



Consumer Federation of America

September 14, 2017

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: Standard of Conduct for Investment Advisers and Broker-Dealers

Dear Chairman Clayton:

In October of 1999, Consumer Federation of America (CFA)¹ wrote to then SEC Chairman Arthur Levitt urging him to reexamine the regulation of broker-dealers to address changing market conditions -- specifically the evolution underway among full-service firms toward a more advice-driven approach to their retail accounts.² The letter was prompted by reports that the Commission was preparing to propose a rule that would exempt fee accounts offered by brokers from regulation under the Investment Advisers Act, which we strongly opposed. Despite sharing Chairman Levitt's goal of encouraging brokers to adopt compensation practices designed to reduce conflicts of interest, we argued that exempting brokers from "the professional standards to which others offering competing services must adhere" was "too high a price to pay. It would set an unfortunate precedent, both for lowering the already modest standards that apply to advisory services generally and for providing the brokerage industry with additional special exemptions from advisory standards, even as they move increasingly into the advisory business." We questioned "whether the suitability standard is an adequate standard for an advice-driven broker-client relationship" and argued that what was missing was "a broader vision of how broker-dealer regulation can help to advance the investor interest as the market for brokerage services evolves."

Nearly 18 years later, little has changed at the SEC. While the particular approach to expanding broker-dealers' exemption from the Advisers Act that was the topic of that letter was ultimately overturned in court -- and all fee accounts are now regulated as advisory accounts -- the Commission's practice of permitting brokers to market themselves as advisers while regulating them as salespeople continues unabated. And, although every SEC Chairman since

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

² Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (CFA), to Arthur Levitt, Chairman, Securities and Exchange Commission (SEC), Oct. 26, 1999, <http://bit.ly/2eXC5T4>.

Christopher Cox has pledged to address the issue, studies have been conducted that support rulemaking, and public input has been sought, the one significant advance in investor protection on this front has come, not from the SEC, but from the Department of Labor (DOL). The SEC's only actions in the intervening years have served to make the problem worse, not better. In particular, by interpreting the broker-dealer exclusion from the Advisers Act to cover any advice given "in connection with and reasonably related to" their sales activities, the Commission turned a narrow broker-dealer exclusion into a gaping loophole and all but erased the functional distinction that once existed between broker-dealers and investment advisers.

It is therefore with a certain skepticism that we contemplate this latest reopening of the issue under your leadership. While we hope for better, and will participate in good faith as we have in the past, experience has taught us that this process is at least as likely to result in a weakening of investor protections as it is to result in a rigorous pro-investor policy for the regulation of the financial professionals. After all, brokerage industry lobbyists have made no secret of their goal to win a watered down, disclosure-based standard from the SEC and then to use that standard to satisfy compliance with DOL's more rigorous rule. The letters submitted in response to this request by SIFMA, Fidelity, and the Investment Company Institute (ICI), among others, provide a roadmap for how that goal of undermining investor protections while pretending to strengthen them could be achieved.³ And the whole premise for this exercise -- that the SEC and DOL need to work together to fix problems in the DOL rule -- is misguided. Early evidence clearly demonstrates that the DOL rule is both workable and working as intended to deliver tangible benefits to retirement savers.

If you are to succeed where your predecessors have failed in developing a pro-investor policy for regulation of financial professionals, you will have to do what they were either unwilling or unable to do:

- **Correctly diagnose the problem.** The central problem the Commission needs to address is *not* that investors are "confused" about the differences between broker-dealers and investment advisers. The problem is that investors are being misled into relying on biased sales recommendations as if they were objective, best interest advice and are suffering significant financial harm as a result. Investor confusion is relevant only because it limits the tools the Commission has available to address that harm.
- **Develop a solution that is tailored to the problem.** There are two possible approaches to address the problem -- either eradicate the misleading practices that allow brokers to portray themselves as advisers when they are acting as salespeople or adopt a fiduciary standard for all recommendations so that investors are appropriately protected regardless of the type of financial professional they turn to for investment advice. The former approach has a certain logical appeal but poses significant operational challenges. The latter offers a cleaner approach, but it will only work if the Commission takes rigorous

³ Letter from Kevin Carroll, SIFMA Managing Director and Associate General Counsel, to the SEC, regarding the Standard of Conduct for Investment Advisers and Broker-Dealers, July 21, 2017, <http://bit.ly/2uRtdUA>. See also, Letter from Dorothy M. Donohue, ICI Acting General Counsel, to the SEC, August 7, 2017, <http://bit.ly/2fhXhjU> and Letter from Mark R. Bryant, Fidelity Senior Vice President and Deputy General Counsel, to the SEC, August 11, 2017, <http://bit.ly/2wLJSKh>.

steps to address the toxic web of financial incentives that pervade the broker-dealer business model.

- **Bring a healthy dose of skepticism to the brokerage industry’s self-serving claims.** Any regulatory approach that provides meaningful protections to investors -- rather than the mere appearance of such protections -- will engender strong opposition from the broker-dealer community. Industry groups try to sugar-coat their opposition to a strong, pro-investor rule by claiming they are motivated by concern over the impact on small investors. As should be patently obvious, however, their real motivation is concern for their own bottom line. The current situation -- in which brokers are allowed to market themselves as advisers while recommending investments that serve their own financial interests rather than the best interests of their customer -- is hugely profitable for them. They won’t give it up without a fight. And if they can get the right to *claim* they are acting in customers’ best interests without actually having to do so, all the better from their point of view.
- **Listen instead to industry groups that embrace a fiduciary standard.** Sometimes drowned out by the better-funded lobbyists for the brokerage and insurance industries, a host of financial professionals have embraced a rigorous fiduciary standard as the appropriate standard for advice. Among them are advisers who have demonstrated that it is possible to provide fiduciary advice at an affordable cost and under a variety of business and payment models to even the smallest accountholders. It is their input that should guide the Commission as it seeks to develop a standard of conduct for investment advice that benefits not just investors but also those advisers and investment product sponsors prepared to compete based on the quality and cost of their products and services.
- **Build support within the Commission for a pro-investor regulatory approach.** Resistance from within the Commission has played as large a role as outside opposition in undermining earlier efforts at reform. Examples include a staff interpretation mischaracterizing the legislative history behind the Investment Advisers Act to justify a definition of “solely incidental to” that allows virtually any advisory services offered by brokers to escape regulation under the Act;⁴ a staff interpretation of financial planning services that provided a roadmap for brokers to evade Advisers Act regulation of such services;⁵ and a Request for Information regarding the appropriate standards for broker-dealers and investment advisers that omitted the “best interest” standard from its description of advisers’ fiduciary duties.⁶ Meanwhile, various commissioners have in

⁴ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2> (challenging the SEC’s reading of the legislative record).

⁵ Letter from Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission to Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, December 16, 2005.

⁶ Letter from Barbara Roper, CFA, to the SEC, Re: Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, at 15-19, <http://bit.ly/2veGjfw> (discussing this and other gaps in the Commission’s description of the uniform fiduciary standard’s duty of loyalty).

recent years expressed determined opposition to any rulemaking that goes beyond the disclosure-based approach the SEC’s own research has shown to be ineffective.⁷

- **Develop a rigorous economic analysis justifying regulatory action that can withstand legal scrutiny.** One thing that makes rulemaking in this area so challenging is that there is no consensus between brokerage industry lobbyists and investor advocates with regard to the appropriate regulatory approach. And, since both sides view the issue as of the highest priority, the Commission must accept the likelihood that any rule it adopts will be challenged in federal court by one side or the other. The Commission’s surest defense against a claim that it acted in a manner that is arbitrary and capricious or otherwise contrary to law is, first, to develop a regulatory proposal based in logic and fact and, second, to support that proposal with an airtight economic analysis as thorough and well-reasoned as the DOL’s Regulatory Impact Analysis (RIA). Indeed, it is incumbent on the Commission, in developing its own regulatory proposal, to carefully consider the findings of the RIA, particularly those with regard to the breakdown of the market for investment advice and the limitations of disclosure as a regulatory solution, many of which are directly relevant to the task at hand. We are confident that an approach based on an unbiased assessment of the market for investment advice will support a strong and effective rule, one that reins in the toxic conflicts of interest that are responsible for tens of billions of dollars a year in investor harm.

Unless you can overcome these obstacles and build support within the Commission for a strong, pro-consumer rule, investors would frankly be better off if the Commission refrained from acting. After all, thanks to the actions of the DOL, investors today are better protected when it comes to their retirement accounts, which is where most Americans, particularly middle income Americans, have the majority of their investments. And, despite what industry lobbyists would have you believe, early evidence shows the DOL rule is benefitting investors by reducing conflicts, lowering investment costs, improving investment products, and preserving access to advice under a variety of business models for even the smallest accountholders.⁸

A weak SEC rule that undermines protections for retirement savings without significantly enhancing protections for non-retirement accounts would leave investors considerably worse off than they are today. On the other hand, a strong and effective SEC rule that extends the core protections of the DOL rule to all securities accounts would deliver on your promise to make the SEC work for “Mr. and Mrs. 401(k).”

⁷ Letter from Commissioner Michael S. Piwowar, to the DOL, July 25, 2017, <http://bit.ly/2uuUN9X> (chiding the DOL for being “overly dismissive of the efficacy of conflict-of-interest disclosure” and characterizing Section 913 of the Dodd-Frank Act as promoting disclosure-based regulation is a recent example). However, the fact that Congress identified acting “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” as the appropriate fiduciary standard demonstrates a clear interest in mitigating the potentially harmful impact of conflicts. Further proof that Congress had more than disclosure in mind can be found in the law’s mandate that the SEC study conflicts of interest (as yet unfulfilled) and its authorization for the Commission to adopt rules to limit or ban practices that create conflicts that pose undue risks to investors.

⁸ See discussion in Sections III(C) and (D), below. See also Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, April 17, 2017, at 60-91, 101-118, <http://bit.ly/2oXIZfq> (providing an extensive discussion rebutting industry arguments that the rule is harming investors). See also Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, August 7, 2017, <http://bit.ly/2gIouff>.

Table of Contents

Introduction	7
I. The problem in the market for investment advice is not that investors are confused. The problem is that investors are being misled, and the SEC has actively enabled misleading practices.	7
A. Research has consistently shown that investors do not distinguish between broker-dealers and investment advisers. Nor do they understand the different legal standards that apply to their “advice.”	8
B. Investors and fiduciary advisers are harmed when investors are misled into hiring a salesperson when what they want is fiduciary advice.	12
C. Despite years of study, the SEC has failed to address this problem. In fact, the Commission’s actions over the years have made this problem worse, not better. . .	14
II. Conflicts of Interest pervade the broker-dealer business model, creating strong incentives for brokers to offer recommendations that advance their own financial interests, rather than the best interests of their customers. Investors suffer real financial harm as a result, but the Commission has failed to take effective action to address those conflicts and prevent that harm.	20
A. Conflicts of interest pervade the broker-dealer business model.	20
B. Conflicts of interest influence advisers’ recommendations, and do so in ways that are harmful to investors.	24
C. The SEC has not effectively addressed conflicts of interest.	33
III. The situation demands a strong regulatory response from the Commission.	35
A. Investors are ill-equipped to protect themselves against the harmful impact of conflicted advice.	36
B. Disclosure alone is not sufficient either to reduce investor confusion or to protect investors from the harmful impact of conflicts of interest.	37
C. The Department of Labor has shown that it is possible to reduce the harmful impact of conflicts of interest while preserving access to advice offered under a variety of business models.	42
D. Technology tools exist to support compliance with a best interest standard for even small accounts.	54
IV. The Commission has two regulatory options for addressing the interrelated problems of investor confusion and conflicted advice.	58
A. The Commission could choose to protect investors by restoring a functional distinction between broker-dealers and investment advisers.	59
B. The Commission could choose to protect investors by holding broker-dealers to a fiduciary standard when they provide investment recommendations.	64

V. Industry proposals to rebrand the suitability standard as a best interest standard and add a few disclosures would not protect investors. 71

A. The industry proposal is based on a series of false assumptions and mischaracterizations. 72

B. The industry groups’ proposed regulatory approach is entirely inadequate to protect investors. In some areas, it could actually weaken existing protections. 76

Conclusion 81

Appendix A: Letters to the SEC Regarding the Standard of Conduct for Broker-Dealers and Investment Advisers 83

Appendix B: Letters from CFA to the Department of Labor Regarding its Conflict of Interest Rule 84

Introduction

Over the past 18 years, CFA has submitted more than 20 letters to the SEC either alone or in concert with other groups, urging the Commission to update its approach to regulating broker-dealers and investment advisers to reflect changing market realities.⁹ Recognizing the degree to which investors rely on the recommendations they receive, we have identified reform in this area as the single most important step the Commission can and should take to improve protections for average, unsophisticated investors.¹⁰ And we have expressed a willingness to support a variety of approaches to achieve our goal of ensuring that all those who provide personalized investment advice do so under the appropriate fiduciary standard of care. We have, for example, supported an approach based on narrowing the broker-dealer exclusion from the Advisers Act in order to restore the functional distinction Congress intended between brokers and advisers, as well as an approach based on creating a uniform standard of conduct for brokers and advisers when they provide personalized investment advice to retail investors. In recent years, we have expanded on these ideas in a series of letters to the Department of Labor commenting on its proposed conflict of interest rule. (A listing with links to our key letters on this topic to the SEC and DOL is provided in Appendix A and Appendix B respectively.)

In those letters we have answered virtually every question raised in this request for input. Rather than repeating those arguments in their entirety, the goal of this letter is to provide an overview of the reasoning and evidence that brought us to our current position on the need for and appropriate approach to reform, backed by citations to previous letters and other resources where we have dealt with the issue in greater detail. A significant portion of this letter will then be devoted to a discussion of the various regulatory options available to the Commission, how the Commission must approach each if it is to achieve the goal of improving protections for investors, and why the approach proposed by SIFMA in its July 21 comment letter (and echoed in subsequent letters from ICI and Fidelity, among others) would undermine, rather than enhance, investor protection.

I. The problem in the market for investment advice is not that investors are confused. The problem is that investors are being misled, and the SEC has actively enabled misleading practices.

In your request for input, you begin by noting that retail investors “have expressed confusion about the type of professional or firm that is providing them with investment advice, and the standards of conduct applicable to different types of relationships.” You follow up with a series of questions about the causes and effects of this “confusion,” including asking to what extent “this reported confusion” has been addressed. As we have discussed at length in a series of comment letters spanning nearly 20 years, the central problem in the market for investment advice is not that investors are confused, it’s that investors are being actively misled. Broker-dealers have been permitted to rebrand themselves as advisers, offer extensive advisory services, and market their services as if investment sales were solely incidental to advice, rather than the

⁹ That tally doesn’t include related letters where we urged the Commission to do more to address specific issues, such as the harmful conflicts associated with revenue sharing payments or the need to reform 12b-1 fees.

¹⁰ See, e.g., Letter from Barbara Roper, CFA, to the SEC, Re: Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, at 1, <http://bit.ly/2veGjfw>.

other way around, all while being exempted from the fiduciary standard of conduct appropriate to that role. Both investors who rely on biased sales recommendations as if they were fiduciary investment advice and advisers who compete for customers on an uneven playing field have been harmed as a result. This harm has persisted, not *despite* the SEC’s best efforts, but with the full support and encouragement of a Commission seemingly more intent on protecting the full service broker-dealer business model than on protecting investors.

A. Research has consistently shown that investors do not distinguish between broker-dealers and investment advisers. Nor do they understand the different legal standards that apply to their “advice.”

In the early years of this debate, broker-dealer trade associations routinely maintained that investors fully understood the differences between broker-dealers and investment advisers. While that is now generally acknowledged to be false, industry trade associations resurrected the argument in their legal challenge to the DOL fiduciary rule, which rests on the claim that there is a bright-line distinction between sales and advice.¹¹ A number of studies have been conducted over the years to test this assertion, including several commissioned by the SEC itself. They have explored whether investors can in fact distinguish between broker-dealers and investment advisers, are aware that brokers are primarily salespeople, and understand the different legal standards that apply to the recommendations they receive from broker-dealers and investment advisers. All have similarly concluded that investors do not understand these distinctions or their implications. The following are among their key findings.

- Investors struggle to distinguish between broker-dealers and investment advisers.

In 2005 focus group testing designed to help the Commission better understand “how investors differentiate the roles, legal obligations, and compensation” among several types of financial services professionals, Siegel & Gale LLC found that, “Respondents in all focus groups were generally unclear about the distinctions among the titles brokers, financial advisors/financial consultants, investment advisers, and financial planners.”¹² As one participant explained, “I don’t know the difference. I mean I’ve got a guy that gives me advice. I don’t know what he is.” A few years later, RAND Corporation researchers similarly concluded that most investors who responded to their survey and participated in their focus groups, including those who had employed financial professionals for years, “do not have a clear understanding of the boundaries between investment advisers and broker-dealers.”¹³ One source of the problem, according to RAND focus group participants, is that “common job titles for investment advisers

¹¹ See SIFMA opening appellate brief, *Chamber et al. v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, at 1, <http://bit.ly/2f4wVBW> (“The DOL seeks to...erase universally recognized distinctions between salespeople and fiduciary advisers...”).

¹² Siegel and 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, <http://bit.ly/2wXS33l>.

¹³ Angela A. Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*. Santa Monica, CA: RAND Corporation, 2008, <http://bit.ly/1OrrZ3v>.

and broker-dealers are so similar that people can easily get confused over the type of professional with which they are working.”¹⁴

- Investors do not understand the different functions broker-dealers and investment advisers perform.

While a large majority of RAND Study survey respondents (89 percent) understood that brokers execute transactions on behalf of customers, only 51 percent were aware that brokers recommend specific securities. They were more likely to think brokers provide advice about securities (63 percent) than that they recommend specific investments. A 2010 survey conducted by Opinion Research Consultants (ORC) on behalf of consumer groups, state securities regulators, and groups representing investment advisers and financial planners similarly 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).¹⁵

- Investors are even more confused about the different legal obligations that apply.

Just under half of RAND Study survey respondents (49 percent) in the 2008 study were aware that investment advisers are held to a fiduciary standard. They were considerably more likely to believe that financial consultants and financial advisors are held to a fiduciary standard (59 percent). A more recent study by RAND researchers found that just 3 percent of survey respondents knew that investment advisers were the only type of financial professional listed that is held to a fiduciary standard.¹⁶ Even after a multi-year, high-profile discussion over the different standards of conduct that apply to different types of financial providers, a 2017 survey by Personal Capital found that nearly half of Americans (46 percent) believe all financial advisors are required by law to always act in their client’s best interests, and nearly a third (31 percent) are unsure.¹⁷ Another recent survey by Jefferson National found that nearly six in ten investors (59 percent) incorrectly believe that all financial advisers are already required by law to put their clients’ best interests first. While investors are confused about these differences, they are not indifferent to them.¹⁸ The Jefferson National survey found, for example, that nearly half of investors (48 percent) say they would stop working with their financial adviser if they learned the adviser is not required by law to serve their clients’ best interests.¹⁹

¹⁴ *Id.* at 111.

¹⁵ Press Release, CFA, AARP, North American Securities Administrators Association, CFP Board of Standards, Financial Planning Association, Investment Adviser Association, and National Association of Personal Financial Advisors, “Survey: Vast Majority of U.S. Investors Support Clear “Fiduciary Standard” for Financial Professionals, Widespread Confusion Seen Linked to Current SEC Rules,” September 15, 2010, <http://bit.ly/2xb1vED>. (2010 ORC Survey)

¹⁶ Jeremy Burke and Angela A. Hung, Trust and Financial Advice, RAND Working Paper, January 2015, at 14, <http://bit.ly/2j3GHZC>.

¹⁷ Personal Capital, 2017 Personal Capital Financial Trust Report, <http://bit.ly/2rUJOpU>.

¹⁸ Press Release, Jefferson National, “Third Annual Advisor Authority Study Shows Investors and Advisors Aligned on Importance of Fiduciary Standard--Regardless of DOL Fiduciary Rule,” June 27, 2017, <http://prn.to/2valhhr>.

¹⁹ As reported in the 2008 RAND Study, a majority of respondents to both the 2004 CFA-Zero Alpha Group survey and the 2006 TD Ameritrade survey indicated they would be less likely to obtain services from a broker if they knew they were subject to weaker investor protections.

- Use of such titles as financial consultant and financial advisor by brokers contributes to that confusion.

Although financial advisor and financial consultant are titles commonly used by broker-dealer registered representatives, RAND Study survey respondents viewed them very differently. Only 28 percent thought financial advisors/consultants execute stock or mutual fund transactions on behalf of clients, while 89 percent recognized that brokers do. Respondents were significantly more likely to think that financial advisors/consultants provide advice about securities than to think that brokers provide such advice. And they were even more likely to believe incorrectly that financial advisors/consultants are held to a fiduciary standard than to believe correctly that investment advisers are. Similarly, a large majority of respondents to the 2010 ORC survey (76 percent) incorrectly believed that financial advisors are held to a fiduciary duty when providing investment advice, matching the 77 percent of ORC survey respondents who answered correctly that investment advisers are held to a fiduciary standard.

- Misleading marketing contributes to investor “confusion” regarding the services offered by brokers and the legal standard that applies to those services.

Brokers’ use of titles like financial consultant and financial advisor is just one component of a broader campaign to portray themselves as trusted advisers. All aspects of brokers’ communication with the public -- in particular their advertisements and websites -- are designed to send the message that they are trusted advisers, committed to putting their customers’ interests first. These practices have gone unchecked by the SEC, which has continued to permit brokers to rely on their “solely incidental to” exclusion from the Advisers Act even as they marketed themselves to the public as advisers.

In 1991, for example, Shearson Lehman ran a multi-page ad in the *New York Times* in which it urged investors to think of their “Shearson-Lehman Financial Consultant more as an advisor than a stockbroker.” In 1999, a Prudential Securities ad proclaimed that “it’s advice, not execution, that’s at the heart of our relationships,” and Morgan Stanley Dean Witter promised that its “Financial Advisors” will “help you identify your financial goals, then give you tailored advice to help you meet them.”²⁰ For decades, brokers have been allowed to market themselves as advisers in ads like these, because the SEC has taken the position that broker-dealers, unlike accountants or lawyers, should be allowed to rely on the “solely incidental to” exception from the Advisers Act even when they hold themselves out as being in the business of providing advisory services.²¹ This is clearly contrary to congressional intent and a major source of investor “confusion.”²²

As our recent analysis of broker-dealer and insurance company websites makes clear, brokerage firms continue to take full advantage of this freedom today.²³ Based on a review of the

²⁰ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, January 13, 2000, <http://bit.ly/2eMqEhg>.

²¹ *Id.* at 9.

²² Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2>.

²³ Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, Jan. 18, 2017, <http://bit.ly/2jKUuFD>.

websites of 25 major broker-dealer and insurance companies, our study documents how everything from the titles brokers use to the way they describe their services is designed to send the message that they are in the business of “providing expert investment advice, comprehensive financial planning, and retirement planning that is based on their clients’ needs and goals and that is designed to serve their best interests.”²⁴ For example, Janney Montgomery Scott’s website describes its “wealth management approach” as focusing on “the delivery of strategic financial plans that utilize a variety of financial products and services best suited to help individual investors and families meet their financial goals.”²⁵ Wells Fargo claims to “provide advice and guidance to help maximize all elements of your financial life.”²⁶ And Edward Jones states, “Our goal is to provide advice and guidance based on your needs. We have more than 13,000 financial advisors in the U.S. – each one dedicated to doing what’s right for our clients.”²⁷

Not once on any of the 25 websites we reviewed did we find “any prominent reference that described their services as providing arm’s length investment sales recommendations.”²⁸ On the other hand, we found repeated statements designed to send the message that these are relationships of trust, in which they put the client first, and act in customers’ best interests -- claims that are the very hallmark of a fiduciary relationship.²⁹ And other forms of marketing materials are equally misleading. Consider, for example, the Schwab commercial in which the Schwab financial consultant declares: “I’m the kind of guy who doesn’t like being sold to. The last thing I want is to feel like someone’s giving me a sales pitch, especially when it comes to my investments. You want a broker you can trust. A lot of guys at the other firms seem more focused on selling than their clients. That’s why I stopped working at my old brokerage and became a financial consultant with Charles Schwab.”³⁰ Even highly sophisticated investors are unlikely to understand that firms that market their services in this fashion are really offering episodic arm’s length sales recommendations, not best interest advice.

There are two possible interpretations. The first is that these titles and marketing materials accurately reflect the scope of advisory services provided by broker-dealers. If that is the case, the Commission has failed investors by not regulating brokers under the Investment Advisers Act, since the advice provided is clearly not “solely incidental to” transactions. The second is that these titles and marketing materials are misleading, and broker-dealers truly are the “mere salespeople” they’ve claimed to be in their legal challenge to the DOL fiduciary rule. If that is the case, the Commission has failed investors by not preventing what are clearly unfair and deceptive practices. Neither interpretation reflects well on the Commission, and both demand a regulatory response. Which interpretation the Commission adopts could drive its regulatory response.

²⁴ *Id.* at 7-10.

²⁵ *Id.* at 7.

²⁶ *Id.* at 8.

²⁷ *Id.*

²⁸ *Id.* at 7.

²⁹ *Id.* at 10-13.

³⁰ Charles Schwab TV Commercial, “Financial Consultant,” iSpot.tv, <http://bit.ly/2gHwIVm>.

B. Investors and fiduciary advisers are harmed when investors are misled into hiring a salesperson when what they want is fiduciary advice.

We care about investor “confusion” because it leads to investor harm. Both investors who are misled into hiring a salesperson when what they want is an adviser and fiduciary advisers who are forced to compete on an unlevel playing field are harmed by deceptive marketing practices that are widespread among brokers and by the inconsistent standard the Commission applies to services that are marketed as advice.

- Investors who want fiduciary investment advice are harmed when they are misled into relying on non-fiduciary sales recommendations.

At the most basic level, investors who go into the market seeking investment advice are harmed when they are misled into instead hiring a “mere salesperson.” Instead of getting the best interest advice they expect and need, they receive what industry trade associations have described as arm’s length commercial sales recommendations. Because investment advice and sales recommendations are often indistinguishable, investors are misled into relying on those sales recommendations as if they were best interest advice. As discussed above, studies have found that many if not most investors mistakenly believe that all financial professionals are required to act in their best interests, and the difference in standards is important to them.³¹ Roughly half of respondents to one recent survey indicated they would change advisers if they learned their adviser was not legally required to act in their best interest.³²

Given investors’ reasonable expectation that all advisers are required to act in their best interests, it shouldn’t be surprising that many investors rely heavily on the investment recommendations they receive. A 2006 CFA survey found, for example, that among mutual fund investors who purchased most of their funds from a financial services professional, nearly three in ten said they relied totally on that professional’s recommendation without doing any independent evaluation of the fund.³³ Another 36 percent said they relied a great deal on the professional’s recommendation but reviewed some written material about the fund before the purchase.³⁴ According to the survey, women were significantly more likely than men both to value one-on-one expert advice and to act on that advice without doing any additional research.³⁵ The CFA survey is consistent with other research, including the Commission’s own financial literacy study, which has found that investors are heavily reliant on their financial adviser both to explain the disclosures they receive and to recommend a course of action.³⁶

³¹ Press Release, Jefferson National, “Third Annual Advisor Authority Study Shows Investors and Advisors Aligned on Importance of Fiduciary Standard--Regardless of DOL Fiduciary Rule,” June 27, 2017, <http://prn.to/2valhhr>.

³² *Id.*

³³ Barbara Roper and Stephen Brobeck, “Mutual Fund Purchase Practices, An Analysis of Survey Results,” June 2006, <http://bit.ly/1IicqGD>.

³⁴ *Id.*

³⁵ *Id.*

³⁶ 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. *See also*, Siegel & Gale, LLC, Investor Research Report, Submitted to the Securities and Exchange Commission on July 26, 2012, <http://1.usa.gov/1MfBbss>. *See also*, IFF Research Ltd, Investment Disclosure Research, prepared for the Financial Services Authority by IFF Research Ltd. (November 2006), <http://bit.ly/1LmSJ6Z>.

