments, such as stocks, bonds and mutual funds. We will recommend investments that we believe are appropriate for you. We will also execute transactions that you direct us to make. In either case, the ultimate decision about whether to make the investment will be yours.

This is not an advisory account. We do not provide ongoing management of your investments. You will bear the responsibility for monitoring your investments to ensure that they continue to be appropriate for your needs and perform as expected. We will provide you with quarterly account statements that you can use to monitor your investments.

This covers the key issues related to services offered that the Commission highlights in the Release as likely to be of interest to investors, and does so in a logical order. There’s room for variation based on differences in brokers’ business models. For example, brokers who offer goals-based recommendations, for example, might state, in place of the second sentence above, something along the following lines: “We will work with you to identify your goals and recommend investments that we believe are appropriate for you.” However, if they do not provide ongoing account monitoring, they should have to clearly disclose that they do not monitor the account to ensure that the investor remains on track to achieve their goals. The key is to ensure that the description accurately portrays the sales-based nature of the firm’s services, including what they do, and do not, provide.

Our proposed description also assumes that the Commission fails to fix its highly problematic approach to ongoing duty under Reg BI, discussed in detail above. If this is the case, firms that voluntarily decide to provide some degree of ongoing monitoring should be permitted to substitute a statement that accurately describes those services. It might read, for example: “We do not provide ongoing management of your investments. However, we will review your account at least once a year to determine whether your investments continue to be appropriate for your needs and perform as expected.” Commission officials have suggested that some firms may choose to offer such monitoring as an option, for which they would charge an additional fee.<sup>213</sup> In such cases, they might state: “We do not provide ongoing account management. If you want us to monitor your account, we can provide that service for an additional cost. Otherwise, you will bear the responsibility for monitoring your investments to ensure that they continue to be appropriate for your needs and perform as expected.”

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<sup>212</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 14, <http://bit.ly/2f4wVBW>.

<sup>213</sup> The Commission would need to consider whether charging a fee to provide monitoring would constitute special compensation for advice that would preclude brokers from relying on their exclusion from the Advisers Act.

For advisory accounts, there may be more variation in the description, depending on whether the adviser exercises discretion, provides only ongoing portfolio management or also provides one-time advice, or whether they provide their advice as part of a financial planning practice. But a typical description of an adviser that offers portfolio management might read something like this:

We offer advisory accounts in which we manage your investments for you. We will work with you to identify your investment goals, develop a strategy to achieve those goals, and make the investments to implement that strategy.

You can choose a discretionary account, in which you delegate responsibility to us to make all the investment decisions and buy and sell investments in your account without first consulting you. Or you can open a non-discretionary account, in which we will consult with you and seek consent from you for every investment decision.

Regardless of which type of account you choose, we will continuously monitor your account to ensure that your investments continue to perform as intended and continue to be appropriate for you needs. We will provide quarterly account statements and meet with you either in person or by phone once a year to review your account.

This represents just one advisory business model, albeit one that we understand is fairly common among federally registered investment advisers. A financial planning firm that also offers portfolio management would describe their services somewhat differently. They might state, for example: “We offer financial planning services. We provide advice about the full range of your financial needs, including tax management, retirement planning, and insurance needs. We will work with you to identify your financial goals, develop a strategy to achieve those goals, and implement that strategy. As part of our implementation of your financial plan, we will make investments on your behalf and manage those investments.” A financial planning firm that offers limited engagements or one that is dually registered and sells investments to implement its recommendations would describe their services differently still. Again, the key is to ensure that the descriptions are accurate and informative.

Under our proposed approach, dual registrants would be required to briefly describe the various options they offer, which could include more than one type of brokerage account, more than one type of advisory account, and more than one option for combining those services. We recognize that this poses challenges for developing concise disclosures, but we believe this type of specificity is needed to make the information useful to investors in choosing among different providers. As always, we defer to the disclosure experts and the results of usability testing to determine whether our assumptions in this regard are valid.

The Commission proposes to require that brokers and investment advisers that significantly limit the types of investments that they make available to retail investors to make the following disclosure: “We offer a limited selection of investments. Other firms could offer a wider range of choices, some of which might have lower costs.”<sup>214</sup> While we agree that this is an important issue for investors to consider, we fear the proposed disclosure provides too little

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<sup>214</sup> Form CRS Release at 39.

information to be of value to the investor. Moreover, as we discuss below in the legal analysis, requiring firms to compare their own services unfavorably to those of their competitors may raise First Amendment concerns.<sup>215</sup> To make the information more useful, the firms should have to describe how they limit the selection of investments. “We offer only mutual funds. We do not offer individual stocks or bonds or other types of investments.” “We offer only investments managed by our parent company.” “We offer only annuities. We do not offer mutual funds, individual stocks or bonds.” We believe this approach would better ensure that investors understand these limitations when selecting a provider or account type.

Finally, unlike the Commission’s proposed approach, our proposal does not include a description of how the customer pays in this section. While we appreciate the Commission’s intent to highlight this information, we believe that is better accomplished by including it under a separate heading, “How will I pay for your services?” We describe that proposed approach below.

2. Form CRS should include a new section titled, “How will I pay for your services?”

We agree with the Commission that it is important to highlight how firms charge for their services. Not only is this an issue that is likely to influence choices investors make about the type of account that best meets their needs, it is also an area where investors display a woeful lack of knowledge. Although the percentage of investors who understand how they pay for investment services appears to have improved over the last decade, recent research nonetheless indicates that 44% of investors remain in the dark on this important topic.<sup>216</sup> This suggests that many financial professionals are less than transparent on this key point.

We believe the best way to highlight this issue of how investors pay for investment advice and sales recommendations is to give it its own heading. We preliminarily believe this section should come immediately after the section describing the firm’s services. We think the topic follows naturally out of the previous section. We also believe the sections on standard of conduct and conflicts of interest need to be juxtaposed. Our choice, then, is between putting the information on how the customer pays before or after those two sections, and we are inclined to think putting it first works best. As always, however, we would be receptive to a different order, if usability testing were to show that a different order was called for.

This section should start with a statement, along the lines of that proposed by the Commission for inclusion at the start of the relationship and services section. Brokers would state: “If you open a brokerage account, you will pay us a sales charge, generally referred to as a commission or sales load, every time you buy or sell an investment.”<sup>217</sup> And investment advisers would provide a similar statement describing their fee model, whether percentage of assets under management, hourly fee, or engagement fee. It is important for the Commission to test these

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<sup>215</sup> See *infra* Section V.D.

<sup>216</sup> Danielle Andrus, *Investors Increasingly Willing to Pay for Financial Advice: Cerulli*, Think Advisor, January 5, 2017, <https://bit.ly/2LOD0F3>.

<sup>217</sup> Form CRS Release at 37.



statements to ensure that they are well understood by investors. And it should work with disclosure experts to improve the clarity of the descriptions if they are not.

This section would also include additional information, along the lines of the information the Commission has proposed to include in the section of Fees and Costs. We propose starting by describing the fees and costs associated with the firm's services to the customer and following that with additional information on product related costs. We would also provide less information than the Commission proposes about what the different kinds of transaction fees are called. In reviewing the disclosures, we found that discussion unnecessarily technical, without adding significantly to the key information investors need to understand about how they pay and how the broker gets compensated. For a broker, the description might look something like this:

If you open a brokerage account with us, you will pay us a sales charge, generally referred to as a commission or sales load, every time you buy or sell an investment. The amount that you pay, and the amount we get paid, will vary depending on how often you trade, the size of your investments, and what type of investment product you purchase.

We also charge certain account fees in addition to what you pay when you buy or sell investments. These include [fill in examples of the most significant fees, e.g., account maintenance fees, account inactivity fees, and custody fees.] [Electronic versions should include a link to the firm's complete fee table. Paper documents should inform the investor of where they can find more complete information.]

Some investments, such as mutual funds, annuities, and ETFs, also charge you ongoing fees to cover the costs of operating the funds. Those fees are subtracted directly from your investments and reduce the value of those investments. Typically, those charges go directly to the fund company, but we also receive a portion of that money in the form of an ongoing payment, sometimes referred to as a 12b-1 fee, for as long as you hold the investment. In addition, some investments we sell, such as variable annuities, charge a surrender fee if you sell the investment early.

We propose adopting a similar approach for investment advisers, focusing first on their basic method of compensation, then on additional fees, if any, that might be paid for the operation of the account, and then on costs associated with investments purchased in the account. So, for a portfolio manager that charges an AUM fee, it might start: "If you open an advisory account with us, you will pay us a percentage of the money we manage for you, generally referred to as an asset-based fee. These asset-based fees are paid directly from your account on a quarterly basis and reduce the value of your account. The amount you pay, and the amount we get paid, will vary depending on how much money you invest with us." In addition, the adviser disclosure might state: "Some investments that we invest in on your behalf, such as mutual funds and ETFs, also charge you ongoing fees to cover the costs of operating the funds. Those fees are subtracted directly from your investments and reduce the value of those investments." If the adviser receives 12b-1 fees or revenue sharing payments on top of their asset-based fee, they should be required to include a statement similar to the one we suggested above for brokers.

Here again, providing this kind of information for the various options available for dual registrants is likely to be considerably more complex. That complexity is not reflected in the binary approach to disclosure the Commission has proposed to adopt for these firms, based on the false assumption that their services are likely to be cleanly divided between brokerage and advisory accounts. The Commission should work with dual registrant firms with various different business models to identify representative scenarios, develop disclosures based on those scenarios, then subject them to cognitive usability testing to determine whether they convey the key information about costs and fees in a way that average investors are likely to understand.

The Commission proposes to require brokers and advisers alike to include a statement in the costs and fees section describing conflicts of interest that arise out of their payment method. We believe this is important information, but that it is more appropriately included in a section on conflicts of interest. Moreover, while not all conflicts of interest in a particular business model will arise out of the firm's compensation practices, many of them do. We, therefore, preliminarily believe that the section on conflicts of interest should follow directly after the section on compensation.

We are concerned, however, that the result of our proposed ordering of disclosure items is that the information on standard of conduct would come toward the end of the document. This is of particular concern if, against our recommendation, the Commission insists on adopting a regulatory approach that maintains different standards for brokers and advisers. The Commission should engage in usability testing to determine whether this ordering causes investors to underrate the importance of the differing standards of care that apply to brokers and advisers. Conversely, it may be that providing the information regarding standard of conduct immediately after the sections on compensation and conflicts helps the investor to understand the information's relevance. The results of usability testing would strongly influence our views on this topic.

3. The proposed approach to disclosing conflicts does too little to alert investors to the importance of conflicts and should be completely revised.

As the Commission itself acknowledges, conflicts of interest are at the root of much investor harm. As such, a document designed to help investors make an informed choice among providers and accounts should clearly describe the nature of conflicts of interest present in the disclosing firm's business model. The disclosure should also make clear why the investor needs to be concerned about conflicts, which is that they could cause the broker or adviser to act in ways that are not in the investor's best interests. Moreover, because the extent of conflicts varies greatly not just between brokers and advisers, but between firms of the same type, the disclosures should be designed to do more than give investors a high level understanding of the different types of conflicts likely to be present in a "typical" brokerage or advisory firm. They should be designed to help the investor determine the nature and extent of conflicts present in a particular firm's business model. The Commission's proposed disclosures are completely inadequate to that task, and as such are all but useless in helping investors make an informed choice related to conflicts of interest.

The Commission's proposed conflict disclosures start with a meaningless statement that all firms would be required to make: "We benefit from our recommendations to you" for brokers or "We benefit from the advisory services we provide to you" for investment advisers.<sup>218</sup> This tells investors absolutely nothing that they don't already know. After all, even the most financially unsophisticated of investors presumably understands that broker-dealers and investment advisers are in business and, therefore, expect to benefit financially from the services they provide. The relevant point, as the Commission surely knows, isn't that the broker or adviser benefits from providing the service, but that they have interests that conflict with the investor's interests and that they benefit from taking actions that are not in the customer's best interests. Form CRS needs to make that clear. We therefore urge the Commission to work with disclosure experts to develop an introductory statement about conflicts of interest that clearly conveys, as the Commission's proposed language does not, why the investor needs to be concerned about this issue.

Problems with the Commission's proposed approach to conflict disclosure don't stop with the introduction. Under the Commission's proposed approach, information on the basic conflict related to the compensation model would be provided in the cost section, rather than the conflict section. This raises the concern that investors who skim the disclosure specifically looking for information on conflicts may overlook that information. Moreover, by focusing disclosures on the issues the Commission has decided are important, rather than those most relevant to the firm in question, Form CRS is likely to inadequately address the conflicts that pose the greatest risk to the investor. Indeed, the Commission's failure even to discuss conflicts related to differential compensation all but guarantees that investors will get little if any useful information about the most pervasive conflict of interest in the broker-dealer business model, one with a proven record of investor harm. Finally, the Commission's proposed language describing those conflicts is so vague and generic that it fails to convey the extent of the conflict or to clearly explain how investors could be harmed as a result.

As a result, the Commission cannot reasonably assume that the required disclosures will enable investors to make an informed choice among providers and account types based on a clear understanding of the conflicts of interest they present. We, therefore, urge the Commission to work with disclosure experts to develop and test disclosures related to conflicts of interest to ensure that they effectively convey information about the nature and extent of the conflicts and their potentially harmful impact.

We preliminarily believe this is best achieved by: (1) starting with a much stronger introductory statement, one that clearly signals the importance of the topic; (2) following that with a description of the basic conflict inherent to that firm's compensation method; and (3) requiring firms to summarize the most significant conflicts present in their particular business model, with sufficient detail to make the nature of the conflict clear and with a clear statement regarding the incentive it creates. Under our proposed approach, the required conflict of interest disclosures for a brokerage firm might read something like this:

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<sup>218</sup> Form CRS Release at 105.

The firm and our associates have financial interests that do not align with yours. This section describes some of the key conflicts of interest present in our business model that create an incentive for us to act in ways that are not in your best interests.

Because we are paid through sales charges, we only get paid when you complete a transaction. We therefore have an incentive to encourage you to trade more frequently. This would generate higher costs for you.

The amount the firm and our representatives get paid varies depending on what investments we recommend. This amount can be as little as a few dollars for certain investments, such as individual stocks or ETFs, where we receive a set sales commission regardless of the amount of your investment. It can be much higher for a comparable investment in other products, such as mutual funds, variable annuities, or non-traded REITs, where the amount you pay, and the payment we receive, increases as the size of your investment goes up. We therefore have an incentive to recommend the products that pay us the most even if other options are available that would be better for you.

Some investments we recommend pay us a percentage of the investment, known as 12b-1 fees, for as long as you hold the investment. Others do not. We therefore have an incentive to recommend investments to pay us 12b-1 fees even if other options would be better for you or have lower costs.

[For firms that include proprietary products on the investment menus] We make more money when we recommend investments that are managed by us or our affiliates. We impose sales quotas on our representatives and pay them more to recommend these products. Your financial professional therefore has an incentive to recommend these in-house funds, even when other options are available that may have lower costs or better performance.

Some investment sponsors share a portion of their revenues with the firm while others do not. We pay our representatives more to recommend annuities and mutual funds [or whatever other investments this is relevant for] that make revenue sharing payments. Your financial professional therefore has an incentive to recommend investments that make revenue sharing payments to the firm, even when other options are available that have lower costs or better performance.

In addition to providing much clearer information about the nature and extent of conflicts, forcing firms to provide clear, unvarnished information about practices that create conflicts could create an incentive for them to abandon harmful practices. For example, firms may be less likely to impose sales quotas or pay bounties for recommending proprietary funds if they have to clearly disclose that practice. They might be more likely to adopt clean shares if it allows them to make more favorable statements about their compensation practices. As long as they can hide behind the kind of generic language proposed by the Commission in its Form CRS mock-ups, however, common conflicted practices are likely to continue unabated. We've already seen evidence of this in the ADV Form disclosures provided by large dual registrant firms that operate with a wide array of conflicts. Without usability testing to show that investors who read

the conflict disclosures come away with a clear understanding of the extent of those conflicts and their potential impact on the investor, the Commission cannot reasonably assume that the outcome will be any different for Form CRS just because it is shorter.

For advisers, the disclosure would vary based on the actual compensation model. For the majority of advisers who charge an asset-based fee, the introductory statement might read something like this: “Because we are paid based on a percentage of the amount of money you invest with us, we have an incentive not to recommend investments or actions that reduce the amount of money we manage directly.” Like brokers, they would then be required to clearly describe the key conflicts most relevant to their own business model. For dual registrants, the disclosures should reflect their actual business model and not simply assume that services are neatly divided between brokerage and advisory accounts. Also, it is imperative that the disclosures for dual registrants explain the incentive they have to recommend the type of account that is most profitable for the firm, and not just the conflicts specific to each business model. The failure to include this information is a glaring oversight in the Commission’s proposed approach.

4. The proposed disclosures regarding the standard of conduct that applies to brokers and advisers are uninformative and potentially misleading.

The Commission proposes to require firms to include a brief section, titled “Our Obligations to You,” which is designed to describe, using prescribed language, the legal standard of conduct that applies to the firm. The purpose of the disclosure, according to the Release, is to alleviate investor confusion regarding the legal standards that apply, “including the differences between the standards of care of broker-dealers and investment advisers.”<sup>219</sup> Unfortunately, the proposed disclosures fail to clarify these differences, differences that the Commission itself has failed to clearly articulate in its 408-page Release on Reg BI. Until the Commission defines the best interest standard under Reg BI, and clearly describes how it is similar to the Advisers Act fiduciary duty and how it differs, it will not be possible to develop a disclosure that clearly conveys those differences to investors. Specifically, the Commission should make clear whether the broker-dealer relationship is a relationship of trust and confidence or an arms-length sales relationship. This will allow investors to compare that with an investment adviser's fiduciary relationship of trust and confidence with their clients.

- a. The proposed disclosures do not clearly describe either the Reg BI best interest standard or the Advisers Act fiduciary standard as those standards are interpreted and enforced by the Commission.

The worst problem with the proposed disclosure regarding standard of conduct is not that the disclosures are unclear. Even more troubling is that the description the Commission proposes to require brokerage and advisory firms to provide regarding their legal obligations bears little resemblance to the Commission’s actual interpretation and application of those legal standards. The result is that investors are likely to be misled by these Form CRS disclosures into expecting legal protections the Commission appears unwilling to provide. Ideally, the Commission would revise its interpretation of Reg BI and the Advisers Act fiduciary duty to include a real best interest standard, backed by meaningful restrictions on conflicts, in order to ensure that both

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<sup>219</sup> Form CRS Release at 51.

standards live up to the proposed descriptions. (The previous section of this letter describes in detail how that could be accomplished.) However, if the Commission fails to strengthen the standards that apply to brokers and advisers, the least it should do is stop misrepresenting those standards to the investing public. That would require a complete rewrite of this section of Form CRS.

Under the Commission’s proposed approach, brokers would be required to state that they must “act in your best interest and not place our interests ahead of yours”<sup>220</sup> while investment advisers would be required to state that they “are held to a fiduciary standard.”<sup>221</sup> For years, however, the Commission, investor advocates, and personal finance writers have all equated a fiduciary duty with a best interest standard when describing investment advisers’ legal obligations to their clients. The result is that investors are unlikely to perceive any meaningful difference between a broker’s obligation to act in the customer’s best interests and an adviser’s fiduciary duty. Some may even believe that a best interest standard is the higher standard, as the word “best” implies. That misimpression is likely to be reinforced by the brokers’ statement that they must treat customers fairly, which has no corollary in the required disclosures for investment advisers. If the Commission retains this basic approach, it should counteract the misimpression that Reg BI is the higher standard by clarifying, as it does in the proposed Advisers Act Guidance, that a fiduciary duty is the “highest standard of conduct.”<sup>222</sup>

If the Commission intends these standards to be essentially the same in principle, as some have suggested, then it should describe them using the same terms. If the Commission intends these standards to be fundamentally different, in principle as well as application, it needs to be far clearer than it is here (or elsewhere in the Reg BI Release) about the nature of those differences. Ideally, the Commission would fix underlying problems in its interpretation of Reg BI and the Advisers Act fiduciary standard. Then it could require both brokers and advisers to provide disclosures that make clear that they are required to do what is best for the customer – brokers by recommending the best of the reasonably available investments and advisers in all aspects of the advisory relationship.

Unfortunately, that is not what either standard requires under the Commission’s proposed interpretation of those standards. For example, nowhere in Reg BI or the Release describing its requirements does the Commission make clear that brokers must recommend the investments, from among those they have reasonably available to recommend, that are the best match for the investor. Its interpretation of the situations in which brokers’ would be precluded from putting their own interests ahead of their customers’ interests is so narrow as to be all but meaningless. Under the Commission’s proposed interpretation of the Advisers Act fiduciary duty, it appears that the only aspect of an adviser’s obligations that couldn’t be disclosed away is the obligation to disclose. Describing either standard as a best interest standard is thus inherently misleading. Doing so will lead investors to expect protections that the standard does not in fact provide. Thus, if the Commission fails to strengthen its interpretation of the standards, it needs to require disclosures that more accurately reflect their actual requirements. Without further clarification of Reg BI, it is difficult to suggest revisions to make any differences clear to the investors.

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<sup>220</sup> Form CRS Release at 52.

<sup>221</sup> Form CRS Release at 54.

<sup>222</sup> IA Guidance at 3.

- b. The proposed disclosures do not adequately alert investors to the lack of an ongoing duty of care in brokerage accounts or its implication for investors.

Assuming that the Commission were to fix its interpretation of Reg BI and the Advisers Act fiduciary duty to actually require both types of financial professionals to do what is best for their customers consistent with their business models, the Commission would still need to clarify the episodic nature of brokers' best interest obligations. In its proposed descriptions of the different standards, the Commission attempts to highlight the distinction between brokers' obligations, which apply "when we recommend an investment or an investment strategy involving securities"<sup>223</sup> and advisers' obligations, which covers "our entire investment advisory relationship with you."<sup>224</sup> And, in order to further clarify this point, brokers would be required to state that, unless they agree otherwise, they are not required to monitor the investor's portfolio or investments on an ongoing basis.<sup>225</sup> We agree with the Commission that this is an important distinction for investors to understand, but we doubt investors will truly understand the episodic nature of brokers' best interest obligations based on this disclosure.

For investors who receive the disclosure for a stand-alone broker, the description is provided without any context that might cause investors to examine the issue closely. If the Commission wants investors to understand the transaction-by-transaction nature of brokers' "best interest" obligations, firms need to be required to state that much more clearly. For example, it might state: "We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities. Our obligation to act in your best interests applies only at the point of the recommendation. We do not have any obligation to monitor your account between recommendations. You will bear sole responsibility for monitoring your investments to determine whether they continue to perform as intended and continue to be suitable for your needs." Only if it describes the limitation on brokers' best interest obligations in this clear and unequivocal fashion can the Commission expect investors to understand the relevance of brokers' limited legal obligations to their choice of advisers.

There is at least a small chance that investors who receive the relationship summary for a dual registrant firm will notice the distinction that the Commission is intending to highlight with this disclosure. And it is even possible, though in our view unlikely, that they might be prompted to ask questions. But, even if you assume that the investor notices the difference and asks the financial professional about that difference, there is no guarantee that they will get a clear and straightforward answer to their question. In our experience, financial professionals can be extremely evasive, and in some cases outright deceptive, when talking about the nature of their legal obligations to clients. The Commission will have no way to monitor those discussions to ensure that they convey the information clearly and accurately. It should therefore ensure that the disclosures provide the necessary information in a way that minimizes the need for follow-up questions. We believe our proposed language better achieves that goal than the Commission's

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<sup>223</sup> Form CRS Release at 52.

<sup>224</sup> Form CRS Release at 54.

<sup>225</sup> Form CRS Release at 52-53.

proposed language. However, in this as in all matters related to the proposed disclosure, the Commission needs to conduct cognitive usability testing to determine what works best to convey the relevant information to investors.

- c. The proposed disclosures would give investors a misleading impression of what brokers and investment advisers are required to do to address conflicts of interest.

As discussed above, we are deeply concerned that the proposed disclosure will give investors an inaccurate view of the best interest standard for brokers and fiduciary duty for advisers. The inconsistency between the legal standards as interpreted by the Commission and as described in the disclosures is particularly glaring when describing firms' legal obligations with regard to conflicts. As part of their basic description of their legal obligations, brokers would be required to state that they "must not place our interests ahead of yours."<sup>226</sup> In addition, both brokers and investment advisers would be required to state that, "Our interests can conflict with your interests."<sup>227</sup> Brokers would be required to add, "When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them."<sup>228</sup> Investment advisers would be required to state, "We must eliminate these conflicts or tell you about them in a way you can understand, so that you can decide whether or not to agree to them."<sup>229</sup> The Commission states that it believes "this could help prompt a conversation between retail investors and their financial professionals about both the conflicts the firm and financial professional have and what steps the firm takes to reduce the conflicts."<sup>230</sup> We see no evidence to support that belief. Worse, experience tells us that, if those conversations do occur, firms are all too likely to sugarcoat practices with the potential to cause real harm to investors.

More fundamentally, however, the proposed disclosure encourages investors to believe that both brokerage and advisory firms are taking steps to eliminate conflicts. But this is rarely true, except in the case of fee-only investment advisers who are paid exclusively by the client and accept no third-party compensation in any form. The Commission's interpretation of the Advisers Act fiduciary duty makes clear that conflicts can and will continue to be addressed almost entirely through disclosure at many firms, making the statement that advisers are required to "eliminate" conflicts inherently misleading, particularly for dual registrant firms that bring many of the conflicts common in the broker-dealer business model into the advisory relationship.<sup>231</sup> Similarly, while Reg BI theoretically prohibits brokers from placing their interests ahead of the customer's interests, the Commission's interpretation of that language leaves ample room for conflicts to influence recommendations.<sup>232</sup> Its discussion of brokers' obligation to mitigate conflicts fails to make clear, as this language suggests, that those conflicts would have to be "reduced."<sup>233</sup> The Commission doesn't even interpret either standard as prohibiting investment firms from artificially creating incentives that encourage conduct that is

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<sup>226</sup> Form CRS Release at 52.

<sup>227</sup> Form CRS Release at 53-54.

<sup>228</sup> Form CRS Release at 53.

<sup>229</sup> Form CRS Release at 54-55.

<sup>230</sup> Form CRS Release at 53-54.

<sup>231</sup> See *supra* Section II.C.

<sup>232</sup> See *supra* Section II.B.2.

<sup>233</sup> See *supra* Section II.B.2.f.



not in investors' best interests, as long as they disclose and, in the case of brokers, "mitigate" those incentives. As a result, this language creates an exaggerated view of what the standards actually require, and an even more misleading picture of how firms are likely to respond to that standard.

- d. Disclosures should be based on firms' actual conflict management practices rather than the standards' theoretical requirements.

Given the gap between theory and practice, we believe investors would be better served by disclosures that actually reflect what firms do, rather than what the standard theoretically requires. Under this approach, a firm that actually takes steps to minimize conflicts could highlight those steps. But firms that deal with conflicts exclusively or primarily through disclosure and consent should be required to state that fact. For example, an investment adviser that accepts no third-party payments could state, "Our interests can conflict with yours. We seek to minimize those conflicts. We do not accept any third-party payments and we do not have a direct interest in any of the investment products we recommend. As a result, our compensation does not vary depending on what investments we recommend and we do not have an incentive to recommend one product over another." They could then add something along the following lines: "When conflicts of interest do arise, we will tell you about them in a way you can understand, so that you can decide whether or not to agree to them." The key would be to ensure that the statements are accurate and not misleading.

Similarly, a broker-dealer that levelizes compensation across different products, doesn't accept revenue sharing payments, doesn't sell proprietary products, and doesn't offer sales contests could highlight these as steps it takes to minimize conflicts. But a broker that fails to take any or all of these steps shouldn't be allowed to include the obligation to eliminate conflicts in its description of its legal obligations with regard to conflicts, since that statement, even if theoretically correct, is likely to be misunderstood by investors. Instead, it should be required to disclose that it is required to disclose, and in some cases take steps to reduce, conflicts of interest that could influence its recommendations. Our suggested approach would have the added benefit, absent under the Commission's proposed approach, of encouraging firms to rein in conflicts of interest in order to place their practices in a more favorable light.

As we have indicated repeatedly throughout this section on the proposed Form CRS disclosures, we believe it is essential for the Commission to work with disclosure experts to test both its own proposed language and suggested alternatives to see whether they achieve the desired clarity. The disclosures should be evaluated based on whether financially unsophisticated investors are able to understand what protections the standards actually provide and how those protections differ between brokers and advisers. If testing shows that investors do not understand these distinctions, the Commission would need to rethink its proposed regulatory approach, and either eliminate inconsistencies in the standards or dramatically improve the proposed disclosures.

5. The required disclosure regarding disciplinary events does not give adequate prominence to this issue.

One important step investors can and should take when selecting a financial professional is to check out the disciplinary record of the firm and the individual who would be responsible for their account. As the Commission notes in the Release, information about a firm's and its financial professionals' disciplinary information "may assist retail investors in evaluating the integrity of a firm and its financial professionals. For example, a prior disciplinary event could reflect upon the firm's integrity, affect the degree of trust and confidence a client would place in the firm, or impose limitations on the firm's activities."<sup>234</sup> We agree. Unfortunately, the Commission proposes to bury this information with an obscure and generic reference in the Additional Information section of the proposed disclosure document.

We believe this information is important enough to be highlighted under its own separate heading, "Do you have a disciplinary record?" At the very least, firms should be required to provide a yes or no answer and directions on how to find more complete information. Where the documents are provided electronically, that should include a link to BrokerCheck or IAPD, whichever is appropriate. Moreover, if testing shows that investors do not typically follow up on those cross references, as we suspect is likely the case, the Commission should consider requiring inclusion of some abbreviated information regarding the firm's disciplinary record, particularly if it involves regulatory actions related to sales practices or fraud. Furthermore, testing should seek to determine whether providing that kind of summary information would make investors more likely to check out the disciplinary record in greater detail. If so, that would be an added benefit, since regulators have long sought to increase investor usage of BrokerCheck and IAPD with only limited success.

The Commission should also consider moving the disclosure on where to find additional information about the firm's services to the end of the section on what services the broker or adviser provides. We are concerned, however, that the required references for brokers are unlikely to provide information that is sufficiently accessible or relevant to provide additional value. If those changes are made, that would leave only the information on how to report a problem in the "Additional Information" section. Thus, the section could be eliminated and the sentence on how to report a problem could be highlighted in some other way.

6. The required comparisons should be eliminated entirely.

In addition to proposing changes to the order and content of the main sections of Form CRS, we also propose to eliminate the proposed "comparison" section entirely. As we discuss at greater detail in the legal analysis of this letter, the required comparison raises serious First Amendment concerns, because it would compel standalone investment advisers to express certain views about broker-dealers, as compared with themselves, with which they object, and vice versa.<sup>235</sup> Investment advisers, for example, would be required to state: "You can receive advice in either type of account [investment advisory or brokerage], but you may prefer paying: a

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<sup>234</sup> Form CRS Release at 115-116.

<sup>235</sup> See *infra* Section V.D.

transaction-based fee from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time; an asset-based fee if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee.”<sup>236</sup>

There are a number of statements in that one sentence that many, if not most, advisers would likely object to. The first is the statement equating sales recommendations with investment advice. Our experience suggests that you would find few investment advisers who would agree that brokers’ arm’s length sales recommendations constitute advice. We share that concern. In our view, the required disclosure would not only make it more difficult for investors to distinguish brokerage services from advisory services, it would mislead them about the nature of those services.

Investment advisers are also likely to disagree with the suggestion that transaction-based fees are typically more affordable for buy-and-hold investors who do not trade often. We strongly suspect that many standalone investment advisers would object to having to express such positive views about broker-dealers to prospective clients and such comparably negative views of themselves. Moreover, there are any number of circumstances in which the required statement would be false and misleading. For example, Vanguard charges 0.30% for its Personal Advisor Services, Schwab charges 0.28% for its Intelligent Advisory Services, and Betterment charges 0.25% for its Digital offering and 0.40% for its Premium offering. These firms, which charge barely more for their comprehensive advisory services than a broker is likely to receive in 12b-1 fees for a one-time mutual fund sale, would be required to provide a comparison suggesting that brokers’ transaction-based fees are more affordable than their asset-based fees. Similarly, a fee-only financial planner who charges a one percent AUM fee for comprehensive financial planning services, equivalent to what a broker charges when selling mutual fund C shares, would have to provide this misleading comparison suggesting the broker may be a more cost-effective option for its clients.

These few examples don’t even begin to take into account the much higher costs that are typical for brokers that sell other higher-cost investment products, such as variable annuities, non-traded REITs, and private placements. Nor do they take into account the fact that many investment advisers implement their advice using investments with lower operating expenses than those sold by brokers. And the Commission provides no meaningful analysis to support its suggestion that brokerage accounts are “typically” more cost effective for buy-and-hold investors than advisory accounts. As the Commission surely understands, the determination of which account is the better option for a particular investor is a determination that must be analyzed based on the facts and circumstances, taking into account the investor’s needs as well as the level of advisory fees charged, the costs of investments recommended, and the range of services offered. It cannot be boiled down to a simple rule of thumb in this way. As a result, the required statement is objectionable, not just because it would require investment advisers to tout their competition as more cost-effective for certain investors, but because it would require them to make a statement that would be inaccurate and misleading in many instances.

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<sup>236</sup> Form CRS Release at 24, footnote 62.

