Consumer Federation of America

July 5, 2013

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

Re: Duties of Brokers, Dealers, and Investment Advisers
File Number 4-606

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America[1] in response to the Commission's request for information (RFI) regarding the standard of conduct and other obligations of broker-dealers and investment advisers. CFA appreciates the opportunity to comment on an issue that we believe is central to improving protections for unsophisticated investors in their dealings with sometimes predatory and often self-interested financial professionals. We are encouraged that the Commission has finally taken this crucial step toward rulemaking. We remain concerned, however, that if the Commission adopts an approach to rulemaking that relies on faulty assumptions, it could let this opportunity slip away without providing meaningful and much needed new protections to vulnerable investors. We therefore appreciate that the Commission has requested not just data to support an economic analysis of these issues, but also comment on the assumptions that are presented in the release and the alternative regulatory approaches that the Commission should consider in deciding how best to proceed. Our comments will focus primarily, but not exclusively, on these issues.

Background

Over the past 25 years, CFA has consistently advocated improved protections for investors in their dealings with the financial professionals they rely on to guide them as they save for retirement, fund a child's college education, or provide for their families in an emergency. As we have worked on these issues over the years, we have become increasingly convinced that strengthening and closing loopholes in the regulation of financial intermediaries is the single most important step the SEC can take to promote the well-being of average, unsophisticated investors.

[1] The Consumer Federation of America (CFA) is an association of nearly 300 national, state and local consumer organizations established in 1968 to advance the consumer interest through research, advocacy, and education.

Research has shown that investors typically rely heavily on the recommendations they receive from brokers and investment advisers alike, and indeed generally do not have the expertise to second-guess those recommendations even if they understand, as most do not, the significant conflicts that may bias those recommendations.[2] This trusting approach, which is actively encouraged by industry marketing, leaves investors extremely vulnerable not only to fraud, but also to those who would take advantage of that trust in order to profit at their expense. These investors need a regulatory system for investment professionals that is designed to promote the best interests of the investor and that imposes comparable standards on investment professionals who are performing essentially the same function. Ensuring that all securities professionals who offer investment advice to retail investors are subject to a fiduciary duty is a necessary component of a rationale, pro-investor system of regulation.

As the Commission knows, this issue has been under consideration for many years. CFA's involvement with the issue began with a 1987 report on abuses in the financial planning profession.[3] At the time, the Commission had already been grappling for several years with questions of how the securities laws, and the Investment Advisers Act in particular, applied to the then emerging field of financial planning.[4] Among the most pervasive problems CFA identified in our report on financial planning abuses was self-interested advice, "illustrated by the planner who sells a client a legitimate product, not primarily because it suits that client's circumstances, but because the planner earns a good commission or sales incentive on that product." That is of course precisely the problem the Commission is now grappling with in the context of brokers who market themselves as financial advisers and offer advisory services, such as investment planning and retirement planning, but remain free to recommend investments that put their own interests ahead of the interests of the investor.

There is good news for the Commission from the financial planning experience. First, it shows that a fiduciary duty can be implemented in a way that is consistent with a business model that combines advice and product sales. Second, it shows that the brokerage industry's understandable initial nervousness is likely to dissipate once brokers become accustomed to living under a fiduciary standard. A planning profession that once hotly contested the notion that their fiduciary obligations should extend through plan implementation has since come to acknowledge and even embrace that concept. While there will inevitably be resistance from some quarters, the same is likely to be true of brokers if the SEC proceeds with a fiduciary rulemaking, so long as it does so in a way that continues to allow for provision of transaction-specific advice compensated through commissions and other forms of transaction-based payments. Indeed, that evolution has already begun, with SIFMA having publicly advocated adoption of a fiduciary standard for brokers that includes a broad, principles-based obligation to act in the best interests of the customer.[5] Indeed, a SIFMA spokesman recently stated that the

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[2] See, for example, Roper, Barbara and Brobeck, Stephen, "Mutual Fund Purchase Practices, An Analysis of Survey Results," June 2006.
[3] Roper, Barbara, *Financial Planning Abuses: A Growing Problem*, July 1987.
[4] See, for example, SEC Investment Advisers Act Rel. No. 770 (1981) as well as SEC Rel. No. IA-1092 (1987).
[5] Materials outlining SIFMA's position on the fiduciary duty for brokers can be found here on the SIFMA website.

benefits of such a standard are "self-evident" and that the industry is willing to bear significant costs to deliver those benefits.[6]

Commission Must Reject Common Fallacies to Develop a Sound Regulatory Response

In order to develop a sound economic analysis and arrive at a reasonable approach to rulemaking, the Commission will need to reject two common misconceptions about the reasons for the current regulatory failure and the purpose of rulemaking to correct that failure. The first fallacy, which is heard often from the opponents of a fiduciary rule, is that the sole or primary purpose of the rulemaking is to eliminate investor confusion. The second fallacy, which has been perpetuated by the Commission itself, is that the difference in standards for investment advice by broker-dealers and investment advisers is the result of statutory differences. The first threatens to lead the Commission down a regulatory blind alley. The second causes the Commission to ignore regulatory alternatives that might offer a cleaner, more streamlined solution to the problem of inconsistent standards for investment advice.

- *Investor confusion is merely a symptom; Commission rulemaking must cure the disease.*

Investor confusion is the inevitable result of a market for investment advice that makes no sense. Simple logic dictates that all financial professionals offering investment planning, retirement planning, or similar advisory services would be subject to the same standards. It should hardly be surprising that investors do not understand that this is not the case. But the source of confusion goes deeper than this regulatory inconsistency. Inherent in the concept of advice, as distinct from a sales pitch, is the notion that advice is designed to promote the best interests of the client in ways that simple sales recommendations are not. When investors assume that their "financial advisor" is acting in their best interests, it is not because they are being naïve, nor is it a sign that they simply need better information. It is a sign that they are being understandably misled by deceptive titles and marketing campaigns. After all, promoting salesmen as advisers and promoting sales recommendations as advisory services when the recommendations are not designed to serve the best interests of the customer is inherently deceptive. But it is also perfectly legal under our current regulatory system.

A regulatory response that takes as its goal eliminating investor confusion would be analogous to a doctor's prescribing an aspirin to treat a patient's fever while ignoring the underlying infection that is the cause of that fever. It will be doomed to failure. The purpose of Commission rulemaking is, or should be, to eliminate the *source* of investor confusion. The Commission can only achieve this goal by creating a market for investment advice in which financial professionals who are indistinguishable to the average investor are subject to the same fiduciary duty to act in the best interests of the customer when they deliver investment advice.

Those who argue erroneously that the purpose of Commission rulemaking is to eliminate investor confusion typically suggest that improved disclosure is the most logical solution to this problem. In doing so, they ignore or fail to grasp the most salient implications of pervasive investor confusion, which is that a disclosure-based solution cannot be effective. The

[6] Schoeff, Mark, "Reps willing to bear 'substantial costs' of fiduciary duty: SIFMA Exec," *Investment News*, June 13, 2013 (available here).

Commission's recently completed financial literacy study documents the extreme limitations of disclosure as an effective investor protection tool.[7] In a market in which brokers and advisers use comparable titles and offer similar services and when brokerage firms spends millions of dollars on marketing campaigns designed to blur those distinctions, there is simply no basis for believing that disclosure alone would resolve that confusion. Indeed, the Commission has already been down that road (as we will discuss further below) and realized the impossibility of designing a disclosure to effectively convey such a complex set of issues in a way that typical investors are likely to comprehend.[8]

The key point is this: the relevance of investor confusion is not that it is the problem Commission rulemaking is intended to solve, but rather that it eliminates as viable options certain disclosure-based regulatory approaches that the Commission might otherwise consider. The existence of widespread investor confusion also exposes the absurdity of suggesting that inaction is acceptable since investors can simply choose whether they prefer to deal with an investment adviser, who is subject to a fiduciary duty, or a broker-dealer, who is not. Investors who cannot distinguish between brokers and advisers and who do not understand that these two types of investment professionals are subject to different legal standards when they offer advice simply cannot make an informed choice. Thus, widespread investor confusion not only limits the regulatory alternatives available to the Commission, but it also highlights the need for Commission action to address this market failure.

- *Past Commission actions, not statutory differences, created the problem the Commission now seeks to solve.*

Over the years, the Commission has repeatedly suggested that the difference in standards of conduct that apply to investment advice offered by broker-dealers and investment advisers results from the fact that broker-dealers are subject to a statutory exclusion from the definition of investment adviser under the Investment Advisers Act. An unbiased reading of the statute, the legislative history, and the record of past Commission action (and inaction) demonstrates conclusively, however, that it is not the statutory exclusion itself, but rather the Commission's overly broad interpretation of that exclusion, that has allowed brokers to rebrand themselves as advisers and offer extensive investment advice without being regulated under the Advisers Act. CFA has previously detailed this argument in a comment letter on the legislative history behind the broker-dealer exclusion, which we incorporate by reference.[9] While we will not reargue the issue in detail, a few of the key points bear repeating.

When Congress adopted the Investment Advisers Act of 1940, it adopted a very broad definition of investment advice, essentially covering anyone in the business of giving advice about securities for compensation. That definition clearly would have swept in brokers under the auspices of the Advisers Act absent an exclusion. In crafting that exclusion, Congress rejected

[7] Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)*, August 2012.
[8] See 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.
[9] Letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan Katz regarding "Certain Broker-Dealers Deemed Not to be Investment Advisers," File No. S7-25-99, (February 7, 2005). A copy of that letter is available here.

the approach that had been adopted in some states of providing brokers with a blanket exclusion from the definition. Instead, under the approach adopted by Congress, brokers would escape regulation under the Advisers Act only if they limited themselves to providing advice that was "solely incidental to" their function as brokers and did not receive any special compensation for that advice.

As the legislative record clearly shows, in deciding to adopt this narrower broker-dealer exclusion, Congress was aware of and concerned about abuses associated with brokers offering investment advice. As one witness described it, a key concern was that "some organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commission on transactions executed upon such free advice."[10] In explaining why he thought legislation, rather than self-regulation of advisers, was necessary, the chief sponsor of the Senate bill told a representative of the Investment Counsel Association of America: "Let me say that ***if I thought you could get all the brokers in***, I – as one member of the committee – would be quite satisfied by your regulation under your own association's rules. However, how are you going to get in the others, who may not want to live up to your high standards?"[11] (Emphasis added.) In short, Congress was well aware of the problems that would flow from allowing brokers to market themselves as advisers without being regulated accordingly, and it sought to address that problem by ensuring that brokers were excluded from regulation under the Advisers Act only to the extent that they stuck to their traditional role of effecting transactions in securities on behalf of customers.

Had the Commission heeded these concerns and interpreted the broker-dealer exclusion as Congress intended, brokers who wished to offer investment advice that went beyond the advice inherent to the sales function would have faced regulation under the Advisers Act, regardless of whether that advice was offered in connection with their brokerage activities and was reasonably related to those activities. Brokers who wished to expand into advisory activities would have faced a simple business decision: did the benefits of holding themselves out as an adviser and offering advisory services outweigh the costs of regulation under the Advisers Act? Those who chose to offer advisory services would have had to develop those services in a manner that is consistent with the Advisers Act fiduciary obligations. Investors, in turn, would have benefited from the assurance that all those in the business of offering investment advice were held to the same high standards. And we would not now find ourselves in the position of trying to retrofit a fiduciary standard onto broker-dealers whose traditional brokerage activities now appear to be "solely incidental to" their advisory functions.

Instead, over the last several decades, nearly every time the Commission has had to make a decision over whether to apply the Advisers Act to brokers' advisory activities, it has expanded the broker-dealer exclusion to accommodate the new practices. When the Commission undertook its early interpretation of how the Advisers Act would apply to financial planning, for example, the staff concluded that accountants and attorneys who held themselves out as financial planners would be subject to regulation under the Advisers Act because holding out as a planner creates the impression that the advice is more than solely incidental, but it gave brokers who held

[10] Ibid, citing testimony of ICAA President Dwight Rose from the Senate hearing record at p. 736.
[11] Ibid., citing Senator Robert F. Wagner of New York from the Senate hearing record at p. 739.

themselves out as financial planners a free pass.[12] As a result, by the 1990s the major full-service broker-dealer firms were offering clearly advisory services, such as financial planning, using titles such as financial planner, financial consultant, and financial adviser for their sales reps, and aggressively marketing their services as if advice were the primary service being offered – all without being regulated under the Investment Advisers Act.[13] Either advice had long since ceased to be solely incidental to the sales function, or the firms were actively misleading investors about the nature of their business. Instead of reining in these misleading practices, the Commission proposed to further expand the broker-dealer exclusion by allowing it to apply even in cases where the broker was receiving fee-based compensation for that advice.

We raise these issues now not to point the finger of blame, but because they are directly relevant to the current undertaking. First, by attributing the difference in standards of conduct to statutory differences, rather than to the Commission's own misinterpretation of the statute, the Commission overlooks a regulatory alternative that is available to "harmonize" the standard of conduct for investment advice by brokers and advisers without diluting protections under the Advisers Act. It could accomplish this goal in a straightforward fashion by revising its interpretation of the broker-dealer exclusion from the Advisers Act so that the exclusion functions as Congress intended, applying only where brokers limit their advisory activities to those inherent to their traditional sales activities and do not hold themselves out as offering investment advice. (We will discuss this further in the section of our comment letter below that deals with regulatory alternatives.)

