



## Consumer Federation of America

August 30, 2010

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**Re: File Number 4-606  
Study Regarding Obligations of Brokers, Dealers, and Investment Advisers**

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America (CFA)<sup>1</sup> in response to the Commission's request for comment as part of its study regarding the standard of care that should apply to brokers and investment advisers when they give investment advice and recommend securities. CFA congratulates the Commission for providing an early opportunity for the public to provide input into a study that, if properly carried out, could at long last lay the groundwork for a pro-investor approach to regulating investment professionals.

### **Introduction**

Improving protections for investors in their dealings with brokers, financial planners, and investment advisers has been a priority for CFA for nearly a quarter century. Our focus on this issue reflects several factors:

- Investors' lack of sophistication and heavy reliance on recommendations by investment professionals makes them vulnerable to abuse.
- Abusive conduct by investment professionals, both in compliance with and in violation of existing rules, has been a recurrent problem.
- Regulatory standards in this area are notably weak and inconsistent, promoting investor confusion and setting an unreasonably low bar for professional conduct.

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<sup>1</sup> The Consumer Federation of America is an association of nearly 300 nonprofit consumer organizations established in 1968 to advance the consumer interest through research, advocacy, and education.

There is a positive flip side to these concerns, and that is that strengthening regulatory protections in this one area has the potential to provide dramatic benefits. Moreover, those investor protection benefits should be far easier to achieve than would be possible through a piecemeal approach that relies exclusively on strengthening product-specific regulations.

One of the key issues CFA has highlighted as part of its on-going efforts to improve regulation of investment professionals is the confusion that inevitably results and the investor harm that can occur when brokers are permitted to call themselves advisers, offer extensive personalized investment advice, and market their services based primarily on the advice offered, all without having to meet the fiduciary standard and regulatory requirements appropriate to that advisory role. For these reasons, CFA strongly supported inclusion of legislative language in the financial regulatory reform bill imposing a fiduciary duty on brokers when they give investment advice. The final compromise reached in the Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes but does not require the Commission to adopt rules imposing the Investment Advisers Act fiduciary duty on brokers when they give personalized investment advice to retail investors. While we would have preferred a clear mandate, this provision if implemented effectively has the potential to revolutionize the agency's approach to regulating investment professionals.

For the legislation to achieve that goal, the Commission will have to reverse course on several decades' worth of policy decisions that have undermined investor protection by expanding the ability of brokers to act as advisers without having to meet the appropriate standards. The legislation offers an opportunity to do so by changing the terms of the debate. No longer is the question one of what investment advisory services by brokers should be deemed more than "solely incidental" to their activities as brokers and therefore subject to regulation under the Investment Advisers Act. Instead, the debate has now shifted to the question of what standard of care should apply *whenever* brokers give investment advice or recommend securities. Moreover, the legislation makes clear that the intent is to remove the current inconsistent treatment of that advice and ensure that the standard adopted is at least as stringent as the standard that currently applies under the Investment Advisers Act.<sup>2</sup>

This study should serve to lay the groundwork for a new, pro-investor approach to an old issue. Part I of our comment letter will focus on the factors we believe the Commission should focus on and the data it should collect as part of this study to provide a thorough and objective analysis of the issues. In Part II, we will provide our own views on a number of the issues to be addressed in the study. The appendices provide additional supporting documents that discuss some of these issues in greater detail.

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<sup>2</sup> Section 913(g) of the Dodd-Frank Act authorizes the SEC to adopt a fiduciary duty for brokers and dealers that is "*the same as* the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940." (emphasis added) The act also amends Section 211 of the Investment Advisers Act to authorize the Commission to adopt rules imposing a fiduciary duty on brokers and dealers and specifies that "Such rules shall provide that such standard of conduct shall be *no less stringent* than the standard applicable to investment advisers under sections 206(1) and (2) of this Act when providing personalized investment advice about securities." (emphasis added)

## **Part I: Factors for the Commission to Consider in Conducting its Study**

### Timing and the Challenge of Encouraging Investor Input

CFA appreciates the time constraints the Commission is under in completing the study in the allotted six months. However, both the timing and the brevity of the comment period, while understandable under the circumstances, pose a significant challenge for those seeking to add an investor perspective to the debate. The Commission has already taken the essential first steps to promote investor comment by inviting that comment at the outset of the study and by providing an easy mechanism for doing so on its website. Despite these efforts, we are concerned that many investors who stand to benefit from a fiduciary duty are likely unaware that this opportunity exists. A preliminary review of comment letters submitted through the beginning of last week suggests that virtually all letters submitted at that time had come from members of the industry. While the comment period had one week remaining when this review was conducted, the results suggest that more needs to be done to encourage greater input from investors. We therefore urge the Commission to take additional steps to reach out to average investors.

In an effort to encourage more investor response, CFA issued a news release to personal finance writers in mid-August designed to prompt them to write columns and articles encouraging investors to make their voices heard.<sup>3</sup> In addition, CFA is pursuing and participating in other projects designed to provide additional insight into the experience of shopping for financial advice and the expectations investors bring to the advisory relationship. Unfortunately, these will not be completed prior to the August 30 comment deadline, though we hope to conclude both shortly thereafter. We hope that, in addition to providing valuable information to the Commission, the release of these studies release will prompt additional comment to the Commission from members of the investing public.

What CFA can accomplish in this regard is dwarfed by what the Commission could accomplish if it made a major effort to solicit investor input. One possible approach would be for the Commission to hold a series of town hall meetings specifically to seek investor input on the issue. These meetings would have to be carefully planned to ensure that they not become just another venue where industry voices predominate and drown out investor concerns. Another option would be for the Commission to release an appeal for comments from Chairman Schapiro, sent to newspapers throughout the country. Such an appeal could and should hone in on the issues where investors are most likely to have relevant input: whether they understand the differences between different types of investment professionals, what they expect from a financial adviser, what protections they believe would be beneficial, and what their experience has been in shopping for and working with investment professionals. Investors need to understand that, even if they lack technical expertise in the issues covered by the study, they have a view that deserves consideration.

Obviously, if the SEC were to encourage additional investor comment, the comment period would need to be held open to allow for any resulting responses to be considered as a part of the study. Indeed, regardless of whether it undertakes any such additional efforts, we urge the Commission to continue to accept and review investor comments and input received within a

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<sup>3</sup> CFA's news release urging investors to submit comments is available here.

reasonable period after the August 30 deadline. While this may complicate the agency’s task in completing the study in the required timeframe, we believe it has the potential to add valuable insights that deserve to be incorporated into the Commission’s analysis.

### The Scope of the Study

One temptation in conducting a study such as this – particularly in light of the rushed time-frame – would be simply to enumerate any and all differences in the regulatory treatment of broker-dealers and investment advisers. However, while there is overlap in the functions performed by brokers and advisers, significant differences remain. The study is specifically designed to focus on one area of functional overlap – personalized investment advice and recommendations about securities to retail customers – and the standard of care that applies to such recommendations. The challenge for the Commission when assessing regulatory differences will be to determine which fall within the scope of the study – by virtue of the fact that they are directly related to the standard of care for investment advice and recommendations about securities to retail customers – and which do not.

Making this determination is likely to be particularly difficult when conducting the required assessment of differences in the “regulatory, examination, and enforcement resources” devoted to enforcement of the standard of care for investment advice and recommendations about securities, since pinpointing the degree to which differences are attributable to differences in functions is likely to be at best an inexact science. Without that focus, however, the study simply will not produce relevant information that can be used to assess regulatory changes needed to resolve those differences. In our comments below, we will attempt to address in more detail some of the methods the Commission can use to make those evaluations.

### Consideration of Previously Collected Information

The Commission has been “studying” various aspects of the issue currently before it since at least the mid-1980s, and doing so intensively since it issued its proposed fee-based brokerage account rule in 1999. Research done in that context, such as the RAND Study, and many of the comment letters submitted to the agency regarding various proposals put forward are directly relevant to the issues to be addressed in the current study. For example, Appendix A includes links to more than a dozen letters CFA has sent to the Commission in this context. While those letters relate to regulatory proposals that differ in certain aspects from the one currently under consideration, they nonetheless provide commentary on issues raised by the current proposal as well. We would encourage the Commission to carefully review these comments, along with previously conducted research, with a particular eye toward supplementing what may otherwise be limited input from individual investors.

## Issues Addressed in the Request for Comments

### **1. The Effectiveness of Existing Legal or Regulatory Standards of Care**

This one question gets to the heart of the issues the Commission is asked to analyze as part of its current study. Do the existing legal and regulatory standards of care that apply to brokers and investment advisers when they give personalized investment advice and recommend securities to retail clients provide the appropriate level of investor protection? The standards of care in this case refer, of course, to the suitability obligation that applies to recommendations by brokers and to the fiduciary duty that applies to advice by investment advisers. In essence, the Commission is being asked to evaluate the relative effectiveness of these two standards in protecting investors who receive personalized investment advice and recommendations about securities.

As part of its evaluation of this issue, and in order to provide a concrete basis for its evaluation, we urge the Commission to include consideration of the following factors:

- Are there differences in the quality of advice or product recommendations investors receive from brokers and investment advisers?
- Are there differences in investor complaint levels or arbitration filings with regard to brokers and investment advisers?
- Does one standard provide regulators with a better means of holding financial professionals accountable than the other?

Collecting data in each of these areas poses its own particular challenges. While the resulting data may not be conclusive, however, we believe even less-than-conclusive information can help to provide texture to a purely legal analysis of requirements under different standards.