7. The key questions section should be removed from Form CRS and used instead in an investor education campaign.

The Commission proposes to devote a significant portion of an abbreviated disclosure document to key questions investors should ask. While we agree that these are generally good questions that would aid investors in making an informed choice if they could get a straight answer, we are skeptical that including them here will, in fact, succeed in spurring investors “to have conversations with their financial professionals about how the firm’s services, fees, conflicts and disciplinary events affect them.”<sup>237</sup> At the very least, the Commission should seek to establish through cognitive usability testing whether this is likely to be the case. But our concerns go beyond questions of whether this is a good use of limited space. As we discuss above, relegating certain of these issues to conversations between the financial professional and the investor leaves too much room for obfuscation on topics about which firms may have an incentive to keep investors in the dark. And the Commission will have no way to monitor those conversations to ensure that the information is presented fairly.

It is therefore imperative that the information the Commission believes is crucial for investors to understand is included in the disclosure document itself. To the degree that there are questions here that the disclosure document does not answer, the Commission should consider requiring additional information on that topic in the document itself. The questions could still be used as part of an investor education campaign designed to focus investors on issues important to their selection of a financial professional. We have also adopted the question-and-answer format in our suggested revisions to Form CRS.

### **C. The Commission should hire a disclosure expert to help redesign the content and presentation of Form CRS.**

Getting investors to read disclosure documents is an uphill battle, even when the information is made easily accessible and they recognize the importance of the information being disclosed. Where the information being provided is complex and technical in nature, as is the case here, the task is that much more difficult. There are experts available who specialize in developing understandable and visually appealing disclosures of even complex topics, and the Commission needs to avail itself of their services to completely revamp the proposed Form CRS disclosures. But the Commission also needs to recognize that getting the disclosures right is likely to be a time-consuming and labor-intensive process – one that includes multiple rounds of testing and revisions to refine the disclosure messages and formats to ensure they convey the desired information in a way that typical, financially unsophisticated investors can understand.

In this regard, it is important to emphasize that the Commission cannot simply defer to brokerage and advisory firms to improve the presentation of the disclosures. While firms have a good record of providing clear and visually engaging disclosures of information they want investors to read and understand, they’ve shown themselves to be equally adept at obscuring or sugar-coating information that they do not want the investor to comprehend. This includes information about costs and conflicts. Moreover, when they are exposed to liability risks, firms can be counted on to cast their disclosures in a way that is designed to protect the firm from

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<sup>237</sup> Form CRS Release at 126.

liability, not promote investor understanding. While the documents firms produce may very well make good use of basic rules of disclosure design – they may be pretty to look at – if the Commission doesn’t get the content right, the end result will still be investors who remain in the dark about the nature and costs of the services the firm is providing, the conflicts of interest that could bias the recommendations they receive, and the legal protections that apply.

Given the central role disclosure plays in the Commission’s proposed regulatory approach, it has an obligation to get the disclosures right before finalizing its rule. Particularly if it insists on maintaining different standards for brokers and advisers, the Commission must not allow its eagerness to complete this project to justify a rushed process that results in deficient disclosures that do not enable investors to make an informed choice among different types of financial firms and different types of accounts. If it is not willing to take the time necessary to ensure that its disclosures are effective, then it must reduce its reliance on disclosure to protect investors. This can be accomplished in one of two ways. One option would be to create a much clearer functional distinction between brokers and advisers, thereby making it easier for investors to tell them apart. The Commission’s proposed restriction on use of the title adviser/advisor is completely inadequate to the task. Or it can strengthen the standard of conduct that applies across the board to investment advice, thereby reducing the risk that investors will be harmed as the result of an uninformed selection of advisers.<sup>238</sup>

#### **IV. The Commission’s proposed restriction on use of the title “adviser/advisor” will not help to reduce investor confusion.**

The Commission has proposed to prohibit standalone broker-dealers and their associated persons, as well as representatives of dual registrant firms who operate exclusively in a brokerage capacity, from using titles that incorporate the term “adviser” or “advisor.” The Commission suggests that this will help retail investors to determine “whether the firm is a registered investment adviser or registered broker-dealer, and whether the individual providing services is associated with one or the other (or both), so that retail investors can make an informed selection of their financial professional, and then appropriately monitor their financial professional’s conduct.”<sup>239</sup> However, the Commission’s proposed approach is far too narrow to achieve its intended result. In light of this fact, there is simply no basis for the Commission to conclude that its proposal will provide any investor benefits that would offset the cost to affected firms of updating their business cards and websites to reflect the change in title. On the contrary, there is strong reason to believe the proposal would increase, rather than reduce, investor confusion.

In discussing the proposed approach, the Release makes clear that the reason the proposal is so fundamentally flawed is that the Commission itself is not willing to acknowledge that there is a meaningful difference between sales recommendations and advice. This is evident in the first sentence, which states that “both broker-dealers and investment advisers provide investment

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<sup>238</sup> As we discuss in Section II of this letter, regardless of what actions the Commission may take to improve the Form CRS disclosures, both Reg BI and the proposed guidance regarding investment advisers’ fiduciary obligations must be strengthened to make the Commission’s characterization of those standards as imposing an obligation to act in the customer’s or client’s best interests not misleading.

<sup>239</sup> Form CRS Release at 163.

advice to retail investors.”<sup>240</sup> The problem the proposal is intended to solve, the Release suggests, is not that investors can’t distinguish sales recommendations from advice, but rather that they struggle to determine the regulatory status of their particular “adviser.” In reality, however, if brokers were simply a different type of adviser, as the Commission suggests, there would be no reason to restrict their ability to call themselves advisers. All that would be needed would be a clearer disclosure of the firm and its associates’ regulatory status, along the lines the Commission has proposed separately. We disagree with the Commission’s diagnosis of the problem and oppose its proposed solution.

The reason to restrict titles, and to provide clear and unambiguous Form CRS disclosures about the nature of services offered, is to highlight what the brokerage firms’ trade associations have described as the “distinction between selling products and giving advice that has been fundamental to the securities laws for nearly 80 years.”<sup>241</sup> It is on this basis that SIFMA, FSI and others argued in their 5th Circuit challenge to the DOL rule that brokers could not reasonably be regulated as fiduciaries, and it is on this basis that brokers can reasonably be prohibited from calling themselves advisers. If the Commission agrees with the 5th Circuit that brokers are mere salespeople, who do not have a relationship of trust and confidence with their customers, it needs to stop referring to brokers’ arm’s length commercial sales transactions as advice. And it needs to adopt sweeping restrictions designed to prevent brokers from holding themselves out as advisers. Anything less will perpetuate the problem this rulemaking is purportedly designed to solve.

**A. To be effective, title restrictions must cover the full range of titles and marketing practices used by brokers to portray their sales recommendations as advice.**

As we have discussed elsewhere in this letter, and raised repeatedly with the Commission over the years, broker-dealers routinely hold themselves out, not as the salespeople they claim to be in court, but as advisers who occupy positions of trust and confidence with their clients. The practice is specifically designed to obscure the sales-based nature of their services in a market where investors are desperate for advice they can trust. The Commission has played its role in this charade, permitting broker-dealers to rebrand themselves as advisers – using titles such as “financial advisor,” “financial consultant,” and “wealth manager” – and market their services as if investment sales were solely incidental to advice, rather than the other way around. The Commission has an opportunity with this regulatory package to correct the problem that it helped to create. Unfortunately, it has passed on that opportunity, failing not only to adopt a true best interest standard for brokers and advisers, backed by meaningful restrictions on conflicts, but also by failing to impose tight restrictions on brokers’ ability to portray themselves as advisers.

The proposal to restrict use of the title “adviser/advisor” reflects this fundamental weakness, which pervades the entire regulatory package. It fails to cover the full range of titles that investors find confusing. It would allow brokers’ representatives who are prohibited from using the title “adviser” in one context to use it in other contexts when dealing with the same

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<sup>240</sup> Form CRS Release at 162.

<sup>241</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 14, <http://bit.ly/2f4wVBW>.

customer. Even where it restricts use of the title “adviser,” it fails to restrict other practices these same brokers use to portray themselves to potential investors as providing services that are essentially advisory in nature. In short, the proposed approach to restricting titles is so narrow in its application as to be essentially meaningless.

1. The proposed title restriction is too narrow in scope.

The overly narrow focus of the proposed restriction on brokers’ ability to call themselves advisers starts with the fact that it would apply only to standalone brokers, their registered reps, and the registered reps of dual registrants who operate solely in a brokerage capacity when dealing with retail investors. This would leave the majority of registered reps employed by dual registrant firms and the majority of brokerage accounts unaffected. Even standalone brokers and reps covered by the restriction would be free to call themselves advisers when dealing with non-retail customers,<sup>242</sup> when recommending insurance investments, or when acting on behalf of a municipal advisor or a commodity trading advisor.<sup>243</sup>

It is conceivable under this approach that a single representative, dealing with a single client could use different titles, depending on the capacity in which they are acting. For example, a broker that has a customer who is a small business owner with both a personal (retail) account and a 401(k) plan for its business, could refer to herself as an adviser in the latter instances, because the non-retail account would not be covered by the rule. Moreover, brokers who are prohibited from using the title “adviser” would remain free to use variations on the term in communications outside the names and titles contexts. They could, for example, continue to characterize their services as “advisory services” or use those terms in metadata to attract internet search engines.<sup>244</sup>

Moreover, registered reps of dual registrants would remain free to call themselves advisers, even when acting in their broker-dealer capacity. The result is that where the confusion is likely to be greatest, when dealing with a dual registrant firm, the protections will not apply. Imagine, for example, that the registered rep of a dual registrant firm whose business card describes him as a “financial advisor” recommends a brokerage account as the customer’s best option for receiving “investment advice,” a recommendation that currently wouldn’t be covered under Reg BI’s best interest standard. That “financial advisor” will be required to provide the investor a Form CRS for a dual registrant firm, but that document, as currently drafted, will not clearly spell out that the brokerage account is in fact a sales account. Meanwhile, the registered rep will be free to describe all the advisory services he will provide through that brokerage account as investment advice. Is the investor really likely in that scenario to recognize that she is dealing with a salesperson and not an adviser? We don’t think so.

The Commission recognizes that this scenario “could lead to some investor confusion,” but doesn’t propose a solution. While we certainly recognize the complexity that would be involved in forcing firms and their reps to change nomenclature when they change functions, the

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<sup>242</sup> Form CRS Release at 172-173.

<sup>243</sup> *Id.*

<sup>244</sup> Form CRS Release at 326 (“[T]he proposed restriction would not affect the use of terms such as “advisory services” in other content, or using them in metadata to attract internet search engines.”).

Commission explicitly permits firms that would otherwise be covered by the title restriction to change nomenclature when it suits their purposes. In short, the difficulty of applying such a requirement in the context of a dual registrant firm doesn't justify adopting an approach that is doomed to be ineffective. It simply illustrates the futility of restricting one title in one narrow context as a means of reducing investor confusion. Given the extremely narrow focus of its proposal, the Commission can't reasonably suggest that its proposed approach would deter misleading practices or contribute in any meaningful way to investor's ability to make an informed choice among different types of providers.

Not only does the Commission apply its limitation on use of the term "adviser" in only the narrowest of circumstances, it also fails to include the broad range of other titles firms can and do use to portray their sales reps as advisers. These include "financial consultant" and "wealth manager."<sup>245</sup> In explaining its proposal to limit the restriction to the title "adviser," and not to include these other potentially confusing titles, the Release suggests that the title "adviser" is uniquely likely to be misunderstood by investors. Even as it acknowledges that other titles "might confuse and thus potentially mislead investors," the Commission states that it focused its proposal on the term "adviser" or "advisor," because "they are more closely related to the statutory term 'investment adviser.' Thus, as compared to additional terms such as 'financial consultant,' 'adviser' and 'advisor' are more likely to be associated with an investment adviser and its advisory activities rather than with a broker-dealer and its brokerage activities."<sup>246</sup> But the Commission provides no evidence to support this assumption. On the contrary, the findings it does cite from the RAND Study support the opposite conclusion. According to that study, "Respondents tended to believe that financial advisors *and consultants* are more similar to investment advisers than to brokers in terms of the services provided, compensation methods, and duties."<sup>247</sup> (emphasis added) The Release glosses over this fact, pointing only to the results with respect to the one title it has chosen to restrict.<sup>248</sup>

## 2. The Commission's proposed restrictions could easily be evaded.

A related downside of the Commission's proposed approach is that it could be easily evaded. Under the proposal, standalone brokers have several options that would allow them to continue to hold out in a way that conveys to investors that they are trusted advice providers. One option is to change their names to other titles, such as "financial planner," "financial consultant,"<sup>249</sup> or "wealth manager."<sup>250</sup> As a result, a standalone broker whose registered representatives use the title "advisor" could change their title to "wealth manager" and continue

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<sup>245</sup> Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, at 5-6, January 18, 2017, <http://bit.ly/2jKUbFD>.

<sup>246</sup> Form CRS Release at 173.

<sup>247</sup> Angela A. Hung, et al., RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, at 90, (2008), <https://bit.ly/2LSDOsr>. ("RAND Study")

<sup>248</sup> Form CRS Release at 166.

<sup>249</sup> The RAND Study highlighted how one brokerage firm's advertisement "stressed the importance of building a relationship with one's financial consultant based on trust." RAND Study at 109.

<sup>250</sup> USAA states, "Your wealth manager can advise you on a range of issues through a comprehensive financial planning process and provide you a personalized suite of integrated solutions to address even the most complex needs..." Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, at 10, January 18, 2017, <http://bit.ly/2jKUbFD>.



to describe themselves as offering “advisory services.” If a potential customer searches online for a financial advisor in their area, they could pop up.

While it glosses over this shortcoming in the main body of the Release, the Commission acknowledges this is a risk in the rule’s economic analysis. There it states that broker-dealers may “use new names and titles that are equally efficient at conveying they are providing advice.”<sup>251</sup> The Commission further acknowledges that this could perpetuate, not solve, the problem, stating, “The proposed rule may also increase investor confusion to the extent some firms and financial professionals invent new names or titles to substitute for the restricted ones. Studies already indicate that the wide variety of names and titles used by firms and financial professionals causes general investor confusion about the market for investment advice.”<sup>252</sup>

Alternatively, standalone brokers could become dual registrants and keep their titles “adviser” or “advisor,” regardless of whether they are acting in that capacity. The Commission concedes this, stating, “Another potential limitation of the proposed restriction on the use of certain titles is that a dual registrant could still call itself an ‘adviser’ or ‘advisor,’ but then only offer brokerage services to investors that may not be legally and financially sophisticated enough to understand the differences in types of relationships and standards of conduct available.”<sup>253</sup>

### 3. The proposed approach does nothing to address misleading marketing practices.

Problems with the Commission’s narrow focus on a single title are exacerbated by its failure to impose any restrictions on other actions firms can take to market themselves as if advice were the primary service they have to offer. Taking away just one of the misleading titles brokers use to portray their sales recommendations as advice and doing nothing to rein in misleading marketing practices cannot reasonably be expected to counterbalance million-dollar marketing campaigns designed to send the opposite message, even if combined with improved disclosure. On the contrary, as the Commission itself acknowledges, Form CRS disclosures have the potential to be “overwhelmed by the way in which financial professionals present themselves to potential or current retail investors, including through advertising and other communications.”<sup>254</sup> We agree that is likely to be the case, even if the Commission adopts the extensive changes needed to make the Form CRS disclosures even marginally useful to investors.

The Commission acknowledges, moreover, that it has had concerns regarding broker-dealer marketing efforts and had requested comment on the issue as far back as 1999.<sup>255</sup> It noted that, while the Commission had “never viewed the broker-dealer exclusion as precluding a broker-dealer from marketing itself as providing some amount of advisory services, we have noted that these marketing efforts raised ‘troubling questions as to whether the advisory services

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<sup>251</sup> Form CRS Release at 326.

<sup>252</sup> Form CRS Release at 316.

<sup>253</sup> Form CRS Release at 315.

<sup>254</sup> Form CRS Release at 163.

<sup>255</sup> Form CRS Release at 180, citing to Commission Release 42099 (“For example, we have previously requested comment on whether we should preclude broker-dealers from relying on the solely incidental prong of the exclusion if they market their services in a manner that suggests that they are offering advisory accounts, including through the use of names or titles.”).

are not (or would be perceived by investors not to be) incidental to the brokerage services.”<sup>256</sup> It is all the more remarkable, then, that in taking up the issue here, the Commission has undertaken no new study of an issue that has been before the Commission for decades. Instead, it simply dismisses a “holding out” approach as likely to “create uncertainty regarding which activities (and the extent of such activities) would be permissible” and based on an unsubstantiated concern that broker-dealers might “decide to provide fewer services out of an abundance of caution.”<sup>257</sup>

In short, the Commission appears to simply be going through the motions with this proposal, without making any serious effort to adopt a regulatory approach that would solve even the very limited problem it has identified. It essentially acknowledges that there is no evidentiary basis for its conclusion that its proposed approach would help to clear up investor confusion and that there are strong reasons to believe it would not. Before it could justify such a narrowly focused approach, the Commission would need to conduct testing that showed that its approach effectively addressed the problem of investor confusion. That testing would need to take into account firms’ ability to adopt different but similar titles to evade the rule’s restrictions. And it would need to consider whether other approaches would be more effective in addressing the problem. Until it undertakes that analysis, it cannot justify its proposed approach. It should either scrap the proposal in its entirety or start from scratch to develop a credible approach covering the full range of misleading titles and marketing practices.

#### **B. The proposal to require firms to disclose their regulatory status in communications with investors could be modestly beneficial.**

In addition to restricting use of the title “adviser/advisor,” the Commission proposes to require firms and their associated persons to disclose their regulatory status in print or retail investor communications.<sup>258</sup> The requirement is intended to “complement” the proposed Form CRS disclosures and provided added clarity where firms use titles that do not reflect their regulatory status. Specifically, the Commission states that, “Even if a firm uses various titles, such as ‘wealth consultant’ or ‘wealth manager,’ the legal term for these firms is ‘investment adviser’ and/or ‘broker-dealer.’ These statutory terms have meaning because they relate to a particular regulatory framework that is designed to address the nature and scope of the firm’s activities, which the firm would describe for a retail investor in the relationship summary.”<sup>259</sup> We agree that the required disclosure could have some modest benefit, though it is important not to overstate their likely value.

While the terms investment adviser and broker-dealer have legal meaning, those meanings are not well understood by investors. Prior testing conducted on behalf of the Commission shows that investors do not understand the meaning of these terms<sup>260</sup> and much of what they think they know is incorrect.<sup>261</sup> It is therefore incumbent on the Commission to engage in disclosure testing to determine whether the disclosures, as proposed, add value and, if not,

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<sup>256</sup> Form CRS Release at 180.

<sup>257</sup> Form CRS Release at 182-183.

<sup>258</sup> Form CRS Release at 194.

<sup>259</sup> Form CRS Release at 195.

<sup>260</sup> Siegel & Gale Study; RAND Study.

<sup>261</sup> RAND Study.

whether they could be revised to better convey the intended information. For example, would a clearer statement of the implications of that regulatory status, e.g., that a broker is regulated as a salesperson, provide more useful information to investors?

**V. The Commission’s overall regulatory approach is legally questionable.**

On every page of the Reg BI Release, the Commission makes clear that it views brokers primarily as advice providers who just happen to offer their “advice services” on different terms and under a different compensation model than investment advisers. If that is the Commission’s view, however, it has two legally defensible options for regulating brokers’ “advice services,” neither of which it has adopted. It could make clear that brokers who function primarily as advisers cannot rely on the exclusion from the Investment Advisers Act that is available to brokers who limit themselves to giving only that advice that is “solely incidental to” their primary business of effecting transactions in securities. Or it could use its authority under Section 913(g) of the Dodd-Frank Act to adopt a uniform fiduciary standard for brokers and advisers that is no less stringent than the Advisers Act standard. Not only does the Commission not adopt either of these options, the Release doesn’t even seriously discuss the first option. Its justification for ignoring the second option is both unsupported by the evidence and completely inadequate.

**A. The Commission assumes, without any legal or factual analysis, that Reg BI is compatible with the Advisers Act. It is not.**

In crafting the laws that govern broker-dealers and investment advisers, Congress drew a clear distinction between broker-dealers, who are regulated as salespeople under the Exchange Act, and investment advisers, who are regulated as advice providers under the Investment Advisers Act. Brokers are excluded from regulation under the Advisers Act only if the advice they provide is “solely incidental to” their business as a broker-dealer and they do not receive “special compensation” for that advice. As we have discussed at length in previous letters to the Commission, Congress intended to provide only a narrow exception for brokers engaged exclusively in typical brokerage activities, such as recommending to customers that they purchase or sell securities and expressing opinions on the merits of various investments.<sup>262</sup> The Commission totally ignores the limitations on broker-dealers’ advisory activities that Congress set forth in the broker-dealer exclusion of the Advisers Act.

1. The plain language of the Advisers Act and its legislative history make clear “solely incidental” was meant to limit the advice that broker-dealers could provide without being deemed investment advisers.

The plain language of the “solely incidental” exclusion supports the view that Congress intended any advice provided by brokers to be minor, by chance, or not the primary service being offered. According to Law Professor Arthur Laby, at the time the Advisers Act was debated and drafted, “five contemporaneous dictionaries define the term ‘incidental’ as an event happening

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<sup>262</sup> See Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2>.

by chance and, therefore, of secondary importance to another.<sup>263</sup> Webster’s New International Dictionary from 1938, for example, describes an ‘incidental’ event as ‘not of prime concern’ and ‘subordinate,’<sup>264</sup> and Black’s Law Dictionary from 1933 similarly defined ‘incidental’ as something ‘[d]epending on or appertaining to something else as primary.’<sup>265</sup> Finally, a thesaurus from the same year gives as synonyms for ‘incidental’ the following words: accidental, casual, fortuitous, subordinate, contingent, occasional, adventitious, extraneous, and non-essential.<sup>266,267</sup> The plain meaning makes clear that Congress did not intend for brokers to provide advice as their primary service without being regulated under the Advisers Act.

In addition, the congressional committee reports for the Advisers Act explained that the term “investment adviser” was intended to exclude broker-dealers “insofar as their advice is **merely incidental** to brokerage transactions for which they receive only brokerage commissions).”<sup>268</sup> (emphasis added) The use of the term “merely” reinforces this view that Congress intended to place a limit on the advice brokers could offer and still rely on the exclusion, and that advice should be of lesser import to their brokerage transactions.

Moreover, the legislative history of the Advisers Act makes clear that Congress did not intend this exclusion to permit broker-dealers to hold themselves out to the public and their customers as if providing advice was their primary function, call themselves advisers or use other titles to convey the message that their primary function is providing advice, label their services as “advisory,” foster relationships of trust and confidence with their customers as part of an “advice relationship,” or compete with investment advisers for clients who were in the market for investment advice.<sup>269</sup> On the contrary, Congress specifically identified this as conduct the Advisers Act was intended to address.

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<sup>263</sup> Arthur B. Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 BUS. LAW. 395, 420 (2010) (citing WEBSTER’S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1257 (2d ed. 1938) (“Happening as a chance or undersigned feature of something else; casual; hence, not of prime concern; subordinate.”); WEBSTER’S COLLEGIATE DICTIONARY 506 (5th ed. 1938) (“Happening as a chance or undersigned feature of something else; casual; hence, minor; of secondary importance.”); NEW STANDARD DICTIONARY OF THE ENGLISH LANGUAGE 1242 (1935) (“Occurring in the course of or coming as a result or an adjunct of something else; concomitant . . . . Happening or coming without regularity or design; foreign or subordinate to the general purpose.”); THE WINSTON SIMPLIFIED DICTIONARY 287 (1929) (“[C]asual, liable to happen unexpectedly; happening as a chance feature of something else . . . something casual or subordinate.”); THE NEW CENTURY DICTIONARY OF THE ENGLISH LANGUAGE 809 (1927) (“Occurring or liable to occur in connection with something else; happening in fortuitous or subordinate conjunction with something else; casual or accidental; often, incurred casually and in addition to the regular or main amount.”)).

<sup>264</sup> WEBSTER’S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE.

<sup>265</sup> BLACK’S LAW DICTIONARY 942–43 (3d ed. 1933).

<sup>266</sup> RICHARD SOULE, A DICTIONARY OF ENGLISH SYNONYMS AND SYNONYMOUS EXPRESSIONS 280 (1938).

<sup>267</sup> Arthur B. Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 BUS. LAW. 395, 421 (2010).

<sup>268</sup> S.Rep. No. 76-1775, at 22; H.R.Rep. No. 76-2639, at 28; *accord Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

<sup>269</sup> Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2> (highlighting evidence from the legislative history of the Advisers Act that Congress was aware of, and concerned about, problems associated with brokers’ claiming to act as advisers and provided only a narrow exclusion from the Advisers Act for that reason) (“The Commission even ignores a statement by the Senate bill’s chief sponsor, Senate Robert F. Wagner of New York, that a significant reason, in his mind, for insisting on legislation rather than deferring to self-regulation, was the need to regulate the advisory

2. Contemporaneous SEC staff opinions when the Advisers Act became law make clear they understood the “solely incidental” language to limit the advice brokers could provide without being deemed investment advisers.

SEC staff opinions at the time the Advisers Act became law contrasted the broker’s advice, on the one hand, and the broker’s “regular business” on the other. The Commission staff’s first legal opinion on the Advisers Act stated, for example, that the Act excluded broker-dealers “whose investment advice is given **solely as an incident of their regular business.**”<sup>270</sup> (emphasis added) This same formulation was repeated in the Commission’s 1941 Annual Report.<sup>271</sup> Thus, the Commission did not view advice itself as the broker-dealers’ “regular business.” Implicit in this is that the Commission did not view “brokerage advice” as a central part of brokers’ value proposition. It further suggests that the Commission understood any advice should be limited and of secondary importance to broker-dealers’ primary function of effecting transactions in securities.

An opinion by the SEC’s General Counsel Chester T. Lane, also issued in 1940, further supports this view. Lane stated that the broker-dealer exclusion “amounts to a recognition that brokers and dealers commonly give a **certain amount of advice to their customers in the course of their regular business**, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business.” (emphasis added) That he stipulated that brokers could offer a “certain amount of investment advice” in the course of their “regular brokerage services” makes clear the SEC understood that Congress intended to place a limitation on the advisory activities broker-dealers could engage in without breaching the “solely incidental to” requirement. It also provides further support for the view that advice would be considered “solely incidental” so long as the “regular brokerage” is the broker’s primary function and any advice is merely a secondary aspect of their business.

The Commission understood that Congress did not intend to permit brokers to offer a more extensive array of advisory services outside the protections of the Advisers Act simply because those advisory services were offered in connection with a package of brokerage services.

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activities of brokers. Responding to a representative of the Investment Counsel Association of America (ICAA), who had been arguing in favor of self-regulation, Sen. Wagner made the following comment: “Let me say that if I thought you could get all the brokers in, I – as one member of the committee – would be quite satisfied by your regulation under your own association’s rules. However, how are you going to get in the others, who may not want to live up to your high standards?” (Senate hearing, at p. 739) and “Brokers were clearly identified in the hearing record as one of the groups that was a subject of concern. ICAA President Dwight Rose noted, for example, that their association’s survey of the field had found that: “Some of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commission on transactions executed upon such free advice.” It is shortly after this comment that Sen. Wagner made his statement regarding the need to regulate Brokers.” and “The Commission acknowledges that Congress knew of the abuses that might arise when brokerage services are combined with advisory services. It cites, among other things, the above quote from Mr. Rose, as well as a portion of the Illinois memorandum. A later section of the Illinois report is even more explicit in its warnings than the section cited by the Commission: “The criticisms of counselors also acting as brokers or dealers are founded upon possible encouragement of practices bordering on fraud. The major danger is that a counselor connected with a brokerage house will unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investments.”).

<sup>270</sup> Advisers Act Release No. 1 (September 23, 1940).

<sup>271</sup> Seventh Annual Report of the Securities and Exchange Commission (1941), <https://bit.ly/2vBgd4G>.

It is equally clear that the Commission in the past has seemed to agree that advice “incidental to” traditional brokerage business “implies that the advice must be a side occurrence that arises along with brokerage as the main occurrence.”<sup>272</sup>

3. This narrow reading of the “solely incidental” language comports with how securities markets and broker-dealers functioned at the time the Advisers Act became law.

This understanding of the “solely incidental to” language reflects how securities markets operated in the 1930s and 1940s. At that time, brokerage was a highly technical profession, requiring skill and judgment. According to Law Professor Arthur Laby, brokerage was “quite cumbersome, requiring the sedulous efforts of several professionals and entailing sound judgment on behalf of the broker. In the Depression era and before, trade execution was a vital function performed by Wall Street firms. As a result, it made sense to consider brokerage as primary and advice secondary.”<sup>273</sup> In other words, given broker-dealers’ highly technical and demanding roles, it was the execution of transactions itself that was crucial to their value proposition, not the “solely incidental” advice in fulfilling that role.

Since that time, the world has changed, and effecting transactions in securities is no longer a highly technical profession, requiring skill and judgement. To remain relevant, brokers have chosen to compete as advisers, but that demands a serious reexamination of the “solely incidental to” exclusion from the Advisers Act that the Commission once again fails to provide.

4. Today, advice is not “solely incidental to” brokers’ traditional brokerage function. Providing advice *is* broker-dealers’ primary function in the retail market.

Technological advances have revolutionized our securities markets. The manual features of the markets in 1940 that required broker-dealers to exhibit skill and judgment have been displaced by computers.<sup>274</sup> Automation has made it simple and efficient to execute an order with a click of a mouse, in the span of milliseconds, and virtually cost-free. As a result, retail brokerage as it existed in 1940 has become largely obsolete, much like switch board or elevator operators.

In an effort to adapt their business model, maintain relevance, and address a market need, the brokerage industry rebranded itself as advisers. They have achieved this by holding themselves out to the public and their customers as if providing advice is their primary function, calling themselves advisers or using other titles to convey the message that they are advice providers, labeling their services as “advisory,” fostering relationships of trust and confidence with their customers as part of an “advice relationship,” and competing with investment advisers for clients who are in the market for investment advice. As Professor Laby has so aptly described it, “Advice long ago eclipsed in importance the execution of securities transactions. ... [T]he

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<sup>272</sup> Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 *BUS. LAW.* 395, 420 (2010).

<sup>273</sup> Laby at 421.

<sup>274</sup> Laby at 412 (“Changes in securities trading brought about by changes in technology have rendered brokerage a commodity, which no longer entails the level of judgment and skill required to conduct brokerage services in the bygone era of the early twentieth century.”).

idea that most advice provided today by broker-dealers is or could be considered solely incidental to brokerage sounds fanciful. ... Providing information and advice is the signal role of a broker-dealer; the purchase or sale, once a decision to invest is made, is secondary.” In short, as Professor Laby argues, brokers’ primary function has reversed. “Instead of referring to advice as solely incidental to brokerage, it is today more apt to refer to *brokerage* as solely incidental to *advice*. Nowadays, advice is the main course served up to investors; brokerage is the side dish.”<sup>275</sup>

The Commission long ago acknowledged that brokers serve primarily as advisers, although it has failed to adjust its regulatory regime accordingly. For example, the Tully Report stated that, “The most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues.”<sup>276</sup> Instead of taking advantage of this opportunity to finally update its regulatory regime, the Commission proposes to continue to regulate brokers separately from investment advisers without even considering whether it needs to update its faulty interpretation of the “solely incidental” exclusion.

5. Proposed Reg BI and Form CRS disregard the “solely incidental” limitation on broker-dealers’ ability to offer advice.

Proposed Reg BI and Form CRS forcefully, if inadvertently, make the case that broker-dealers provide advice that goes well beyond what can reasonably be characterized as “solely incidental.” The proposals provide dozens if not hundreds of references suggesting that providing advice to retail customers is broker-dealers’ key function, not execution or sales. The following are just a few of the many examples where the Commission supports the notion that brokers simply offer a different type of advice relationship, in which brokers get paid for their advice through commissions rather than through an assets under management model:

- The Reg BI Release characterizes the brokerage model as a “‘pay as you go’ model for advice from broker-dealers;”<sup>277</sup>
- The Reg BI Release states how important it is to the Commission to “Preserv[e] access to advice and choice with regard to advice relationships and compensation methods;”<sup>278</sup>
- The Reg BI Release states that there are different “advice models” (referring to brokers and investment advisers);<sup>279</sup>
- The Reg BI Release states that the broker-dealer relationship is “a different type of advice relationship”<sup>280</sup> and claims that “some retail investors may seek out [this] different advice relationship that better suits their preferences...;”<sup>281</sup>

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<sup>275</sup> Laby at 412-413.

<sup>276</sup> Tully Report at 3.

<sup>277</sup> Reg BI Release at 9.

<sup>278</sup> Reg BI Release at 11.

<sup>279</sup> Reg BI Release at 12.

<sup>280</sup> Reg BI Release at 40.

<sup>281</sup> Reg BI Release at 41.

- The Reg BI Release refers to the broker-dealer relationship as one in a range of “registered investment advice relationships;”<sup>282</sup>
- The Reg BI Release describes the “Broker-dealer model as an option for retail customers seeking investment advice;”<sup>283</sup>
- The Reg BI Release refers to “the brokerage advice relationship and associated services;”<sup>284</sup>
- The Reg BI and From CRS Releases compare “commission-based advice relationships” with “asset-based fee for advice,” claiming commission-based advice relationships can be more cost-effective ways for retail investors to receive advice;<sup>285</sup>
- The Reg BI Release repeatedly refers to the “market for financial advice;”<sup>286</sup> the “market for advice services;”<sup>287</sup> and the “market for broker-dealer advice;”<sup>288</sup>
- The Reg BI Release acknowledges that broker-dealers “compete with investment advisers for customers;”<sup>289</sup>
- In seeking to undercut the DOL’s regulatory impact analysis, the Reg BI Release states that the DOL improperly compared “broker-dealer advised investments to unadvised investments” and that the correct comparison is between “broker-dealer advised accounts subject to the current legal framework and broker-dealer advised accounts subject to the proposed rule overlaid on the existing legal framework;”<sup>290</sup>
- The proposed Form CRS disclosure states that “You can receive advice in either type of account, but you may prefer paying: a transaction-based fee/an asset-based fee...;”<sup>291</sup>
- The Form CRS Release discusses how investors “search[ ] for a provider of financial advice” and don’t distinguish between broker-dealers and advisers;<sup>292</sup>
- The Form CRS Release repeatedly refers to “the type of investment advice relationship that [investors] prefer” and the “type of advice relationship that [investors] seek;”<sup>293</sup>

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<sup>282</sup> Reg BI Release at 47.