There is a second reason, however, why this issue is important in the current context. In failing to apply the Advisers Act to brokerage practices that are clearly more than solely incidental, the Commission appears to have been motivated at least in part by a concern over the continued viability of the full-service broker-dealer business model. By the 1980s, brokers were facing competition on one side from discount brokers offering cheaper execution of trades for the self-directed investor and by financial planners on the other side offering more comprehensive advice to those seeking recommendations from a financial professional. Rather than letting the market decide the fate of full-service firms' retail business, the Commission stepped in to prop up those businesses by allowing them to compete as advisers without being regulated accordingly.

Similar concerns can be seen today among those advocating a regulatory approach that seeks to change as little as possible about the broker-dealer business model. Indeed, such an attitude appears to be embedded in some of the assumptions presented in the RFI (as discussed in greater detail below). But the whole reason for adopting a fiduciary duty for brokers is that there are practices that brokers engage in when they offer "advice" under the existing suitability standard that are harmful or excessively costly to investors and need to be reformed. In examining these issues, the obligation of the Commission is not to water down the fiduciary standard so that it can accommodate those practices, but to use the fiduciary rulemaking to adopt

[12] See SEC Release IA-1092. See also *Investment Advisers, Financial Planners, and Others -- An Overview of the Investment Advisers Act of 1940*, by Robert E. Plaze, Division of Investment Management (undated).

[13] In ads taken from that period, Shearson-Lehman urged investors to think of their Shearson-Lehman Financial Consultant "more as an advisor than as a stockbroker." Prudential Securities advertised that "it's advice, not execution, that's at the heart of our relationships ..."

appropriate new restrictions designed to protect the interests of investors.[14] We are frankly concerned that, unless the Commission is prepared to abandon its past propensity to protect the broker-dealer business model at the expense of protecting investors, it will be incapable of developing a fiduciary standard for brokers that truly puts the interests of investors first.

Assumptions Would Lead to an Inadequate Fiduciary Standard

CFA applauds the Commission for adopting the approach of laying out basic assumptions about a possible rulemaking in its release. This strikes us as a useful exercise that should limit the amount of irrelevant comment the Commission receives (such as assessing the impact of a fiduciary standard on investor costs and access to services based on the assumption that brokers operating under a fiduciary standard would be prohibited from earning commissions). Because the Commission has invited comment on the assumptions themselves, this approach also provides an opportunity to provide input on the key principles that must be in place to ensure that any rule adopted meets what we believe should be the overriding goals of this rulemaking: ensuring that there is no weakening of the existing protections for those individuals who invest through investment advisers; strengthening protections for those who invest through brokers while maintaining their ability to get transaction-specific advice paid for through transaction-based payments; and adopting consistent standards for advisory services, regardless of the type of firm or individual offering those services.

Our analysis of the assumptions set forth in the RFI leaves us concerned that any rule adopted under this set of assumptions would fail to meet these goals. On the contrary, unless the Commission significantly changes its approach to these issues, we could end up with a rule that weakens protections for those who receive investment advice from federally registered investment advisers without providing significant new protections for those who receive advice from broker-dealers. Assuming that states would not follow the SEC's lead in watering down the fiduciary standard for state-registered investment advisers, we wouldn't even have achieved the goal of harmonization. Instead, harmonization of standards for federally registered investment advisers and brokers would be bought at the price of "disharmonization" of the standards for state and federally registered investment advisers and a weakening of protections for investors overall. This is surely not the outcome that the Commission intends or that Congress was seeking when it adopted Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The chief source of our concern (though by no means our only concern) is the absence of any assumption that fiduciary rules adopted by the Commission would impose an enforceable, principles-based obligation on brokers and advisers to act in the best interests of their clients without regard to the financial or other interests of the broker or adviser. It is of course possible that the Commission takes for granted that any fiduciary rule would incorporate a best interest

[14] This is not intended to suggest that receipt of commissions would create an unacceptable conflict. CFA agrees that investors can benefit from the availability of commission-compensated advice, as long as that advice is subject to appropriate regulatory standards. It does not follow from that, however, that all forms of transaction-based compensation are equally acceptable. Indeed, Section 913 of the Dodd-Frank Act recognizes this and specifically directs the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

obligation, since that standard is specifically referenced in the Section 913 language. However, the RFI carefully repeats other aspects of the Dodd-Frank language in laying out its assumptions, suggesting that the omission may have been intentional. Moreover, the RFI's discussion of the nature of the fiduciary standard fails to incorporate essential components of such a standard, suggesting to us that the Commission may be badly off course in how it is approaching this issue.

Indeed, the assumptions presented in the RFI strongly suggest that the Commission may once again be adopting a regulatory approach designed to protect brokers at the expense of investors. A weak fiduciary standard could have the perverse effect of making it even easier for brokers to compete as advisers without making any meaningful changes to harmful broker-dealer practices. We recognize that the RFI repeatedly states that the assumptions presented in the release are "not designed to indicate the ultimate direction of any rule-making." However, while not yet etched in stone, it seems reasonable to assume that the RFI assumptions do reflect current Commission thinking on these issues. We therefore think it is important to make absolutely clear that we would view a rulemaking based on these assumptions as an empty gesture. CFA could not support such a rule.

The assumptions, and our specific concerns about the assumptions, are discussed in greater detail below.

- *The Definition of "Personalized Investment Advice"*

Defining the term "personalized investment advice" is crucial to determining when the fiduciary duty will apply to brokers and, as a result, whether it will afford investors meaningful new protections. For it to achieve this goal, the definition of advice must include recommendations of specific securities as well as general advice about whether investment in securities would be appropriate. Such an approach would be consistent with the goal of raising the standard of conduct while preserving the ability of brokers to offer transaction-specific advice. Toward that end, the definition suggested by SIFMA in its Section 913 comment letter seems to adopt a generally appropriate approach. SIFMA's proposed definition would capture "investment recommendations that are provided to address the objectives or needs of a specific retail customer after taking into account the retail customer's specific circumstances." As long as it captured all recommendations that a reasonable investor would view as being intended to address their objectives and needs based on a consideration of their circumstances, and all services that a broker describes and markets as advisory services, such an approach ought to function reasonably well. The RFI assumption that personalized advice would include recommendations, as that term is interpreted under existing broker-dealer regulation, plus any other actions or communications that would be considered investment advice (but not impersonal investment advice) under the Advisers Act is generally consistent with this approach.

In implementing a rule based on a definition of personalized investment advice that generally follows this approach, the Commission will likely need to provide additional clarification regarding whether particular types of accounts and services trigger the definition. In the 913 study, for example, the staff recommends that the Commission "specify that personalized investment advice provided to retail customers includes both advice to a specific retail customer on a one-on-one basis and advice to a group of retail customers under circumstances in which members of the group reasonably would believe that the advice is intended for them." We agree. In addition, a number of organizations, including both SIFMA and CFA, have already weighed in with specific suggestions on what should and should not be considered personalized investment advice.[15] While our organizations may disagree over the details in certain areas, we seem to share a general conceptual approach.

Hammering out the precise details of the kind addressed in our letters is best achieved, in our view, through guidance rather than rules. As the Commission staff notes in the Section 913 study: "Whether a recommendation has been made is a facts-and-circumstances determination to be made on a case-by-case basis that is not susceptible to a bright-line definition." If the Commission issues reasonably detailed guidance along with the fiduciary rules, firms should have a clear roadmap to follow in determining when they are subject to a fiduciary duty.

❖ *Definition of "Retail Customer"*

We agree that the definition of retail customer included in Section 913 of Dodd-Frank should provide sufficient clarity with regard to the meaning of this term. We would note, however, that Section 913 authorizes the Commission to impose a fiduciary duty not just on investment advice that is offered to retail customers, but also to advice to "such other customers as the Commission may by rule provide." While we believe it is appropriate to prioritize strengthened protections to individual investors, we are dismayed that the Commission does not appear to be giving serious consideration to whether there are additional classes who are similarly in need of enhanced protections. As the Commission well knows, investment advisers have a fiduciary duty with respect to all their clients. What is the rationale for treating brokers differently? Is it because the services they provide to those institutional clients are fundamentally different in nature than the services provided by investment advisers? If not, is it that institutional investors are assumed to understand the different role that brokers and advisers play? If the latter, what evidence does the Commission have to support that assumption? What steps has the Commission taken to determine whether there are additional classes of investors, beyond retail investors, who are in need of enhanced protections in their dealings with brokers proffering investment advice? We would encourage the Commission to include consideration of these issues in its economic analysis preparatory to rulemaking.

❖ *Application to SEC-registered Brokers and Advisers*

The RFI assumes that any rule would apply to SEC-registered broker-dealers and investment advisers. What is not clear from the RFI is whether this would result in an approach that would ensure that all brokers and advisers who offer personalized investment advice to retail customers would be covered by a fiduciary duty. The key question is this: do groups of brokers or advisers exist who would escape the fiduciary standard, whether imposed at the state or

[15] See, for example, the July 14, 2011 letter from Ira D. Hammerman, SIFMA Senior Managing Director and General Counsel, to SEC Chairman Mary Schapiro regarding a "Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act" (File No. 4-604). See also, March 28, 2012 letter from Consumer Federation of America, Fund Democracy, AARP, Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, and the National Association of Personal Financial Advisors to SEC Chairman Mary Schapiro regarding a "Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act" (File No. 4-604).

federal level, under this approach? If so, this is not an acceptable approach. In determining who should be covered under a proposed rule, the Commission must adopt an approach that ensures that all brokers and advisers end up being subject to a comparable fiduciary standard when providing investment advice. Currently, while there may be subtle differences in the rules adopted at the federal and state level, the fiduciary duty for state- and federally-registered advisers is essentially the same. It would be unacceptable if a rule to "harmonize" the standard of conduct for brokers and advisers were to water down existing protections for investors who receive advice from an investment adviser, all the more so if it also created inconsistency in the standard for state- and federally-registered advisers.

- *Designed to Accommodate Different Business Models and Fee Structures*

CFA agrees that the Commission should adopt a rule that continues to permit brokers to receive transaction-based compensation, including compensation in association with principal transactions. We further agree that, in doing so, it should require disclosure of the conflicts of interest associated with those compensation practices. Dodd-Frank makes clear that the "receipt of compensation based on commissions, fees or other standard compensation for the sale of securities, for example, would not, in and of itself, be considered a violation" of the uniform fiduciary standard of conduct. However, it does not follow that all such forms of compensation would be acceptable under a fiduciary standard or that disclosure alone would offer a sufficient remedy where compensation practices create particularly distorting incentives. On the contrary, Section 913 specifically directs the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

We are disappointed that the Commission has in the intervening years since the Act's passage apparently undertaken no such examination. We frankly do not see how the Commission can adopt a fiduciary standard for brokers without first determining that common broker-dealer compensation practices are consistent with such a standard. To be clear, our concern is not the receipt of transaction-based compensation *per se*. Certainly, transaction-based compensation creates a conflict of interest; the broker only gets paid if there is a purchase or sale. But this is not all that different from the conflict of a fee-only adviser paid based on a percentage of assets under management who therefore has an incentive to discourage forms of investment, such as direct investments in real estate, that would reduce the portfolio on which their compensation is based. Both strike us as manageable conflicts, easily addressed through disclosure and creating only minimal distortions on the broker or adviser's incentives to provide good advice. The real concern arises with various forms of differential compensation, which create incentives to make recommendations on terms other than the best interest of the customer, or compensation practices that impose excess costs on investors. Two areas strike us as deserving particular attention in this regard: revenue sharing payments and 12b-1 fees.

CFA has long advocated reform of revenue sharing payment practices on the grounds that these payments lack transparency and create incentives that can distort recommendations.[16] Past SEC examination of revenue sharing practices concluded that most brokers who received revenue sharing payments "appear to have favored the sale of the revenue sharing funds by providing increased access and visibility in the broker-dealer's sales networks (e.g. listings on firms' websites, access to sales staff, promotional material sent to customers, inclusion on firms' recommended lists)." About half of the brokers examined by SEC staff in a 2004 sweep examination also paid their registered representatives more to sell the revenue sharing funds than they paid for the sale of other funds (except, in three cases, for the sale of proprietary funds).[17] It is possible that practices have changed in the intervening years, in response to enforcement actions for example, but receipt of revenue sharing payments remains widespread. And the fact remains that revenue sharing payments create a financial incentive for brokers to favor certain investment products based on their own financial interests rather than on which are best for the customer. As it considers whether to apply a fiduciary standard to brokers, the Commission should update its examination of revenue sharing practices and consider whether new limitations on these practices are warranted.

The Commission itself has acknowledged the need to reform12b-1 fees. Since their introduction as marketing fees in the 1980s, these payments have been largely transformed into a form of incremental sales commission that goes primarily toward compensating brokers. Because they are charged through the administrative fee, however, 12b-1 fees operate outside FINRA rules on excessive compensation. And because they can be charged indefinitely, compensation payments by long-term investors can exceed those limits. The SEC has a thoughtful proposal on the table to reform 12b-1 fee payments in a way that would preserve the ability to charge incremental commissions. In keeping with Dodd-Frank's directive to promulgate rules to restrict compensation practices that are contrary to the public interest, the Commission should revive that rule proposal as part of its adoption of a fiduciary standard.

These are just two examples that have long been on the Commission's radar screen and are long overdue for reform. A more thorough examination of compensation practices is needed to identify additional practices that similarly distort financial incentives or expose investors to excess costs. Both the Commission's own research, as part of its financial literacy study, and academic research on conflict disclosure have raised serious concerns about the ability of disclosure to effectively address these issues.[18] Where the Commission has reason to believe that disclosure is likely to be ineffective in protecting investors, it must, in keeping with the directive in Dodd-Frank and the requirements of a fiduciary duty, consider further measures to reduce or eliminate those conflicts.

