Mr. Jay Clayton
Chair, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: IA-BD Conduct Standards

Dear Chairman Clayton:

We are writing on behalf of Americans for Financial Reform in response to the request for input from the Securities and Exchange Commission (SEC) regarding conduct standards for broker-dealers and investment advisors. AFR is a coalition of over 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

We strongly support the Commission using this opportunity to strengthen protections for investors by extending a strong fiduciary "best interest" standard to all those who hold themselves out as advisers or offer personalized investment advice to clients.

We are concerned, however, that certain industry groups will try to use this process to win a watered down standard that pays lip service to the best interest of the customer but doesn't actually deliver on that promise. The recently submitted comment by the Securities Industry and Financial Markets Association (SIFMA) illustrates this problem well, as it advocates a standard that lacks the clear and meaningful restrictions on conflicts of interest that are essential to protect investors from the harmful impact of such conflicts.

If the SEC takes such an approach it will be doing serious harm to investors. It would be a great disservice to investors for the SEC to promulgate a standard which was labelled as a fiduciary standard but lacked real protections from the harmful impact of conflicts of interest. Such a standard would be ineffective in preventing conflicted advice, advice which demonstrably does major financial harm to investors. It would also add to already endemic confusion among investors as to the real meaning of the standards applying to different types of financial professionals. The Commission must not create a situation where investors continue to be

[1] A complete list of AFR's coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

exposed to the harm created by conflicted advice while receiving inaccurate assurances of protection.

The key difference between a pro-investor standard and one that lacks substance lies in how it addresses conflicts of interest. Over the years, practices have become deeply embedded in the broker-dealer business model that that encourage and reward advice that is *not* in customers' best interests. These include large variations in the payouts for selling different products, ratcheted payout grids, sales quotas and other aggressive tactics to push the sale of in-house products, and more. As a result, even those investors who understand that their "financial advisor" is paid to sell investments, not advice, are unlikely to fully grasp the scope and magnitude of these conflicts or the harm they can suffer as a result. ***If there is a single point we wish you to take from this letter, it is that any Commission action on a fiduciary duty for broker-dealers must require that brokers genuinely mitigate these kind of unmanageable conflicts before they can claim to be delivering best-interests advice to investors.***

Congress clearly recognized the need for such an approach in Section 913 of the Dodd-Frank Act, where it stated that:[2]

> "The Commission shall…examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisors that the Commission deems contrary to the public interest and the protection of investors."

The Department of Labor (DOL) has laid out a rule which demonstrates that such mitigation is possible. The rule requires the real restraints on conflicts necessary to support a best interest standard, reflected in firm policies and procedures and payment methods. In doing so, it has shown that firms can rein in such conflicts if they are required to do so, preserving the benefits of transaction-based advice while eliminating its most harmful features. As detailed below, the DOL rule, even before it is being fully implemented and enforced, has already led to beneficial innovation in the creation of financial products that benefit investors and minimize conflicts. If the SEC produces an equally strong standard, this will be extremely useful in expanding the zone of investor protection to non-ERISA covered investments, and will facilitate informed investor choice by creating a standard of protection that is both strong and consistent.

However, it would be deeply counterproductive for the SEC to promulgate a vague and non-specific standard that does not require genuine mitigation of conflict of interests, or relies solely on disclosure of conflicts to do the work of actually addressing conflicts. A weak fiduciary

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[2] Section 15(l)(2) of the Securities Exchange Act of 1934, as added by Section 931 of the Dodd-Frank Act.

standard in the SEC space would multiply investor confusion by allowing those who offer advisory services to claim fiduciary status when they are not bound by a strong standard.

Below, we offer more detailed comments and an outline of a potential SEC standard that draws on the lessons learned from the DOL fiduciary experience to address the investor harms resulting from the current system. We highlight several major points:

- **The issue is not just investor confusion but investor harm.** Investors clearly do not understand the standards of conduct that apply to different providers of financial advice. However, the reason this confusion is so harmful and destructive is that there are so many advice providers who are not covered by a meaningful duty of care. In rulemaking, the SEC needs to keep its eye on the central goal of reducing investor harm, which requires a meaningful fiduciary standard.

- **Strong, clear regulatory action is needed to address pervasive conflicts in the broker-dealer business model.** Despite overwhelming evidence that broker-dealers are extensively conflicted and are frequently paid to place products that are not in the best interests of the customer, the SEC has permitted brokers to present themselves as trusted advisors. This has demonstrably increased both investor confusion and investor harm.

- **Disclosure alone cannot do the work of real fiduciary protection.** Overwhelming academic literature shows that disclosure is not sufficient to protect investors from poor or conflicted advice. Constructing a fiduciary policy simply around the disclosure of conflicts would be completely inadequate.

- **A standard that reduces investor harm is well within reach, but requires specific conduct and compliance requirements for those who hold themselves out as advisors.** Advisors should be required to demonstrate that they conduct business in a manner that matches reasonable investor expectations for non-conflicted advice. As the DOL rule shows, such a requirement could continue to permit a range of compensation types, but would also trigger substantial market innovation in rendering these forms of compensation more investor-friendly.

