THE AMERICAN COLLEGE
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CENTER FOR
ETHICS
IN FINANCIAL SERVICES

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RE: File Number 4-606
In response to release No. 34-69013; IA-3558
Duties of Brokers, Dealers, and Investment Advisers

Thank you for the opportunity to provide information and analysis that may be useful as you consider the duties of brokers, dealers, and investment advisers. The Cary M. Maguire Center for Ethics in Financial Services at The American College is part of an accredited, non-profit educational institution that has an 86-year heritage, and it is the Center's mission to raise the level of ethical behavior in financial services. The Center does not take advocacy positions on matters of public policy, and we will not do so here. Rather, we will make some observations on the ethical implications of your potential actions and what appear to be your underlying assumptions. We believe you will find our observations helpful in your deliberations.

With all respect, we are concerned that while your request for information asks for a lot of data – much of which may not be readily available in useful forms based on confidentiality concerns, data aggregation issues, accessibility, or other factors – the results may not inform your decision-making in the way you had hoped. It is easy enough to say that retail investors should be served by advisors who act solely in their best interest. Few could disagree with the sentiment or intent of broadly implementing such a standard. Unfortunately, it is much harder to determine what the practical result may be across all business models to consumer choice, access to advice, and product availability. The key question is what standard(s) of care will be in the ***ultimate*** best interest of all retail investors, at all income and asset levels, when costs and availability of products and services are considered.

Importantly, to paraphrase a common tenet of the medical profession, regulators should first agree to do no harm, even if that harm is inadvertent and unintended. What are the implications if an already-underserved middle class receives less financial advice than it does now? In a survey The American College of Financial Services jointly conducted with the National Association of Insurance and Financial Advisors (NAIFA) in May, 2013, we found that 45.7% of registered representatives and dual-registered reps would likely shift their practices to higher-income clients were the SEC to implement a uniform fiduciary standard. Allowed multiple responses, significant percentages of respondents also indicated they would likely increase prices (39.4%) or offer a more limited set of products (35.4%).

A pressing ethical issue concerns the ability of all Americans to access the financial products and planning they need to protect their family's financial future. Financial security is a fundamental good, that is, a good upon which other goods depend and which is necessary for a flourishing and full life. Therefore, an important objective of regulatory action is to secure access to this fundamental good for all of those in need of it.

Because we see this request for comment as a welcomed opportunity to engage in serious thinking about the regulatory structure that governs financial services professionals in their activity of serving the American public, we want to move beyond the data to pose a series of important questions. We ask the Commission to consider these issues carefully as it addresses this important, complex issue.

Confusion of the Definition of "Fiduciary"—How Do We Define "Best Interest"?

Advocates for a uniform fiduciary standard emphasize the differences between a fiduciary and a suitability standard, while those groups who disagree with a uniform fiduciary standard minimize these differences. Since the main thrust of the argument in favor of a uniform fiduciary standard is that it offers more protection to investors and can therefore can be characterized as 'meaningfully' rather than merely 'semantically' different, this is an important point to examine.

Advocates of a universal fiduciary standard, quite understandably, place a great deal of emphasis on the requirement of a fiduciary to make recommendations that are in the best interest of the client. Their argument is that while brokers are free to promote their own interests, or the interests of their organization, only constrained by the requirement that the product be 'suitable,' fiduciaries are held to a highe standard.

Therefore, we need to consider what is meant by the term 'best interest.' *If it is not possible to articulate a coherent definition of the term 'best interest' that can be widely accepted and readily applied in this context, an important part of the legal/technical distinction between fiduciary and suitability standards is undermined.* This question is further complicated by the disparate needs of people with varying degrees of investment experience, all of whom may require different levels of services from their financial professionals. We believe it is an ethical imperative to ensure access to financial services planning and products to as wide a group of the American public as possible.

Perhaps an analogy is helpful. Imagine that a mother wants to purchase the 'best' present for her child's upcoming birthday. She goes to a local children's toy superstore and begins to browse.

But which toy is 'best'? Is the best toy the cheapest toy? Perhaps if she spends less money on the toy, there may be additional resources for other wanted items, like swimming lessons. But, maybe the best toy is one made by a well-known brand with a reputation for quality? If so, she could be more confident that it would not break or fall apart. But, then again, maybe the best toy is one that complements the rest of her child's toys. Perhaps she should purchase a toy to round out a collection of stuffed animals?