It is clear, for example, that the Commission could not produce definitive information on the relative quality of recommendations by brokers and advisers. However, it might be possible to collect data on mutual fund recommendations by brokers and advisers to determine whether the fiduciary duty has offered any benefit in keeping investor costs down.<sup>4</sup> Mutual funds would lend themselves to such an analysis because they are so widely recommended, cost information is readily accessible, and costs are an important factor in determining how well investors fare.<sup>5</sup> Relevant past research suggests that such a difference may exist. Previous research has found that those who buy load index funds pay higher mutual fund costs even after the distribution costs are subtracted than those who buy pure no-load index funds.<sup>6</sup> Additional research has found that those who invest through conventional distribution channels experience substantially

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<sup>4</sup> If the evidence suggests it has not, that suggests that there is a problem with how the standard has been implemented rather than a problem with the standard itself, which clearly provides a basis for considering costs when determining what fund is in the best interests of the customer.

<sup>5</sup> Indeed, recent Morningstar research indicates they are the single most important factor in determining performance.

<sup>6</sup> Bullard, Mercer and O'Neal, Edward S., *The Costs of Using a Broker to Select Mutual Funds*, November 2006, available at <http://www.funddemocracy.com/Index%20fund%20article%2010.pdf>.

poorer timing performance than investors who purchase no-load funds.<sup>7</sup> Neither of these studies differentiates based on the standard of conduct that applies, but both suggest that investors are getting a poor return for the added money they pay for an investment professional's services in recommending funds. And, since advisers are more likely than brokers to recommend no-load funds, it is possible that the fiduciary duty is one factor affecting the results.<sup>8</sup> It would be interesting to see whether a closer examination could determine the effect if any of fiduciary duty on recommendations.

On a somewhat different note, the Commission could analyze its past enforcement actions involving abuses of retail investors (and seek information from the states on enforcement actions they have brought) to determine whether those abuses were more likely to involve brokerage or advisory accounts or services and, by implication, more likely under a fiduciary duty or suitability standard. Similarly, the Commission could look at areas that it and the state securities regulators have previously identified as problem areas (e.g., unsuitable sales of variable annuities) to determine whether those practices are equally common at firms or among individuals operating under a fiduciary duty as they are at firms and among individuals operating exclusively under a suitability standard. And it could attempt a similar analysis of consumer complaint data and arbitration filings. The analysis of complaints and arbitration filings would be particularly helpful, since they should be unaffected by other factors that could influence regulatory actions (such as level of resources devoted to oversight in a particular area or a tendency for abuses by brokers to follow similar patterns and thus attract regulatory attention at the federal level because of the influence of large brokerage firms with a nationwide sales force).

A legal assessment of the standards in terms of the tools they provide to regulators in going after abusive conduct could also be supported by concrete examples. For example, in addition to describing the technical legal differences between the two standards, the Commission could and should identify examples, provided by its own enforcement division and by state securities regulators, of actions they were unsuccessful in bringing or didn't even attempt to bring under a suitability standard that would likely have succeeded had a fiduciary duty applied. (In the unlikely event that there are counter-examples of actions that were or would have been possible under a suitability standard but not a fiduciary duty, the Commission should identify those as well.) In other words, the Commission should seek to clarify with specific examples the kind of abusive conduct that is permissible under one standard that would either not be permissible or would be easier to combat under the other. In looking for such examples, the Commission should not limit itself solely to the kinds of cases that *have been* brought under the fiduciary duty, but should look at what kinds of cases *could be* brought. In other words, it should not assume that past enforcement of the fiduciary duty defines the limits of what it would be possible to achieve, and should look instead at what could be accomplished under an aggressively enforced standard that really sought to hold investment professionals accountable for acting in their customers' best interests.

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<sup>7</sup> Bullard, Mercer, Friesen, Geoff, and Sapp, Travis, *Investor Timing and Fund Distribution Channels*, December 2007, available at <http://www.funddemocracy.com/Investor%20Timing%20final%20final%2012.4.07.pdf>.

<sup>8</sup> Of course, other factors, including differences in compensation methods, may also play a significant part.

## **2. The Existence of Regulatory Gaps, Shortcomings, or Overlaps**

As noted above in the discussion of scope, this analysis should not simply consist of an enumeration of regulatory differences between brokers and advisers. The only regulatory differences that are relevant to this particular study are those that pertain to “legal or regulatory standards in the protection of retail customers relating to the standards of care ... for providing personalized investment advice about securities to retail customers.” The obvious, glaring regulatory gap that falls into this category is the fact that, in large part because of the Commission’s past overly expansive interpretation of the broker-dealer exclusion from the Advisers Act, brokers have been permitted to offer extensive investment advisory services without being held to the fiduciary duty, disclosure obligations, and other regulatory requirements that apply to the same services offered by investment advisers. That discussion is likely to be virtually identical to the preceding discussion regarding the effectiveness of existing regulatory protections in this area.

In its direction to examine regulatory “shortcomings,” however, this provision also offers the Commission an opportunity to explore how the existing fiduciary duty for investment advisers could be strengthened. One area that deserves particular attention, in our opinion, is a tendency to rely too heavily on disclosure to satisfy all fiduciary obligations. The duty to disclose all material information, including information about conflicts of interest, is an admittedly important aspect of the Advisers Act fiduciary duty. But it would be a mistake to conclude, as some appear to do, that disclosing a conflict of interest fully satisfies that fiduciary obligation. On the contrary, we firmly believe that the most important obligation of a fiduciary adviser is to give advice that he or she has a reasonable basis for believing is in the best interest of the client. Moreover, while an assessment of what is in the client’s best interests should include a variety of factors, one of those factors should clearly be the cost to the investor. Second, as a fiduciary, the adviser should seek to avoid conflicts of interest where possible, and to manage and disclose conflicts of interest that are unavoidable. In other words, disclosure should be the last line of defense, not the first, in protecting the customer from conflicts of interest, and it should supplement, not substitute for, the affirmative duty to act in the customer’s best interests.

As a part of its study, the SEC should examine whether the Advisers Act fiduciary duty has consistently been applied in this fashion and, if not, what steps should be taken to adopt a more robust approach to regulation and enforcement in this area. Second, the Commission should explore how this robust fiduciary duty can be applied to the broker-dealer business model, which is replete with conflicts of interest. While the Dodd-Frank Act makes clear that it is intended to impose a fiduciary duty that works with the broker-dealer business model (by allowing commission-based compensation, for example, and sale from a limited menu of products), it also directs the SEC to examine and address compensation practices that create unacceptable conflicts of interest. A properly implemented fiduciary duty for recommendations of securities by brokers could serve to advance that goal while simultaneously raising the standard as it applies to investment advisers. We encourage the Commission to approach this study, and future policy initiatives, with that goal in mind.

### **3-4. Investor Understanding of and Confusion Regarding Differing Standards of Care**

Previous studies have documented that investors do not understand the differences between brokers and investment advisers. These have included a 2005 focus group study commissioned by the SEC and conducted by Siegel and Gale, LLC and Gelb Consulting Group, a 2004 survey commissioned by CFA and the Zero Alpha Group, a 2006 survey commissioned by TD Ameritrade, and of course the RAND Study. While we certainly have no objection to the Commission's conducting additional research in this area, we are not convinced that it would be the best use of limited agency time and resources. Instead, we believe the Commission should be able to rely on outside studies to verify a point on which virtually all stakeholders in this debate agree: that investors do not understand the differences between different types of investment professionals and that disclosure alone cannot resolve this confusion.<sup>9</sup>

### **5. Regulatory, Examination, and Enforcement Resources and Activities**

As noted above, the Commission faces a particular challenge in analyzing this issue: how to determine the degree to which similar activities by brokers and advisers – in this case personalized advice and recommendations of securities to retail customers – are subject to differing levels of oversight that cannot be justified. To conduct a valid comparison of relative regulatory resources devoted to this task, the Commission will need to identify what portion of the broker-dealer examinations are designed to police for suitability violations and compare them to the portion of investment adviser examinations designed to police for fiduciary violations.

More importantly, the Commission will need to try to identify measures of the effectiveness of those examinations. It is no mystery that the Commission has for decades been starved of the resources needed to provide effective oversight of investment advisers, nor that the existence of a self-regulatory organization for broker-dealers has served to supplement regulatory resources devoted to the oversight of brokers. What is less clear is whether this has made those who invest through brokers “safer” than those who invest through investment advisers. If not, the Commission should seek to understand why that is not the case. One possible explanation is that the existence of a fiduciary duty for advisers has had a positive effect on adviser conduct, even when that conduct has been subject to inadequate regulatory oversight. Another is that the function of giving advice simply entails fewer risks than that of selling securities. If the Commission finds (as we expect it will) that examinations of brokers are more frequent and longer in duration than examinations of advisers, the Commission will therefore still need to determine the degree which these differences reflect differences in the activities of and risks posed by brokers and advisers as well as differences in the areas covered by those examinations.

Only those differences that reflect different treatment of comparable conduct are relevant to an evaluation of the effectiveness of that regulatory oversight. And that is the most important issue with regard to regulatory oversight that the Commission must address in the study: how effective the examinations are in determining compliance with regulations. To address that question, the Commission should look at such factors as whether abusive conduct is more likely

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<sup>9</sup> In its 26 interviews with stakeholders as part of its study, RAND found widespread agreement that investors didn't understand these differences and only one who thought disclosures were effective in dispelling this confusion.

to be uncovered by examinations or by some other means (e.g, customer complaints or media reports), and whether there are differences in this regard between examinations of brokers and advisers. Moreover, if a disproportionate number of abuses by either brokers or advisers are missed by examinations, the Commission should explore the reason for this shortcoming. What has worked (or failed to work) in the past? Are different types of examinations or regulatory activities more effective than others in uncovering violations? Have certain states, for example, been particularly successful in uncovering abuses and, if so, what accounts for their success? Can new techniques be developed or existing techniques be expanded to improve the success rate of examinations in uncovering problems?