<sup>283</sup> Reg BI Release at 21.

<sup>284</sup> Reg BI Release at 43.

<sup>285</sup> Reg BI Release at 22; Form CRS Release at 68-69.

<sup>286</sup> Reg BI Release at 216.

<sup>287</sup> Reg BI Release at 225.

<sup>288</sup> Reg BI Release at 224; Form CRS Release at 318.

<sup>289</sup> Reg BI Release at 320, 235, 237; Form CRS Release at 326.

<sup>290</sup> Reg BI Release at 267, footnote 460.

<sup>291</sup> Form CRS Release at 24, 92.

<sup>292</sup> Form CRS Release at 301.

<sup>293</sup> Form CRS Release at 302-304.



- The Form CRS Release states that broker-dealers use names and titles that are “efficient at conveying they are providing advice”<sup>294</sup> and that “suggest such an advice relationship to maximize their customer flow;”<sup>295</sup>
- The Form CRS Release states that, by choosing titles such as “adviser” or “advisor,” the broker-dealer is “indicating that advice is an important part of its broker-dealer’s business;”<sup>296</sup>
- The Form CRS Release states that broker-dealers “rely on advice services as an important part of their value proposition to retail investors and directly compete with investment advisers.”<sup>297</sup>

None of these advisory activities even remotely sound like advice that is “solely incidental to” the conduct of their business as a broker or dealer. The notion that Congress could have intended “solely incidental” advice to include these clearly advisory activities in the context of a clearly advisory relationship cannot be supported. And yet, even as it updates the regulatory treatment of broker-dealers’ “advice services,” the Commission fails to even seriously consider whether the “solely incidental” exclusion remains valid.

We suspect that the Commission continues to incorrectly interpret the “solely incidental to” language as meaning “in connection with and reasonably related to.”<sup>298</sup> That interpretation was contained in a rule that was vacated<sup>299</sup> and has never been formally adopted. If the Commission continues to interpret “solely incidental to” as meaning “in connection with and reasonably related to,” it must state so explicitly. Regardless, the Commission can’t refuse to engage on the issue.

#### 6. Broker-dealers receive “special compensation.”

As discussed above, under the first prong of the broker-dealer exclusion of the Advisers Act, broker-dealers who provide advice that is more than “solely incidental to” their regular broker-dealer conduct are deemed investment advisers. In addition, under the second prong of the exclusion, which is independent of the first, broker-dealers who provide advice for “special compensation” are deemed investment advisers. It is on this basis that the Commission’s fee-based brokerage account rule was vacated, but the Commission continues to ignore the question of whether brokers today receive compensation that constitutes special compensation for advice.

In determining whether “special compensation” has been paid, the purpose of the compensation is a key factor. According to Investment Advisers Act Release No. 2, this prong provides a “clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the

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<sup>294</sup> Form CRS Release at 326.

<sup>295</sup> Form CRS Release at 308.

<sup>296</sup> Form CRS Release at 181.

<sup>297</sup> Form CRS Release at 326.

<sup>298</sup> See *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 51523 (Apr. 12, 2005).

<sup>299</sup> *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

purview of the Act merely because he is also engaged in effecting market transaction in securities.”<sup>300</sup> In determining whether a broker-dealer has received “special compensation, “[t]he essential distinction to be borne in mind...is...between compensation for advice itself and compensation for services of another character to which advice is merely incidental.”<sup>301</sup>

The form of the compensation can also determine whether “special compensation” has been paid. The Commission itself has acknowledged that, “At the time the Advisers Act was enacted, Congress understood ‘special compensation’ to mean compensation **other than commissions.**”<sup>302</sup> (emphasis added) Asset-based fees for advice, on the other hand, a particular kind of non-commission compensation, have been deemed “special compensation.”<sup>303</sup> This is the case even if the broker-dealer provides the customer with a traditional package of brokerage services that includes execution, arranging for delivery and payment, and custodial and recordkeeping services, in addition to the advice they provide.<sup>304</sup> As Professor Laby has explained, the difference in the form of payment can lead to different investor expectations: “Paying a commission is a one-time affair, akin to paying a turnpike toll or buying a ticket for an event. An asset-based fee, however, might lead to an expectation by the customer that the financial services professional will perform a tutelary role over the account, carefully husbanding the assets and monitoring performance.”<sup>305</sup>

Thus, the two questions relevant to whether “special compensation” has been paid are first, what is the purpose of the payment and second, what is the form of the payment? Compensation to brokers today clearly meets both criteria.

First, as the Commission makes clear throughout this Release, the primary purpose of the transaction-based payments investors make to brokers today is clearly for advice itself and not for services of another character to which advice is merely incidental. The Commission acknowledges as much in the Release, stating that, “we sought to preserve the ability to **pay for advice in the form of brokerage commissions.**”<sup>306</sup> (emphasis added) Moreover, the Commission describes its goal to preserve the “‘pay as you go’ model for advice from broker-dealers,” stating how important it is to the Commission to preserve “access to advice and choice with regard to advice relationships and compensation methods,” and frequently comparing “commission-based advice relationships” with “asset-based fee for advice.” Moreover, the proposed Form CRS disclosure states that, “You can receive advice in either type of account, but you may prefer paying: a transaction-based fee/an asset-based fee...” implying that the main difference is the payment option for the advice. The Release never states or even implies that the payment is for something other than advice.

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<sup>300</sup> Opinion of Chester T. Lane, SEC General Counsel, Advisers Act Release No. 2 (October 28, 1940).

<sup>301</sup> *Id.*

<sup>302</sup> See *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), citing *Certain Broker-Dealers*, 70 Fed.Reg. at 20,431 & n. 75. (citing S. Rep. No. 76–1775, 76th Cong., 3d Sess. 22 (1940), at 22 (“The term ‘investment adviser’ is so defined as specifically to exclude \* \* \* brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.)”) (emphasis in the original); See also H.R. Rep. No. 76–2639, 76th Cong., 3d Sess. 28 (1940) (“H.R. Rep. No. 76–2639”) at 28.

<sup>303</sup> *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

<sup>304</sup> *Id.*

<sup>305</sup> Laby at 417.

<sup>306</sup> Reg BI Release at 38.

It is not just the Commission that acknowledges that the payment brokers receive is payment for advice. So does the industry. In comment letters, many industry participants have compared the broker-dealer model of receiving compensation for advice to the investment adviser model, arguing that the transaction-based fee model is a more cost-effective model for receiving advice.<sup>307</sup> The Release cites several industry letters for this proposition. For example, it cites Franklin Templeton Letter, stating that, “[W]hile asset-based fees are appropriate in many circumstances, for some investors—such as long-term, ‘buy-and-hold’ investors—a transaction-based charge can result in substantial savings.”<sup>308</sup> It seeks to bolster this argument by citing ICI’s analysis claiming that “investors who plan to hold fund shares for longer than five years would end up with a higher account balance under a commission-based approach that charges a 2.5 percent front-end fee (plus an ongoing 12b-1 fee) than investors paying a 1 percent per year asset-based fee.”<sup>309</sup> Leaving aside the highly questionable math on display in the ICI analysis, implicit in these comparisons is the notion that both payments are being provided for the same fundamental service, and that service is advice.

Moreover, in the Form CRS economic analysis, the Release refers to broker-dealers’ “advice-related revenues,” stating that “broker-dealers that are not dually registered generated approximately 43% of their advice-related revenues as commissions and only 32% of their advice-related revenues from fees.”<sup>310</sup> If the advice is truly “solely incidental to” their conduct as a broker-dealer and not for “special compensation,” why are broker-dealers receiving any “advice-related revenues?” The answer is they shouldn’t be. Because the payment is clearly for advice, broker-dealers receive “special compensation” for their advisory activities.

The form of the payment also leads one to conclude that “special compensation” – compensation other than commissions – is being charged for advice. As discussed above, paying a commission is typically a “one-time affair,” whereas paying an asset-based fee continues indefinitely, which might lead investors to expect ongoing advisory services for that fee. Based on this criteria, 12b-1 fees, as currently charged, should properly be viewed as “compensation other than commissions.” 12b-1 fees didn’t exist in 1940. They are clearly asset-based and continue indefinitely, providing an ongoing stream of revenue to the broker for as long as the investor holds the investment. For example, C shares charge a “level load” of 100 bp 12b-1 fee for as long as the investor owns the shares.<sup>311</sup> In turn, the broker-dealer receives 100 bp in compensation.

The Commission has received comments, including statements by those in the broker-dealer industry, that 12b-1 fees associated with level load funds “pay for valuable ongoing investment advice provided by the intermediary, and are an alternative to mutual fund wrap fee

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<sup>307</sup> See, e.g., Reg BI Release at 38, footnotes 81 and 82, citing SIFMA 2017 Letter; BlackRock Letter; ICI August 2017 Letter; Franklin Templeton Letter.

<sup>308</sup> Reg BI Release at 38, footnote 81.

<sup>309</sup> *Id.*

<sup>310</sup> Form CRS Release at 207-208.

<sup>311</sup> Mutual Fund Distribution Fees; Confirmations, Release Nos. 33-9128, 34-62544, IC-29367 [75 FR 47063 (August 4, 2010)].

programs, which often charge a 100 basis point (or greater) wrap fee.”<sup>312</sup> Moreover, in its proposing release to reform 12b-1 fees, the economic analysis stated that one of the effects of the proposal would be that “some investors might determine that they need or want continuing high levels of service, and may choose to move their assets out of level load share classes and into fee-based or wrap fee accounts.”<sup>313</sup> That the Commission predicted that investors would substitute advisory accounts for C shares, if C shares were eliminated, provides further evidence that the Commission believes investors view C shares (and the 100 bp 12b-1) as a way to pay for ongoing advice through an asset fee. Certainly, C shares do not provide a commission under any reasonable understanding of that term.

In short, because 12b-1 fees are asset-based, continue in perpetuity, and create the risk that investors reasonably believe they are paying those fees for ongoing advice, 12b-1 fees constitute “special compensation.” Brokers who are compensated for their “advice services” through 12b-1 fees should therefore be regulated under the Advisers Act.

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In sum, it is clear that Congress did not intend to permit brokers to offer a more extensive array of advisory services outside the protections of the Advisers Act simply because those advisory services were offered as part of a package of brokerage services. Nor did it intend to permit brokers to hold themselves out to the public as “pay as you go” advisers as part of a “different type of advice relationship” without being regulated accordingly. And yet, even as it updates the regulatory regime for broker-dealers, the Commission proposes to continue to permit them to do just that.

Moreover, in justifying its proposed regulatory approach, the Commission doesn’t even attempt to explain why brokers’ advisory activities fit within any reasonable understanding of the term “solely incidental,” as that term was interpreted in 1940 when Congress was crafting the exclusion. They do not. The Commission similarly fails to explain on what grounds it concludes that brokers’ compensation for advice does not constitute “special compensation.” It does. As a result, proposed Reg BI and Form CRS are simply incompatible with the broker-dealer exclusion of the Advisers Act.

**B. Broker-dealers foster relationships of trust and confidence with their customers that are the hallmark of a fiduciary relationship at common law. They should be regulated accordingly.**

Both the Commission and prominent court cases have recognized that, when broker-dealers place themselves in a position of trust and confidence with their clients, they become fiduciaries.<sup>314</sup> Broker-dealers today routinely do just that. They seek to persuade the investing

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<sup>312</sup> *Id.*, citing Comment Letter of Gregory A. Keil (June 1, 2007) (“The current ‘Class C’ share is really the next step toward a more ‘advice driven’ model \* \* \* removing a ‘transaction cost’ from the equation—and applying an “always-on” Advisory Fee to a DISCRETIONARY investment vehicle—the mutual fund. \* \* \*”); Comment Letter of Daryl Nitkowski (July 19, 2007) (“In fact, I believe the typical 1% fee charged on class C shares represents the best option for clients who want continuing advice, but do not want to have a fee based account.”)

<sup>313</sup> *Id.*

<sup>314</sup> See, e.g., *Arleen W. Hughes*, 27 S.E.C. 629 (1948) (noting that fiduciary requirements generally are not imposed upon broker-dealers who render investment advice as an incident to their brokerage unless they have placed themselves in a position of trust and confidence), *aff’d sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949);

public that they are providing trusted investment advice in myriad ways. These include adopting titles that give the impression of specialized advisory expertise, describing their services as “investment advice” or “retirement planning,” and marketing those services as designed to serve customers’ best interests.<sup>315</sup> As we discuss elsewhere in this letter, those practices would be perpetuated under this regulatory proposal.

The following are just a few examples of broker-dealers’ marketing materials which support the conclusion that brokers routinely seek to create relationships of trust and confidence with their customers, including by using those exact words:

- Schwab states: “A relationship you can **trust**, close to home.”<sup>316</sup>
- D.A. Davidson states: “**Trust** is the cornerstone of the relationship between you, as an investor, and the D.A. Davidson & Co. financial professionals working for you.”<sup>317</sup>
- Mass Mutual states: “Join millions of people who place their **confidence and trust** in us.”<sup>318</sup>
- Raymond James states: “[I]t’s developing a long-term relationship built on understanding and **trust**. Your **advisor** is there for you throughout the **planning** and investing process, giving you **objective and unbiased advice** along the way.”<sup>319</sup>
- Stephens states: “We are committed to establishing and maintaining long-term relationships based on integrity and **trust** and delivering long-term results based on deep research and independent thinking.”<sup>320</sup>
- UBS states: “The UBS Wealth Management Americas approach is based on the **trusted relationship** of our Financial Advisors and their clients.”<sup>321</sup> (emphasis added for all)

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*Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d. 508 (Colo. 1986) (evidence “that a customer has placed trust and confidence in the broker” by giving practical control of account can be “indicative of the existence of a fiduciary relationship”); *MidAmerica Federal Savings & Loan v. Shearson/ American Express*, 886 F.2d. 1249 (10th Cir. 1989) (fiduciary relationship existed where broker was in position of strength because it held its agent out as an expert); *SEC v. Ridenour*, 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002) (“Although it is true that there ‘is no general fiduciary duty inherent in an ordinary broker/customer relationship,’ a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.”); *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1215 (8th Cir. 1990) (finding that the district court did not abuse its discretion in instructing the jury that licensed securities brokers were fiduciaries that owed their customers a duty of utmost good faith, integrity, and loyalty when the customer was unsophisticated investor who completely trusted the broker and relied on his advice, including never turning down any of the broker’s investment recommendations.).

<sup>315</sup> Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, January 18, 2017, <http://bit.ly/2jKUuFD>.

<sup>316</sup> SCHWAB, Find a Branch, <http://bit.ly/2vE8fYn> (last visited August 21, 2016).

<sup>317</sup> D.A. DAVIDSON, Your Rights, <http://bit.ly/2MgVxpr> (last visited August 21, 2016).

<sup>318</sup> MASS MUTUAL, <http://bit.ly/2KskJrj> (last visited August 21, 2016).

<sup>319</sup> RAYMOND JAMES, Why a Raymond James Advisor, <http://bit.ly/2O7RqNd> (last visited April 4, 2018).

<sup>320</sup> STEPHENS, About Stephens, <http://bit.ly/2OKGB4D> (last visited August 21, 2016).

<sup>321</sup> UBS, About Us, <http://bit.ly/2AHvRkF> (last visited August 21, 2016).

Indeed, the National Association of Insurance and Financial Advisors (NAIFA), one of the trade groups that sued the DOL rule and claimed in court that they were mere product salespeople, has a consumer advertising campaign called “**Trust a NAIFA Advisor.**” Their website carries the heading “**Advisors You Can Trust.**”<sup>322</sup> There is a video advertisement on the website, with voiceover stating: “Contact a NAIFA member for **advice you can trust.**”<sup>323</sup> (emphasis added for all).

These and other broker-dealer firms’ marketing materials and advertisements make clear that broker-dealers seek to occupy positions of trust and confidence with their clients. Why else would they use those precise words? Their marketing materials are devoid of any prominent reference that indicates they are mere salespeople engaged in arms-length commercial transactions, as they argued in court. They certainly don’t give the impression to the investing public that broker-dealers are no different from a car dealer soliciting interest in inventory.<sup>324</sup>

It should come as no surprise, then, that retail investors understand and expect the relationship with their broker-dealers to be one of trust and confidence. According to RAND, for example, “trust plays an important role in financial decision-making, particularly regarding financial advice. In fact, investors cite ‘trust’ as the most important determinant in seeking a financial service professional for advice.”<sup>325</sup> Moreover, according to Vanguard research, “By hiring an advisor, investors are taking a leap of faith that the advisor will provide proper guidance and oversight of their finances. The cornerstone of that relationship is the bond of trust between the advisor and client.”<sup>326</sup>

In its research paper, Vanguard explained how a relationship of trust is cultivated. It states that, “Early in the relationship, trust is based on a calculus or the use of ‘proof sources.’ This is where credentials, past performance, and referrals are important. It is followed by relational trust, which develops over time through repeated and reciprocated interactions. In spite of the original motivation for the advisory relationship—improving the investor’s financial outcomes—the personal aspect of trust tends to permeate the relationship. There is evidence that investor satisfaction in the advisory relationship tends to come from personal attention rather than from actual financial returns.” (internal citations omitted) This understanding is consistent with RAND’s earlier findings that investors often choose financial professionals based on referrals and that the most commonly cited reasons for investors’ satisfaction are the professional’s attentiveness and accessibility and the fact the investor has trust in their financial professional. (Given low levels of investor literacy, however, it does not necessarily follow that the trust is warranted.)

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<sup>322</sup> NAIFA, NAIFA: Advisors You Can Trust, <http://bit.ly/2n9mY9M> (last visited August 21, 2016).

<sup>323</sup> *Id.*

<sup>324</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 41, <http://bit.ly/2f4wVBW> (“A broker, insurance agent, or other financial-sales professional may make ‘individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.’”) (internal cites omitted).

<sup>325</sup> Jeremy Burke and Angela A. Hung, Trust and Financial Advice, RAND Labor & Population, Working Paper, January 2015, <http://bit.ly/2nelxH7>.

<sup>326</sup> Anna Madamba and Stephen P. Utkus, Trust and financial advice, Vanguard Research, September 2017, <https://vgi.vg/2LZ7kMh> (Vanguard appears to use the term “advisor” to include both investment advisers and broker-dealers).

Broker-dealers cultivate relationships of trust and confidence because doing so makes good business sense. According to the Vanguard research paper, “A high level of trust is associated with client loyalty and improved business development for the advisory business. Investors who have high trust in their advisor almost unanimously say they are highly satisfied and likely to recommend the advisor.”<sup>327</sup> Thus, it makes sense that broker-dealers would foster relationships of trust and confidence with their clients. Broker-dealers would prefer that their clients view them the same way their clients view their attorneys and accountants, rather than their car salesman. But the clear implication is that they should be held to a fiduciary standard when they do.

The Commission fails to explain why it does not view broker-dealers’ relationships with their customers as relationships of trust and confidence. They clearly are. As a result, the Commission cannot justify failing to hold them to a fiduciary standard of care.

### **C. The Commission is flouting the will of Congress by disregarding the framework Congress set out in Section 913(g).**

In Section 913(g) of the Dodd-Frank Act, Congress provided a very clear framework to the Commission for how a standard of conduct should be formulated for broker-dealers and investment advisers when they are providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide). Congress made clear that the standard should take the form of a uniform fiduciary duty for broker-dealers and investment advisers. Congress stated that the standard for brokers and advisers alike should be “the same as” and “no less stringent than” the Investment Advisers Act standard. Further clarifying its intent, Congress specified that the standard “shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.”

In adopting this approach, Congress reflected an awareness of differences in the broker-dealer and investment adviser business models and made clear that the uniform fiduciary standard it prescribed nonetheless was compatible with both. For example, Congress stated that the receipt of commissions should not in and of itself be considered a violation of the standard, that the sale of only proprietary products or other limited range of products should not in and of itself be considered a violation of the standard, and that the standard would not require a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities. Further reflecting a keen awareness of the different business models, Congress was careful to exclude the Advisers Act restrictions on principal trading from the standard, understanding that such restrictions would be incompatible with the broker-dealer model. In other words, the statutory language clearly shows that Congress was attuned to the key issues that could arise under a uniform fiduciary standard, and was intent on addressing them, while still clearly expressing its desire that the standard for brokers and advisers be a uniform fiduciary standard.

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<sup>327</sup> Anna Madamba and Stephen P. Utkus, Trust and financial advice, Vanguard Research, September 2017, <https://vgi.vg/2LZ7kMh>.

Instead of engaging in rulemaking under Section 913(g) and following the standard and nuances that Congress so carefully prescribed, the Commission has chosen to flout the clear will of Congress by proposing to exercise its authority under Section 913(f). It has done so in order to propose a standard of conduct that is different from, and weaker than, the standard of conduct that Congress laid out. Most prominently, the standard does not include the critical “without regard to” language that is a centerpiece of the 913(g) standard. The fact that the standard is neither “the same as” nor “no less stringent than” the standard that Congress expressly provided has serious implications, not only for the standard that the Commission proposes to apply to broker-dealers, but also for its proposed interpretation of the Advisers Act standard. Specifically, the Commission’s interpretation of advisers’ fiduciary duty is also different from, and weaker than, the standard that Congress prescribed.

In what can only be described as a “regulatory veto,” the Commission second guesses and disregards the clear will of Congress and its prescribed legislative language. In justifying this decision, the Commission acknowledges that it was guided by industry criticisms of the 913(g) standard, even as it makes clear that it recognizes them to be untrue. Specifically, the Commission points to industry concerns that the “without regard to” language in the 913(g) standard could be interpreted as requiring the elimination of all conflicts. The Release goes on to make clear that the Commission knows this is an incorrect reading of the statute and that the standard laid out by Congress could in fact be reconciled with the broker-dealer business model. It nonetheless states that, “In lieu of adopting wording that embodies apparent tensions, we are proposing to resolve those tensions through another formulation that appropriately reflects what we believe is the underlying intent of Section 913.”<sup>328</sup> In other words, instead of simply clarifying that it would be an incorrect reading of the 913(g) standard to suggest that it requires elimination of all conflicts, as the Commission clearly understands to be the case, the Commission has chosen to adopt its own standard in place of the standard prescribed by Congress. And it has the hubris to suggest that its proposed standard better reflects congressional intent than Congress’s own express statutory language.

In adopting a new “best interest” standard for brokers that differs from, and is weaker than, both the Advisers Act fiduciary standard and the 913(g) definition of that standard, the Commission relies on Section 913(f) of the Dodd-Frank Act. In contrast to Section 913(g), Section 913(f) grants the Commission very general rulemaking authority to commence a rulemaking “as 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), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers.” In developing that standard, 913(f) requires the Commission to “consider the findings, conclusions, and recommendations” of the staff study required under Section 913(b).

The Commission’s reliance on Section 913(f) to propose an entirely different regulatory framework is misplaced for several reasons. First, properly considered alongside 913(g), 913(f) cannot reasonably be read as supporting adoption by the Commission of a less-than-fiduciary standard for broker-dealers that is different from and weaker than the specific standard set out in

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<sup>328</sup> Reg BI Release at 49.



913(g). When a statutory text clearly lays out the parameters of a rulemaking, an agency may not use a general rulemaking clause to redefine the boundaries that Congress laid out.<sup>329</sup> In other words, Congress does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions.<sup>330</sup> It strains credulity that Congress would be so explicit about the standard of conduct that should apply, then provide the Commission with an escape hatch that it could choose to use if the Commission didn't want to provide a uniform fiduciary rule. If Congress were intending to do so, it would have stated clearly that it was providing the Commission with alternative regulatory authority if the Commission determined that a uniform fiduciary standard was not appropriate. Simply put, Congress doesn't "hide elephants in mouseholes."<sup>331</sup>

In addition, Section 913(f) states that rulemaking under that provision must be "as 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)." This proposal fails that test. In reality, the reasoning that the Commission has provided for engaging in rulemaking under Section 913(f) rather than 913(g) suggests that it was motivated by a desire to protect the broker-dealer business model, rather than by the protection of investors or the public. It is telling, in this regard, that the strongest support for this proposal comes from the brokerage industry, not investor advocates, who have consistently warned against a regulatory approach that simply rebrands the existing suitability standard as a best interest standard. But, in adopting a standard whose language is based on FINRA's characterization of its suitability standard, rather than the 913(g) standard, that is precisely what the Commission appears to have done.

Moreover, Section 913(f) provides the Commission authority to apply the rulemaking to "such other customers as the Commission may by rule provide." Yet the Commission never considers this aspect of the statutory language as part of its rulemaking. For example, it never considers applying Regulation Best Interest to small employer plans, where the potential impact on investor protection and the public interest is enormous. This issue is particularly important now that the DOL rule has been vacated and firms are walking away from being fiduciaries to small plans.<sup>332</sup> That the Commission doesn't even ask questions about this central aspect of Section 913(f) reflects either a lack of awareness about, or an unwillingness to seek comment on, the issue.

Finally, Section 913(f) requires the Commission to "consider the findings, conclusions, and recommendations" of the staff study required under Section 913(b). Yet the Commission hasn't come close to fulfilling its obligation to do so. In this regard, it is particularly telling that the staff study never raised the "apparent tension" issue with the "without regard to" language and assumed that Section 913(g) could be implemented without requiring complete elimination of conflicts. At the very least, before it could reasonably rely on this "apparent tension" to justify rulemaking under Section 913(f), the Commission would need to explain why it reached a different conclusion from the staff study on this important issue. Instead, as we discuss above,

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<sup>329</sup> See *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

<sup>330</sup> *Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001).

<sup>331</sup> *Id.*

<sup>332</sup> Greg Iacurci, *Fidelity backs away from being "point in time" fiduciary for 401(k) plans*, Investment News, July 18, 2018, <http://bit.ly/2ndKbb4>.

the Commission makes clear that it reached precisely the same conclusion as the staff study, but nonetheless chose to adopt a different standard under 913(f).

Moreover, the Commission must recognize that these concerns about the “without regard to” language don’t arise in the vacuum. The industry made the same arguments in the DOL fiduciary context, falsely suggesting that they were being subject to a “no conflicts” standard under the best interest contract exemption that was inconsistent with their business model. But even as they challenged the DOL rule on those grounds, the plaintiffs pointed to Section 913(g) as the answer. In their 5th Circuit legal brief, for example, the plaintiffs specifically cited to 913(g) to support their argument that, “In fact, in the Dodd-Frank Act, Congress gave the SEC—the nation’s principal securities regulator—the authority to develop a uniform fiduciary standard for broker-dealers.”<sup>333</sup> And, in vacating the DOL rule, the court chastised DOL for its “decision to outflank” Congress’s action in adopting Section 913(g), which it cited as “empowering the SEC to promulgate enhanced, uniform standards of conduct for broker-dealers and investment advisers who render ‘personalized investment advice about securities to a retail customer ...’”<sup>334</sup> The Commission cannot reasonably reshape its entire regulatory approach to avoid relying on statutory authority reflecting congressional intent in order to avoid a fabricated concern regarding the “without regard to” language.

**D. Form CRS raises serious First Amendment concerns. Certain required disclosures constitute impermissible compelled speech that goes beyond “purely factual and uncontroversial information.”**

The Supreme Court in *Zauderer v. Office of Disciplinary Counsel* ruled that disclosures that are traditionally compelled by government, including by the SEC, are permissible so long as they are designed to convey “purely factual and uncontroversial information about the terms under which his [the provider’s] services will be available.”<sup>335</sup> The justification for a disclosure regime is that companies have no legitimate (or at most a minimal) interest in withholding certain factual information about their own products and service from consumers, particularly when weighed about the value such disclosures provide consumers and the market in general.<sup>336</sup>

For example, as applied to securities markets, public companies are required to disclose detailed, purely factual, information about themselves, their management, and their activities. This disclosure forms the backbone of our thriving capital markets by providing “all investors, whether large institutions or private individuals...access to certain basic facts about an investment prior to buying it, and so long as they hold it.”<sup>337</sup> As the Commission explains on its website, we achieve this transparency by requiring all public companies “to disclose meaningful financial and other information to the public,” in order to create “a common pool of knowledge”

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<sup>333</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 50, <http://bit.ly/2f4wVBW>.

<sup>334</sup> *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep’t of Labor, et. al.*, No. 17-10238, at 41 (5th Cir.) (Mar. 15, 2018).

<sup>335</sup> *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 651 (1985).

<sup>336</sup> See Note, Repackaging Zauderer, 130 Harv. L. Rev. 972, January 5, 2017, <http://bit.ly/2vieT7d>.

<sup>337</sup> SEC, About the SEC, What We Do, <http://bit.ly/2MngEXy>.

all investors can use to decide whether to buy, sell, or hold a particular security.<sup>338</sup> “Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.”<sup>339</sup> These disclosures ensure that our capital markets operate with efficiency and integrity and they promote investor confidence.

While public companies are required to disclose purely factual and uncontroversial information about the terms under which their services will be available, they are not required to make disclosures about the terms under which their competitors’ services will be available. Certainly, public companies aren’t required to suggest in any way to potential investors that they should consider investing in the company’s competitors instead of them. The same principle applies to food labeling. While Coke is required to state what its ingredients are, it is not required to state to consumers, for example, “You may prefer to drink Pepsi, if you prefer sweeter drinks with less sodium.”<sup>340</sup>

In contrast, Form CRS, as currently proposed, would not be limited to “purely factual and uncontroversial information about the terms under which his [the provider’s] services will be available.” In particular, standalone investment advisers would be required to state that, “You can receive advice in either type of account [investment advisory or brokerage], but you may prefer paying: a transaction-based fee from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time; an asset-based fee if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee.”<sup>341</sup>

This is problematic, first, because the SEC has not provided evidence that this statement is purely factual, either as a general rule or as applied to the range of market participants, investors, investment products, or accounts. As we discuss above, there are many instances in which this statement would be false. For example, Vanguard charges 0.30% for its Personal Advisor Services,<sup>342</sup> Schwab charges 0.28% for its Intelligent Advisory Services,<sup>343</sup> and Betterment charges 0.25% for its Digital offering and 0.40% for its Premium offering.<sup>344</sup> All of these are likely to be more cost-effective than purchasing many A shares, let alone C shares. And they are certainly more cost-effective in most, if not all, instances than purchasing higher-cost broker-sold products, such as variable annuities or non-traded REITs. As a result, this disclosure could easily mislead “buy and hold” investors into believing that brokerage accounts are more cost-effective than advisory accounts in instances when that is not in fact the case. Information that is “purely factual” isn’t true in just some instances, it is true all the time. The inescapable conclusion is that this information is not “purely factual.”

Second, whether brokers provide advice more cost-effectively than investment advisers is not just factually questionable, it is also a highly controversial issue, as the Commission should

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<sup>338</sup> *Id.*

<sup>339</sup> *Id.*

<sup>340</sup> Diffen, *Coke vs. Pepsi*, <http://bit.ly/2OcAXaA>.

<sup>341</sup> Form CRS Release at 24, 89.

<sup>342</sup> Vanguard, *Personal Advisor Services*, <https://vgi.vg/2AGokme>.

<sup>343</sup> Schwab, *Intelligent Advisory*, <http://bit.ly/2OcB0mM>.

<sup>344</sup> Betterment, <http://bit.ly/2OJlhvo>.

be well aware. Indeed, the basic proposition that brokers provide bona-fide advice at all is itself a highly controversial issue and subject to differing opinions.

Third, the proposed disclosures do not simply provide information about the terms under which the provider's services will be available. It forces them to compare with alternative providers in the market. But, as courts have since made clear, "Zauderer does not leave the state 'free to require corporations to carry the messages of third parties, where the messages themselves are biased against or are expressly contrary to the corporation's views.'"<sup>345</sup> Any attempt by the government either to compel individuals to express certain views or to subsidize speech to which they object is subject to strict scrutiny.<sup>346</sup> The general rule "that the speaker has the right to tailor the speech [] applies not only to expressions of value, opinion, or endorsement, but equally to statements of fact the speaker would rather avoid."<sup>347</sup>

This is directly relevant in the context of Form CRS, where the Commission is seeking to deliver its own message that a brokerage account is a more cost-effective way than an advisory account for some investors to get advice. The Commission acknowledges that it is attempting to use Form CRS to drive investors to the "more cost-effective" solution when it states, "We believe that these factors – cost, trading frequency, and the desire to "buy and hold" – are important for retail investors to consider when determining whether to use brokerage or advisory services. ... [W]e believe these factors reflect common circumstances in which a brokerage account could be more cost-effective for a retail investor than an advisory account..."<sup>348</sup> While the SEC is free to make this statement, it is not free to require investment advisers to make this statement.

Form CRS would compel standalone investment advisers to express certain views about broker-dealers, as compared with themselves, with which most if not all would object. Standalone investment advisers would be required to effectively tout their competition as a more cost-effective method of providing advice, for example, by having to state that their clients "may prefer paying a transaction-based fee from a cost perspective" and "[an asset-based fee] may cost more than a transaction-based fee." There can be little doubt that many standalone investment advisers would object to having to express such positive views about broker-dealers to prospective clients and such comparably negative views of themselves, as it could result in lost business. Such statements could reasonably be seen as "expressions of value, opinion, or endorsement about their counterparts." Because requiring investment advisers to make such disclosures would undermine their own economic interest and support their competition's perceived value, the proposed requirement is subject to strict scrutiny and would fail.