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[16] See, for example, Testimony of CFA Legislative Director Travis Plunkett before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security regarding "Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors," January 27, 2004.
[17] "SEC Revenue Sharing Examination Findings" email provided to reporters by SEC Tuesday, January 13, 2004.
[18] See, for example, Cain, Daylian M.; Loewenstein, George; and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," *Journal of Legal Studies,* vol. 34 (January 2005).

- *No Continuing Duty of Care After the Advice*

How the Commission defines what is meant by "after providing personalized advice" will determine whether the fiduciary standard waters down existing protections. After all, it is our understanding that the primary basis on which brokers are held to a fiduciary standard today is their adoption of marketing and other practices that create a reasonable expectation on the part of the client that they will receive on-going account management and oversight.[19] In describing their view of a fiduciary duty that is applicable to the broker-dealer business model, SIFMA uses a term, "episodic advice," that appears problematic to us in this context. SIFMA seems to envision an approach under which brokers who have an on-going relationship with customers that includes repeated instances of transaction-specific advice would be viewed as providing episodic, rather than on-going, advice and thus could avoid or contract out of an on-going duty of care to those customers. Such an approach would create significant opportunities for misrepresentation and abuse.

The RFI lays out what generally seems to be a reasonable approach to what is frankly one of the more troubling provisions in Section 913. Critically important in this regard is the RFI's acknowledgement that, not contract language alone, but the "totality of the circumstances of the relationship and course of dealing between the customer and the firm" would determine the scope and nature of the duty. Moreover, we agree with the RFI interpretation that marketing documents and "reasonable customer expectations" arising from the firm's course of conduct are also factors that would determine whether an on-going duty exists. In adopting such an approach, the Commission would need to make absolutely clear that brokers could not contract out of an on-going duty of care when their marketing materials and other representations to clients are designed to create a reasonable expectation of on-going account management.

The RFI seriously undercuts the Commission's credibility on this issue, however, with its brief mention of how the on-going duty of care that applies to investment advisers who act as financial planners. In footnote 37, the Commission attributes to "market participants" the view that "investment advisers who act as financial planners generally would not have a continuing duty to a customer after providing the financial plan." The only "market participants" we are aware of who hold this view are the brokers and insurance agents who use the title of financial planner and offer canned financial plans in order to promote their sale of securities and investment products. By citing this view – and citing it without also mentioning that this view has been rejected by investor advocates, planning organizations, and state securities regulators – the Commission appears to be implicitly endorsing a regulatory approach that would allow brokers to switch in and out of their fiduciary obligations in ways that are inherently misleading to investors.

In contrast to the picture of financial planning that this footnote reference creates, a financial plan is not a document, but a process. As the Financial Planning Association states on its website: "Financial planning is the long-term process of wisely managing your finances so you can achieve your goals and dreams, while at the same time negotiating the financial barriers that inevitably arise in every stage of life. ***Remember, financial planning is a process, not a***

[19] This appears to be a primary basis on which investors base violation of fiduciary duty claims against brokers in arbitration.

product." (Emphasis added.) It goes on to identify six steps in the planning process, including step five, implementing the plan, and step six, monitoring the plan and making adjustments.[20] FPA further explains that, under the standard of care that applies to financial planning, planners: must put the client's best interests first, must act with due care and in upmost good faith, must not mislead the client, must provide full and fair disclosure of all material facts, and must disclose and fairly manage all material conflicts of interest.[21] In sharp contrast to the view expressed in the RFI footnote, FPA makes clear that this standard applies to "all financial planning services," which based on their definition clearly does not end with the delivery of a plan.

It is frankly deeply disturbing the Commission staff would so badly misstate the common perception of the fiduciary obligations of financial planners. A Commission that is prepared to accept hat switching by financial planners can hardly be expected to interpret the on-going duty of brokers in a way that puts the interests of investors first. It is not enough for the RFI to state that "the totality of the circumstances of the relationship and course of dealing between the customer and the firm" will determine whether there is an on-going duty of care. The Commission must be prepared to implement the requirement in a way that does more than give lip service to that concept. The reasonable expectations of the customer, based on the totality of the circumstances, must be the driving criteria for determining whether there is an on-going obligation to monitor and adjust the account and thus an on-going duty of care.

❖ *Effect on Sale of Proprietary or Limited Range of Products*

The RFI restates as an assumption the provision in Dodd-Frank that specifies that sale of proprietary products or a limited range of products would not, in and of itself, be considered a violation of the fiduciary duty. If the Commission decides to move forward with rulemaking under its Section 913 grant of authority, this will be among the thorniest issues it will have to address. Can it adopt an approach to sale of proprietary products or sale of a limited range of products that is consistent with a fiduciary duty to act in the best interests of the customer?

Sale of proprietary products creates a clear conflict of interest with the potential to inflict considerable harm on investors. This was illustrated by a recent *New York Times* article on J.P. Morgan's aggressive tactics aimed at pushing the sale of in-house products.[22] According to the article, several advisers who resisted the pressure to sell the firm's proprietary products said "they were told to change their tactics or be pushed out." As the article notes, while the promotion of in-house products is not illegal, the concern is that, "driven by fees, banks will push their own products over lower-cost options with stronger returns." And at least one former J.P. Morgan broker left the firm because he did not feel that the firm's policy on sale of in-house products allowed him to do what was best for his customers.

In the face of that kind of sales pressure, conflict disclosure alone is not going to provide sufficient protection for investors. And even a clear best-interest obligation may not be strong

[20] See FPA website definition of financial planning here: http://www.fpanet.org/WhatisFinancialPlanning/
[21] See FPA website description of the standard of care here: http://www.fpanet.org/AboutFPA/StandardofCare/
[22] Craig, Susanne and Silver-Greenberg, Jessica, "Selling the Home Brand: A Look Inside an Elite JPMorgan Unit," *The New York Times*, March 2, 2013.

enough to counter a culture where sale of proprietary products is crucial for professional advancement. If it is to provide meaningful protection for investors under a fiduciary duty that tolerates the sale of proprietary products, the Commission will need to consider what additional policies and procedures firms must have in place to ensure that recommendations are indeed in the best interest of customers. This ought at a minimum to include a prohibition on using sale of proprietary products as a factor in decisions about promotion, offering any form of direct or indirect financial incentives to favor in-house products over alternatives, and a requirement that the adviser document the basis on which he or she concluded that the in-house product was in the best interest of the investor (taking into account such factors as costs and performance and third-party ratings of the investment).

Sale of a limited range of products raises a somewhat different challenge for the Commission, should it promulgate rules under Section 913. While the statute states that sale of a limited range of products would not, in and of itself, be a violation of the fiduciary duty, it does not offer any insight into what conditions regarding the sale of limited range of products would constitute a violation. Is it possible, for example, for the range of products to be so limited that it would be impossible to satisfy a fiduciary duty based on sales from that menu? To offer an extreme example – for illustrative purposes only and not because we believe this is common industry practice – what if an independent broker sold a single variable annuity with above average costs, below average performance, offered by an insurance company with less than stellar solvency ratings? Could the broker who recommended that product to clients for whom a variable annuity is a suitable investment satisfy his or her fiduciary obligation?

We would argue that the broker clearly could not satisfy a fiduciary duty under these admittedly extreme circumstances. The question then becomes where to draw the line. For a fiduciary duty to offer meaningful new protection to investors, the Commission will need to set some standards to ensure that brokers selling a limited range of products can act in the best interests of the customer. Just as the Commission and FINRA have interpreted that satisfaction of the suitability standard requires that the investment be suitable for someone, satisfaction of the fiduciary duty must require that the investment be in the best interests of someone. And brokerage firms should have some obligation, in developing the menu of products that their brokers can sell, to ensure that those brokers will be reasonably able to act in the best interests of their customers when recommending those products.

- *Advisers Act Section 206(3) and 206(4) Not Applicable to Brokers*

In drafting Section 913 of the Dodd-Frank Act, Congress sought to ensure that the existing Advisers Act rules governing principal trades would not apply to broker-dealers. Without apparently giving too much thought to the broader consequences, Congress chose to achieve this by specifying that the standard for brokers and advisers must be the same, and that the standard for advisers must be “no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities.” Having closely observed the legislative proceedings, we have no doubt that the intent in omitting any reference to 206(3) was to avoid applying Advisers Act restrictions on principal trading to brokers. It is less clear what the intent was in omitting any reference to 206(4), which is the source of a number of Advisers Act rules in such areas as advertisements, solicitation, custody, pay to play, and compliance. Regardless of congressional intent, however, in a release that specifically seeks comment on the need for "harmonization" beyond the fiduciary duty, it is clearly inappropriate for the Commission to fail even to consider whether any of the rules under 206(4) should be applied to broker-dealers.

Moreover, we are deeply disappointed that the RFI suggests, with little or no discussion of whether this is an appropriate approach, that brokers' principal trades would be treated like any other conflict under a harmonized fiduciary standard. For years, we have tolerated and even supported extension of the interim rule regarding principal trading in fee-based accounts, despite our concerns about that regulatory approach, in reliance on Commission assurances that it would address the issue as part of a fiduciary rule.[23] As recently as the Section 913 Study, the Commission staff recommended that the Commission "address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading." And although the Commission has provided few details, it has acknowledged when extending the temporary rule governing principal trading in fee-based accounts that it had found evidence of significant compliance failures among brokers relying on the temporary rule.

It is hard to see how the Commission can adequately assess its regulatory alternatives in this area without considering whether a different approach to principal trades is warranted. In considering this matter, we urge the Commission to assess whether the current approach to principal trading under Advisers Act rules should also be updated not just for brokers, but for advisers as well. As we have previously indicated, we believe the existing Advisers Act rules – which are both burdensome and not terribly effective – are in need of an overhaul.[24] In updating the rules, we have advocated that the Commission adopt an approach that focuses less on mechanical compliance with a notice-and-consent regime and more on ensuring that transactions are conducted in investors' best interests. As such, the fiduciary rulemaking would provide a logical context in which to consider such changes. Moreover, by considering revisions to the principal trading rules as part of the fiduciary rulemaking, the Commission could arrive at a workable approach that is consistent for brokers and investment advisers and provides improved protection for investors.

❖ *Continued Applicability of Existing Broker-Dealer Rules*

The RFI includes an assumption that "existing applicable law and guidance governing broker-dealers, including SRO rules and guidance, would continue to apply to broker-dealers." While this generally seems right to us, we reserve final judgment until we've had an opportunity to further evaluate whether certain such rules and guidance might need to be updated and others might be rendered obsolete if a uniform fiduciary standard is adopted.

* * *

[23] See, for example, the December 20, 2010 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Elizabeth Murphy regarding "Temporary Rule Regarding Principal Trades with Certain Advisory Clients," (File No. S7-23-07).

[24] See November 30, 2007 letter from Fund Democracy and CFA to SEC Secretary Nancy M. Morris regarding "Temporary Rule Regarding Principal Trades with Certain Advisory Clients," (File No. S7-23-07).

As the above discussion should make clear, we believe that a fiduciary standard based on the RFI assumptions would fail to deliver meaningful new protections to investors who receive investment advice from brokers. Worse, it could end up watering down protections for those who receive advice from investment advisers. We therefore urge the Commission to extensively revise its underlying assumptions before beginning the rulemaking process. As the next section of this comment letter should make clear, we believe the Commission must similarly revise its understanding of the obligations that would flow from a robust fiduciary standard for investment advice.

The RFI Discussion of a Fiduciary Standard Lacks Key Elements of an Effective Standard

If the Commission chooses to move forward with rulemaking under Section 913's grant of authority, it will face the challenging task of reconciling the statute's seemingly contradictory dictates: to develop a standard that is the same for brokers and advisers and no less stringent than the existing Advisers Act standard but that also accepts a series of common broker-dealer practices (sales-based compensation, selling proprietary products or a limited range of products, proprietary trading) that could be construed as demanding a fiduciary standard that is weaker than the existing Advisers Act standard. As discussed above, we believe this is possible, but only if the Commission adopts a very different set of assumptions and understanding of fiduciary duty than is reflected in this RFI.

One thing that is unambiguous in the Section 913 language, however, is the fundamental nature of the fiduciary standard the Commission is authorized to adopt, which "shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." This focus on "best interest of the customer" as the key, defining element of the fiduciary standard is consistent also with the staff discussion of the nature of the Advisers Act fiduciary duty in the Section 913 study. The study describes the chief difference between the advisers' fiduciary duty and the conduct standard for brokers this way:

> The Commission has stated that the fiduciary duty of investment advisers includes a duty of loyalty and a duty of care (encompassing, among other things, a duty of suitability), with the duty of loyalty requiring investment advisers ***to act in the best interests of clients*** and to avoid or disclose conflicts. The standard of conduct for broker-dealers has been characterized as primarily to deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade... [25] (Emphasis added.)

Thus, inherent in the Section 913 study's recommendation that the Commission adopt a fiduciary standard that incorporates both a duty of loyalty and a duty of care is the assumption that such a standard would impose a best interest obligation on advisers and brokers alike.

[25] The study goes on to state that brokers are also "subject to a number of specific obligations, including a duty of suitability, as well as requirements to disclose certain conflicts. In practice, with broker-dealers, required disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship."