In short, rather than simply comparing regulatory oversight of investment advisers and brokers to determine which is “best,” the Commission should recognize the existence of weaknesses in both areas and use its mandate to identify regulatory shortcomings to seek to address them. FINRA’s board has conducted a thorough and credible analysis of its regulatory failings in the Madoff and Stanford frauds. There is much the Commission can learn from its review of that study, and any other relevant information from its own internal evaluation of these regulatory failures, that would be relevant to this study of regulatory shortcomings.<sup>10</sup> The goal should be to determine what can be done to strengthen regulatory oversight by federal, state, and industry regulators for brokers and investment advisers alike.

## **6. Substantive Differences in Regulation**

It is unclear how provision 6 of the study differs from earlier requirements, given that the entire purpose of the study is to examine differences in standards of conduct for brokers and advisers and the impact of those differences on investor protection. One possibility is that its focus on “substantive” differences in regulation suggests an intent that the SEC look not just at differences in legal requirements but also at how those differences play out in actuality. If that is the case, the suggestions we have provided above on how to supplement the legal analysis with concrete examples of real world impact should satisfy this requirement.

## **7. Specific Instances Where Different Standards of Care Provide Greater Protection**

Provision 7 also seems to be little more than a restatement of earlier study requirements. With its focus on “specific instances,” however, this provision also seems to call for the agency to look beyond generalities to specific examples where either the fiduciary duty or the suitability requirement provides greater protection to retail investors. Here again the SEC will need to distinguish between regulatory protections unrelated to the standard of care and those that are related to the provision of personalized investment advice about securities to retail investors in order to maintain the proper focus for this study. But the examination we have suggested above

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<sup>10</sup> In conducting that review, the Commission must eschew past attempts to pass off the Madoff fraud as a failure of investment adviser oversight. As has been well established, Madoff was regulated exclusively as a broker throughout most of the life of the fraud. Moreover, had the accounts and activities he purported to offer been real, as commission-based discretionary accounts they would have been exempt from Advisers Act regulation and thus subject exclusively to broker-dealer oversight, until the rule changed in 2005 brought such accounts under the jurisdiction of the Advisers Act.

of enforcement actions that would be permissible under one standard but not the other should provide the specificity this provision demands.

## **8. State Legal and Regulatory Standards**

As written, this provision appears to call on the SEC to simply enumerate the existing legal and regulatory standards of state securities regulators and “other regulators” related to the standard of care. The only ambiguity appears to be who those “other regulators” might be. FINRA is the obvious candidate. If the Commission chose to take a particularly expansive view of this provision, however, it could look beyond securities regulators *per se* to include other enforcement authorities (such as state attorneys general) and even private litigation, both of which play a role in protecting retail investors. The goal should be to provide as complete a picture as possible of the various factors that serve to protect retail investors with regard to the standards of care that apply to investment advice and recommendations about securities.

## **9, 12. The Potential Impact on Retail Investors of Imposing the Advisers Act Fiduciary Duty and Other Advisers Act Requirements on Brokers**

Provisions 9 and 12 of the study requirements focus on different aspects of the same thing – the impact on retail investors of imposing a fiduciary duty, and possibly other Advisers Act requirements, on brokers when they give personalized investment advice and recommend securities to retail investors. Under these two provisions, the SEC is asked to examine the potential impact on retail investors both in terms of access to personalized advice and to the range of products and services offered by brokers and in terms of protection from fraud. These provisions were clearly designed to respond to industry arguments that imposition of a fiduciary duty on brokers would deny investors access to valued products and services. However, most of those industry arguments are based on false assumptions and misleading statements about the impact of a fiduciary duty. (Appendix B includes links to documents CFA produced during congressional consideration of the Dodd-Frank bill that responded in varying degrees of detail to misleading industry arguments along these lines.)

In assessing the impact of imposing a fiduciary duty, the Commission can and should look to the real-life example provided by financial planners, who have long sold securities and insurance products while complying with the Advisers Act fiduciary duty.<sup>11</sup> If financial planners or other investment advisers are able to offer a product or service under a fiduciary duty, and particularly if they can do so at a competitive price, the presumption should be that brokers could do so as well if they chose to. Moreover, the fact that some brokers might choose not to offer such services if a fiduciary duty is imposed should not be deemed to deny investors access to those services, since the services would still be available from other sources. In other words, the fact that some brokers may choose to alter their business model in order to avoid having to act in customers’ best interests should not automatically be deemed to deny investors access to those services. And threats to stop offering certain services should not be taken at face value. Time and again brokers have threatened to cease offering certain products or services if subject to

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<sup>11</sup> While financial planners initially resisted application of the Advisers Act fiduciary duty to their product sales, using many of the same arguments brokers and insurance agents now put forward, the profession has since come to embrace the notion that they are fiduciaries throughout the planning engagement.

increased regulation – fee-based brokerage accounts being one example – only to back down from those threats once faced with the reality of that regulation.

Finally, not all changes that deny investors access to certain products or services should be seen as a negative. If investors lose access to high-risk, poorly performing, or over-priced products as a result of the imposition of a fiduciary duty, investors will benefit. Indeed, that is precisely the outcome the legislation is intended to bring about. Moreover, the inclusion of a requirement that the Commission look at the impact on investors in terms of protection fraud is clearly designed to ensure that precisely this outlook is included in the study. In this context, we would encourage the Commission to look beyond outright fraud and to include examples of abusive or harmful conduct that would be permissible under the suitability standard but not under an aggressively and effectively enforced fiduciary duty.

Provision 9 also directs the SEC to look at the potential impact of imposing other Advisers Act requirements on brokers and their registered representatives. In this context, CFA encourages the Commission to look at the potential benefits of imposing the Advisers Act pre-engagement disclosure requirements on brokers. This requirement relates directly to the fiduciary duty to provide material information that might influence an investor's decision, would have a direct impact on the ability of investors to choose an investment professional that best matches their needs and preferences, and could help to reduce investor confusion.

On the other hand, because the study is focused on requirements that relate specifically to provision of personalized investment advice and recommendations of securities to retail investors, the SEC need not address how the Advisers Act requirements would affect services offered by brokers that do not entail investment advice or recommendations to retail investors. During the legislative debate, industry groups repeatedly argued that the fiduciary duty would limit their ability to perform functions that would not be affected because they do not entail personalized investment advice. For example, much as CFA would support extension of the fiduciary duty to advice about any financial product, the legislation does not provide the Commission with that authority. As a result, recommendations of products that are not securities would not be covered by a new fiduciary duty for investment advice, and thus their availability would not be limited by a fiduciary duty for investment advice.<sup>12</sup> Similarly, services that do not entail personalized advice, such as issuing research reports or acting strictly in the capacity of a discount broker, would not be covered.

That leaves it to the Commission to determine just what is covered by the terms personalized investment advice and recommendations of securities. Appendix C includes a document CFA developed with Fund Democracy, the North American Securities Administrators Association, and several investment adviser organizations at the request of Senate Banking Committee staffers. The letter describes what types of brokerage services do and do not constitute investment advice that should be subject to a fiduciary duty. The document does not

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<sup>12</sup> It may be appropriate for the SEC to describe the gap in investor protections that would result, if advice and recommendations about securities are subject to a fiduciary duty but advice and recommendation involving non-securities, such as certain types of annuities that are sold in competition with securities, are not subject to a fiduciary duty.

address what is meant by the added term in the legislation, “recommendations of securities,” but we believe its analysis remains generally consistent with the intent of the legislation.

#### **10. The Potential Impact of Eliminating Brokers’ Exclusion from the Advisers Act**

When the study requirements enumerated in the legislation were first developed, the Senate was contemplating legislation that would have removed the broker-dealer exclusion from the Advisers Act. This provision is a legacy of that debate. No one that we are aware of is seriously contemplating advocating this approach, which would require legislative action. If investors are to receive the benefits of a fiduciary duty for brokers, it is up to the Commission to provide it through its rulemaking process. Thus, given the limited timeframe under which the Commission is operating, we believe that time would best be spent analyzing issues that are directly relevant to actions the Commission is likely to take. We therefore recommend that the Commission spend the minimum time and effort necessary to satisfy this aspect of the study.

#### **11. The Varying Level of Services Provided by Brokers and Advisers**

Tucked in near the end of the list of study requirements, this provision actually serves as the study’s logical starting point, since an analysis of regulatory gaps and overlaps should proceed from a clear understanding of the functional differences and similarities between brokers and investment advisers. We believe this analysis will show that there are both expansive areas of overlap in the services provided by brokers and advisers and significant remaining differences.<sup>13</sup> It is only when we understand these differences and similarities that we can begin to understand which regulatory differences are justified and which are not and what can be done to lessen investor confusion and improve investor protections. Moreover, this information can help the Commission to understand exactly how a fiduciary duty would be applied to different types of advisory services and in different types of customer relationships. That should assist the Commission in developing a rule proposal that satisfies the twin objectives of the legislation: to impose a fiduciary duty that works with the broker-dealer business model but one is no less stringent than the existing Advisers Act fiduciary duty.

#### **13. The Potential Additional Costs Posed By Any Changes**

One problem with this type of cost analysis is that certain types of costs, such as compliance costs, are relatively easy to quantify, while benefits (such as reduced costs to investors that could result from imposition of a fiduciary duty) are speculative and thus inherently difficult to quantify. In conducting its study, the Commission will need to be careful to avoid falling into the trap of placing greater emphasis on certain costs simply because they are more easily calculated. This is particularly important in this context, since some industry members have argued against imposition of a fiduciary duty on the grounds that it would increase investor costs. They have offered no evidence to support this contention, however, which is based in part on a false assumption that such a requirement would inevitably lead to adoption of fee-based compensation and which ignores the potential benefits of a fiduciary duty in disciplining excessive costs.