The proposed disclosure is particularly troublesome when one considers advisory and brokerage as fundamentally different services, despite the Commission's attempt to paint both as different versions of the same thing.<sup>349</sup> Given the fundamental differences that would persist

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<sup>345</sup> *American Meat Institute v. U.S. Department of Agriculture*, 760 F.3d 18 (D.C. Cir. 2014) (en banc) (citing *Pacific Gas & Electric Co. v. Public Utilities Commission*, 475 U.S. 1, 15-16 n.12 (1986) (plurality opinion)).

<sup>346</sup> See *United States v. United Foods, Inc.*, 533 U.S. 405, 410-11 (2001).

<sup>347</sup> *Hurley v. Irish-Am. Gay, Lesbian & Bisexual Grp. of Bos.*, 515 U.S. 557, 573-74 (1995).

<sup>348</sup> Form CRS Release at 68-69.

<sup>349</sup> See *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor*, et. al., No. 17-10238, at 37 (5th Cir.) (Mar. 15, 2018) ("Congress distinguished sales from the provision of investment advice...").

under the proposed regulatory proposal – where advisers would be required to provide bona fide advice subject to a fiduciary standard while broker-dealers would be allowed to make sales recommendations subject to a less-than-fiduciary standard – it is simply not appropriate to require advisers to disclose to customers that they can get a more cost-effective version of their services from broker-dealers.

For these reasons, even if a court determined that strict scrutiny does not apply, the proposed disclosures likely would not survive even intermediate standard.<sup>350</sup>

## **VI. The Commission has not conducted an even remotely credible economic analysis to support its proposed regulatory approach.**

In our previous comment, we stated that it is imperative that the Commission correctly diagnose the problem it intends to address and develop a solution that is tailored to the problem. Correctly diagnosing the problem requires identifying and analyzing the market failure that has occurred in investment advice securities markets, as well as assessing the significance of that problem. It also requires considering whether existing regulations have created, or contributed to, the problem that the proposed regulation is intended to correct. Once the Commission determines that the proposed regulation is the best available method of achieving the regulatory objective, the proposed regulation should be designed in the most cost-effective manner to achieve that regulatory objective.

As we stated in our previous comment, the central problem the Commission needs to address is not that investors are “confused” about the differences between broker-dealers and investment advisers. The problem is that investors are being misled into relying on biased sales recommendations as if they were objective, best interest advice and that they are suffering significant financial harm as a result. Investor confusion is relevant only because it limits the tools the Commission has available to address that harm. Given these considerations, we stated that there are two possible approaches the Commission could take to address the problem: (1) eradicate the misleading practices that allow brokers to portray themselves as advisers when they are acting as salespeople; or (2) adopt a fiduciary standard for all recommendations so that investors are appropriately protected regardless of the type of financial professional they turn to for investment advice.

In every aspect of this proposal, the Commission has failed to develop a coherent analysis to support its proposed approach. In the context of Reg BI, it’s not clear that the SEC even acknowledges that a problem exists that requires a regulatory solution. In the context of Form CRS, the Commission incorrectly relies on the notion that investors are “confused,” without so much as acknowledging that investors are being misled about the differences between the broker-dealer relationship and the investment adviser relationship. On the contrary, the Commission continues to enable that “confusion” by failing to acknowledge that there is a meaningful difference between brokers’ sales recommendations and investment advisers’ advice that goes beyond the payment method for or duration of that “advice.”

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<sup>350</sup> See, e.g., *Nat’l Ass’n of Mfrs. v. SEC*, 748 F.3d 359 (D.C. Cir. 2014) (striking down conflict mineral disclosures); *R.J. Reynolds Tobacco Co. v. FDA*, 696 F.3d 1205 (D.C. Cir. 2012) (striking down a rule requiring graphic warning labels on cigarette packages).

Because it refuses to admit there's a problem in one respect and fails to diagnose the problem correctly in another, the Commission is proposing a regulatory approach that makes it a virtual certainty that the market failures in the investment advice market will persist and investors will continue to suffer serious harm as a result. If the Commission is truly interested in fixing the market failure, it must conduct a serious analysis that confronts the source of the problem head on and then design its regulatory approach based on that analysis. This is too serious an issue to be based on the kind of slapdash analysis on display here.

**A. In the context of Reg BI, it's not clear that the Commission even acknowledges that a genuine problem exists. As a result, it's not clear what specific problems in the market the Commission is trying to fix.**

The first step to recovery is admitting you have a problem. But when it comes to analyzing the broker-dealer sales practices that have led to calls for reform, the Commission refuses to admit there's a problem. Indeed, the Release seems to go out of its way to avoid stating that conflicted advice is a real problem and that retail investors suffer as a result. The farthest it appears willing to go is to say that "concerns" about conflicts exist. The Release states, for example:

- **"[I]t has been asserted"** that retail investors don't understand the broker-dealer relationship and associated conflicts and don't understand that the broker-dealer regime doesn't require broker-dealers to serve their clients' best interest.<sup>351</sup>
- "These **concerns** about the potential harms that may result from broker-dealer conflicts of interest have been echoed by commenters over the years. Recent commenters' analyses suggests that retail customers have been harmed by conflicted advice..."<sup>352</sup>
- "These **concerns** are not new. The Commission has previously expressed long-held **concerns** about the incentives that commission-based compensation provides..."<sup>353</sup>
- "The issue at hand, therefore, is how we should address these **concerns** in a manner that both improves investor protection and preserves these beneficial characteristics—in particular choice regarding access to a variety of products and advice relationships."<sup>354</sup>
- "[W]e are addressing these **concerns** by providing clarity about the requirements imposed by the proposed best interest obligation, and offering guidance on how a broker-dealer could comply with these requirements."<sup>355</sup> (emphasis added for all)

It should be abundantly clear to anyone with a passing familiarity with this issue that "concerns" about broker-dealer conflicts have existed for a long time. But that's not the same

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<sup>351</sup> Reg BI Release at 16.

<sup>352</sup> Reg BI Release at 19.

<sup>353</sup> Reg BI Release at 17.

<sup>354</sup> Reg BI Release at 22.

<sup>355</sup> Reg BI Release at 50.

thing as saying these concerns are legitimate, that conflicts are real and widespread, that they take a variety of forms, and that conflicts drive harmful behavior that results in serious injury to investors. It certainly isn't the same thing as carefully analyzing market evidence and peer reviewed academic literature to better understand the influence of conflicts on brokers' sales recommendations and the investor harm that results. Instead of conducting that kind of careful review, the Commission appears willing to acknowledge only a theoretical concern about conflicts in its economic analysis; it refuses to state, or even seriously examine whether, these concerns are borne out in reality.

Because it fails to acknowledge that conflicts of interest are a real problem that result in real harm to investors, refers only to "concerns" about conflicts of interest, and suggests that the regulatory proposal is intended to "address[ ] these concerns," the Release fails to make clear whether the Commission is truly seeking to address the underlying problem of conflicts' harmful impact on investors or an "appearance" problem that has dogged the agency and perceptions of broker-dealers' practices for decades. If the agency is focused on removing the *appearance* that brokers are subject to a lower standard, rather than the *fact* that conflicts have a harmful impact on investors, that could help to explain the fundamental weakness and lack of clarity in the Commission's proposed regulatory approach.

1. The Commission's economic analysis is based on a mischaracterization of the nature of the brokerage relationship.

The Commission's economic analysis gets off to a faulty start by mischaracterizing, or at least over-simplifying, the broker-customer "advice" relationship, as a principal-agent relationship.<sup>356</sup> While there are certainly instances where a broker and its customer can exhibit features of a bona fide principal-agent relationship – for example when executing a customer's order<sup>357</sup> -- it's not clear that, in the context of receiving investment recommendations, those same characteristics are present. Certainly, the brokerage industry expressly refutes this characterization, having argued successfully in the Fifth Circuit that brokers engage in nothing more than an arm's length commercial sales transaction, no different from a car dealer soliciting interest in inventory.<sup>358</sup>

Given this inconsistency, the Commission should, at the very least, provide an analysis of whether and to what extent industry's legal arguments relating to the nature of the brokerage relationship are compatible with the Commission's assumption that the relationship is one of principal and agent. Among other things, it would need to address how its interpretation applies

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<sup>356</sup> Reg BI Release at 215.

<sup>357</sup> See, e.g. Norman S. Poser and James A. Fanto, *Broker-Dealer Law and Regulation*, (4th Edition and Supp. 2013), Aspen Publishers § 1603[B]; See also FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, Reg. Notice 15-46 (Nov. 2015), <http://bit.ly/2M1fjs9> (A broker's obligation to obtain best execution "is based, in part, on the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest, and also has been incorporated explicitly in FINRA rules.").

<sup>358</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 41, <http://bit.ly/2f4wVBW> ("A broker, insurance agent, or other financial-sales professional may make 'individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.'") (internal cites omitted).

when a broker-dealer is acting in its dealer (principal) capacity, which is clearly not in a principal-agent relationship with its customer and how it applies to an employee of a broker-dealer, a registered representative who is an agent of its employer.<sup>359</sup> Yet the Release never explains how a registered representative can be an agent serving different principals with very different interests at the same time.

This is a crucial issue in the context of Reg BI because, to the extent that a bona fide principal-agent relationship, exists, it is inherently fiduciary in nature.<sup>360</sup> According to the Restatement (Third) of Agency, “If the relationship between two persons is one of agency . . . , the agent owes a fiduciary obligation to the principal.”<sup>361</sup> An agency relationship “arises when one person (the ‘principal’) manifests consent to another person (the ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control.”<sup>362</sup> The common law of agency includes a duty of loyalty that obligates an agent to act exclusively in the principal’s best interest and to refrain from any self-dealing behavior.<sup>363</sup> Professor and fiduciary law expert, Deborah DeMott, has stated that, “as the principal’s representative, the agent should aim to act ‘as if’ the principal personally had taken action and as the principal ‘would have’ acted.”<sup>364</sup> Thus, if the relationship between brokers and their customers is indeed a principal-agent relationship, then a fiduciary duty is clearly appropriate.

Regardless, the Commission’s discussion of this critically important issue provides an overly simplistic explanation that neglects critical features of the relationship. Typically, principal-agent relationships don’t involve third party payments to the agent, which can adversely affect the level of loyalty the agent provides to the principal.<sup>365</sup> For example, there is a fundamental difference between a scenario in which a person arranges for a private chef to prepare her a dinner, based on detailed instructions, and a scenario in which a person goes to a restaurant and asks the chef for a recommendation on what to order, relies entirely on the chef’s recommendation, and the chef receives incentives from a third party to recommend certain dishes over others. It would likely affect the chef’s loyalty to the customer, for example, if the restaurant had a daily sales quota to sell the restaurant’s day-old fish, if the chef received a bonus every time he sold a burger that was diluted with filler, or the bonus increased with the increasing amount of filler that was included in every burger sold. While the former scenario is consistent with a principal-agent relationship, the latter is more consistent with compensation practices that are all too common in the broker-dealer business model.

In the end, what the Release assumes without any analysis is a principal-agent relationship does not accurately reflect how the market works or how the industry itself views its

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<sup>359</sup> The employer-employee relationship is perhaps the most common principal-agent relationship.

<sup>360</sup> See generally Deborah A. DeMott, *The Fiduciary Character of Agency and the Interpretation of Instructions*, Forthcoming in *Philosophical Foundations of Fiduciary Law* (Andrew S. Gold & Paul B. Miller eds. Oxford Univ. Press 2014), <http://bit.ly/2OHYvKf>.

<sup>361</sup> Restatement (Third) of Agency § 1.01, Comment e (2005); *Hollingsworth v. Perry*, 133 S. Ct. 2652, 2666- 67 (2013).

<sup>362</sup> Restatement (Third) of Agency § 1 (St. Paul: American Law Institute Publishers 2007).

<sup>363</sup> See Demott.

<sup>364</sup> See Demott at 3.

<sup>365</sup> Restatement (Third) of Agency § 2.03, cmt. d. & § 8.02 (agent has duty not to acquire material benefit from a third party through the agent’s use of position).



role. Moreover, as discussed below, the proposed regulation does not appropriately transform the relationship into a principal-agent relationship, with an attendant fiduciary duty, as it should. In contrast, in the proposed IA Guidance, the Commission states that the Investment Advisers Act fiduciary duty requires an adviser “at all times” to adopt “the goals, objectives, or ends” of the investor. This is something proposed Reg BI does not similarly require, as it should if the Commission views the broker’s relationship to the customer as a principal-agent relationship.<sup>366</sup> (Unfortunately, as we discuss above, the Commission’s interpretation of the real world requirements for adhering to that Advisers Act standard also fail to live up to its rhetorical characterization of that duty.)

2. The Commission fails to meaningfully analyze existing FINRA suitability rules and their impact on firms’ and financial professionals’ conduct.

The Release is littered with references that suggest broker-dealers are already well-regulated in ways that limit harm to customers when broker-dealers make investment recommendations. For example, the Release states that “broker-dealers are subject to comprehensive regulation under the Exchange Act and SRO rules,” that “broker-dealers have a duty of fair dealing,” and that they “are also subject to general and specific requirements aimed at addressing certain conflicts of interest, including requirements to eliminate, mitigate, or disclose certain conflicts of interest.”<sup>367</sup> In addition, the economic analysis states that, “A central aspect of a broker-dealer’s duty of fair dealing is the suitability obligation, which has been interpreted as requiring a broker-dealer to make recommendations that are consistent with the best interest of his customer.”<sup>368</sup>

This suggests that the Commission fails to see any shortcomings in the current regulatory approach that demand a regulatory solution. For example, the economic analysis never states where the existing suitability framework falls short, which is critical if the Commission genuinely intends to address shortcomings in the standard. In making its case, the Commission’s analysis is virtually indistinguishable from industry groups’ claims that greatly exaggerate the investor protections afforded by the existing suitability framework. For example, SIFMA states that, “FINRA has ... interpreted this suitability obligation as requiring that BDs’ recommendations be consistent with their customers’ best interests, thereby prohibiting BDs from placing their interests ahead of their customers’ interests.”<sup>369</sup> Fidelity notes that, “In interpreting FINRA’s suitability rule, numerous cases explicitly state that ‘a broker’s recommendation must be consistent with his customer’s best interests.’ The suitability requirement that a broker make only those recommendations that are consistent with the customer’s best interests prohibits a broker from placing his or her interests ahead of the customer’s interests.”<sup>370</sup> Fidelity also writes, “With respect to broker-dealers, we view FINRA’s existing suitability standard as an already highly effective best interest standard of conduct that protects investor interests, is appropriately tailored to a broker-dealer business model, and is subject to strong and long-standing SEC and FINRA enforcement practices.”<sup>371</sup>

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<sup>366</sup> IA Guidance at 7.

<sup>367</sup> Reg BI Release at 12-13.

<sup>368</sup> Reg BI Release at 247.

<sup>369</sup> Letter from Kevin M. Carroll, SIFMA, to the SEC, at 4, July 21, 2017, <http://bit.ly/2uRtdUA>.

<sup>370</sup> Letter from Marc R. Bryant, Fidelity, to the SEC, at 2, August 11, 2017, <http://bit.ly/2wLJSKh>.

<sup>371</sup> *Id.*

We have repeatedly warned about the risks to investors of a regulatory approach that simply rebrands the existing suitability standard as a best interest standard.<sup>372</sup> And we previously documented how that standard, as enforced, falls well short of a true fiduciary best interest standard.<sup>373</sup> Because the Commission’s analysis fails to explain where the existing suitability standard under FINRA rules falls short on its promise of requiring brokers to act in their customers’ best interest or prohibiting them from placing their interests ahead of the customer’s interests, it fails to make clear whether Reg BI is intended to raise the standard that currently applies under FINRA rules or simply rebrand that standard as a best interest standard.

Instead, the Commission seems to want to have it both ways, arguing that FINRA suitability already provides a best interest standard that protects investors and, at the same time, claiming it is creating a new best interest standard where one does not currently exist. One possible interpretation is that the Commission is making a distinction based on the fact that the FINRA “best interest” standard is part of guidance and not the actual FINRA suitability rule. The Release states, for example, that, “While not an explicit requirement of FINRA’s suitability rule, FINRA and a number of cases have interpreted the suitability rule as requiring a broker-dealer to make recommendations that are ‘consistent with his customers’ best interests’ or are not ‘clearly contrary to the best interest of the customer.’”<sup>374</sup> If this is the case, one would expect the Commission to provide some analysis of whether firms and reps are following or disregarding FINRA’s guidance and whether, in the Commission’s view, it makes a material difference that the best interest standard is in guidance as opposed to FINRA’s suitability rule itself. These are critical questions the Commission doesn’t even attempt to answer.

Until the Commission provides that analysis, it will be impossible to determine what the regulatory baseline is, what’s wrong with it, why it needs changing, and what the changes will accomplish. Failure to provide that analysis reinforces the concern that Reg BI is designed to enshrine FINRA’s guidance in Exchange Act rules, without actually seeking to change

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<sup>372</sup> Letter from Barbara Roper and Micah Hauptman, CFA to Chairman Clayton, March 15, 2018, <http://bit.ly/2Ku0QAI>.

<sup>373</sup> Letter from Barbara Roper and Micah Hauptman, CFA, to DOL, at 8-13, July 21, 2015, <http://bit.ly/2MfTp1h>.

<sup>374</sup> Reg BI Release at 14, footnote 15 citing FINRA Regulatory Notice 12-25, Additional Guidance on FINRA’s New Suitability Rule (May 2012) (“FINRA Regulatory Notice 12-25”) and selected cases for the proposition that FINRA already applies a best interest standard to brokers’ recommendations. A closer look at the cases reveals that a best interest standard is only being cited as a secondary factor in cases that involve more fundamental violations of suitability or fraud. The fact that the broker in question put his interests ahead of the interests of his customers helps to explain the motivation behind the misconduct, but it is not the primary basis for the regulatory action. *In re Sathianathan* (in addition to recommending higher class B shares over lower cost A shares, the broker recommended that a client, who was an inexperienced and conservative investor, purchase mutual funds and warrants on margin using a concentrated position in stock as collateral.); *In re Dane Faber* (broker sold securities through fraudulent misrepresentations and omissions, and made unsuitable recommendations to his customer); *In re Powell & McGowan* (the Commission cites a 1964 case, well before FINRA’s current suitability rule and guidance became applicable. In that case, the broker charged markups up to 18.21% over the price he paid for the securities on the same day and induced an elderly person with physical and mental deficiencies to invest in the broker’s firm when the broker knew it had a capital deficiency. The SEC determined that his conduct was “so grossly” inappropriate as to violate the antifraud provisions of the Exchange Act). Surely the SEC does not intend to suggest that this case stands for the proposition that existing rules safeguard investors’ best interest rather than protect against basic fraud?

applicable regulatory requirements or firm practices. The lack of clarity in the regulatory proposal itself only adds to that concern.

In addition, the Release mentions certain applicable heightened FINRA suitability rules for higher risk contexts, implying that they provide enhanced protections beyond the “best interest” standard that, at least in theory, already exists under FINRA’s standard suitability rule. For example, the Release states that broker-dealers already have additional specific suitability obligations with respect to certain types of products or transactions, such as variable insurance products and non-traditional products, including structured products and leveraged and exchange-traded funds.<sup>375</sup> Yet, here again, the Release is silent on what practical impact the heightened obligations have on brokers’ recommendations. Nowhere does it discuss the large number of customer complaints and high level of investor harm that occurs as a result of inappropriate sales of these products, despite these “heightened” requirements.

Statements by FINRA’s former Chairman and CEO, Rick Ketchum, suggest either that suitability doesn’t provide the level of protection that the Commission and the industry suggest or that firms aren’t even complying with that lower standard, much less a true best interest standard. For example, in 2015, Ketchum stated, “First, our examinations and enforcement dockets continue to reveal unacceptable instances of unsuitable sales of more complex products without the appropriate disclosure to clients of the downside risks and fees associated with the products. Second, while we provided best practice examples in our Conflicts Report of firms implementing rigorous programs to identify and aggressively manage conflicts relating to their retail client businesses, some firms continue to approach conflict management on a haphazard basis, only implementing an effective supervisory process after a failure event involving customer harm occurs. Third, despite our Notice on firms’ obligations regarding recommendations of 401(k) conversions to IRAs, we continue to be concerned that there is often not enough effort made to provide a balanced discussion of the potentially higher fees involved in IRAs to permit a customer to make a fully informed decision.”<sup>376</sup>

The fact that Ketchum called for the development of a best interest standard suggests that the existing framework, including the existing FINRA suitability standard and enforcement of the existing standard, isn’t delivering on its “best interest” promise. Moreover, the concerns he cites highlight, in a way that the Commission’s economic analysis does not, the role that conflicts of interest play as a root cause of broker misconduct.

**B. The Commission’s economic analysis fails to analyze current market practices under the existing regulatory framework and how those practices adversely affect investors.**

By its own account, the Commission has been studying this issue for decades. The Commission itself conducts regulatory exams and enforcement proceedings that presumably

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<sup>375</sup> Reg BI Release at 248, citing FINRA Rules 2330, 2370. In addition to heightened suitability requirements for variable annuities and securities futures, there are also heightened suitability requirements for certain other securities and strategies that are particularly complex or risky, including direct participation programs (FINRA Rule 2310), index warrants (FINRA Rule 2353), and options (FINRA Rule 2360), among others.

<sup>376</sup> Richard G. Ketchum, Remarks From the 2015 FINRA Annual Conference (May 27, 2015), <http://bit.ly/2nd5oly>.

inform its regulatory analysis. It could and should also take advantage of FINRA’s and state securities regulators’ experience in this area as the frontline enforcers in cases that involve retail investors. Moreover, a wealth of academic and empirical research has been conducted on this issue of conflicts of interests’ adverse impact on consumers in the financial services markets. None of that presumed market expertise is evident in the Release’s woefully inadequate economic analysis.

1. The SEC’s, FINRA’s, and state securities regulators’ many years of exams and enforcement should provide illuminating evidence of the nature, scope, and significance of the problem that the Commission intends to address with this regulatory package. Unfortunately, the economic analysis fails to provide any specific insights into what the staff gleaned from its experience.

The Commission has years of experience that should shed light on the harm to investors that results from conflicted brokerage “advice.” The Release states, for example, that, “This apprehension about the potentially harmful effects of conflicts has been reflected over the years in, among other things, our National Examination Program’s examination priorities, which have continually included conflicts of interest as an exam focus—either generally or specifically (e.g., the role of conflicts of interest in and suitability of recommendations involving retirement accounts (such as investment or rollover recommendations), complex or structured products, variable annuities, higher yield securities, exchange traded funds, and mutual fund share class selection (i.e., share classes with higher loads or distribution fees))—for many years.”<sup>377</sup>

In addition to these yearly exams, OCIE launched a multi-year Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative in 2015 to examine both SEC-registered investment advisers and broker-dealers in four key areas: reasonable basis for their recommendations; conflicts of interest, supervision and compliance controls; and marketing and disclosures.<sup>378</sup> As part of that special review, the Commission:

- assessed the actions of registrants and their representatives when (i) selecting the type of account, (ii) performing due diligence on investment options, (iii) making initial investment recommendations, and (iv) providing ongoing account management to assess the reasonable basis for their recommendations;
- assessed whether registrants identified material conflicts of interest, designed compliance programs to address the risks caused by those conflicts, and/or disclosed material conflicts of interest;
- reviewed registrants’ supervision and compliance controls, oversight, and supervisory policies and procedures to assess whether the firms were reasonably supervising persons acting on their behalf and adopting effective compliance programs; and

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<sup>377</sup> Reg BI Release at 17, footnote 20 listing OCIE Examination Priorities for 2013 through 2017.

<sup>378</sup> See OCIE Risk Alert, “Retirement-Targeted Industry Reviews and Examinations Initiative” (June 22, 2015), <http://bit.ly/2AGYC0H>.

- reviewed registrants’ brochures, sales and marketing materials, and disclosures to retail investors to, among other things, validate, to the extent applicable and required, that (i) the content of the materials and representations of representatives are true and accurate and do not omit material information where there is a duty to disclose, (ii) disclosures regarding the fees are complete and accurate, and (iii) credentials or other endorsements are valid and meet any stipulated standards.<sup>379</sup>

Given such comprehensive and detailed exams, it would be reasonable to expect that the Commission would have a strong understanding of where, specifically, firms are and aren’t complying with the existing regulatory framework, the role of conflicts of interest as a root cause of that misconduct, products and business practices that are particularly prone to abuse, and where, specifically, the existing regulatory protections need to be strengthened to improve protections for investors. It would also be reasonable to expect that the Commission would provide some concrete analysis of the evidence the staff gathered. Yet the economic analysis provides no evidence or insights about what the OCIE staff found in its exams. In a presentation at the Practising Law Institute’s Investment Management Institute earlier this year, the chief counsel of OCIE’s National Exam Program said OCIE “found ‘lots of problems’ last year when monitoring how broker-dealers and advisors work with clients about to retire.”<sup>380</sup> That one statement provides a more meaningful assessment of the problem than the Commission has provided in the entire economic analysis. Instead, the Release only offers a general and conclusory statement: “As our exam staff has noted, ‘[c]onflicts of interest, when not eliminated or properly mitigated and managed, are a leading indicator and cause of significant regulatory issues for individuals, firms and sometimes the entire market.’”<sup>381</sup>

The Release notes that FINRA has similarly focused on the potential risks to broker-dealers and to retail customers presented by broker-dealer conflicts and their impact on brokerage recommendations. For example, it cites a 2013 FINRA Regulatory Notice, in which FINRA “remind[ed]” firms of their responsibilities concerning IRA rollovers.<sup>382</sup> The fact that FINRA felt it necessary to “remind” firms of their responsibilities suggests that FINRA was seeing evidence in more than isolated instances that firms were putting their own interests ahead of their customers’ best interest when recommending IRA rollovers.

It would be reasonable to expect that, in preparing this economic analysis, the Commission would consult FINRA to get a better sense of the scope and magnitude of these apparent improper rollover recommendations, and the harms to investors that resulted from them. For example, it would be reasonable to expect the Commission to seek to fully understand whether improper rollover recommendations are happening across the market or are focused among certain firms. Similarly, it would be reasonable to expect the Commission to seek to understand the types of investors being targeted, as well as the types of investments that firms are recommending investors to roll out of and into. Were firms recommending rollovers for investors with already low-cost, diversified plans to load mutual funds that provided largely the

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<sup>379</sup> *Id.*

<sup>380</sup> Jill Gregorie, *SEC Finds ‘Lots of Problems’ With Rollover Advice*, Ignites, May 14, 2018, <http://bit.ly/2vCFnzX>.

<sup>381</sup> Reg BI Release at 17-18.

<sup>382</sup> FINRA Regulatory Notice 13-45, *Rollovers to Individual Retirement Accounts: FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers* (Dec. 2013), <http://bit.ly/2AJwvOE>.

same benefits but at significantly higher cost for the investor? Were firms recommending even higher cost variable annuities, or still higher cost non-traded REITs and structured products? The economic analysis is inexplicably devoid of any discussion of these issues, despite the fact that rollovers are the point at which retail investors are typically both most dependent on high-quality advice and most vulnerable to being harmed, given the amounts of money at stake and financial professionals' incentives to capture assets.

In January 2015, FINRA published a letter announcing its regulatory and examination priorities for 2015. In it, FINRA stated that “a central failing [it] has observed is firms not putting customers' interests first. The harm caused by this may be compounded when it involved vulnerable investors (e.g., senior investors) or a major liquidity or wealth event in an investor's life (e.g., an inheritance or Individual Retirement Account rollover). Poor advice and investments in these situations can have especially devastating and lasting consequences for the investor.”<sup>383</sup> Later in 2015, FINRA launched a targeted exam program regarding incentive structures and conflicts of interest in connection with firms' retail brokerage business, which encompassed firms' conflict mitigation processes regarding compensation plans for registered representatives, and firms' approaches to mitigating conflicts of interest that arise through the sale of proprietary or affiliated products, or products for which a firm receives third-party payments (e.g., revenue sharing).<sup>384</sup> FINRA also engaged in a Conflict of Interest Review focused on compensation and oversight and asking a series of questions about the efforts employed by firms to identify, mitigate and manage conflicts of interest, specifically with respect to compensation practices.<sup>385</sup> Again, it appears the Commission could gain valuable knowledge and insights from FINRA's work in this area. It would be reasonable to expect the Commission to incorporate specific insights in its economic analysis based on this review. Yet, here again, there is no evidence that the Commission reviewed the information, let alone incorporated it in its economic analysis.

2. The economic analysis ignores the rich body of academic and empirical research on conflicts of interest and their resulting harms to investors.

In our September 2017 comment letter to the Commission, we stated that, “it is incumbent on the Commission, in developing its own regulatory proposal, to carefully consider the findings of the [DOL Regulatory Impact Analysis (RIA)], particularly those with regard to the breakdown of the market for investment advice and the limitations of disclosure as a regulatory solution, many of which are directly relevant to the task at hand.”<sup>386</sup> The DOL RIA includes a thorough and balanced analysis of the academic and empirical research in this area that the Commission cannot reasonably ignore. Yet the Commission has done just that in its economic analysis. In one passing footnote,<sup>387</sup> the Commission attempts to disregard not only the entire DOL Regulatory Impact Analysis but all of the research underlying it. The Commission states that, because of “differences in scope” between the DOL rule and proposed Reg Best

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<sup>383</sup> FINRA 2015 Regulatory and Examination Priorities Letter, January 6, 2015, <http://bit.ly/2OKGMNh>.

<sup>384</sup> FINRA 2016 Regulatory and Examination Priorities Letter, January 5, 2016, <http://bit.ly/2vdzwSb>.

<sup>385</sup> FINRA Conflicts of Interest Review - Compensation and Oversight (Aug. 2015), <http://bit.ly/2ACYW0M>.

<sup>386</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 4, September 14, 2017, <http://bit.ly/2vAiDjN>.

<sup>387</sup> Reg BI Release at 266-267, footnote 460.

Interest and because the DOL did not use “the relevant metric,” in the Commission’s view, it is “unable to apply the DOL’s analytical framework.”<sup>388</sup>

But while the Commission is free to reach a different conclusion based on its analysis, or to use a different “metric” in assessing investor harm, it cannot reasonably ignore the extensive qualitative analysis compiled by the DOL. At the very least, it has an obligation to explain why it reaches a different conclusion based on the evidence presented. The Commission’s superficial dismissal of the RIA, and its failure to independently assess the independent economic literature on which it is based, reinforces the impression that the Commission is not interested in undertaking a serious examination of the evidence in order to develop an appropriately targeted regulatory response.

The rich body of independent economic literature, much of which was peer-reviewed and published in prestigious academic journals, and which the DOL comprehensively examined, supports the finding that conflicted advice is widespread, that advisers’ conflicts take a variety of forms and can bias their advice in a variety of ways, and that following such biased advice can inflict significant losses on investors in a variety of ways.<sup>389</sup> Those are serious issues that deserve serious analysis that the Commission once again fails to provide.

### 3. The economic analysis fails to examine product-based conflicts.

Academic studies compiled by RAND, for example, have found “empirical evidence suggesting that financial advisors act opportunistically to the detriment of their clients.”<sup>390</sup> Among these are several academic papers that indicate that “fund flows are positively associated with investment fees” and that “investors in the broker channel receive lower returns on their investments than investors in the direct channel.”<sup>391</sup> Based on their review of the literature, authors of the RAND Study concluded that, “there is substantial empirical evidence that financial advisors are influenced by their compensation schemes and that investors who purchase through advisors earn lower returns than those who invest autonomously.”<sup>392</sup> Yet the Commission makes no mention of RAND’s findings. The Commission can’t reasonably ignore the studies’ existence or disregard their relevance to the issue at hand.

In its literature review, RAND examines the rich body of academic and empirical literature on how financial advisors’ compensation-related conflicts impacts retail investors’ financial well-being. Based on its review of the literature, RAND finds “substantial empirical evidence that financial advisors are influenced by their compensation schemes and that investors who purchase through advisors earn lower returns than those who invest autonomously.” It cites, for example, academic literature that suggests mutual funds that are distributed through a broker underperform mutual funds that are not distributed through a broker, even after removing the

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<sup>388</sup> *Id.*

<sup>389</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 24-32, September 14, 2017, <http://bit.ly/2vAiDjN>.

<sup>390</sup> Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, Impacts of Conflicts of Interest in the Financial Services Industry, RAND Working Paper, August 2014, <http://bit.ly/2w8gzOt>.

<sup>391</sup> *Id.* at 14.

<sup>392</sup> *Id.* at 20.

distribution costs.<sup>393</sup> It also cites a highly relevant study that shows that the greater the scope of the conflict (i.e. the larger the load-sharing payments to brokers), the more flows those funds receive.<sup>394</sup>

As discussed above, the Commission suggests in a passing footnote that these comparisons are not the “relevant metric,”<sup>395</sup> yet several of the academics who authored the cited papers would disagree with the Commission’s assessment. For example, Boston College Finance Professor Jonathan Reuter stated that, “conflicted advice is readily observed in real-world data and, in the settings that we study, associated with significantly lower after-fee, risk-adjusted returns....This evidence of conflicted advice is inconsistent with brokers recommending the better-than-average funds on their platforms. Furthermore, because the brokers in our sample sell variable annuities, it is not the case that existing evidence of conflicted advice is limited to mutual funds.”<sup>396</sup> When Reuter updated his research in 2015, he found that broker-sold funds continue to underperform direct-sold funds, even after removing distribution costs.<sup>397</sup> In other words, investors were paying for brokers’ “advice” only to be put in inferior funds. In addition, he found that value-weighted return differences were larger than equal-weighted return differences, which suggests that brokers were steering clients to worse performing funds. This finding is inconsistent with the notion that brokers recommend the best of the reasonably available investments for their customers.