Unaccountably, in describing a "potential uniform fiduciary standard of care," the RFI makes no mention of the "best interest" standard that Section 913 identifies as the chief aim such a standard would be designed to achieve and that the Commission staff has previously identified as a defining difference between the current standards for brokers and advisers. As such, a fiduciary standard of care based on this description would be inconsistent with the Dodd-Frank Act mandate, would provide few if any new protections for investors who receive advice through brokers, and would water down protections for investors who receive advice from investment advisers. CFA would not support a fiduciary rule based on this inadequate formulation.

- *The Duty of Loyalty*

There is a subtle but enormously important distinction between how the Commission staff described the duty of loyalty in the Section 913 study and how the RFI describes that duty. As noted above, the 913 study specifically states that the duty of loyalty includes a requirement to act in the best interests of clients. The RFI suggests that the duty "is designed to promote advice that is in the best interest" of the client, which it suggests would be accomplished by "eliminating … material conflicts, or providing full and fair disclosure to retail customers about those conflicts of interest." This characterization seems to suggest that brokers and advisers wouldn't actually be held accountable for *acting* in the best interests of their customers as long as they followed specific practices designed to *promote* advice in the customer's best interest.

Moreover, the Commission has made crystal clear that it has no intention of requiring broker-dealers to eliminate conflicts of interest, or even to constrain those conflicts to the degree that Section 913 would permit. It has taken no steps that we are aware of to examine broker-dealer and investment adviser sales practices, conflicts of interest or compensation practices, as Section 913 requires, and has offered no suggestions for how practices that create particularly distorting conflicts of interest might be limited or banned. In each of the other areas identified in Section 913 – sale of proprietary products, sale of a limited range of products, proprietary trading – the RFI suggests that the Commission plans to adopt the least interventionist approach possible (as discussed in greater detail above). Instead, the only conflict-creating practices the RFI mentions as likely to be prohibited are certain sales contests. Since the Commission clearly doesn't intend to eliminate conflicts, that leaves disclosure as the only meaningful new requirement it is prepared to impose as part of a uniform duty of loyalty.

Our point is not to suggest that the Commission should seek to eliminate all conflicts of interest, which would effectively eliminate broker's ability to receive transaction-based compensation. On the other hand, a fiduciary duty of loyalty that relies on disclosure alone would be an empty gesture at best. Indeed, an approach that relies on disclosure alone could leave investors worse off. There is compelling research that seems to demonstrate that those who disclose conflicts of interest may be more willing to take advantage of their clients' trust, feeling that the client has been given fair warning, and that those who receive such disclosures may be more, rather than less, likely to rely on conflicted advice.[26] While we believe this

[26] See, for example, Cain, Daylian M.; Loewenstein, George; and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," *Journal of Legal Studies,* vol. 34 (January 2005). Also, Rotblut, Charles and Ariely, Dan, "Dishonesty, Choices and Investing," *Financial Planning*.

represents just one side of the question, and that there are additional benefits to conflict disclosure when combined with a best interest standard,[27] the Commission's own financial literacy study casts doubt on the likely effectiveness of conflict disclosure alone to protect investors from recommendations that fail to put their interests first.

The primary mechanism that the Commission appears to anticipate using to provide that disclosure is a general relationship guide to be presented at the outset of the engagement. CFA strongly supports development of a uniform, pre-engagement disclosure document for all securities professionals.[28] Well-designed, uniform up-front disclosures covering the topics the Commission identifies as likely to be included in such a document should significantly enhance the ability of investors to make an informed choice among different types of financial professionals, particularly if those financial professionals are not permitted to mischaracterize themselves as "advisers" when they do not meet the fiduciary standard appropriate to an adviser. As such, a general relationship guide is an essential component of an effective system of conflicts disclosure.

We have two concerns with the RFI's proposed approach to conflict disclosure, however. First, while a general relationship guide is necessary, it is just one component of a more comprehensive approach to conflicts disclosure. The RFI also assumes that "oral or written disclosure" will also be required "at the time personalized advice is provided" covering "any new material conflicts or any material change of an existing conflict." Our concern with this approach is that it may not adequately convey the nature and extent of conflicts associated with a particular recommendation. Therefore, as part of its consideration of a uniform fiduciary standard, the Commission should revive and revise its earlier proposal to require pre-sale disclosures, including information about costs and conflicts.[29] This is particularly important in light of the significant conflicts that pervade the broker-dealer business model.

Second, the Commission suggests that the general relationship guide developed as part of a fiduciary rulemaking would resemble the ADV Form that is the basis for investment adviser disclosures. In our experience, however, the ADV Form does not always do as good a job as it could of conveying key information to investors. Disclosures of disciplinary records of large firms, for example, tend to devolve into a meaningless mass of data that the typical investor would find it difficult if not impossible to evaluate. Given the conflicts that pervade the broker-dealer business model, a similar problem could develop with conflict disclosures in a general relationship guide, undermining their effectiveness in promoting an informed choice by investors. As it seeks to develop a general relationship guide for brokers, we urge the Commission to revisit the ADV Form as well. In doing so, it should consider whether it would be possible to develop a more user-friendly version of this general relationship guide for use by brokers and advisers alike.

[27] One of the benefits of conflict disclosure is the potential of well-designed disclosures to discourage practices that entail significant conflicts of interest.
[28] In an ideal world, all financial professionals, including insurance agents, would be required to provide comparable pre-engagement disclosures.
[29] While the original Commission proposal would have applied only to mutual funds, such point-of-recommendation disclosures should instead be required for all types of investment products and services.

But even if the approach to conflict disclosure is dramatically improved, it will not fully satisfy the duty of loyalty of a true fiduciary standard. Instead, the starting point for a fiduciary standard's duty of loyalty must be a broad, enforceable, principles-based statement of the broker or adviser's obligation to act in the best interests of the customer without regard to his or her own financial interests. In keeping with this obligation, the broker or adviser should be required to document their basis for believing a particular recommendation is in the best interest of the customer. In addition, with respect to conflicts of interest, the Commission should both take steps to minimize potential conflicts, as discussed above, and require brokers and advisers alike to appropriately manage any such conflicts, making clear that management of conflicts is a supplement to, not substitute for, the best interest standard. If effectively enforced, such an approach should result in significantly enhanced protections for investors who receive investment advice through brokers without eliminating their choice of compensation methods or their access to transaction-specific advice.

❖ *The Duty of Care*

If the duty of loyalty is designed to protect against the risk that the fiduciary will take advantage of those who are relying on his or her advice, the duty of care is designed to protect against the faulty performance of the fiduciaries' responsibilities. As Tamar Frankel explains in her book, *Fiduciary Law*, the duty of care requires fiduciaries to perform their services well, "with prudence, attention, and proficiency."[30] In describing the key components likely to be included as part of a duty of care, the RFI includes suitability, product-specific requirements, best execution, and fair and reasonable compensation, all of which are appropriate and all of which currently apply to broker-dealers. We believe, however, that the Commission should expand on this approach in keeping with the recommendations of the Section 913 study and in order to support a fiduciary obligation based on best interest rather than mere suitability.

In the Section 913 study, the staff notes that an adviser's duty of care includes an obligation to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information." And the staff recommends that the Commission develop minimum professional standards under a duty of care "regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice to retail customers." It further suggests that the Commission could "articulate and harmonize any such standards, by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty of care currently applicable to broker-dealers (e.g., suitability (including product-specific suitability), best execution, and fair pricing and compensation requirements) under Commission and SRO rules."

In discussing this approach, the staff notes that an adviser's suitability obligation has been interpreted to include an obligation to determine the suitability of its advice, not just for the client generally, but in the context of the client's overall portfolio. This would be an example of an area where the existing guidance for brokers may need to be expanded upon to bring it into line with a fiduciary standard. Similarly, the know-your-customer obligation of brokers may need to be revised to reflect the additional information gathering needed, if any, to make a

[30] Frankel, Tamar, *Fiduciary Law*, Oxford University Press, New York (2011).

recommendation designed to serve the best interests of the customer, rather than one that is merely suitable. Also, further clarity may be needed regarding what steps, beyond mere disclosure, brokers must take to appropriately manage conflicts of interest. This will be particularly important if the Commission continues to neglect its responsibility to examine compensation practices and adopt limits or bans on practices that create particularly troubling conflicts of interest.

In developing rules and guidance in this area, the Commission should seek to preserve the flexible nature of the fiduciary duty. One way to achieve that, as the 913 study notes, is by making clear that any such standards represent minimum professional standards. Another means of achieving that goal is by outlining clear principles to govern such determinations rather than prescriptive rules that can be satisfied with check-the-box behavior.

- *Applicability of Prior Advisers Act Guidance and Precedent*

Given that our understanding of the Advisers Act fiduciary duty exists almost exclusively in the form of staff guidance and legal precedent, we do not believe it would be possible to adopt a fiduciary standard that is no less stringent than the existing Advisers Act standard without incorporating that guidance. Nor would it be possible, in our view, to meet the requirement to adopt a standard that is the same for brokers and advisers (an often overlooked requirement of the Dodd-Frank Act) if advisers continued to be subject to that guidance but brokers were not.

Furthermore, industry concerns in this regard strike us as exaggerated. When SIFMA wrote to the Commission describing a proposed framework for rulemaking, it identified four examples of guidance or precedent that SIFMA said would require the elimination of conflicts and would thus be incompatible with the broker-dealer business model. But a closer look at each of those examples showed that each was consistent with the eliminate-or-disclose approach to conflicts that SIFMA has said elsewhere that it supports, as we discussed in our group letter responding to the proposed SIFMA framework. Moreover, because the fiduciary duty is a facts-and-circumstances-based standard, there is no reason to believe that it will be applied rigidly to different business models. To the degree that the Commission offers additional guidance regarding how the fiduciary standard should apply to brokers, the existence of such guidance should minimize the concern that Advisers Act requirements will be applied to brokers in unintended ways.

We therefore strongly support an approach that applies existing legal precedent and guidance to brokers. The burden of proof should be on those who oppose application of Advisers Act legal precedent and guidance to provide specific examples that would directly conflict with the proposed SEC rulemaking approach (as strengthened along the lines recommended in this letter). Rather than abandoning the proposed approach of applying existing precedent and guidance, the staff should update guidance to clarify any points of conflict. Under such an approach, the Commission can comply with the requirement to adopt a rule that is as stringent as the existing standard, is the same for brokers and advisers, and that accommodates pro-investor aspects of the transaction-based broker-dealer business model.

Analyzing Alternative Regulatory Approaches

The RFI outlines a number of possible regulatory alternatives, in addition to a uniform fiduciary standard, that the Commission could adopt. A key purpose of the economic analysis should be to identify which approach would best serve the public interest and promote the protection of investors. Before attempting that analysis, it is important to establish a clear understanding of the problem rulemaking is intended to solve.

❖ *What is the Problem?*

A regulatory loophole allows brokers to hold themselves out as financial advisers and offer extensive investment advice without being subject to the fiduciary duty that is the appropriate standard for advisory services.

❖ *Does This Problem Warrant a Regulatory Solution?*

Two arguments are used to refute the claim that this regulatory disparity actually constitutes a problem in need of a regulatory solution. The first is that the difference in standards for brokers and advisers is unimportant because investors are able to choose whether they prefer to work with an adviser, who is subject to a fiduciary duty to act in their best interests, or a broker, who is not. The second reason the difference in regulatory standards is sometimes dismissed as unimportant is that there is no evidence that investors are harmed as a result. Thus, even before it analyzes which of various alternative regulatory approaches is most appropriate, the Commission will need to evaluate these arguments against further regulation.

o *What is the Effect on Competition?*

Toward that end, a useful exercise is to think about the effect of the existing regulatory inconsistency on competition, one of the key factors the Commission is required to weigh in assessing possible regulatory approaches. The current regulatory approach distorts competition in two fundamental ways:

- Allowing brokers to hold themselves out as advisers without having to meet the regulatory standards appropriate to that role distorts the competition for clients among different classes of financial professional.

- Allowing brokers to offer recommendations based on their own financial incentives rather than the best interest of their customers distorts competition in the market for investment products.

The first point is fairly straightforward. Legally, brokers are salespeople, in the business of effecting transactions in securities on behalf of their customers and providing only that investment advice that is “solely incidental” to their sales function. In reality, as discussed further above, the Commission has allowed brokers to rebrand themselves as advisers – adopting titles such as financial advisor or financial consultant, offering advisory services such as retirement planning or investment planning, and marketing their services based primarily on the advice offered – all while continuing to regulate them as salespeople. As a result, brokers are able to compete for clients who are seeking advisory services without having to meet the Advisers Act requirements with which all other investment advisers have to comply, including enhanced disclosure requirements and a fiduciary duty to act in the best interests of their customers. As discussed further below, extensive evidence has shown that investors who are seeking investment advice do not distinguish between brokers and advisers, do not understand that brokers are subject to a weaker standard of conduct than advisers, and thus do not make an informed choice when choosing between the services of a broker or an investment adviser. Any regulatory solution to the problem should seek to restore fair competition to the market for investment advice.

The freedom of brokers to make recommendations, within the constraints of the suitability standard, that best serve their own financial interests rather than the interests of their customers, also undermines competition in the market for investment products. This is a market where investments compete to be sold, not bought. Without the distortion created by brokers' financial incentives, mutual funds and annuities and other investment products would have to compete on such factors as lower costs, better performance, better customer services, etc. While those factors are not irrelevant in the broker-sold market, investment products that cannot compete on quality can still compete by offering brokers financial incentives to favor their product over alternatives that would arguably be better for the customer. Such incentives make take the form of revenue sharing payments, for example, or a higher sales commission.