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<sup>13</sup> A thorough review is also likely to show just how confusing this whole area is to the average, unsophisticated investor.

It will be up to the Commission to hold those claims up to objective scrutiny. One way to do so is to compare the costs typically paid by investors through brokers, financial planners, and investment advisers for comparable products and services. That poses a challenge, however, since to some degree at least this will entail a comparison of apples and oranges. The fees charged for a comprehensive financial plan, for example, might cover a number of services not included in advisory services offered either by a traditional asset manager or a broker offering advisory services. So, a higher price for the plan might not reflect a higher price for the investment advice itself. Even a comparison between an investment adviser and a broker would offer an imperfect basis for comparison, since an investment adviser may be providing more active account monitoring than is provided through a typical brokerage account. The different ways in which different investment professionals charge for their services also subverts easy comparison. Moreover, any meaningful cost comparison would need to cover the cost for advice and implementation of that advice, since the two are often inseparable and the total cost to the investor is what is most relevant.<sup>14</sup> Finally, in order to provide a meaningful analysis, the Commission will need to look beyond current practices to what could be accomplished if the fiduciary duty were effectively enforced to discipline costs.

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CFA firmly believes that a thorough, objective study of regulatory gaps and shortcomings with regard to investment advice and recommendations of securities will support imposition of a fiduciary duty on brokers and their registered representatives when they perform these functions. Producing a thorough and objective study may be easier said than done, however, both because of the limited time allotted for that study and because many of the problems that the study must analyze are problems created by past policy decisions of the SEC itself. If these obstacles are overcome, however, the reward will be a study that promotes a pro-investor approach to regulation of investment advisers that ensures: 1) that regulatory requirements are based on the nature of the services being offered, rather than the nature of the firm offering the services, and 2) that those regulatory requirements afford the highest possible level of protection to vulnerable and unsophisticated retail investors.

## **Part II – CFA Position Regarding the Standard of Care for Investment Advice and Securities Recommendations**

CFA strongly supports requiring brokers to meet the same fiduciary standard to which all other investment advisers are held when they provide personalized investment advice and recommend securities. This portion of our comment letter lays out what we believe is the overwhelming case in support of doing so.

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<sup>14</sup> Previous analyses have shown, for example, that while fee-only financial planners appear to impose higher charges for advice, the total cost to investors of that advice is often lower than for commission-based planners because the cost of implementation ends up being much lower.

## **1) Lines between brokers and investment advisers have become blurred.**

The original legislative distinction between broker-dealers and investment advisers was based on the fact that these two different classes of investment professionals performed distinctly different functions. Broker-dealers were in the business of effecting transactions in securities on behalf of themselves and their customers, and investment advisers were in the business of giving advice about securities for compensation. In setting up this distinction, Congress exempted brokers from regulation as advisers as long as they met two conditions: 1) they limited themselves to giving only that investment advice that was “solely incidental” to their activities as brokers and 2) they received no “special compensation” for that advice. Although Congress clearly intended to regulate brokers and advisers based on the functions they performed, the SEC for many years relied primarily on method of compensation to draw the line between brokers and advisers.<sup>15</sup> Brokers charged commissions, investment advisers charged fees, and the Commission didn’t find it necessary to define what constituted “solely incidental” advice by a broker.

### Market Forces Prompt Changes in the Broker-Dealer Business Model

For nearly 50 years, that approach appeared to work reasonably well. The first serious challenge to the system came with the rapid growth of the financial planning profession in the 1980s and 1990s. Financial planning posed a challenge because these hybrid practitioners, who consolidated many different separately regulated financial functions in a single firm or individual, didn’t fit neatly into any existing regulatory category. Most offered financial advice that included advice about securities, generally for a fee, and most (though not all) also sold securities and insurance on commission to implement their recommendations. After exploring various options, regulators ultimately settled on the approach of regulating the planning firms primarily as investment advisers. To the degree that individual planners sold securities and insurance to implement their plans, they were required to be licensed and regulated accordingly.

The growing popularity of financial planning, and the simultaneous growth in the availability of discount brokerage services, posed a challenge for brokerage firms as well. On one side they faced competition from financial planners, who offered securities sales within the context of advice that was arguably both more comprehensive and more objective than that offered by brokers. And on the other side they faced competition from discount brokers, who offered cheaper execution of trades. The full service brokerage business model was in danger of becoming obsolete, at least insofar as retail investors were concerned. It didn’t take long for brokerage firms to respond, and the primary way in which they did so was by remaking themselves in financial planners’ image. By the late 1980s, a number of firms had begun offering financial plans to their customers. Soon after, they began adopting titles such as

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<sup>15</sup> For a more detailed discussion of Congress’s legislative intent with regard to the broker-dealer exclusion, please see the CFA comment letter on that topic, available at [http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative\\_history\\_bdrule\\_reproposal.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative_history_bdrule_reproposal.pdf)

financial consultant or financial advisor for their sales reps. And increasingly, brokerage firm advertisements touted investment advice as the primary service being offered.<sup>16</sup>

### SEC Policies Undermine Investor Protection

In short, the evolution of broker-dealer business practices suggested that either these firms had fundamentally altered their business model to be more advisory in nature, or they were actively misrepresenting themselves to investors. Either way, they appeared to have the full support of the Commission, which continued to allow the firms to rely on their “solely incidental” exemption from the Advisers Act even as Shearson Lehman ads encouraged investors to “Think of your Shearson-Lehman Financial Consultant more as an advisor than a stockbroker,” and Prudential Securities proclaimed that “it’s advice, not execution, that’s at the heart of our relationships.” SEC Release Number IA-1092, one of its earliest documents interpreting how securities laws applied to the newly emerging field of financial planning, had set the agency on this course. In it the agency expressed the view that lawyers or accountants who held out to the public as financial planners could not claim their Advisers Act exclusion because, “In such cases it would appear that advisory services by the person would not be incidental to his practice as a lawyer or accountant.”<sup>17</sup> But the Commission did not apply the same standard to broker-dealers, despite the fact that the Act’s language limiting their exclusion to “solely incidental” advice is identical to that for lawyers and accountants and the potential for investor confusion and abuse was, if anything, far greater.

Instead, the Commission continued to rely primarily on method of compensation to draw what was becoming an increasingly blurred line between brokers and advisers. And they did so right up until the advent of fee-based brokerage accounts threatened to erase the line altogether. As rumors emerged that the SEC was developing a rule proposal to respond to this development, CFA wrote to then SEC Chairman Arthur Levitt urging a fundamental rethinking of Commission’s approach to regulating financial professionals and warning against “providing the brokerage industry with additional special exemptions from advisory standards, even as they move increasingly into the advisory business.”<sup>18</sup> Unfortunately, the Commission chose to take the opposite course, issuing a proposal that did nothing to subject brokers’ extensive advisory activities to regulation under the Advisers Act and opening up a new loophole for advice for which “special compensation” was charged.<sup>19</sup>

When the agency proposed the fee-based brokerage account rule, it simultaneously adopted a “no action” position while the rule proposal was under consideration. As a result, the policy outlined in the rule proposal was effectively in force for roughly five years without any

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<sup>16</sup> For a more detailed discussion of brokerage practices adopted in response to market changes, see CFA’s comment letter on the 1999 fee-based brokerage account rule proposal, available at [http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC\\_Comments\\_Broker-Dealer011300.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC_Comments_Broker-Dealer011300.pdf).

<sup>17</sup> Securities and Exchange Commission Release No. IA-1092, *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, available at <http://www.sec.gov/rules/interp/1987/ia-1092.pdf>.

<sup>18</sup> See Oct. 26, 1999 letter from CFA Director of Investor Protection Barbara Roper to SEC Chairman Arthur Levitt, available at <http://www.consumerfed.org/elements/www.consumerfed.org/File/LEVITTLT.pdf>.

<sup>19</sup> For a more detailed discussion of the rule proposal’s shortcomings, see CFA’s comment letter, available here [http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC\\_Comments\\_Broker-Dealer011300.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC_Comments_Broker-Dealer011300.pdf).

formal action on the part of the Commission until a lawsuit forced the agency to act. In response to the lawsuit, the agency re-proposed and ultimately adopted a somewhat revised final rule. The final rule took two important steps forward. It defined all discretionary accounts (including commission-based accounts) as advisory accounts on the grounds that advice could not be deemed “solely incidental” where the broker was making all the decisions for the investor. Its previous proposal had treated only fee-based discretionary accounts as advisory accounts on the grounds that these most closely resembled traditional advisory accounts. Second, it required investment advice offered as a part of a financial plan to be regulated under the Investment Advisers Act.

This long-sought victory on the regulation of financial planning was reversed within months, however, when the Commission issued a staff interpretative letter that provided brokers with a roadmap for evading the rule simply by eliminating some key component of a comprehensive financial plan.<sup>20</sup> As we noted at the time, under the tortured logic of the staff interpretation, “it is not the extensive personalized investment advice involved that makes financial planning an investment advisory service. Rather, it is the inclusion of a number of elements that clearly do not constitute investment advice, such as advice about insurance, tax planning, and estate planning.”<sup>21</sup> As a result of this staff interpretation, brokers’ investment advice was regulated under the Advisers Act if the broker offered it as part of a comprehensive financial plan. But leave out some unrelated component of a comprehensive plan, such as tax advice, and the broker was regulated exclusively as a sales person.

The revised rule itself also included one giant step backward.<sup>22</sup> For years, investor advocates had urged the Commission to define what constituted “solely incidental” advice in order to restore the functional regulation of brokers and advisers that Congress had intended to create. When the Commission staff finally proposed a definition, however, it defined this key term in such a way as to allow brokers virtually unlimited leeway to offer any advisory services “reasonably related” to their brokerage services without triggering regulation under the Advisers Act. This interpretation was in direct conflict with the plain meaning of the legislative language, was inconsistent with congressional intent, and did not even support the Commission’s own rule proposal. After all, both discretionary accounts and financial planning (which the Commission proposed to regulate as advisory services) are clearly offered “in connection with and reasonably related to” brokerage services.