But, the mother thinks, maybe I am on the wrong track. Surely, there are other toy stores and one may have a better selection. She could be confident she would ge the best toy if she followed a thorough process of looking at multiple local and regional stores and on the Internet, where the savvy shopper can pursue toys from shops around the world. If a mother is truly committed to the 'best' toy, shouldn't she explore those options as well?

At this point, a reasonable person may object that there are both time and cognitive limitations that come into play; surely the mother has other goals and projects besides finding the very best toy. There has to be some kind of limit. Besides, the mother will somehow 'know' when she's reached this point; it's just common sense.

But this is part of the problem: *if we cannot define the standard, but instead rely on our rough intuitions of when it has been met ("I know when I've looked enough"), then whether one has actually met the standard becomes hopelessly subjective.* Trying to add objectivity to the process leads to a muddle: at what point has our beleaguered mother exhausted her obligations?

Moving from toy emporiums to the financial services industry, it is possible to use our analogy to generate two definitions of what it means to recommend products in the 'best interest' of the client.

> (1) Products in the best interest of the client always possess a certain characteristic, for example, are they always the cheapest or always issued from a certain company or always complement the other products in the client's portfolio.
>
> (2) Product recommendations that are in the client's best interest are generated through a certain process that contains a specifiable level of comprehensiveness and diligence.

It's possible to advance arguments against each of the 'particular characteristic' approaches. Most people believe that the best product is one that is fairly priced, issued from a good organization and fits well with an overall financial plan. But once you move into balancing multiple characteristics, it is important to specify which balance is 'best' in an objective way, taking us back to where we began.

The process approach does not lend itself to determining an objective standard that can be used to distinguish those that act as fiduciaries from those merely required to recommend suitable products. Suitability, it can be argued, is already a process-based (rather than outcome based) approach. We certainly demand some level of diligence and some level of knowledge about various products, but it is hard to define which process would guarantee the 'best' client outcome.

But we do not think it is either of these understandings of the term 'best interest' that is operating in the current debate. *The tacit understanding operating in your data request is that recommending products that are in the best interest of the client is determined by the characteristics of the person doing the recommending.* Is there an underlying supposition that:

> (3) Practitioners who are compensated on the basis of commissions or who are limited to the sale of proprietary products are incapable of recommending the 'best' product.

If (3) holds, then we can jettison our project of seeking a positive definition of what it means to recommend products in the best interest of the client. *What it means to recommend products in the best interest of the client is that the recommender simply <u>not</u> be a member of a class that is either incapable of or unlikely to act in the best interest of their clients based on incentives and limited product availability.* While this understanding enables us to avoid the regressive muddle that trying to adjudicate the term 'best interest' provokes, it suffers from its own problems.

So the first question to consider in determining a new approach to standards of care is whether, in fact, a uniform "best interest" standard would really create a better set of outcomes for retail investors.

Secondly, let's move to the concept of conflicts of interest. If there is a perception that certain business models could lead to potential conflicts of interest, does it necessarily follow that conflicts actually result?

<u>A Closer Look at Conflicts of Interest</u>

All financial services professionals have an ethical obligation to look out for the best interest of their clients. While defined in different ways, this responsibility is clearly articulated in the Codes of Ethics that govern each of the professional and educational organizations within the industry. [1] This ethical obligation is rooted in the information asymmetry between practitioners and clients, the trust that the clients place in their advisers to act in their interests and the significant harm that can result if this trust is exploited. Conflicts of interest pose a potential problem to every profession in which they exist and therefore deserve a closer look.

John Boatright defines a conflict of interest as occurring: "when a person or institutional interest interferes with the ability of an individual or institution to act in the interest of another party when that individual or institution has an ethical or legal obligation to act in the other party's interest."[2] But, according to Boatright, all conflicts of interests are not the same. It is possible to distinguish along three points:

1. Actual versus Potential conflicts of interest: "it is the concrete misconduct of a person or an organization that turns the systemic/systematic potential into a real act against fiduciary duties."[3]

2. Individual versus Organizational conflicts of interest: "an individual conflict of interest is due to a professional's personal behavior, whereas an organizational conflict of interest is due to an organizational structure...in the end, it is also the question of who is the agent, e.g., the person in charge of the account or the organization as a whole." [4]

3. Personal versus Impersonal Conflicts of Interest: "exploitation of conflicts of interest is often provoked by the individual gains it promises to individual professionals or organizations."[5]

There are three important points to note:

(a) The presence of a conflict does *not* equal the presence of an actual harm.