In other words, this is a market characterized by unhealthy reverse competition that disadvantages both investors and those investment products that would thrive in a merit-based market. While it is impossible to measure the total economic impact of this market distortion, there is evidence that it is significant (as discussed further below). The Commission should seek to adopt a regulatory approach that better aligns the interests of brokers and their customers, thus promoting market competition among investment products on terms that are beneficial to investors and to providers of high quality investment products.

- *Can Investors Make an Informed Choice?*

Extensive evidence has already been submitted to the Commission, and uncovered through the Commission's own research, showing conclusively that, under current market conditions, a large majority of investors are unable to make an informed choice regarding whether to receive investment advice from a broker or an investment adviser. The following is just a brief summary of information that should be included in the Commission's evaluation of this issue, which is fundamental to the question of whether a regulatory solution is needed.

In 2005, the SEC commissioned Siegle & Gale, LLC and Gelb Consulting Group, Inc. to conduct focus group testing "to understand how investors differentiate the roles, legal obligations, and compensation among … brokers, financial advisors/financial consultants, investment advisers, and financial planners" and "to provide feedback regarding a proposed disclosure statement developed by the SEC." That study found that investors:

- were generally "unclear about the distinctions" among the various titles;

- were generally unfamiliar with the term investment adviser; and

- assumed that financial advisers and financial consultants (titles commonly used by brokers) provided “a broader scope of long-term planning advice” than brokers.

Study participants also provided feedback on a proposed disclosure intended to alert investors that there may be differences between brokerage accounts and advisory accounts. In general, according to the report on focus group findings, “investors found 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.”

Unable to arrive at an approach to disclosure that was likely to be effective, and recognizing “that any future regulatory reform would have to be based on a clearer understanding of the industry’s complexities,” the SEC commissioned the RAND Corporation to conduct a study that could provide the basis for future rulemaking. RAND was charged with examining “investment advisers’ and broker-dealers’ practices in marketing and providing financial products and services to individual investors” and evaluating “investors’ understanding of the differences between investment advisers’ and broker-dealers’ financial products and services, duties, and obligations.” Among the wide-ranging study’s key findings:

- the once-clear functional distinctions between brokers and investment advisers had become blurred;

- investors found it difficult to distinguish between brokers and investment advisers and tended to view financial advisors and financial consultants “as being more similar to investment advisers than to brokers in terms of services and duties;”

- even when plain English explanations were provided, focus-group participants struggled to understand the differences between a fiduciary duty and suitability standard and “expressed doubt that the standards differ in practice;” and

- they expected brokers and advisers alike to act in the investor’s best interest.

While some attribute investors’ lack of understanding of these key concepts to their failure to make good use of the disclosures provided to them, this explanation is undercut by the RAND study findings that investors struggled to understand differences in the standard of care even after receiving a plain English explanation and that investors were typically unable to tell whether their own financial professional was a broker or an adviser even after reading brief fact sheets explaining the differences. In other words, the “confusion” that investors expressed regarding issues that are central to an informed choice among advisers was not dispelled through disclosure or education, further evidence that a more interventionist regulatory solution is required. More recently, the Commission conducted a financial literacy study that cast further doubt on the likely effectiveness of disclosure in eliminating investor confusion and enabling an informed choice among financial services providers.

Both before and after the RAND study, a number of third-party surveys have been conducted that reached similar conclusions. In 2010, for example, CFA joined with AARP, the North American Securities Administrators Association (NASAA), the Certified Financial Planner Board of Standards, Inc. (CFP Board), the Investment Adviser Association (IAA), the Financial Planning Association (FPA), and the National Association of Personal Financial Advisors (NAPFA) to commission a survey covering some of these same issues. The telephone survey conducted by Opinion Research Corporation found that:

- a majority of investors believed that investment advice was either the primary service offered by brokers (34 percent) or that "advice and transactions were equally important services offered by brokers" (27 percent);

- a large majority of investors mistakenly believe that stockbrokers are held to a fiduciary standard (66 percent) and the percentage of investors who incorrectly believe a fiduciary duty applies increases (to 76 percent) when brokers adopt the title "financial advisor;" and

- an overwhelming majority (91 percent) believe that brokers and advisers who "provide the same kind of investment advisory services" should have to follow the same investor protection rules.

Not a single study, to our knowledge, has provided contrary evidence that investors clearly understand the information necessary to make an informed choice among financial professionals.

In adopting rules, the best approach for the Commission to take would be to eliminate the regulatory inconsistency that makes an informed choice necessary. This is the same conclusion the staff reached in the 913 study, which stated: "Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations."

- *Are Investors Being Harmed?*

Some have suggested that it is not enough to show that investors cannot make an informed choice and that, to justify further regulation, the Commission must also show that investors are being harmed by the advice they receive from brokers under the existing standard of care. As a matter of principle, we disagree. The burden of proof ought to be on those who argue to maintain the regulatory loophole that allows brokers to offer non-fiduciary advice, not on those seeking to close it. However, while we agree with the SIFMA spokesman who said that the benefits of adopting a fiduciary duty for brokers are "self-evident," the sad reality is that some evidence of harm will likely be necessary to fend off political interference or a possible legal challenge. Moreover, we believe the Commission is likely to adopt a stronger regulatory approach if it acknowledges the harm to investors under the existing system and designs a rule to reduce or eliminate that harm.

The challenge the Commission faces is to identify the harm that investors suffer as a result of investment advice that satisfies the suitability standard for brokers but would not pass muster under a fiduciary duty. While it is impossible to quantify the full scope of that harm, even in approximate terms, there is strong evidence that investors are being systematically harmed under the current regulatory approach.

One place to look for evidence of the kind of harm investors suffer when they receive “advice” under a suitability standard is in the sale of index funds. Minimizing costs is important in all fund classes, but there is simply no justification for paying high costs in a fund that is designed simply to match the performance of an index. If you look at data regarding S&P 500 index funds, two things are immediately apparently. The large majority of investor assets in funds purchased outside retirement plans are held in a handful of very low-cost, direct-marketed funds managed by Vanguard ($139.593 billion), Fidelity ($58.497 billion), T. Rowe Price ($17.699 billion), and Schwab ($15.446 billion).[31] No single broker sold fund comes close to matching these funds for level of assets under management, and even on an aggregated basis S&P 500 index funds sold by brokers to investors outside retirement plans appear to have far fewer assets under management.

One possible interpretation of the data is that brokers steer away from plain vanilla index funds because they cannot justify their compensation recommending a product that investors could easily purchase directly without much investment sophistication. To sell the value of their “advice,” they must purport to offer superior investment selection. In some cases, that may entail sale of actively managed funds that closely match the performance of the index, but with higher management expenses. Under such an approach, investors receive index-like returns but with above-index prices. In other cases, brokers may recommend funds with more exotic investment strategies. This too can be costly for investors both in terms of fees and in terms of investment risk. After all, year after year the bulk of actively managed funds fail to match the performance of the index. This is not to suggest that there is never a reason to recommend a fund other than an index fund, but that brokers may have reasons for avoiding recommending index funds that have nothing to do with the best interests of their customer.

When brokers do sell S&P 500 index funds outside retirement plans, those funds appear to carry higher administrative costs than direct-marketed funds, even after the cost of compensating the broker is excluded. In making this analysis, we have erred on the side of understating such costs by subtracting all 12b-1 fees from the expense ratio.[32] According to data provided by Morningstar, net expense ratios among the largest direct-marketed funds range from a low of 0.06 percent for the Fidelity Spartan 500 Index Advantage fund to a high of 0.29 percent for the T. Rowe Price Equity Index 500 Fund. While a few no load funds on the Morningstar list have net expense ratios as high as 0.50 or 0.60 percent, most are significantly lower, as one would expect in a competitive market where costs are directly related to performance.

A number of broker-sold funds also have competitive administrative fees, once the broker’s compensation is subtracted. But others do not. In these cases, the “benefit” the investor

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[31] This data was supplied by Morningstar, which provided a list of S&P 500 index funds ranked by assets under management and excluding share classes sold through retirement plans or to non-retail investors.
[32] We use the maximum possible 12b-1 fee in making this calculation, again using data supplied by Morningstar.

received from investing through a broker is advice to put their money into an index funds with expenses several times higher than the best available funds. The following are a few examples taken from the Morningstar data:

- Investors in the Wells Fargo Advantage Index A pay a maximum front load of 5.75 percent for an S&P 500 index fund with a current net expense ratio of 0.56 percent (0.68 gross). That is roughly twice as high as the expense ratio of the highest cost of the large direct-marketed funds and ten times the expense ratio of the lowest-cost fund. Investors have over $400 million invested in this share class of the fund.[33]

- Investors hold nearly $600 million in A shares of the J.P. Morgan Equity Index Fund. This fund charges a maximum front load of 5.25 percent for a fund with a net expense ratio of 0.45 percent (including .25 percent in 12b-1 fees) and a gross expense ratio of 0.94 percent.

- A total of about $739 million is invested in a series of State Farm S&P 500 index funds, including two A share funds and two B share funds. The bulk of that money (about $564 million) is invested in the A shares, which have maximum front loads of 3.0 and 5.0 percent and net expense ratios of .77 percent.[34]

- An even more extreme example is offered by the Rydex S&P 500 Fund. Investors have approximately $349 million invested in the largest share class of this fund, which has a net expense ratio of 1.5 percent (including 12b-1 fees of 0.25 percent). That is roughly 20 times the expense ratio on the Fidelity fund and 10 times the expense ratio on the Vanguard fund.

While some may see good news, that the level of investor assets in these funds is relatively small, that doesn't change the fact that, in each of the above examples, investors are compensating brokers for advice to invest in an index fund with excessively high costs. As discussed above, the excess costs charged by these funds reflect a market in which broker-sold funds compete on terms other than cost and quality, to the detriment of investors. If this is true with regard to S&P 500 index funds, where the disadvantage to investors is transparent, how much more likely is it to be the case in the sale of other investment products, including the funds brokers recommend instead of index funds to demonstrate their investment picking prowess? By introducing a best interest standard for brokers, a well-designed and well-implemented fiduciary standard would change the terms of competition to the benefit of both investors and high quality investment products.

The potential to bring competitive pressures to bear to reduce excess costs is a major benefit of strong, well-enforced fiduciary standard, but excess costs are not the only concern associated with advice delivered under a suitability standard. Recent ratings of variable annuities

[33] Some of these investors may have paid lower than the maximum front load, because of breakpoints for example, but we believe the basic point still holds. These investors are paying a premium for questionable advice.
[34] Far less money is held in the B shares, which have maximum deferred loads of 3.0 and 5.0 percent and net expense ratios of 1.17 (including a 0.65 percent 12b-1 fee) and 1.47 percent (including a 0.95 percent 12b-1 fee). This may reflect that expenses of that magnitude are difficult to justify even under a suitability standard.

by Weiss Ratings help to illustrate how other factors can be incorporated in recommendations based on a best interest standard.[35] While cost is one factor Weiss incorporates into its ratings, it also includes the availability of a wide selection of mutual fund subaccounts with good performance and the financial strength of the insurance company issuing the annuity. In explaining the basis for arriving at its recently issued 10 best list, Weiss explained that "mutual fund subaccount performance played an important role in the selection process. After all, a variable annuity can have low costs and a strong Financial Strength Rating, while at the same time offering only mediocre fund performance." Lack of fund choice and high surrender fees were clearly also major factors in determining which annuities ended up on Weiss's 10 worst list.

A look at the annuities on the 10 worst list raises the question of whether these funds could even exist in a truly competitive market. For example, the list includes two versions of the Polaris Preferred Solution annuity, offered by SunAmerica. Both of the versions on Weiss's list include just one fund option, which Weiss describes as "weak," and both charge high surrender fees, 9 percent decreasing over 9 years for the Bonus Fund and 8 percent over 4 years for the L shares. A separate site, Annuity Digest, lists Polaris Preferred Solution as offering a choice of 50 funds (possibly for a different share class), with maximum total expenses of nearly 3 percent, including a maximum mortality and expense risk charge (M&E fee) of 1.15 percent.[36] According to Annuity Digest, the annuity also imposes an 8 percent surrender charge decreasing over 8 years and a maximum commission of 7.5 percent. Here again, the hefty commission may explain the existence of a fund with M&E charges many times higher than other available funds. (Annuity Digest lists a number of funds with M&E charges in the 0.2 to 0.4 range and a number of which charge no commissions and no surrender fees.)

This is just a sampling of evidence demonstrating that investors suffer significant harm – in the form of increased costs, poorer performance, and greater risks – when they receive investment advice from brokers under a suitability standard. In addition to the direct harm to specific investors, the ability of brokers to make recommendations based on their own financial incentives is a major factor undermining competitive pressures that might otherwise reduce costs and reward quality. If brokers were subject to a strong, well-enforced fiduciary duty, one that includes an obligation to act in the best interests of their customers without regard to their own financial interests, the benefits to investors would be considerable, particularly when you factor in the beneficial effects of competition and the compounding effect of paying excess costs over the life of a long-term investment.