Above all, the SEC must not adopt a vague and undefined fiduciary standard that leaves sellers free to use business models that are rife with conflicts of interest, while presenting themselves to investors as trustworthy fiduciary advisers. Instead, as described below, a fiduciary standard must involve a clear and enforceable set of requirements that ensure those who present themselves to investors as providing advisory services provide such services in a manner that puts the interests of investors first.

Investor Confusion Is Endemic In Advice Markets

The Commission starts its inquiry on this topic by correctly noting that "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." Investor confusion isn't the only problem, however, or even the primary problem that the Commission needs to address. We would be considerably less concerned about investor confusion if it didn't also result in serious investor harm. But widespread investor confusion – and the ineffectiveness of disclosure in eliminating that confusion – does limit the solutions available to the Commission for reducing the harm investors suffer when they mistake suitable, but self-interested sales recommendations for fiduciary investment advice.

The RAND study examining these same issues, commissioned by the SEC a decade ago, famously demonstrated that a majority of investors cannot distinguish broker-dealers from investment advisers and that the titles they use play a role in creating this confusion.[3] Its investor survey found, for example, that investors were significantly more likely to believe that financial advisors or financial consultants provide advice about securities as a part of their regular business (78%) than they were to believe that brokers provide such services (63%), despite the fact that financial advisor and financial consultant are titles commonly used by brokers for their sales representatives.[4] Respondents were even less likely to know which types of financial professional were likely to recommend specific investments; only 51% thought brokers made such recommendations, compared with 83% for investment advisers and 72% for financial advisors/consultants. Nearly all understood that brokers earn commissions (96%), but only a third (34%) understood that financial advisors and financial consultants do. That's fewer than believed that investment advisers typically receive commissions (43%).

Survey respondents' confusion extended not just to the services these different types of securities professionals provide, but also to the standard of conduct that applies to those services. Survey respondents demonstrated little understanding generally regarding which type of advisers are required to act in customers' best interests and disclose conflicts of interest. (The survey did not ask about requirements to manage conflicts.) In fact, respondents were more likely to believe that financial advisors and financial consultants are required by law to act in customers' best interests (59%) than they were to believe that investment advisers were held to a best interest standard

[3] 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.
[4] Ibid. page 89.

(49%).[5] Without an understanding of these key characteristics, investors cannot make an informed choice among different types of financial professional.

In addition to documenting the extensive confusion among investors, the RAND Study also provided evidence that this confusion cannot easily be reduced through disclosure or education. Specifically, the RAND researchers presented focus group participants with fact sheets on investment advisers and broker-dealers that described common job titles, legal duties and compensation methods used by such professionals. They found that: "Even after being presented with fact sheets, participants were confused by the different titles. They noted that the common job titles for investment advisers and broker-dealers are so similar that people can easily get confused over the type of professional with which they are working. Some participants said they knew which type of investment professional they have, *but most did not*."[6] (Emphasis added.)

Moreover, the RAND Study simply confirmed what the SEC had previously learned when it attempted to develop a disclosure to help investors distinguish fee-based brokerage accounts from similar accounts offered by investment advisers. Even after being presented with a sample disclosure, "investors were confused as to the differences between accounts and the implications of those differences to their investment choices."[7] This confusion created a serious impediment to developing a simple, plain English disclosure, the researchers concluded, because every relevant term – from broker and investment adviser to fiduciary duty and suitability – would have to be defined and the implications of those differences would have to be explained. This was apparently a key reason that the Commission abandoned its efforts to develop a disclosure to distinguish between fee-based brokerage and advisory accounts and commissioned the RAND Study to lay the foundation for a more comprehensive approach.[8]

Although a decade has passed since these studies were conducted, we see no evidence that investor understanding of these core concepts has improved significantly in the intervening years. That has serious implications for the policy approaches the Commission can reasonably consider. If investors cannot determine which type of investment professional they work with, even after the distinguishing characteristics have been explained to them, and if they don't understand the different roles of brokers and advisers or the legal standards that apply to their

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[5] Ibid.
[6] Ibid. page 111.
[7] 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. As of December 28, 2007: http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf
[8] The courts later ruled that all fee-based accounts were to be regulated under the Investment Advisers Act on the grounds that fees constitute "special compensation" for advice.

recommendations, the Commission cannot reasonably assume that a policy solution based exclusively or even primarily on disclosure and investor education is likely to make significant inroads in investor confusion. It must instead adopt an approach that either eliminates the root causes of investor confusion or ensures that investors don't suffer harm as a result of their confusion. We believe the latter is more likely to be successful.

Conflicted Advice Means That Investor Confusion Leads To Serious Investor Harm

Investors who cannot distinguish broker-dealers from investment advisers are harmed in two different but related ways. First, when they enter the market for investment advice, they may be misled into hiring a broker-dealer, unaware that they will receive suitable sales recommendations rather than fiduciary investment advice. That in itself is sufficient harm to justify a regulatory response. But the more serious harm results from the fact that recommendations that comply with a suitability standard can impose unjustified costs on investors, expose them to unwarranted risks and result in significant underperformance, with potentially devastating consequences for their ability to meet long-term investment goals.