Hardest hit are financially unsophisticated investors who appear to be more likely to rely without question on the recommendations they receive.³⁷ This is likely explained, at least in part, by their lack of expertise to independently assess the quality of the investment recommendations they receive or the degree to which those recommendations may have been influenced by conflicts of interest. In determining what regulatory approach to adopt, the Commission cannot reasonably assume that investors have the expertise necessary to assess the quality of advice they receive. Instead, it must take into account the well-documented low level of financial sophistication among investors generally, and it must give particular consideration to the needs of the most vulnerable investors.

In addition to placing unwarranted trust in individual sales recommendations, investors may mistakenly believe their “financial advisor” is carefully monitoring their account to ensure that they stay on track when this is not the case. This is the natural result of marketing practices by firms, in which they describe their services as “investment planning” or “retirement planning” and emphasize their long-term commitment to promoting their clients’ financial well-being. This is typified by the statement on the Edward Jones website that, “Your financial advisor is your long-term financial partner.”³⁸ Investors who fail to understand that they bear sole responsibility for monitoring their investments between sales recommendations may be put at considerable risk.

- Fiduciary investment advisers are harmed by unfair competition from non-fiduciary sellers masquerading as trusted advisers.

Fiduciary advisers are also harmed when they compete on an uneven playing field against broker-dealers who misrepresent themselves as advisers rather than sellers. This harms investment advisers directly, when they lose business that would have otherwise been theirs if the broker’s services had been accurately described as constituting episodic, arm’s length sales recommendations rather than bona fide advice. They also suffer indirect harm when brokerage firms fail to live up to clients’ reasonable expectation that they will provide ongoing, best interest advice. The reputation of the industry as a whole gets tarnished, including that of fiduciary advisers who do provide the services investors want and need.

This has an impact on the overall market for investment advice. A 2015 RAND Corporation study on Trust and Financial Advice found that overall investor trust in the financial system is quite low, with brokers receiving the lowest trust scores among the categories evaluated.³⁹ They found, moreover, that those who have less trust in the financial sector are less likely to seek professional financial advice.⁴⁰ Similarly, a recent study conducted by Harris Poll on behalf of Personal Capital, found that approximately 32 percent of Americans believe a

³⁷ Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, Impacts of Conflicts of Interest in the Financial Services Industry, RAND Working Paper, August 2014, at 13, <http://bit.ly/2w8gzOt>.

³⁸ Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, Jan. 18, 2017, at 12, <http://bit.ly/2jKUbfD> (citing EDWARD JONES, Working with a Financial Advisor, <http://bit.ly/2rXh1Bd> (last visited August 21, 2016)).

³⁹ Jeremy Burke and Angela A. Hung, Trust and Financial Advice, RAND Working Paper, January 2015, at 10, <http://bit.ly/2j3GHZC>.

⁴⁰ *Id.* at 18.

financial adviser is likely to take advantage of them.⁴¹ And, among the 54 percent of those polled who do not work with a financial adviser, 45 percent say the reason is lack of trust. The *Investors in the United States 2016* report from the FINRA Investor Education Foundation similarly finds significantly higher levels of mistrust among those who do not work with a financial professional, providing further evidence that lack of trust undermines the market for investment advice.⁴²

While our primary concern is the investor harm that results from the current, deeply flawed regulatory approach, the Commission must also consider the impact on competition of allowing broker-dealers, who argue in legal documents that they are mere sellers, to market themselves as trusted advisers.

C. Despite years of study, the SEC has failed to address this problem. In fact, the Commission’s actions over the years have made this problem worse, not better.

The request for input asks whether the problem of investor confusion has been addressed. It has not. On the contrary, the agency has taken a series of actions over the years that have made the problem worse by making it easier for brokers to market themselves as advisers and offer extensive advisory services without being held to the fiduciary standard appropriate to that role. The agency’s early efforts to develop a disclosure-based solution to investor confusion proved entirely ineffective. Even after the Commission began to explore broader regulatory solutions to the problems, it has appeared reluctant to adopt the kind of bold approach needed to reform harmful industry practices.

- SEC actions have made the problem worse, erasing the functional distinction between broker-dealers and investment advisers while retaining the regulatory distinction.

When Congress adopted the Investment Advisers Act in 1940, it was keenly aware of and concerned about abuses associated with brokers’ holding out as advisers⁴³ and, because of that concern, provided only a limited broker-dealer exclusion from the Act.⁴⁴ One memorandum relied on in developing the Adviser’s Act exclusion for broker-dealers stated, for example: “The

⁴¹ Personal Capital, 2017 Personal Capital Financial Trust Report, at 2, <http://bit.ly/2rUJOpU>.

⁴² FINRA Investor Education Foundation, *Investors in the United States, 2016*, at 8, <http://bit.ly/2hMrppX>.

⁴³ Letter from Barbara Roper, CFA, to the SEC, *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, February 7, 2005, <http://bit.ly/1T6xNS2> (challenging the SEC’s interpretation of the solely incidental to exemption for brokers, based on the legislative history. *See, for example*, p 4-5. The bill’s Senate sponsor, Sen. Robert F. Wagner of New York, said in response to a suggestion that investment advisers should be allowed to self-regulate: “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?” Also, “ICAA President Dwight Rose noted, for example, that their association’s survey of the field had found that: “Some of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commission on transactions executed upon such free advice.” It is presumably in response to this concern that Section 208(c) of the Investment Advisers Act makes it unlawful for “any person registered under section 203 of this title to represent that he is an investment counsel or to use the name “investment counsel” as descriptive of his business unless (1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services.”)

⁴⁴ *Id.* at 2-8.

criticisms of counselors also acting as brokers or dealers are founded upon possible encouragement of practices bordering on fraud. The major danger is that a counselor connected with a brokerage house will unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investments.”⁴⁵ And in the only congressional testimony directly relevant to the intent behind the “solely incidental to” exception, Harvard Law Professor E. Merrick Dodd, Jr. specifically noted that the exemption would not be available to those who held themselves out “as giving good investment advice to all comers.”⁴⁶ Further evidence that Congress was concerned about individuals who held themselves out in misleading ways can be found in Section 208(c) of the Act, which makes it unlawful for an individual to use the title “investment counsel ... unless (1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services.”

But when the Commission confronted a similar challenge in the 1980s -- how to regulate broker-dealers when they held out as providing financial planning -- they ignored congressional intent. Instead, the Commission took the position that broker-dealers could hold themselves out as financial planners or as providing financial planning without triggering regulation under the Advisers Act. In interpreting the standard, the staff gave lip service to retaining the “solely incidental to” requirement, stating that “a registered representative who holds himself out to the public as a financial planner cannot rely on the broker-dealer exception unless he receives no special compensation therefor and gives investment advice solely in his capacity as a registered representative.”⁴⁷ By way of contrast, the staff took the position that the identical exclusion for attorneys and accountants would not be available if they held out as providing financial planning because, “In such a case it would appear that the performance of investment advisory services by the person would not be incidental to his practice as a lawyer or accountant.”⁴⁸ In other words, the Commission staff apparently recognized that financial planning was an advisory service and would be perceived as such by investors but chose to allow brokers to offer such services without regulating them under the Advisers Act. The alternative interpretation, that the Commission was prepared to let brokers hold themselves out as financial planners as long as they didn’t actually provide the advisory services the title implies, reflects no better on the agency.

It was in the wake of that decision that brokerage firms began to broadly adopt titles, like financial advisor and financial consultant, designed to portray their registered representatives as advisers rather than salespeople. Instead of reining in those practices, the Commission took a number of actions in subsequent years to preserve and expand the ability of brokers to act and hold out as advisers without being regulated accordingly.

- In 1999, the Commission proposed a rule designed to allow brokers to receive fees, which the Commission viewed as constituting “special compensation for advice,” and still qualify for their broker-dealer exclusion from the Advisers Act. The Commission

⁴⁵ *Id.* at 5, citing Illinois memorandum at 1014 of the Senate hearing record.

⁴⁶ *Id.* at 10.

⁴⁷ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, January 13, 2000, at 9, <http://bit.ly/2eMqEhg> (FN 25, citing to Investment Adviser, Financial Planners, and Others -- An Overview of the Investment Advisers Act of 1940, by Robert E. Plaze, Division of Investment Management (undated)).

⁴⁸ *Id.* at 8-9, FN 24 (citing to SEC Rel. No. IA-1092).

claimed to be creating an approach in which the nature of services, rather than method of compensation, determined regulatory status, but this was not the case. It did nothing to clarify the meaning of “solely incidental to,” an essential step if its goal truly was to restore the functional distinction between broker-dealers and investment advisers intended by Congress. Moreover, under the proposed rule, both financial planning and discretionary accounts would have continued to receive disparate regulatory treatment based on the method of compensation. As we said at the time, “Under the proposed rule, broker-dealers ... could hold themselves out to the public as advisers, they could offer advice or claim to offer advice that clearly exceeds that which Congress intended to exclude from the Adviser's Act, they could charge their customers a fee that they identify as being a fee for advice, and they would still be regulated as salespeople. This is so clearly inappropriate it is difficult to see how the Commission could even propose it.”⁴⁹ Despite these concerns, the proposed rule was allowed to take effect through a no action position without formal action by the Commission.

- In 2004, when the Commission finally offered an interpretation of brokers’ “solely incidental to” exclusion from the Advisers Act, it proposed a definition designed to give brokers virtually unlimited freedom to offer advisory services without being regulated as advisers.⁵⁰ The only restriction proposed by the Commission was that such services had to be offered “in connection with and reasonably related to” brokers’ primary business of effecting transactions on behalf of customers. As we and other consumer groups wrote at the time, “If the Commission were to endorse this interpretation, it would effectively repeal the ‘solely incidental’ test, leaving no meaningful basis for regulating advisory services offered by brokers under the Investment Advisers Act.”⁵¹ Moreover, in order to justify a proposed definition that was inconsistent with the clear meaning of the statutory language, the Commission “misrepresented much of the legislative record it cites as supporting its position and ignored the vast majority of the legislative record, which directly contradicts its interpretation.”⁵²
- When the Commission finalized a fee-based brokerage account rule, it retained the deeply flawed definition of “solely incidental to” but included two modest steps toward restoring a functional distinction between brokers and advisers. It determined that both financial planning services and discretionary accounts fell outside the exclusion for “solely incidental to” advice. That meagre victory was quickly snatched away, however, when the Commission staff issued an interpretation of the financial planning provision that provided a roadmap for brokers seeking to hold out as providing financial planning

⁴⁹ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, January 13, 2000, at 9, <http://bit.ly/2eMqEhg>.

⁵⁰ Letter from Fund Democracy, CFA, Consumers Union, and Consumer Action, to the SEC, Re: Proposal to exempt certain fee-based brokerage accounts from regulation under the Investment Advisers Act, February 7, 2005, <http://bit.ly/2xc8M7i>.

⁵¹ *Id.* at 2-3.

⁵² Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, at 2, <http://bit.ly/1T6xNS2> (challenging the SEC’s interpretation of the solely incidental to exemption for brokers, based on the legislative history).

without triggering regulation under the Advisers Act.⁵³ In describing how the provision would be enforced, the only thing the staff interpreted as constituting financial planning services was something that “bears the characteristics” of a comprehensive financial plan.⁵⁴ As a result, all a broker had to do was leave out some important component of a comprehensive financial plan -- such as tax or estate planning, for example -- to escape regulation as an adviser. Under this tortured logic, it wasn’t the inclusion of extensive personalized investment advice, but the inclusion of components that clearly did not constitute investment advice, that subjected financial planning to regulation under the Advisers Act. As we wrote at the time, the staff interpretation “effectively nullified the rule’s provision requiring investment advice provided as part of a financial plan or in connection with financial planning services to be regulated under the Investment Advisers Act.”⁵⁵

That fee-based brokerage account rule was ultimately overturned in court in a decision that required all fee accounts to be regulated under the Advisers Act but that was silent on the definition of “solely incidental to.” As a result, the method of compensation and the nature of firm offering the services, rather than the nature of services offered, continues to determine the regulatory status of securities firms.

- SEC attempts to resolve the problem through disclosure proved entirely ineffective.

Instead of reining in misleading marketing, maintaining a strict functional distinction between brokers and advisers, or holding brokers to the fiduciary duty appropriate to an advisory role, the Commission sought throughout this period to address the problem of “investor confusion” by strengthening disclosures. For example, the Commission’s 1999 proposal to exempt fee-based brokerage accounts from regulation under the Advisers Act included a disclosure requirement designed to ensure that investors would understand the nature of the account being offered and not confuse it with an advisory account. In comments on that proposal, we expressed skepticism that disclosure could “adequately substitute for enforcement of the solely incidental” component of the broker-dealer exclusion, or that the disclosure itself would be meaningful. “Based on our understanding of the knowledge and sophistication of the average investor, we are convinced most investors will not understand the significance of the disclosure,” we wrote. “Specifically, we do not believe the average investor understands that a brokerage account is not an advisory account and that a broker is not an adviser. Certainly, they cannot be expected to understand this fact if the ad the disclosure is required to accompany either strongly implies or specifically states that the broker is an adviser and that the primary service being offered is advice.”⁵⁶

⁵³ Letter from CFA and Fund Democracy, to the SEC, February 15, 2006, <http://bit.ly/2xQ5I36>. (challenging the staff interpretation regarding financial planning regulation under the Advisers Act).

⁵⁴ Letter from Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission to Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, December 16, 2005.

⁵⁵ *Id.* at 2.

⁵⁶ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, January 13, 2000, at 10, <http://bit.ly/2eMqEhg>.

In 2005, when the SEC once again turned its attention to the issue, it conducted the Siegel and Gale focus group testing discussed above in order “to understand how investors differentiate the roles, legal obligations, and compensation among several types of financial services professionals.”⁵⁷ As part of those focus groups, participants were asked to provide feedback on a proposed disclosure that had been developed by the SEC for use on forms that broker-dealers provide to their customers. The proposed disclosure read as follows:

Your account is a brokerage account and not an advisory account. As a consequence, your rights and our duties and obligations to you, including the scope of our fiduciary obligations, may differ. You can discuss these differences with our Compliance Department at (800) 555-1234.

According to the Siegel and Gale report, “investors found the statement communicates that differences might exist, but did not do enough to explain those distinctions ... the statement was viewed to lack sufficient detail.” In particular, “investors were confused as to the differences between accounts and the implications of those differences to their investment choices.”⁵⁸ Put more succinctly, the disclosures failed to make clear precisely that information that they were intended to convey.

This should hardly come as a surprise, since the disclosure was almost entirely devoid of meaningful content. In fact, we anticipated this response in a February 2005 comment letter from CFA, Fund Democracy, Consumers Union and Consumer Action, commenting on a slightly expanded version of the proposed disclosure.⁵⁹ “We ... do not see how the additional disclosure proposed by the Commission will more than minimally improve brokerage customers’ understanding of their rights,” we wrote. “The legend will still leave the customer guessing as to the scope of differences between the legal duties owed by brokers and investment advisers. Investors will naturally assume that if these differences were important, and they are, they would be fully explained, rather than being implicitly relegated to the category of information that is not necessary to understand.”

While the Commission’s proposed disclosure was grossly inadequate, subsequent research by the RAND Corporation confirmed that the problem went deeper than poorly designed disclosures. As discussed above, RAND’s researchers found a general lack of understanding among investors with regard to all the key factors one would need to understand in order to understand the significance of the disclosure, including the services provided by different types of advisers and their legal obligations to their clients.⁶⁰ Significantly, RAND found that investors’ inability to distinguish between different types of financial professionals

⁵⁷ Siegel and 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, <http://bit.ly/2wXS33l>.

⁵⁸ *Id.* at 4.

⁵⁹ Letter from Fund Democracy, CFA, Consumers Union, and Consumer Action, to the SEC, Re: Proposal to exempt certain fee-based brokerage accounts from regulation under the Investment Advisers Act, February 7, 2005, at 8, <http://bit.ly/2xc8M7i>.

⁶⁰ Angela A. Hung, et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers. Santa Monica, CA: RAND Corporation, 2008, at 89, <http://bit.ly/1OrrZ3v>.

persisted after they were presented with “fact sheets” designed to clarify those differences.⁶¹ Even after reading the fact sheets, “some participants said they knew which type of investment professional they have, *but most did not.*” (emphasis added)

- Even after the Commission began to weigh a more comprehensive regulatory response, it stalled and equivocated.

A decade ago, in response to the findings of the Siegel and Gale report and the RAND Study, momentum on the issue shifted, and the Commission began laying the groundwork for a regulatory approach that would rationalize the regulation of financial professionals. In 2011, the SEC staff produced a report calling for rulemaking to adopt a uniform fiduciary standard for broker-dealers and investment advisers when they provide personalized investment advice to retail investors. For perhaps the first time in its history on this issue, the Commission staff took an unabashedly pro-investor stance, stating: “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.”⁶²

Even then, efforts from within the Commission to impede rulemaking or promote a weak and watered down approach to regulation continued. Two Commissioners issued a statement objecting to the staff report’s release to Congress.⁶³ They stated that the study “should be viewed as a starting point for further research and consideration, rather than as forming the primary basis for rulemaking,” and they called for further economic analysis. Progress on the issue immediately slowed to a crawl. It was another two years before the Commission released a Request for Information to inform further economic analysis, which was viewed as a necessary predicate to rulemaking in the face of a likely legal challenge. By that time, leadership at the Commission had changed, and the RFI represented a significant retreat from the strong pro-investor stance of the 2011 staff study.⁶⁴ Of particular concern was the Commission’s failure, in describing a potential uniform fiduciary standard of care for brokers and advisers, to make any mention of the “best interest” standard that the Commission staff had previously identified as a defining difference between the suitability standard governing broker-dealers and the fiduciary duty governing investment advisers.⁶⁵

There were additional suggestions in the RFI that the Commission was preparing to adopt a watered down rule. It assumed, for example, that the fiduciary duty of loyalty could be adequately addressed through disclosure of conflicts, made clear that the Commission had no intention of using its authority to rein in conflicts that pose an undue risk to investors, and proposed to take the least interventionist approach possible on issues such as sale of proprietary products, principal trading, and sale from a limited menu of products. “[U]nless the Commission significantly changes its approach to these issues, we could end up with a rule that weakens

⁶¹ *Id.* at 111.

⁶² SEC Staff, Study on Investment Advisers and Broker-Dealers, January 2011, at 101, <http://bit.ly/1VIB4zw>.

⁶³ Statement by SEC Commissioners Kathleen L. Casey and Troy A. Paredes, Regarding Study On Investment Advisers And Broker-Dealers, January 21, 2011, <http://bit.ly/2w8rcR8>.

⁶⁴ Letter from Barbara Roper, CFA, to the SEC, RFI on Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, <http://bit.ly/2veGjfw>.

⁶⁵ *Id.* at 7.

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,” we wrote.⁶⁶ We warned that we would not support a rule based on the RFI’s deeply flawed assumptions.

II. Conflicts of Interest pervade the broker-dealer business model, creating strong incentives for brokers to offer recommendations that advance their own financial interests, rather than the best interests of their customers. Investors suffer real financial harm as a result, but the Commission has failed to take effective action to address those conflicts and prevent that harm.

The RFI asks whether conflicts of interest related to the provision of investment advice to retail investors have been appropriately identified and, if so, whether they have been appropriately addressed. They have not. The SEC itself has not contributed significantly to our understanding of conflicts in recent years, despite a Dodd-Frank Act mandate to examine the issue. Fortunately, others have including, first and foremost, the Department of Labor. The Commission can and should benefit from the detailed picture the DOL, and others, have provided of the complex, often toxic conflicts that pervade the broker-dealer business model, to the detriment of investors. Similarly, while the Commission has not taken effective action to address those conflicts, either among investment advisers or among broker-dealers, the Department of Labor has done so. In the process, it has proved that it is possible to rein in conflicts associated with the broker-dealer business model while preserving access to commission accounts, with beneficial effects for investors.

A. Conflicts of interest pervade the broker-dealer business model.

The Dodd-Frank Act directed 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.”⁶⁷ To the best of our knowledge, the Commission has conducted no such direct examination of conflicts in the seven years since the Act was signed into law. The Commission did receive input on this topic in response to its 2013 RFI, but it has failed to publish the economic analysis that RFI was intended to support.⁶⁸ As a result, the Commission’s publicly available research on this topic -- the 2008 RAND Study, which provides only a cursory discussion of conflicts, and the 1995 Tully Commission report -- is incomplete and out of date. Fortunately others, most notably the Department of Labor, have filled in the gap. FINRA too has compiled a study on conflicts, and while it doesn’t provide a catalog of conflicts, it does provide a good overview of industry best practices in addressing

⁶⁶ *Id.*

⁶⁷ Dodd-Frank Act 913(g).

⁶⁸ See, e.g., Letter from AARP, CFA, CFP Board, FPA, Fund Democracy, and NAPFA, to the SEC, Section 913 Fiduciary Rulemaking – Evidence of Investor Harm, April 14, 2014, <http://bit.ly/2gPXyhx>. See also Dr. Michael Finke, “Fiduciary Standard: Findings from Academic Literature,” attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the “Duties of Brokers, Dealers and Investment Advisers,” <http://bit.ly/1KgdRZu>.

conflicts.⁶⁹ These studies can and should provide a good starting point for the Commission’s own updated analysis of the conflicts of interest that pervade the broker-dealer business model.

- The Tully Commission identified concerns related to broker-dealer compensation practices more than two decades ago.

The Commission’s last effort to adopt broad reforms addressing conflicts of interest dates to the mid-1990s, when Chairman Levitt appointed a blue ribbon panel headed by Merrill Lynch Chairman and CEO Daniel Tully to review industry compensation practices, identify actual and perceived conflicts of interest, and identify the best practices used in the industry to eliminate, reduce, or mitigate these conflicts.⁷⁰ The Committee had been convened because of concern that broker-dealer compensation practices were contributing to a series of sales abuse scandals targeting unsophisticated retail investors. A major focus of the Tully Commission was how a shift toward more fee-based compensation could help to reduce those conflicts. The Committee began its report with a bold statement: “If the retail brokerage industry were being created today from the ground up, a majority of the Committee that developed this report would not design a compensation system based only on commissions paid for completed transactions. The most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues. The prevailing commission-based compensation system inevitably leads to conflicts of interest among the parties involved.”⁷¹

The Tully Commission specifically identified differential compensation, along with product-specific sales contests, conflicts around signing bonuses for brokers that change firms, and incentives to encourage the sale of proprietary products, as conflicts with the potential to result in investor harm. Ultimately, the Tully Commission declined to recommend changes to address concerns about differential compensation on the grounds that “the current compensation system is too deeply rooted to accommodate radical alteration in the near-term.”⁷² Instead, the Tully Commission identified a series of “best practices” that firms were encouraged to adopt to better align the interests of registered representatives and their clients,⁷³ including: paying identical commissions to registered representatives (RRs) for proprietary and non-proprietary products within a product category, “so that with respect to products in the same category at least, RRs are indifferent to incentives;” paying a portion of RR compensation based on client assets in an account, regardless of transaction activity, “so the RRs receive some compensation even if they advise a client to ‘do nothing;”” prohibiting sales contests, or permitting contests based only on broad measures, rather than on single products; deferring a portion of RR compensation for several years, and linking payment to a clean compliance record; and

⁶⁹ FINRA, Report on Conflicts of Interest, October 2013, <http://bit.ly/1Kxdp9z>.

⁷⁰ Tully Commission, Report of the Committee on Compensation Practices, April 10, 1995, <http://bit.ly/2nwNb0E> (discussed in our April 2017 DOL comment letter at 71-72, 142-143).

⁷¹ *Id.* at 3.

⁷² The SEC chose to rely on best practices guidance to encourage reform of the other practices identified by the Tully Commission as problematic, which proved to be predictably ineffective in eradicating such practices. The NASD, a precursor to FINRA, later came back and adopted rules to restrict sales contests. *See* NASD, Notice to Members 99-55, Questions And Answers Relating To Non-Cash Compensation Rules, July 1999, <http://bit.ly/2eOpy93>. Issues related to signing bonuses and inappropriate pressure to push proprietary products remain a concern today.

⁷³ The Tully Commission report also recommended best practices to better align the interests of firms and their registered representatives.

eliminating up-front bonuses (or paying them over several years). The Committee pointed to the emerging shift among brokerage firms toward fee accounts as a promising development likely to reduce conflicts of interest, and SIA, a precursor to SIFMA, endorsed fee accounts as a “best practice” that offered broad benefits to both active traders and buy-and-hold investors.⁷⁴

- The Department of Labor’s Regulatory Impact Analysis expands on and updates that earlier study.

Many of the issues identified as points of concern in the Tully Commission report, including differential compensation, remain an issue today. These issues and more are discussed in the DOL RIA, which provides the most comprehensive picture to date of conflicts of interest related to investment advice.⁷⁵ While the RIA focuses specifically on retirement investment advice, much of its discussion is directly relevant to securities accounts more generally. In compiling its analysis, the Department collected and studied a wide range of evidence, including public comments submitted in response to both its 2010 and 2015 rule proposals; peer-reviewed academic research papers, many of which were compiled by RAND Corporation in a study on the Impacts of Conflicts of Interest in the Financial Services Industry;⁷⁶ and government and industry statistics on the IRA marketplace. It also consulted a number of other regulators, including the SEC and FINRA, the U.K.’s Financial Conduct Authority, and the Australian Securities and Investments Commission.

Central to the RIA is the finding that conflicts of interest “are widespread and often acute in the market for IRA investment advice.”⁷⁷ While industry rule opponents have disputed the RIA’s estimate of harm, few would try to dispute the basic premise on which the RIA is based. Put simply, conflicts of interest that can affect their recommendations pervade the broker-dealer business model and go far beyond the fact that they are paid through commissions. The real threat to investors, as identified more than two decades ago by the Tully Commission -- comes from the fact that an individual broker’s compensation and the firm’s profitability can vary greatly depending on which investments are recommended. The size of the commission paid by the product sponsor, the percentage of the commission that is paid out to the broker, whether the investment pays 12b-1 fees or makes revenue sharing payments, whether the investment is a proprietary investment, or whether it is sold from the broker’s own inventory can all affect how much the broker gets paid and how much the firm profits from the transaction. The Commission must carefully assess the RIA’s analysis of conflicts, and the underlying research on which it is based, to better inform and update its own picture of conflicts of interest in the securities market more generally.

⁷⁴ Letter from Ira D. Hammerman, General Counsel, Securities Industry Association, to the Securities and Exchange Commission regarding Release No. IA-2278, Certain Broker-Dealers Deemed Not To Be Investment Advisers, September 22, 2004, <http://bit.ly/2oxtk2w>.

⁷⁵ DOL, *Regulating Advice Markets, Definition of the Term “Fiduciary,” Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions*, April 2016, <http://bit.ly/2mT9Gfq>.

⁷⁶ Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, *Impacts of Conflicts of Interest in the Financial Services Industry*, RAND Working Paper, August 2014, at 13, <http://bit.ly/2w8gzOt>.

⁷⁷ *Id.* at 127-134.

- Conflicts related to differential compensation remain a primary concern.

Conflicts of interest can take a variety of forms. They can include, for example, human resources policies that favor brokers who are top sellers over those that achieve the best results for their customers. Also included are sales quotas or other forms of pressure exerted on advisers to promote the sale of proprietary products or other investments the firm has an interest in pushing. The central issue, however, is differential compensation. As University of Mississippi School of Law Professor Mercer Bullard outlined in testimony before the House Financial Services Committee, a “wide variety of compensation structures” have been developed by broker-dealers to “incentivize financial advisers to make recommendations that pay them the highest compensation” rather than those that are best for the investor.⁷⁸ Based on an analysis of mutual fund sales incentives, Bullard’s testimony does an excellent job of describing common broker-dealer practices that create conflicts and the “mind-boggling” magnitude of the conflicts that can result. As Bullard makes clear, the substantial differences in compensation that result are entirely unrelated to the services provided.