In addition, recent research by three professors from the University of Pennsylvania and the University of Southern California, suggests that distribution payments drive the sale of inferior products, which in turn imposes costs on investors.<sup>398</sup> The researchers find that decreasing the amount that funds spend on marketing would substantially improve investor welfare, as more capital would be invested in index funds and price competition would decrease fees on actively managed funds, forcing them to compete based on cost and quality. These findings are directly relevant to the concerns the Commission’s regulatory proposal is purportedly designed to address but are not considered in its analysis.

Disturbingly, the Commission fails to engage in any analysis on the extent to which 12b-1 fees, a significant source of the broker-dealer conflict, erode returns over time. In fact, the term 12b-1 fee is referred to only three times throughout the entire Reg BI Release, by our count. The

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<sup>393</sup> See, e.g., Bergstresser, Chalmers, and Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, *Review of Financial Studies* 22, no. 10 (2009); Bullard, Friesen, and Sapp, *Investor Timing and Fund Distribution Channels*, Social Science Research Network, 2008; Chalmers and Reuter, *Is Conflicted Investment Advice Better than No Advice?*, NBER Working Paper No. 18158, September 14, 2015; Christofferson, Evans, and Musto, *What Do Consumers’ Fund Flows Maximize? Evidence from their Broker’s Incentives*, *Journal of Finance* 68 (2013); Del Guercio, Reuter, and Tkac, *Broker Incentives and Mutual Fund Market Segmentation*, NBER Working Paper No 16312, 2010; Del Guercio and Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, *Journal of Finance* 69, no. 4 (2014); Friesen and Sapp, *Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability*, *Journal of Banking and Finance* 31, no. 9 (2007), Reuter, *Revisiting the Performance of Broker-Sold Mutual Funds* (2015).

<sup>394</sup> Christofferson, Evans, and Musto (2013).

<sup>395</sup> Reg BI Release at 266-267, footnote 460.

<sup>396</sup> Written testimony of Jonathan Reuter, to the DOL, August 11, 2015, <http://bit.ly/2LViAdg>.

<sup>397</sup> Reuter, *Revisiting the Performance of Broker-Sold Mutual Funds* (2015), <http://bit.ly/2LQWs47>.

<sup>398</sup> Nikolai Roussanov, Hongxun Ruan, and Yanhao Wei, *Marketing Mutual Funds*, April 8, 2018, <http://bit.ly/2AHXQ3I>.



Commission fails to engage in any analysis on the extent to which investors are kept in C shares, which charge a 1% 12b-1 fee in perpetuity, for the lifetime of the investment, and as a result, pay more than they would pay in distribution costs, if they were placed in A shares. Our review of market practice indicates that most firms don't automatically convert C shares to A shares after a certain point and only began doing so as a result of the DOL rule.<sup>399</sup> Yet the Commission routinely implies, and would require investment advisers to disclose, that brokers' transaction-based fees, which would include 12b-1 fees imposed by C shares,<sup>400</sup> are typically more cost-effective for buy-and-hold investors than asset-based fees.

Moreover, even when firms do change their policies to convert C shares to A shares, evidence suggests that some registered representatives will look to evade the policy change in order to preserve their compensation, regardless of the additional costs it imposes on their clients. A recent *AdvisorHub* article, for example, described registered reps' reaction after Morgan Stanley announced that it would convert C shares held by customers for six or more years to load-waived A shares that pay brokers lower annual fees. According to the article, several Morgan Stanley brokers told *AdvisorHub* that they plan to get around the change by "flipping" C shares, selling out of one fund and into another C share as they approach the conversion date so that they can continue to collect the higher 12b-1 fee. "Losing 75 basis points on every six-year-old share on my team's book will cost us \$300,000 in gross and \$120,000 in commissions," lamented one broker, who said the team expects to "flip til the cows go home." Is the Commission troubled about such activities? Or looking into actions it could take to reduce brokers' incentives to prioritize their pay over their customers' financial well-being? One can't tell from the economic analysis, and the Release's discussion of the regulatory proposal sends decidedly mixed messages.

While the richest body of literature relating to conflicts of interest is found in the mutual fund market, due to the transparency and availability of high quality data, conflicts are not limited to that market. Rather, they are likely more pronounced in other parts of the market, where conflicts can be stronger and products less transparent. In a study on how brokers' conflicts of interest distort investment decisions in the convertible bond market, for example, Harvard Business Professor Mark Egan found that these products' fee structures incentivize brokers to sell higher cost, lower-performing products.<sup>401</sup> According to his research, consumers are more likely to buy reverse convertibles with high broker's fees, and reverse convertibles with high fees tend to have worse payoffs. In this sense, brokers are incentivized to sell consumers inferior products.<sup>402</sup> Egan finds that aligning broker incentives with those of consumers would increase consumers' risk-adjusted returns by over 100 bps.<sup>403</sup>

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<sup>399</sup> Jed Horowitz, *EXCLUSIVE: Morgan Stanley to Squeeze Mutual Fund Sales Compensation*, AdvisorHub, March 29, 2018, <http://bit.ly/2LRx1Pz>.

<sup>400</sup> See *supra* Section V.A.6. on why 12b-1 fees are more appropriately considered asset-based and therefore constitute "special compensation."

<sup>401</sup> Mark Egan, *Brokers vs. Retail Investors: Conflicting Interests and Dominated Products*, University of Chicago, 2014.

<sup>402</sup> The empirical evidence suggests that broker incentives are responsible for the inferior investments, as brokers earn a 1.12 percentage point higher fee relative to the notional invested for selling the dominated bond on average.

<sup>403</sup> *Id.*

And, as we've discussed in our previous comment, according to Craig McCann and his colleagues at the Securities Litigation and Consulting Group, investors purchased at least \$116 billion in non-traded REITs over the last 25 years and, as a result, are at least \$45 billion worse off than they would have been if they had merely invested in a diversified portfolio of traded REITs.<sup>404</sup> In their study, Dr. McCann and his colleagues found that non-traded REIT investors pay upfront fees that average 13.2% of the purchase amount, and in some cases are as high as 16%. These fees dramatically reduce the capital available to purchase portfolio holdings. A significant portion of these payments goes to the brokers who recommend these products.

To their credit, the Commission and FINRA have expressed concern over the sale of non-traded REITs<sup>405</sup> and brought certain enforcement actions for suitability violations related to their sale. But the cases brought were for the worst abuses, not garden variety sales of these products when they are not in customers' best interests.<sup>406</sup> In our view, as they are currently structured and sold, these products would clearly violate a true best interest standard. In fact, there was a significant reduction in the sale of non-traded REITs and BDCs following the DOL rule's initial implementation. While some have pointed to this decline as evidence of a loss to investor "choice," in our view this was evidence of the rule working as intended to prevent recommendations that promote the broker's interests in high compensation rather than the investor's best interest. Unfortunately, new evidence suggests sales are rebounding following the DOL rule's demise.<sup>407</sup>

Another area of concern is the sale of high-cost variable annuities of questionable value, some of which are virtually impossible for economists and quants, much less ordinary retail investors, to understand or value. Some, for example, commonly known as "buffer annuities," use structured products — not mutual funds — in the sub account as the underlying investment.<sup>408</sup> To value these products and their potential payoffs, an investor would need to know how to value embedded derivatives.<sup>409</sup> According to experts at FINRA, these products raise serious questions. "We have some individuals who really understand VAs and they were struggling with this," Donald Lopezi, senior vice president and regional director for FINRA's western region reportedly said during a presentation at a financial industry conference. "You have to wonder, does the firm understand it? Does the rep? To be honest my head spins."<sup>410</sup>

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<sup>404</sup> Craig McCann, *Fiduciary Duty and Non-Traded REITs*, Investment Management Consultants Association Inc, July / August 2015, <http://bit.ly/2xdEUHw>.

<sup>405</sup> SEC Investor Bulletin: Non-Traded REITS, SEC Office of Investor Education and Advocacy, August 31, 2015, <http://bit.ly/2LRxtgJ>; FINRA Investor Alerts, Public Non-Traded REITS – Perform a Careful Review Before Investing, October 4, 2011, <http://bit.ly/2AHSPbv>.

<sup>406</sup> See, eg., Press Release, FINRA, "FINRA Sanctions David Lerner Associates \$14 Million for Unfair Practices in Sale of Apple REIT Ten and for Charging Excessive Markups on Municipal Bonds and CMOs," (October 22, 2012) <http://bit.ly/2LUNcvw>; Press Release, FINRA, "FINRA Fines Berthel Fisher and Affiliate, Securities Management & Research, \$775,000 for Supervisory Failures Related to Sales of Non-Traded REITs and Leveraged and Inverse ETFs" (February 24, 2014), <http://bit.ly/2naey27>; Bruce Kelly, *Finra fines six IBDs for failing to give discounts on large REIT sales*, Investment News, October 14, 2015, <http://bit.ly/2OG0IGy>.

<sup>407</sup> Bruce Kelly, *Are nontraded REIT sales back from the dead?*, Investment News, July 12, 2018, <http://bit.ly/2AS7QHV>.

<sup>408</sup> Bruce Kelly, *Complaints surface at Finra over buffer annuities*, Investment News, January 25, 2017, <http://bit.ly/2vxvy60>.

<sup>409</sup> Geng Deng, Tim Dulaney, Tim Husson, and Craig McCann, *Structured Product Based Variable Annuities*, Securities Litigation and Consulting Group, Inc. September 11, 2013, <http://bit.ly/2ObC769>.

<sup>410</sup> Bruce Kelly, *Complaints surface at Finra over buffer annuities*, Investment News, January 25, 2017,

Yet these products are growing in popularity. Indeed, according to the annuity trade association, Insured Retirement Institute, they are “beginning to flourish.”<sup>411</sup> LIMRA data estimates that buffer-annuity sales exceeded \$9 billion last year, up roughly \$2 billion — or 25% — from 2016, and \$7 billion — or 350% — from 2014.<sup>412</sup> When one sees the advertising campaign the annuity manufacturers are waging to promote these products, it makes sense why sales are growing. The products sound like they are perfect in every way.<sup>413</sup> After all, who wouldn’t want a product that “maintain[s] a level of protection in down markets – while taking advantage of growth opportunities in up markets,”<sup>414</sup> particularly when that product is marketed as having “no annual fees...unlike many financial products.”<sup>415</sup> However, slick advertisements alone don’t fully account for the sales of these products. Most of them are sold through brokers, who receive significant incentives to sell them.<sup>416</sup>

In addition, sales of private placements are surging, particularly among firms with troubled brokers.<sup>417</sup> More than 1,200 firms sold around \$710 billion of private placements last year, and sales for the first five months of this year are on track to top that record-setting tally, according to a recent *Wall Street Journal* analysis. There are concerns that sales of these products are being driven, not by the quality of the offering, but by high commissions and markups that come with them. “Sales of private placements are so lucrative to the brokerage firms that they are a perennial concern for regulators,” Brad Bennett, a former FINRA enforcement official, reportedly told the *Journal*. If there are concerns about whether sales of these products meet a suitability standard, there’s even more reason to be concerned about whether the same sales would meet a true best interest standard. The takeaway is not that regulation cannot stem such abuses, but rather that it needs to target the root cause of the abuse – toxic incentives that reward conduct that is not in customers’ best interest.

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<http://bit.ly/2vxvy60>.

<sup>411</sup> Greg Iacurci, *Buffer annuities grow in popularity*, Investment News, February 13, 2018,

<http://bit.ly/2OGW85v>.

<sup>412</sup> *Id.*

<sup>413</sup> Brighthouse Financial, 'The Vineyard' Commercial from Brighthouse Financial, YouTube, April 23, 2018,

<http://bit.ly/2LRBnGK> (“Shield annuity from Brighthouse Financial, allows you to take advantage of growth opportunities in up markets, while maintaining a level of protection in down markets. So you can be less concerned with market volatility and can focus more on the things you’re passionate about.”); Brighthouse Financial, ‘The Drive’ TV Commercial, YouTube, October 9, 2017, <http://bit.ly/2nhywbr>.

<sup>414</sup> Brighthouse Financial, Shield Annuities, <http://bit.ly/2naf4NB>.

<sup>415</sup> *Id.*

<sup>416</sup> See, e.g., Brighthouse Financial Prospectus, Shield Level Select 6-Year Annuity, at 47, July 24, 2017, <http://bit.ly/2M1QBYV> (“Compensation Paid to Selling Firms. We and Brighthouse Securities pay compensation to all selling firms in the form of commissions and may also provide certain types of non-cash compensation. The maximum commission payable is 6% of the Purchase Payment. Some selling firms may elect to receive a lower commission when the Purchase Payment is made, along with annual trail commissions up to 1% of Account Value for so long as the Contract remains in effect or as agreed in the selling agreement. We also pay commissions when an Owner elects to begin receiving regular income payments. (See ‘INCOME PAYMENTS—(THE INCOME PERIOD).’) Brighthouse Securities may also provide non-cash compensation items that we may provide jointly with Brighthouse Securities. Non-cash items may include expenses for conference or seminar trips, certain gifts, prizes and awards. Ask your registered representative for further information about what payments your registered representative and the selling firm for which he or she works may receive in connection with your purchase of a Contract.”)

<sup>417</sup> Jean Eaglesham and Coulter Jones, *Firms With Troubled Brokers Are Often Behind Sales of Private Stakes*, The Wall Street Journal, June 24, 2018, <https://on.wsj.com/2Mnkf81>.

Nowhere in its economic analysis does the Commission consider this empirical evidence of how the characteristics of certain investment products contribute to investor harm. On the contrary, it appears from the economic analysis that the Commission simply isn't willing to engage in any serious analysis of the harm to investors that can result from the sale of more complex, more conflicted, higher cost products. In fact, the Commission appears to take the opposite view, that the "diversity" of products currently on the market is inherently beneficial and preserving that diversity should be a goal of the Commission's regulation, regardless of whether those types of products actually deliver positive value to investors. The proposal states, for example, "We do not intend to limit through proposed Regulation Best Interest the diversity of products available, the higher cost or risks that may be presented by certain products, or the diversity in retail customers' portfolios. This proposal is not meant to effectively eliminate recommendations that encourage diversity in a retail customer's portfolio through investment in a wide range of products, such as actively managed mutual funds, variable annuities, and structured products."<sup>418</sup>

While no credible commentator would support restrictions on diversification or the availability of a wide array of products suitable to a varied population of investors, that does not excuse the Commission from analyzing whether certain products in that mix are being sold primarily or exclusively because of the high compensation they pay to the selling broker. The Commission's failure to draw that distinction makes a mockery of its claim to having analyzed the issue. Moreover, the economic analysis fails to consider how the variety of products available in the market could pose serious challenges, as well as benefits, for retail investors.

The fact is that, in a market with seemingly limitless product choices, whose features can vary widely, most retail investors are bewildered by all of the complex choices available to them. They often can't independently assess the quality of the product being recommended, including any "special or unusual features," or the product's ability to provide valuable diversification benefits at a reasonable cost.<sup>419</sup> As a result, retail investors typically can't assess the quality of the advice they receive to invest in a certain product, or the nature or extent of conflicts associated with the recommendation, either at the product level or at the firm level. This helps drive retail investors to rely on professionals to make their investment decisions, a dynamic that can be extremely costly and result in significant harm to investors in the absence of adequate investor protections.

Inexplicably, the Commission appears unwilling to make even these fairly anodyne observations about how investors' lack of financial sophistication makes them vulnerable to abuse by conflicted advisers. Its analysis fails to acknowledge the simple fact, backed by academic and empirical evidence, that conflicts that are embedded in many broker-sold investment products often taint brokers' recommendations, to retail investors' detriment. If it

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<sup>418</sup> Reg BI Release at 52.

<sup>419</sup> SEC economist Matthew Kozora recognizes that, "Recent research finds that securities which are more difficult to evaluate are often sold to investors at significant premiums (e.g., Henderson and Pearson (2011), and Hoechle, Ruenzi, Schaub, and Schmid (2015)), and also relates the increase in the number and the opacity of financial products to the incentive of financial intermediaries to maximize information rents (e.g., Carlin and Manso (2011) and Sato (2014))." The proposal's economic analysis ignores this research. Matthew L. Kozora, Security Recommendations and the Liabilities of Broker-Dealers, Working Paper, May 1, 2016, <http://bit.ly/2KnLqO5>.

disagrees with that analysis, the Commission has an obligation to explain its reasoning and support that explanation with evidence, but it fails to do so. Determining whether and how conflicts of interest influence brokers' recommendations, and what the impact on investors is when they do, is critical if the Commission intends for the proposal to effectively address the conflicts that are associated with broker-dealers' product recommendations.

4. The economic analysis fails to consider findings from audit studies showing brokers acting on their conflicts in ways that harm investors.

As we discuss above, evidence suggests that broker-sold investment products' embedded conflicts often taint broker-dealers' investment recommendations. That evidence is backed by audit studies, which show brokers making recommendations that will leave their clients worse off in order to secure financial gains for themselves and their firms. The Commission fails to consider this research as part of its economic analysis.

In a 2012 study published in the National Bureau of Economic Research, for example, trained auditors posing as retail investors met with financial professionals in search of investment advice.<sup>420</sup> The auditors presented different portfolios reflecting different biases and misconceptions. The academics found that, by and large, the financial professionals failed to correct any of the investors' misconceptions and, worse, they often reinforced biases and misconceptions when it was in their interests to do so. For example, financial professionals encouraged returns-chasing behavior and pushed higher-cost funds, even when the clients started with well-diversified, lower-cost portfolios. According to the authors, "Moving the low-fee portfolio to an actively managed portfolio with the same risk/return profile but average management fees would result in additional costs of about one percentage point per year, i.e., between U.S. \$500 and U.S. \$1,000 in our scenario."<sup>421</sup>

A subsequent audit study's results corroborate the findings of the initial study.<sup>422</sup> According to one of the authors, the researchers found that advisers who have a fiduciary duty to their clients provided better and less biased advice than those that were registered as brokers, who did not have a fiduciary duty. Among other things, advisers were less likely to move people away from lower cost funds and to reinforce erroneous beliefs about the market than non-fiduciary advisers. Yet the Commission, in a Release that is supposed to analyze the economic impact of imposing a heightened standard of care on brokers, makes no mention of the aforementioned audit studies.

The economic analysis similarly fails to mention a 2013 GAO report that provides alarming evidence of the tactics that financial services firms engage in when recommending an IRA rollover to secure workers' assets.<sup>423</sup> According to the report, financial firms aggressively encouraged rolling 401(k) plan savings into an IRA, and did so with only minimal knowledge of

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<sup>420</sup> Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar, *The Market for Financial Advice: An Audit Study*, NBER Working Paper No. 17929, March 2012.

<sup>421</sup> *Id* at 7.

<sup>422</sup> Antoinette Schoar, *We Put Financial Advisers to the Test—and They Failed*, *The Wall Street Journal*, October 27, 2016, <https://on.wsj.com/2MiyppqS>.

<sup>423</sup> 401(K) PLANS: Labor and IRS Could Improve the Rollover Process for Participants, GOVERNMENT ACCOUNTABILITY, OFFICE, March 7, 2013, <http://1.usa.gov/1iQFeOR>.

a caller's financial situation. They also made misleading claims, such as that 401(k) plans had extra fees and that IRA's "were free or had no fees," or argued that IRAs were always less expensive, notwithstanding that the opposite is generally true. The report also found that investment firms sometimes offer financial or other incentives to financial advisers who persuade workers to perform a rollover.

A 2015 report found evidence that brokerage firms were often recommending to participants in the federal Thrift Savings Plan (TSP) that they roll their accounts over to high fee products.<sup>424</sup> Military service members are often targeted by these recommendations, according to the report.<sup>425</sup> The TSP is one of the lowest if not the lowest cost retirement plan available, with broadly diversified investment options. Investors' annual costs could easily increase by 30 to 40 times for similar products, excluding the cost of the load or commission that they may pay to complete the transaction. Most employees would be best served staying in the TSP. In fact, several former and current SEC staffers with deep knowledge of the investment management industry have indicated in private conversations that they would never think of rolling out of the TSP upon separation from the government. Yet, according to a 2014 AonHewitt survey, an estimated 16,400 participants made a withdrawal of all or part of their TSP account in 2013 because they were advised by their financial adviser to do so.<sup>426</sup> To our knowledge, neither the Commission nor FINRA has brought a single case involving unsuitable recommendations to roll out of the TSP.<sup>427</sup> And, of course, this like other evidence of investor harm from conflicted advice goes unmentioned in the Commission's economic analysis.

In light of the Commission's failure to make any mention of these audit studies, it's not clear whether the Commission believes it is a problem that brokers often recommend that their clients and prospective clients move from low-cost, diversified portfolios to higher-cost portfolios, portfolios that often provide no apparent value-add to offset their value draining added costs. Certainly, the Commission does not seem to take that into account in its repeated suggestions that brokerage accounts are typically the lower cost option for buy-and-hold investors. But the Commission cannot reasonably justify its proposed regulatory approach without addressing this type of conduct and demonstrating whether, or how, it would aim to clear up these abuses.

Meanwhile, other recent research suggests that conflicts of interest may not tell the whole story, providing an alternative explanation about why brokers often provide costly and low-quality advice. According to this research, which examined a large sample of Canadian financial advisers who are not subject to a fiduciary duty under Canadian law, many of these advisers typically invest personally just as they advise their clients.<sup>428</sup> They engage in the same misguided practices as they recommend to their clients, including frequent trading and investing in

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<sup>424</sup> John A. Turner, Bruce W. Klein, and Norman P. Stein, Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers, April 2015, <http://bit.ly/2M2Dpmn>.

<sup>425</sup> *Id.* at 14, (citing a 2014 USAA ad, which stated, "Leaving the Military? Give your TSP some TLC."); *See also* Gerri Walsh, President, FINRA Investor Education Foundation, Thinking about rolling over funds from your Thrift Savings Plan? Consider this., Military Saves, October 9, 2014, <http://bit.ly/2vkWWoy>.

<sup>426</sup> *Id.* at 3 (citing AonHewitt, "2014 TSP Withdrawal Survey Results," September 2014).

<sup>427</sup> *Id.*

<sup>428</sup> Juhani T. Linnainmaa Brian T. Melzer Alessandro Previtero, The Misguided Beliefs of Financial Advisers, May 2018, <http://bit.ly/2vhlHSw>.

expensive products. As a result, they deliver net returns substantially below their benchmarks, both for their clients and for themselves. The research supports the view that broker's advice is costly and underscores the need for a true best interest standard that includes both a duty of care to act like a prudent professional and a duty of loyalty to refrain from self-dealing. Here, the duty to act like a prudent professional would seek to curb brokers' misguided beliefs and practices that taint their recommendations, to their clients' detriment.

5. The Release takes a deeply troubling view of harmful incentives, failing to explicitly recognize how damaging to investors they can be.

The economic analysis spends less than two-and-a-half pages describing incentives, and does so in a cursory, general, and superficial way. The Commission provides absolutely no analysis of how these incentives affect conduct and how that, in turn, impacts investors. When discussing variable compensation, for example, the economic analysis simply lists a series of ranges, providing no analysis on how those ranges affect behavior and outcomes. It states, for example: "Several firms had varying commission payout rates depending on the product type being sold. For example, payouts ranged from 76.5% for stocks, bonds, options, and commodities to 90% for open-ended mutual funds, private placements, and unit investment trusts. Several firms charged varying commissions on products depending on the amount of product sold (e.g., rates on certain proprietary mutual funds ranged from 0.75% to 5.75% depending on the share class), but did not provide those payout rates to financial professionals based on product type. Some firms also provided incentives for their financial professionals to recommend proprietary products and services over third-party or non-proprietary products. Commission rates for some firms, however, declined as the dollar amount sold increased and such rates varied across asset classes as well (e.g., within a given share class, rates ranged from 1.50% to 5.75% depending on the dollar amount of the fund sold). With respect to compensation to individual financial professionals, if payout rates for mutual funds were approximately 90% (as discussed above, for example), financial professionals could earn between 0.68% and 5.18%, depending on the type and amount of product sold."<sup>429</sup>

After listing these ranges, the Commission provides absolutely no analysis of exactly how these differentials are structured, or whether, how, and to what extent they are likely to drive harmful conduct.<sup>430</sup> Economic theory suggests that these types of incentives would increase registered representatives' motivation to recommend higher compensating products rather than lower compensating products. Such incentives reasonably could be expected to distort broker-dealer behavior, to the customer's detriment. And, as we discuss above, academic research provides evidence that this is the case. Given that the Commission's proposal includes a requirement to mitigate such incentives, it is frankly astounding that the economic analysis gives the topic such short shrift.

The Commission need not look very far for strong evidence that firms engage in such harmful incentive practices. The Securities Division of Massachusetts recently brought an enforcement action against Scottrade for holding sales contests over a span of years that

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<sup>429</sup> Reg BI Release at 244.

<sup>430</sup> Reg BI Release at 313 ("[T]he Commission lacks data on the extent to which current broker-dealer recommendations are subject to conflicts of interest related to financial incentives.").

encouraged their brokers to put their own interests ahead of their clients' interests.<sup>431</sup> The complaint describes a "firm-wide culture characterized by aggressive sales practices and incentive-based programs." The firm allegedly set performance metrics and quotas for referrals to its investment advisory program, for example, that agents had to meet to qualify for certain prizes. In addition, "internal-use materials instructed agents to target a client's 'pain point' and emotional vulnerability, while training sessions lauded the use of emotion over logic in getting a client to bring additional assets to the firm," according to the complaint. The firm distributed weekly net new assets reports and closely tracked progress during these sales contests and used internal quotas that ranked agents during the contests. Moreover, the firm frequently used performance metrics to rank the different branches and agents in order to incentivize them to make recommendations to retirement account clients.

One branch manager reportedly stated, "This...is honestly the most interested I have ever been in 1 of our contests. We are going to make a concerted effort to win this thing." A Divisional Vice President stated in email, "The first week of the Q3 "RUN-THE-BASES" contest is done, and we have a few regions off to a SCREAMING start! [... ] You certainly knocked the cover off the ball! Some would say you knocked it out of the park! Very soon, we will get an official count on how we did, and more exciting, a chance to see where we stack-up against our peers on our official scoreboard! [...] Happy Selling!" Many other emails referred to these contests. But the Commission's economic analysis provides no analysis of these practices.

In our previous comment, we provided citations to congressional testimony by Law Professor Mercer Bullard in which he discusses a variety of incentives that encourage registered reps to work against their clients' best interest. Most prominently, Bullard provided detailed examples showing the "mind-boggling" magnitude of the conflicts that can result from retroactive ratcheted payout grids.<sup>432</sup> Because increased payouts to brokers at each new level on the grid are applied retroactively, the conflicts can quickly escalate and create extraordinary incentives to make specific sales. A broker who is approaching the next rung on the payout grid may have more riding on a single transaction than the entire value of that transaction. Yet, the only veiled reference in the Release that could be loosely construed to discuss ratcheted payout grids is the statement that "some firms used a tiered system within their compensation grids depending on firm experience and production levels." This is not serious analysis.

Moreover, the economic analysis provides no meaningful assessment of firms' incentives to recommend advisory accounts over brokerage accounts or vice versa. This is peculiar, as many Commission officials and industry participants have expressed deep concern that customer accounts were being inappropriately switched from brokerage accounts to fee accounts as a

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<sup>431</sup> *In re Scottrade, Inc.*, Administrative Complaint, No. E-2017-0045 (Feb. 15, 2018), <http://bit.ly/2By4rMW>.

<sup>432</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 23, September 14, 2017, <http://bit.ly/2vAiDjN> (citing Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and MDLA Distinguished Lecturer and Professor of Law University of Mississippi School of Law, before the Subcommittees on Capital Markets and Government Sponsored Enterprises, and Oversight and Investigations, Committee on Financial Services, United States House of Representatives, Preserving Retirement Security and Investment Choices for All Americans, September 10, 2015, <http://bit.ly/2j6Lb1r>). We also discussed the implications of Professor Bullard's testimony in our September 24, 2015 comment letter to the DOL. Letter from Roper and Hauptman, CFA, to the DOL, at 10-11, September 24, 2015, <http://bit.ly/1Rkslum>.



result of DOL fiduciary duty. This has been offered as crucial evidence of the DOL rule's harmful impact on investors, even though the practice clearly violates that rule, as we have previously explained.<sup>433</sup> In light of the concerns expressed about this particular issue, one would expect the Commission to at least endeavor to analyze it rigorously. Yet, in discussing firms' incentives to recommend advisory over brokerage accounts, the Release states nothing more than, "Financial professionals' variable compensation could also increase when they enrolled retail customers in advisory accounts versus other types of accounts, such as brokerage accounts."<sup>434</sup> The Commission provides no analysis on whether, and if so, to what extent, these financial incentives drive recommendations to use advisory accounts when the investor should be in brokerage accounts. Similarly, the Commission fails to engage in any analysis on whether recommendations regarding the type of account should be covered under the rule.

Similarly, the economic analysis glosses over other compensation practices that create perverse incentives, which are likely to harm investors in significant ways. For example, the Release states in vague, seemingly positive language that, "While the majority of firms based at least some portion of their bonuses on production, usually in the form of total gross revenue, other forms of bonus compensation were derived from customer retention, customer experience, and manager assessment of performance."<sup>435</sup> The economic analysis goes on to state that, "some firms awarded non-cash incentives for meeting certain performance, best practices, or customer service goals, including trophies, dinners with senior officers, and travel to annual meetings with other award winners."<sup>436</sup> In short, the economic analysis makes it sound like incentive programs are designed with the customer in mind, when that is clearly not the case in the vast majority of instances. The Release neglects to discuss the many ways incentive programs are structured that have a harmful impact on investors. If certain firms have structured incentives that are designed to reward beneficial advice, the Commission should explain how such practices are structured and how those practices achieve their objective. If, however, the Commission is trying to suggest that all such practices are designed with investors' interests in mind, its obligation to back its questionable claim with evidence is all the greater. Without that analysis, it cannot reach a reasonable conclusion on how to structure its regulatory proposal to address the issue.

The Release builds on its distorted picture of conflicts with its discussion of how incentives can benefit investors by "motivating greater effort"<sup>437</sup> by the broker representative. Similarly, it states that compensation arrangements can provide "incentives...to expend effort in providing quality advice."<sup>438</sup> Troublingly, the Release fails to distinguish between incentives that motivate brokers to expend greater effort to provide high quality advice and incentives that motivate brokers to expend greater effort to maximize sales, regardless of the impact on investors. The two are not the same. "Increased effort" is not always a good thing, if the effort involves selling investments the customer doesn't need or that are inferior to other available options. Indeed, given the skewed incentives that reward the sale of higher cost products, it

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<sup>433</sup> Press Release, Consumer Federation of America, "CFA Calls on DOL, SEC, and FINRA to Use Their Authority to Hold Firms Accountable for Acting in Customers' Best Interest," (October 5, 2017), <http://bit.ly/2vEVFYQ>.

<sup>434</sup> Reg BI Release at 245-246.

<sup>435</sup> Reg BI Release at 245-246.

<sup>436</sup> Reg BI Release at 246.

<sup>437</sup> Reg BI Release at 303 ("Such compensation structures are designed to benefit both the broker-dealers and the registered representatives by motivating greater effort by registered representatives.").

<sup>438</sup> Reg BI Release at 257, 274, 310.

seems more likely to have a negative effect. Unfortunately, the Commission never seems to make that connection, and it fails to provide any evidence to support its positive spin.

In short, one would reasonably expect the Commission to undertake a comprehensive and rigorous analysis of market practices that create potentially perverse incentives and share the results in the economic analysis. Yet, as is all too common in this Release, the Commission fails even to acknowledge in any meaningful way that such practices exist. If the Commission refuses to describe broker-dealer incentives or provide a clear sense of how broker-dealer incentives work in practice, how can it develop and justify a regulatory proposal to protect investors from the harmful impact of those practices? Indeed, how can it justify requiring brokers to provide disclosures of conflicts and their potentially harmful impact if the Commission itself is unwilling to do so?

6. The Commission fails to consider the quality of brokers' recommendations affecting taxable accounts.

Finally, the economic analysis fails to address an important issue that is squarely within the Commission's orbit – but not relevant in the DOL context – brokers' recommendations within taxable accounts. Evidence suggests that in most cases, brokers recommend actively managed load mutual funds to retail investors. To be clear, we do not take the position that actively managed funds are generally unsuitable, but the fact remains that actively managed funds tend not to be the most tax-efficient products on the market. First, they typically have higher turnover rates than passively managed funds. Higher turnover rates trigger more taxable events, which can be costly in taxable accounts.<sup>439</sup> Second, the mutual fund structure isn't the most tax-efficient structure. Rather, ETFs are more tax-efficient, due to their ability to take advantage of the creation/redemption process.

The Commission doesn't even raise this issue, much less provide any serious analysis of the question. A serious review of the economic issues at play in proposing a best interest standard would examine the extent to which brokers consider the tax consequences of their recommendations. Do broker-dealers make substantially different recommendations to invest in lower turnover funds in taxable accounts? Do they recommend that their clients use ETFs in taxable accounts, despite the fact that ETFs don't pay nearly as much up-front compensation as load mutual funds do, and ETFs don't pay trailing compensation (12b-1 fees)?<sup>440</sup> If not, how much are investors losing as a result? And would Reg BI help to stem those losses? Or would these products be viewed as being "materially different from the point of view of the investor," leaving brokers free to recommend the higher cost product. Based on the Commission's narrow interpretation of its best interest standard, we are concerned that it would not prevent brokers from placing their interests in earning higher compensation ahead of investors' interest in minimizing taxes. If not, it is not a true best interest standard.