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<sup>20</sup> Letter from Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission to Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, December 16, 2005.

<sup>21</sup> For a more detailed critique of the SEC interpretive letter, see the February 15, 2006 letter from Consumer Federation of America and Fund Democracy to SEC Chairman Christopher Cox, available here: [http://www.consumerfed.org/elements/www.consumerfed.org/File/Cox\\_Letter\\_Responding\\_to\\_Staff\\_Interpretation.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/Cox_Letter_Responding_to_Staff_Interpretation.pdf).

<sup>22</sup> For a more detailed discussion of the strengths and weaknesses of the Commission’s rule proposal, see a consumer group comment letter submitted to the Commission, available here [http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/group\\_letter\\_bdrule\\_reproposal.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/group_letter_bdrule_reproposal.pdf), as well as CFA’s analysis of legislative history, available here [http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative\\_history\\_bdrule\\_reproposal.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative_history_bdrule_reproposal.pdf)

In March 2007 the United States Court of Appeals for the District of Columbia Circuit vacated the SEC's fee-based brokerage account rule. As a result, fee-based accounts that had previously been regulated as brokerage accounts were subject to regulation under the Advisers Act. While the decision was a win for investors, it nonetheless contributed to the blurring of the lines between brokerage and advisory services. The court decided the case not on the basis of the Commission's faulty definition of "solely incidental," but on the grounds that fees charged constituted "special compensation" for advice. By making method of compensation rather than the nature of services offered the key factor that determines regulatory treatment, the decision actually further undermined the goal of reestablishing a system of functional regulation of brokers and investment advisers.

## **2) The market for retail investment services has become impenetrably complex.**

The combined effect of all these factors – 1) misleading industry practices designed to portray sales activities as advisory activities, 2) evolution of the brokerage business model toward one that is in many ways more advisory in nature, 3) the SEC's tolerance of these misleading practices and its lenient regulatory treatment of brokers' advisory activities, and 4) the court decision overturning one narrow aspect of that policy – is a market for retail services of impenetrable complexity. The following are just a few of the things an investor would have to understand to be an informed consumer of investment services:

- Investment advisers, financial advisors,<sup>23</sup> and financial planners perform many of the same services – including providing personalized investment advice and recommending securities to retail investors – but they are regulated differently when they do so.
- Investment advisers, including financial planners, are required to act in their customers' best interests when they give investment advice, but financial advisors may or may not be subject to this standard depending on how they are compensated and on what services they offer.
- Financial advisors who recommend securities through a commission-based account are regulated as salespeople and thus are required to make suitable investments. When they offer precisely the same services through a fee-based account, they are regulated as investment advisers and are therefore required to act in their customers' best interests.
- Financial advisors who offer financial planning may not be regulated as advisers and thus may not be subject to a fiduciary duty, but independent financial planning firms are.
- Investment planning when offered by a brokerage firm is not regulated as investment advice and thus is not required to be designed with the customers' best interests in mind.
- When regulated as investment advisers, investment professionals have to disclose all material information about their recommendations, including information about conflicts of interest. When regulated as salespeople, where the conflicts of interest are arguably greatest, they do not have to disclose those same conflicts.

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<sup>23</sup> As noted above, this is the title brokerage firms most commonly use for their registered representatives.

## Broker Marketing Adds to the Confusion

Review the website of any of the major full service brokerage firms that cater to retail investors and you are likely to find descriptions of the services offered that do little or nothing to clarify the situation. The following passage lifted from the Wealth Management section of the Merrill Lynch website is fairly representative:

Merrill Lynch Financial Advisors bring the most powerful elements available to help clients achieve the life they envision. When you become a Merrill Lynch client, your Merrill Lynch Financial Advisor will work with you to develop strategies that can help you achieve your most important goals, whether you're saving for your children's education, buying a home, growing your business, or building a legacy for your family.

It starts with a conversation. You and your Financial Advisor will talk about your specific goals, needs, dreams and interests, as well as your entire financial picture. Only then can you work together to match your short- and long-term goals with your personal risk tolerance and investment timelines. As your priorities or global market conditions change, your Financial Advisor will help you find the best solutions to ensure your long-term strategies remain on track.

Merrill Lynch Financial Advisors are supported by the full breadth of the firm's vast resources, including its world-class investment research, which they apply to help their clients manage their portfolios effectively. Depending on your needs, your Financial Advisor also may arrange for you to access the services of institutional-level investment managers through the Merrill Lynch Consults<sup>®</sup> program.

Together you and your Merrill Lynch Financial Advisor will build solutions for your entire financial life.<sup>24</sup>

## Disclosures Fail To Provide Meaningful Information

At the bottom of the web page, nearly lost amidst a variety of boilerplate statements in tiny type, Merrill Lynch offers the following disclosure: "Merrill Lynch offers a broad range of brokerage, investment advisory (including financial planning) and other services. There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties."<sup>25</sup> In the unlikely event that investors even notice the disclosure, they are unlikely to gain any better understanding of the nature their relationship with their financial advisor by reading it. However, it is hardly the worst example. A careful review of the website for Wells Fargo

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<sup>24</sup> Copied from the Merrill Lynch website at the following address on August 27, 2010:  
<http://www.totalmerrill.com/TotalMerrill/pages/WorkingWithMerrillLynch.aspx?Refferrer=HomeL2>

<sup>25</sup> Ibid.

Advisors, for example, revealed no comparable disclosures, including on the page specifically devoted to legal disclosures.

Morgan Stanley offers disclosures on its website that are more informative and, perhaps precisely for this reason, are even more disturbing. The financial planning section of the website includes the following statement clearly displayed at the bottom of the text describing the planning services:

A Morgan Stanley Smith Barney Financial Advisor will prepare a financial plan at your specific request through Morgan Stanley Financial Outlook<sup>SM</sup>. During this preparation process, you and Morgan Stanley Smith Barney will have an investment advisory relationship with respect to the financial plan. This provides you with greater rights and us with greater obligations than those provided in a brokerage relationship. Upon delivery to you of the completed financial plan, the investment advisory relationship created by the financial plan will terminate. You may choose to implement your financial plan at Morgan Stanley Smith Barney or elsewhere. If you implement at Morgan Stanley Smith Barney, we will act as your broker unless you expressly choose to implement in one or more of our advisory accounts.<sup>26</sup>

Although Morgan Stanley's disclosure statement is arguably more complete than that on the Merrill Lynch website, it reads more like a disclaimer than a disclosure. It still fails to tell the investor anything of value about the different standards that apply to advisory and brokerage services. It does not clearly inform investors, for example, that brokerage services are not subject to a fiduciary duty to act in the customer's best interests. Moreover, it reflects an inherently confusing practice, known as hat-switching, in which the broker accepts a fiduciary duty while developing a financial plan, but abandons that obligation once the plan itself is complete and the broker starts recommending the securities and other financial products to implement the plan.<sup>27</sup>

### **3) Investors can't distinguish between brokers and investment advisers.**

No rational person looking at the complexity of the market for retail investment services would expect investors to be able to distinguish between brokers and investment advisers or to understand their different legal obligations to customers. There is substantial survey data to support the validity of that assumption. For example:

- A 2006 survey by TD Ameritrade (conducted before the SEC fee-based brokerage account rule had been overturned) found that 43 percent of investors were unaware that brokers and investment advisers are held to different legal and regulatory standards when

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<sup>26</sup> Copied from the following Morgan Stanley website at the following address on August 27, 2010: <http://www.morganstanleyindividual.com/planning/financialplanning/Default.asp>.

<sup>27</sup> It is this practice that makes it so important that the SEC, in developing its regulatory proposal, focus not just on services that have traditionally been characterized as advisory activities, but include all personalized recommendations of securities to retail investors under the fiduciary duty.

they offered fee-based financial advice.<sup>28</sup> While most (90 percent) understood that investment advisers are fiduciaries, more than 60 percent believed that brokers are also fiduciaries.

- A 2004 survey conducted by CFA and Zero Alpha Group found that only a small minority of investors (26 percent) understood that brokers are primarily salespeople.<sup>29</sup> The largest percentage (28 percent) expressed the view that financial advice was the primary service offered by brokers.
- A focus group study commissioned by the SEC in 2005 and conducted by Siegel & Gale, LLC and Gelb Consulting Group found that focus group participants generally did not know the differences between brokers, financial advisers, financial consultants, investment advisers, and financial planners.<sup>30</sup>

As part of its study, the RAND Corporation conducted both a national household survey and six focus groups to explore these issues. That study resulted in overwhelming evidence to support the conclusion that investors were badly confused both about the nature of services offered by different types of investment professionals and about their legal obligations. As the study itself stated, “most survey respondents and focus-group participants do not have a clear understanding of the boundaries between investment advisers and broker-dealers. Even those who have employed financial professionals for years are often confused about job titles, types of firms with which they are associated, and the payments they make for their services. Respondents and participants also understand relatively little about the legal distinctions between investment advisers and broker-dealers.”<sup>31</sup>

A closer look at the survey results provides more detailed findings to support this general conclusion. It found, for example, that:

- A strong majority of respondents (63 percent) thought brokers provide advice about securities. The percentage grew significantly (to 78 percent) for titles, such as financial consultant and financial advisor, commonly used by brokers. Indeed, respondents were more likely to think a financial consultant or financial advisor provided such advice than that a financial planner did (63 percent).<sup>32</sup>
- Similarly, respondents were nearly as likely to think financial consultants and financial advisers provide general financial planning services (80 percent) as they were to think that financial planners provide such services (88 percent).