While Bullard focuses on the mutual fund market, the magnitude of those conflicts only grows when one looks beyond the fund market to include recommendations of annuities or non-traded REITS, where both the conflicts of interest and the risks to the investor can be much greater. For brokers who are paid based on a retroactive, ratcheted payout grid, the conflicts quickly escalate even further, to the point where a broker who is approaching the next rung on the payout grid may have more riding on a single transaction than the entire value of that transaction.⁷⁹ It is, presumably, conflicts such as these that Congress had in mind when it directed the Commission to limit or ban practices that it deems to be “contrary to the public interest and the protection of investors.”⁸⁰ And, as the Commission determines what regulatory approach to adopt, a key consideration must be whether the proposed approach is likely to be effective in protecting investors from the potentially harmful impact of such conflicts.

- Investment advisers can also be affected by potentially harmful conflicts of interest.

While the conflicts associated with investment advice tend to be both more transparent and less complex than those embedded in the broker-dealer business model, that is not always the case. Conflicts are magnified, for example, when the adviser is a dual registrant, combining advice for a fee with the commission-based sale of investments to implement that advice. But even advisers paid exclusively through fees can have significant conflicts, particularly if their firm offers proprietary products and pressures its advisers to recommend those products. This was the issue at the heart of the Commission’s 2015 enforcement action against J.P. Morgan. J.P. Morgan advisers complained that they were under heavy pressure to recommend the firm’s

⁷⁸ Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and MDLA Distinguished Lecturer and Professor of Law University of Mississippi School of Law, before the Subcommittees on Capital Markets and Government Sponsored Enterprises, and Oversight and Investigations, Committee on Financial Services, United States House of Representatives, Preserving Retirement Security and Investment Choices for All Americans, September 10, 2015, <http://bit.ly/2j6Lb1r>. We discussed the implications of Professor Bullard’s testimony in our September 24, 2015 comment letter to the DOL. Letter from CFA, to the DOL, September 24, 2015, at 10-11, <http://bit.ly/1Rkslum>.

⁷⁹ *Id.*

⁸⁰ Dodd-Frank Act Section 913.

proprietary products over alternative funds with lower costs and better performance and that this prevented them from doing what was best for their customers.⁸¹ While the Commission imposed a hefty fine, it did not require J.P. Morgan to abandon the practice of favoring its own financial interests over the interests of investors. Instead, it settled for “improved” disclosures in a document that, based on our review, seems unlikely to be read by the majority of investors and likely to be understood by even fewer.⁸² In assessing the standard of care for broker-dealers and investment advisers, the Commission should consider the harmful impact of such conflicts and the adequacy of its existing regulatory approach for addressing them.

B. Conflicts of interest influence advisers’ recommendations, and do so in ways that are harmful to investors.

There is a wealth of evidence that demonstrates that conflicts of interest influence advisers’ recommendations and often do so in ways that are harmful to investors. Immediate evidence can be found, for example, in the vast range in cost and quality that can exist among investments – i.e., a particular class of mutual funds or variable annuities – that would all satisfy a suitability standard. Otherwise similar products may impose different fees on the investor, or achieve comparable investment results with significant differences in volatility, or provide different guarantees, impose different surrender periods and fees, or, in the case of variable annuities, offer the investor a greater or lesser degree of choice among underlying investment options that are of varying quality. Although all of the options within a particular category may be deemed suitable for a particular investor or in a particular circumstance, these differences in features can profoundly impact costs, risks and overall performance.⁸³ If advisers were truly acting in customers’ best interests, we would expect to see these differences compress, as advisers would tend to recommend those investments that provide the best combination of quality and cost.

- The investment market is characterized by reverse competition.

Instead, in the absence of an enforceable best interest standard, we see evidence of a market characterized by reverse competition. Rather than competing to be bought, by offering a good product at a reasonable price, some investments compete to be sold, by offering higher compensation to sellers. In order to afford that higher compensation, however, investment sponsors increase costs to investors, counting on investors’ lack of cost sensitivity or hiding those costs inside complex, opaque products. The lack of cost awareness among investors helps to explain why, in one of the most competitive markets imaginable, front-load mutual funds sold by brokers often have significantly higher fund operating costs than direct sold funds, even after the costs of compensating the broker are subtracted, as our earlier analysis of S&P 500 index funds helped to illustrate.⁸⁴ The aggressive cost competition that has brought fund operating

⁸¹ Susanne Craig and Jessica Silver-Greenberg, *Selling the Home Brand: A Look Inside an Elite JPMorgan Unit*, THE NEW YORK TIMES, March 2, 2013, <http://nyti.ms/2wLy88M>.

⁸² See, e.g., a recent Form ADV for J.P. Morgan Investment Management Inc., <http://mgstn.ly/2wxQEA6>.

⁸³ See, e.g., Letter from AARP, CFA, CFP Board, FPA, Fund Democracy, and NAPFA, to the SEC, Section 913 Fiduciary Rulemaking – Evidence of Investor Harm, April 14, 2014, at 2, <http://bit.ly/2gPXyhx>.

⁸⁴ Letter from Barbara Roper, CFA, to the SEC, RFI on Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, at 25-26, <http://bit.ly/2veGjfw>.

costs down to rock bottom levels in the direct sold market hasn't fully extended to the broker-sold market.

Shortly after the DOL fiduciary rule was finalized, financial planner and blogger Michael Kitces described how this reverse competition has worked to undermine the quality of typical annuities products, and how a fiduciary duty could benefit annuities by forcing them to compete based on quality.⁸⁵ Among investments more generally, but particularly for annuities, “the best products with the lowest cost are often NOT the ones that actually get sold in practice,” Kitces explains. Early in his career, he said, some annuities companies were producing good products that were transparent and had “very reasonable costs,” and “they got squeezed out of the marketplace” by other lower quality products that paid higher commissions. “So now when we look at the products that are in the marketplace today, they are higher cost, more complex, and more difficult to even vet.” Products that are more complex and opaque tend “to get loaded up with a lot of fees and expenses on the back end that no one can see because the thing is too darn opaque and complex to evaluate. The good products get squished out of existence,” Kitces wrote.⁸⁶

The harmful impact of reverse competition extends to features beyond cost, as we demonstrated in an earlier letter to the Commission using an analysis of ratings of variable annuities by Weiss Ratings.⁸⁷ 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. Based on these factors, Weiss compiles lists of the 10 best and 10 worst annuities. A look at the annuities on the 10 worst list, which includes a number of products that combine very high costs, very long surrender periods, and very poor investment options, raises the question of whether these funds could even exist in a truly competitive market. The only reasonable explanation for their ability to attract buyers is the explanation offered by Kitces: they offer a high commission so that brokers and insurance agents will “sell the heck out of it.”⁸⁸

Investors are harmed when they are steered into higher cost, riskier, less liquid, or poorly performing investments because they are the ones that pay the broker more. High quality investment products also suffer in a market characterized by reverse competition. Both would benefit from a regulatory approach that combines an enforceable best interest standard with restrictions on conflicts that undermine that standard.

- Evidence of investor harm is found in peer reviewed academic studies.

The evidence of investor harm that can be seen through basic market observation is also backed by a wealth of peer-reviewed academic studies. This evidence has been thoroughly documented and analyzed in the DOL's RIA and the 2014 RAND study that compiled that

⁸⁵ Michael Kitces, *Why The DoL Fiduciary Rule Won't Kill Annuities, It Will Make Them Stronger!*, KITCES.COM, April 21, 2016, <http://bit.ly/22THLKe>.

⁸⁶ *Id.*

⁸⁷ Letter from Barbara Roper, CFA, to the SEC, RFI on Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, at 26-27, <http://bit.ly/2veGjfw>.

⁸⁸ Michael Kitces, *Why The DoL Fiduciary Rule Won't Kill Annuities, It Will Make Them Stronger!*, KITCES.COM, April 21, 2016, <http://bit.ly/22THLKe>.

research on the Department's behalf.⁸⁹ While few question the existence of conflicts of interest in the investment advice market, some have sought to suggest that the conflicts do not have an undue or harmful influence on brokers' recommendations either because existing regulations are sufficient to prevent that from happening or because of reputational concerns.⁹⁰ That argument was effectively rebutted by RAND researchers in a February 2015 study, which characterizes the proponents' supporting evidence as unconvincing and cites several studies that "support the view that acting on potential conflicts of interest is fairly widespread and is costly to investors."

Academic studies compiled by RAND have, for example, found "empirical evidence suggesting that financial advisors act opportunistically to the detriment of their clients."⁹¹ Among these are several academic papers that indicate that "fund flows are positively associated with investment fees" and that "investors in the broker channel receive lower returns on their investments than investors in the direct channel."⁹² Based on their review of the literature, authors of the RAND Study concluded that, "there is substantial empirical evidence that financial advisors are influenced by their compensation schemes and that investors who purchase through advisors earn lower returns than those who invest autonomously."⁹³ One of the studies that contributed to that finding, a 2013 study by Christoffersen, Evans, and Musto, found that increasing revenue sharing and load sharing increases the likelihood that a mutual fund will be recommended, and that increasing load sharing decreases investor returns. Specifically, the authors found that a one percentage point increase in load sharing reduces excess return 0.34 percentage points.⁹⁴ This study formed the basis for the Department of Labor's estimate of harm.

- Evidence suggests harm to investors from conflicted advice totals tens of billions of dollars a year.

The Department's estimate of harm in this one segment of the retirement advice market starts from the assumption, based on extensive evidence, that "because of agency conflicts between advisers and investors that reflect the way advisers are compensated and IRA investors' high information costs, IRA investors will sometimes receive and follow advice that

⁸⁹ See Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," <http://bit.ly/1KgDRZu>.

⁹⁰ Steven Garber, Jeremy Burke, Angela Hung, and Eric Talley, Potential Economic Effects on Individual Retirement Account Markets and Investors of DOL's Proposed Rule Concerning the Definition of a 'Fiduciary,' RAND Report, February 2015, Chapter 3, <http://bit.ly/2gK1hti>.

⁹¹ Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, Impacts of Conflicts of Interest in the Financial Services Industry, RAND Working Paper, August 2014, <http://bit.ly/2w8gzOt>.

⁹² *Id.* at 14.

⁹³ *Id.* at 20.

⁹⁴ Susan Christoffersen, Richard Evans, and David Musto, "What Do Consumers' Fund Flows Maximize? Evidence from Their Broker's Incentives." *Journal of Finance* 68 (2013): 201-235. While ICI and others have argued that the DOL misused this study in developing its estimate of investor harm, both the study's authors and the independent consultant brought in to evaluate industry studies affirmed the validity of the DOL's approach. See Letter from Susan Christoffersen and Richard Evans, to the DOL, September 10, 2015, <http://bit.ly/2xSfPiD>. See also Karthik Padmanabhan, Constantijn Panis, and Timothy J. Tardiff, Review of Selected Studies and Comments in Response to the Department of Labor's Conflict of Interest 2015 Proposed Rule and Exemptions, Advanced Analytical Consulting Group, Inc., March 4, 2016, at 32-40, <http://bit.ly/2ofTF4N>. See also DOL, Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions, April 2016, at 163-166, <http://bit.ly/2mT9Gfq>.

subordinates their financial interests to their advisers', and consequently their net investment results will suffer."⁹⁵ The evidence it examined consistently points to a substantial failure of the market for retirement advice, the Department found. Based on its careful review of the evidence, the DOL estimated that IRA holders receiving conflicted investment advice -- in the front-load mutual fund segment alone -- can expect their investments to underperform by an average of 50 to 100 basis points per year. The DOL concluded that the underperformance associated with conflicts of interest just in the front-load mutual fund market could cost IRA investors between \$95 billion and \$189 billion over the next 10 years and between \$202 billion and \$404 billion over the next 20 years. Moreover, the Department found that the harm to investors "persists despite existing consumer protections, including those provided under securities and insurance regulations."⁹⁶ It is on this basis that DOL concluded that, "Regulatory action that effectively mitigates advisers' conflicts and ensures that advice puts IRA investors' interests first can deliver large, welfare-improving financial benefits for IRA investors that justify associated costs."

The DOL's analysis of investor harm should serve as a starting point for the Commission's own assessment of the harm to investors from conflicted advice in the securities markets. In weighing the harm that results from conflicted advice, however, it is important to remember that mutual funds are among the most transparent and liquid of investment products, with information widely available that provides detailed comparisons among funds, including with regard to cost and performance. These factors should serve to reduce the harmful impact of conflicts on recommendations of mutual funds, particularly relative to other investments, such as annuities and REITs, that are more complex and less transparent, and where much less third-party information is available comparing the various investment options. That complexity and opacity creates greater potential for investor harm outside the mutual fund market.

When examining the costs of conflicts for retirement and non-retirement accounts, the harm to securities investors is unquestionably much greater than the DOL's estimates, since the DOL estimate is based on only a limited portion of the retirement account market. Even using a conservative estimate of the harmful impact of conflicted advice, the total harm measures in the tens of billions. For example, according to the ICI's 2017 Fact Book, there was roughly \$1.95 trillion invested in front-load mutual funds at the end of 2016.⁹⁷ If, as is indicated by research examined in the RIA, we assume that front-load mutual funds, on average, underperform available alternatives by 50 basis points per year because front-load mutual fund investors are not receiving best interest advice, that means these investors are losing \$9.75 billion annually as a result of conflicted advice. If you consider the costs of conflicts for all load mutual fund investors, not just front-load mutual funds, the losses grow significantly. According to ICI's 2017 Fact Book, there was roughly \$2.37 trillion invested in load mutual funds of all types at the end of 2016.⁹⁸ If we assume that these mutual funds, on average, also underperform available alternatives by 50 basis points per year because load mutual fund investors are not receiving best interest advice, that means these investors are losing \$11.85 billion annually as a result of conflicted advice.

⁹⁵ DOL, Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions, April 2016, at 105, <http://bit.ly/2mT9Gfg>.

⁹⁶ *Id.* at 105.

⁹⁷ ICI 2017 Fact Book, Figure 5.13, at 106, <http://bit.ly/2vKt8zV>.

⁹⁸ *Id.*

Finally, we consider the costs of conflicts for investors in all load mutual fund as well as variable annuities. According to ICI's 2017 Fact Book, there was roughly \$2.37 trillion in load mutual funds and \$1.64 trillion in variable annuities at the end of 2016, totaling just over \$4 trillion invested in these products that are typically sold pursuant to conflicts of interest. If we assume that these products, on average, underperform available alternatives by 50 basis points per year because investors in these products are not receiving best interest advice, that means these investors are losing roughly \$20 billion annually as a result of conflicted advice. We know, however, that costs in variable annuities are often much higher, imposing an even greater lag on performance. If, instead of using the conservative assumption that conflicted advice results in underperformance amounting to 50 basis points, you assume underperformance of 100 basis points, investor losses attributable to conflicted advice total more than \$40 billion annually. It should hardly come as a surprise under the circumstances that many in the industry do not want to give up the tens of billions of dollars in excess profits that they've been able to extract from unsophisticated investors under the existing regulatory approach. This, and not concern for the impact on small savers, represents the best explanation for why they oppose meaningful regulation in this space.

The magnitude of harm that investors suffer as a result of conflicted advice grows even further when you add non-traded REITs to the equation. According to Craig McCann and his colleagues at the Securities Litigation and Consulting Group, investors purchased at least \$116 billion in non-traded REITs over the last 25 years and, as a result, are at least \$45 billion worse off than they would have been if they had merely invested in a diversified portfolio of traded REITs.⁹⁹ In their study, Dr. McCann and his colleagues found that non-traded REIT investors pay upfront fees that average 13.2 percent of the purchase amount, and in some cases are as high as 16 percent. These fees dramatically reduce the capital available to purchase portfolio holdings. A significant portion of these payments goes to the brokers who recommend these products. While non-traded REITs are often advertised as high-yield assets, their performance statistics tell a different story. For example, according to Dr. McCann's analysis, non-traded REITs underperform traded REITs by approximately 7.3 percent annually (11.3 percent for a diversified portfolio of traded REITs vs. 4 percent for the nontraded REITs sample they examined). According to the analysis, investors in non-traded REITs would have earned the same performance in short and intermediate term Treasury mutual funds – without the higher risks and illiquidity. Given these deficiencies, evidence that sales of nontraded REITs have diminished since the DOL rule was adopted should be viewed as a benefit of the rule, and not as a sign that it is harming investors by limiting their investment choices.

While industry rule opponents dispute the DOL's estimate of harm, they have done so on questionable grounds. Included in the public input the DOL received, for example, were a number of industry-funded studies and surveys challenging the Department's analysis. In order to independently evaluate those studies, the Department submitted them for review by a consulting firm, which carefully assessed the methodologies used and the validity of the

⁹⁹ Craig McCann, *Fiduciary Duty and Non-Traded REITs*, Investment Management Consultants Association Inc, July / August 2015, <http://bit.ly/2xdEUHw>.

findings.¹⁰⁰ Almost without exception, the consultants found the industry studies’ findings questionable and their methodologies deeply flawed. If it is to develop a sound and defensible policy, the Commission will need to be just as rigorous in its own analysis, particularly with regard to non-verifiable industry claims based on non-transparent data.

As we described in greater detail in our April 2017 DOL comment letter, more recent studies have confirmed these findings that conflicts of interest have a harmful influence on recommendations.¹⁰¹ They include: 1) a recent study showing that brokers fail to recommend superior mutual funds, suggesting that many investors who pay for a brokers’ help in selecting mutual funds are not being directed into the best available option and instead are paying higher than necessary costs for their investments;¹⁰² 2) a law review article that uses case studies based on non-traded REITS and closed end funds sold through IPOs to show how the regulatory structure for financial advice “tolerates incentives motivating financial advisors to manipulate and deceive retail investors,” with harmful consequences for investors and the economy as a whole;¹⁰³ and 3) an updated mystery shopper survey that provides new evidence that fiduciary advice is in fact superior to non-fiduciary advice.¹⁰⁴ The latter study found, for example, that, instead of correcting for customers’ misconceptions, non-fiduciary advisers seemed to exaggerate clients’ existing misconceptions if it made it easier to sell more expensive and higher fee products. The report’s author said their results suggested non-fiduciary advisers were “willing to make their clients worse off in order to secure financial gain for themselves.”

Ultimately, it simply isn’t credible to suggest that brokers who can earn two, or five, or many times more money recommending one investment product over another will be unaffected by those conflicts. After all, if the financial incentives didn’t work, why would financial firms persist in offering them? As FINRA noted in its report on conflicts, “While the existence of a conflict does not, *per se*, imply that harm to one party’s interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly.”¹⁰⁵ Commission policy needs to reflect that reality.

- The harm investors suffer when the “financial advisors” they rely on prey on their trust can be devastating.

What the academic studies do not fully capture are the human stories behind the statistics. A recent article by Bob Veres, a well known writer and commentator on the financial services industry, helps to capture the often devastating human consequences of non-fiduciary

¹⁰⁰ Karthik Padmanabhan, Constantijn Panis, and Timothy J. Tardiff, Review of Selected Studies and Comments in Response to the Department of Labor’s Conflict of Interest 2015 Proposed Rule and Exemptions, Advanced Analytical Consulting Group, Inc., March 4, 2016, <http://bit.ly/2ofTF4N>. (With few exceptions, the consultants found the industry studies’ findings questionable and their methodologies deeply flawed).

¹⁰¹ Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, April 17, 2017, at 20-24, <http://bit.ly/2oXIZfq>.

¹⁰² Michael Cooper, Michael Halling and Wenhao Yang, The Mutual Fund Fee Puzzle, October 2016, <http://bit.ly/2nEq7MK>

¹⁰³ Benjamin P. Edwards, “Conflicts & Capital Allocation,” Ohio State Law Journal, Vol. 77, 2017, Forthcoming, <http://bit.ly/2nlbP8v>.

¹⁰⁴ Antoinette Schoar, *We Put Financial Advisers to the Test—and They Failed*, WALL STREET JOURNAL, Oct. 27, 2016, <http://on.wsj.com/2k9LMMT>.

¹⁰⁵ FINRA, Report on Conflicts of Interest, October 2013, <http://bit.ly/1Kxdp9z>.

“advice.”¹⁰⁶ Veres asked his readers, made up primarily of financial planners, whether they had “any stories about the harm caused by predatory recommendations from sales agents posing as advisors.” Many responded, and as Veres says, “The stories they tell are shocking.”

- A pre-retiree with plenty of money in her TIAA accounts to provide her with more than sufficient income in retirement once she is ready to retire was talked by her broker into putting \$300,000 of her IRA assets “into a high-commission variable annuity with a lifetime income rider that will guarantee income (that the client doesn’t need) in case the market goes down.” As the financial planner who reviewed her situation told Veres, “She’s paying north of 3.7% a year for a useless lifetime benefit and a 4-year surrender schedule.” The broker also reportedly talked the client into taking \$30,000 a year in early withdrawals from the TIAA retirement account in order to invest it in the variable annuity. As Veres explains, “Money is being distributed out of a tax-deferred account, taxes are being paid unnecessarily, then the proceeds are re-contributed to a much more expensive tax-deferred annuity, with the agent receiving a nice fat sales commission on each transfer. And, of course, each contribution extends the surrender period on the annuity, which is up to seven years now.”¹⁰⁷
- A 94-year-old recent widow who was living in a care facility that cost \$9,000 a month received a \$250,000 insurance payment when her husband died. The adviser who was asked by her daughter to look over her mother’s finances to see if she could afford to continue living in the facility found that the \$250,000 had already been invested in a variable annuity by a broker who had been working with the husband and “swooped in” immediately after his death to make the sale. This had the effect of “turning the liquid assets into illiquid assets and adding a heap of fees on top of them.” The mother, who “didn’t want to ‘make trouble’” for her husband’s “friend,” chose to pay the surrender fees and live on what was left, an amount that has nearly been depleted three years later, Veres reported.¹⁰⁸
- A widow in her 70s who survived a car accident that killed her husband was visited two weeks after she got out of the hospital by the “financial advisor” who had sold annuities to both her and her husband. As spousal beneficiary of her husband’s annuity, she had the option to roll over the full value of his annuity into hers. Instead, Veres reports, “the ‘advisor’ sold her a new annuity for that money, with of course a new surrender schedule and a new commission bonus for him.” In this case, the financial planner who assisted the woman helped her write to the insurance company to complain, and the company, to its credit, rescinded the new annuity and rolled her husband’s annuity over into hers.¹⁰⁹
- A financial planner asked to do a portfolio review for a man on the verge of turning 70 discovered that an insurance agent had talked his client into taking Social Security at 66, when he was still working and earning a high income, in order to invest the after-tax

¹⁰⁶ Bob Veres, *The Awful Consequences of Non-Fiduciary Advice*, INSIDE INFORMATION, Vol. 27, No. 9, September 2017, <http://bit.ly/2f81yXb>.

¹⁰⁷ *Id.* at 2-3.

¹⁰⁸ *Id.* at 3-4.

¹⁰⁹ *Id.* at 4.

amounts in a couple of equity-indexed annuities. The client not only ended up paying unnecessary tax on his Social Security benefits, he lost the increase to his benefits that he would have received had he held off taking them until age 70. The planner added that the payments the client could begin taking from the annuities at age 70 were “nowhere near” the added income he could have gotten from Social Security if he’d waited to collect.¹¹⁰

- Another example provided by Veres illustrates the benefits of fiduciaries’ obligation to monitor client accounts “to make sure the recommendations perform as advertised.” In this case, a fiduciary planner met with an 85-year-old client who had been sold \$11 million (face amount) worth of cash value life insurance policies. Aware that the client’s health was deteriorating, the planner looked into the policies for him and found that, “There had been a serious decline in the dividend crediting rate since 2008 on the policies, and nearly all of them were seriously underfunded and in danger of lapsing within six months.” Fortunately, the review was conducted in time for the planner to make some needed adjustments. But, as the planner explained, “Had we not done a timely review and proposed some changes ... the client’s family would have lost more than half of his death benefits and wasted millions of dollars in the premiums he had paid into the policies over decades.”¹¹¹
- A 74-year-old widow saw her taxable account at UBS, which she relied on for income, decline from \$1.3 million to \$800,000. According to the planner who referred the story to Veres, “The broker had been using a complicated covered call writing strategy in an effort to generate her desired monthly income—apparently without much success.” When the widow bought a new home, the broker convinced her to take out a mortgage through a UBS subsidiary, only to learn that she couldn’t qualify for a traditional 30-year, fixed-rate mortgage because his unsuccessful trading strategy left her unable to document that she had a consistent, regular monthly income. To “solve” the problem, the UBS broker reportedly had her “sign up for an asset-backed loan—through a UBS subsidiary, of course—using her brokerage account as collateral. The interest rate was a floating, not fixed rate.” When the investment account continued to decline, according to the planner who tried without success to intervene, the widow began getting calls from the lender to pay down the loan, due to the account’s declining value.¹¹²
- A 71-year-old man and his 68-year-old wife, who had never had a lot of money and were entering retirement with Social Security and a portfolio of less than \$200,000, had been working with a dually registered “advisor” at one of the major independent brokerage firms when they asked a family friend to look of their portfolio. When he did so, their friend, a financial planner, found that about 25 percent of their portfolio, \$48,000 altogether, had been invested in non-traded REITs. “I was furious,” the planner told Veres. “These are, to use an old phrase, honest, hard-working, God-fearing people, who were invested in garbage.” The problem with non-traded REITs, as Veres explains, is that “they’re almost completely illiquid; once you buy them, you’re stuck with them. Meanwhile, the huge up-front expenses and 10% commissions, disclosed deep in the

¹¹⁰ *Id.* at 5.

¹¹¹ *Id.*

¹¹² *Id.* at 8.

prospectus, makes them unlikely ever to make money for their investors.” The best offer the planner was able to get for the illiquid securities was \$15,000.¹¹³

- Another planner recalled an 18-year-old who inherited an IRA that was entirely invested in non-traded REITs. As the planner described it, “The commission [paid to the representative] cost more than the position was worth.”¹¹⁴
- Another dually registered advisor reportedly charged his clients a one percent asset under management fee, which he disclosed, then invested a significant portion of their money in non-traded REITs, which paid a 10 percent commission that he apparently did not disclose.¹¹⁵

That is just a sampling of the horror stories reported by Veres, representing just one week’s worth of responses to his request, as Veres informed us in an email. It should come as no surprise that many of the worst examples involve the sale of annuities and non-traded REITs, which typically pay among the highest commissions and, for annuities regulated exclusively under state insurance laws, often offer lavish prizes to the top sellers.¹¹⁶ The problem is that lavish financial rewards can and do tempt financial professionals to take advantage of their clients’ trust, as these examples demonstrate.

Industry advocates would doubtless argue that many of the examples cited in Veres’ article violate, not just a fiduciary standard, but the existing suitability standard. And that would appear to be true in some, though not all, of these cases. But the relevant fact here, as the Commission considers whether and how to strengthen protections for investors, is that the existing standard wasn’t sufficient to counteract the incentives motivating the misconduct. And, heartbreaking as their stories are, the victims described here are, in one sense, the lucky ones; they had the good fortune to seek out a second opinion from a fiduciary adviser, who at least in a few instances was able to help unwind the mess. How many more people are out there who have been similarly victimized and who don’t even realize it?

A regulatory approach that relies solely on a principles-based best interest standard cannot hope to prevent abuses such as these when the chances of getting caught appear to be minimal and the profits from misconduct are high. The best it can do is provide a basis for legal claims after the harm has been done, and industry has been working hard to defeat efforts to hold them legally accountable. To have a hope of preventing abuses such as these, the regulations must include meaningful restrictions on the financial incentives that encourage misconduct. In light of the devastation that these abuses can cause, and the difficulty investors have in recovering from such losses, prevention of harm through better alignment of financial incentives should be the goal of the Commission’s regulatory approach.

¹¹³ *Id.*

¹¹⁴ *Id.* at 9.

¹¹⁵ *Id.*

¹¹⁶ Office of Senator Elizabeth Warren, “Villas, Castles, and Vacations: How Perks and Giveaways Create Conflicts of Interest in the Annuity Industry,” October 2015, <http://bit.ly/2nNgb8t>; Office of Senator Elizabeth Warren, “Villas, Castles, and Vacations Americans’ New Protections from Financial Adviser Kickbacks, High Fees, & Commissions are at Risk, 2017 Edition,” February 2017, <http://bit.ly/2l3OUbl>.