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<sup>439</sup> See Index Fund Investors, Turnover is Costly in Taxable Accounts, <http://bit.ly/2OHY8zf> (citing Joel M. Dickson and John B. Shoven, "Taxation and Mutual Funds: An Investor Perspective," Tax Policy and the Economy, National Bureau of Economic Research, Vol. 9: MIT Press, 1995.).

<sup>440</sup> See, e.g., Deanna Flores, Jay Freedman, and Sean McKee, ETF tax efficiency: Fact or fiction?, KPMG, <http://bit.ly/2MjBMOF>; Scott J. Donaldson, Francis M. Kinniry Jr., David J. Walker, and Justin C. Wagner, Tax-efficient equity investing: Solutions for maximizing after-tax returns, Vanguard Research, March 2015, <https://vgi.vg/2LS0pW4>.

Similarly, the Commission doesn't provide any analysis on the quality of recommendations for retail investors to purchase individual municipal securities. The municipal bond market is opaque, and there are hundreds of thousands, if not over a million of bonds, outstanding at any time.<sup>441</sup> Tax-exempt municipal securities, are largely held by individual or "retail" investors. As with many other product choices that are available, most retail investors can't independently assess the quality of the product, so they rely on professionals to help make their investment decisions. One investor we spoke with, for example, had previously received a \$35,000 windfall and was looking to invest it conservatively, as she was approaching retirement and wanted to avoid the stock market. Her "financial advisor," who was referred to her by a family friend, worked for a large national broker-dealer. He recommended that she take \$20,000 of her windfall to purchase bonds from one small county in California. She couldn't remember why he recommended bonds from that specific county, and she had no way of independently evaluating his recommendation. She said she trusted that he knew what he was doing and assumed he was working in her best interest. She ended up receiving little more than her principal over almost a decade.

If the Commission fails to assess the quality of brokers' recommendations in this market, it cannot understand whether the current regulatory structure is resulting in best interest recommendations or whether their proposed regulatory approach would improve investor outcomes.

7. The economic analysis fails to consider conflicts of interest and resulting harms in small retirement plans.

The Commission has proposed to apply its new best interest standard for brokers exclusively to recommendations to retail investors, in contrast to the Advisers Act fiduciary standard which applies in all circumstances. But the Commission fails to provide any economic analysis to justify this decision. Importantly, the economic analysis provides no analysis of the harms that result from conflicted advice in the plan context, particularly with regard to small plans that would have been protected under the DOL rule had it not been vacated. Many plan sponsors lack the specialized knowledge needed to fulfill their obligations as plan fiduciaries.<sup>442</sup> As a result, many plan sponsors, particularly small plan sponsors, rely on financial professionals to help carry out their duties, including constructing plan menus. In short, small plan sponsors have many of the same characteristics as retail investors. But their lack of financial sophistication doesn't just put *them* at risk, it also affects their employees.

According to a GAO report, "plan sponsors are often not aware when a service provider is not an ERISA fiduciary and often assume that the advice they receive from the service

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<sup>441</sup> As of December 31, 2011, there were over one million different municipal bonds outstanding. SEC Report on the Municipal Securities Market, at 5, July 31, 2012, <http://bit.ly/2vi7LrA>.

<sup>442</sup> See GAO, Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors, at 23, July 2008, <http://bit.ly/2prHMcS> ("Several pension practitioners observed that most sponsors, especially sponsors of small plans, have very little fiduciary knowledge."); Alison Cooke Mintzer, 2017 PLANADVISER Micro Plan Survey, PLANADVISER, February 2017, <http://bit.ly/2mbAvy5> (finding that, of the micro plans that use retirement plan advisers, 40% said they were unaware of whether their adviser is a fiduciary to the plan or not).

provider is subject to ERISA standards and safe from harmful conflicts.”<sup>443</sup> As a result, “plan sponsors may not be aware that service providers can have a financial incentive to recommend certain funds that would be prohibited if they were ERISA fiduciaries.”<sup>444</sup> The problem is particularly acute for smaller plan investors, because smaller plans are less likely than larger plans to receive investment assistance from a service provider that is acting as a fiduciary, particularly after the DOL rule was vacated.<sup>445</sup> Plan sponsors and plan officials that rely on biased advice may make poor investment decisions, which can in turn compromise participants’ retirement security.

A recent study published in the Yale Law Journal found, for example, that a significant portion of 401(k) plans establish investment menus that predictably lead investors to hold high-cost portfolios.<sup>446</sup> The study by Professors Ian Ayres, Yale Law School, and Quinn Curtis, University of Virginia School of Law, uses data from more than 3,500 401(k) plans with more than \$120 billion in assets to analyze the effectiveness of the ERISA fiduciary requirements in protecting plan participants from high costs. Based on their analysis, the authors conclude that fees and menu restrictions in an average plan lead to a cost of 78 basis points in excess of the cost of index funds. The authors also document the existence of a wide array of “dominated” menu options, which they define as “funds that make no substantial contribution to menu diversity but charge fees significantly higher than those of comparable funds in the marketplace.” As the authors explain, “Since investors in retirement plans are limited to choosing from the menu offered by their employers, high-cost funds in the menu can greatly affect the performance of a retirement account. The stakes are high: reforms that reduce fees incurred by investors by only ten basis points on average would save more than \$4.4 billion annually, and these savings compound over the course of investors’ careers.”<sup>447</sup>

Another study raises similar concerns with regard to the harmful impact of conflicts that arise when mutual fund families acting as service providers in 401(k) plans display favoritism toward their own affiliated funds.<sup>448</sup> The study finds that “affiliated mutual funds are less likely to be removed from and more likely to be added to a 401(k) menu. In addition, fund deletions and additions are less sensitive to prior performance for affiliated than for unaffiliated funds.” It finds “no evidence that plan participants undo this affiliation bias through their investment choices.” On the contrary, the study finds that “the reluctance to remove poorly-performing affiliated funds from the menu generates a significant subsequent negative abnormal return for participants investing in those funds.”

In addition, a recently released report from researchers at RiXtrema examined the fund holdings of more than 52,000 plans and found retirement plan participants could save \$17 billion

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<sup>443</sup> GAO Publication No. GAO-11-119, 401(K) PLANS Improved Regulation Could Better Protect Participants from Conflicts of Interest, at 27, January 2011, <http://bit.ly/2p3UIZk>.

<sup>444</sup> *Id.*

<sup>445</sup> *Id.* at 28; Greg Iacurci, *Fidelity backs away from being “point in time” fiduciary for 401(k) plans*, Investment News, July 18, 2018, <http://bit.ly/2ndKbb4>.

<sup>446</sup> Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and “Dominated Funds” in 401(k) Plans*, Yale Law Journal, 124:1476, March 2015, <http://bit.ly/2OLbgPc>.

<sup>447</sup> *Id.* at 1480.

<sup>448</sup> Veronika K. Pool, Clemens Sialm, and Irina, Stefanescu, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, Journal of Finance, April 15, 2016, <http://bit.ly/2KpjkSp>.

a year just by switching to lower cost investment options.<sup>449</sup> The authors of the study, Daniel Satchkov and Yon Perullo, compared the fund holdings of plan investments with other funds that have similar holdings but lower costs and higher returns (both raw and risk-adjusted) over the preceding 10 years. Where there was a better alternative available based on these factors, they replaced the inferior fund with a superior version. Using this method, Satchkov and Perullo estimated that participants could save 0.25% a year on a weighted average basis by switching into lower cost investments that are quantitatively very similar to those they already hold, resulting in savings to 401(k) investors of roughly \$17 billion a year. According to the authors, that estimate is likely on the low end because, when information on share class was not available, they assumed the plan held the lowest cost share class of the fund.

In addition to asset-based investment management fees, plans may also pay asset-based administrative and advice fees, as well as other non-asset-based fees. These total plan costs, like investment expenses, are largely driven by plan size. And just like investment expenses, small plans often pay extremely high all-in costs. As illustrated by Brightscope data released in 2015, the average all-in fees for small plans are between 1.5 and 2%, and it is in fact quite common for small plans to pay between 2.5 and 3% in total costs.<sup>450</sup> While less common, there are even small plans that are paying between 3 and 4.5%. However, it is not just the smallest of plans that pay arguably excessive costs. Even plans with \$100 million in assets are typically paying well over one percent annually. It is not until you get to the largest plans, those with over \$1 billion in assets, that total costs consistently drop to under 0.50%. Other recent research further confirms that the smallest of plans are paying often exorbitant fees, and economies of scale explain only a portion of those higher costs.<sup>451</sup> Lower cost options are available for even the smallest plans.

Despite having clear authority under Section 913(f) of Dodd-Frank to engage in rulemaking, “as 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**),” the Commission has failed even to consider whether it should include small plans within the scope of the rule. (emphasis added) Because it restricts its best interest standard to recommendations to retail investors, the same advice recipients may receive advice that is subject to different standards of conduct depending on the context in which they receive the advice.<sup>452</sup> As a result, assuming proposed Reg BI does enhance protections for investors beyond the FINRA suitability standard, investors would be at increased risk of being harmed if they believe that proposed Reg BI’s protections apply in contexts where it doesn’t. And, ironically, the brokerage industry’s deep concern about being subject to multiple, inconsistent standards, which they raised at every opportunity during the DOL rulemaking process, would persist.

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<sup>449</sup> Daniel Satchkov, CFA and Yon Perullo, CFA, Significant Fee Waste in Retirement Plans – New Study Using Quantitative Methods Working Paper, RiXtrema, <http://bit.ly/2ogbjV2>.

<sup>450</sup> Ryan Alfred, The One Chart That Explains 401(k) Plans, Brightscope, 2015, <http://bit.ly/2pksy99>.

<sup>451</sup> See Eric Droblyen, (Possibly) The Biggest Small Business 401k Fee Study Ever!, EMPLOYEE THE FIDUCIARY FRUGAL FIDUCIARY BLOG, August 24, 2016, <http://bit.ly/2ogoDZr> (In the two years it has provided this service, Employee Fiduciary has analyzed 121 401(k) plans, all with less than \$2 million in assets. It found average all-in-fees of 2.22%, which is generally consistent with the Brightscope study).

<sup>452</sup> See Fred Reish, Interesting Angles on the DOL’s Fiduciary Rule #96, FredReish.com, June 25, 2018, <http://bit.ly/2OJShF2>; See also Fred Reish, Interesting Angles on the DOL’s Fiduciary Rule #97, FredReish.com, July 10, 2018, <http://bit.ly/2AD4dFv>.

**C. Because it doesn't clearly explain what problem the Commission is attempting to solve or even recognize that a problem exists, the economic analysis can't (and doesn't) explain how the proposal would address the problem.**

The economic analysis fails to provide any concrete analysis of how the proposal would address deficiencies in the existing regulatory framework, change broker-dealer practices, and improve investor outcomes. As a result, it is useless in assessing either the need for the regulatory proposal or its likely effectiveness.

1. It is unclear what the regulatory baseline is.

First, it's not entirely clear from the economic analysis what the regulatory baseline is and how the proposed rule compares with the regulatory baseline. The Release alternates in different sections between comparing the proposal with the Exchange Act and comparing the proposal with FINRA rules. In some places, it is simply unclear what regulatory framework the Commission is comparing the proposal to. The lack of consistency makes it extremely challenging to decipher the exact changes the Commission is making and what the practical implications of such changes are, both for broker-dealers and retail investors. As we discuss above, it is impossible to tell whether or to what extent Reg BI would enhance protections already available under the FINRA suitability standard.

For example, early in the Release, buried in a footnote, the Release states that “some of the enhancements that Regulation Best Interest would make to existing suitability obligations under the federal securities laws, such as the collection of information requirement related to a customer's investment profile, the inability to disclose away a broker-dealer's suitability obligation, and a requirement to make recommendations that are ‘consistent with his customers' best interests,’ **reflect obligations that already exist under the FINRA suitability rule or have been articulated in related FINRA interpretations and case law**...Unless otherwise indicated, our discussion of how Regulation Best Interest compares with existing suitability obligations focuses on what is currently required under the Exchange Act.”<sup>453</sup> (emphasis added)

On the other hand, in the economic analysis the Release states that, “In this section, we describe the existing regulatory baseline for broker-dealers, including existing obligations under the federal securities laws and FINRA rules, in particular those related to the suitability of recommendations and disclosure of conflicts of interest, state regulation, existing antifraud provisions, and state laws that impose fiduciary obligations, and other obligations that would be imposed by the DOL Fiduciary Rule and related PTEs, most notably the BIC Exemption.”<sup>454</sup> Yet even in the economic analysis, there are spots where it appears to be comparing the proposal to the Exchange Act, not FINRA rules. For example, when discussing the conflict of interest provision, the Release refers to Exchange Act requirements, stating “one key difference and enhancement resulting from the obligations imposed by Regulation Best Interest, **as compared to a broker-dealer's existing suitability obligations under the antifraud provisions of the federal securities laws**, is that the antifraud provisions require an element of fraud or deceit, which would not be required under Regulation Best Interest. More specifically, the Care

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<sup>453</sup> Reg BI Release at 10, footnote 7.

<sup>454</sup> Reg BI Release at 246.

Obligation could not be satisfied by disclosure.”<sup>455</sup> (emphasis added) But this statement ignores the fact that FINRA suitability rules do not require a showing of *scienter* to prove a violation. Nor can FINRA rules be satisfied by disclosure alone.

It’s not clear why the Commission alternates between comparing the proposal to the Exchange Act standard and FINRA rules. The result is a lack of clarity that makes it difficult to determine what the Commission is seeking to achieve. If the Commission’s only goal is to “enhance” the Exchange Act suitability standard to match the protections offered under FINRA’s suitability standard, it should make that clear, including by consistently using the Exchange Act suitability requirement as its regulatory baseline and comparing its “enhancements” to FINRA rules. If its goal is to raise the standard beyond the protections provided under FINRA rules, it needs to use the FINRA rules as its economic baseline and be much more transparent in its economic analysis regarding how its standard improves on the FINRA standard and what the impact on investors of any such improvements would be.

2. The Commission provides only vague descriptions of what the proposal would actually achieve.

Next, the Release provides only the vaguest of descriptions of how Reg BI would improve broker-dealer practices and investor outcomes. For example, the Release proclaims that, “Regulation Best Interest incorporates and goes beyond the existing broker-dealer regulatory regime for advice.”<sup>456</sup> Yet it’s not really clear what “goes beyond” means in practice, including how it would tangibly improve the regulatory framework, meaningfully change broker-dealer practices, and improve investor outcomes. Similarly, the Release states, “The best interest standard of conduct for broker-dealers would enhance the quality of investment advice that broker-dealers provide to retail customers, help retail customers evaluate the advice received, and improve retail customer protection when soliciting advice from broker-dealers.”<sup>457</sup> Again, the Release provides no explanation of how the proposal would achieve this. In another spot, it states, “By imposing a best interest obligation on broker-dealers, Regulation Best Interest would achieve these benefits by ameliorating the agency conflict between broker-dealers and customers.”<sup>458</sup> Here again, it implies that the proposal would somehow fix problems that it is not even prepared to acknowledge are real. The Release is silent on how it would fix those unidentified problems.

The Release uses similarly vague and imprecise terms throughout in an effort to compare the proposed Reg BI to a fiduciary duty. For example, it states that in developing the proposal, the Commission has “drawn from”<sup>459</sup> state common law fiduciary principles and that its proposed standard “resemble[s]”<sup>460</sup> the state common law duty. It’s not clear what “drawn from” means in this context, but the implication seems to be that the standards are similar, but not the same. The use of these words tells us nothing about how the proposed standard would be the same as or different from those standards in practice. This makes it impossible to assess whether,

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<sup>455</sup> Reg BI Release at 290, footnote 488.

<sup>456</sup> Reg BI Release at 246.

<sup>457</sup> Reg BI Release at 255.

<sup>458</sup> Reg BI Release at 255-256.

<sup>459</sup> Reg BI Release at 249.

<sup>460</sup> *Id.*

or to what extent, the Commission’s proposal enhances or falls short of existing standards. Such a lack of clarity and precision is problematic in the context of the economic analysis. But it is even more problematic in the regulatory context, leaving firms in the dark about what specific compliance measures they must adopt and investors in the dark about what specific protections they should expect to receive.

Despite refusing to acknowledge in its economic analysis that there’s a real problem to be fixed, much less what the scope or magnitude of that problem is, the Commission nonetheless suggests that the proposal will improve market practices and address any concerns about the quality of brokers’ advice. And it offers that assurance without saying precisely how it will achieve the promised outcome. Surely, if the Commission’s intent is to raise the standard, it can and should be far more precise about the specific changes its proposal would make and their intended impact on broker-dealer conduct. Here again, because of the Commission’s lack of precision in its economic analysis, we are left to wonder whether the Commission is actually attempting to raise the standard for brokers or simply rebranding the existing FINRA suitability regulatory framework as a “Best Interest” standard, without actually changing practices or outcomes.

As we have repeatedly warned, rebranding the suitability standard as a best interest standard would be disastrous for investors, effectively endorsing as acceptable common highly conflicted industry practices. Moreover, it would lead investors to believe they have certain protections that they don’t. And it would perpetuate, or even exacerbate, the harm investors suffer as a result of conflicted advice. Under such an approach, broker-dealers would be free to aggressively advertise that they now have a legal obligation to serve their clients’ best interest, when nothing has really changed. And, investors would be even more likely to inappropriately rely on the recommendations they receive as serving their best interest when they don’t in fact do so. If that is what the Commission is proposing to do, it at least needs to be transparent about that fact, and the potential harm to investors from misinterpreting conflicted sales recommendations as best interest advice needs to be factored into the economic analysis.

3. The Commission provides no meaningful analysis of the tangible impact that the Reg BI disclosure obligation would have on broker-dealer practices or investor outcomes.

Reg BI would impose extensive new obligations on brokers to “reasonably” disclose material facts and conflicts of interest related to their recommendations. The Release fails to provide any meaningful analysis detailing the specific changes broker-dealers would have to make to comply with this requirement or the specific benefits that would flow to investors from those changes. Instead, it provides only a vague and speculative description of the impact this obligation would be expected to have. The Release even seems to suggest that broker-dealers may already be required to provide many of the types of disclosures contemplated in the disclosure obligation, which would suggest that the rule’s disclosure obligations are far less extensive than the Commission has made them out to be elsewhere in the Release and would offer little if any new benefits to investors.



The economic analysis states, for example, that broker-dealers already may be liable under federal securities laws' antifraud provisions if they do not give "honest and complete information" or disclose any material adverse facts or material conflict of interest, including economic self-interest.<sup>461</sup> Accordingly, "broker-dealers may provide information about their services and accounts, which may include disclosure about a broker-dealer's capacity, fees, and conflicts on their firm websites and in their account opening agreements."<sup>462</sup> Yet when discussing the proposed disclosure obligation, the Release states that its requirements are "more express and more comprehensive compared to existing disclosure requirements and liabilities."<sup>463</sup> Unfortunately, it fails to make clear what "more express and more comprehensive" would mean practically for broker-dealer disclosure practices. The Commission never answers this critical question, making it impossible to assess either the costs or the benefits of its proposed approach.

Here again, the Commission provides only a vague and speculative discussion about the benefits that the proposed disclosure obligation is expected to produce. The Release states, for example, that the disclosure obligation "would reduce the informational gap between a broker-dealer making a recommendation and a retail customer receiving that recommendation, which, in turn, **may** cause the retail customer to act differently with regard to the recommendation . . . . Anticipating a potential change in the behavior of the retail customer . . . a broker-dealer **may** adjust its own behavior by providing recommendations that are **less likely** to be rejected by the retail customer."<sup>464</sup> (emphasis added) The Commission's prolific use of the word "may" underscores just how speculative the estimated benefits are.

Moreover, the Commission's statement regarding the benefits of disclosure is based on a series of highly questionable assumptions, and the Commission provides no evidence to support its assumptions. For example, the Commission provides no evidence that the proposed disclosure would reduce the informational gap sufficiently to enable investors to independently assess the quality of various recommendations they receive or the nature and extent of various conflicts of interest that may have influenced the recommendation. Similarly, the Commission provides no evidence that the proposed disclosure would increase the likelihood that investors would reject bad recommendations. Nor does the Commission provide any evidence that brokers would rein in bad recommendations based on the increased risk that investors would reject those recommendations.

While the Commission acknowledges the limits of disclosure in the context of Form CRS, it fails to seriously consider the implications of that research, including the Commission's own past studies, when assessing the likely effectiveness of the disclosure obligations under Reg BI. As has been extensively documented elsewhere, investors typically lack an understanding of basic financial concepts and are largely incapable of independently assessing the quality of the recommendations they receive or the nature and extent of conflicts of interest, contradicting the Commission's rosy assumptions. Most retail investors seek investment advice because they don't feel comfortable making investment decisions on their own. Common sense tells us that, given

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<sup>461</sup> Reg BI Release at 262.

<sup>462</sup> Reg BI Release at 98.

<sup>463</sup> Reg BI Release at 262.

<sup>464</sup> Reg BI Release at 260.

most investors' lack of financial acumen and their predisposition to rely entirely on broker-dealers' recommendations, it's highly unlikely that the disclosure contemplated here will act as a check on broker-dealer behavior. Evidence that conflicts persist at dual registrant firms that provide extensive disclosure of the conflicts of their ADV Forms reinforces that view.

The Commission cannot reasonably rely on theoretical arguments about the benefits of disclosure to claim benefits for its proposed regulatory approach without seriously engaging the vast body of knowledge that contradicts its theory. But the Commission has provided no quantitative or qualitative analysis on the extent to which any of its predicted beneficial results from its regulatory proposal can be expected to occur. The Release even admits it has no basis for either its assumptions or its views on the estimated benefits of the disclosure obligation, stating: "The magnitude of the benefit from the reduced agency conflict would depend on a number of determinants ... Given the number and complexity of assumptions, the Commission lacks the data that would allow it to narrow the scope of the assumptions regarding these determinants and estimate the magnitude of the benefit."<sup>465</sup>

In short, the Commission is proposing a disclosure obligation for brokers without even attempting to estimate its costs and without seriously considering whether it will deliver significant benefits. This is a serious shortcoming, since the proposed regulatory approach relies heavily on disclosure in place of real restrictions on conflicts or strict limits on harmful practices. Nowhere does the Commission analyze whether tighter restrictions on certain types of conflicts would better protect investors without imposing the same operational costs on firms.

4. The Commission provides no meaningful analysis on the tangible impact that the care obligation would have on broker-dealer practices or investor outcomes.

Just as with the disclosure obligation, the Release fails to provide any meaningful analysis detailing the specific changes broker-dealers would have to make to comply with the proposed care obligation or the specific benefits that would flow to investors from those changes. Once again, it provides only a vague and aspirational description of the impact the Commission expects this obligation to have. For example, the Release states that the requirements under the care obligation "would go beyond the existing broker-dealer obligations under FINRA's suitability rule."<sup>466</sup> Yet it does not make clear how, exactly, it would change broker-dealer obligations, let alone common industry practices and investor outcomes.

Instead, the Commission speaks in vague, aspirational terms, stating for example that, "by promoting recommendations that are **better** aligned with the objectives of the retail customer, the Care Obligation of proposed Regulation Best Interest would provide an important benefit to retail customers, ameliorating the agency conflict between broker-dealers and retail customers and, in turn, **improving** the quality of recommendations that broker-dealers provide to retail customers."<sup>467</sup> (emphasis added) Typically when one uses terms such as "better" and "improving," the natural question is "Better how?" "Improving from what to what?" And "What exactly would change?" But, as discussed above, the Release never answers those questions.

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<sup>465</sup> Reg BI Release at 264.

<sup>466</sup> Reg BI Release at 264.

<sup>467</sup> Reg BI Release at 265.

Instead, even though the Commission never acknowledges that there's a real problem to be solved, it assures us that the proposal would make things "better."

The Commission continues its evasive and circular approach, stating, "to the extent that currently broker-dealers comply at all times with FINRA's suitability requirements but do not always account for the retail customer's best interest, as proposed here, when choosing between securities with similar payoffs but different cost structures, the Care Obligation would encourage broker-dealers to recommend a security that would be more appropriately suited to achieve the retail customer's objectives."<sup>468</sup> This sentence is peculiar in two ways. First, the discussion in the Release suggests that brokers would only have to consider costs between "otherwise identical" securities, not between securities with similar payoffs. Which is the accurate characterization of the standard? While we agree that the requirement should be interpreted more broadly, the Commission cannot reasonably base its economic analysis of the potential benefits of the rule on an interpretation of the standard it does not intend to enforce.

Second, given that the Commission has stated several places elsewhere in the Release that the FINRA suitability standard has been interpreted as a best interest standard, is the Commission acknowledging here that it is not? Otherwise, how could brokers comply at all times with FINRA's suitability requirements, including accompanying guidance, while not always accounting for the customer's best interest? Once again, we would like to be able to assume that the Commission is proposing a best interest standard that is a higher standard than FINRA suitability, but that is not clear from the Release. And the Commission cannot base its economic analysis on the assumption that it is imposing a heightened standard of conduct without first showing that it is, in fact, doing so.

Finally, just as with the disclosure obligation, the Commission has provided no quantitative or qualitative analysis on the extent to which any of the expected benefits from the care obligation will materialize. Once again, the Release admits the Commission has no basis for either its assumptions or its views on the estimated benefits of the care obligation, using virtually the same language as with the disclosure obligation discussion to explain its lack of analysis. The Release states, "The Commission is unable to quantify the magnitude of these benefits to retail customers for a number of reasons ... Because the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, would not be informative about the magnitude of these benefits to retail customers."<sup>469</sup> But the Commission doesn't just fail to quantify the benefits, it fails to provide a meaningful qualitative analysis as well.

The only clear instance where the care obligation would make a concrete change to the existing suitability framework is that the proposal would eliminate the requirement under the quantitative suitability prong requiring proof that the broker exercised actual or de facto control over a customer account. But FINRA has already taken action separately to remove this requirement. In April, FINRA issued a regulatory notice seeking comment on a proposed

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<sup>468</sup> Reg BI Release at 264-265.

<sup>469</sup> Reg BI Release at 265.

regulation to “remove the element of control that currently must be proved to demonstrate a violation.”<sup>470</sup>

Otherwise, it’s not clear what practical impact the change to quantitative suitability would have on conduct and outcomes. For example, does changing the quantitative suitability standard to a “best interest” standard mean that the quantitative factors<sup>471</sup> that are typically used to judge whether a quantitative suitability violation has occurred will change as well? Ostensibly, raising the standard would mean lowering the thresholds on the amount of trading that is deemed to be excessive. For example, annual turnover rates of approximately three times (meaning an investor being placed in an entirely new portfolio every four months) have been found to be excessive under the suitability standard. If a best interest standard is more robust than a suitability standard, would a best interest standard lower those turnover rate guideposts? If so, to what? The Commission never attempts to answer these questions.

Just as with the disclosure obligation and the care obligation more generally, the Commission has provided no quantitative or qualitative analysis on the extent to which the quantitative suitability prong of the best interest standard would produce benefits to investors. The Release uses what should now sound like familiar language that, “The Commission is unable to quantify the magnitude of the benefits that retail customers could receive as a result of the new obligations for broker-dealers that provide a series of recommendations to retail customers for largely the same reasons that make the quantification of the other Care Obligation benefits, as discussed above, difficult.”<sup>472</sup> And, here again, it also fails to provide a meaningful qualitative analysis.

5. The Commission provides no meaningful analysis on the tangible impact that Reg BI’s conflict of interest obligations would have on broker-dealer practices or investor outcomes.

Just as with the disclosure and care obligations, the Release fails to provide any meaningful analysis detailing the specific changes broker-dealers would have to make to comply with Reg BI’s conflict of interest obligations or the specific benefits that would flow to investors from those changes. Properly implemented, this aspect of Reg BI, more than any other, has the potential to require real, pro-investor changes to the way brokers conduct their businesses and compensate their representatives. But the Release’s discussion of the requirement fails to make clear whether the Commission will implement the requirement in a way that would deliver those benefits. The economic analysis fails to add to our understanding, once again providing only a vague and aspirational description of the impact this obligation would have.

For example, the Release states that the conflict of interest obligations “may benefit retail customers to the extent that a broker-dealer establishes, maintains and enforces policies and procedures to disclose, or eliminate, a material conflict of interest that may have a negative

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<sup>470</sup> FINRA Regulatory Notice 18-13, Quantitative Suitability FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111, April 20, 2018, <http://bit.ly/2KsmXqF>.

<sup>471</sup> The proposal states that, although no single test defines excessive activity, factors such as turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a serious of recommended transactions was excessive. Reg BI Release at 151-152.

<sup>472</sup> Reg BI Release at 266.

impact on its recommendations to retail customers.”<sup>473</sup> But the Release offers no evidence to support that statement. It doesn’t include any examination of the extensive academic literature regarding the limited benefits of disclosure generally and of conflict disclosures in particular. It doesn’t include any serious analysis of the relative benefits of different approaches firms might take to deal with conflicts.

When discussing the likelihood that firms will eliminate, rather than disclose, the most egregious conflicts of interest, the Commission makes unsupported statements that are based on faulty assumptions. For example, the Commission states that, “We also preliminarily believe that broker-dealers may be more inclined to evaluate and address material conflicts of interest and eliminate more egregious conflicts of interest to the extent that disclosure of the conflict would result in reputation risk.”<sup>474</sup> Yet the Commission fails to demonstrate that there would be a reputation risk, since it fails to analyze the extent to which investors would read and understand the conflict disclosures. It makes no effort to determine whether reputational risk stemming from conflict disclosure is a serious enough threat to broker dealers that it would affect their decision of whether to eliminate the more egregious conflicts.

Evidence strongly suggests that the reputational risk of disclosing conflicts, particularly more complex conflicts, is exceedingly low.<sup>475</sup> This is particularly true here, since the proposed disclosure requirements are so weak (as discussed above). As a result, we believe there is little likelihood that reputational risk from disclosing conflicts would act as a check on broker-dealer conduct. Certainly, the Commission can’t reasonably assume that it will do so without conducting further analysis or comparing the likely effectiveness of disclosure to other alternatives. To reach a reasonable conclusion about the adequacy of its proposed approach, it must also analyze the relative effectiveness of requiring firms to eliminate the more egregious conflicts, including those conflicts that firms artificially create to encourage and reward harmful behavior.

That analysis is made more difficult, because it is not clear from the Release what conflict mitigation practices would be required and what practices, if any, would be restricted or prohibited. As a result, it is unclear what practical changes firms would have to make to their compensation and supervisory practices. Under FINRA rules, firms already need to have supervisory policies and procedures that must be reasonably designed to ensure that their brokers

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<sup>473</sup> Reg BI Release at 268.

<sup>474</sup> Reg BI Release at 269.

<sup>475</sup> See DOL Regulatory Impact Analysis, Lack of Reputation Effects at 140-143 (comparing and contrasting the existing research as it relates to investment advice markets); See also Ralph Bluethgen, Steffen Meyer, and Andreas Hackethal, High-Quality Financial Advice Wanted!, European Business School, Working Paper (2008) (noting that, “as financial advice is an expert service just as the ones provided by lawyers or doctors, the ordinary investor will hardly be able to determine the quality of the advice given even ex-post because the investor simply lacks the knowledge or the information to assess the quality of the advice.”) Thus, one key element to determining whether reputational effects are a realistic risk is whether the advice recipient is able to adequately assess the nature and extent of the disclosed conflict of interest and of the quality of the advice provided. Based on the available research, there’s no reason to believe consumers are able to make this type of an assessment in today’s advice market. As a result, it can be expected that when faced with both an opportunity and an incentive to preferentially recommend products that increase their profits, without fear that their reputation or market share will suffer much if at all, brokers will do so.

comply with suitability requirements.<sup>476</sup> So what additional steps, if any, would firms be required to implement, particularly if it's the Commission's belief that FINRA already interprets its suitability standard as a best interest standard? The Release fails to make that clear.

On the other hand, the Release does make clear that the Commission intends to provide firms with broad discretion in determining how best to implement the conflict of interest obligations. It suggests that firms "consider" adopting "best practices" outlined in FINRA's 2013 Conflicts Report, but it doesn't mandate even a minimum standard for addressing even the most egregious of conflicts. And, as we discuss above, it doesn't clearly identify the standard it will use to determine whether policies and procedures are reasonably designed. If the Commission adopts the most pro-investor interpretation of the requirements, the benefits could be substantial. If, however, the Commission is prepared simply to defer to firms to implement conflict mitigation policies as they see fit, it is unlikely that firms will implement robust policies and procedures that curtail harmful conduct that is bad for investors but good for the firm's bottom line.

In a remarkable display of economic theory divorced from market reality, the Release suggests that the market already adequately mitigates conflicts on its own. The Release states, for example, that, "Certain aspects of the market for brokerage services may serve, on their own, to mitigate, to some extent, conflicts of interest between broker-dealers and retail customers that may arise from compensation structures. Potential legal liability and reputational risk related to unsuitable recommendations can serve as a motivation to ameliorate the conflict between broker-dealer representatives and customers. Concerned about their potential legal liability as well as their reputations, many broker-dealers currently take actions to ameliorate conflicts."<sup>477</sup> The Release fails to analyze whether actions firms take to address conflicts under a suitability standard are adequate to support a best interest standard. The answer, in our view, is a resounding no. But the Commission appears to be suggesting that they do, at least "to some extent," without, of course, providing any evidence to support that assumption.