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<sup>28</sup> Hung, Angela A., Clancy, Noreen, Dominitz, Jeff, Talley, Eric, Berrebi, Claude, and Suvankulov, Farrukh, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealer*, a technical report sponsored by the Securities and Exchange Commission and prepared by the RAND Institute for Civil Justice, 2008. (Hereinafter, RAND Study)

<sup>29</sup> CFA and Zero Alpha Group, *Survey: In Blow to SEC Rule Proposal, 9 Out of 10 U.S. Investors Back Equally Touch Broker, Investment Adviser Regulation*, Oct. 24, 2004, available on the Zero Alpha Group website at <http://www.zeroalphagroup.com/news/cfazagsurvey102704.cfm>.

<sup>30</sup> RAND Study

<sup>31</sup> *Ibid.*, pg. 84.

<sup>32</sup> *Ibid.*, pg. 89.

- Substantial differences in responses with regard to brokers and responses with regard to financial consultants or financial advisors provide compelling evidence that investors are confused by these titles. For example, only 13 percent of respondents thought brokers provide general financial planning services, compared with the 80 percent who thought financial advisers and financial consultants provide such services. Similarly, while nearly all respondents (96 percent) realized that brokers typically receive commissions on purchases or trades, only 34 percent realized that financial consultants and financial advisors receive commissions.
- Significantly, respondents were substantially more likely to believe a financial advisor or financial consultant is required to act in the customer’s best interests than that a broker is required to do so (59 percent compared with 42 percent).
- Respondents were only slightly more likely to think that investment advisers are required to disclose conflicts of interest (62 percent) than they were to think brokers were required to make such disclosures (58 percent). They were less likely to think that financial planners were required to disclose conflicts (51 percent).

These findings were borne out in the focus group discussions conducted for the RAND Study. Those discussions further revealed that some participants “did not understand such terms as *fiduciary* and whether fiduciary was a higher standard than suitability.”<sup>33</sup>

### Disclosure and Education Can’t Dispel Investor Confusion

While not so extensive as to be conclusive, research also suggests that investors’ lack of understanding cannot be dispelled through disclosures or investor education. When the SEC began its reconsideration of the fee-based brokerage account rule, it commissioned Siegel & Gale, LLC and Gelb Consulting Group, Inc. to conduct a focus group study to test the effectiveness of proposed disclosures regarding legal obligations of brokers and investment advisers.<sup>34</sup> The proposed disclosure statement was intended to alert investors in fee-based brokerage accounts that there are differences between brokerage accounts and advisory accounts. Focus group participants who reviewed the disclosure, however, found that “the statement communicates that differences might exist, but did not do enough to explain those distinctions ... As a result, investors were confused as to the differences between accounts and the implications of those differences to their investment choices.”<sup>35</sup> Based on the study findings, the Commission made modest improvements to the disclosures that were required to be provided but acknowledged that, even with these improvements, the proposal did not address all concerns about investor confusion.<sup>36</sup> Indeed, the Commission concluded that it would not be possible to

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<sup>33</sup> Ibid., pg. 111.

<sup>34</sup> 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, available online at <http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf>.

<sup>35</sup> Ibid, pg. 4.

<sup>36</sup> Securities and Exchange Commission, *Certain Broker-Dealers Deemed Not To Be Investment Advisers; final rule*, April 19, 2005 available online at <http://www.sec.gov/rules/final/34-51523fr.pdf>.

develop a disclosure that both accurately and clearly conveyed the complexity of these distinctions.

Even as it adopted the rule, the Commission concluded that further study was needed “to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes.”<sup>37</sup> It was from this mandate that the RAND Study was born. As part of its extensive evaluation of investor confusion, RAND attempted to determine whether investor confusion was dispelled or at least lessened when investors were educated about differences between brokers and advisers. RAND found, however, that even after it had provided focus group participants with educational materials describing the differences between brokers and investment advisers, participants remained confused about the different titles. Focus group participants noted that common titles are so similar that people could “easily get confused over the type of professional with which they are working.” Indeed, while some said they knew which type of investment professional they personally worked with, most did not.<sup>38</sup>

The many articles written each year by personal finance writers on this topic seem to have been similarly ineffective in clarifying the issue for investors. Indeed, simple common sense suggests that disclosures and investor education will never be effective until there is a simple, straightforward policy on which to base those efforts.

### Investors Expect All Financial Professionals to Meet the Same High Standards

If investors are confused by titles, services, and actual legal obligations of brokers and advisers, they are absolutely certain on one point – the conduct they *expect* from an adviser. When CFA and Zero Alpha Group conducted their survey in 2004, 91 percent of respondents said that stockbrokers and financial planners who provide investment advice should be subject to the same investor protection rules. And almost as many (86 percent) said that stockbrokers should be required to disclose prior to the purchase of the investment any incentives or other forms of compensation they receive to push particular products. A majority of respondents to both the CFA-Zero Alpha Group survey and the TD Ameritrade survey indicated they would be less likely to obtain services from a broker if they knew they were subject to weaker investor protections.<sup>39</sup> More recently, six statewide surveys conducted by AARP during consideration of the Dodd-Frank Act found support ranging from 88 percent to 95 percent for reforms requiring financial professionals to put the client’s interest ahead of their own when making recommendations and to disclose upfront any fees or commissions they earn and any conflicts of interest that could bias their recommendations.<sup>40</sup>

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<sup>37</sup> Ibid.

<sup>38</sup> Ibid., pg. 111.

<sup>39</sup> TD Ameritrade survey findings are taken from the RAND Study at pg. 31.

<sup>40</sup> Available on the AARP website at [http://www.aarp.org/money/scams-fraud/info-04-2010/finprotect\\_states.html](http://www.aarp.org/money/scams-fraud/info-04-2010/finprotect_states.html).

**4) The only logical solution at this point is to require brokers and investment advisers alike to meet the Advisers Act fiduciary duty when they give personalized investment advice or recommend securities to retail investors.**

For nearly a quarter century, CFA has advocated policies that were designed to make the bifurcated system of regulation for brokers and investment advisers work to provide appropriate investor protections despite rapidly changing market conditions. A primary focus of our policy was to ensure that all those who offered investment advisory services were appropriately regulated under the Investment Advisers Act, because only the Advisers Act provided the fiduciary duty and disclosure obligations appropriate to that role. We sought to achieve that policy first by advocating for regulation of financial planners under the Investment Advisers Act, a goal that has largely been achieved,<sup>41</sup> and then by urging the closing of loopholes that had allowed brokers to remake themselves as advisers without being held to the appropriate professional standards. Unfortunately, the latter policy has met with markedly less success, having been undermined at every step by the Commission itself.

For a variety of reasons, we have now reached a point where it makes more sense to go forward than to go back. Rather than try to restore the functional division Congress intended to create between brokers and advisers, the best course now available to the Commission is to accept the world as it exists – with both brokers and advisers offering extensive personalized investment advice – and move forward from there. And the only logical approach, under the circumstances, is to impose the same Advisers Act fiduciary obligations on brokers when they give personalized investment advice and recommend securities to retail investors as apply to all other advisers. The SEC has shown conclusively over the years that it is not capable of drawing a clean line between the advisory services offered by an investment adviser and the recommendations offered by brokers. Only by holding both these functions to a fiduciary duty can the SEC escape the policy errors of the past and prevent the industry from exploiting new loopholes.

Industry Arguments in Opposition Do Not Hold Water

Industry arguments in opposition are predictable. The brokerage firms are likely to argue that they are prepared to accept a fiduciary duty as long as it is clearly defined through rules. The insurance agents – affected primarily because of their sales of variable annuities – are likely to argue against any imposition of a fiduciary duty, on the grounds that they are already adequately regulated, that imposition of a fiduciary duty would pose significant compliance burdens, and that any added costs would likely be passed on to investors or drive them from the business. In addition, insurance agents are likely to join the brokers in arguing for a rules-based rather than a principles-based approach. Neither argument holds water.<sup>42</sup>

Fiduciary duty is by its very nature a facts and circumstances based standard. In other words, while the fiduciary principle is universal, the specific obligations it imposes are determined by the particular facts and circumstances of an individual case. It would be

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<sup>41</sup> With the notable exception of financial planning by brokers, which may or may not be covered.

<sup>42</sup> See the documents provided in Appendix B for a more complete refutation of insurance industry arguments.

impossible to write a rule that would cover all the different eventualities that might arise that would have an impact on a broker or adviser's obligations. A fiduciary duty that is reduced to a rule would therefore cease to be a true fiduciary duty. That does not mean that guidance can't be issued and rules can't be developed in support of a fiduciary duty. But the overarching fiduciary duty must take precedence, and brokers and advisers must be accountable for complying with this principle (and face punishment for violations) even where no rule violation occurs. To do otherwise would weaken the protections afforded by the Investment Advisers Act, something the Dodd-Frank Act explicitly prohibits.

Insurance industry arguments are even more dubious. Insurance agents argue that they are already adequately regulated, and that there is no evidence of a problem to justify imposition of a fiduciary duty. In reality, however, no area stands to benefit more from imposition of a fiduciary duty than the dubious and abusive sales of variable annuities by insurance agents posing as financial planners or financial consultants. Moreover, insurance industry arguments are based on the false assumption that adoption of a fiduciary duty would force them to move to a fee-based compensation system. But decades of experience in the financial planning industry clearly demonstrate that the commission-based sale of securities can easily be accommodated under a fiduciary duty. Moreover, by imposing the fiduciary duty under the '34 Act, rather than requiring brokers to register and be regulated under the Advisers Act, this proposal minimizes any added compliance costs associated with the rule. What additional costs are imposed are certain to pale in comparison with the billions of savings that investors could receive each year if brokers were required to consider costs when determining which investment option is in the best interests of the customer.