(b) There is a meaningful difference between conflicts the practitioner creates through her own actions (i.e. commingling client funds with their own funds) and conflicts in which the practitioner finds herself on account of company policy or industry norms, i.e. certain compensation models.

[1] Ragatz, Julie A. and Ronald Duska (2010) "Financial Codes of Ethics" in Finance Ethics: Critical Issues in Theory and Practice ed. John Boatright. John Wiley & Sons Press: Hoboken, NJ: 297-324
[2] Boatright, John (1999) Ethics in Finance Blackwell Press: Waldon, MA: 51
[3] ibid, 197
[4] ibid, 197
[5] ibid, 197

(c) Conflicts can be personal, involving the practitioner's self interest, or impersonal, involving competing imperatives from stakeholders.

The point is that not all conflicts are created equal and should not be treated as such. It is probably impossible to eradicate conflicts. *None of this means that conflicts, of whatever kind, should not be taken seriously.* There is a wide body of academic literature that discusses the unconscious bias created by the presence of conflicts, even ones not created by the practitioner.[6] Moreover, it is also important to note that conflicts are not limited to the commission based compensation model.[7] *It is premature to assume that the mere presence of a conflict entails its actualization and renders the practitioner incapable or unlikely to act in the interest of the client.*

The Challenge of Multiple Motivations

The German philosopher Immanuel Kant famously argued that for an action to be worthy of the appellation "moral" it had to be done exclusively from a sense of duty, that is, because it was the right thing to do. The presence of any other motive, such as self-interest or affection, sullied the moral goodness of the action. Commentators have longed critiqued the stringency of Kant's requirement, arguing that it was both unappealing and impractical, i.e. do you want your friends visiting you in the hospital because it is the right thing to do or, at least partially, from the affection they bear you? Further, it is intuitively true that the presence of a self-interested motive can give extra incentive to complete the act when a commitment to moral rectitude falters. The point that Kant missed is that the presence of the other motivations (affection and self-interest) can make the action more valued and efficacious, not less.

The important point is not which other motivations are present, but which motivations are directing the act. As a wide range of literature on organizational behavior indicates, we can work in environments that either exacerbate or mitigate these motivations. This remains true whatever compensation model is in effect or whatever range of products a practitioner can recommend.[8]

Since it is inappropriate to render the presence of other incentives (motivations) as disqualification for the capacity or likelihood of offering good advice to clients, approaching the concept of 'best interest' by type of compensation model fails as

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[6] Bazerman, Max H., Don A. Moore, Lloyd Tanlu and Philip Tetlock (2006) "Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling" Academy of Management Review 31(1): 10-29

[7] Robinson, John H. (2007) "Who's the Fairest of Them All? A Comparative Analysis of Financial Advisor Compensation Models" Journal of Financial Planning 20(5): 56-65

[8] Trevino, Linda K. and Katherine A. Nelson (2007) Managing Business Ethics: Straight Talk About How to Do It Right. Wiley: Hoboken, NJ.

well. Whether an advisor is compensated by fees, commissions, or a blend of the two structures, the research on ethical behavior suggests that there is no reason to assume that a more restrictive structural approach to advisor compensation will change investor outcomes for the better.

Where do we go from here with 'best interest'?

We have outlined the conceptual confusions that surround an attempt to meaningfully define the term 'best interest.' We believe that while there is a great deal of rhetoric surrounding this terminology, it is difficult to determine how to define this standard, difficult to determine when this standard has been met and difficult to determine that practitioners held to the fiduciary standard are meeting this standard while other practitioners held to different standards are not.

We welcome a discussion on how this standard will be determined in practice and ultimately enforced. We believe that a focus on tracing out the thought patterns of individuals engaged in the process of financial planning would be very valuable. However these examples need to move beyond the realm of a 'collection of anecdotes' to genuine knowledge through systematic analysis.