C. The SEC has not effectively addressed conflicts of interest.

The request for comment asks whether conflicts of interest have been effectively addressed. They have not, with the notable exception of the Department of Labor's new rules governing retirement accounts. The Commission itself has taken a largely hands off approach.

- The Commission has relied primarily on “best practices” guidance, rather than concrete actions, to reduce the harmful impact of conflicts of interest.

Even after Chairman Levitt appointed the Tully Commission to study conflicts, the Commission did not for the most part take concrete steps to rein in problematic practices identified in the Committee's report. Instead, the SEC chose to rely on encouraging firms to adopt “best practices” to better align the interests of customers, registered representatives, and brokerage firms.¹¹⁷ Among the suggested reforms were elimination of up-front signing bonuses, sales contests, and differential compensation to push the sale of certain products, including proprietary mutual funds, as well as paying a portion of registered representative compensation “based on client assets in an account, regardless of transaction activity, so the RRs receive some compensation even if they advise a client to ‘do nothing.’”¹¹⁸

A few years later, the *Wall Street Journal* was reporting that relying on firms to police themselves had been a failure.¹¹⁹ “Initially, some firms cut back. More recently, however, intense competitive pressures to build client assets have led PaineWebber, Salomon Smith Barney, Prudential Securities and even Merrill to ratchet up efforts to pay upfront bonuses and provide other perks to brokers,” the paper reported. “At Morgan Stanley Dean Witter, some brokers say they are under constant pressure to sell in-house, or ‘proprietary,’ mutual funds, despite past assurances by Dean Witter and other firms that they would abide by the Tully Commission's recommendations in this area.” The *Journal* added that Chairman Levitt, “once a leading proponent of self-regulation,” had concluded that rulemaking was likely to be necessary to achieve the desired results and supported a rule to ban sales contests based on single securities. Two decades later, signing bonuses that create major conflicts of interest remain an issue, and while FINRA has adopted rules to restrict sales contests, firms still impose quotas to encourage the sale of proprietary products. In the wake of the Tully Commission experience, Kurt Cerulli, founder of financial consulting firm Cerulli Associates, explained backsliding among firms this way: “Marketplace forces are stronger than self-regulatory forces ... I think the Tully Commission has been almost irrelevant.”¹²⁰

¹¹⁷ Tully Commission, Report of the Committee on Compensation Practices, April 10, 1995, <http://bit.ly/2nwNb0E>.

¹¹⁸ *Id.*

¹¹⁹ Charles Gasparino and Pui-Wing Tam, *Wall Street Seems to Backslide On Pay and Bonus Practices*, WALL STREET JOURNAL, March 28, 2000, <http://on.wsj.com/2nOBTHK>.

¹²⁰ *Id.*

- The Commission’s efforts to reduce conflicts by encouraging a shift toward fee accounts has had greater success, despite the fact that the rule the Commission adopted to achieve this goal was ultimately overturned in court.

The one exception to the Commission’s hands off policy regarding conflicts has been its role in encouraging the shift toward fee accounts. This was a major focus of the Tully Commission report. It is also the one area where the SEC proposed new regulations to bring about the desired change -- its ill-fated proposal to exempt brokers’ fee accounts from regulation under the Investment Advisers Act. Echoing the arguments industry lobbyists make today against the Department of Labor rule, the SIA had insisted that regulating the accounts under the Advisers Act would cause brokers to drop the accounts, harming investors who would lose access to these valued services.¹²¹ Proving the fallacy of this argument, the shift to fee accounts has continued even after the courts overturned the SEC rule, which had the effect of requiring all fee accounts to be regulated under the Advisers Act. Indeed, there is perhaps no clearer illustration of the cynicism behind industry lobbyists’ attacks on the DOL rule than the fact that the same group that once embraced fee accounts as a “best practice” with the potential to benefit even buy-and-hold investors, and which adamantly opposed regulations they argued would deprive investors of access to such accounts, now identifies the shift to fee accounts as a harmful consequence of the DOL rule.

- The Commission has failed to use its existing authority to limit or ban practices that put investors at risk.

Despite the failure of its “best practices” approach to dealing with conflicts identified by the Tully Commission, the Commission has not subsequently adopted a more effective approach. As noted above, it has not even conducted the examination of conflicts required by the Dodd-Frank Act. And, while the staff study on duties of broker-dealers and investment advisers included a recommendation to adopt rules to rein in conflicts, the Commission has not specified any conflicts it is considering limiting, nor has it acted on that recommendation. And, as discussed above, the assumptions included in the Commission’s earlier RFI strongly suggested that the Commission had no intention of adopting any such restrictions. FINRA has adopted some targeted rules to address conflicts over the years, including the conflicts associated with sales contests, but these rules are far from comprehensive. They do not, for example, address the conflicts associated with differential compensation or sale of proprietary products. FINRA’s 2013 conflict study provides a good overview of voluntary industry practices to address such conflicts. But, as the Commission’s experience in the wake of the Tully Commission should make clear, relying on best practice guidance is unlikely to adequately discipline practices that firms find highly profitable.

Even under the Advisers Act, which theoretically requires investment advisers to avoid conflicts of interest that can reasonably be avoided, the Commission has taken a largely hands off approach that relies on disclosure rather than avoidance of conflicts. Evidence that Congress

¹²¹ Letter from Ira D. Hammerman, General Counsel, Securities Industry Association, to the Securities and Exchange Commission regarding Release No. IA-2278, Certain Broker-Dealers Deemed Not To Be Investment Advisers, September 22, 2004, <http://bit.ly/2oxtk2w>. See also Letter from CFA, to the DOL, April 17, 2017, at 72, <http://bit.ly/2oXIZfq>.

supported steps to minimize conflicts can be found in the strict limits the Advisers Act places on principal trading.¹²² And many investment advisers have adopted fee-only business models structured in ways that minimize conflicts and eliminate, to the degree possible, incentives to recommend investments that are not in customers' best interests. But this reflects a choice on their part, rather than a requirement of the law.

In enforcing the law, the Commission has typically required only that conflicts of interest be disclosed, permitting investment advisers to act in ways that are not in customers' best interests as long as they "clearly" disclose their incentives for doing so. The disclosures themselves typically come in ADV Forms that, for large firms, can run to more than 100 pages in length. As we discuss further below, we believe the Commission must take more aggressive steps to protect investors from the harmful impact of these conflicts, by giving real meaning to the Advisers Act's best interest standard, requiring firms to appropriately manage conflicts to ensure they don't negatively influence recommendations, and requiring advisers to document the reasonable basis on which they concluded their recommended investment or strategy is the best available option for the investor.

As a result of the Commission's inaction, investors rely without question on self-interested investment recommendations from financial professionals who have been allowed to place their own financial interests ahead of the best interests of their customers. This is commonplace among broker-dealers, where conflicts of interest are pervasive and restrictions on those conflicts are minimal at best. While the harm that results from self-interested sales recommendations may be difficult to quantify precisely, evidence suggests it runs to tens of billions of dollars a year, directly affecting the ability of many middle-income Americans to accumulate funds adequate for their retirement needs and other long-term financial goals. It demands a strong regulatory response. The laissez-faire approach the Commission has taken to enforcing Advisers Act fiduciary duties will not be sufficient to protect vulnerable, and financially unsophisticated retail investors, particularly when extended to the conflicts common among broker-dealers.

III. The situation demands a strong regulatory response from the Commission.

Taken in isolation, either of the two main problems in the market for investment advice -- the fact that investors cannot distinguish mere sellers from bona fide advisers and the fact that much of the advice they receive is biased by conflicts -- is serious, but not entirely unmanageable. An investor who cannot distinguish sellers from advisers would nonetheless not face insurmountable risks if the sales recommendations weren't unduly influenced by conflicts of interest. Conversely, an investor who could readily distinguish sellers from advisers, and understood the salient differences, could at least in theory protect himself, either by choosing to work with an adviser, if advice is what he wanted, or by entering the relationship with the seller with a clear understanding that he would be receiving highly conflicted episodic sales

¹²² As we have explained in a previous comment letter, we believe regulations governing principal trading could be made both less burdensome and more effective through appropriate application of a fiduciary standard. *See, e.g.*, Letter from Fund Democracy and CFA, to the SEC, Re: Interim Exemption from Principal Trading Restrictions under the Investment Advisers Act, November 30, 2007, <http://bit.ly/2eKiJ0h>.

recommendations. Taken together, however, the problems pose a massive threat to investors and demand a forceful regulatory response.

A. Investors are ill-equipped to protect themselves against the harmful impact of conflicted advice.

One reason conflicts of interest in the investment advice market are so problematic is that investors typically lack the financial expertise to determine whether or to what degree the advice they receive has been negatively affected by conflicts. As discussed above, research has clearly shown that investors cannot distinguish between broker-dealers and investment advisers, and many mistakenly believe that all financial professionals are required to act in customers' best interests. As a result, they are likely to enter their relationship with a conflicted adviser with their guard down, unaware of the conflicts that could bias her recommendations and unaware of the lack of protection afforded by existing securities laws. 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."

Research from a variety of sources supports this conclusion, including both the 2008 RAND Study commissioned by the SEC and the Commission's 2011 financial literacy study.¹²³ These and other studies suggest that, not only do investors struggle to distinguish sellers from advisers, but many don't understand what information they need to know to make an informed choice among financial professionals, let alone how to assess that information. They are even less equipped to assess the advice they receive. As the DOL stated in the RIA, "Without a good understanding of the quality and price of advice, [investors] cannot make optimal decisions about purchasing it, and are vulnerable to paying too much for bad advice and to incurring financial losses by following it."¹²⁴ According to RAND researchers who examined the impact of conflicts in a 2014 study, "it can be difficult for individual investors to evaluate the advice they receive and to identify when it has been influenced by a conflict of interest."¹²⁵

More recent studies support this conclusion, including studies by FINRA and various financial firms, as we discussed in greater detail in our April 2017 DOL comment letter.¹²⁶ For example, research shows that many investors do not understand something as basic as how their

¹²³ Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi and Farrukh Suvankulov. *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*. Santa Monica, CA: RAND Corporation, 2008, <http://bit.ly/1OrrZ3v>; 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, <http://bit.ly/1RXrU76>; Seth L. Elan, *Financial Literacy Among Retail Investors in the United States*, A Report Prepared by the Federal Research Division, Library of Congress under an Interagency Agreement with the SEC, December 30, 2011, <http://bit.ly/2eK31CA>.

¹²⁴ DOL, *Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions*, April 2016, at 136, <http://bit.ly/2mT9Gfq>.

¹²⁵ Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, *Impacts of Conflicts of Interest in the Financial Services Industry*, RAND Working Paper, August 2014, <http://bit.ly/2w8gzOt>.

¹²⁶ Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, April 17, 2017, at 15-17, <http://bit.ly/2oXIZfq>.

adviser gets paid. On the 2016 survey by FINRA Investor Education Foundation, for example, just 56 percent of those who work with a professional adviser said they have a clear understanding of how their adviser gets paid.¹²⁷ An A.T. Kearney survey of “mass affluent” investors (defined as those with \$50,000 or more in investable assets) found that nearly 30 percent of those who receive advice believe they do not pay for that advice, and another 12 percent said they do not know how they pay.¹²⁸ Among the nearly 60 percent who say they do know how they pay for advice, many do not know how much they pay.¹²⁹ The authors of the Kearney study found that low level of awareness regarding the cost of investment advice “astounding.”¹³⁰

It is simply not conceivable that those who aren’t sure how or how much their adviser gets paid fully comprehend the complex web of financial incentives that can affect that pay. The conflicts are often opaque. For example, while most (but not all) investors understand that their broker gets paid through commissions, investors do not typically receive clear information regarding the different levels of compensation a broker can receive depending on the investment he recommends. They are even less likely to get information about the conflicts associated with firms’ specific pay schemes, such as ratcheted payout grids, or personnel policies that can create conflicts of interest. When they do get information, it is often buried in lengthy legal documents that investors struggle to understand, if they read them at all.

As a result, the Commission cannot reasonably conclude that investors who cannot distinguish sellers from advisers and don’t know how or how much they pay for advice are capable of protecting themselves from the harmful impact of pervasive conflicts. Moreover, as one study noted, “The extent to which conflicted advice can harm advisees depends on how likely advisees are to follow advice.” According to that study, “less knowledgeable individuals discount [conflicted] advice less, and may be more vulnerable.”¹³¹ The Commission must base its regulatory approach on a realistic assessment of the low level of financial sophistication common among investors, and it must take into account the needs of these most vulnerable investors when considering what regulatory approach to adopt.

B. Disclosure alone is not sufficient either to reduce investor confusion or to protect investors from the harmful impact of conflicts of interest.

The Request for Input asks repeatedly whether there is a disclosure-based solution available that would address concerns regarding investor confusion and conflicts of interest. There is not. The Commission has already wasted years trying to develop a disclosure-based solution to the problem of investor “confusion,” as discussed above. Based on the results of those efforts, it should be patently obvious by now that, unless and until the Commission is prepared to prevent brokers from misrepresenting their sales representatives as advisers and their arm’s

¹²⁷ FINRA Investor Education Foundation, *Investors in the United States 2016*, Dec. 2016, at 7, <http://bit.ly/2hMrppX>.

¹²⁸ A.T. Kearney, 2016 *Future of Advice Study, Why Investing Will Never Be the Same*, June 2016, <http://bit.ly/2nwbAEz>.

¹²⁹ *Id.* at 10.

¹³⁰ *Id.* at 11.

¹³¹ Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, *Impacts of Conflicts of Interest in the Financial Services Industry*, RAND Working Paper, August 2014, at 12, <http://bit.ly/2w8gzOt>.

length sales recommendations as advice, even the best designed disclosures aren't going to be sufficient to prevent investors confusion. There is even less reason to believe that disclosure alone is likely to be effective in protecting investors from the harmful impact of conflicts of interest. While disclosures can serve as an important component of a comprehensive regulatory approach, they do not, in and of themselves, offer a solution to the intertwined problems of investor confusion and conflicts of interest.

- Disclosure alone cannot counteract the misleading marketing that portrays brokers' arm's length sales activities as advice.

In a market in which brokers and advisers use comparable titles and offer seemingly similar services (e.g., retirement planning, investment planning), and when brokerage firms spends millions of dollars on marketing campaigns designed to blur the distinctions between selling and advice, there is simply no basis for believing that disclosure alone would be sufficient to enable investors to make an informed choice among these two different types of securities professionals. Moreover, the Commission has already thoroughly explored this approach without success. To its credit, the Commission abandoned those earlier efforts when investor testing showed them to be ineffective.

If it were to revive those efforts to devise a disclosure-based solution to confusion now, it would be incumbent on the Commission to test any proposed disclosures for effectiveness. And that investor testing would need to be conducted in a way that takes into account the manner in which broker-dealers market their services. In light of past experience, we believe this would be a waste of Commission resources only to achieve a predictable outcome. On the other hand, for the Commission to adopt a disclosure-only approach to resolving investor confusion, without addressing the underlying misrepresentation and without engaging in investor testing, would be arbitrary and capricious.

- Disclosure alone cannot protect investors from the harmful impact of conflicts of interest.

Assuming brokers' conflicts of interest go unchecked, a number of conditions would have to be met for a disclosure-based approach to conflicts to be even minimally effective, none of which is realistic. First, the Commission would need to develop a format for disclosures that clearly and briefly described both the nature of all material conflicts and their potential for influencing the adviser or broker's recommendations. Investors would need to read and understand those disclosures in order to be able to make an informed choice among financial professionals they are considering hiring. And investors who end up working with a conflicted adviser would need to be able to independently assess the quality of recommendations they receive in order to make an informed choice regarding whether to follow those recommendations. None of these conditions is likely to be met. After all, the Commission has been unable to design a disclosure that effectively conveys what should be a relatively straightforward distinction between brokers, who are sellers offering episodic sales recommendations, and investment advisers, who offer ongoing fiduciary advice. There is even less reason to believe it could develop a clear, concise disclosure to convey the key information investors need to understand about the conflicts of interest that could bias their broker's recommendations.

The insurmountable problem is that the conflicts are so extensive and complex that they defy easy description in a form that typical investors could readily absorb. It would not be sufficient, for example, to disclose that brokers are paid through commissions and only get paid when the investor buys or sells a security. As discussed above, that is the least of the concerns regarding broker-dealer conflicts. Disclosures would need to convey the full range of practices likely to influence the broker's investment recommendations, including, for example, the differences in compensation they could receive depending on what investment they recommend. They would need to do so in a way that effectively conveys not just the existence, but also the magnitude of the conflict. Any such disclosure is likely to devolve into a laundry list, undermining the intent to provide clear, accessible information that even unsophisticated investors can understand and act on. One need only look at the ADV Forms compiled by large firms with complex conflicts to see how ineffective most are in conveying the relevant information.

Adding to the challenge, any such disclosures would need to be designed with the financial literacy of the typical investor in mind. For example, a review of studies and surveys on investor knowledge, prepared by the Library of Congress for the SEC, found that many investors do not understand key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns.¹³² Moreover, investors lack critical knowledge about investment fraud. In addition, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average person in the general population. These findings have been confirmed by other researchers as well.¹³³

How likely is it that investors who do not know the difference between a stock and a bond, and who do not know something as fundamental as how or how much they pay for advice, are going to read and understand disclosures describing the influence that differential compensation, ratcheted payout grids, revenue sharing payments, 12b-1 fees, and preferences for proprietary products can have on brokers' recommendations? But unless they read and understand those disclosures, investors who cannot distinguish sellers from advisers are likely to end up working with a conflicted "adviser," perhaps under the mistaken belief that the "advice" is free. When that occurs, those same investors are even less equipped to independently evaluate the recommendations they receive than they are to make an informed choice among financial professionals. Even if they do understand that the advice is conflicted, what are these financially unsophisticated investors supposed to do with that information?

Advocates of disclosure as an effective solution to conflicts assume that having to disclose conflicts will discourage firms from adopting practices that they would be reluctant to disclose. But as long as firms can get away with disclosing those practices in dense legal

¹³² Seth L. Elan, *Financial Literacy Among Retail Investors in the United States*, A Report Prepared by the Federal Research Division, Library of Congress under an Interagency Agreement with the SEC, December 30, 2011, <http://bit.ly/2eK31CA>.

¹³³ See discussion of the low level of investor knowledge in the April 2017 CFA comment letter to DOL <http://bit.ly/2oXIZfq>, at 17-19.

documents that few investors will read or understand, there's no reason to believe that disclosure alone will discourage unsavory practices. We know, for example, that requiring investment advisers to disclose in their ADV Forms that they favor proprietary products over non-proprietary products doesn't prevent them from incentivizing advisers to favor the firm's profits over customers' best interests. There is no reason to believe that requiring disclosure of brokers' myriad conflicts will be any more effective in discouraging practices that encourage and reward advice that is not in customers' best interests.

Other research confirms this concern that conflict of interest disclosures are generally ineffective as a method of protecting investors. A 2016 RAND Corporation study, for example, examined the academic literature related to effective disclosures in financial decision-making and concluded that, "disclosure, particularly disclosure used in isolation, may not provide sufficient support in helping investors make more informed decisions."¹³⁴ Looking specifically at disclosures related to conflicts of interest, the RAND researchers found that "many consumers fail to adjust their behavior sufficiently, if at all" when conflicts are disclosed.¹³⁵ Research has shown, moreover, "that the longer, more detailed disclosure documents have not been effective at helping consumers make informed choices in selecting mortgages, credit cards, and mutual funds, due to either limited attention or limited understanding of the material itself."¹³⁶ This raises serious doubts about the likely effectiveness of broker-dealer conflicts, since the conflicts are too pervasive and complex to be conveyed succinctly, and the lengthy, detailed disclosures necessary to convey the relevant information would be unlikely to be read or understood by investors.

In developing its fiduciary rule, the Department of Labor carefully weighed the evidence regarding disclosure effectiveness and concluded that disclosure alone did not provide an adequate protection against the harmful impact of conflicted advice. Relying on disclosure alone, and assuming that investors can make an informed decision based on that disclosure, "necessarily presumes that investors will adequately understand the implications of disclosed conflicts and factor that understanding into their choice of adviser and investments. This presumption is highly questionable," the DOL stated.¹³⁷ The DOL RIA discusses at length the evidence that led it to this conclusion. This included reports from representatives of brokerage firms interviewed by RAND researchers that investors rarely read the disclosures they are currently required to receive.¹³⁸

The DOL's analysis also included evidence that investors can't evaluate the recommendations they receive or identify harmful advice. The RIA reports on a study of actual retirement investment advice interactions in Australia, for example, which found that investors "were rarely able to tell whether or not the advice they received had a reasonable basis." In most cases where the Australian authority found "major shortcomings in the advice," the investors

¹³⁴ Angela A. Hung, Min Gong, and Jeremy Burke, *Effective Disclosures in Financial Decisionmaking*, RAND Research Report, July 2015, <http://bit.ly/2wbY000>.

¹³⁵ *Id.* at 24.

¹³⁶ *Id.*

¹³⁷ DOL, *Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions*, April 2016, at 268, <http://bit.ly/2mT9G>.

¹³⁸ *Id.*

“thought the advice was satisfactory and said they intended to follow it.”¹³⁹ Others noted that it is precisely their lack of expertise that leads investors to seek advice. DOL pointed to research showing that “disclosure is effective only where it provides ‘pertinent information that enables users to substantially improve their decisions with acceptable [user] costs’ and is comprehensible as having important implications for conflict disclosure. Given that investors are hard pressed to understand advisers’ conflicts or their implications, this suggests that disclosure of conflicts will be ineffective,” it concluded.¹⁴⁰ Regulators in the United Kingdom concluded that even combining disclosures with a best interest standard “did not sufficiently discourage mis-selling of retail investment products largely due to commission-driven sales practices and low qualification standards for advisers.”¹⁴¹ That is what led the U.K. to prohibit advisers from receiving commission compensation.¹⁴²

There are even studies which seem to indicate that disclosure of conflicts of interest can have a negative effect on investors. A 2005 study found, for example, that in certain situations, disclosure can lead advisers to give more biased advice by providing them with “moral license” to engage in self-interested behavior.¹⁴³ The results of this study were confirmed by subsequent research, which found that, absent other conditions, disclosure lessens moral reluctance to provide biased advice.¹⁴⁴ At the same time, researchers have found that investors feel increased pressure to follow the recommendations where conflicts have been disclosed, motivated in part by their “reluctance to appear unwilling to help the advisors once the advisors’ interests were publicly disclosed.”¹⁴⁵ This research, which suggests that a regulatory approach based on conflict of interest disclosure could backfire, doing more to harm than to help investors, must be factored into any decision the Commission makes about the appropriate regulatory approach.

Before it adopts a regulatory approach that relies on disclosure alone to protect investors from the harmful impact of conflicts of interest, the Commission would need to test that approach. Specifically, it would need to develop sample disclosures based on common brokerage industry conflicts and test them for effectiveness. As part of that testing, the Commission should also test the effectiveness of existing ADV disclosures where complex conflicts are present. We are convinced that the results of any such testing would confirm not only that disclosure does not provide effective protection against broker-dealer conflicts, but that the Commission also needs to abandon its over-reliance on disclosure to satisfy investment advisers’ compliance with their fiduciary obligations under the Advisers Act.

¹³⁹ *Id.* at 269.

¹⁴⁰ *Id.* at 271.

¹⁴¹ *Id.* at 271.

¹⁴² Industry lobbyists have consistently misrepresented the lessons to be learned from the U.K. experience, both by ignoring differences between the DOL rule and the U.K. approach and by falsely characterizing experience in the U.K. since its commission ban was adopted. *See* CFA, U.K. Experience Suggests Retirement Savers Will Benefit from DOL Rule to Rein in Conflicts of Interest, Promote Best Interest Advice, <http://bit.ly/1MnWqLr>.

¹⁴³ Daylian M. Cain, George Loewenstein, and Don A. Moore, “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest,” *Journal of Legal Studies*, vol. 34 (January 2005), <http://bit.ly/2f7RUHm>.

¹⁴⁴ George Loewenstein, Daylian M. Cain, and Sunita Sah, *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, *American Economic Review: Papers and Proceedings* 2011, 101:3, 423–428, <http://bit.ly/2eOGd8i>.

¹⁴⁵ *Id.* at 426.

- Disclosures can and should serve to supplement a more comprehensive regulatory solution to the twin problems of investor confusion and conflicts of interest.

While disclosure alone is insufficient either to prevent investor confusion or to protect investors from the harmful impact of conflicts, disclosure can play an important role in supplementing other regulatory actions, as we discuss in greater detail below. If the Commission were to adopt a regulatory approach designed to restore a functional distinction between broker-dealers and investment advisers, for example, it would need to incorporate clear pre-engagement disclosures to alert investors to the differences so that they could make an informed choice. But this could only work if broker-dealers were required to clearly label their registered representatives as salespeople, to clearly label their services as arm's length sales transactions, and to market them accordingly. The Commission would need to require that the disclosures be made in unvarnished terms and engage in investor testing in order to ensure that they effectively convey the relevant information.

Similarly, if the Commission were to adopt a regulatory approach that applied a best interest standard backed by tight restrictions on harmful conflicts, it might then be possible to develop conflict disclosures that would clearly and succinctly convey those conflicts that would inevitably remain. Even then, however, disclosures should not be viewed as a substitute for compliance with the best interest standard. Fiduciary advisers should still be required to avoid conflicts of interest where that is reasonably possible, and to manage and disclose conflicts of interest that are unavoidable. In other words, disclosure should be the last line of defense, not the first, in protecting the customer from conflicts of interest, and it should supplement, not substitute for, the affirmative duty to act in the customer's best interests. Here again, the Commission would need to test the disclosures for effectiveness.

C. The Department of Labor has shown that it is possible to reduce the harmful impact of conflicts of interest while preserving access to advice offered under a variety of business models.

In its approach to this issue, the SEC has consistently refused to consider an approach that reins in the conflicts of interest that bias the recommendations of broker-dealers and, to a lesser degree, investment advisers. This reluctance to take more forceful action was evident in the Tully Commission report, which concluded that “the current compensation system is too deeply rooted to accommodate radical alteration in the near-term.”¹⁴⁶ And it could be seen, years later, in the Commission's RFI to inform its economic analysis, which failed even to consider tighter restrictions on conflicts. Instead, it proposed at every turn to adopt the least interventionist approach to practices that pose conflicts. Similarly, FINRA's proposed approach to a best interest standard, which it put forward as an alternative to the DOL rule, relegated “differential compensation” to the category of unavoidable conflicts.¹⁴⁷ In developing its fiduciary rule, however, the Department of Labor proved that it is possible to adopt a regulatory approach that

¹⁴⁶ Tully Commission, Report of the Committee on Compensation Practices, April 10, 1995, at 3, <http://bit.ly/2nwNb0E>.

¹⁴⁷ Letter from Marcia E. Asquith, FINRA Senior Vice President and Corporate Secretary, to DOL, Proposed Conflict of Interest Rule and Related Proposals, July 17, 2015, at 2, <http://bit.ly/2x0ey8Z>.

reins in conflicts while preserving access to investment advice paid for through transaction-based payments.

In crafting its rule, the Department of Labor struck a balance between the outright prohibition on conflicts in ERISA and the historically disclosure-based approach of the SEC. In an approach that closely follows the model adopted in Section 913 of the Dodd-Frank Act, the rule combines a best interest standard with restrictions on practices that encourage recommendations that are not in customers' best interests.¹⁴⁸ Its "best interest without regard to" standard is taken directly from that statute. In keeping with the directives in that statute, it permits the receipt of commissions and other transaction-based compensation, permits the sale of proprietary products, sale from a limited menu of products, and principal trading, but bans or limits conflicts of interest that expose investors to undue risk. And its definition of advice is based on FINRA guidance regarding what constitutes a recommendation. In short, the Department has shown that it is possible to develop a strong, pro-investor standard based on securities law concepts.

- The DOL has developed a best interest standard based on securities law concepts that can be operationalized in ways that are workable for industry and beneficial for investors.