- *Are Investors Capable of Independently Evaluating the Recommendations They Receive?*

A third factor drives the need for a regulatory response. Investors are highly dependent on the investment advice they receive from brokers and advisers alike, with most exercising little or no independent judgment in evaluating recommended investments. When CFA examined investors' mutual fund purchase practices, for example, we found that a majority of investors

[35] See Weiss Ratings Best and Worst Variable Annuities, available here: http://weissratings.com/ratings/best-and-worst-variable-annuities.aspx.
[36] See Annuity Digest profile of the SunAmerica Polaris Preferred Solution annuity here: http://www.annuitydigest.com/sunamerica/variable-annuity/sun-america-polaris-preferred-solution.

who purchased funds through a financial professional reported either relying totally on that professional's recommendation without doing any independent evaluation of the fund (28 percent) or relying a great deal on the professional's recommendation but reviewing some written material about the fund before the purchase (36 percent).[37] Other research, including the SEC's recent financial literacy study, has found that most investors lack even rudimentary financial knowledge necessary to make sound investment decisions.[38] As the Commission staff noted in the 913 study, investors' lack of understanding of the basic differences between brokers and advisers is "compounded by the fact that retail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."

For all these reasons -- because investors are unable to make an informed choice among financial professionals, rely heavily on the recommendations they receive, lack the ability to independently evaluate their investment options, and are systematically harmed by "advice" offered under a suitability standard – the unavoidable conclusion, in our view, is that further regulatory action is needed to address this problem.

- *What is the Best Regulatory Approach?*

The RFI requests comments on a number of alternative regulatory approaches. In evaluating its various options, the Commission must ask itself not, as the RFI does, whether it will eliminate investor confusion but rather whether the potential regulatory approach will improve protections for investors seeking investment advice and do so in a reasonably cost-effective manner that retains investor choice of beneficial products, services, and compensation methods. The list of possible regulatory alternatives includes several that are inadequate and at least one that, while it may (or may not) have other merits, is not responsive to the problem that has been identified: investors being harmed by bad recommendations delivered by brokers claiming to be advisers but exempt from the fiduciary duty that applies to all other investment advisers. It also fails to include at least one potential regulatory approach that is directly relevant to the problem at hand: narrowing the broker-dealer exclusion from the Investment Advisers Act to more closely reflect congressional intent and the clear meaning of the statutory language. We discuss each of these options below.

  - *Pre-Engagement Disclosure*

CFA has long advocated and strongly supports adoption of uniform pre-engagement disclosure requirements for brokers and investment advisers. We believe such disclosures are essential to any effort to improve investors' ability to make an informed choice among different types of financial professionals. In our view, such a requirement should be adopted regardless of whether the Commission also imposes other aspects of a fiduciary duty on broker-dealers. The

[37] Roper, Barbara and Brobeck, Stephen, *Mutual Fund Purchase Practices: An Analysis of Survey Results*, June 2006.

[38] See, for example, Chater, Nick; Huck, Steffen; Inderst, Roman; and Goethe, Johann Wolfgang, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective,* November 2010. (Coordinated by Decision Technology Ltd with participation by Online Interactive Research Ltd.) Also, Lusardi, Annamaria and van Rooij, Maarten, *Financial Literacy: Evidence and Implications for Consumer Education*, November 2009.

goal of any such disclosures should be to provide a straightforward, plain English explanation of the key factors that are relevant to a selection of investment professional: what services do you provide, what and how do I pay, how are you compensated, what is your legal obligation to me, what are your conflicts of interest or other limitations on your services, what is your professional background, and are there any blemishes on your disciplinary record.

Prior to developing such a document, the Commission should evaluate the effectiveness of the ADV Form. We believe such an evaluation will lead the Commission to conclude that additional revisions are needed to make the document more user-friendly, particularly with regard to disclosure of disciplinary record. The focus should be on clearly conveying essentially messages rather than on comprehensively disclosing even the most minor of infractions. It might be possible, for example, to adopt a layered approach to disclosure in which a summary brochure was provided to customers while the lengthier ADV Form was made available online or provided directly to those seeking more detailed information. Ideally, we would like to see the Commission work with both state securities regulators and state insurance regulators to develop a uniform document that could be used for all types of financial professionals. But, short of that, a uniform document for advisers and brokers would be a good starting point.

Despite our support for improved pre-engagement disclosure, we see no evidence that disclosure alone would be effective even in eliminating investor confusion. (By definition, it would do nothing to solve the problem of bad advice delivered under a suitability standard.) Given the weight of evidence from the Commission's own research that disclosure is likely to be ineffective, we believe the burden of proof would be on the Commission to show otherwise if it chose to adopt this approach. In examining this question, the Commission should ask whether a disclosure-based solution would be adequate to protect the most vulnerable, least sophisticated investors or whether, as we suspect, it would protect only those investors who are already best equipped to look out for their own best interests.

At the very least, a regulatory approach that seeks to rely on disclosure to better protect investors would also need to include restrictions on the use of titles and marketing practices adopted by brokers to sell themselves to the public as advisers. Even then, only the starkest of disclosures would be likely to be effective – e.g., "I am a salesperson, not an adviser. I am not required to act in your best interests. I have x, y, z conflicts of interest that may bias my recommendations, and I am legally permitted to favor my own financial interests over yours in recommending products as long as the products that I recommend are generally suitable for you. As a result, I may recommend products with higher prices and poorer performance than other alternatives that are available in the market." We doubt brokers would relish making such disclosures or that many investors would know what to do with the information.

- *Will it eliminate investor confusion?* We believe it is unlikely that improved pre-engagement disclosure will significantly reduce investor confusion unless it is accompanied by new restrictions of the use of misleading titles and marketing and stark warnings of the lack of protections for investors relying on brokers for advice.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* Such an approach, which does not raise the standard of care for brokers offering investment advice, will only protect investors from the harm that results from bad advice delivered under a suitability standard if it is effective in warning investors away from relying on brokers for advice. We are frankly skeptical that the Commission would adopt an approach sufficiently stark in its warnings to achieve this result, or that brokers would view it as preferable to a uniform fiduciary standard.

- *Will it promote fair competition on terms that are beneficial to investors?* Improved disclosures could help to promote fair competition among financial professionals offering investment advice. But it would only meaningfully improve competition for these services, in our view, if it were accompanied by new restrictions on use of titles and marketing practices designed to promote brokers as advisers. Meanwhile, because brokers would continue to be compensated in ways that create distorting conflicts of interest and would remain free to make recommendations on terms that favor their own financial interests over those of their customers, it would do nothing to promote healthy competition in the market for financial products.

Thus, while we encourage the Commission to adopt a uniform pre-engagement disclosure requirement for brokers and advisers, we do not believe disclosure alone offers a sufficient solution to the problem of investor confusion, let alone to the more serious problem of investor harm. Instead, this approach should be adopted as part of a broader fiduciary rule.

- o *Adopt a Uniform Fiduciary Standard of Care without Extending Existing Advisers Act Guidance or Precedent to Brokers*

Given that the role of staff guidance and legal precedent in clarifying the scope of and obligations associated with the Advisers Act fiduciary duty, we do not see how the Commission can meet the Dodd-Frank mandate to adopt a fiduciary duty that is both no less stringent than the existing standard and the same for brokers and advisers adopting this approach. Moreover, (as discussed above) we believe the burden of proof should be on those arguing that existing guidance and precedent would not permit brokers to offer transaction-specific advice compensated through commissions or other sales-based payments. If examples are uncovered that would inhibit the ability of brokers to offer such services, rather than adopting a sweeping exemption for brokers from all existing guidance and legal precedent, the Commission should take additional steps to clarify the applicability (or non-applicability) of such specific examples of guidance or legal precedent to brokers.

- *Will it eliminate investor confusion?* Because it would impose a higher standard of care on brokers when they provide investment advice, such an approach, if properly implemented, could address investor confusion by mitigating the primary source of that confusion (i.e., the inconsistent regulatory standards that apply to investment advice offered by brokers and advisers). In other words, it becomes significantly less important if investors are confused about the differences between brokers and advisers if they receive appropriate protections when dealing with each. However, to achieve this goal, the Commission would have to write guidance regarding application of the fiduciary duty to the broker-dealer business model that would provide protections for investors who receive investment advice through brokers that are no weaker than Advisers Act protections.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* As long as the Commission took steps to ensure that the fiduciary standard for brokers is not watered down, such an approach could significantly reduce the harm to investors that results from bad advice delivered under a suitability standard. We would be more willing to consider this approach as a viable option, however, if the Commission did not show such a propensity to water down the standard both through its past actions and in this RFI (as discussed above).

- *Will it promote fair competition on terms that are beneficial to investors?* Similarly, by requiring brokers to act in the best interests of their customers, such an approach could help to promote fair competition both in the market for investment advice and in the market for investment products. But any watering down of the standard would undermine that potential benefit.

Given the Commission's past willingness to elevate concerns over the continued viability of the broker-dealer business model over concerns about investor protection, as well as the existence of glaring weaknesses in the assumptions underlying this RFI, we are frankly skeptical that the Commission would, under this approach, provide fiduciary protections to investors who receive advice from brokers that are comparable to the protections afforded by the Advisers Act fiduciary standard.

- o *Adopt a Fiduciary Standard for Brokers without Changing the Advisers Act Standard*

A fundamental principle for CFA in evaluating the available options is that the price of an improved standard of care for brokers should not be a weakened standard of care for advisers. Put another way, investors should not see existing protections weakened. This approach of adopting a fiduciary duty for brokers without adopting new rules under the Advisers Act would at least have the advantage of not weakening existing protections. On the other hand, unless the Commission truly adopts a fiduciary standard of care for brokers that is equivalent to the standard for advisers, this approach could create the false impression that the problem of inconsistent standards had been eliminated when that was not the case. A fiduciary standard based on the assumptions in this RFI would not provide comparable protections.

- *Will it eliminate investor confusion?* Like the previous alternative, this approach would seek to eliminate the source of investor confusion, by eliminating the regulatory inconsistency that allows brokers to offer advice without being subject to a fiduciary duty. As noted above, that renders investor confusion less of a concern if protections for investors are truly comparable in either business model. Whether this approach achieves that goal would depend entirely on the Commission's willingness and ability to adopt a fiduciary standard for brokers that is no weaker than the existing Advisers Act standard. Nothing in this RFI leads us to believe that the Commission is prepared to adopt such a standard. As such, this approach could worsen investor confusion by implying that the difference in standards had been eliminated when that is not in fact the case.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* Adopting a broker-only fiduciary standard would only protect investors from bad advice delivered under a suitability standard if that standard includes all the key components of a robust fiduciary standard, including an explicit, enforceable obligation to act in the best interests of investors. Otherwise, such an approach risks leaving investors even more vulnerable, by implying that brokers are subject to a fiduciary duty when all that has really changed is their obligation to disclose conflicts of interest.

- *Will it promote fair competition on terms that are beneficial to investors?* Again, this approach will only promote fair competition in the market for investment advice and the market for investment products if the standard adopted is a true fiduciary standard of care that requires brokers to act in the best interest of their customers and prevents them from labeling as "advice" services that do not meet that standard.

Separating the broker-dealer fiduciary standard from parallel rulemaking under the Advisers Act increases the risk that the broker standard is a fiduciary duty in name only. On the other hand, it would protect against watering down of the Advisers Act standard. Thus, while we do not by any means view this is the best approach, we do view it as marginally preferable to parallel rulemaking under the assumptions in this RFI, which would water down existing investor protections for clients of advisers while doing little to improve protections for customers of brokers.

- o *Without Modifying the Standard of Care for Brokers, Impose New Minimum Professional Obligations on Advisers*

It is not clear to us what problem such a regulatory approach is intended to address. Is there evidence that investors are being harmed as the result of a lack of such rules? If so, the Commission should provide that evidence, so that we can evaluate whether additional rules are needed. We are not opposed in theory to additional Advisers Act rules, but we do not see how this regulatory proposal would do anything to address either investor confusion regarding the different standards that apply to brokers and advisers or the harm to investors from bad advice under a suitability standard. As such, it appears to be irrelevant to the current undertaking.

- *Will it eliminate investor confusion?* No.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* No.

- *Will it promote fair competition on terms that are beneficial to investors?* No.

There may or may not be other reasons to adopt this proposed regulatory approach, but it is certainly not a reasonable alternative to a uniform fiduciary standard for brokers and advisers.

- *Consider Models Set by Regulators in Other Countries*

Both the United Kingdom and Australia have adopted regulations imposing a best interest obligation on all those providing investment advice and imposing restrictions on the types of payments advisers can receive for their services. Regulators in both countries have looked to ban various types of compensation practices that create conflicts that cannot, in their view, be adequately addressed through disclosure. Australia appears to have gone furthest in banning "conflicted remuneration," which it defines as any "monetary or non-monetary benefit given to a licensee or representative that might influence or distort advice, by either influencing the choice of financial products being recommended or by otherwise influencing financial product advice more generally." The "conflicted remuneration" concept appears to cover traditional product commissions as well as other types of payments.

CFA has not taken the position that transaction-based compensation, in and of itself, creates a conflict that cannot be appropriately managed under a fiduciary standard. We do, however, believe that the Commission has a clear obligation to explore whether additional steps are needed to limit or ban forms of compensation that create financial incentives to act in ways that subvert the best interests of the customer. Among the areas where we believe reform is needed are 12b-1 fees and revenue sharing payments. Beyond that, we believe further consideration should be given to the question of whether investors would benefit if brokers were compensated directly for their services, rather than being compensated indirectly through commissions and other payments associated with the purchase or sale of investment products.