## **Conclusion**

With passage of the Dodd-Frank Act, the Commission has a real opportunity to adopt a rational, pro-investor approach to regulating brokers and investment advisers. We greatly appreciate the role that Chairman Schapiro and other Commissioners have played in bringing us to this point with their strong support for inclusion of a fiduciary requirement in the financial regulatory reform bill. Even with the best of intentions, however, this opportunity could slip through our fingers if the Commission caves in the face of industry pressure or produces a report that simply rehashes the arguments it has used in the past to justify its lenient treatment of broker-dealers. Instead, if investors are to benefit, the Commission must produce a credible and objective report that lays the groundwork for a policy that imposes the Advisers Act fiduciary obligations on all investment professionals when they give personalized investment advice or recommend securities to retail investors. That is what the Administration promised when it released its White Paper on financial regulatory reform more than a year ago, it is what Congress intended when it adopted the Dodd-Frank Wall Street Reform Act, and it is what investors both expect and deserve.

Respectfully submitted,

Barbara Roper  
Director of Investor Protection

cc: Chairman Mary Schapiro  
Commissioner Luis Aguilar  
Commissioner Kathleen Casey  
Commissioner Troy Paredes  
Commissioner Elisse Walter  
Sen. Christopher Dodd, Chairman, Committee on Banking, Housing and Urban  
Development, U.S. Senate  
Sen. Richard Shelby, Ranking Member, Committee on Banking, Housing and Urban  
Development, U.S. Senate  
Sen. Jack Reed, Chairman, Securities, Insurance, and Investment Subcommittee, U.S.  
Senate  
Sen. Jim Bunning, Ranking Member, Securities, Insurance, and Investment  
Subcommittee, U.S. Senate  
Rep. Barney Frank, Chairman, Financial Services Committee, U.S. House of  
Representatives  
Rep. Spencer Bachus, Ranking Member, Financial Services Committee, U.S. House of  
Representatives  
Rep. Paul Kanjorski, Chairman, Capital Markets, Insurance, and Government-Sponsored  
Enterprises Subcommittee, U.S. House of Representatives  
Rep. Scott Garrett, Ranking Member, Capital Markets, Insurance, and Government-  
Sponsored Enterprises Subcommittee, U.S. House of Representatives

## **APPENDIX A – CFA Communications to the SEC on the Broker-Dealer Exclusion from the Advisers Act (1999-2006)**

Since the SEC first began to consider the fee-based brokerage account rule in 1999, CFA has regularly communicated our concerns about that rule proposal and our suggestions for a more pro-investor approach to the regulation of investment professionals. Although the nature of the debate has now shifted – no longer focusing primarily on the issue of what constitutes “solely incidental” advice that qualifies for the broker-dealer exclusion from the Advisers Act – many of the points raised in these letters remain relevant to the current debate over whether brokers’ investment advice and recommendations regarding securities to retail customers should be subject to the Advisers Act fiduciary duty. Rather than re-argue these issues in detail, we are asking that the below listed letters be considered as part of the current study. Moreover, these letters should serve as a cautionary tale, documenting how the Commission’s consistent practice over the years of elevating industry concerns over investor interests has largely created the problem Section 913 of the Dodd-Frank Act seeks to correct. A complete change of direction in the agency’s approach to this issue is absolutely essential if the legislation is to result in a pro-investor approach to the regulation of investment professionals.

### **October 26, 1999 CFA letter to Chairman Arthur Levitt preceding release of the fee-based brokerage account rule**

<http://www.consumerfed.org/elements/www.consumerfed.org/File/LEVITTLT.pdf>

### **January 13, 2000 CFA comment letter on SEC’s fee-based brokerage account rule proposal**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC\\_Comments\\_Broker-Dealer011300.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC_Comments_Broker-Dealer011300.pdf)

### **February 28, 2000 CFA letter to Chairman Levitt responding to industry comments and proposing an alternative regulatory approach**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC\\_IA\\_Letter022800.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC_IA_Letter022800.pdf)

### **May 31, 2000 group supplementary comment letter on the fee-based brokerage account rule proposal**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC\\_Comments053100.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/SEC_Comments053100.pdf)

### **December 13, 2001 letter to Chairman Harvey Pitt**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/Pitt\\_Letter\\_121301.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/Pitt_Letter_121301.pdf)

### **May 6, 2003 group letter to Chairman William Donaldson**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/donaldson\\_broker\\_exception\\_group\\_letter\\_043003.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/donaldson_broker_exception_group_letter_043003.pdf)

### **September 20, 2004 comment letter**

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/bdrule\\_comment\\_ltr\\_091704.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/bdrule_comment_ltr_091704.pdf)

**November 4, 2004 letter to Chairman Donaldson regarding survey results**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/donaldson\\_survey\\_letter%281%29.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/donaldson_survey_letter%281%29.pdf)

**October 5, 2004 letter to Chairman Donaldson refuting SIA arguments and outlining an alternative regulatory approach**

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/bdrule\\_Donaldson\\_ltr\\_100504.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/bdrule_Donaldson_ltr_100504.pdf)

**February 7, 2005 comment letter challenging the agency's interpretation of the legislative history of the Advisers Act with regard to the meaning of the broker-dealer exclusion**

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative\\_history\\_bd\\_rule\\_reproposal.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/legislative_history_bd_rule_reproposal.pdf)

**February 7, 2005 CFA, Fund Democracy, Consumers Union and Consumer Action comment letter on the SEC's re-proposal of the fee-based brokerage account rule**

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/group\\_letter\\_bdrule\\_reproposal.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/group_letter_bdrule_reproposal.pdf)

**September 30, 2005 CFA-Fund Democracy letter to Chairman Christopher Cox**

<http://www.consumerfed.org/elements/www.consumerfed.org/File/coxletterbdversion.pdf>

**February 15, 2006 CFA-Fund Democracy letter to Chairman Christopher Cox regarding staff interpretation of the financial planning definition**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/Cox\\_Letter\\_Responding\\_to\\_Staff\\_Interpretation.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/Cox_Letter_Responding_to_Staff_Interpretation.pdf)

## **APPENDIX B – Letters Refuting Misleading Industry Arguments in Opposition to a Fiduciary Duty**

Throughout the legislative fight to win inclusion of a provision imposing a fiduciary duty on brokers when they give investment advice, certain industry groups, particularly the insurance groups, opposed the requirement based on false and misleading arguments. The following is a sampling of CFA letters to Congress refuting those arguments. The arguments varied slightly depending on the version of the legislation under consideration at the time, whether the original Senate bill to eliminate the broker-dealer exclusion under the Advisers Act or the version closer to the final bill that authorized the SEC to adopt rules imposing a fiduciary duty. We expect these same arguments to be reflected in comment letters submitted to the SEC as part of this study and urge the Commission to view them with an appropriately skeptical eye.

### **Myth/Fact Sheet on Broker Dealer Fiduciary Duty Akaka Amendment, 4/27/10**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/Broker\\_dealer\\_fiduciary\\_duty\\_myth-fact\\_Akaka\\_amendment.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/Broker_dealer_fiduciary_duty_myth-fact_Akaka_amendment.pdf)

### **Groups Urge Senate Banking Committee to Support Strong Fiduciary Duty Standards, 1/7/10**

[http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Strong%20Fiduciary%20Duty%20Standards%20Letter%201\\_7\\_10.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Strong%20Fiduciary%20Duty%20Standards%20Letter%201_7_10.pdf)

### **Groups Express Strong Support for Senior Citizen Investor Protections in Restoring American Financial Stability Act, 2/3/10**

[http://admin.consumerfed.org/elements/www.consumerfed.org/File/NASAA-AARP-CFA-Fund%20Democracy%20letter%202\\_3\\_10%281%29.pdf](http://admin.consumerfed.org/elements/www.consumerfed.org/File/NASAA-AARP-CFA-Fund%20Democracy%20letter%202_3_10%281%29.pdf)

### **Akaka-Menendez Amendment Protects Investors and Commission-based Business Model, 5/10/10**

[http://www.consumerfed.org/elements/www.consumerfed.org/File/Re%20NAIFA%20letter\(2\).pdf](http://www.consumerfed.org/elements/www.consumerfed.org/File/Re%20NAIFA%20letter(2).pdf)

### **Simple Facts on Fiduciary Duty Support Akaka-Menendez-Durbin Amendment, 5/12/10**

<http://www.consumerfed.org/elements/www.consumerfed.org/File/Basic%20facts%20on%20fiduciary%20duty.pdf>

**Appendix C – Group Letter to Senate Banking Committee Staffers Describing What Constitutes Investment Advice**

**Consumer Federation of America  
North American Securities Administrators Association, Inc.  
Investment Advisers Association  
Certified Financial Planner Board of Standards, Inc.  
Financial Planning Association  
National Association of Personal Financial Advisers  
Fund Democracy**

October 21, 2009

Dean Shahinian  
Democratic Senior Counsel  
Committee on Banking, Housing  
and Urban Affairs  
U.S. Senate  
Washington, D.C. 20510

Hester Peirce  
Republican Counsel  
Committee on Banking, Housing  
and Urban Affairs  
U.S. Senate  
Washington, D.C. 20510

Dear Dean and Hester:

Recently, representatives of a number of our organizations met with you to discuss how best to implement the Administration proposal to impose a fiduciary duty on brokers who provide investment advice. As we indicated during that meeting, our organizations strongly support this recommendation, but we are concerned that the draft legislation proposed by the Treasury Department may not achieve its intended outcome. For that reason, we have recommended changes to the legislative language that would impose the fiduciary duty not simply through SEC rulemaking but as a matter of statute, clarify that it is the fiduciary duty as established under the Investment Advisers Act that would apply, and specify that the duty includes an obligation to act in the *best* interests of the client. We also expressed opposition to the “harmonized standard of care” being advocated by SIFMA on the grounds that it does not represent a true fiduciary duty.