As detailed in the preamble to the rule, the Department's best interest standard is first satisfied through adoption of a prudent process, in which the adviser conducts a careful analysis based on reasonable assumptions to determine what investment product or strategy is best for the customer. The adviser is not required to consider every investment option available in the market, simply those he or she has available to recommend. Nor, contrary to what some have suggested, is the adviser required to recommend the lowest cost option. Indeed, the adviser is required to consider the full range of factors relevant to a determination of which investment option is best for the customer, and must be able to document the reasonable basis on which he or she reached that conclusion. The firm responsible for overseeing the adviser must adopt policies and procedures designed to ensure compliance with the best interest standard. Among them must be policies that eliminate practices, including differential compensation that cannot be justified based on neutral factors, that could reasonably be expected to cause advisers to base their recommendations on factors other than the customer's best interests.

Industry groups that have been quick to proclaim their support for a "best interest" standard have nonetheless condemned the DOL rule as overly complex and burdensome. But the difficulties some firms face in complying with the rule don't result from any particular complexity in the rule itself. Rather, those difficulties are the direct result of the complex incentives that pervade the broker-dealer business model and undermine compliance with a best interest standard. Any serious effort to protect investors from the harmful impact of such conflicts is going to require extensive changes in the way broker-dealers do business. A policy that seeks to avoid such "disruptions" is unlikely to bring any significant investor benefits. But reducing such conflicts is an achievable goal, as demonstrated by the several firms that have

¹⁴⁸ CFA Fact Sheet, DOL Rule Proposal Meets Standards Industry Rule Opponents Claim to Support, <http://bit.ly/2jr3K0i>

developed innovative, pro-investor plans to implement the DOL rule.¹⁴⁹ They have shown that firms acting in good faith to comply with the rule can and will do so in ways that preserve their profitability while improving investors' experience.

- The DOL rule is already delivering tangible benefits to retirement investors.

The good news is that experience since DOL finalized its rule have been overwhelmingly positive. The following is a brief overview of the beneficial effects of the rule, which we have detailed at greater length in two of our recent DOL comment letters:¹⁵⁰

- Most firms have chosen to continue to offer commission accounts to retirement investors, defying industry predictions that the rule would prove “unworkable” for such accounts. As a result, investors who prefer to pay through commissions will now receive fiduciary advice regarding their retirement account investments, and not just arm’s length sales recommendations misleadingly portrayed as best interest advice.
- Some firms have chosen to comply with the rule by shifting some or all of their retirement accounts to fee accounts, reducing conflicts and expanding the advice that these customers receive. Contrary to rule opponents’ claims, this can be achieved without increasing investors’ overall costs, and the rule helps to ensure that any such conversions will be conducted on terms that are beneficial to investors.
- Retirement investment advice under a fiduciary standard remains available at an affordable price to even those with minimal savings and under a variety of business models, disproving industry claims that small savers would be relegated to getting advice solely from robo-advisers or call centers.
- Several firms have developed pro-investor plans for reducing conflicts in commission accounts under approaches that will also deliver cost savings to many investors. The variety of these plans belies rule opponents’ claims that the rule is an overly rigid, one-size-fits-all regulation.
- Innovative new investment products have been introduced to help ease implementation. These include mutual fund clean shares and T-shares, which can be used by firms to create more compensation-neutral investment menus, and fee-based annuities, which will preserve access to annuities even in fee accounts.
- Compliance with the best interest standard has led firms to cull their investment menus of products that do not meet that standard, which should help to lower investors’ costs, reduce their risks, and improve their performance over the long term. Among other things, this helps to account for a large drop-off that has occurred in the sale of non-traded REITs, which have been a major source of investor abuse.

¹⁴⁹ Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, April 17, 2017, at 79-91, 118-136, <http://bit.ly/2oXIZfg>; Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, at 3-20, <http://bit.ly/2gIoufF>.

¹⁵⁰ *Id.*

- To stay competitive under a best interest standard, product sponsors have developed more investor-friendly products, including annuities with shorter surrender periods and lower overall costs, demonstrating the rule’s potential to harness market forces to help rather than harm investors.

Several of these developments are particularly relevant to the Commission’s current consideration of the appropriate regulatory approach. These include the development of innovative new mutual fund share classes that reduce conflicts and the beneficial effect of competition under a best interest standard on both investment products and firms’ investment menus.

Clean Shares: The Department of Labor rule’s restriction on conflicts of interest has led to a redesign of some investment products where incentives are baked into the products themselves. Among the most promising of these developments is the Commission’s approval earlier this year of mutual fund “clean shares,” which eliminate payment for distribution, leaving the broker’s compensation to be separately negotiated between the broker and the customer. Under this approach, commissions on mutual fund transactions would be set in the same way they currently are for purchases and sales of individual stocks and ETFs.

As you know, American Funds, a leader among broker-sold funds and actively managed funds in particular, became the first fund family to win approval of the shares in January, and Janus received approval shortly thereafter. Other mutual funds are reportedly either adapting already existing share classes that meet the SEC’s definition of clean share or are developing new share classes that meet the definition. They include Lord Abbett,¹⁵¹ MFS,¹⁵² Columbia Threadneedle,¹⁵³ Fidelity,¹⁵⁴ J.P. Morgan,¹⁵⁵ Oppenheimer,¹⁵⁶ and Federated Investors.¹⁵⁷ We have been given to understand that Franklin Templeton, BlackRock, and several other fund complexes are also planning to offer mutual funds that meet the clean share definition. At least one brokerage firm, PNC Investments, has adopted a DOL rule implementation plan using clean shares offered by its 17 fund partners.¹⁵⁸ Based on an inquiry to the company, we understand that PNC is charging a 3% commission for purchases and a \$75 flat fee for exchanges among funds.

¹⁵¹ Daisy Maxey, *5 Things Mutual-Fund Investors Should Know About Mutual-Fund ‘T’ Shares*, THE WALL STREET JOURNAL, April 9, 2017, <http://on.wsj.com/2oY1S0U>.

¹⁵² Bernice Napach, *MFS Adds Funds With ‘Clean Shares,’* THINKADVISOR, May 31, 2017, <http://bit.ly/2uxyOMk>.

¹⁵³ Greg Iacurci, *In new fiduciary rule FAQs, DOL gives quasi-endorsement of clean shares*, INVESTMENTNEWS, May 23, 2017, <http://bit.ly/2qOQq7Q>.

¹⁵⁴ Bradley Saacks, *PNC Brokerage Unit: We Are Ready to Go ‘Clean,’* IGNITES, June 9, 2017, <http://bit.ly/2uwZWuM>.

¹⁵⁵ *Id.*

¹⁵⁶ Hannah Glover, *‘Archaic’ Pricing Disclosure ‘Hobbling’ Mutual Funds*, Video interview with Art Steinmetz, IGNITES, June 8, 2017, <http://bit.ly/2sE2ms4>.

¹⁵⁷ According to J. Christopher Donahue - President and CEO, Federated Investors: “We are prepared for the changes in the landscape related to DOL Fiduciary rules. We have 26 funds with R6 pricing, 56 funds that fit the definition of clean shares.” Federated Investors’ (FII) Q1 2017 Results – Earnings Call Transcript, April 28, 2017, SEEKING ALPHA, <http://bit.ly/2wm2Uoj>; Financial Advisor IQ, *Fund Shares Without Distribution Fees Are on the Rise*, May 31, 2017, <http://bit.ly/2wkBRtl>.

¹⁵⁸ Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, at 8-10, <http://bit.ly/2gIoufE>.

By taking the mutual fund out of the role of setting the broker's compensation, clean shares make it a simple matter for firms to adopt product-neutral compensation in commission-based retirement accounts. As a Ropes & Gray alert issued shortly after the SEC decision explains, clean shares enable brokers to establish their own fee schedules based on the level of service provided.¹⁵⁹ "Because this type of broker-dealer will be able to charge a client similar commissions or transaction fees regardless of the products recommended and would not accept Third-Party Payments, compliance with the DOL's Impartial Conduct Standards is likely to be less burdensome than it would be if, instead, the broker-dealer received variable one-time sales loads/fees," according to the Ropes & Gray alert. The same would, of course, be true for compliance with an SEC rule that similarly restricted harmful conflicts. Morningstar's Aron Szapiro and Paul Ellenbogen have also written extremely favorably about this market development.¹⁶⁰ In their white paper, *Early Evidence on the Department of Labor Conflict of Interest Rule*, they observe that, "Early evidence suggests that the asset management industry is adapting in ways that will benefit investors by reducing conflicts of interest and adding transparency....Using a clean share model, advisors can align the level of advice they provide to their fee, and clients can choose how they would prefer to pay for advice: a flat dollar amount, a commission, or a level fee on assets under management."¹⁶¹

History suggests that, if they are widely adopted, "clean shares" will also significantly reduce investor costs by finally bringing market forces to bear on broker compensation for mutual fund sales. This has the potential to dramatically reduce transaction costs for mutual funds, just as market competition has driven down transaction costs for purchases and sales of stocks and ETFs. It is worth noting, in this regard, that the SEC's 1975 decision to ban fixed commissions faced heavy opposition from Wall Street, which argued that it would have a devastating impact on the industry.¹⁶² In reality, however, that decision paved the way for a whole new industry -- discount brokerage -- and public participation in the markets skyrocketed.¹⁶³ Meanwhile, stock trading costs have declined more than 70 percent in the last 20 years alone, according to one estimate, even as execution speeds have improved dramatically.¹⁶⁴ The lesson here is to take industry's self-serving claims of rules' harmful impacts with a grain of salt.

Clean shares are far from the only positive development in the mutual fund market that can be attributed to the DOL rule's restriction on conflicts. LPL has developed a somewhat different approach, in the form of its Mutual Fund Only Platform, that has similar potential to simultaneously reduce conflicts and reduce investor costs.¹⁶⁵ The LPL Mutual Fund Only platform will offer investors access to more than 1,500 mutual funds from 20 fund families while

¹⁵⁹ Ropes & Gray LLP, "DOL Fiduciary Rule Compliance—SEC Says Brokers Can Impose Their Own Commissions on Sales of "Clean" Fund Shares," <http://bit.ly/2osqP3E>.

¹⁶⁰ Aron Szapiro and Paul Ellenbogen, *Early Evidence on the Department of Labor Conflict of Interest Rule*, MORNINGSTAR, April 13, 2017, <http://bit.ly/2wld88b>.

¹⁶¹ *Id.*

¹⁶² Kenneth Silber, The Great Unfixing, RESEARCH MAGAZINE, May 1, 2010, <http://bit.ly/2nWuDXe>.

¹⁶³ Jenny Strasburg, *The genesis of discount brokerage / 1975 SEC deregulation offered an opening; Schwab stepped in*, SFGATE, May 1, 2005 <http://bit.ly/2p0Akov>.

¹⁶⁴ Business Wire, *On May 1, 1975, The SEC Deregulated Brokerage Commissions And, Through New Competition, The Doors Of Wall Street Slowly Opened To Main Street Investors*, THESTREET.COM, May 1, 2015 <http://bit.ly/2osDELz>.

¹⁶⁵ Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, at 11-13, <http://bit.ly/2gIoufF>.

standardizing compensation for financial professionals and thus neutralizing incentives to favor one fund or fund family over another.¹⁶⁶ Investors in the mutual fund only accounts will pay an initial maximum 3.5 percent onboarding commission for new investments in the account plus a 0.25 percent 12b-1 fee to cover the cost of servicing the account.¹⁶⁷ Rights of accumulation toward breakpoint discounts will apply across the platform, rather than within a single fund family, and exchanges among funds on the platform will be conducted free of cost.¹⁶⁸ This will provide increased choice and greater flexibility to move between fund companies, thus expanding the benefits of rights of accumulation farther than they've previously existed in the brokerage context. In addition, LPL is eliminating certain annual account and trading fees, including annual IRA maintenance fees, confirm fees, and inactive account fees, thereby eliminating the added costs that can sometimes be associated with holding mutual funds at the broker rather than at the fund company itself.¹⁶⁹ This new platform reportedly will be available for retirement and non-retirement accounts.

Without the DOL rule and its restrictions on conflicts, there is no reason to believe that clean shares would have been created or that this new distribution model would have developed. Unless that restriction on conflicts is retained, this pro-investor innovation could quickly fade away. Currently, with compliance with the DOL rule stalled by the Department's ongoing reconsideration, the fate of clean shares hangs in the balance. SEC action to adopt a strong rule incorporating restrictions on differential compensation similar to that in the DOL rule would remove that uncertainty and unleash the promise of clean shares and similar innovations for all investors, not just those who invest through retirement accounts.

More Investor-friendly Annuities: The DOL rule has also prompted development of more investor-friendly annuities, just as experts predicted it would. A recent survey of retail annuity manufacturers found that 45 percent either have already or will introduce new annuity products in response to the DOL fiduciary rule.¹⁷⁰ Moreover, at least one in four variable annuity writers said they expect to be more innovative with their product design in 2017. Industry leaders and experts have predicted that, in addition to prompting development of more fee-based alternatives, the rule's best interest and reasonable fees requirements would also lead to development of commission-based products with more investor-friendly features. Annuity expert Stan Haithcock credited the DOL rule with returning annuities to their former glory, when they were simple, consumer friendly, and provided value.¹⁷¹

That has been a common theme among experts who have written about the DOL rule's impact on the annuity industry. Writing shortly before the rule was finalized, for example, Scott Stolz, a senior vice president with Raymond James, predicted that the rule would result in

¹⁶⁶ Press Release, LPL Financial, "LPL Financial Announces Details and Fund Companies For Its Industry-First Mutual Fund Only Platform," July 13, 2017, <http://bit.ly/2vc25hy>.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*; See LPL Financial, Miscellaneous Account and Service Fees Schedule, <http://bit.ly/2vuY8qJ>.

¹⁷⁰ *Disruption leads to innovation in the annuity market*, INSURANCE FORUMS, January 17, 2017, <http://bit.ly/2oBwJxn>; DOL Viewpoints, The Dol Fiduciary Rule, Retail Annuity Manufacturers' Perspective, LIMRA Secure Retirement Institute <http://bit.ly/2oByVFo>.

¹⁷¹ Stan Haithcock, *The Department of Labor's version of an indexed annuity has arrived*, MARKETWATCH, August 23, 2016, <http://on.mktw.net/2oNv8qq>.

commission compression and the elimination of long surrender periods and high surrender charges, as companies develop products designed to ease compliance with the rule.¹⁷² Two Texas A&M law professors, writing in *ThinkAdvisor*, credited the DOL rule with providing an impetus for innovation in the annuity market, particularly with regard to variable and fixed-indexed annuities, which in recent years have included harmful features and been driven by harmful incentives, according to the authors.¹⁷³ “Many recently announced fee-based variable annuity products have sought to lower overall fees and penalties that clients may be held responsible for, developing features that can make the product more valuable to the client (also providing justification for the reasonableness of the fee),” they wrote. They cited as an example the fact that “some of these products provide for very short surrender charge periods, an option that adds value because it limits the period of time during which the client is locked into the product.” As a result of features such as these, new annuity products being developed in response to the rule “may actually add value for clients,” they concluded.

Shortly after the rule was finalized, Kitces devoted a blog to a discussion of how the rule would benefit annuities. “I think ultimately, what you’re going to find when we look back on this in 5 or 10 years, is that this was not the beginning of the end of annuities. This was the beginning of annuities actually getting a lot better,” he wrote.¹⁷⁴ When companies can no longer drive sales by offering the highest commission, they’ll learn to compete by offering a good product and persuading advisers of its benefits, he said. “[I]t will take a while for this to play out,” he added, but he predicted that the rule would result in annuity costs coming down; benefits getting “less gimmicky;” and surrender charges largely disappearing, “because the truth of a surrender charge is it’s nothing more than the penalty that the company looms over the client in order to recover the commissions that were paid upfront to the agent.” Kitces also predicted that product illustrations would become more realistic, “because no broker/dealer is going to want to encourage an annuity on their platform with all their brokers using aggressive or unrealistic sales illustrations that over-project the returns.” He said advisers would get “better clarity about how the annuity products are working under the hood, because that’s what anybody doing fiduciary due diligence is going to be looking for.” Overall, he said, “I think what we’re going to see is a huge wave of innovation for annuities.”¹⁷⁵

Leaders within the industry made similar predictions in an *Insurancenews.net* article.¹⁷⁶ “On the product side, gimmicks will fall away and you’re going to see more and more focus on client value,” David Rauch, chief operating officer and general counsel for the insurance marketing organization Annexus, told the publication. Companies want to simplify their products and return to basics instead of overwhelming advisers with product features, said Paula Nelson, head of annuity distribution, retirement, with Global Atlantic Financial Group. Some of these changes are evident in the rapid development of fee-based variable annuities. These new

¹⁷² Scott Stolz, *How Annuities Will Be Transformed by DOL Fiduciary Rule*, THINKADVISOR, February 1, 2016, <http://bit.ly/2pGn5Jd>.

¹⁷³ Robert Bloink, and William H. Byrnes, *After the DOL Fiduciary Rule, Enter the Fee-Based Variable Annuity*, THINKADVISOR, July 4, 2016, <http://bit.ly/29xyBnk>.

¹⁷⁴ Michael Kitces, *Why DOL Fiduciary Won’t Kill Annuities, It Will Make Them Stronger!*, NERD’S EYE VIEW, April 21, 2016, <http://bit.ly/22THLKe>.

¹⁷⁵ *Id.*

¹⁷⁶ Cyril Tuohy, *DOL Rule Will Lead To Simplification Of Many Retirement Products*, INSURANCENEWSNET, September 27, 2016, <http://bit.ly/2p60IkV>.

products generally appear to have lower costs and shorter surrender periods than earlier commission alternatives. But pro-investor innovations have also occurred among commission-based products, and more are expected.

Improved Investment Menus: Experience since the DOL rule was finalized has provided clear evidence of how the rule’s restrictions on conflicts and best interest standard can work together to improve the quality of investment products sold to retirement savers. Evidence suggests that these aspects of the rule are having a similarly beneficial effect on the overall investment menus offered by firms to comply with the rule. Specifically, in order to comply with the rule’s best interest standard, firms are increasing their due diligence and research to ensure that they are recommending only the best products. In a recent article describing how the rule is likely to benefit actively managed funds, Kitces described how the process brokers are going through, as part of their implementation plans, to decide which funds to keep on their platforms is improving the quality of fund offerings.¹⁷⁷ “[W]ith major broker-dealers and wirehouses now rationalizing which funds to keep on their platforms and eliminating a lot of higher cost and lower performing funds, I think a lot of the weakest funds actually will die from the lack of flows in the coming years,” Kitces wrote. “These funds probably should’ve gone away in the first place, but that means the surviving funds going forward, on average, are going to be even better, right?”¹⁷⁸

This product review for compliance with the best interest standard has resulted in reductions in some firms’ investment menus. It was recently reported, for example, that Ameriprise was cutting more than 1,500 funds that no longer meet the firm’s due diligence standards.¹⁷⁹ The firm will still have more than 2,000 different funds from hundreds of firms available for advisers to recommend to clients. Similarly, Voya announced that it will trim its mutual fund menu by roughly half by the end of the year, taking it down from 4,000 products to roughly 2,000, still a considerable menu of products from which to recommend.¹⁸⁰ Other broker-dealers, including Morgan Stanley and Merrill Lynch, are reportedly trimming funds with poor performance, high fees, or few assets from their menus.¹⁸¹ While industry lobbyists have sought to portray changes such as these as limiting investor choice, it simply isn’t accurate to suggest that there won’t be sufficient selection from which to choose going forward and it ignores the beneficial effects of these reductions. As Tom Halloran, Voya Financial Advisors’ president, stated, for many firms this culling of funds is long overdue. “We have needed to get this done for a bit,” he reportedly told *Ignites*.¹⁸²

In addition, the DOL rule appears to be discouraging the sale of harmful products, including those with excessive costs or that expose retirement investors to unwarranted risks or substandard performance. This appears to be attributable, at least in part, to the fact that firms are

¹⁷⁷ Michael Kitces, *Why Actively Managed Mutual Fund Performance Is About To Improve*, NERD’S EYE VIEW, June 15, 2017, <http://bit.ly/2vDUKtc>.

¹⁷⁸ *Id.*

¹⁷⁹ Bruce Kelly, *Ameriprise slashes number of funds available to advisers ahead of DOL fiduciary rule*, INVESTMENTNEWS, June 6, 2017, <http://bit.ly/2vEVj6U>.

¹⁸⁰ Bradley Saacks, *Voya B-D Unit Begins Chopping Down Fund Menu*, IGNITES, July 19, 2017, <http://bit.ly/2wkQKvB>.

¹⁸¹ *Id.*

¹⁸² *Id.*

evaluating their investment offerings not just in light of their compensation conflicts but also to assess the appropriateness of the products under a best interest standard. For example, it likely helps to explain the recent drop in sales of non-traded REITs and high-cost variable annuities inside IRAs that some have sought to paint as a harmful consequence of the rule.¹⁸³ A CoreData survey of financial advisers found, for example, that 60 percent of the “advisers” it surveyed plan to decrease allocations to non-traded REITs in response to the rule, and 57 percent say they will limit offering variable annuities in retirement accounts.¹⁸⁴ On the other hand, six in ten (62 percent) say they will increase ETF recommendations in their retirement accounts due to the rule. This suggests that a beneficial shift away from high-cost products and toward lower-cost alternatives is underway. In its study on the impact of the rule, A.T. Kearney predicted that such a shift would occur.

As examples such as these demonstrate, the negative picture of the DOL rule’s impact painted by industry groups simply doesn’t match the real world experience since the rule was adopted. To create this picture of investor harm, they 1) use cherry picked anecdotes about what “some firms” are doing and speculative surveys about what some might do to predict a significant withdrawal of advice for retirement savers, particularly small account holders. 2) They draw no distinction between non-fiduciary sales recommendations and fiduciary advice when describing the lost benefits retirement investors would supposedly suffer as a result of their imagined withdrawal of advice from this market. 3) They cynically point to the decision by some firms to shift to fee accounts as a harmful impact of the rule, and they misleadingly claim that doing so will necessarily drive up costs to investors. 4) They continue to claim that the rule will make it impossible to sell certain types of investments, including annuities, even after it has become clear that this is not the case. We rebut these claims in detail in both our April 2017 DOL comment letter and our August 2017 letter.¹⁸⁵ Rather than repeat those explanations at length here, we incorporate those letters by reference into this comment. Two of these claims, however, deserve at least a brief discussion.

Fee Accounts: The same groups that now argue that investors are harmed when they are moved to fee accounts used to extol their benefits. In 1996, SIFMA’s predecessor organization, the Securities Industry Association (SIA), endorsed fee accounts as a “best practice.”¹⁸⁶ In doing so, SIA specifically argued that the benefits of fee accounts extended to buy and hold investors as well as to more active traders. “As is pointed out in the Tully Report, sometimes the best advice to a client is to ‘do nothing,’” SIA’s General Counsel Ira Hammerman wrote in 2004. “SIA strongly believes that many clients in fee-based accounts are better off today because they were dissuaded by their brokers from selling positions in which substantial unrealized losses had

¹⁸³ See, e.g., Letter from Kent A. Mason, Davis & Harmon, on behalf of a group of unnamed clients, to the Department of Labor, March 16, 2017, <http://bit.ly/2nLi44l>.

¹⁸⁴ Press Release, CoreData Research, “Fiduciary Rule To Leave Us Mass-market Investors Stranded, Study Shows,” Value Walk, November 2016, <http://bit.ly/2oBDXuU>.

¹⁸⁵ Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, at 60-118, <http://bit.ly/2oXIZfq>; Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, at 3-24, <http://bit.ly/2gloufF>.

¹⁸⁶ Letter from Ira D. Hammerman, General Counsel, Securities Industry Association, to the Securities and Exchange Commission regarding Release No. IA-2278, Certain Broker-Dealers Deemed Not To Be Investment Advisers, September 22, 2004, at 3, <http://bit.ly/2oxtk2w>. At the time SIA was seeking to avoid regulation of the accounts under the Advisers Act, predicting that firms would stop offering the accounts and investors would lose access to valued services if the SEC subjected the accounts to Advisers Act regulation. As subsequent events have shown, that prediction was entirely inaccurate.

occurred after the sharp market declines that occurred between 2000 and 2002. Thus, fee-based accounts can create an environment in which ‘buy and hold’ behavior flourishes to the benefit of investors.”¹⁸⁷ SIA also argued that, “Fee-based programs also enable investors to better control their investment costs because they make overall fees more transparent.”

Even as industry lobbyists have tried to label the shift to fee accounts as a harmful consequence of the DOL rule, a number of industry leaders have acknowledged that the shift predates the rule and is motivated by other considerations. As former LPL Financial CEO Mark Casady explained it in an earnings call last fall, “Our industry continues to experience long-term secular trends, including the movement from brokerage assets to advisory assets, and among brokerage, from sales commissions to trailing commissions. The same is true for our business. Most of our gross profit is recurring from advisory assets that are already managed to a fiduciary standard, and most of our brokerage commissions come from recurring trailing revenues that are grandfathered under the DOL Rule.”¹⁸⁸ Similarly, Legg Mason Chairman and CEO Joseph Sullivan said, “So what you’ve seen in the industry over the last few years is a lot of advisors increasingly moving to advisory from brokerage. And that’s going to continue, that’s going to accelerate as a result of DOL. But it’s not something that’s just starting, right. This move from advisory – or from brokerage to advisory has been underway.”¹⁸⁹ Or, as Envestnet put it, “What we expect to see is that the long-term trend of moving from commission-based to fee-based will be slightly accelerated by the DOL regulations.”¹⁹⁰

The question of the cost of fee versus commission accounts is also much more complex than SIFMA, ICI and others would have you believe. Often these groups simply state, as if it were a given, that fee accounts are more costly than commission accounts “particularly for small account holders and buy-and-hold investors.” ICI has sought to attach a numerical value to that difference. Using numbers from the DOL RIA, ICI estimates that the cost for brokerage services for those investing in front-load mutual funds is roughly 50 basis points a year, which they contrast with an average of 111 basis points for advice in fee accounts, a figure apparently taken from a Cerulli Associates study.¹⁹¹ They then estimate that the rule will cause a shift to fee accounts that will have a net cost over ten years of \$47 billion. They have extended that same analysis in their comment letter to the SEC.

There are, however, a number of obvious flaws in this calculation that are evident even to a non-economist. First, as the RIA itself has shown, it is not enough to compare the costs attributable to the services of the broker and adviser in recommending a fund without also considering the costs of the products recommended. Evidence abounds that administrative costs among broker-sold mutual funds are measurably higher than costs for funds sold directly or through fee accounts. CFA found this to be the case, for example, when we compared direct-

¹⁸⁷ *Id* at 5.

¹⁸⁸ LPL Financial Holdings (LPLA) Q3 2016 Results - Earnings Call Transcript, November 02, 2016, SEEKING ALPHA, <http://bit.ly/2nPHoYf>.

¹⁸⁹ Legg Mason (LM) Q2 2017 Results - Earnings Call Transcript, October 28, 2016, SEEKING ALPHA, <http://bit.ly/2p5EVcr>.

¹⁹⁰ Envestnet (ENV) Q2 2016 Results - Earnings Call Transcript, August 08, 2016, SEEKING ALPHA, <http://bit.ly/2nPBpTg>.

¹⁹¹ Letter from Brian Reid and David Blass, Investment Company Institute, to the Department of Labor, July 21, 2015, at 17, <http://bit.ly/2niSeBZ>.

marketed and broker-sold S&P 500 index funds.¹⁹² This is a point that Vanguard Research makes more broadly in its analysis of how quality, fee-based advice can result in better returns for investors that more than make up for the higher costs of the advice itself.¹⁹³ The authors of the Vanguard study estimate that implementing advice using low-cost funds can provide a value-add of 40 basis points relative to the asset-weighted expense ratios, and they note that the difference is even greater for those who switch from using funds with expense ratios that are higher than the asset-weighted average. Given the high level of fee dispersion among mutual funds, that one difference -- implementing through lower cost rather than higher cost funds -- could erase the entire cost advantage ICI attributes to commission accounts for many commission-based advisers. Yet ICI has completely ignored those costs in its estimate of the costs of brokerage advice.