The current broker-dealer compensation system lacks transparency. It is difficult for investors to determine what portion of a mutual fund annual fee goes to pay for the operations of the fund, for example, and what portion goes to pay the broker for his or her services in recommending the fund and servicing the account. And some other forms of compensation are even less transparent than mutual fund fees. No wonder the RAND Study found that investors were confused about the fees they paid. This system not only diminishes the ability of investors to evaluate whether the services they receive from brokers justify the cost, it also prevents price competition from disciplining those costs. Finally, it is a fundamental contributor to the reverse competition that allows investment products to compete on terms that favor financial professionals rather than investors. Requiring brokers to charge for their services directly would increase transparency and allow for price competition while reducing incentives to make recommendations that are not in the best interests of the customer. It is a concept worth exploring.

The arguments are not all on one side, however. In theory, at least, the current system subsidizes small accounts. An investor who puts $1,000 into a mutual fund and one who invests $100,000 may pay an identical commission or 12b-1 fee on a percentage basis, but pay very different dollar amounts for essentially the same brokerage service. Discounts offered to large accounts at least partially offset this subsidization, however. And revenue sharing payments, which are sometimes identified as a means of making it more affordable for brokers to serve small accounts, may also be used for less benign purposes. Nonetheless, there is a risk that requiring brokers to be compensated directly would drive costs for small accounts up and costs for large accounts down. In weighing whether that is the case, the Commission would need to assess total costs, including the operating costs of the investments recommended. After all, a regulatory approach that increased the cost of brokerage services for small accounts, but resulted in recommendation of lower cost mutual funds and annuities, could provide a net benefit. It is instructive that some of the industry groups who make this argument have a business model – largely dependent on the sale of variable annuities – that exposes investors to some of the highest costs in the market.

At the very least, however, further study of the issue is warranted as part of a broader examination, required under Dodd-Frank, of broker-dealer and investment adviser conflicts and compensation practices. In the meantime, regulatory changes in the U.K., Australia and elsewhere can provide real world data on the benefits and repercussions of this approach. Their clear, unequivocal embrace of a best interest standard is an approach we believe the Commission should emulate. And the approach they have adopted of requiring firms to have policies and procedures in place to manage conflicts of interest could and should be incorporated into the U.S. approach. Under such an approach, firms would be required to have policies and procedures in place to identify all potential material conflicts of interest and to specify how to manage each conflict (by controlling, avoiding, or disclosing these conflict). They would have to have controls in place to ensure compliance, including a requirement that the adviser document the basis on which he or she concluded that a particular recommendation was in the best interests of the customer despite those conflicts. Such an approach could easily be adopted in place of the notice and consent approach to principal trading, for example, with improved protection for investors, in our opinion, and less burdensome procedures for firms.

- *Will it eliminate investor confusion?* To the degree that they embrace a universal best interest standard, these approaches should reduce the harmful effect of investor confusion, if not the confusion itself.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* By imposing a best interest standard and significantly reducing conflicts of interest, the approach adopted in Australia and (to a lesser extent) the U.K. should greatly reduce the risk that investors will receive bad advice that promotes the interest of the financial professional over their own. Industry has argued, however, that if you go too far in eliminating their ability to offer transaction-based compensation, you risk driving up costs to small investors or depriving those small investors of access to advice. While we believe some of these concerns are exaggerated (brokers also said they would flee the fee-based accounts business if those accounts were deemed to be advisory accounts, and that does not appear to have been the case) and self-interested (many of the brokers making them are among the worst offenders in selling high-cost, low-quality investments), we do believe the Commission should focus on eliminating, not all transaction-based compensation, but only those forms of compensation that create real distortions in market incentives. In the meantime, other countries' regulatory changes can offer the Commission a real world experiment to study in order to determine the likely impact of any such changes.

- *Will it promote fair competition on terms that are beneficial to investors?* As discussed above, we believe applying a uniform best interest standard will help to promote fair competition in the market for investment advice. And we further believe that eliminating the ability of brokers to recommend products based not on which are best for the client but on their own self-interest should reduce distortions that undermine competition in the market for investment products. Steps that further reduce conflicts of interest should just reinforce that benefit.

- *Narrow the Broker-Dealer "Solely Incidental" Exclusion from the Advisers Act*

One regulatory alternative that the Commission has omitted from its list would be to narrow the broker-dealer exclusion from the Advisers Act, in essence reversing the earlier Commission decisions (or inaction) that effectively erased the functional distinction between brokers and advisers. Under such an approach, brokers who wished to qualify for that exemption would have to both limit themselves to giving only that investment advice that is an essential component of their business of effecting transactions in securities on behalf of customers and refrain from holding themselves out as advisers either through the titles they adopt or the way the describe and market their services.

For such an approach to work, the Commission would have to adopt an approach that excepts broker-dealers from the Advisers Act only insofar as they limit themselves to giving nothing more than (solely) the investment advice that follows as a consequence of (incidental to) their primary business of effecting transactions in securities on behalf of customers. Services such as investment planning, retirement planning, and financial planning clearly entail more than solely incidental advice. Indeed, for such services, effecting transactions is solely incidental to the advice. Titles such as "financial adviser" would need to be off limits for those wishing to claim the exemption, as would marketing efforts aimed at promoting the services based on the advice offered.

Brokers who wished to promote themselves as advisers and offer more extensive advisory services would be regulated under the Advisers Act on the same terms as all other investment advisers. Contrary to the claims sometimes put forward by opponents of this approach, it would not require them to abandon commission-based compensation methods, as the experience of financial planners operating under that standard makes clear. Absent further action by the Commission to update the principal trading rules, it would require them to obtain written consent before engaging in principal trades. (As noted elsewhere, we believe the Commission should update the principal trading rules for brokers and advisers alike to improve protections for investors and reduce regulatory burdens associated with such trades.) Those brokers who wished to offer advisory services would be faced with a simple business decision: do the benefits of competing as an investment adviser outweigh the costs of being regulated under the Advisers Act? We believe many brokers would conclude that they do. But others who prefer to avoid regulation under the Advisers Act would have a clear roadmap to follow to avoid such regulation.

- *Will it eliminate investor confusion?* Yes. By restoring a clear functional distinction between brokers and advisers and prohibiting practices designed to blur that distinction, such an approach would make it far easier for investors to distinguish between brokers and advisers and choose a financial professional based on the nature of the services they desire. In addition, this approach would apply a consistent regulatory standard to all those providing investment advice, thus removing the most harmful consequence of investor confusion.

- *Will it reduce harm to investors from bad advice delivered under a suitability standard?* In part. Investors who receive recommendations from brokers who do not hold themselves out as advisers would still be at risk of bad recommendations based on a suitability standard. In that sense, this approach is less favorable to investors than one that adopts a strong fiduciary standard for all advice, including incidental advice. On the other hand, investors would be less likely to mistake those transaction recommendations for objective investment advice. And we believe many brokerage firms would conclude that the ability to compete as investment advisers would justify the costs of regulation under the Advisers Act (just as most brokers chose to continue to offer fee-based accounts once the court ruled that they were advisory accounts). If we are right, then the net benefit to investors could be substantial, since there would be no attendant risk of inconsistent standards for brokers and advisers offering investment advice and no watering down of the fiduciary duty in the process.

- *Will it promote fair competition on terms that are beneficial to investors?* In part. By regulating all those who offer investment advisory services or hold themselves out as advisers under the Advisers Act, this approach would promote fair competition in the market for advisory services. To the degree that brokers chose to continue to offer advisory services under the Advisers Act fiduciary duty, it would also help to promote pro-investor competition in the market for investment products by imposing a best interest obligation on brokers' recommendations. On the other hand, to the degree that a significant percentage of brokers continued to offer recommendations under a suitability standard and subject to substantial conflicts of interest, the benefits of improved competition in the market for investment products would be limited accordingly.

The Optimum Regulatory Approach

A broad consensus exists that personalized investment advice should be subject to a fiduciary duty regardless of whether that advice is offered by a broker-dealer or an investment adviser. As a SIFMA spokesman recently stated, the question is no longer one of whether the Commission should adopt a fiduciary duty for brokers, but how it should go about doing so. Though imperfect, Dodd-Frank Section 913 offers a framework for rulemaking that has won broad support. Properly implemented, it would significantly improve protections for investors while preserving their ability to choose among different business models and different compensation methods. To achieve that goal, however, the Commission will need to radically revise its assumptions about how such a rulemaking would be structured, as discussed in further detail above. The following section discusses how parallel rules adopted under Section 913's grant of authority would need to be crafted to achieve the three primary goals for this rulemaking: eliminating investor confusion, reducing harm to investors that results from bad advice delivered under a suitability standard, and promoting healthy competition in the markets for both investment advice and investment products.

❖ *Eliminating Investor Confusion*

The most important goal of rulemaking is not to eliminate investor confusion but to mitigate the harmful effects of that confusion by adopting a strong fiduciary standard governing investment advice regardless of the source. There are, nonetheless, good reasons to adopt a regulatory approach that also seeks to reduce investor confusion and promote their ability to make an informed choice among different types of financial services providers. A key element of the Section 913 rulemaking in this regard is development of a uniform pre-engagement disclosure document for brokers and advisers. As discussed above, we believe the Commission has generally done a good job of identifying the key issues that should be addressed in such a document. In developing a pre-engagement disclosure document, we urge the Commission:

- To adopt a format for disclosures by brokers and investment advisers that are uniform to the extent possible given differences in their basic business models. The goal should be to promote easy side-by-side comparisons of different types of financial professionals.

- Keep the disclosures brief and clear. For example, instead of requiring a listing of every blemish on the broker or adviser's disciplinary record, require a description of any significant issues (as defined by the Commission) with information on how to access more detailed information if the investor desires it. Similarly, it will be important to develop disclosures about conflict of interest that go beyond meaningless boilerplate about conflicts the broker or adviser "may" have. The goal should be to clearly convey the risks to investors resulting from those conflicts.

- Work with disclosure design experts to develop and test the documents for effectiveness in conveying the essential information and promoting investor understanding of that information. Research has shown that how disclosures are designed can have a major impact on how effective they are. The Commission should work with design experts to ensure that it maximizes the benefits of any new disclosure requirements.

The ability of such an approach to reduce investor confusion would be significantly enhanced if the Commission simultaneously took steps to prevent any broker engaged in activities that are not deemed to be "personalized investment advice" to a retail investor, and thus not covered by a fiduciary standard, from holding themselves out as an adviser or as providing advisory services. We have long held that use of titles, such as financial advisor, and marketing practices designed to encourage investors to rely on brokers as trusted advisers are inherently misleading in the absence of a fiduciary duty and should be prohibited. We strongly encourage the Commission to adopt this approach as part of a rulemaking imposing a clear fiduciary duty on all brokers' advisory activities.

❖ *Reducing Harm to Investors*

The real point of adopting a uniform fiduciary standard is not simply to reduce or eliminate investor confusion, but to reduce or eliminate the real harm that investors suffer as a result of costly and otherwise bad "advice" delivered under a suitability standard. Dodd-Frank Section 913 imposes some significant challenges for those who would use it to achieve this goal.

Specifically, it includes provisions with regard to on-going advice, sale of proprietary products and a limited range of products, principal trading, and sales-based compensation that, if implemented poorly, will result in a standard that is weaker than the existing standard under the Advisers Act. Whether the Commission is prepared to define a strong fiduciary standard and interpret these issues in a way that promotes investors' interests will determine whether it is successful in delivering meaningful new protections to those investors who receive investment advice from brokers and, thus, whether the rule is worth supporting.

- First and foremost, the Commission must include as the central component of its fiduciary standard a broad, principles-based requirement that those providing personalized investment advice to retail customers act in the best interests of the customer without regard to their own financial interest. It is not enough to impose disclosure rules in the hopes that they will promote advice that serves the client's interests, the Commission must be prepared to hold brokers and advisers accountable for the advice they offer. Specifically, the Commission must require that brokers and advisers have a reasonable basis for believing that their recommendations are in the best interest of the customer and be prepared to demonstrate the basis on which they reached that conclusion.

- The definition of personalized investment advice adopted by the Commission must be sufficiently broad to include specific advice about whether or not to invest in a particular security as well as general advice about whether investment in securities would be appropriate. Advice not to invest in securities should be included. Otherwise it would be all too easy for brokers to evade their fiduciary obligations by recommending non-securities, such as equity-indexed annuities, all while leaving the investor under the mistaken impression that they are dealing with someone who is required to act in their best interest.[39]

- As part of that definition of advice, the Commission will need to look closely at the conditions that are likely to create a reasonable expectation among investors that the broker is providing on-going advice and oversight of the account. In such cases, where brokers create a reasonable expectation of on-going account management, the Commission must impose an on-going duty of care to match that expectation. The Commission should not allow brokers to use contract language to get customers to sign away unknowingly fiduciary protections to which they would otherwise be entitled.