As follow-up to our meeting, you asked our organizations to provide additional guidance on the services provided by broker-dealers that constitute investment advice and should therefore be subject to a fiduciary duty. We appreciate the opportunity to do so. The following suggestions for implementation are designed to achieve the outcome identified in the

Administration white paper on regulatory reform: to enact legislation that raises the standard that applies to brokers who give investment advice by requiring that they meet “the same fiduciary obligations as registered investment advisers.”

## **What is Investment Advice?**

In this letter, we seek to provide guidance on specific services provided by broker-dealers that constitute investment advice and therefore should be subject to the fiduciary standard. As background, the scope of what constitutes investment advice is quite broad under the Investment Advisers Act. The breadth of investment advice reflects the current statutory framework, which provides for a broad definition of “investment adviser” as a person who is in the business of providing advice about securities for compensation.

In keeping with that broad definition, any advice about securities, from specific advice about investing in a particular security to advice about whether investment in securities would be appropriate, would be considered investment advice under the Investment Advisers Act. Investment advice includes when a financial professional provides a client with any form of guidance or recommendation regarding specific securities, classes of securities, the advisability or inadvisability of investing in securities, and even advice about the selection or retention of an investment adviser. The principal limits on what constitutes investment advice are: 1) that the information must include an opinion or analysis rather than simply relaying facts, and 2) that the advice must concern securities. Therefore, any advice about securities provided by broker-dealers to clients could be considered investment advice.

That is separate from the question of whether the advice would be deemed to qualify for the broker-dealer exclusion from the Advisers Act, which applies when brokers limit themselves to giving advice that is “solely incidental to” brokerage activities and do not charge special compensation for that advice. The current exclusion under the Advisers Act for broker-dealers has raised numerous issues as activities of broker-dealers have evolved over time. We do not attempt in this letter to make specific recommendations on how that exclusion might be revised. The Administration has made clear that they intend the fiduciary duty to apply regardless of whether the advice is “incidental.” For example, in describing the problem the legislation is designed to correct, the White Paper states: “Brokers are allowed to give ‘incidental advice’ in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker.” Consistent with the Administration’s proposal, our focus in this letter is on the activities by brokers that constitute “investment advice” and not where to draw the line between “incidental” and non-incidental advice.

### **I. Services of Broker-Dealers That Involve Investment Advice and Therefore Should Be Subject to Fiduciary Duty**

Brokers provide investment advice in many different contexts. To fulfill the intent of the Administration proposal to apply a fiduciary duty to investment advice by broker-dealers, advice

about securities provided to a client in an actual or apparent relationship of trust and reliance must be covered by a fiduciary duty.

- Discretionary Authority: Investment advice is provided, and a fiduciary duty clearly should apply, when a financial professional exercises decision-making authority over a client account that holds or may hold securities. Delegation of decision-making authority is a clear, unequivocal indication of the relationship of trust and reliance that triggers a fiduciary responsibility. (After years in which the regulatory treatment of discretionary accounts was based on method of compensation, that view is now reflected in SEC policy, which treats both fee-based and commission-based discretionary accounts as advisory accounts.)

- Investment Planning: A financial professional gives investment advice when she provides investment planning services, including identifying investment goals and recommending strategies to achieve those goals that incorporate recommendations regarding specific securities, classes of securities, or the advisability or inadvisability of investing in securities. This clearly creates, and brokerage ads for these services are intended to create, a relationship of trust and reliance that triggers a fiduciary duty. Fiduciary duty should apply regardless of whether the broker recommends a single course of action or lays out alternatives for the investor to choose among, and it should continue to apply when brokers sell products to implement the recommendations made. Investors cannot be expected to understand that the broker has “switched hats” and that the relationship of trust and reliance that existed in the planning stage has been abandoned during implementation.

- Personalized Investment Recommendations: Investment advice is provided when a financial professional’s recommendations regarding specific securities, classes of securities, or the advisability or inadvisability of investing in securities reflect the particular circumstances of a client. This service provided by broker-dealers generates confusion among investors about brokers and advisers as found by the RAND Study and the SEC’s own research. Brokerage firms also have encouraged a relationship of trust and reliance between brokers and clients – calling their salespeople financial advisors, for example, and marketing their services based on the advice offered. Moreover, CFA research, while far from definitive, suggests that investors rely heavily on the recommendations they receive from brokers, doing little if any additional research on the products recommended.<sup>43</sup>

- Portfolio Management and Monitoring: When brokers offer ongoing management and monitoring of client portfolios, they are providing investment advice that should be subject to a fiduciary duty. These services closely resemble the portfolio management services offered by investment advisers and also encourage a relationship of reliance and trust. The clear implication is that the client can trust the broker to inform them when changes to the portfolio are needed.

- Portfolio Analysis and Evaluation: For the same reasons, portfolio analysis and evaluation constitute investment advice and should be subject to a fiduciary duty.

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<sup>43</sup> Barbara Roper and Stephen Brobeck, *Mutual Fund Purchase Practices*, Consumer Federation of America, June, 2006. Available at: [http://www.consumerfed.org/pdfs/mutual\\_fund\\_survey\\_report.pdf](http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf) .

- Asset Allocation: Investment advice is provided, and a fiduciary duty should apply, when a financial professional recommends a particular asset allocation plan (including the advisability or inadvisability of investing in securities) for a client based on an assessment of that client’s particular needs.

- Retirement, Education, and Estate Planning: To the degree that these services include personalized recommendations with regard to specific securities, classes of securities, or the advisability or inadvisability of investing in securities, they would constitute investment advice and should be subject to fiduciary duty.

- Responses to Investor Questions: Some brokers, including some discount brokers, offer investors the opportunity to ask representatives for their thoughts on a purchase the investor is contemplating. If the purchase involves a security and a broker gives his or her opinion on whether or not that security is appropriate for a specific investor, then the response is investment advice and should be subject to a fiduciary duty.

## **II. Services That Do Not Constitute Investment Advice and Would Not be Subject to Fiduciary Duty**

In each of the following examples, fiduciary duties may apply – for example, the duty of best execution. Our statement that they “would not be subject to a fiduciary duty” refers specifically to the duty for investment advice and not to any other legal obligations that may apply.

- Discount Brokerage: Traditional and online discount brokerage services, offering inexpensive trades to self-directed investors, do not constitute investment advice and should not be subject to fiduciary duty.

- Pure Execution Services: In situations where the broker only executes an unsolicited order, placed by a client without recommendation by the broker, the execution service does not involve investment advice and should not be subject to fiduciary duty. These services may be subject to best execution obligations imposed on broker-dealers.

- Other Lines of Business: Broker-dealers are not providing investment advice when they engage in underwriting activities, investment banking, advising issuers regarding the structure of securities offerings, market-making, or other lines of business that do not involve advice about securities investments to clients.

## **III. Services That May or May Not Constitute Investment Advice**

Certain activities, while technically investment advice, may not be the type of activities intended to be reached by the Administration proposal with its focus on “retail” clients and personalized advice. As in the above examples, the fiduciary duty we refer to here is the duty that applies to investment advice and not to other legal obligations that may apply.

- Research/Fundamental Analysis: Simply providing investors with access to research reports or fundamental analysis (choosing investments based on the intrinsic characteristics of the issuer) may not be an area that should be covered by fiduciary duty, as long as the research is neither tailored for the particular client nor presented in a way that implies that it represents a personalized recommendation for that client. Where the research is provided in the context of a client relationship, for example in association with a personalized recommendation, it is part of an investment advisory service and should be subject to a fiduciary duty.

- Providing Investor Education/Information Materials: Similarly, providing clients with generic educational or informational materials may not be subject to fiduciary duty, unless the material is either customized for the client or presented in the context of a personalized recommendation to the client. For example, presenting the client with generic information on asset classes or asset allocation strategies may not constitute investment advice, while providing the information in the context of recommending a specific asset allocation plan would constitute advice.

## **Conclusion**

The proposal to impose a fiduciary duty when brokers give investment advice has the potential to bring significant benefits to the investing public. To achieve that goal, the fiduciary duty must be applied broadly to all services that constitute investment advice. The good news is that, because it is a facts-and-circumstances-based standard, the fiduciary duty is adaptable to the many different types of activities that constitute investment advice and the many different contexts in which such advice is offered.

In other words, although a universally applied fiduciary duty would require all who offer investment advice to act in the best interests of the client, it does not follow that the means of fulfilling that responsibility would be the same in each circumstance. Take, for example, two very different services that nonetheless both constitute investment advice – on-going portfolio management and one-time, transaction-based advice in response to a client query. In both cases, the adviser should be required to act in the best interests of the client, but the obligations they must meet to satisfy that duty are quite different. For example, for on-going portfolio management, the fiduciary duty clearly includes an obligation to monitor the account. It imposes no such obligation on one-time, transaction-based advice of the type offered by discount brokers, so long as the nature of the service is clearly described and the limits of the advice are clearly disclosed.

Properly implemented, this proposal could offer the best of both principles-based and rules-based regulation. Fiduciary duty would serve as the clear, over-arching principle, while rules could be adopted, as needed, to clarify the obligations financial professionals must meet in various circumstances to fulfill their fiduciary duty. As long as such rules were viewed as interpreting, but not supplanting, the fiduciary standard, and as long as activities that would otherwise fit the definition of personalized investment advice could not be carved out from the fiduciary obligation, such an approach would support both the manifest intent of the

Administration proposal and the public interest in clear, comprehensible, and consistent regulation.

Respectfully submitted,

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Daniel J. Barry  
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National Association of Personal Financial  
Advisors

Mercer Bullard  
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