Moreover, even relatively high cost mutual funds are among the more affordable investments sold by brokers. Conduct a similar evaluation using cost estimates for annuities or non-traded REITs¹⁹⁴ and the higher total cost of investing through commission accounts become readily apparent. As Kitces pointed out in his blog on the business benefits of transitioning from commissions to fee-based advisory accounts, brokers and insurance agents whose income depends on sales commissions will eventually hit the limit on how many prospects they can see and how many sales they can close.¹⁹⁵ The only way left for them to grow their income is either to make bigger sales or to sell products that pay bigger commissions. Unfortunately, the products that pay the biggest commissions are often the ones that are the worst for investors, leading to total costs for many commission accounts that are far higher than those projected by ICI.

ICI's estimates of harm were soundly rebutted in both the DOL RIA¹⁹⁶ and in an independent consultant's review of industry research submitted in response to the DOL rule.¹⁹⁷ The consultant, Advanced Analytical Consulting Group, concluded that, "With regard to ICI's estimates of the cost of the Proposed Rule, ICI offers no support for its assumptions that investors currently selecting front-end load funds would either have to pay as much as more active incumbent fee-based investors or lose access to advice. The first assumption ignores the likely emergence of new fee structures or products to continue to service investors that ICI characterizes as placing less demand on financial advisers. ICI's companion assumption that investors with balances under \$100,000 would no longer receive financial advice is inconsistent

¹⁹² Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the Department of Labor, July 21, 2015, at 16-18, <http://bit.ly/2omHMxq>.

¹⁹³ Francis M. Kinniry Jr., Colleen M. Jaconetti, Michael A. DiJoseph, Yan Zilbering, and Donald G. Bennyhoff, Putting a value on your value: Quantifying Vanguard Advisor's Alpha®, Vanguard research, September 2016, <http://bit.ly/2tyQNT7>.

¹⁹⁴ See, e.g., Craig McCann, Fiduciary Duty and Non-Traded REITs, Investment Management Consultants Association Inc, July / August 2015, <http://bit.ly/2xdEUHw>.

¹⁹⁵ Michael Kitces, *The Business Benefits Of Transitioning From Commissions To Fee-Based Advisory Accounts*, NERD'S EYE VIEW, March 27, 2017 <http://bit.ly/2opXo3h>.

¹⁹⁶ DOL, Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions, April 2016, at 163-166, 330-339, <http://bit.ly/2mT9Gfg>.

¹⁹⁷ Karthik Padmanabhan, Constantijn Panis, and Timothy J. Tardiff, Review of Selected Studies and Comments in Response to the Department of Labor's Conflict of Interest 2015 Proposed Rule and Exemptions, Advanced Analytical Consulting Group, Inc., March 4, 2016, at 32-40, <http://bit.ly/2ofTF4N>.

with the fact that a large proportion of investors with accounts at or below this level have the fee-based accounts that ICI presumes are too costly to provide.”

As we now know, “new fee structures” and products have emerged in response to the rule, though ICI continues to ignore these developments in providing estimates of the rule’s “harm.” Indeed, ICI must have known even when it made its initial estimate that its basic assumption about access to advice was false, since two of its largest members -- Vanguard and Schwab -- offer fee accounts advised by human advisers with far lower account minimums than ICI claimed would go unserved under the rule.¹⁹⁸ The Commission cannot reasonably rely on analysis, such as this, that ignores inconvenient information and distorts easily verifiable facts.

Orphaned Accounts: In their quest to provide further “evidence of harm” from the DOL rule, industry rule opponents have placed particular emphasis on an increase in orphaned mutual fund accounts since the DOL rule was adopted. But the fact that the number of orphaned accounts has risen tells us nothing about whether investors whose accounts have been orphaned are being harmed as a result. If a brokerage firm has a customer who is a buy-and-hold investor with a small mutual fund investment in a retirement account, it may not be worth it to the firm to keep that account on its books, and monitor for compliance with the DOL rule, in return for 12b-1 fees that may amount to just \$100 a year or less. That’s not a sign the rule is overly burdensome, that’s just simple economics. So, the fact that there appears to have been a recent increase in orphaned accounts since the rule was finalized shouldn’t come as a surprise.

There are at least two reasons, however, why it doesn’t necessarily follow that investors are being harmed as a result. First, as SIFMA and others have pointed out, brokers provide “episodic” sales recommendations, and do not accept any responsibility to monitor accounts between transactions to ensure that the investor is continuing on course. If the investor wasn’t being actively “advised” prior to being orphaned -- as would likely be the case for a buy and hold investor with only a small amount invested -- then the investor hasn’t lost anything just because the account is now being held directly at the mutual fund company instead of at the brokerage firm. Indeed, the investor could see his or her costs drop as a result of the move if the broker was charging an IRA custodial fee or imposing other similar charges. Second, should the investor decide at a future date that she wants advice, there are many firms willing to advise investors with even very small accounts under a fiduciary standard.¹⁹⁹ Indeed, there’s a good chance that the investor who has previously been getting self-interested sales recommendations would get better, cheaper advice as a result of the move.

Our point is not to deny the possibility that some investors may be experiencing at least a minor inconvenience as a result of having their accounts orphaned, but industry rule opponents have failed to provide evidence of real harm and we’ve seen no outcry from investors indicating this is the case. Without that additional evidence, the Commission can’t reasonably conclude that any harm that may, or may not, be occurring is sufficient to justify changes to the DOL’s regulatory approach, particularly when weighed against the overwhelmingly positive effects of the rule in other areas.

¹⁹⁸ Letter from Roper and Hauptman, CFA, to the DOL, September 24, 2015, at 27, <http://bit.ly/1Rkslum>.

¹⁹⁹ Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, at 68-71, <http://bit.ly/2oXIZfq>.

In short, in deciding how to approach this issue under its own authority, the Commission cannot reasonably rely on industry predictions about the effects of the DOL rule that have been proven time and again to be false. Instead, the Commission must demand that industry back their claims with solid, verifiable data so that their claims can be independently validated. And the Commission needs to weigh the many beneficial effects of the DOL rule before acting. This is particularly important since industry clearly envisions using the SEC rulemaking as an end run around the DOL standard, and your own comments about the need to coordinate and harmonize the SEC and DOL standards play into that.

We remain confident that a fair evaluation of the evidence will lead you to conclude that the DOL rule is both workable and working even better than expected to reduce conflicts and improve the quality of advice. Those improvements have been achieved while preserving investors' access to advice and choice regarding how to pay for that advice. Indeed, by transforming self-interested sales recommendations into best interest advice, the rule has expanded access to bona fide advice, particularly for the smaller savers who are disproportionately likely to rely on non-fiduciary sales recommendations from "sellers" falsely portraying themselves as "financial advisors."

D. Technology tools exist to support compliance with a best interest standard for even small accounts.

The Commission has the luxury of undertaking this effort at a time when technological advances have greatly improved both the ability of firms to advise even small accounts affordably and their ability to comply, and demonstrate compliance, with a best interest standard. As the DOL experience has shown, this gives the Commission the latitude to adopt a strong rule -- one that combines a best interest standard with restrictions on conflicts -- without worrying that doing so will create unaffordable compliance costs for firms or cause small investors to lose access to advice.

- Technology makes it affordable to serve small accounts under a fiduciary standard.

FolioDynamix, a leading provider of wealth management technology and advisory services focused on serving small accounts, debunked the argument that small accounts would lose access to advice in a white paper on the Department of Labor rule.²⁰⁰ In it, the firm states, "While automated robo platforms have been suggested as an alternative, many firms—conscious of the fact that small investors have the possibility to become larger investors, with guidance and support—are hesitant to simply jettison those investors (these investors, after all, are often those who might benefit most from informed advice vs. a self-service approach)."²⁰¹ Fortunately, the authors argue, it is possible to "offer small-balance advisory accounts that can be made efficient even with low balances through a combination of low-fee underlying investments and a technology component that allows for automation of client account opening, rebalancing, and reporting."²⁰² Contrary to the claims made by rule opponents, this does not mean investors will lose access to human advice. As FolioDynamix's President Steve Dunlap recently explained it,

²⁰⁰ FolioDynamix, Success in the Wake of the DOL Fiduciary Rule, <http://bit.ly/2xRQsgP>.

²⁰¹ *Id.*

²⁰² *Id.*

“The future is not about robots—or robo advisors—replacing human advisors. It is about advisors taking advantage of technology to work efficiently ... Advisors and firms who leverage technology effectively will be ahead.”²⁰³ That model has the advantage of freeing up advisors to focus their efforts in areas where they are most able to add value, he said.²⁰⁴

Research has shown that this particular business model is very attractive to clients. A recent study by Accenture found, for example, that investors value and prefer a hybrid model, combining human advisors with automated digital advice, and that the future of wealth management is not an either/or scenario.²⁰⁵ According to Kendra Thompson, managing director and head of Accenture’s global wealth management practice, “The robo-versus-human advisor debate has lost relevance for investors and wealth and asset managers in North America.”²⁰⁶ Rather, “providing an automated platform with periodic access to a human advisor ranks as the most preferred scenario across a range of investor profiles. Combining the best of both worlds—the low cost and access of robo-platforms with an advisor’s expertise in handling more nuanced or complex investing scenarios—hybrid firms ranked higher than all others in several dimensions critical to customer loyalty and satisfaction, from ‘customized service’ to ‘low-cost products.’”²⁰⁷ This is not just true for younger investors, according to recent research by MoneyGuidePro, which shows that consumers between 50 and 70 years old prefer virtual meetings with advisers over in person discussions.²⁰⁸ Conversely, Scivantage’s Chief Commercial Officer of Digital Wealth Strategies, Joe Stensland, has stated, “Ongoing research has shown that investors—even millennials, who are comfortable with technology—are searching for a hybrid model when it comes to wealth management.”²⁰⁹

Consistent with this view that technology offers a solution for small accounts, a growing number of firms now offer fee accounts for even very small investors. These include firms, such as Edward Jones and LPL, that have announced their intention to lower the minimums on their traditional fee accounts to \$5,000 and \$10,000 respectively. (LPL simultaneously announced that it was lowering the fees on those accounts.²¹⁰) Two other leading national firms -- Vanguard and Schwab -- offer advisory services at a very low cost to slightly larger accounts, combining digital services with access to a human adviser. The account minimum at Vanguard is \$50,000, while the minimum at Schwab is just \$25,000. And minimums at other robo and hybrid advisers are

²⁰³ Press Release, FolioDynamix, “FolioDynamix and Scivantage Partner To Deliver Enterprise-Grade Digital Advice Robo Solution,” September 22, 2016, <http://bit.ly/2o5Qih2>.

²⁰⁴ Press Release, FolioDynamix, “FolioDynamix Announces Collaborative Partnership with PIEtech Enhancing Comprehensive DOL Solution,” November 16, 2016, <http://bit.ly/2oKwbaC>. (“[T]he adoption of technology [] enable and empower advisors, automating non-revenue generating activities and providing the tools for an advisor to maximize time spent collaborating with clients.”)

²⁰⁵ Kendra Thompson and Edward Blomquist, *The New Face of Wealth Management*, Accenture Consulting, <https://accntu.re/2nSVcxb>.

²⁰⁶ *Id.*

²⁰⁷ Karen DeMasters, *Human Advisors Vs. Robo: Both Are Winning*, FINANCIAL ADVISOR MAGAZINE, March 30, 2017, <http://bit.ly/2nSNh2Z>.

²⁰⁸ Ian McKenna, *Stunned, amazed and in awe - a day of exceptional revelations at T3*, DIGITAL WEALTH INSIGHTS, February 17, 2017, <http://bit.ly/2kwjBeh>.

²⁰⁹ Press Release, FolioDynamix, “FolioDynamix and Scivantage Partner To Deliver Enterprise-Grade Digital Advice Robo Solution,” September 22, 2016, <http://bit.ly/2o5Qih2>.

²¹⁰ Michael Wursthorn, *Brokerages Adapt to Pending Labor Rule*, WALL STREET JOURNAL, March 16, 2016, <http://on.wsj.com/2nWHUCu>

either non-existent (Betterment) or insignificant (\$500 at Wealthfront and \$5,000 at Fidelity Go).²¹¹ We doubt most commission-based advisers are willing to serve accounts of that size. In short, affordable, non-robo, fee-based investment advice is available for accounts at well below the \$100,000 asset level ICI previously predicted would be the cutoff below which fee accounts would not be offered, and robo advice is available to essentially anyone with money to invest.²¹²

- Technological innovation also makes it easier and more affordable for firms to comply with a best interest standard and document their compliance.

A host of new technology-based compliance services have been introduced since the DOL rule was finalized. They have the potential to ease compliance with the rule, lower costs for firms and investors, reduce conflicts, increase transparency and, as a result, improve the quality of advice, particularly to small investors.²¹³ The DOL accurately predicted this development in its RIA, as did other industry observers. For example, an *Investment News* editorial published following the adoption of the rule highlighted how the rule was “likely to unleash a wave of software upgrades and business relationships that will result in greater efficiencies for advisory practices.”²¹⁴

Just as predicted, the DOL rule has accelerated positive innovations in the market, as a variety of firms have introduced cost-effective solutions to ease compliance with all aspects of the rule. According to one industry analyst, “The DOL rule has set off a veritable cottage industry of tools to help advisors and financial planners cope with the additional analysis and reporting requirements.”²¹⁵ A report by the market research firm Cerulli issued just before the rule was finalized provides further evidence that the rule is spurring technology adoption and

²¹¹ Arielle O’Shea, *Best Robo-Advisors: 2017 Top Picks*, NERDWALLET, Jan. 5, 2017 <https://nerd.me/29C4nx6> In addition, Wells Fargo recently announced that it was launching a robo adviser, with call center access, and account minimum of \$10,000, and a .50 percent asset fee. Michael Wursthorn, *Wells Fargo’s Robo Adviser to Cost More Than Rivals’ Options*, WALL STREET JOURNAL, March 27, 2017, <http://on.wsj.com/2oaxAIO>.

²¹² Letter from Brian Reid and David Blass, Investment Company Institute, to the Department of Labor, July 21, 2015, <http://bit.ly/2p5qLrO>. (“Moreover, fee-based accounts may not be available to low- and middle-income IRA investors who cannot meet minimum account balance requirements. Currently, fee-based advisers often require minimum account balances of \$100,000 because, even with a 1 percent fee, accounts with fewer assets generate too little income to make the provision of ongoing advice profitable....Assuming that investors with less than \$100,000 no longer have access to advice because the BIC Exemption is not workable....As we discuss in the comment letter, it is very likely that under the current proposal investors with less than \$100,000 in IRA balances would not be able to get access to fee-based accounts.”) *But see* Letter from Barbara Roper and Micah Hauptman, Consumer Federation of America, to the Department of Labor, July 21, 2015, <http://bit.ly/2omHMxq>. (“In short, to believe ICI’s claims, one has to believe their assumptions that everyone who is providing transaction-based advice will suddenly stop providing transaction-based advice to retirement investors, all of the firms already providing non-transaction based advice to the under \$100,000 market will mysteriously stop providing non-transaction based advice, and no one will fill their shoes by providing either transaction-based or non-transaction based advice. These predictions can’t be supported, are not credible, and are belied by existing market conditions.”)

²¹³ See Section XI of the April 2017 CFA Comment Letter to DOL for a more complete discussion of the variety of compliance tools that have been introduced. Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, at 118-136, <http://bit.ly/2oXIZfq>.

²¹⁴ Editorial, *Bright side of the new DOL fiduciary rule: Tech and efficiency*, INVESTMENTNEWS, April 24, 2016, <http://bit.ly/23j4tvB>.

²¹⁵ Bob Veres, *New Tools to Prove You Acted as a Fiduciary*, ADVISOR PERSPECTIVES, <http://bit.ly/2okO2kB>; See also Bob Veres, *DOL Fiduciary Compliance Part II: The Most Comprehensive Solutions for RIA Firms*, ADVISOR PERSPECTIVES, <http://bit.ly/2oky7mr>.

innovation, allowing firms to serve small accounts, mitigate regulatory risk and grow their revenue.²¹⁶

In our April 2017 letter to the Department of Labor we provided brief descriptions of some of the vast array of compliance tools and services that have been developed to support compliance with the rule. They include tools to:

- help support firms' due diligence and data gathering capabilities so as to ensure that advisers undertake a prudent process;
- provide workflow assistance and Client Relationship Management (CRM) software;
- undertake quantitative analyses, assessments, and comparisons of various products and their attendant costs and features to help advisors justify their recommendations under the best interest standard and evaluate the reasonableness of the fees they are charging;
- provide sophisticated investment management and portfolio optimization; and
- manage document retention and account audit trails to help firms monitor investment recommendations and ensure advisors' compliance with the rule's requirements, as well as to aid with the rule's recordkeeping requirements.

The availability of such tools makes it easier for even small firms to operationalize and supervise compliance with a best interest standard. As Fidelity Clearing and Custody Solutions' Chief Operating Officer Tom Corra recently stated, "The best firms are going to utilize the coming of [the DOL] rule both to comply and to potentially adapt their business to compete in what may be a much different environment moving forward...they're going to find a combination of processes and technology that will ensure that compliance doesn't add a tremendous amount of cost to the way they do business today."²¹⁷ Using these tools has the potential to make firms more efficient and profitable in the long-term and to allow advisers to focus on the aspects of the advisory relationship in which they can have the most beneficial impact on investors.

Investnet commissioned a report by Aite Group analyzing the impact that advanced technology integration, of the type incorporated in many compliance tools, can have on a financial adviser's practice.²¹⁸ According to the report's findings, advisers benefit from advanced technology integration in a number of ways. Financial advisers utilizing advanced technology integration allocate more time to client investment management than their peers with basic or no integration -- an increase of 19 percent for independent registered investment advisers (RIAs), 28 percent for independent broker-dealer practices, and 62 percent for bank/trust advisers. That can help to deepen the relationship with existing clients or increase the practice's client and asset base. They also found that independent RIAs with advanced technology integration generate around 50 percent more financial plans and investment proposals than their peers that don't

²¹⁶ Alessandra Malito, *DOL fiduciary rule is spurring technology adoption and innovation: Cerulli report*, INVESTMENTNEWS, March 16, 2016, <http://bit.ly/1Pmd1d6>.

²¹⁷ Webinar: The DOL Fiduciary Rule – Comply, Compete and Pave the Way, Compliance Week, February 2017, <http://bit.ly/2oBLA1g>.

²¹⁸ Aite Group, *Technology Integration Turbocharges Advisor Productivity: Making Time for Clients*, commissioned by Investnet, September 2016, <http://bit.ly/2prj38b>; See also James Lumberg, *Advisers must seize opportunity to deliver best-interest advice to clients*, INVESTMENTNEWS, April 3, 2017, <http://bit.ly/2nSOHhY>.

benefit from advanced integration. This increased advice activity translates into a greater number of clients served by the practices (57 percent more), larger books of business (78 percent larger), and greater practice revenue/production (46 percent greater). Independent broker-dealers benefiting from advanced technology integration dedicate an additional 11 percent of their time to client investment management and serve a greater number of clients (44 percent greater), according to the study, enabling them to double their books of business, and increase practice revenue/production by 73 percent, compared to their peers that do not have advanced technology integration. As discussed in greater detail in our April 2017 comment letter to the DOL, others who have explored the issue have reached similar conclusions about the benefits of incorporating technology into advisory practices.

The clear message for the Commission, as it considers what regulatory approach to adopt, is that technological tools are available that make it feasible and affordable for firms to comply with a best interest standard, and those same tools have the potential to deliver significant business benefits to firms that employ them.

IV. The Commission has two regulatory options for addressing the interrelated problems of investor confusion and conflicted advice.

No issue is more important for average retail investors than the regulation of financial professionals. That is because investors' lack of financial sophistication and heavy reliance on recommendations by investment professionals makes them vulnerable to abuse. In nearly two decades of urging the Commission to address this festering problem, we have consistently identified the following principles as essential to an effective regulatory response.

- If financial professionals are performing distinctly different functions -- if, for example, brokers are mere sellers providing arm's length commercial sales transactions while investment advisers provide fiduciary investment advice -- then investors need to be able to tell them apart.
- If financial professionals are performing essentially the same functions, -- if, for example, both brokers and advisers provided personalized advice to retail customers -- or if investors cannot distinguish between the two, then those financial professionals need to be held to the same legal standards.
- The appropriate legal standard for advice is a fiduciary standard of care, including a principles-based obligation to act in the customer's best interest. Financial professional should be required to avoid conflicts of interest where reasonably possible, and to appropriately manage conflicts that cannot be avoided, in order to ensure that those conflicts don't interfere with the adviser's ability to act in the client's best interests.

If the Commission is serious about strengthening protections for investors who turn to financial professionals for investment advice, it must adopt a regulatory approach that is consistent with these principles.

Toward that end, the Commission has two basic approaches available with a reasonable chance of protecting investors. It could try to restore the functional distinction between broker-dealers and investment advisers that its previous actions have erased. The goal would be to enable investors to make an informed choice between getting sales recommendations from a broker under a suitability standard and getting investment advice from an investment adviser under a fiduciary standard. Alternatively, the Commission could apply a “best interest” standard to all investment recommendations. The goal of this approach would be to ensure that investors receive the best interest advice they expect and prefer, regardless of whether they receive that advice from a broker or an investment adviser. Whichever of these approaches it chooses to pursue, the Commission will need to take much stronger action than it has in the past to limit the conflicts of interest that bias advice.

A. The Commission could choose to protect investors by restoring a functional distinction between broker-dealers and investment advisers.

Some who identify investor confusion as the primary problem and who see a value in preserving traditional brokerage services have suggested a regulatory approach based on reestablishing clear lines between the sales services provided by brokers and the advice offered by investment advisers. There is a certain logic to this approach, which is consistent with congressional intent when it first established the securities laws. Upon closer examination, however, it becomes apparent that such a separation is harder to achieve than it first appears and may result in preserving a service for which there is no significant market once it is clearly and accurately described. The following outlines the minimum steps the Commission would need to take, if it adopts this approach, to provide the strict functional division needed to enable investors to make an informed choice among securities professionals.

- The Commission would need to adopt a narrowed definition of “solely incidental to” for determining applicability of the Advisers Act to brokers’ advisory services.

The starting point for a regulatory approach designed to restore a functional distinction between broker-dealers and investment advisers must be a revised definition of “solely incidental” advice on which the broker-dealer exclusion from the Advisers Act depends. Consistent with congressional intent, the clear meaning of the statutory language, and the protection of investors, only transaction-specific recommendations, provided outside a broader “planning” or “advisory” context, should qualify for the exclusion. Discretionary accounts, financial planning, investment planning, retirement planning, and any other services a reasonable investor would view as including best interest advice or as entailing ongoing account monitoring and management would be regulated under the Investment Advisers Act. Only the “episodic” sales recommendations that SIFMA has indicated are typical in commission accounts would qualify for the exclusion, and only if they were clearly labeled and marketed as the “arm’s length commercial sales transactions” industry groups have argued are appropriately regulated under a suitability, rather than fiduciary, standard of care.²¹⁹

²¹⁹ SIFMA opening appellate brief, *Chamber et al. v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17-10238, <http://bit.ly/2f4wVBW>.

This functional distinction could be achieved by adopting the definition we recommended a decade ago, when the Commission was considering this same question. Under our proposed definition, broker-dealers would qualify for the “solely incidental to” exclusion 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 (is incidental to) their primary business of effecting transactions in securities on behalf of customers.²²⁰ Unlike the “in connection with and reasonably related to” interpretation long relied on by the Commission, our proposed definition is consistent with the clear meaning of the statutory language, congressional intent, and the Commission’s long-professed preference for having the nature of services offered, rather than the method of compensation, determine regulatory status.

- The Commission would need to strictly limit brokers’ ability to hold themselves out as anything but salespeople engaged in arm’s length commercial sales transactions.

For a functional split to work, however, investors need to be able to easily distinguish those engaged exclusively in investment sales from those who are in the business of providing advice. The Commission’s previous research has shown that similarities in titles muddy the water, and subsequent research has shown how marketing practices worsen that confusion. For a functional separation to have any hope of effectively addressing investor confusion, therefore, broker-dealers would need to be precluded from holding themselves out as advisers, and they would need to be required to provide brief, plain English pre-engagement disclosures designed to alert investors to the fact that they are offering arm’s length sales recommendations, not advice.

The necessary limits on “holding out” cannot be achieved simply by adding to the list of titles brokers are prohibited from using unless they are registered and regulated under the Advisers Act. Experience has shown that, if the Commission were to add “financial advisor,” “financial planner,” and “financial consultant” to the list of restricted titles, brokers would simply adopt a new title designed to obscure the fact that they are “merely selling a product” and engaged in “arm’s length commercial sales transactions.” The only workable solution, therefore, would be to limit brokers to calling their registered representatives either “sales representative” or “salesperson,” thus clearly conveying the nature of services being offered. Marketing messages would need to be similarly restricted. If this approach is adopted, messages that a reasonable investor would perceive as implying that they are in an advisory relationship or a relationship of trust and reliance -- rather than an arm’s length sales relationship consisting exclusively of episodic sales recommendations -- must trigger application of the Advisers Act and its attendant fiduciary standard.

SIFMA’s objection to this approach, that it would not “address the real issue, which is multiple – and ever proliferating – different standards,” does not hold water.²²¹ Different standards only matter, from an investor protection point of view, 1) if the same activity is being

²²⁰ Letter from Barbara Roper, CFA, to the SEC, Certain Broker-Dealers Deemed Not To Be Investment Advisers, February 7, 2005, <http://bit.ly/1T6xNS2> (challenging the SEC’s interpretation of the solely incidental to exemption for brokers, based on the legislative history). *See also* Letter from Fund Democracy, CFA, Consumers Union, and Consumer Action, to the SEC, proposal to exempt certain fee-based brokerage accounts from regulation under the Investment Advisers Act, February 7, 2005, at 2-7, <http://bit.ly/2xc8M7i>.

²²¹ Letter from Kevin M. Carroll, SIFMA, to the Securities and Exchange Commission, July 21, 2017, Appendix 2, at 12, <http://bit.ly/2uRtdUA>.

held to different standards based on arbitrary criteria, such as the regulatory status of the firm offering the service, or 2) if any differences in the services are indistinguishable to the investor. But SIFMA goes to some length to argue elsewhere in its letter that broker-dealers and investment advisers are in fact engaged in fundamentally different activities that justify adopting separate standards. And it proposes an approach that would allow for further proliferation of standards, since each “primary” regulator would be responsible under the SIFMA plan for setting the standards for the professionals it regulates. If the services offered by broker-dealers and investment advisers are sufficiently different to justify a separate regulatory approach, as SIFMA suggests, then those differences need to be made obvious to investors, so that they can make an informed choice among different types of service providers. That can only be achieved through strict limitations on titles and holding out, as described here.

- The Commission would need to supplement those restrictions with brief, plain English pre-engagement disclosures that make clear the sales nature of services offered.

As a further precaution to ensure that investors are able to make an informed selection of financial professionals, brokers and advisers alike should be required to provide a brief, plain English pre-engagement disclosure document that describes key features of their services.²²² In the case of brokers, this should include a clear, straightforward statement that the broker is a salesperson and that this is a sales account, in which the investor will receive sales recommendations, not advice. The fact that the broker gives only episodic recommendations and does not provide ongoing account management or monitoring should also be clearly and prominently disclosed. As the SEC’s previous research has shown, simply identifying the account as a brokerage account would not be sufficient to convey that information.

In addition, the document would need to clearly state that the broker is subject to a suitability standard when making sales recommendations, with a brief description of the significance for the investor. Specifically, it would need to make clear that the broker must recommend investments that are generally appropriate for the investor but is not required to recommend the best available option. Material conflicts of interest that could bias the broker’s recommendations should also be briefly but clearly described, along with the impact those conflicts could have on the investor. This would include, if applicable, the fact that the firm only recommends investments that make revenue sharing payments, the fact that the broker is required to meet certain quotas for the sale of in-house investments, the fact that certain investments pay the broker significantly more than others, all of which could induce the broker to recommend those investments that are most profitable for the salesperson or the firm, rather than those that are best for the customer.