And just as with the disclosure and care obligations, the economic analysis includes no quantitative or qualitative analysis on the extent to which any of the expected benefits from the conflict of interest obligation will materialize. It uses the standard language that, "The Commission is unable to quantify the size of these benefits for several reasons....Any estimate of the size of such benefits would depend on assumptions about how broker-dealers choose to comply with this requirement of the conflict of interest obligations, how retail customers perceive the risk and return of their portfolio, the determinants of the likelihood of acting on a recommendation that complies with the best interest obligation, and, finally, how the risk and return of their portfolio change as a result of how they act on the recommendation. Since the Commission lacks the data that would help narrow the scope of these assumptions, the resulting range of potential estimates would be wide, and, therefore, not informative about the magnitude

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<sup>476</sup> See FINRA Rule 3110 (Supervision) (requiring firms to establish and maintain systems to supervise the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules).

<sup>477</sup> Reg BI Release at 307.

of these benefits.”<sup>478</sup> Here again, the fact that the Commission can’t quantify the benefits doesn’t relieve it of responsibility to provide a qualitative analysis, but that too is entirely missing.

6. Because the Commission provides no meaningful analysis of the tangible impact that proposed Reg BI would have on broker-dealer practices or investor outcomes, it is impossible to know what current brokerage practices would be allowed and what current brokerage practices would need to change.

It is impossible to tell from the Release what practices that are permitted under current law would be restricted under Reg BI. As a result, it is impossible to know what changes, if any, firms would need to make to their existing practices and what tangible benefits, if any, would accrue to investors as a result of those changes. The economic analysis itself highlights this shortcoming, stating that it has “difficulty in identifying systematically recommendations that are consistent with FINRA’s suitability rule but not with the proposed rule. The reason why such identification is difficult is because a broker-dealer recommendation depends largely, as noted earlier, on the facts and circumstances related to that recommendation and the investment profile of the retail customer receiving that recommendation.”<sup>479</sup>

While it is certainly true that a suitability determination, like a best interest determination, depends on the facts and circumstances, there are certain facts that ought to provide *prima facie* evidence of a violation of the best interest standard, if that standard has any meaning. These include:

- Recommendations of higher-cost mutual funds that just so happen to also provide higher load sharing or revenue sharing payments than available alternatives;
- Recommendations to invest in bonds that just so happen to have higher markups/markdowns than available alternatives;
- Recommendations of higher compensating, more complex, higher cost products, such as variable annuities, non-traded REITs, BDCs, and structured products, when the same investment goals could be served through lower cost, more liquid, less risky investments.

If the Commission is sincere about wanting to raise the standard of conduct for brokers, it needs to clearly state that its goal, in adopting a best interest standard, is to eradicate practices such as these that have been generally viewed as satisfying the suitability standard but that raise serious questions about whether they are in investors’ best interests. Its refusal either to describe how its standard improves on FINRA’s suitability standard or to analyze evidence from the marketplace showing how suitability falls short of a true best interest standard reinforces concerns that its goal is simply to rebrand suitability as a best interest standard without requiring any meaningful changes to common industry practices that are not in investors’ best interests.

As discussed above, the Commission appears to take the view in the economic analysis that the “diversity” of products currently on the market is a benefit that should be preserved at

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<sup>478</sup> Reg BI Release at 272.

<sup>479</sup> Reg BI Release at 278.

any cost, without analyzing whether those products are being recommended in ways that actually deliver positive investor value. Should we expect that same view to inform the Commission’s enforcement of the best interest standard? For example, will broker-dealers be able to point to “special or unusual features” as a reason why they sell particular products that cost more than reasonably available alternatives, or are less liquid or riskier than those alternatives, when the same investment objective could be achieved more cost-efficiently or with less risk to the investor through those reasonably available alternatives? Or will the Commission require firms and their representatives to actually demonstrate how their recommendations enhance value for the investor and do so in a cost-efficient manner? The economic analysis suggests that the more permissive approach is likely, and the standard itself is too vague to dispel that concern.

One would expect that a true best interest standard would impose enhanced scrutiny on investment products that have relied on compensation rather than quality to compete for sales. In the short-term, we might even expect to see a significant reduction in sales of many of these products if brokers are required to put customers’ interests ahead of their own financial interests. As we stated above, we would view that as a benefit of the rule, not a cost. In the long-term, however, a true best interest standard would have a beneficial impact on the market for such products, as they’d be forced to compete based on cost and quality, and the best products, rather than those that pay the highest compensation, would thrive. The economic analysis fails to seriously consider the potential of a strong and vigorously enforced best interest standard to improve the quality of investment products available to investors.

In the end, it simply isn’t clear whether the Commission is really seeking to meaningfully change broker-dealer behavior. If it is, it hasn’t done the requisite analysis that would support any such changes.

**D. The economic analysis shows an extreme lack of balance, echoing industry arguments without scrutinizing the basis for their claims, even as it ignores independent research.**

In analyzing the costs and benefits of proposed rules, agencies have an obligation to rely on the best reasonably available data.<sup>480</sup> Above we discuss the Commission’s complete failure, as part of its Reg BI economic analysis, to weigh the extensive independent research relevant to the issues under consideration or to provide any meaningful quantitative or qualitative analysis of the proposal’s likely effects. Instead of conducting a serious analysis, the Commission relies without apparent question on highly questionable industry studies and echoes, without substantiation, common brokerage industry talking points designed to prevent adoption of a true best interest standard backed by tight restraints on harmful conflicts.

1. The Commission relies heavily in its analysis on a highly questionable SIFMA study.

The Release repeatedly quotes “findings” from a SIFMA survey of industry executives on the purported impact of the DOL rule as if they were fact.<sup>481</sup> Yet the Release fails to mention

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<sup>480</sup> SEC, Current Guidance on Economic Analysis in SEC Rulemakings, March 16, 2012, <http://bit.ly/2OInLLD>.

<sup>481</sup> Reg BI Release at 253-255.



significant flaws in the methodology and transparency of its “study.” Most importantly, SIFMA failed to make the underlying data available to independent parties, including the SEC staff, academics, market analysts, or the general public, so that the conclusions they reached could be scrutinized and tested. Moreover, this “study’s” “findings” were based on interviews with just 21 of the hundreds of SIFMA member firms. The study provides no data about who these firms are, how they were chosen, or whether they are representative of the market. Nor are we told which individuals at the firms were interviewed. No survey document is included showing precisely what questions were asked. Nor has SIFMA made available raw data on the answers that were given, though providing the data should be quite manageable given the very small sample size. It is particularly troubling that the Commission has so readily embraced “evidence” from a broker-dealer trade association’s advocacy document while totally ignoring the wealth of independent, peer-reviewed, academic and empirical data showing broker-dealer practices in a different light.

Some of the “findings” that the Release quotes from the SIFMA “study” don’t even pass the sniff test. For example, it states that, “For those retail customers that migrated from brokerage to fee-based models, the average change in all-in-fees increased by 141% from 46 basis points (bps) to 110 bps.”<sup>482</sup> First, the Commission describes these findings less accurately and honestly than SIFMA itself. According to SIFMA, a “subset of study participants” provided information on this question.<sup>483</sup> SIFMA never disclosed what this subset was, how it was composed, or made any claims about whether it was representative of the market. The Commission glosses over those facts in its own discussion of the issue. Second, one would be hard-pressed to find an “advised-brokerage” portfolio that costs just 46 bps. Even the lowest cost A share equity mutual funds cost approximately 70 bps, excluding the cost of the load, which would have to be included for an “all-in” comparison. This suggests that SIFMA, in compiling its “data,” may have cherry-picked certain accounts that have much lower costs than most brokerage accounts that hold products that are frequently recommended and sold by brokers.

Yet the Commission never raises questions about this, or any of the report’s other claims. Nor does it independently analyze the overall costs investors typically pay in different types of accounts. Instead, it appears to just accept the survey findings as fact.

2. The Commission makes unsubstantiated claims throughout the economic analysis, often echoing industry talking points.

Above we discuss how the economic analysis rests on assumptions about the proposal’s likely effects that the Commission makes no effort to analyze or support, either qualitatively or quantitatively. This tendency to make unsubstantiated claims pervades the economic analysis. The following are a few of the more egregious examples.

The Purported Value of Conflicted Advice: The Release suggests that, in some cases, “conflicted advice would make [investors] better off than no advice at all”<sup>484</sup> and that, without

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<sup>482</sup> Reg BI Release at 254.

<sup>483</sup> SIFMA, *The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors*, at 12, August 9, 2017, <http://bit.ly/2KsoCMV>.

<sup>484</sup> Reg BI Release at 221.

advice, retail customers “may forgo valuable investment opportunities.”<sup>485</sup> This may or may not be true, but what is clearly true is that it rests on a lot of unsupported assumptions. It starts from a false choice, between conflicted advice and no advice, that coincidentally echoes a common industry talking point. But what evidence does the Commission have that reining in conflicts would reduce access to advice? A serious analysis of this question would have to consider whether, even if some firms chose to limit the availability of their services, other firms would come in to take their place. The evidence from the DOL rule suggests that, even under conflict restrictions much tighter than those proposed by the SEC, many firms innovated so as to avoid that false choice while others stood ready to expand access to their existing services should their competitors choose to withdraw.<sup>486</sup>

Leaving aside the false choice that the Commission’s statement poses, the accuracy of its claims about the benefits of conflicted advice would depend on a variety of factors. For example, whether investors benefit from conflicted advice would depend on how severe and costly the conflicts are, as well as how investors would have invested in the absence of the recommendations.<sup>487</sup> How investors would have invested in the absence of conflicted advice depends, in turn, on the available options. Evidence suggests that when conflicted advice is not available, better available options are pursued and the result is better outcomes for investors.<sup>488</sup> Thus, it is more likely that the continued presence of conflicts clouds and undermines investors’ ability to pursue better options.

At the very least, the Commission has an obligation to consider any evidence that conflicts with its assumption. It fails to do that here. Instead, the Commission makes these statements in passing, without any analysis or even an attempt to support those assumptions. Moreover, the Commission fails to consider whether brokers would deliver greater value to investors if their conflicts were limited. It certainly hasn’t provided any evidence that they provide any more value because they are conflicted.

The Relative Costs of Commission and Fee Accounts: In a similar vein, the Release claims, without offering any independent evidence to support its claim, that “the average fees associated with broker-dealers’ commission-based accounts are significantly lower than the average fees associated with fee-based accounts of registered investment advisers.”<sup>489</sup> The Release fails to make clear what, if anything, it is basing this statement on. It is possible that it is relying on SIFMA’s claims, without verifying those claims for accuracy. Furthermore, it’s not

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<sup>485</sup> *Id.*

<sup>486</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, September 14, 2017, <http://bit.ly/2vAiDjN>.

<sup>487</sup> See John Chalmers Jonathan Reuter, Is Conflicted Investment Advice Better than No Advice?, NBER Working Paper No. 18158, September 14, 2015; See also Neal Stoughton, Youchang Wu, and Josef Zechner, Intermediated Investment Management. *Journal of Finance* 66, no. 3, 947-980 (2011). The authors model a market where financial advisers act as intermediaries between individual investors and portfolio managers, and find that non-conflicted financial advisers improve the welfare of investors. However, when conflicts of interest are introduced – the authors model a “fee rebate” or “kickback” from the portfolio manager to the financial adviser – individual investors are harmed. The authors find that, “kickbacks are always associated with higher portfolio management fees and negatively impact fund performance.” In addition, the investors are not only worse off than they were without the conflict of interest, they are worse off than they would have been if the financial adviser did not exist at all.

<sup>488</sup> *Id.*

<sup>489</sup> Reg BI Release at 333, footnote 523.

clear what the Commission is referring to when it talks about “average fees.” Is it including underlying investment costs as well as the costs of the advice? Is it basing this statement on a particular type or group of investor? A particular type of product sold? A particular type of firm? None of this is clear.

If the Commission is going to make such a conclusive statement, it should back it up with real world evidence. To do so, the SEC would need to analyze a broad set of account-level data to determine actual investors’ experience. And it would need to consider not just “fees” but all costs associated with recommendations. It would also need to consider whether there is a difference between the overall costs associated with standalone investment advisers and the costs of advisory accounts offered by dual registrant firms, where the conflicts of interest are likely greater. Unfortunately, the SEC provides no statistical evidence supporting its statement. It also fails to consider contrary evidence that suggests investment advisers deliver significant value that more than compensates for their asset-based fees.<sup>490</sup> Because it fails to engage in a serious analysis of the relative costs of fee and commission accounts, it provides no new insights into an issue that is important to the regulatory issues under consideration.

Restricting Investor Choice: When discussing potential costs of the rule, the Release suggests that broker-dealers “may determine to eliminate the most expensive products” as a result of the rule.<sup>491</sup> Instead of recognizing that costs and performance are typically inversely related when it comes to investing, the Release suggests that these products, “while being more expensive, may provide better performance than products that are still offered.”<sup>492</sup> While it is certainly possible that more costly products “may” perform better, it is more likely that just the opposite is true. After all, both theory and ample empirical evidence show that fees are one of the strongest predictors of future fund performance.<sup>493</sup> Yet the Commission never acknowledges this point. Nor does it consider that, instead of eliminating the most expensive products, the rule would encourage the development of lower-cost versions of those products, to the benefit of both investors and those product sponsors who are prepared to compete based on cost and quality. A more realistic concern, in our view, is that the rule would do little to restrict the sale of higher cost investments that underperform their competitors, because its requirement that brokers consider costs is so narrowly applied.

At the very least, the Commission has an obligation to conduct a serious evaluation of the question. Instead, the Commission simply echoes, without substantiation, industry’s favorite talking points suggesting requiring brokers to act in customers’ best interests and rein in conflicts could harm investors by limiting their product choices. It states, for example, that the proposal

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<sup>490</sup> See, e.g., Francis M. Kinniry Jr., Colleen M. Jaconetti, Michael A. DiJoseph, Yan Zilbering, and Donald G. Bennyhoff, Putting a value on your value: Quantifying Vanguard Advisor’s Alpha®, Vanguard Research, September 2016, <http://bit.ly/2tyQNT7>.

<sup>491</sup> Reg BI Release at 309-310.

<sup>492</sup> Reg BI Release at 310.

<sup>493</sup> See, e.g., Martin J. Gruber, Another puzzle: The growth in actively managed mutual funds. *Journal of Finance* 51:783–810 (1996); Mark M. Carhart, On persistence in mutual fund performance. *Journal of Finance* 52:57–82 (1997); Brad Barber, Terrance Odean, and Lu Zheng, Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows, *Journal of Business* 78, no. 6:2095-2119 (2005); Russel Kinnel, Predictive Power of Fees Why Mutual Fund Fees Are So Important, May 4, 2016, <http://bit.ly/2nd7UIw>.

may cause brokers to “limit retail customer choice and...impose a cost on retail customers.”<sup>494</sup> Yet the Release never distinguishes between good choices and bad choices, even in the context of a rule that, in theory at least, should be designed to promote better choices for investors by requiring brokers to make recommendations in their best interests. Instead, it seems to suggest that all choices benefit investors, when we know that is not the case. Recommendations to invest in higher cost, lower performing, less liquid, higher risk products, simply because they pay the broker more, are extremely harmful to investors and should not be something that the Commission seeks to preserve on the basis of preserving choice.

Also absent from the discussion is any recognition of the fact that many broker-dealers currently restrict choice by only recommending from a limited menu of proprietary funds or by only recommending products from companies that make revenue sharing payments. If limits on investor choice are of concern to the Commission, surely such limits deserve equal scrutiny. After all, evidence suggests that the limited menus offered by some firms consist entirely of low quality products that impose excessive costs, deliver inferior returns, and expose investors to excessive risk. At the very least, the economic analysis should give equal weight to an analysis of the rule’s potential to improve product menus.

In conducting that analysis, the Commission should evaluate the harmful impact that reverse competition has on the product choices available to investors. And it should consider whether the rule, by forcing product sponsors to compete based on the cost and quality of their investments, rather than the generosity of their compensation to the seller, would benefit investors by improving the choices available to them, even if some choices in the form of products that can’t compete based on quality and cost are eliminated. That is, after all, the point of market competition. Yet the economic analysis fails to consider this issue, choosing instead to echo industry arguments suggesting that the goal of the proposal should be to preserve even bad choices that are profitable to the industry and harmful to investors.

The Role of Incentives: The Release fails to distinguish between incentives to maximize product sales and incentives to provide quality advice. It states, for example, that the conflict of interest obligation “may alter the incentives of registered representatives to expend effort in providing quality advice, and, therefore, may impose a cost on retail customers due to the potential decline in the quality of recommendations.”<sup>495</sup> The Release goes on to state that, “the proposed rules may generate tension between broker-dealers’ regulatory requirements and their incentives to provide high quality recommendations to retail customers, including by recommending costly or complex products.”<sup>496</sup> It adds that “complying with the Conflict of Interest Obligations to mitigate certain material conflicts of interest may reduce broker-dealers’ incentives to provide recommendations of high quality to their retail customers, and, therefore, may impose a cost on retail customers who seek advice from broker-dealers.”<sup>497</sup>

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<sup>494</sup> Reg BI Release at 257, 274, 303, 310.

<sup>495</sup> Reg BI Release at 274, 312 (in the context of receiving lower compensation from clean share recommendations, the Release states, “[I]f the new compensation arrangement reduces the incentives of broker-dealers to exert effort in providing quality advice, broker-dealer recommendations could end up being of lower quality.”).

<sup>496</sup> Reg BI Release at 274.

<sup>497</sup> Reg BI Release at 312.

Even if you view incentives in the most favorable light, as encouraging brokers to gather assets which could also encourage increased savings, there is a potential downside. Brokers who are incentivized to gather assets may be encouraged to make inappropriate rollover recommendations from lower cost 401(k) plans to higher cost IRAs. Likewise, they may be incentivized to recommend transferring assets from another provider whose investments are better suited for the investor. Such recommendations come with no attendant benefit in the form of increased investor savings and with potentially significant added costs. That potential for investor harm from even this type of incentive should be factored into the Commission's economic analysis, but it is not.

As we discuss above, broker compensation is structured to encourage and reward increased revenues to the broker. A wealth of research supports the finding that brokers make recommendations that are tilted toward their own financial interests rather than the customer's best interests and that they provide lower quality recommendations as a result.<sup>498</sup> It perhaps goes without saying at this point that the Commission fails to consider this evidence as part of its economic analysis. It also provides no evidence to support its suggestion that reining in conflicts is likely to reduce brokers' incentives to provide high quality recommendations. For example, the Commission provides no evidence that broker compensation is currently structured to encourage or reward quality advice. Nor does it seriously consider whether, or to what extent, the quality of advice provided by brokers might improve if the incentives were changed. It certainly doesn't provide any support for the highly questionable suggestion that mitigating financial incentives is likely to reduce the quality of advice.

In short, incentives to sell those products that are most profitable for the firm and the sales representative and incentives to provide quality advice are not the same thing. The Commission's analysis doesn't reflect that.

Clean Shares: One of the most promising developments attributable to the DOL rule is the development of clean shares, which have the potential to both reduce conflicts associated with mutual fund investments and subject broker-dealer compensation for the sale of these products to market competition. But the Commission's economic analysis discusses clean shares exclusively in the "cost" section of the analysis, without providing any discussion of the benefits that these innovative products could deliver to investors.<sup>499</sup> For example, the Release begins its discussion of the topic by stating, "The use of tailored products by broker-dealers to mitigate conflicts of interest arising from financial incentives may introduce additional complexities that could ultimately increase the costs borne by retail customers."<sup>500</sup> Referring specifically to the adoption of clean share to mitigate conflicts, it states that "retail customers purchasing clean shares could face higher costs compared to other share classes depending on the investors' holding period for the shares. Moreover, due to the nature of clean shares, retail customers may not receive other benefits associated with some mutual fund share classes, such as rights of

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<sup>498</sup> See DOL Regulatory Impact Analysis.

<sup>499</sup> See, e.g. Aron Szapiro, Why Clean Shares Matter, September 12, 2017, <http://bit.ly/2LQOxDC> ("Clean shares have the potential to benefit investors by removing perverse incentives for financial advisors that sell the funds to enrich themselves rather than their clients. By forcing mutual funds to compete on merit as advisors recommend lower-cost, higher-returning funds rather than funds that are most lucrative for the advisor, clean shares could dramatically improve investors' experiences and their outcomes.").

<sup>500</sup> Reg BI Release at 310.

accumulation that allow investors to account for the value of previous fund purchases with the value of the current purchases. Investors also may not be able to use letters of intent for further purchases to qualify for breakpoint discounts.”<sup>501</sup>

Reflecting a total lack of balance in its analysis, the Commission fails to point out that it is also possible that many retail customers purchasing clean shares could face lower total costs compared with other share classes. It really depends on a variety of factors, including holding periods, cost structures, and the amount invested, none of which the Commission considers, let alone seriously analyzes. The Release seems to assume, based on no evidence, that brokerage firms will levy a new commission every time a customer engages in a transaction, but this doesn’t have to be the case.<sup>502</sup> For example, a brokerage firm could adopt a one-time purchase charge and then allow the investor to freely exchange funds once the investor is on the platform, similar to the way LPL’s announced Mutual Fund Only platform would work.<sup>503</sup> The Commission also assumes, based on no evidence, that firms won’t provide breakpoint discounts for clean shares, and that the loss of such benefits will harm investors as compared with A shares. This also doesn’t have to be the case. For example, PNC Investments, the first and currently only broker that offers clean shares, appears to offer breakpoint discounts for clean shares on its platform.<sup>504</sup> While it is possible that some brokerage firms would seek to structure clean shares in the least beneficial manner possible, it is equally likely that with more transparent pricing and more competition based on pricing, more innovative pricing structures will develop and commission costs will come down.

The Commission also fails to consider that many investors, particularly small, buy-and-hold investors, could experience significantly lower total costs from clean shares. This is attributable to the fact that: (1) clean shares are likely to impose lower upfront charges than A shares; (2) they are likely to impose lower ongoing costs since they do not impose 12b-1 fees; and (3) small savers are unlikely to qualify or benefit from breakpoint discounts, which typically only kick in at investment levels higher than the typical small saver’s total investment balance.<sup>505</sup> Unfortunately, the Release provides no analysis on these issues.

The clean share market is still in its infancy. A range of possibilities could occur. It is troubling that the Commission has only considered the possibility that clean shares raise costs on investors, without considering their potential to revolutionize the market to investors’ benefit. One need only look at the typical commission investors pay to purchase an ETF, and the cost they pay for a comparable mutual fund investment, to recognize the power of market competition to reduce costs when compensation is transparent. But that, of course, goes unrecognized in the Commission’s economic analysis.

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<sup>501</sup> Reg BI Release at 311.

<sup>502</sup> See e.g., Fundkeeper platform allows flexibility <http://bit.ly/2MioRw>; Suleman Din, *Mutual fund trading tool that meets with DoL demands*, Financial Planning, November 7, 2017, <http://bit.ly/2vi87yq>.

<sup>503</sup> Press Release, LPL, LPL Financial Announces Details and Fund Companies For Its Industry-First Mutual Fund Only Platform, JULY 13, 2017, <http://bit.ly/2M16LBS>.

<sup>504</sup> PNC Investments, Client Schedule of Commissions & Fees, Effective January 1, 2018, at 7, <http://bit.ly/2vCGfEJ>.

<sup>505</sup> *Id.* PNC Investments charges a maximum 3% charge on purchases and 1.5% charge on sales, and appears to provide breakpoint discounts.

Treating Investor Savings as a Regulatory Cost: Perhaps most troublingly of all, the Commission repeatedly states that a “cost” of the proposal on broker-dealers is that they may “forgo some of the revenue” associated with certain recommendations.<sup>506</sup> At the very least, one would expect the Commission to acknowledge that investors would be the direct beneficiaries of any such reduction in revenues, since they are the ones currently paying those excess costs. At the most basic level, for example, lower commissions would result in lower broker-dealer revenues, but they’d also result in lower costs for investors. The same is true more generally of recommendations that favor investors’ best interests over brokers’ compensation. This would seem to be the whole point of adopting a best interest standard, but the analysis never makes that connection. The lack of balance in the discussion of this issue reflects a disturbing tendency, which we’ve seen at the Commission in the past, to put greater emphasis on protecting the broker-dealer business model than on protecting investors.

#### **E. The proposal doesn’t seriously consider regulatory alternatives.**

In conducting its economic analysis, the Commission has an obligation to analyze reasonably available regulatory alternatives to determine which approach is likely to best achieve the desired regulatory outcome in the most cost-efficient manner. This requirement is particularly relevant in a situation such as this, where the Commission is relying on a relatively obscure legislative authorization, rejecting congressional direction on the appropriate standard of conduct to apply, and relying heavily on disclosure to enable investors to make an informed choice among different types of providers held to different standards of conduct. And yet, the Release provides what can best be described as a superficial discussion that doesn’t even discuss one of the most widely recommended approaches – narrowing the broker-dealer exclusion from the Advisers Act. The discussion that is provided consists of assumptions, and conclusions based on those assumptions, without any evidence to show whether those assumptions are, in fact, valid.

The Release’s cursory discussion of regulatory alternatives includes less than two pages on why disclosure alone is insufficient. While we agree with the conclusion that disclosure is not sufficient to address the problem (*see* below discussion on Form CRS), the Commission should provide the analysis needed to support this conclusion. There is, after all, no shortage of research showing that disclosure alone is likely to be an ineffective solution to this problem. But the economic analysis of Reg BI fails to cite any of the relevant research.

The Release devotes another page-and-a-half to analyzing an approach based on applying a principles-based best interest standard to brokers without imposing any additional regulatory obligations. “Under this alternative,” according to the Release, “broker-dealers would be required to comply with a principles-based approach to providing recommendations that are in the best interest of their customers, without expressly being subject to requirements to disclose,

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<sup>506</sup> Reg BI Release at 257, 273, 274, 296, 301 (at 278, stating “To the extent that broker-dealers are currently able to generate revenues from securities recommendations that are consistent with FINRA’s suitability rule but not consistent with this proposed best interest obligation, those revenues would be eliminated under the proposed rule.”) (at 300, stating, “For some broker-dealers, compensation arrangements with product-sponsoring third parties may be an important source of revenue.”) (at 317, stating “In some cases, the reduction in profits may be large enough to cause some broker-dealers or their associated persons to no longer offer broker-dealer advice.”).

mitigate, or eliminate conflicts of interest.”<sup>507</sup> In the end, the Commission concludes that such an approach is “likely to be less effective at reducing harm to retail customers that arises from conflicts of interest. Further, because each broker-dealer could have its own principles-based approach to meeting its care obligation under the Exchange Act, broker-dealers could interpret the standard differently. Variations in retail customer protection could make it difficult for retail customers to evaluate the standard of care offered by a broker-dealer and compare these across broker-dealers.”<sup>508</sup> Here again, we agree with that conclusion, and believe there’s ample evidence that would support that conclusion – none of which is included here. As far as we know, however, no one has seriously proposed such an approach, which begs the question of why the Commission believes it merits any discussion, no matter how cursory, when it ignores or gives short shrift to other broadly supported alternatives.

The Release devotes a wholly inadequate three-plus pages to consideration of an approach based on applying a uniform fiduciary duty. Nowhere in its cursory discussion does the Release acknowledge that this was the approach that Congress advocated in Section 913(g) of the Dodd-Frank Act or that was recommended by the Commission staff in its 913 Study. Nor does it seriously engage with the analysis that had previously led the staff to advocate such an approach. Instead, the Release provides its usual superficial discussion based on assumed outcomes it “preliminarily” believes would result from adoption of a uniform fiduciary standard, unsupported by any evidence to demonstrate that the assumptions are reasonable.

It suggests, for example, that the different standards that apply to broker-dealers and investment advisers “are generally tailored to the different business models of broker-dealers and investment advisers and that provide retail customer protection specific to the relationship types and business models to which they apply.”<sup>509</sup> But it fails to even consider whether the current regulatory standard for brokers does, in fact, provide “protection specific” to the kind of advice relationship the Commission suggests throughout the Release is common between brokers and their customers today. There is a wealth of evidence suggesting that it does not, but none of that evidence is reflected here.

Ultimately, the Release justifies rejecting this approach on the grounds that a uniform fiduciary standard for brokers and advisers “could lead to the potential loss of differentiation between two important business models ... This alternative also could have economic effects on both retail customers and the industry, particularly if payment choice, account choice, or product choice diminishes as a result.”<sup>510</sup> Here again, the Release never explains why it believes a uniform fiduciary duty would lead to potential loss of differentiation or would affect payment choice, account choice, or product choice. It fails to consider, for example, how a fiduciary duty that “follows the contours of the relationship” could be adapted to the broker-dealer business model without producing any such result. It similarly fails to consider how provisions of 913(g) that would presumably form the basis for a uniform fiduciary standard could help to prevent this loss of differentiation.

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<sup>507</sup> Reg BI Release at 327.

<sup>508</sup> Reg BI Release at 327-328.

<sup>509</sup> Reg BI Release at 330.

<sup>510</sup> Reg BI Release at 330-331.



Properly interpreted, a fiduciary duty could preserve different business models and investors' choice about how they pay for advice and products while nonetheless assuring that investors receive loyal, prudent advice under both business models. Given that this was Congress's preferred approach, as reflected in Section 913(g) of the Dodd-Frank Act, it deserves far more careful consideration than the Commission provides here.

Finally, the Release devotes another three pages to a discussion of an alternative approach based on adopting "a fiduciary standard coupled with a series of disclosure and other requirements akin to the full complement of conditions of the DOL's BIC Exemption."<sup>511</sup> In discussing this alternative, the Commission simply repeats the unsubstantiated assumptions it offers elsewhere that such an approach "could drive up costs to retail customers of obtaining investment advice from broker-dealers, and could cause some retail customers to forgo advisory services through broker-dealers if they were priced out of the market."<sup>512</sup> It states, for example, that, "if the costs associated with complying with a set of requirements akin to the full complement of conditions under BIC Exemption are large, broker-dealers could transition away from commission-based brokerage accounts to fee-based advisory accounts. To the extent that such an outcome increases the costs associated with investment advice, some retail customers may determine to exit the market for financial advice."<sup>513</sup>

Moreover, the Commission seems to view the world in binary terms, commission-based versus assets under management, when that's simply not the case.<sup>514</sup> To the extent more broker-dealers were to choose to become investment advisers in response to the rule, it does not follow that the only option available for investors would be an assets under management model where they pay 1% or more. Rather, innovative fee structures already have developed. Yet the Commission's economic analysis doesn't reflect that awareness of market trends. The Release doesn't even pretend to consider that there are attendant benefits to investors from such an approach, such as improved product selections and better advice.

As deficient as the "analysis" is of the various alternative regulatory approaches presented here, perhaps the greatest weakness of this section of the Release is its failure even to consider an approach based on narrowing the broker-dealer exclusion from the Advisers Act. This is an approach that has long had broad support among both investor advocates and fiduciary investment advisers and was also recommended as the best approach by the SEC's Investor Advisory Committee.<sup>515</sup> As we discuss in greater detail in the previous section of the letter devoted to a legal analysis of the Reg BI proposal, every aspect of this Release suggests that the Commission believes that brokers today are first and foremost advisers, who just happen to provide their "advice services" in the form of sales recommendations. Given that fact, the Commission has a clear obligation to explain on what basis it concludes that it can continue to provide brokers with a broad exclusions from the Advisers Act. Yet, the Commission fails to provide even the superficial analysis it gives other far less credible regulatory alternatives.

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<sup>511</sup> Reg BI Release at 332.

<sup>512</sup> Reg BI Release at 333.

<sup>513</sup> *Id.*

<sup>514</sup> See Bernice Napach, *8 Innovative Advisor Fee Structures*, Think Advisor, March 14, 2018, <http://bit.ly/2M0ajUR>.

<sup>515</sup> SEC IAC, Recommendation of the Investor Advisory Committee Broker-Dealer Fiduciary Duty, <https://bit.ly/2jWB4rz>.

In short, this entire section of the economic analysis reads like nothing more than a check-the-box exercise. Nowhere does the Commission engage in a serious consideration of the evidence. Instead, the discussion reads as if it was designed, not to seriously consider other regulatory alternatives or to weigh their relative merits, but simply to go through the motions and justify the chosen approach, regardless of the evidence. This is not a serious economic analysis.

**F. In its economic analysis of Form CRS, the Commission fails to accurately diagnose the problem regulation is intended to address and proposes a regulatory solution that even its own evidence does not support.**

In its economic analysis of the Form CRS proposal, the Commission incorrectly relies on the notion that investors are simply “confused” about the differences between the broker-dealer “advice” relationship and the investment adviser advice relationship and that providing “clarity” about broker-dealers and investment advisers’ services and roles will cure that confusion. The Commission neglects the wealth of evidence that suggests disclosure is unlikely to be effective in this regard. The Commission also seems to assume, without any basis, that its proposed solution will provide the necessary “clarity” it seeks. Instead, as we discuss in detail in our critique of the Form CRS proposal, the disclosures as currently proposed are likely to perpetuate or even worsen investor confusion.

The Release states, for example, that “Studies show that retail investors are confused about the differences [between broker-dealers and investment advisers]. These differences include the scope and natures of the services they provide, the fees and costs associated with those services, conflicts of interest, and the applicable legal standards and duties to investors.”<sup>516</sup> The Release further states that the fact “investors do not fully comprehend the nature of the business relationships and responsibilities in the market...makes them vulnerable to confusion and being misled by firms and financial professionals.”<sup>517</sup> That is true as far as it goes, but it conveniently ignores the ways in which the Commission itself has enabled brokers to mislead their customers and would continue to do so under the proposed regulation.

It also ignores the Commission’s own evidence showing the proposed approach is unlikely to be effective. In formulating Form CRS, the Commission does nothing to clarify the different roles that broker-dealers and investment advisers play in the market. In fact, it reinforces brokers’ ability to mislead their customers, claiming they are just a different type of advice provider who simply provide their advice under a different compensation model. Thus, even if you accept the Commission’s assumption that the relevant problem is that investors are “confused” about the differences between broker-dealers and investment advisers, the proposed solution doesn’t begin to address it. Indeed, there is every reason to believe it would make that problem worse.