- In dealing with transaction-based compensation and related sales practices, the Commission should include as part of a fiduciary rule a requirement that brokers and advisers have policies and procedures in place to ensure that conflicts are identified and appropriately managed and that they do not result in advice that subverts the best interests of the customer. If, and only if, the Commission adopted such an approach for

[39] Such an approach would work better if state insurance regulators would cooperate by imposing a fiduciary duty on insurance agents who hold themselves out as financial planners or financial advisers in order to ensure that use of such titles is more than a ploy to increase their product sales.

addressing conflicts of interest generally would it be appropriate for the Commission to consider treating principal trading as it would any other conflict of interest.[40]

- As required under Section 913, the Commission should examine broker and adviser compensation practices with an eye toward identifying any potentially harmful practices that cannot be appropriately managed under a fiduciary standard. Two areas that should be addressed under the Section 913 directive to limit or ban compensation practices that the Commission deems to be "contrary to the public interest and the protection of investors" are 12b-1 fees and revenue sharing payments. But a more comprehensive review of compensation practices is also warranted

- Similarly, although Dodd-Frank makes clear that sale of proprietary products and sale of a limited range of products would not, in and of themselves, constitute a violation of the fiduciary duty, it also direct the Commission to examine sales practices and act to limit or ban those that it deems "contrary to the public interest and the protection of investors." So, for example, any practices that a brokerage firm might adopt in order to pressure advisers to sell proprietary products should be deemed contrary to the protection of investors and prohibited by the Commission as inconsistent with a fiduciary standard. The Commission could and should take a similar approach to the issue of the sale of a limited range of products. Specifically, it must be prepared to set some minimum standards, much as we do for 401(k) plan menus, below which it would not be possible for an adviser to comply with a fiduciary duty. And, just as an investment, to be deemed suitable, must be suitable for someone, an investment, to satisfy a fiduciary standard, must be reasonably likely to be in the best interest of someone.

- The Commission should avoid an approach that seeks to spell out every detail of how to comply with a fiduciary standard in prescriptive rules. The more extensive or detailed the rules, the more likely courts are to conclude that any conduct not specifically prohibited by rule is permissible under a fiduciary standard. Moreover, it simply would not be possible to spell out through rules how the fiduciary duty would apply in every circumstance. Nonetheless, the industry has a reasonable desire for clarity regarding how to conduct their business in a way that complies with the standard. To help ease the transition to a fiduciary standard and clarify its requirements, the Commission should issue guidance to accompany any rulemaking covering such issues as what is and is not personalized investment advice or what constitutes an unacceptably limited range of products with which to meet a fiduciary duty. Other areas, such as the obligations for pre-engagement disclosure, will likely require more detailed rulemaking.

❖ *Promoting Healthy Competition on Terms that are Beneficial to Investors*

One of the clear benefits of a strong fiduciary standard is its potential to promote healthy competition in the market for investment advice as well as the market for investment products. Currently, brokers are able to compete unfairly for customers seeking investment advice by holding themselves out as advisers without being regulated accordingly. By requiring brokers to

[40] We would suggest, moreover, that the Commission consider adopting a similar approach for principal trading by investment advisers.

meet the most important regulatory obligations associated with giving advice, imposing a fiduciary standard on brokers when they give investment advice to retail investors would help to restore a more level playing field in the competition for clients seeking investment advice. To best achieve this result, the Commission should adopt the approach recommended above with regard to pre-engagement disclosure and limits on holding as an adviser when providing non-fiduciary services. Imposition of a fiduciary duty would also indirectly help to promote healthy competition on terms that are favorable to investors in the market for investment products. To achieve this goal, the rule must include a clear, enforceable obligation to act in the best interest of the customer, and the Commission must be prepared to enforce that requirement.

Potential Areas for Further Regulatory Harmonization

CFA supports regulatory harmonization in areas where brokers and advisers are engaged in the same conduct under rules that provide different levels of protection to investors, as is clearly the case with regard to providing investment advice. At a minimum, regulations for brokers and advisers should not be in conflict. In such instances, we believe it is appropriate for the Commission to identify the stronger of the two regulatory approaches and adopt it uniformly, recognizing that the more prescriptive approach is not always the stronger approach. In analyzing these issues, the Commission should carefully consider whether the conduct in question and the risks to investors genuinely are the same. (Risks to investors may differ depending on whether advice is combined with product sales, for example, or where the adviser has discretionary authority.) In addition, the Commission should consider whether there is evidence that investors are being harmed under the existing regulatory approach. If there is no evidence of investor harm, there may be no need for regulatory change.

We are concerned that the suggestions for further regulatory harmonization presented in this RFI do not reflect that sort of analysis. The Commission has identified areas where regulations differ, but it has not discussed whether those differences are warranted by differences in the business models of advisers and brokers or whether investors are being harmed as a result. Also, it appears to have read through the broker-dealer rule book looking for rules to apply to advisers, but not to have made a similar investigation of whether existing Advisers Act rules beyond the fiduciary standard should also be applied to brokers. As a result, it fails to include several rules that ought to be considered as part of any broader consideration of regulatory harmonization. Among them is the fact that advisers are fiduciaries with respect to all their advisory clients. The Commission does not appear to have given any consideration to whether brokers' fiduciary duty should extend to non-retail customers. Dodd-Frank gives the Commission clear authority to extend the fiduciary protection to additional classes of investors. If the Commission is going to engage in further regulatory harmonization, it ought at least to consider whether there are additional advisory customers of brokers in need of fiduciary protection.

The Commission has also failed to consider whether any of the rules under Section 206(4) of the Advisers Act should apply to brokers. This seems like a particularly significant oversight, since elements of the Advisers Act fiduciary duty are reflected in those rules. If the Commission moves forward with rulemaking to promote further regulatory harmonization, it should at a minimum also consider whether Advisers Act rules, such as those regarding advertising, political contributions, and proxy voting, should also apply to brokers. Indeed, as part of the fiduciary rulemaking, the Commission should consider how imposition of a fiduciary duty on brokers affects their obligations in areas such as these.

To be clear, we would expect to support rules to harmonize regulation where there is evidence that the existing standards are either in conflict or provide different levels of investor protection not warranted by the different risks associated with different business models. Among those areas identified by the Commission, the one that appears to be most directly relevant to the current rulemaking is the recommendation to harmonize requirements with regard to advertisements and other communications. If one goal of a fiduciary rulemaking is to promote fair competition between brokers and advisers, then there ought to be similar limitations on how they advertise their services. The focus here should not be primarily on procedural issues, unless there is evidence that the procedures under the existing regulatory approach are failing to provide adequate protection, but on issues of content. We do not see how the Commission can consider this issue, for example, without addressing the question of testimonials.

In general, however, we do not believe the Commission has yet laid the groundwork to support rulemaking with regard to broader regulatory harmonization. The issue of regulatory harmonization has not received anything like the same degree of study or comment that the proposal on fiduciary duty has received. Nor are we aware that there is evidence of significant harm to investors in any of the areas identified for additional rulemaking that would warrant urgent attention to these issues. (The one area where there is a clear threat to investor protection – the lack of adequate resources for investment adviser oversight – is in the hands of Congress, not the Commission.) Absent evidence of harm to investors, we would urge the Commission not to allow the current rulemaking effort with regard to fiduciary duty to be further delayed while the Commission completes the additional analysis that would be needed to support further regulatory harmonization.

Analyzing the Economic Impact

We recognize the political realities that require the Commission to conduct additional economic analysis on top of the years of study it has already devoted to the question of whether brokers should be subject to a fiduciary standard when they provide investment advice to retail investors. We also recognize that, despite its limitations, this RFI represents a sincere effort to collect the kind of information that would help to inform the rulemaking process. And we appreciate the recognition in the RFI that both qualitative and quantitative factors are important in assessing the likely economic impact of any rule. That said, we have serious concerns about the approach the Commission is likely to take in assessing the economic impact of a fiduciary rule. How the Commission conducts this economic analysis will have an enormous impact on the quality of any resulting regulations.

In our view, the Commission's guidelines for economic analysis as a general matter overweight concerns about costs to industry at the expense of protections for investors. The Commission's practice in implementing those guidelines – particularly in the general solicitation rulemaking – only magnifies our concern that the process is used primarily to reduce the threat of industry legal challenge rather than to improve the quality of resulting regulations. As long as the Commission's primary concern is to produce a rule proposal that minimizes any potential impact on industry, it will not produce a rule that provides meaningful new protections for investors. As the preceding discussion should make clear, we have serious concerns that this may be the direction in which the Commission is currently headed.

Section 913 of the Dodd-Frank Act provides seemingly mixed messages on this point. On the one hand, with its provisions on ongoing advice, commission compensation, and proprietary products and limited range of products, it sends the message that the Commission should take care to preserve the ability of brokers to offer transaction-specific advice and to charge sales-based compensation. But there is a risk of reading too much into this message. While Dodd-Frank clearly intends to preserve the ability of brokers to act as brokers, it should not be read as intending to change little or nothing about the way they conduct their business. (Otherwise, what would be the point of adopting a fiduciary standard?) In developing a regulatory approach, the Commission should pay at least as close attention to two other Section 913 directives: 1) to adopt a fiduciary standard for brokers that is the same as the standard for advisers and that is as strong as the existing Advisers Act standard and 2) to take steps to limit or ban sales practices, conflicts of interest, and compensation practices that it deems to be "contrary to the public interest and the protection of investors." As these provisions make clear, the goal of the Commission should be to adopt a rule that preserves the ability of brokers to act as brokers but reforms practices that are inconsistent with a fiduciary duty and harmful to investors.

In order to achieve that goal, the Commission must produce an economic analysis that begins with a clear definition of the problem the regulation is intended to solve. As discussed above, the problem is the existence of a regulatory gap that allows brokers to call themselves advisers, offer extensive investment advice, and market themselves based on that advice all without having to meet the basic standard that differentiates advice from a sales pitch, a fiduciary duty to act in the best interests of their customers. In describing the baseline against which any regulatory proposal will be measured, the Commission should include a robust discussion of the harmful impact this regulatory gap has on investors. Specifically, the analysis should focus on the harm to investors from "advice" that satisfies a suitability standard but does not promote the best interests of the investor. Even though the Commission will be unable to exactly quantify that harm, it should be able to provide illustrative examples that help clarify the nature and extent of that harm. Investor "confusion" constitutes an important part of that analysis, not because it is the problem the regulatory proposal is intended to address, but because it illustrates that investors are not capable of protecting their own interest by making an informed choice among financial professionals or investment products.

In discussing the harm to investors under the existing regulatory system, the Commission should give careful attention to the effect on market competition, both in the market for investment advice and in the market for investment products and services. As we have discussed further above, investors are harmed indirectly as a result of the distorting effect that brokers' conflicts of interest have in a market where investment products compete to be sold rather than competing to be bought. As a result, investors do not receive the benefits they should from competition based on quality and price and too often end up paying excessive prices for inferior investment products. One of the key potential benefits of a strong fiduciary standard is its potential to restore healthy competition on terms that promote the best interests of investors. To the degree that this competition exerts pressure to bring down excess costs, it also has the potential to benefit capital formation, since any investor money that is diverted to pay excess fees is subtracted from the total amount that actually ends up invested in the capital markets.

In its analysis of the economic impact of the various available regulatory alternatives, the Commission should keep a clear focus on their potential to reduce that harm to investors. The Commission's analysis of costs should look in particular at the potential for a fiduciary standard to reduce the excessively high costs investors may pay when they receive advice from brokers who recommend suitable investments with high fees and substandard performance. In this regard, it is essential to recognize that the costs of investments must be included in any overall estimates of impact a fiduciary standard could have on the cost of the advice. Failure to include those costs would result in a distorted analysis that understates the potential benefits of a fiduciary rulemaking.

This is an ambitious undertaking. The good news for the Commission is that it has over a decade of input and comment it can look to in conducting this analysis. Ultimately, as in all regulatory undertakings, the Commission will have to decide whether to undertake rulemaking and what form those rules should take based on incomplete and imperfect data. As Fund Democracy President Mercer Bullard stated in recent congressional testimony, "regulatory action is invariably based on imperfect information, just as regulation invariably requires the exercise of reasoned judgment in the known absence of information that theoretically could improve the regulatory decision-making process. Efficient rulemaking necessarily reflects accepting the reality that decisive action is not possible if perfect information is a necessary predicate."[41] We urge the Commission not to allow itself to be intimidated by the threat of possible industry challenge to write a weak and meaningless rule that fails to address the real problem. To avoid that outcome, it will have to significantly revise the assumptions reflected in this document.

Conclusion

The discussion of fiduciary rulemaking too often starts with the wrong question: What is the justification for raising the standard of conduct for brokers when they offer investment advice? The real question ought to be: What is the justification for allowing brokers to offer investment advice without being subject to the appropriate regulatory standards? Or, put in a different way: What is the justification for having two different standards for investment advice based on legal distinctions that are incomprehensible to typical investors? The simple answer is that there is no justification for this regulatory loophole, and the Commission's continued failure to address this problem over the decades has resulted in significant harm to investors.

With the release of the Section 913 study, the Commission appeared to be on the brink of a new, pro-investor approach to this issue. That study summed up the importance of the problem when it stated: "Retail investors are relying on their financial professional to assist them with

[41] Testimony of Mercer E. Bullard, Fund Democracy Inc. President and Founder and Jessie D. Puckett, Jr. Lecturer and Associate Professor of Law at the University of Mississippi Law School, before the U.S. House of Representatives Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises, regarding, "Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators," May 23, 2013.

some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations." It is on this basis that the Commission staff concluded, rightly in our view, that "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It also is important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."

In many ways, this RFI appears to reflect a retreat from that strong position. It contains no similarly strong statement of the best interest standard that ought to underpin any fiduciary rulemaking. Instead, it seems to anticipate an approach to rulemaking that does little to change harmful broker-dealer business practices, practices that result in investors' paying excessively high costs for inferior investment products. Unless the Commission can change course, it is unlikely that this process will result in a rule that will be deserving of investor support. We urge you in the strongest possible terms to take this opportunity, at the outset of this process, to redirect your efforts toward adoption of a rule that will deliver true fiduciary protection to those investors who rely on brokers for investment advice about such crucial matters as how to save for retirement, fund a child's college education, or provide for their family in an emergency.

Respectfully submitted,

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cc: Chairman Mary Jo White
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