Finally, it would be essential for the Commission to test this approach to ensure its effectiveness. The Commission’s past efforts have cast doubt on the feasibility of developing a disclosure-based approach that clearly conveys the relevant information to investors. Part of the problem has been the Commission’s reluctance to require firms to state the relevant information in the bald, unvarnished terms most likely to be understood by investors. Given that past

²²² Ideally, investment advisers should be required to provide a similar, plain English disclosure document instead of the lengthy documents full of legalese that are too often used to fulfill advisers’ pre-engagement disclosure obligations.

experience, it would be arbitrary and capricious for the Commission to assume, absent new evidence, that a disclosure-based approach is likely to support informed decision-making, particularly by the least sophisticated investors most in need of enhanced protection.

- The Commission would need to develop an approach for regulating dual registrants that protects investors from hat switching and other misleading practices.

One of the chief challenges the Commission would face if it chose to adopt this approach would be figuring out how to apply it to the many dually registered broker-dealer/investment adviser firms and representatives. Where a firm or representative serves a customer in both capacities in a single engagement, the answer seems obvious. The financial professional would be held to a fiduciary standard throughout the engagement and, as such, would be free to hold out as an adviser. Under this approach, the professional could offer both advice and investment sales to implement that advice under the ongoing fiduciary duty, and rigorous “best interest” standard, necessary to ensure that investors are appropriately protected. The Commission would need to take steps to ensure that firms don’t artificially segregate advice and sales into separate accounts in order to evade the fiduciary duty when it comes time to implement the advice.

The far trickier challenge, however, is coming up with an approach to holding out for firms and representatives that serve as both advisers and sellers, but to different customers and accounts. How, for example, would the Commission propose to prevent a firm from holding out as an adviser, which would accurately describe a portion of its services, and using that marketing to attract clients who would not in fact receive those advisory services? Our skepticism that this can be achieved is a key reason we remain unconvinced that a regulatory approach along these lines will fully protect investors. We remain open, however, to suggestions on how it could be accomplished.

- The Commission would need to adopt a tougher approach to regulating conflicts among brokers who choose to be regulated under the Advisers Act in order to preserve their ability to hold out as advisers.

We are even more skeptical that, if brokers were forced to limit themselves to “episodic,” transactional sales recommendations and to accurately describe the nature of those services, there would be a significant market for them. Surveys have clearly shown that investors have a strong preference for fiduciary investment advice,²²³ which is presumably the main reason brokers have chosen to characterize their services as they have. If the Commission were to adopt a strict functional distinction between sellers and advisers, along the lines we have described here, we are convinced that most brokers would choose to be regulated under the Advisers Act in order to preserve their ability to market themselves as advisers. That would then subject their advisory activities to regulation under the Advisers Act’s fiduciary standard, but whether this afforded investors significant additional protections would depend entirely on whether the Commission is prepared to take serious action to rein in conflicts of interest that bias brokers’ advice. As we discuss at length above, the Commission’s preference for relying on disclosure to address

²²³ See, e.g., S. Kathi Brown, Attitudes Toward the Importance of Unbiased Financial Advice 4, 6 (May 2016), <http://bit.ly/2xesTBN>; Financial Engines, In Whose Best Interest, What Americans know and what they want when it comes to retirement investment advice, March 2016, <http://bit.ly/2wceqkT>.

conflicts of interest simply cannot work when the conflicts are as extensive, complex, and opaque as they are in the broker-dealer business model.

If the Commission is serious about protecting investors from the harmful impact of those conflicts, and ensuring that brokers who offer advice live up to their obligations to act in customers' best interests, it must be prepared to force firms to eliminate or at least severely limit those practices that encourage and reward advice that is not in customers' best interest. That includes differential compensation, sales quotas, incentives to push proprietary products, and ratcheted payout grids. As experience since the DOL rule was finalized has shown, this is an achievable goal with the potential to deliver significant benefits to investors.²²⁴ In addition, the Commission should revive stalled efforts to reform 12b-1 fees and should also reform revenue sharing payments in order to eliminate hidden practices used to encourage recommendations based on factors other than the best interests of the customer. Finally, firms must be required to adopt policies and procedures designed to help ensure that any remaining conflicts do not inappropriately influence recommendations. As part of those policies and procedures, advisers should be required to document the basis on which they reasonably concluded that their recommendation was in the best interests of the investor. That would help to support better recommendations, as well as better supervision and regulatory oversight.

- We question the value of a regulatory approach designed to preserve a business model that is largely obsolete and for which we believe there is a limited market.

When the securities laws were being drafted, effecting transactions on behalf of customers was a skilled operation that required the assistance of a trained professional. Today, that is simply no longer the case. Even the most unsophisticated of investors can buy or sell a mutual fund, ETF, or stock with a few clicks of the computer mouse and at very low cost. Myriad options exist for investing directly through mutual fund companies, discount brokers, and robo-advisers, often with excellent online tools to walk inexperienced investors through the process. Investors who choose to turn to financial professionals do so, not primarily for help with transactions, but for advice on where to invest. In order to stay relevant, broker-dealers have evolved to offer, or at least portray themselves as offering, the advice that investors want and need. The Tully Commission recognized this more than two decades ago, when it stated that the most important role of the registered representative is to “provide investment counsel to individual clients.”

In deciding what regulatory approach to adopt, the Commission needs to ask itself how hard it wants to work to preserve the availability of conflicted sales recommendations offered under a suitability standard, particularly if, as we expect, there is little or no investor demand for those services. What the Commission must *not* do is continue to allow brokers to mischaracterize arm's length sales transactions as advice in order to create a market for those services that would not otherwise exist. Nor, where brokers have truly evolved to offer the advisory services their titles and marketing material suggest, can the Commission justify continuing to regulate those services under a lower standard of conduct than the fiduciary standard that applies to all other investment advisers. Maintaining the status quo is not an acceptable option.

²²⁴ Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, <http://bit.ly/2oXIZfq>; Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, <http://bit.ly/2gIoufE>.

B. The Commission could choose to protect investors by holding broker-dealers to a fiduciary standard when they provide investment recommendations.

Rather than working to preserve the availability of sales recommendations offered under a suitability standard, the Commission could seek to better protect investors by applying a fiduciary standard to all investment recommendations. Although brokerage services are transactional in nature, there are strong reasons to conclude that they should be held to a fiduciary standard. A fiduciary duty “generally arises when one person agrees to act on behalf of and for the benefit of another,” according to law professor and fiduciary expert Arthur Laby.²²⁵ In portraying themselves as advisers, brokers create the reasonable expectation that they will be acting for the benefit of their clients. That impression is reinforced by marketing messages that are explicit in encouraging customers to rely on and trust their “advisor.”²²⁶ The following statement from the UBS website is fairly typical of such marketing: “The UBS Wealth Management Americas approach is based on the trusted relationship of our Financial Advisors and their clients. Our experienced Advisors are committed to understanding clients’ needs and delivering insightful, informed advice to help them realize their dreams.”²²⁷ Evidence suggests that investors take these messages to heart and rely heavily on the recommendations they receive from financial professionals, without distinguishing between broker-dealers and investment advisers. In short, the nature of the relationship, both as it is described by brokers and as it is perceived by investors, demands fiduciary protections.

Moreover, although imposing a fiduciary duty on brokers’ recommendations would, if done right, require significant changes to brokerage practices, it would arguably cause less disruption to the manner in which broker-dealers today operate and market their services than a renewed functional distinction would require. It would also meet investors’ reasonable expectation that all financial professionals be required to act in their best interests when providing investment advice. As such, it would protect investors from harm even if they remain confused about the different types of investment professionals and the different services they offer, since the same high standards would apply to all. And the Commission would be spared the difficult tasks of identifying what constitutes “solely incidental to” advice and of policing “holding out” by brokers to ensure that they don’t misleadingly portray sales activities as advice.

For this approach to work, however, the Commission must recognize the special risks that investors face when advice is combined with investment sales, and it must adopt a regulatory approach that takes those enhanced risks into account. When a financial professional is paid a fee to provide advice, conflicts exist, but they are fewer and more straightforward than the conflicts that arise when an individual who professes to be offering advice is paid for selling a product. This is particularly true in light of the complex web of incentives that brokers face to favor one product over another. While it is conceivable that effective disclosures could be devised to address the conflicts associated with fee accounts -- though the current ADV form fails that test

²²⁵ Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in *RESEARCH HANDBOOK ON MUTUAL FUNDS* (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing), April 21, 2017, <http://bit.ly/2uAL2qU>

²²⁶ Micah Hauptman and Barbara Roper, *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways*, Jan. 18, 2017, <http://bit.ly/2jKUbfD>.

²²⁷ *Id.* at 13.

in many instances -- it is simply not possible to devise disclosures that would adequately convey the array, magnitude, and impact of conflicts that pervade the broker-dealer business model. That means that, far from adopting the watered down, disclosure-based approach to a fiduciary standard advocated by broker-dealer trade associations, the Commission must adopt a robust standard that includes meaningful restraints on harmful conflicts of interest if it is serious about adequately protecting investors.

Properly implemented to complement the Department of Labor's fiduciary rule, such an approach would have the added benefit that it would maximize uniformity of standards across securities accounts, subjecting all recommendations to an enforceable "best interest" standard and tough restrictions on conflicts, regardless of whether the recommendations are offered by broker-dealers or investment advisers, and regardless of whether they relate to retirement or non-retirement accounts. This would benefit investors as well as those in the industry who are prepared to compete by offering high quality products and services at a reasonable cost.

- The Commission would need to adopt a broadly inclusive definition of recommendation.

The starting point for such an approach would need to be a broadly inclusive definition of recommendation. As we have previously written, the definition would need to cover "any advice about securities, from specific advice about investing in a particular security to advice about whether investment in securities would be appropriate."²²⁸ This includes any instance in which "a financial professional provides a client with any form of guidance or recommendation regarding specific securities, classes of securities, the advisability or inadvisability of investing in securities, and even advice about the selection or retention of an investment adviser."²²⁹

While the determination of whether a recommendation has been made will always be based on the particular facts and circumstances, FINRA guidelines provide a sound basis for such a definition.²³⁰ As we discussed in greater detail in our July 2015 comment letter to the Department of Labor, the FINRA guidance includes several elements that we view as key.²³¹ It requires inclusion of some form of "call to action" to distinguish a recommendation from either education or general information,²³² and the suggested action must be particularized for a specific client or group of clients. An essential overarching principle of the FINRA guidance is that how the communication is likely to be reasonably perceived by the client is of central importance. If the client would be likely to perceive a communication as a call to action or as particularized to their circumstances, that should be enough to trigger the definition. FINRA correctly notes that it may be necessary to look at a series of actions to determine whether, taken together, they would reasonably be viewed as including a call to action or as being particularized to a specific client.

The FINRA guidance has two added benefits. Firms that would be affected by a new SEC fiduciary standard for broker-dealers are familiar with that guidance, which currently determines

²²⁸ Letter from Roper to SEC, Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Appendix C, at 29, <http://bit.ly/2f7gcBf>.

²²⁹ *Id.*

²³⁰ FINRA, Regulatory Notice 11-02, Know Your Customer and Suitability, January 2011, <http://bit.ly/1LnB6DU>.

²³¹ Letter from Roper and Hauptman, CFA, to the DOL, July 21, 2015, at 29-30, <http://bit.ly/1SzS9BH>.

²³² A recommendation not to act would also be considered a call to action in this context.

when their communications are subject to the suitability standard. Thus, determining when a fiduciary duty would apply ought to be a familiar process. Also, FINRA guidance serves as the basis for the DOL's revised definition of fiduciary investment advice. Thus, a standard based on this definition of recommendation would maximize uniformity across retirement and non-retirement accounts, which industry groups have indicated is a priority for them.

- The Commission would need to adopt a robust fiduciary standard designed to address the increased risk of investor harm that exists when investment advice and sales are combined.

As the Supreme Court stated in *SEC v. Chenery*, “to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.”²³³ In order to ensure that investors receive the full benefits of a fiduciary standard governing all investment recommendations, the Commission needs to spell out more clearly how those standards would apply to advisers who also act as sellers. This is not to suggest that fiduciary duties can all be neatly described in a handful of rules, but rather that guidance is needed to strengthen and clarify the Commission's application of those fiduciary principles to investment advice that it is combined with investment sales.

Fiduciary expert Arthur Laby has described how an adviser's fiduciary obligation “divides neatly into the duty of loyalty and the duty of care.”²³⁴ The duty of loyalty is designed to protect against “malfeasance,” or wrongdoing, on the part of the adviser, while the duty of care is designed to protect against “nonfeasance,” such as neglect. As Professor Laby explains it, “The duty of loyalty, therefore, is largely negative. It is a duty to prevent misconduct, refrain from self-interested behavior, and avoid conflicts of interest.”²³⁵ In contrast, the duty of care is “largely positive,” requiring the adviser to “pursue the beneficiary's interests with diligence and skill.” While both have a role to play in protecting investors, it is the duty of loyalty that poses the greatest challenge in devising a strong and effective fiduciary standard for brokers who operate under far greater and more complex conflicts of interest than is typical for a traditional fee-only adviser. The question the Commission must ask itself in developing its regulatory approach is, what will it take to “prevent misconduct” by brokers who are being relied on for advice by financially unsophisticated investors?

In interpreting the fiduciary duty under the Advisers Act, the Commission has taken the position that the duty of loyalty requires investment advisers “to act in the best interests of clients and to avoid or disclose conflicts.”²³⁶ Over the years, however, the Commission has demonstrated a reluctance either to enforce the best interest standard that, by its own account, is a central component of advisers' fiduciary obligations, or to require firms to avoid conflicts of interest rather than simply disclose them. While disclosure may be relatively effective when the

²³³ *SEC v Chenery Corp*, 318 US 80, 85-86 (1943).

²³⁴ Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in *RESEARCH HANDBOOK ON MUTUAL FUNDS* (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing), April 21, 2017, at 4, <http://bit.ly/2uAL2qU>.

²³⁵ *Id.*

²³⁶ Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, January 2011, <http://bit.ly/1VIB4zw>.

conflicts are transparent and straightforward (and even that is open to question), it is doomed to failure as soon as the conflicts become more complex and opaque, as we discuss above. And the broker-dealer business model is rife with such conflicts. For investors to receive improved protections from a regulatory approach that imposes a fiduciary standard on all investment recommendations, the Commission will need to take a more rigorous approach to interpreting the fiduciary standard than it has in the past, both in developing a new standard for brokers under the '34 Act and in enforcing the existing standard under the Advisers Act.

- The fiduciary duty must include a principles-based, legally enforceable best interest standard.

First, the fiduciary standard must entail a principles-based, legally enforceable “best interest” standard. And the best interest standard must include an obligation for advisers to seek to identify and recommend the best available investment option for the investor. This does mean that the adviser²³⁷ must look far and wide and consider every investment available in the marketplace to identify the ideal investment. But it does mean the adviser, having carefully considered both the investor’s personal circumstances and the characteristics of the various investment options that she has available to recommend, must recommend the option she reasonably believes best meets the investor’s needs. The adviser must do so even if other suitable options are available that would pay the adviser more or be more profitable for the firm. The analysis should cover the range of factors relevant to such an assessment, including but certainly not limited the risks and costs of the investment. In order to promote compliance with, and effective oversight of, this obligation, the adviser should be required to document the basis on which she reasonably concluded that the recommended investment was the best option for the investor. An adviser who can document that she followed a prudent process based on reasonable assumptions would generally be deemed to have complied with the best interest standard, even if the investment ultimately turned out poorly for the investor. Such an approach would have the added benefit of being entirely consistent with the DOL rule.

- The fiduciary standard must include restrictions on conflicts of interest that unduly pressure or entice advisers to base recommendations on their own financial interests, rather than the customers’ best interests.

Reasonable experts can disagree over what constitutes the best investment strategy in a particular circumstance. Thus, while the best interest standard is an essential component of a strong fiduciary standard, such a standard alone is unlikely to be sufficient to “prevent wrongdoing” by individuals who face significant financial inducements and company pressure to recommend investments that are not in customers’ best interests. In light of the magnitude and scope of brokers’ conflicts, it is unreasonable to expect that even a strongly worded best interest standard will consistently and reliably promote best interest advice if it is not backed by meaningful restrictions on practices that encourage and reward advice that is not in customers’ best interest.

²³⁷ For simplicity, we refer in this section to what the “adviser” must do, by which we mean include broker-dealers who are engaged in making personalized recommendations to retail customers.

As is the case under the DOL fiduciary rule, the appropriate approach is to permit transaction-based compensation, but to prohibit compensation and other practices that can reasonably be expected to cause advisers to base recommendations on their own financial interests rather than the best interests of the customer. For example:

- An adviser who must meet a quota for the sale of proprietary products, and whose bonus may be based on his or her success in meeting that quota, can reasonably be expected to be influenced by that conflict. That is, after all, the whole point of such incentives programs. Sales quotas that are specific to particular investment products or product lines, whether applied directly to the adviser or indirectly to a branch manager, should be prohibited entirely. Where general sales targets are retained, firms should be required to monitor to ensure they are not resulting in excessive or inappropriate sales.
- Differential compensation -- the fact that advisers can earn two, or five, or ten times more selling one investment product over another -- creates a similar incentive for advisers to recommend investments based on which pay them more, rather than which is best for the customer. To the degree that differential compensation at the adviser level is permitted at all under a fiduciary standard, it should be limited to instances in which the difference in compensation can be justified based on neutral factors such as the time or level of expertise required to recommend a particular product, and even this would need to be closely monitored to prevent firms from gaming the system.
- Advisers whose pay is determined based on a retroactive, ratcheted payout grid can have extraordinary incentives to encourage sales, and sales of investments that pay high compensation, as they approach the next rung on the grid. Such payment schemes should either be prohibited entirely under a fiduciary standard, or limited to approaches that provide only gradual increases within a relatively narrow band. Firms that choose to adopt such payout grids should be required to provide enhanced oversight of advisers nearing transition points to ensure compliance with the best interest standard.
- Among the practices identified by the Tully Commission as posing significant risks is the practice of awarding sizeable up-front signing bonuses to brokers who switch firms. The Commission's preferred approach of discouraging, rather than banning, such payments has been notably unsuccessful in limiting their use. It is time for the Commission to take stronger steps, either by eliminating the practice entirely or by imposing significantly enhanced supervisory obligations on firms that retain the practice.

In addition to these obvious examples, the Commission should build on the work already conducted by DOL in its RIA and by FINRA in its report on conflicts to determine whether there are additional conflicts that so threaten compliance with the best interest standard that they should be banned or severely restricted. Two areas, in particular, are deserving of a more detailed regulatory response from the Commission: use of 12b-1 fees and revenue sharing payments to pay for distribution.²³⁸ Indeed, the Commission's failure to deal effectively with these issues

²³⁸ See, e.g., Letter from Fund Democracy and CFA, to the SEC, Re: proposal regarding 12b-1 fees and issues related to the regulation of mutual fund distribution compensation, November 5, 2010, <http://bit.ly/2xSjs7Z>; Testimony of CFA Legislative Director Travis Plunkett before the Senate Governmental Affairs Subcommittee on

complicated the Department of Labor’s task in developing an exemption for advisers who earn transaction-based compensation and would likely pose similar concerns under a new SEC standard. We therefore urge the Commission to revive its earlier proposal for reform of 12b-1 fees and to similarly restrict revenue sharing payments.

- Conflicts that are not avoided should be both disclosed and appropriately managed to ensure that they don’t inappropriately influence recommendations.

Of course, not all conflicts can, or even should, be eliminated. Certain conflicts, like those inherent to fee and commission compensation, will always remain. And others, such as sale of proprietary products or from a limited menu of products, may be viewed as acceptable, as long as they are appropriately managed and clearly disclosed. Thus, the Commission should include requirements for disclosure and management of conflicts as part of any fiduciary standard it may adopt for brokers’ investment recommendations. This should start with disclosure of any such conflicts in a brief, plain English pre-engagement disclosure document that also describes any limitations on the services offered (e.g., that the broker provides only episodic, transaction-based recommendations and does not provide ongoing advice or account management). Any such disclosures should be pre-tested for effectiveness in conveying the relevant information about the nature, scope and implications of any such conflicts. And timing of the disclosure should be required to coincide with timing of ADV Form disclosures.

In addition, firms should be required to adopt policies and procedures reasonably designed to ensure that the conflicts do not inappropriately influence an adviser’s recommendations. This should start with an obligation for the firm to identify all material conflicts in their business that could reasonably be expected to influence recommendations and to develop a company-appropriate plan for managing such conflicts. While plans for managing conflicts will vary from firm to firm based on their particular business model, all should include a mandate that the adviser document the basis on which he or she determined that the investment product or strategy recommended was the best option for the customer. In addition, firms should be required to have a robust supervisory program in place to ensure compliance. As discussed above, technology tools are widely available to assist in the conduct and documentation of the evaluation, helping to make it affordable for firms to provide the necessary supervision.

- While less difficult than the operational challenges of restoring a functional distinction between brokers and advisers, this approach also poses implementation challenges.

This approach avoids some of the operational complexities associated with restoring a functional distinction between sellers and advisers, particularly when it comes to applying the regulations to dual registrants, but it is not without its own challenges. The following are among the key issues the Commission would need to address if it chose to impose a fiduciary standard on all recommendations.

Financial Management, the Budget, and International Security regarding “Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors,” January 27, 2004.

1. How would the Commission address the question of whether brokers have an ongoing duty of care after providing transactional advice?

The Dodd-Frank Act specified that, under a fiduciary standard adopted in reliance on Section 913, brokers would not have an ongoing duty of care “after the advice is rendered.” But brokers today market their services in ways that reasonable investors would perceive as including ongoing account monitoring and management. In such instances, investors’ reasonable expectations should determine whether an ongoing duty applies. One approach to add clarity to this obligation would be to include in the fiduciary standard of care a duty to provide ongoing account monitoring as long as the account is maintained. Alternatively, the Commission could both require pre-engagement disclosures regarding the limitation and prohibit brokers from holding out in ways that imply they offer ongoing account monitoring where this is not the case. If it chose to adopt the latter approach, the Commission would need to test the disclosures for effectiveness.

2. What steps would the Commission take to ensure that advisers can comply with their fiduciary obligations when selling from a limited menu of investments?

The Dodd-Frank Act specifies that selling from a limited menu of investments, including a menu consisting exclusively of proprietary products, would not, in and of itself, be a violation of the fiduciary standard. We generally support this approach. But there may be circumstances where a menu of investment options is so limited, or the available options are of such poor quality, that an adviser couldn’t meet his fiduciary duty by recommending the best of the available options. The best solution, in our view, is for the Commission to specify that firms have a fiduciary obligation to maintain a menu of investment options of sufficient variety and quality to enable its advisers to fulfill their fiduciary obligation to act in the best interest of customers.

3. How would the Commission ensure that limited differential compensation, if permitted, doesn’t inappropriately influence investment recommendations?

In our discussion of limiting conflicts, we leave open the possibility that the Commission would allow advisers to receive differential compensation based on neutral factors, such as expertise or time required to develop the recommendation. As we have indicated in commenting on the DOL rule, however, we believe that allowing even this limited form of differential compensation runs the risk that it will be exploited by advisers seeking to maximize their compensation.²³⁹ While requiring the adviser to document the basis for the recommendation can help, that requirement will at a minimum need to be backed by robust supervisory procedures at the firm level and enhanced oversight by the SEC and FINRA. For a cleaner solution, the Commission could require firms to develop a compensation scheme that is product-neutral at the adviser level for all investments sold on their platform.

²³⁹ See Letter from Roper and Hauptman, CFA, to the DOL, September 24, 2015, at 19-20, <http://bit.ly/1Rkslum>

- Despite these challenges, it is possible for the Commission to develop a pro-investor policy for the regulation of broker-dealers who provide, or hold out as providing, investment advice.

For the better part of three decades, broker-dealers have been given free rein to market themselves as advisers, and to offer extensive advisory services, while still being regulated as salespeople. No one should be surprised if fixing the problem proves challenging. And one of the predictable challenges is entrenched industry opposition to any proposed regulatory approach that would require brokerage firms to make meaningful changes in the way they do business. But maintaining the status quo is not an option for an agency that prides itself on being “the investor’s advocate” nor is it consistent with the long-term interests of “Mr. and Mrs. 401(k).” Because, while the exact degree of harm may be impossible to quantify precisely, evidence clearly demonstrates that investors have suffered financial harm amounting to tens of billions of dollars a year as a result of this regulatory loophole, and competitors have been put at an unfair disadvantage.

Moreover, as the preceding discussion should make clear, it is possible for the Commission to develop a pro-investor policy for the regulation of broker-dealers. It can achieve that, either by restoring the functional distinction that relegates brokers to a strictly limited and clearly labeled role as securities salespeople, or by regulating them as the fiduciary advisers they claim in advertisements and marketing materials to be. While we believe the latter approach offers the better option, we would be prepared to support either approach, so long as the Commission took the steps that we have identified above as essential to its effectiveness. On the other hand, we would strongly oppose and be prepared to challenge an approach that claimed to impose a fiduciary standard without including either a meaningful best interest standard or restrictions on conflicts. Similarly, we would strongly oppose and be prepared to challenge an approach that sought to address investor confusion through disclosure alone, without requiring brokers to abandon deceptive and misleading practices characterizing their sales activities as if they were fiduciary advice.

V. Industry proposals to rebrand the suitability standard as a best interest standard and add a few disclosures would not protect investors.

Since the Commission issued its request for input, some of the most vocal opponents of the Department of Labor fiduciary rule -- including SIFMA, ICI, and Fidelity -- have submitted comments in enthusiastic support of SEC rulemaking. Advocating a substantially identical approach, these groups have called on the SEC to develop a meaningless disclosure-based “best interest” standard for brokers that would serve as the basis for a “streamlined” exemption from DOL’s more rigorous fiduciary standard. All three call for the SEC to use FINRA’s suitability standard at its starting point in developing such a standard, and none offers any clear indication of how that standard would be “enhanced” under their proposed approach except through the addition of disclosures. All call for conflicts of interest to be addressed exclusively through disclosure, without providing any evidence that disclosures are likely to be effective in protecting investors from the harmful impact of those conflicts. And all three misrepresent the industry’s response to the DOL rule in order to justify an approach that fails to strengthen protections in non-retirement accounts while greatly weakening protections that retirement investors currently

receive under the DOL rule. There's no reasonable basis on which the Commission could conclude that their proposed approach would adequately protect investors from the harmful impact of conflicted investment advice. For the Commission to adopt their proposed approach would be arbitrary and capricious.

A. The industry proposal is based on a series of false assumptions and mischaracterizations.

- The industry proposal is based on the false premise that SEC rulemaking is needed to rescue financial firms and investors from the harm that has resulted from the Department of Labor's fiduciary rule.

Industry groups attempt to justify their call for SEC to adopt a different regulatory approach by arguing that the DOL rule is harming investors. According to this false narrative, the "onerous requirements of the [DOL] rule" have forced many firms to abandon commission accounts, forcing investors to "pay an asset-based fee to receive exactly the same services that were previously provided to them for no additional fee under a transaction-based fee structure."²⁴⁰ This statement is false on several counts. First, contrary to industry's sky-is-falling predictions that the best interest contract exemption is "unworkable," a large majority of firms have chosen to maintain commission accounts as an option under the DOL rule. They have done so under a variety of approaches, demonstrating the rule's flexibility. Several financial firms have developed innovative new business models that not only achieve the DOL rule's goal of reducing conflicts in commission accounts, but do so in ways that will lower costs for many investors.²⁴¹

Second, while it is true that some firms, most prominently Merrill Lynch, have chosen to convert most or all of their retirement accounts to fee accounts in response to the rule, it is wrong to suggest that this necessarily exposes investors to higher costs, as we discuss in greater detail above, or that investors will "receive exactly the same services" that they did in commission accounts. As SIFMA itself acknowledges when it serves its purposes, there are substantial differences between the "episodic" sales recommendations investors receive in commission accounts and the ongoing investment advice and account monitoring they are entitled to receive in fee accounts. Thus, it would appear to be a gross mischaracterization to suggest that retirement investors who are moved to fee accounts as a result of the DOL rule are receiving "exactly the same services" as they had previously received in commission accounts. The only other possible explanation is that firms are failing to live up to their fiduciary duty under securities laws that govern those fee accounts. If that is the case, they would also be in violation of the obligation under the DOL rule to ensure that fees are reasonable in light of services offered.