Challenges Surrounding Disclosure

The second component that advocates argue differentiates the fiduciary standard from the suitability standard is the responsibility to disclose. We have concerns with the amount of confidence placed in disclosure to protect investors.

The weaknesses of the disclosure regime are well documented by the RAND Corporation's report, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers released in 2008. "The majority of the interviewees expressed...that disclosures do not help protect or inform the investor, primarily because few investors actually read the disclosures. Many participants said that they think the disclosures themselves are the root of the problem. The way that they are written is not easily understandable to the average investor, and the information in disclosures is not sufficient."[9]

There is a well-defined and fairly exhaustive literature that concerns the well-established problems with the disclosure regime. I will not rehearse that literature here, but simply make the following points:

[9] Hung, Angela, et al., (2008) RAND Corp. Investor and Industry Perspectives on Investment Advisers and Broker-Dealers: 19

- Mandated disclosure can be harmful since it creates a form of moral licensing that releases advisors from moral responsibility to act in the best interest of the client.[10]
- In order for disclosure to be effective, consumers must understand how (and whether) a conflict of interest has influenced the advisor AND how to appropriately discount their advice. Research shows that consumers consistently fail to do this well. [11]
- Research indicates that disclosure requirements focusing on a financial advisor's education, experience, and form of compensation may have little of the desired impact upon low-knowledge consumers.[12]

Ben-Shahar and Schneider convincingly argue that mandatory disclosure is a "Lorelei" that appeals to regulators and consumers alike because it resonates with deeply held commitments to free markets and to personal autonomy.[13] These are important moral goods, which most everyone agrees are valuable and worth pursuing. It is not the value of the goals, but the efficacy of the means used to pursue them that is called into question by empirical research on disclosure. It is certainly a challenging political position to publically disagree with calls for more disclosure. Yet, multiple strands of empirical research agree with the conclusions reached by the authors of the RAND study – disclosure in its current form doesn't achieve the goals of increased client knowledge and engagement. Moreover, mandated disclosure requirements can even work against these goals.

We would like to see the Commission pursue research on the effects of disclosure and explore the academic research that suggests that the focus should not be on *more* disclosure but on rendering disclosure that is both more meaningful and more relevant. Professionals have both a legal and moral obligation to create an environment in which clients can make informed choices about which financial products and strategies meet their needs. This requires both education and disclosure. There is likely much that our industry can learn from other professions' successes and failures in these areas. But in order to begin this process, we need to move away from the debunked theory undergirding the current disclosure-mandate approach and work with practitioners to generate new solutions to advance client knowledge and engagement.

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[10] Prentice, Robert (2011) "Moral Equilibrium: Stock Brokers and the Limits of Disclosure" Winsconsin Law Review (6): 1059-1108
[11] Cain, Daylian M., George Loewenstein, Don A. Moore (2005) "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" 34(1): 1-25
[12] McAlexander, James H. and Debra Scammon (1988) "Are Disclosures Sufficient? A Micro Analysis of the Impact of the Financial Services Market" Journal of Public Policy and Marketing (7): 185-202
[13] Ben-Shahar, Ormi and Carl E. Schneider (2011) "The Failure of Mandated Disclosure" University of Pennsylvania Law Review (3): 647-749

The Problem of Investor Confusion

It appears that part of the concern driving the Commission's request for comment is the level of investor confusion discovered by the 2008 RAND study on investor perspectives. As the study authors report, "even though we made attempts to explain fiduciary duty and suitability in plain language, focus-group participants struggled to understand the differences in standard of care. Furthermore, focus-group participants expressed doubt that the standards differ in practice." [14]

In short, consumers are confused about the technical distinctions that exist between fiduciaries and suitability and doubt whether distinctions that exist *de jure* actually are meaningful in practice.