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<sup>516</sup> Form CRS Release at 8.

<sup>517</sup> Form CRS Release at 252-253.

1. The Commission cannot reasonably rely on disclosure to reduce investor confusion, because investors rarely read disclosures.

The 2008 RAND Study, which was conducted on behalf of the Commission and which the Commission cites here, provided significant evidence that calls into question the Commission's fundamental assumption that Form CRS disclosures are likely to reduce investor confusion. First and foremost, the RAND Study provides evidence that investors rarely read disclosures and do not take the necessary time and effort to fully understand them. In its interviews of interested stakeholders, the majority of interviewees expressed the view that "disclosures do not help protect or inform the investor, primarily because few investors actually read the disclosures."<sup>518</sup> Even several industry representatives acknowledged that, "regardless of how carefully they craft documentation, investors rarely read these disclosures....Clients feel that the reason they engage a professional is so that they do not have to read all the accompanying literature. Therefore, for many investors, the fact that they were given disclosures was seen as meaningless."<sup>519</sup> The RAND Study concluded that "disclosures, which are meant to inform investors of their rights and of the responsibilities of the financial service provider, are of little value because few investors read them."<sup>520</sup>

This evidence of the limited utility of disclosure in this context is reinforced by other research. In his paper, "Moral Equilibrium: Stock Brokers and the Limits of Disclosure," for example, Robert Prentice provides evidence that "investors who receive a document indicating that their stock broker owes them no fiduciary duty often (a) will not even read it and therefore go on assuming that they are, in fact, owed a fiduciary duty by their brokers, as most investors currently believe, or (b) if they do read it, they will not go to the trouble of figuring out what...it means..."<sup>521</sup> (internal citations omitted). The Commission cannot reasonably ignore evidence that challenges the basic foundation of its proposed regulatory approach.

Investors' own responses support the conclusion that investors don't fully read or understand disclosures, including even those investors who are likely to be savvier than the general population. For example, according to the most recent FINRA Foundation Investor Survey, which surveyed investors with taxable accounts, 40% of investors who were surveyed answered either that they don't recall receiving disclosures or don't know, which suggests that the disclosures they received weren't very memorable or useful. Of the 59% of investors who recall receiving disclosures, a meager 19% said they read the entire thing, while 32% said they skimmed, and 8% admitted that they didn't read it at all.<sup>522</sup> This likely overstates both the readership and utility of the disclosures, since investors who have taxable accounts tend to score higher on financial literacy surveys than individuals who only hold retirement accounts. If investors who tend to be savvier than the average investing population don't carefully read disclosures, it is even less likely that the general investing population will read them. Moreover, as we have commented elsewhere, the Commission has an obligation to assess whether its

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<sup>518</sup> RAND Study at 19.

<sup>519</sup> RANDY Study at 77.

<sup>520</sup> RANDY Study at 21.

<sup>521</sup> Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, *Wisconsin Law Review*, 1059-1107, 2011.

<sup>522</sup> FINRA Investor Education Foundation, *Investors in the United States 2016*, December 2016, <http://bit.ly/2O7TC7p>.

proposed regulatory approach would be effective for the least financially sophisticated investors who are most in need of enhanced protections.

2. Many investors lack sufficient financial capability to fully comprehend disclosures and the implications that flow from disclosures, even if they do read them.

The Commission correctly recognizes that “substantial evidence suggests that retail investors lack financial literacy and do not understand many basic financial concepts....”<sup>523</sup> Even those investors who are likely to be more savvy than the general investing population demonstrate disturbingly low levels of financial literacy. For example, FINRA Foundation research has shown that even though individuals with non-retirement investment accounts tend to score higher on financial literacy surveys than individuals who only hold retirement accounts, individuals with non-retirement accounts still don’t score well on a test of investment knowledge.<sup>524</sup> In a ten-question quiz focusing specifically on investing concepts, for example, more than half of investors with non-retirement investment accounts—56%—answered just four or fewer questions correctly.<sup>525</sup> On average, investors who took the quiz could answer only 4.4 questions correctly.<sup>526</sup> Certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average general population. For example, women investors who took the FINRA investor literacy quiz could answer only 3.8 questions correctly, on average.

These findings suggest that most investors don’t have sufficient financial capability to fully comprehend disclosures and the implications that flow from disclosures, even if they do read them. This is one of the many reasons we have emphasized the importance of conducting cognitive usability testing of the proposed disclosures.

3. Specifically, investors don’t understand critical distinctions between brokerage and advisory services, even after reading disclosures clarifying the differences.

The Release appropriately cites research showing that investors don’t understand critical distinctions between broker-dealers and investment advisers. Among the things investors don’t understand are:

- the different services that brokers and advisers provide;
- the different standards of conduct that brokers and advisers owe to their clients;
- different titles used by various professionals;

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<sup>523</sup> Form CRS Release at 252.

<sup>524</sup> FINRA Staff, *They Own What? 5 Surprising Findings From the FINRA Foundation's Investor Survey*, February 3, 2017, <http://bit.ly/2LZvGwo>.

<sup>525</sup> *Id.*

<sup>526</sup> FINRA Investor Education Foundation, *Investors in the United States 2016*, December 2016, <http://bit.ly/2O7TC7p>.

- the various fees and costs that are associated with the account and how fees can affect returns; or
- the nature and extent of various conflicts of interest and how those conflict can affect recommendations and investor outcomes.

For example, the Release cites the Siegel & Gale Study, which found that focus group participants did not understand that the roles and legal obligations of broker-dealers differed from those of investment advisers, and that focus group participants were further confused by different labels or titles used by advice providers (e.g., financial planner, financial advisor, financial consultant, broker-dealer, or investment adviser).<sup>527</sup> The Release also cites the RAND Study, which concluded that investors did not understand the differences between broker-dealers and investment advisers and that common job titles contributed to investor confusion.<sup>528</sup> Specifically, in both the Siegel and Gale Study and the RAND Study focus groups, participants generally did not understand certain legal terms, including the term “fiduciary,” or whether a fiduciary duty was a higher standard than suitability.<sup>529</sup>

Importantly, even after participants in the RAND Study were presented with fact sheets describing the differences between brokers and advisers, including their respective services, legal obligations, titles, and compensation, investors’ confusion persisted. Most could not even identify the type of investment professional they worked with, even after reading the fact sheets.<sup>530</sup> This suggests that a similar approach to disclosure won’t work. At the very least, the Commission must conduct the requisite usability testing to determine whether the proposed disclosures will, despite all the past evidence, support informed decisions by investors among different types of services providers and different types of accounts.

4. Evidence suggests conflict disclosure is unlikely to be effective and may be harmful.

Most retail investors lack the financial sophistication and the time necessary to understand the nature and extent of varied and incredibly complex conflicts of interest, let alone assess their potential effects on recommendations. For example, most retail investors are incapable of adequately assessing whether or how a conflict has influenced the quality of the financial professional’s recommendations, or to what degree it has influenced them. A short and generic disclosure describing various highly complex conflicts of interest seems unlikely to counteract that fundamental incapacity. If the Commission believes that such a description would enable investors to make an informed decision about what type of account to use, it has an obligation to explain on what basis it arrives at these conclusions.

In addition to concerns that conflict disclosures won’t work, there is evidence that they can “backfire.”<sup>531</sup> According to several studies that the Commission appropriately cites, once the

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<sup>527</sup> Form CRS Release at 238-239.

<sup>528</sup> Form CRS Release at 239-240.

<sup>529</sup> *Id.*

<sup>530</sup> RAND Study at 111.

<sup>531</sup> See Daylian Cain, George Loewenstein & Don Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, *Journal of Legal Studies* 34: 1-25 (Jan. 2005); Daylian Cain, George Loewenstein & Don

conflict has been disclosed, the conflicted party might feel “morally licensed” to pursue his own interests over that of the customer who, in the eyes of the conflicted party, has been duly warned. The advice recipient might “anchor” to the advice and then adjust insufficiently for bias. While the Commission has recognized this concern, it has completely failed to address it in its regulatory approach. Both Reg BI and Form CRS would require conflict disclosures as an important component of their proposed regulatory protections, despite a lack of evidence that the approach is likely to be effective.

#### 5. Disclosure is unlikely to inform investors’ selection of providers.

The Commission appropriately cites research that suggests investors make their decisions regarding whom to invest with long before they will likely receive the proposed disclosures. The Release states, for example, that, “A number of surveys show that retail investors predominantly find their current financial firm or financial professional from personal referrals by family, friends, or colleagues. For instance, the RAND Study reported that 46% of survey respondents indicated that they located a financial professional from personal referral, although this percentage varied depending on the type of service provided.”<sup>532</sup> According to the Dodd-Frank Section 917 Financial Literacy Study’s findings, 51% of survey participants identified a referral from family, friends, or colleagues as facilitating the selection of the current financial firm or financial professional.<sup>533</sup> In assessing its proposed approach, the Commission must factor this evidence into its analysis of the likely effectiveness of the proposed disclosures.

Furthermore, evidence suggests that disclosure is unlikely to change investors’ view of the financial professionals with whom they are already working. According to the RAND Study, for example, despite not understanding key distinctions between investment advisers and broker-dealers, investors nonetheless tend to have relatively long-term relationships with their financial services professionals and they express “high levels of satisfaction” with their services.<sup>534</sup> The most commonly cited reasons for survey respondents’ satisfaction had little to do with the quality or impartiality of their advice and related instead to the professional’s attentiveness and accessibility and their tendency to trust their financial professional.<sup>535</sup>

The RAND Study makes clear, moreover, that investors’ personal satisfaction may not match the actual outcomes they experience, stating, “[W]e do not have evidence on how levels of satisfaction vary with the actual financial returns arising from this relationship. In fact, focus-group participants with investments acknowledged uncertainty about the fees they pay for their investments, and survey responses also indicate confusion about fees.”<sup>536</sup> Thus, it is possible that investors’ perceptions of their financial services providers might not comport with the actual services provided. Disclosure is unlikely to alter this dynamic, particularly given the personal

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Moore, When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest, *Journal of Consumer Research* 37: 1-45 (Aug. 27, 2010).

<sup>532</sup> Form CRS Release at 236.

<sup>533</sup> Form CRS Release at 237.

<sup>534</sup> RANDY Study at 112-113.

<sup>535</sup> Trusting a financial professional who rejects the notion that he or she is in a relationship of trust and confidence, and who isn’t held to a fiduciary standard appropriate to such a role, suggests a severe disconnect between investors’ expectations and the actual standard of conduct.

<sup>536</sup> RANDY Study at 113.

relationships of trust and confidence that financial services firms foster. We've seen anecdotal evidence in our own personal encounters with investors of their tendency to trust their "financial adviser" without actually verifying how or how much they are paying or how their investments are performing. Even investors who would be considered sophisticated by any reasonable measure can exhibit a level of trust and confidence in their financial professional that isn't based on data. Any disclosures about their financial professional's services, duties, costs, and conflicts are unlikely to change those views.

6. The Commission assumes the disclosures will benefit investors despite all the evidence suggesting they will not.

Despite acknowledging much of the evidence that calls into question the likely effectiveness of disclosures in diminishing investor confusion, the Commission nonetheless concludes that, "all retail investors would benefit from short summary disclosure that focuses on certain aspects of a firm and its services to retail investors which could be supplemented by additional disclosure."<sup>537</sup> It adds that, "By requiring both investment advisers and broker-dealers to deliver to existing and prospective retail investors and file a publicly available concise relationship summary that discusses, in one place, both types of services and their differences, the proposed rules for Form CRS would also help retail investors to compare certain different types of accounts and firms."<sup>538</sup>

In reaching this conclusion, the Release purports to analyze the disclosures in the context of a set of characteristics, identified by academic research, "including targeted and simple disclosures, salience, and standardization, that may increase the effectiveness of a disclosure regime."<sup>539</sup> However, it doesn't actually demonstrate the proposed disclosures, as currently conceived, effectively embody these characteristics. As we discuss at length above, we are convinced that they do not. The only credible method for resolving that question is to have an independent expert conduct cognitive usability testing on the disclosures. While the Commission has indicated that it has plans underway to conduct such testing, it should have been conducted before the proposal was finalized and put out for public comment. At the very least, the Commission needs to make the results of its testing public, once it has been completed, and provide an opportunity for all interested parties to comment on the results.

7. The disclosures as designed will not facilitate cross-firm comparisons.

One of the key benefits the Commission claims for its proposed disclosure is that Form CRS will "facilitat[e] cross-firm comparisons and make it easier for [investors] to find a firm and a financial professional that most closely meet their expectations, depending on how important different types of fee structures, services, standards of conduct or other information points are to them."<sup>540</sup> But this claim appears to rest on a faulty foundation. The Commission acknowledges, for example, that many of "the proposed disclosures in the relationship summary are general and

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<sup>537</sup> Form CRS Release at 246.

<sup>538</sup> *Id.*

<sup>539</sup> Form CRS Release at 249.

<sup>540</sup> Form CRS Release at 256.

contain prescribed language in many parts...<sup>541</sup> Thus, in a number of important areas, the same, general and prescribed language is likely to be mirrored in all firms' Form CRS. Rather than being specific to the firm, much of the information will simply compare a generic brokerage account with a generic advisory account. In other words, Morgan Stanley's Form CRS will probably have much the same content as Merrill Lynch's and Edward Jones', minimizing the disclosure's potential to facilitate cross-firm comparisons between firms that may vary significantly in their offerings.

The Commission attempts to address this concern by arguing that it can be "mitigated to the extent the required Additional Information section employs layered disclosure and the Key Questions encourage more personalized information gathering on part of the retail investors."<sup>542</sup> But this approach puts the onus on investors to seek out additional information in order to conduct the cross-firm comparison the Commission assumes the Form CRS will facilitate. The Commission presents no evidence to suggest that investors will be willing to conduct that additional research and thus has no sound basis for assuming that they actually will. As a result, it cannot reasonably assume that the proposed disclosures will, in fact, produce the predicted benefit.

**G. In formulating Form CRS, the Commission does nothing to clarify the different roles that broker-dealers and investment advisers play in the market. In fact, it perpetuates brokers' ability to mislead their customers and the investor confusion that inevitably results.**

Despite all of the evidence, discussed above and in our previous letters to the Commission, that disclosure of the type contemplated by the Commission won't enable investors to make an informed decision about what type of financial professional to work with and what type of account to use, the Commission proposes to proceed with this fundamentally unsound regulatory approach. The Commission provides no explanation or evidence as to why it believes investors will read Form CRS, understand critical differences between brokerage and advisory services based on those disclosures, and use the information to make an informed decision. In other words, the Commission doesn't even attempt to explain why it believes that this time things will be different.

For example, as discussed above, the RAND Study already tested a disclosure approach similar to what the Commission has proposed. After presenting investors with fact sheets describing the differences between brokers and advisers, including their respective services, legal obligations, titles, and compensation, investors' confusion persisted. Most could not even identify the type of investment professional they worked with.<sup>543</sup> The Commission never explains, as it has an obligation to do, on what basis it believes Form CRS will result in a different outcome.

Worse, the Commission seems to be relying on theoretical arguments in favor of disclosure, rather than real-world evidence showing disclosure is unlikely to be effective in this

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<sup>541</sup> Form CRS Release at 268-269.

<sup>542</sup> *Id.*

<sup>543</sup> RAND Study at 111.



regard. The Release states, for example, “The content of the proposed relationship summary is intended to alert retail investors to information that would help them to choose a firm or a financial professional and prompt retail investors to ask informed questions. It is also intended to facilitate comparisons across firms that offer the same or substantially similar services.”<sup>544</sup> The Release continues, stating that Form CRS “could help alleviate investor confusion and would promote effective communication between the firm and its retail investors and assist investors in making an informed choice when choosing an investment firm and professional and type of account to help to ensure they receive services that meet their preferences and expectations.”<sup>545</sup> But it offers no evidence to support that assumption.

As further evidence that the proposal was developed without regard to reasonable expectations regarding the long-term effects this disclosure is likely to have, the Release states that it “may increase the overall level of retail investor understanding in the market. When retail investor understanding increases, the degree of competitiveness of the financial services industry may also increase because retail investors could better assess the type of services available in the market. . . . Increased competitiveness in the market for financial services could have ancillary effects as well, reduced pricing power for firms and incentives for firms to innovate products and services.”<sup>546</sup> The Commission states that it also preliminarily believes that by increasing transparency, Form CRS could increase investor trust in the market. It is certainly possible that the disclosures “could” have these beneficial effects, but overwhelming evidence suggests it is far more likely that they will not.

Given all we know about the limited utility of retail disclosures, the Commission can’t credibly point to theoretical benefits of disclosure as its sole justification for its proposed approach. Without any credible evidence that Form CRS would provide real-world benefits to investors, Form CRS could be difficult to justify economically, given that the costs it will impose on broker-dealers and investment advisers are likely to be considerable.

Based on public and private comments of some Commission officials, we are concerned that the Commission may attempt to fill this gap in evidence to support its proposed approach with “evidence” from its investor roundtables and other sources suggesting that investors find the disclosure “very useful” or “useful.”<sup>547</sup> Whether investors check a box saying the disclosure is useful is not the relevant question. Rather, the relevant question is whether the disclosure enables them to make an informed decision based on the information provided. Without engaging in independent, cognitive usability testing to determine investors’ understanding of the disclosure, as well as their ability to synthesize the information to make an informed decision, the Commission can’t simply point to evidence that investors “like” the disclosures as evidence that Form CRS will serve its intended goal.

Indeed, because we view usability testing as so critical to a reasonable analysis of the Commission’s proposed approach, we have joined with several other organizations to engage an

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<sup>544</sup> Form CRS Release at 253.

<sup>545</sup> *Id.*

<sup>546</sup> Form CRS Release at 279.

<sup>547</sup> Your Relationship with Your Financial Professional: Feedback on the Relationship Summary <http://bit.ly/2LSMuiF>.

independent disclosure expert to conduct such testing on our behalf. As indicated above, we expect to have the results of that testing available to submit to the Commission within 45 days.

**H. As currently drafted, the proposed title restriction imposes costs without benefits and therefore can't be justified economically.**

As we discuss at length above, the Commission's proposed restriction on the title "adviser" or "advisor" is so limited that it would, in our view, provide no real benefit to investors to offset its costs. Dual registrants would continue to be free to call themselves advisers, even when acting solely in a brokerage capacity. And even those standalone brokers who would be covered by the title restriction would still be free to refer to their services as advice and to market themselves as if trusted advice is the primary service they offer. Moreover, they would still be free to adopt other titles, such as "financial consultant" or "wealth manager," that are equally likely to mislead investors about the sales nature of the services they offer.

The Commission's economic analysis of its proposed approach to limiting titles attributes benefits to the proposal that it is unlikely to produce. It suggests, for example, that the proposal may: "reduce investor confusion about what type of firm or financial professional is likely to match with their preferences for a particular type of investment advice relationship;" "reduce corresponding search costs for some investors under certain conditions;" and "reduce the likelihood that a mismatch between an investor's preferences and the services offered by a firm or financial professional occur."<sup>548</sup> The Release goes on to state that, "to the extent investors looking for an advice relationship of the type provided by investment advisers, and believe that names or titles containing the terms 'adviser' or 'advisor' are associated with this type of advice relationship, the proposed rule would make it easier to identify firms and financial professionals that offer such advice relationships, thereby reducing investor confusion, search costs, and any mismatch in the advice relationship that may occur from the potential misleading nature of such names or titles, as well as any associated harm with such mismatch."<sup>549</sup> Once again, it provides only theory, unbacked by facts, to support its predictions.

For example, the Commission fails to seriously consider how likely it is that limiting just one title for one subset of brokers would produce the expected benefits. It fails to provide any serious analysis of the issue, despite acknowledging the risk that broker-dealers may "use new names and titles that are equally efficient at conveying they are providing advice"<sup>550</sup> and that this could perpetuate, not solve, the problem. The Release states, for example, that, "The proposed rule may also increase investor confusion to the extent some firms and financial professionals invent new names or titles to substitute for the restricted ones. Studies already indicate that the wide variety of names and titles used by firms and financial professionals causes general investor confusion about the market for investment advice."<sup>551</sup> Despite these and other reservations about the likely effectiveness of the proposal discussed in the economic analysis, the Release fails to justify the basis on which the Commission proposes to move forward with its proposal.

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<sup>548</sup> Form CRS Release at 310.

<sup>549</sup> *Id.*

<sup>550</sup> Form CRS Release at 326; *see also* Form CRS Release at 307, footnote 667 ("Alternatively, these firms may choose relatively generic names or titles that in other ways suggest an advisory service, such as "financial planner" or "financial consultant," which are not subject to the present rulemaking proposal.").

<sup>551</sup> Form CRS Release at 316.

It becomes clear from reading the economic analysis that the Commission isn't apparently trying to address the real problem that exists in the market and is instead seeking to address a theoretical problem that the Commission hasn't proved exists. While the real problem is that investors are being misled into relying on biased sales recommendations as if they were trusted advice, and suffering real financial harm as a result, the economic analysis is focused on reducing "search costs" and the risk of mismatched relationships for those investors who are searching for an investment adviser and who risk misidentifying a standalone broker-dealer as an investment adviser if the broker-dealer is permitted to call himself an adviser. The Release states, for example, that the Commission expects "the greatest potential reduction in search costs for retail investors who know that they specifically want the services provided by investment advisers and also would use names and titles in their search. The proposed rule would potentially make it easier for such investors to distinguish firms and professionals providing investment adviser services from firms and professionals providing brokerage services"<sup>552</sup>

The Commission has provided no evidence that a significant percentage of investors are sufficiently aware of the differences between investment advisers and broker-dealers to know that they are looking for an investment adviser. Nor has the Commission demonstrated that investors who are knowledgeable enough to know they are looking for an investment adviser nonetheless suffer excessive search costs when seeking out investment advisers. And it certainly hasn't provided any evidence that limiting standalone brokers' ability to use the title "adviser," but not their ability to market themselves as advisers in other ways, would, in fact, be likely to have a measurable impact on either investors' search costs or their mismatch risks.

We frankly question why the Commission would propose a solution that imposes "potentially substantial"<sup>553</sup> costs to address a problem it hasn't proved exists through an approach it clearly views as unlikely to be successful. For, in contrast with the unquestioning confidence with which the Release proclaims the likely benefits of Reg BI, the economic analysis of the title restriction suggests on every page that the authors are highly skeptical of the proposed approach. This suggests that the proposed approach is offered for political reasons, without any real prospects that it will ultimately be adopted, because the Commission is unwilling to put forward a serious proposal to address a problem it has, over the years, done so much to create.

This would help to explain why the Commission fails to seriously consider, as part of its economic analysis, the costs and benefits of alternatives that might actually solve the problem, including broader restrictions on brokers' ability to hold themselves out as advisers. The Commission apparently is unable to provide compelling reasons against holding out restrictions, so it falls back on weak arguments that basically suggest that the Commission simply wasn't willing to put in the effort to develop an effective holding out proposal. The Release suggests, for example, that holding out restrictions "could create uncertainty" for broker-dealers as to which activities (and the extent of such activities) would be permissible, without explaining why the Commission couldn't develop appropriate guidance to limit any such uncertainty.<sup>554</sup> And, of

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<sup>552</sup> Form CRS Release at 310-311.

<sup>553</sup> Form CRS Release at 323-324.

<sup>554</sup> Form CRS Release at 340.

course, the Commission rolls out its tried and true argument – once again totally unsupported by evidence – that imposing a limit on brokers’ ability to misrepresent themselves as advisers when they are regulated as salespeople “may also limit or reduce allowable advice provided by broker-dealers.”<sup>555</sup> “[I]f some broker-dealers avoid providing advice as a result of this alternative, some retail investors may be shut out of the advice market entirely or may have to incur higher costs that may be associated with investment advisory services”<sup>556</sup> But keeping in mind that the “advice” that brokers currently offer consists of sales recommendations, the Commission offers no explanation for why prohibiting them from calling themselves “advisers” would cause them to discontinue providing sales recommendations. As with other instances in this proposal, these arguments sound more like a regurgitation of broker-dealer industry talking points than a serious consideration of the issue.

In a similar vein, the Release fails to include any analysis of what the impacts would be if the Commission required broker-dealers to describe their services to investors the way they describe their services in legal settings. In their legal challenge to the DOL conflict of interest rule, the broker-dealer industry made abundantly clear that they view themselves as salespeople engaging in arms-length transactions, rather than as bona fide advisers. They have stated, for example, that, “A broker, insurance agent, or other financial-sales professional may make ‘individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.’”<sup>557</sup> If brokers described themselves to their prospective customers as more like car dealers than advice providers, and were prohibited from characterizing their services as advisory in nature, it would likely have an impact on investor’s ability to make an informed choice. Yet, the Commission provides no analysis on this potential alternative. Indeed, nowhere in the entire regulatory package does the Commission reflect any awareness of the arguments that the broker-dealer industry made in court, much less provide an analysis of those arguments as it relates to this proposal.

Ironically, in arguing against broader title restrictions, the Commission reinforces the view that brokers are currently violating the broker-dealer exclusion by holding out as advisers and would continue to be able to do so under the proposal. The Release states, for example, that broker-dealers are efficient in their marketing efforts and rationally choose titles that they believe to be “most effective at helping attract customers and **that best describe their business model**...”<sup>558</sup> (emphasis added) The Commission then claims that title restrictions might lead to a loss in efficiency in their marketing efforts because they may not be as effective at conveying they are providing advice. The Release states, “In particular, those broker-dealers that **rely on advice services as an important part of their value proposition** to retail investors and **directly compete with investment advisers** may lose competitiveness, if names and titles become less descriptive of this aspect of their business in the eyes of retail investors.”<sup>559</sup> (emphasis added) None of these characterizations sound like their advice is “solely incidental to” their traditional function of buying and selling securities.

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<sup>555</sup> Form CRS Release at 340.

<sup>556</sup> Form CRS Release at 341.

<sup>557</sup> Brief for Chamber of Commerce, SIFMA, et al., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 41, <http://bit.ly/2f4wVBW>.

<sup>558</sup> Form CRS Release at 326.

<sup>559</sup> *Id.*

The fact that the Commission so readily acknowledges: 1) that broker-dealers currently hold out as advisers in order to attract customers; 2) that calling their services advice “best describe[s] their business model; and 3) that providing advice is an “important part of their value proposition” reinforces the argument that brokers are currently in violation of the broker-dealer exclusion from the Advisers Act, since none of this remotely resembles a business model where advice is solely incidental to product sales. Moreover, the fact that the Commission acknowledges that, if only the title “adviser” is restricted, broker-dealers are likely to “use new names and titles that are equally efficient at conveying they are providing advice,” makes clear that brokers would likely continue to be in violation of the exclusion under this proposal. In short, the Commission makes a strong case here for either narrowing the broker-dealer exclusion or imposing a uniform fiduciary duty on brokers and advisers alike, neither of which has been given serious consideration in this regulatory package.

In particular, the Commission didn’t consider the alternative regulatory approach that we believe would be more successful and cost-effective at addressing the real problems in the market. That alternative would impose a uniform fiduciary duty under Section 913(g) of the Dodd-Frank Act, backed by strong and clear conflict mitigation requirements, on anyone providing investment advice, regardless of whether they are acting as a broker or adviser. Under this alternative, anyone providing advice would still be allowed to call themselves “adviser” or “advisor.” Further, Form CRS disclosure would be significantly shortened and simplified under this approach, because the differences between the standards that apply and the conflicts that are likely to be present would be reduced. (Such disclosures would still need to be grounded in research, supported by investor testing, and designed by experts.) Such an approach would likely be much more cost-effective than what the Commission has proposed, as it would provide greater protections to investors without imposing the same operational costs associated with changing titles.

In contrast, the Commission’s proposed approach would impose considerable unjustified costs on standalone brokers, who would be forced to change business cards, websites, and other materials that list the associate’s title. And those costs would fall disproportionately on smaller brokers, as most standalone brokers skew to the smaller side, while most large brokers are already dually registered. Worse, there is no evidence that these costs would deliver any meaningful benefits. As such, the proposal cannot be economically justified.

## **VII. Conclusion**

In our September 2017 letter in response to the Chairman’s request for comment, we expressed a “certain skepticism,” borne out of years of experience, that what was being promoted as an effort to improve protections for investors would instead end up weakening those protections or preserving the status quo. With that in mind, we laid out six steps the Commission would need to take if it wanted to avoid repeating the Commission’s past failures and develop a pro-investor policy for the regulation of financial professionals.<sup>560</sup> These included: correctly diagnosing the problem; developing a solution that is tailored to the problem; bringing a healthy

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<sup>560</sup> Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, at 2-3, September 14, 2017, <http://bit.ly/2vAiDjN>.

dose of skepticism to the brokerage industry's self-serving claims; listening instead to industry groups that embrace a fiduciary standard; building support within the Commission for a pro-investor regulatory approach; and developing a rigorous economic analysis justifying regulatory action that can withstand legal scrutiny.

Unfortunately, the same failings that have dogged the Commission's past efforts in this area are fully on display here, with the result that: the proposed "best interest" standard for broker-dealers will not meet investors' reasonable expectations; the proposed interpretation of the Advisers' Act fiduciary duty will enshrine the Commission's weak enforcement of that standard; and the proposed Form CRS disclosures will not provide the basis for an informed decision among different types of providers and different types of accounts. There are aspects of the proposal that could form the basis for a true fiduciary best interest standard for broker-dealers and investment advisers alike, but it would require an extensive reworking of both proposed Reg BI and the Advisers Act Guidance. The proposed Form CRS disclosure requires a similar top-to-bottom revision, but that can only be accomplished once independent cognitive usability testing has been conducted and the results of that testing have been incorporated in a revised document.

In short, while we appreciate that the Commission has finally produced a regulatory proposal on this important issue, it is still a long way from the finish line. The Commission cannot and should not attempt to rush this process to finalization without addressing the very serious shortcomings that pervade its proposed regulatory approach. To do so would leave investors worse off than they were before, misled into believing they are receiving protections they are not. On the other hand, if the Commission is prepared to overhaul its proposed approach in order to deliver the promised protections, we are prepared to assist in any way that we can to transform this deeply flawed proposal into a meaningful best interest standard we can enthusiastically endorse.

Respectfully submitted,



Barbara Roper  
Director of Investor Protection



Micah Hauptman  
Financial Services Counsel

## Appendix A: Redline of Best Interest Standard

As we indicated in our letter, we believe it is possible to develop a principles-based best interest standard that, unlike the standard proposed by the Commission, would create a clear obligation for brokers to do what is best for the investor and impose meaningful restrictions on practices that undermine compliance with that standard. Working within the parameters of the Commission's proposed approach, we offer this redline of the best interest standard, reflecting the changes that would be needed to turn the Commission's proposal into a true best interest standard that meets investors' reasonable expectations regarding the legal protections they should receive when receiving investment advice from a broker-dealer.

### § 240.15l-1 Regulation Best Interest.

(a) *Best Interest Obligation.* (1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction, ~~or~~ investment strategy involving securities, **securities account, or investment service** to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without **regard to the financial or other interest** ~~placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.~~

(2) **To satisfy the best interest obligation in paragraph (a)(1) shall be satisfied if the broker, dealer, or natural person who is an associated person of a broker or dealer must, at a minimum, comply with the following duties:**

(i) **Duty to Disclose ~~Disclosure Obligation~~.** The broker, dealer, or natural person who is an associated person of a broker or dealer, **as soon as reasonably practicable** prior

to ~~or at the time of~~ such recommendation, **must provide full and fair disclosure** reasonably discloses to the retail customer, in writing, **of all the** material facts relating to the ~~scope and terms of the relationship with the retail customer~~ **recommendation**, including all material **costs, risks, and** conflicts of interest that are associated with the recommendation.

(ii) **Duty of Care-Obligation.**

(A) The broker, ~~or dealer~~ **shall make available a menu of investment options sufficient to reasonably ensure that it and its associated persons can satisfy their best interest obligations.**

(B) **The broker, dealer,** or natural person who is an associated person of a broker or dealer, in making the recommendation, **shall** exercise reasonable diligence, care, skill, and prudence to:

~~(A)~~1. Understand the **material facts, including** potential risks and rewards, associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

~~(B)~~2. Have a reasonable basis to believe that the recommendation is **in** the best **option, from among the reasonably available options, for** ~~interest of~~ a particular retail customer based on that retail customer's investment profile and ~~the potential risks and rewards associated with~~ the **material characteristics of the recommended securities transaction, investment strategy, securities account, or investment service-recommendation;** and



~~(C)~~3. Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

(C) The broker, dealer, or natural person who is an associated person of a broker or dealer who provides periodic, episodic, or ongoing recommendations to a customer shall, throughout the duration of that relationship, periodically monitor the customer's account to determine whether investments in the account continue to be in the customer's best interests.

(iii) ~~Conflict of Interest Obligations~~ Duty of Loyalty.

(A) The broker or dealer shall establishes, maintains, and enforces written policies and procedures reasonably designed to prevent violations of the best interest standard by identifying and at a minimum disclose disclosing and mitigating, or eliminate eliminating, all material conflicts of interest that are associated with such recommendations.

(B) The broker or dealer may not create incentives (including but not limited to sales quotas, contests, or special awards) that are intended or would reasonably be expected to encourage recommendations based on factors other than the customers' best interests.

(C) ~~The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate,~~

~~or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.~~ When recommending a securities transaction, investment strategy, securities account, or investment service, natural persons who are associated persons of a broker or dealer shall comply with the written policies and procedures of the broker or dealer and act without regard to their own financial or other interests or the financial or other interests of the broker or dealer.