Similarly, as discussed above, ICI's survey of members regarding "orphaned" accounts tells us nothing about whether investors have been harmed by having their accounts held at the fund company instead of the broker, since there's no way of verifying whether these accounts were being actively advised before they were "orphaned." If the only effect on investors is that they pay 12b-1 fees to the fund company rather than to a broker, there is no harm. There could

²⁴⁰ See, e.g., Letter from Marc R. Bryant, Fidelity, to the SEC, August 11, 2017, at 3, <http://bit.ly/2wLJSKh>.

²⁴¹ Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, <http://bit.ly/2oXIZfq>; Letter from Roper and Hauptman, CFA, to the DOL, August 7, 2017, <http://bit.ly/2gIoufE>.

even be a benefit if those investors are no longer forced to pay nuisance fees often charged by brokers but not fund companies, such as IRA custodial fees or inactivity fees. SIFMA, ICI, and Fidelity's claims that investors have been harmed by having their choice of investment products narrowed is equally false. As discussed above, and described at length in our recent DOL comment letters, new products with more investor-friendly features have been introduced since the rule was finalized.

The lesson from industry lobbyists' mischaracterization of the impact of the DOL rule is that the Commission cannot reasonably rely on their obviously skewed research to reach conclusions about the appropriate regulatory approach. That includes ICI's deeply flawed estimate of investor harm, as well as biased industry studies based on opaque, non-verifiable information, such as the study SIFMA recently commissioned from Deloitte. On the contrary, the Commission must follow DOL's past example and demand the underlying data if it is to rely on such studies. In addition, it must carefully assess the best available independent, transparent, peer reviewed academic research, including that compiled by the Department of Labor in its RIA. As discussed above, based on its comprehensive, well documented analysis, DOL concluded that the investment advice market is rife with conflicts, that those conflicts result in harm to investors, and that a regulatory approach that combines a best interest standard with restraints on conflicts is necessary to protect investors from the harmful impact of those conflicts. If the Commission disagrees with those conclusions, it must explain the reasonable basis on which it reached that different conclusion.

As part of its analysis, the Commission can and should look at how the market has responded to the DOL rule, in particular how it was responding before uncertainty over the rule's fate interrupted firms' implementation plans. Contrary to what industry rule opponents would have you believe, the following are among the key lessons the Commission should take from that experience:

- Brokerage firms can and will develop pro-investor business models that reduce conflicts of interest in commission accounts while preserving access to advice, but only if they are forced to do so by a strong and effective rule.
- Forcing product providers to compete based on quality and cost will result in more investor-friendly investment options, with the result that investors are likely to see their total costs decline, and decline significantly, under a best interest standard.
- The key to bringing about these pro-investor developments is inclusion in the rule of an enforceable best interest standard backed by real restraints on conflicts of interest.
- Liability concerns are overblown.²⁴² Broker-dealers' exposure to class action claims under FINRA rules has led to none of the harmful outcomes predicted by industry under DOL's identical provisions. The vast majority of firms will be willing to face that liability risk in order to serve this market.

²⁴² Letter from Roper and Hauptman, CFA, to the DOL, April 17, 2017, 91-101, <http://bit.ly/2oXIZfq>.

- As discussed above, technology tools are available that make it affordable for firms to serve even the smallest accounts under a fiduciary standard.

In short, far from justifying a radically different approach than that adopted in the DOL rule, we are confident that a fair evaluation of the evidence will lead to the conclusion that the best approach to harmonizing standards across accounts, if that is the Commission's goal, is for the Commission to develop a rule that, like the DOL rule, combines an enforceable best interest standard and real restraints on harmful conflicts. Indeed, there are lessons from the DOL approach not just for the standard that should apply to brokers, but for how the Commission should address conflicts of interest under the Advisers Act.

- The industry proposal is based on a misrepresentation of the services offered by brokers and how a fiduciary standard would apply to those services.

In making their case, SIFMA, ICI, and Fidelity are highly opportunistic in how they describe the services offered by broker-dealers. When they are justifying adopting a new "best interest" standard for broker-dealers that is different than that imposed under the Advisers Act, they emphasize the "episodic" and transactional nature of brokers' sales recommendations and the traditional distinction, under securities law, between selling and advice. When they are talking about how investors would be harmed if they lost access to brokerage services, however, suddenly those same sellers are transformed into "investment advice providers." What they fail to confront is this: if brokers are engaged in "mere sales," as they suggest when they are seeking to avoid application of a robust fiduciary standard, then they ought to be labeled accordingly. If they are, in fact, investment advice providers, there is simply no justification for holding them to a different or lower standard of conduct than the standard that applies to all other investment advice providers.

In making this argument, they also fail to acknowledge the flexibility of the fiduciary standard. Because it is a facts and circumstances based standard, where compliance requirements are based on the nature of the business model, there is no need to develop a new or different fiduciary standard to accommodate the "episodic" and transactional nature of broker-dealers' investment advice. Issues, such as whether there is an ongoing duty of care, would be determined under the existing standard based on whether the firm offers, or holds out as offering, ongoing advice and account management. Similarly, decisions with regard to how to protect against the harmful conflicts associated with sale from a limited menu of investment options or sale of proprietary products would be addressed through strong pro-investor requirements for the management of conflicts more generally, something that is needed for advisers and brokers alike. Suggesting that conflicts such as these in the broker-dealer business model require a more lenient approach is the exact opposite of how a fiduciary standard of care should work.

- The industry proposal is based on a mischaracterization of Section 913 of the Dodd-Frank Act, which they point to as providing the Commission with the authority to adopt their proposed approach.

SIFMA, ICI, and Fidelity point to Section 913 of the Dodd-Frank Act as providing the SEC with authority to adopt a revised standard for brokers, but in doing so they misrepresent the

direction provided by Congress in that statute. Most egregiously, SIFMA states in its letter that, “The language ‘without regard to the financial or other interest of’ [in DOL’s best interest standard] derives from the fiduciary duty standard under ERISA, which is recognized as the ‘highest known to the law.’” As SIFMA surely knows, however, given its high level of involvement when Section 913 of Dodd-Frank was being drafted, the “without regard to” language comes from Dodd-Frank. Specifically, Section 913 authorizes the Commission to “promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.” In other words, DOL based its best interest standard for retirement investment advice, not on ERISA’s sole interest standard, but rather on the standard Congress had so recently indicated was the appropriate standard for broker-dealers and investment advisers under the securities laws.

The groups’ other mischaracterizations of the Commission’s authority under Section 913 consist of omissions, rather than direct misrepresentations. They acknowledge that Section 913 directs that the standard adopted under its authority should be no weaker than the existing standard under the Advisers Act, but they fail to acknowledge that it also directs that the standard for brokers and advisers should be the same and that enforcement of that standard should be consistent. As a result, they cannot point to Section 913 as providing the necessary authority for a regulatory approach that adopts a distinctly different standard for investment advice provided by brokers than the standard that applies under the Advisers Act.

They also fail to acknowledge Section 913’s direction to 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.” Far from supporting a standard that looks to disclosures alone to address conflicts, as they have proposed, both this provision of Section 913 and the “without regard to” language, reflect Congress’ awareness of and concern regarding the harmful impact of conflicts of interest on retail investors. Indeed, contrary to industry group’s assertions, the DOL rule is an excellent embodiment of the fiduciary standard Congress outlined in Dodd-Frank.²⁴³

In short, while the Commission is under no obligation to adopt a rule based on its Section 913 authority, it cannot reasonably justify adopting the regulatory approach advocated by SIFMA, ICI and Fidelity in reliance on that authority.

- The groups greatly exaggerate the investor protection afforded by the suitability standard, which does not require best interest advice as that term is understood by investors.

Among the most important of these groups’ misrepresentations is their exaggeration of the level of protection afforded by FINRA’s suitability standard. In arguing that the suitability standard should serve as the basis for a “best interest” standard for brokers, these group make

²⁴³ CFA Fact Sheet, “DOL Rule Proposal Meets Standards Industry Rule Opponents Claim to Support,” <http://bit.ly/2jr3K0i>.

much of the fact that FINRA has interpreted the suitability standard to include an obligation to act in customers' best interest. SIFMA states, for example, that "FINRA has ... interpreted this suitability obligation as requiring that BDs' recommendations be consistent with their customers' best interests, thereby prohibiting BDs from placing their interests ahead of their customers' interests." Fidelity further notes that, "In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendation must be consistent with his customer's best interests.' The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."

While we applaud FINRA for taking steps over the years to strengthen its interpretation of the suitability standard, it is simply not accurate to suggest that it has been enforced to require brokers to seek to recommend the investment option that is best for their customers. Nor has it prevented brokers from placing their own interests ahead of their customers' interests by recommending investments that are more profitable for them rather than those that are best for their customers. On the contrary, as we have explained in greater detail in an earlier comment on the DOL rule proposal, a reading of the cases in which brokers' best interest obligations have been cited "does not support the contention that brokers are currently being held to a best interest standard by either the SEC or FINRA. Indeed, these cases make the opposite point, calling into question whether suitability is being enforced in a way that provides investor protections beyond a basic fraud standard."²⁴⁴ Moreover, the well-documented investor harm that results from conflicted advice has gone unchecked under the suitability standard these groups propose as the basis for rulemaking. Frankly, their proposal to rely on suitability as providing the basis for a "best interest" standard for brokers reinforces our belief, based on the positions they have taken in the debate over the DOL rule, that their real goal is a best interest standard in name only that will not require firms to make the changes to harmful business practices that are necessary to protect investors.

B. The industry groups' proposed regulatory approach is entirely inadequate to protect investors. In some areas, it could actually weaken existing protections.

Having started from false assumptions, SIFMA, ICI and Fidelity propose a regulatory approach that is entirely inadequate to protect investors from the harmful effects of conflicted investment advice. Instead, their proposed approach would allow brokers to claim to be subject to a best interest standard, which would be useful to them for marketing purposes, but it wouldn't actually require them to change practices that allow them to profit at customers' expense. Moreover, it would do nothing to rein in broker-dealers' ability to portray themselves as if they were providing ongoing advice and planning while regulating them as if they provided nothing more than episodic sales recommendations. If the Commission were to adopt this approach, it would expose investors to even greater risks than they face under current regulations for retirement and non-retirement accounts alike.

²⁴⁴ Letter from Roper and Hauptman, CFA, to the DOL, July 21, 2015, at 13, <http://bit.ly/1SzS9BH>.

- The industry groups’ proposal makes no identifiable improvements to strengthen the suitability standard.

Under the industry groups’ proposal, the best interest standard that has been interpreted to exist under the suitability standard would be made explicit. Also in keeping with existing FINRA guidance regarding suitability, ICI states that, “The standard would require that a broker-dealer’s recommendation to a retail customer not put the broker-dealer’s interests (or the interests of anyone else) above the client’s interests.” Having defined best interest in terms of existing FINRA guidance, the groups do not identify a single practice that is currently permitted under the suitability standard that would be prohibited under this new “best interest” standard. In particular, no mention is made of any obligation to avoid, or even appropriately manage, conflicts of interest that could undermine adherence to a true best interest standard.

On the contrary, all three groups emphasize the adequacy of existing protections under the suitability standard and argue that any “enhancements” to that standard should come in the form of increased disclosures. Fidelity writes, for example, “With respect to broker-dealers, we view FINRA’s existing suitability standard as an already highly effective best interest standard of conduct that protects investor interests, is appropriately tailored to a broker-dealer business model, and is subject to strong and long-standing SEC and FINRA enforcement practices.”²⁴⁵ Fidelity adds that, if the SEC does draft new regulations, it should “develop standards of conduct that are principles-based and primarily implemented through disclosure consistent with the SEC’s long-standing approach to broker-dealer regulation.”

SIFMA’s proposed “duty of care” is also defined entirely in terms of existing FINRA rules. It says nothing about the added analysis that would be necessary to determine which of the many suitable investments would be best for the customer, presumably because they have no expectations that brokers would be required to make such an assessment under the best-interest-standard-in-name-only they’ve proposed. The SEC staff study, however, specifically recommended 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.”²⁴⁶ Moreover, by defining the duty of care as reflecting “the ‘reasonable diligence’ and the reasonable care, skill, and prudence that a prudent registered representative,” as opposed to a prudent expert, would exercise, SIFMA further suggests that they have no interest in raising the standards that currently apply under existing rules. Instead, their goal appears to be to specifically endorse the adequacy of current industry standards and common industry practices while claiming to have improved protections for investors.

²⁴⁵ Letter from Marc R. Bryant, Fidelity, to the SEC, August 11, 2017, at 2, <http://bit.ly/2wLJSKh>.

²⁴⁶ Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011, at 122, <http://bit.ly/1VIB4zw>.

- The industry groups' proposal could weaken existing protections for non-retirement accounts.

Currently, violation of fiduciary duty is the most common claim brought against brokers in FINRA arbitration. These cases reportedly often involve situations where a broker has portrayed their services in such a way that they created a reasonable expectation on the part of the investor that the broker would provide ongoing account management and oversight that they did not in fact provide. This results from what SIFMA describes as the typical broker-dealer practice of providing “episodic” advice, in which there is an ongoing relationship between the broker and the customer characterized by repeated instances of transaction-specific “advice.” Investors reasonably expect that the broker is monitoring the account between transactions, particularly when brokers advertise their commitment “to establishing and maintaining long-term relationships based on integrity and trust,” to use just one representative example.²⁴⁷ Brokers, on the other hand, disclaim any obligation to monitor the account between recommendations, and the suitability standard itself only applies to specific recommendations.

Investors who sometimes prevail in these arbitration cases under the existing standards would be less likely to do so under SIFMA’s proposed standard, which explicitly states that a broker “shall not have a continuing duty to the customer after making the recommendation.” As we stated in an earlier comment letter objecting to a similar suggestion, SIFMA seems to envision an approach under which brokers who have an ongoing relationship with customers that includes repeated instances of transaction-specific advice would be viewed as providing episodic, rather than ongoing, advice and thus could avoid or contract out of an ongoing duty of care to those customers. Such an approach would create significant opportunities for misrepresentation and abuse.²⁴⁸ By making it less likely that investors would prevail in arbitration, SIFMA’s proposal could weaken protections investors receive now to ensure that their reasonable expectations are met.

There is no reasonable basis for believing investors would understand these limitations on brokers’ services, particularly in light of SIFMA’s completely inadequate proposed approach to disclosure. Only if the Commission were to adopt an approach that strictly limited broker-dealers to holding out and marketing themselves as salespeople engaged in arm’s length commercial sales transactions could it reasonably consider adopting such an approach. If brokers remain free to market themselves as advisers, whether they have an ongoing duty of care must continue to turn on the facts and circumstances, including in particular whether they portray themselves in ways that create a reasonable expectation that they will provide ongoing advice.

- The industry groups’ proposed disclosures are inadequate in terms of content, timing, and delivery.

SIFMA’s proposal relies exclusively on “enhanced” disclosures to combat investor confusion over the nature of services offered, to convey any limitations on the scope of those

²⁴⁷ Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, Jan. 18, 2017, at 12-13, <http://bit.ly/2jKUbfD>.

²⁴⁸ Letter from Barbara Roper, CFA, to the SEC, RFI on Duties of Brokers, Dealers, and Investment Advisers, July 5, 2013, at 12, <http://bit.ly/2veGjfw>.

services, and to protect investors from the harmful impact of conflicts of interest. As we have discussed above, extensive research, including studies conducted on behalf of the Commission, clearly demonstrate that disclosures are of limited value under the best of circumstances and cannot begin to counteract conflicting statements in marketing materials. So, for example, a disclosure that the broker-dealer offers investment sales recommendations and has no ongoing duty of care is unlikely to be effective if the broker remains free to call its sales representatives “financial advisors,” to call its services “investment planning,” and to market those services as if product sales were incidental to advice, instead of the other way around. Similarly, disclosures about the existence of conflicts are of little value to an investor who lacks the financial expertise necessary to assess the impact of those conflicts and no ability to determine whether the investment recommended is a good option for them or whether better options are available.

Thus, even the best designed disclosures couldn’t carry the weight of investor protection delegated to disclosure under SIFMA’s proposed approach. SIFMA, however, is proposing to give brokerage firms total discretion to “elect the timing and content, form (whether paper, electronic, web-based, or otherwise), and manner of delivery (whether hard copy or electronic delivery or access) of disclosure, including any updates to disclosure and notices thereof, based on the BD’s particular business model.” Such an approach would ensure that many investors would never see the disclosures, which would in many cases be delivered through the “access equals delivery” approach to disclosure long sought by industry. Even where investors received the disclosures, they’d be unlikely to receive them prior to the engagement, when they could help to inform the investors’ decision about who to hire. Instead, as SIFMA explicitly states, delivery would likely be delayed until the time when the first trade is executed. Finally, giving firms discretion to determine the content of the disclosures would undermine comparability and clarity, providing no assurance that the disclosures effectively conveyed the required material, indeed virtually guaranteeing that in many cases they would not.

- The industry groups’ proposal would weaken protections for retirement accounts without creating a uniform standard of care for investment advice.

The argument that standards governing advice to retirement and non-retirement accounts should be the same ignores the basic fact that Congress intentionally set a higher standard of protection for retirement accounts under ERISA than it had under securities laws. This was done precisely because retirement assets are special, as evidenced by their tax preference. Moreover, those who invest exclusively or primarily through retirement accounts tend to be less wealthy, less financially sophisticated, and thus more vulnerable than those who have significant non-retirement account investments.²⁴⁹ Creating a prohibited transaction exemption based on securities laws -- particularly one where conflicts of interest are addressed primarily through disclosure rather than through avoidance and mitigation -- risks subjugating DOL’s purpose to protect retirement plans and retirement investors to a standard that is not in the interests of plan participants, beneficiaries, and IRA owners, and is not sufficiently protective of their rights. If

²⁴⁹ See DOL, *Regulating Advice Markets, Definition of the Term “Fiduciary,” Conflicts of Interest - Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions*, April 2016, at 163-166, <http://bit.ly/2mT9Gfq>. See also Barbara Roper and Stephen Brobeck, “Mutual Fund Purchase Practices, An Analysis of Survey Results,” June 2006, <http://bit.ly/1IicqGD>.

industry believes uniformity of standards is important, then that uniformity can and should be achieved by raising the standards for all accounts, not reducing the protections that apply to tax advantaged retirement accounts.

Industry groups' arguments that DOL and SEC need to coordinate to develop a uniform standard for retirement and non-retirement accounts are feeble at best, self-serving at worst. One argument is that greater coordination is needed because investors are "confused" by the differing standards. Fidelity writes, for example, that, "The DOL Fiduciary Advice Rule has increased investor confusion, rather than reduce it. Many investors and regulated entities are now faced with standards of conduct, disclosure requirements, and enforcement mechanisms for their retirement accounts that are different than for their non-retirement accounts. The outcome is confusing to retail investors who reasonably question why certain products, services and fees are not the same across their accounts, even if the provider is the same." Unlike the confusion that exists under securities laws, in which investors are led to rely on self-interested sales recommendations as if they were fiduciary advice, the groups identify no harm that investors suffer as a result of this supposed DOL-rule-induced confusion. Moreover, if they do perceive it as a problem, there is a simple solution. Firms could simply choose to comply with the higher standard set by the DOL rule for all their accounts, and some firms have reportedly chosen to do just that.²⁵⁰

Even if you agree, as we do not, that uniformity across different types of accounts is needed, SIFMA's proposal fails to provide that uniformity. Instead, SIFMA proposes that securities regulators, insurance regulators, and banking regulators all act separately to adopt standards for the individuals and entities for which they serve as primary regulator. This all but guarantees that differences will emerge in how the standards are drafted and certainly in how they are enforced. Indeed, because SIFMA has intentionally proposed a standard for broker-dealers that is different from the standard for investment advisers, it doesn't even create a uniform standard for all securities accounts.

Under this approach, retirement investors would no longer be assured that all investments sold in retirement accounts are subject to consistent standards, as is currently the case under the DOL rule. As one obvious example, requirements for recommendations of fixed-indexed annuities, which are regulated by state insurance departments, could differ from those for variable annuities or mutual funds, which are subject to securities regulation. Given that firms often offer a variety of different types of accounts and investments -- a registered representative may also be regulated as both an investment adviser representative and an insurance agent -- there is no guarantee under SIFMA's fragmented approach that all accounts or all products recommended by the same "adviser" would be governed by the same standard of care. In short, SIFMA's proposed approach weakens existing standards without creating the uniformity it uses to justify a revision to the rules and without doing anything to clarify the distinctions between

²⁵⁰ PNC reportedly plans to offer clean shares in both retirement and non-retirement accounts. *See, e.g.*, Bradley Saacks, *PNC Brokerage Unit: We Are Ready to Go 'Clean,' IGNITES*, June 9, 2017, <http://bit.ly/2uwZWuM>; Daisy Maxey, *PNC, in Fiduciary Move, Offers 'Clean' Mutual Fund Shares*, THE WALL STREET JOURNAL, June 9, 2017, <http://on.wsj.com/2s5fSgC>. Similarly, LPL's new mutual fund only platform reportedly will be available for retirement and non-retirement accounts. Press Release, LPL Financial, "LPL Financial Announces Details and Fund Companies For Its Industry-First Mutual Fund Only Platform," July 13, 2017, <http://bit.ly/2vc25hy>.

those services.

- The proposal would not reduce investor confusion or protect investors from the harmful impact of conflicts of interest.

As we discuss above, even a strong principles-based best interest standard cannot adequately protect investors from the harmful effects of conflicted advice if it is not backed by restrictions on the practices that encourage and reward advice that is not in customers' best interests. That is even more of a concern here, where the backers of this approach have made clear that they do not anticipate any meaningful changes to the existing suitability standard beyond the addition of a few poorly timed, boilerplate disclosures. Moreover, the approach is specifically designed to preserve a regulatory distinction between the standard that would apply to brokers as "sellers" and the standard that applies to investment advisers under the Advisers Act. However, its only measure to dispel investor confusion regarding that distinction takes the form of disclosures that, under SIFMA's proposed approach, would come too late to be factored into the hiring decision and, because of its reliance on the "access equals delivery" method for "delivering" the disclosures, might never be seen by a majority of investors.²⁵¹

As a result, if the Commission were to adopt this proposed approach, investors would continue to be misled about the nature of services offered by broker-dealers, who would remain free to hold themselves out as advisers while being regulated as sellers. Worse, investors would face a new deception in the form of a false claim that regulations had been strengthened and brokers were now required to act in their customers' best interests, when in reality the regulatory standards had not materially changed. For the Commission to adopt such an approach, with no evidence that it would protect investors from the harmful impact of conflicted investment advice, would be arbitrary and capricious and expose the Commission to legal challenge.

Conclusion

The history of the Commission's involvement in this issue has been characterized by the Commission's willingness to tie itself into knots to preserve the broker-dealer business model at the expense of investor protection. Toward that end, the Commission has turned a blind eye to clearly misleading practices, bent the rules regarding application of the Advisers Act to brokerage activities, and mischaracterized the record, all to avoid holding broker-dealers to the fiduciary standard appropriate to the advisory role they claim in their marketing materials to fulfill. Investors who were misled into relying on self-interested sales recommendations as trustworthy advice have suffered untold harm. The Commission now has an opportunity to rescue this failed policy and to develop the rational, pro-investor policy for the regulation of financial professionals that we and others have sought for close to two decades. To achieve that goal, however, the Commission will need to ignore self-interested arguments of industry groups intent on maintaining a status quo that is very profitable for them, and act instead to benefit the average, financially unsophisticated investors who turn to financial professionals for advice.

²⁵¹ When FINRA asked investors about the disclosure delivery preferences, only six percent indicated a preference for receiving disclosures by accessing them online. FINRA Education Foundation, *Investors in the United States 2016*, December 2016, at 14, <http://bit.ly/2hMrppX>.

It is true, as some have suggested, that developing sound policy in this area is hard. It is unreasonable to expect that you can unwind bad policy and eradicate harmful practices that have developed over several decades without requiring some potentially wrenching changes in the way firms do business. But the long-term benefits to investors from requiring advisers to act in their best interests, by requiring firms to eliminate practices that encourage and reward recommendations that are not in customers' best interests, and by promoting market competition among both advisers and investment products on terms that benefit investors are unquestionable. This is without a doubt the most important thing you can do to fulfill your pledge to protect the long-term interests of Mr. and Mrs. 401(k).

Respectfully submitted,



Barbara Roper
Director of Investor Protection



Micah Hauptman
Financial Services Counsel

Cc: The Honorable Michael Piwovar, Commissioner
The Honorable Kara Stein, Commissioner

Appendix A: Letters to the SEC Regarding the Standard of Conduct for Broker-Dealers and Investment Advisers

Letter from Barbara Roper, CFA Director of Investor Protection, to Securities and Exchange Commission Chairman Arthur Levitt, urging him to strengthen regulation of broker-dealers' investment advice, October 1999, <http://bit.ly/2eXC5T4>.

Letter from Roper to SEC, commenting on fee-based brokerage account rule proposal, January 2000, <http://bit.ly/2eMqEhg>.

Letter from Roper to SEC, commenting on renewed proposal to adopt a fee-based brokerage account rule, September 2004, <http://bit.ly/2wZ3xHw>.

Letter from Roper to SEC Chairman William Donaldson, rebutting SIA arguments regarding the fee-based brokerage account rule and offering a pro-investor alternative, October 2004, <http://bit.ly/2vVbiKP>.

Letter from Roper to SEC, CFA letter challenging the SEC's interpretation of solely incidental to exemption for broker-dealers, including its mischaracterization of the legislative history on which that interpretation is based, February 2005, <http://bit.ly/1T6xNS2>.

Letter from Fund Democracy, CFA, Consumers Union and Consumer Action to SEC, commenting on the revised fee-based brokerage account rule proposal, February 2005, <http://bit.ly/2xc8M7i>.

Letter from CFA and Fund Democracy to SEC Chairman Christopher Cox, challenging the staff interpretation of the applicability of the Investment Advisers Act to financial planning services offered by broker-dealers, February 2006, <http://bit.ly/2xQ5l36>.

Letter from Roper to SEC, commenting for the staff study regarding the standard of conduct for broker-dealers and investment advisers, August 2010, <http://bit.ly/2f7gcBf>.

Letter from Roper to SEC, commenting on the RFI on the standard of conduct for broker-dealers and investment advisers, July 2013, <http://bit.ly/2veGjfw>.

Letter from AARP, CFA, Fund Democracy, CFP Board of Standards, Financial Planning Association, and NAPFA in response to the Request for Information regarding the standard of conduct for broker-dealers and investment advisers (with a particular focus on evidence of investor harm), April 2014, <http://bit.ly/2gPXyhx>.

Additional letters are available on the Investment Professionals page of the CFA website at: <http://consumerfed.org/issues/investor-protection/investment-professionals/>

Appendix B: Letters from CFA to the Department of Labor Regarding its Conflict of Interest Rule

Letter from Barbara Roper, CFA Director of Investor Protection, and Micah Hauptman, CFA Financial Services Counsel, to the Department of Labor, commenting on its proposed revised definition of fiduciary investment advice under ERISA and related prohibited transaction exemptions, July 2015, <http://bit.ly/1SzS9BH>.

Letter from Roper and Hauptman to DOL, responding to industry comments on the Department's conflict of interest rule proposal, September 2015, <http://bit.ly/1Rkslum>.

Letter from Roper and Hauptman to DOL, opposing delay of the rule's implementation as arbitrary and capricious, March 2017, <http://bit.ly/2y0T9vs>.

Letter from Roper and Hauptman to DOL, commenting on reconsideration of the conflict of interest rule, April 2017, <http://bit.ly/2oXIZfq>. Appendices available at: <http://bit.ly/2h52BLa>.

Letter from Roper and Hauptman to DOL, responding to the Department's RFI Regarding the Fiduciary Rule and Prohibited Transaction Exemptions, August 2017, <http://bit.ly/2gIoufF>.

Additional materials, including reports and fact sheets are available on the CFA website at: <http://consumerfed.org/issues/investor-protection/investment-professionals/>