Despite this confusion, most consumers are satisfied with their financial services provider. As the authors of the RAND study note, "However, despite their confusion about titles and duties even among experienced investors, most survey respondents and focus-group participants are happy with their own financial services provider. It is clear from their responses that the personal service given by the financial services provider is a very important dimension of the business relationship."[15]

We believe that attempts to effectively educate consumers about these lega differences are likely to be futile, especially given the evidence that consumers believe the distinction is not particularly relevant to the quality of service they receive from their provider. As the research of the success of disclosures indicates, people have limited cognitive and time resources and are unwilling to spend those where they do not see the immediate relevance (and often reluctant to spend them even where they do acknowledge the importance of their time and attention)

At the outset, it is important to distinguish between (i) how practitioners *do*, in fact act and (ii) how practitioners are *bound* (by law) to act. Even putting aside the murky question of how to determine, in a positive way, when someone is acting in the best interest of the client, it is evident that practitioners and organizations often hold themselves to higher standards than merely not running afoul of legal regulations. Most professionals agree with the former Chairman of the SEC, Richard C. Breeden who stated that, "it is not an adequate ethical standard to aspire to ge through the day without being indicted." To assume that practitioners merely fulfill the strict letter of their legal obligations does not reflect the experiences of many consumers of financial services, as evidenced by the participants in the RAND study.

<u>It would be instructive to learn more about the differences between required standards of care and standards of care as implemented in practice by securing</u>:

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[14] Rand Corp. <u>Investor and Industry Perspectives on Investment Advisers and Broker-Dealers;</u> xix
[15] ibid, xix

(1) Examples of the kind of cases that could have been effectively prosecuted under the fiduciary standard that could not have been so prosecuted under the suitability standard. *These examples would clarify the depth and breadth of the 'gray zone' in which practitioners held to the suitability standard are able to* **legally** *exploit their clients in ways that those individuals held to a fiduciary standard could not.*

(2) Facts concerning the frequency and success of these sorts of prosecutions. *How often are those held to a fiduciary standard successfully punished or sanctioned for actions that would have been legally permissible under the suitability standard?* A difference in protection is not relevant or meaningful to the consumer if there is no entity capable of enforcing the rights of consumers and responsibilities of financial services providers.

We believe that a demonstrated real gap in protection could provide a more meaningful basis on which to base action to remedy this deficiency.

But to establish this gap in protection requires two things: (i) the proof of a meaningful *broad and deep* 'gray zone' in which practitioners held to the suitability standard could legally exploit their clients' trust in ways that those held to a fiduciary standard could not; and (ii) For this gap to be more than merely theoretical, it is necessary that there be a meaningful number of successful prosecutions or sanctions imposed on practitioners held to a fiduciary standard. Note that this requirement moves beyond the basic number of examinations and sanctions, and needs to focus explicitly on examinations and disciplinary actions for violations of fiduciary inside the 'zone' described above.

We should not assume the existence of a meaningful gap in protection based on the assumption that those held to the suitability standard only act in accordance with the strict letter of their legal obligations, exploiting their clients as much as possible within the legal framework. This assumption, until established by empirical research, is belied by the level of confidence most consumers place in their financial services practitioners and in need to establish the foundations of a trusting relationship to secure continual business. *An additional interesting area of research would be to survey practitioners held to the suitability standard to determine how they interpret their professional obligations.*

Conclusion

It is often unpopular to raise substantive questions such as those outlined in this brief paper. It is tempting to ask instead "what harm could result from the raising of standards?" And further, "wouldn't the decision to impose a universal fiduciary standard work to increase consumer confidence and restore consumer trust in an industry that is so vitally important to the well being of individuals and society?"

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We do not take a position on whether the expansion of the fiduciary standard is good idea or not. We are concerned that in the midst of a passionate debate, certain important ethical questions are not getting the attention they deserve. Moreover, these are not new questions. The problems posed by the ambiguity over the proper definition of 'best interest' and the troubles caused by a disclosure mandate that is not meaningful or even helpful to the consumer are only exacerbated by an expansion of this standard. The goal of investor protection is crucially important—and we need to be certain that the universal application of a fiduciary standard would increase that protection - at least to be more certain of that outcome than we are at this time.

Finally, we are concerned that the step of 'taking action' - any action - essentially resolves the issue in the minds of regulators. We do not believe that the expansio of the fiduciary standard divorced from a meaningful commitment to increased professionalism and education will achieve the laudable goals set by Congress and the Commission. We want to remind the Commission that whatever course of action is chosen with regard to this matter, the work is not done but will require continued monitoring of consumer outcomes. We want to encourage the Commission to employ those outcomes as their north star: will retail investors in fact, not just in theory, be better served at every level of income and assets under any new standard of care than they are under the current structure? Investors are counting on the SEC's ability to answer that question before any action is taken.

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