Because investments in the broker-sold market compete to be sold, not bought, and do so under a suitability standard that allows brokers to take their own financial interests as sellers into account when deciding what investments to recommend, market forces tend to work against investors' interests. This helps to explain research which has shown that costs of broker-sold investments – whether mutual funds, annuities, non-traded REITs – tend to be higher than comparable investments either sold directly to investors recommended by fiduciary advisers, even after the cost of compensating the broker has been taken into account. This appears to be a direct result of financial incentives that often pay the highest rewards for recommending products that are high-cost, complex, opaque, illiquid, and otherwise inferior to alternatives available in the market.

In conducting the Regulatory Impact Analysis that underpins its fiduciary rule, the Department of Labor meticulously analyzed the market for retirement investment advice and concluded that conflicts of interest pervade the market, that those conflicts influence recommendations, and that they do so in ways that are harmful to retirement investors.[9] To reach these conclusions, DOL analyzed a wide body of economic evidence, including "statistical analyses of conflicted investment channels, experimental studies, government reports documenting abuse, and economic theory on the dangers posed by conflicts of interest and by the asymmetries of information and expertise that characterize interactions between ordinary retirement investors

[9] Department of Labor, "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. ("RIA")

and conflicted advisers." Although rule opponents have attempted (without success) to poke holes in the RIA's estimate of harm, none has successfully challenged its basic premise that conflicts are pervasive and result in investor harm.

All of the conclusions that the Department reached regarding the harmful impact of conflicts of interest in the retirement advice market, and particularly the IRA market, are equally true for investment markets more generally. Indeed, several recent studies, examining various aspects of this issue, reinforce those conclusions and suggest that a universal fiduciary standard for all investment advice (one that incorporates restrictions on conflicts of interest) would provide broad benefits to investors.

A study by Vanguard Research, for example, demonstrates how advisers who provide "relationship-oriented services such as … cogent wealth management via financial planning, discipline, and guidance" offer better value to investors than those who do not provide this fiduciary level of advice, even after the costs of the advice are taken into account.[10] While industry groups have cited the study as suggesting that all advice – including non-fiduciary, transactional sales recommendations – provides the benefits cited in the Vanguard Research study, this interpretation is directly contradicted by the study itself.

While the Vanguard Research study focuses on the relative benefits of fiduciary investment advice, a law review article by Barry University School of Law Professor Benjamin P. Edwards examines the harmful impact of broker-dealer conflicts of interest, not just on investors, but also on the broader economy. To reach its findings, it examines case studies based on non-traded REITs and closed-end funds bought through IPOs as examples where financial incentives encourage product recommendations based on the financial interests of the seller rather than the best interests of the investor.[11] Crucially, Edwards outlines the ways in which these conflicts not only harm investors, but harm market efficiency and capital allocation in the broader economy, thus directly impacting the Commission's responsibility to safeguard efficient markets and facilitate capital allocation.

Perhaps most significantly, a mystery shopped study conducted by Professors Antoinette Schoar of MIT, Sendhil Mullainathan of Harvard University and Markus Noeth of Hamburg University provides direct evidence that fiduciary advice is generally superior to non-fiduciary sales

[10] Vanguard Research, *Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha,* http://bit.ly/2tyQNT7. (Vanguard study)
[11] Benjamin P. Edwards, "Conflicts & Capital Allocation," Ohio State Law Journal, Vol. 78 (2017), http://bit.ly/2utAGJc.

recommendations.[12] The non-fiduciary advice the shoppers received did not correct any of their misconceptions, according to Schoar. Instead, the non-fiduciary advisers seemed to exaggerate existing misconceptions of clients if it made it easier to sell more expensive and higher fee products. If these advisers did happen to mention fees, they usually downplayed their importance. All of which led Schoar to conclude that, non-fiduciary advisers were "willing to make their clients worse off in order to secure financial gain for themselves."

The SEC Has Contributed to the Problem by Permitting Broker-Dealers to Present Sales Pitches as Trustworthy Advice

It should come as no surprise that investors find it difficult to distinguish between broker-dealers and investment advisers. Despite being regulated as salespeople, broker-dealers have been permitted to hold themselves out as "financial advisors" and promote their services as primarily advisory in nature. Most major brokerage firms do just that, using titles and marketing messages designed to send the clear message that providing advice, not sales recommendations, is their primary business.[13] Under the circumstances, it is frankly unreasonable to expect investors to understand that these "financial advisors" aren't actually advisers at all and that, unlike investment advisers, they aren't held to a fiduciary standard to act in customers' best interests.

Instead of alleviating investors' confusion, the SEC's actions over the last several decades have made the problem worse. The SEC has permitted broker-dealer practices that portray their sales representatives as trusted advisers. It has failed to enforce the "solely incidental to" exception from the Investment Advisers Act, even after brokers had begun to offer advisory services far beyond those that could reasonably be viewed as solely incidental to their traditional sales function. Indeed, in interpreting "solely incidental to" as meaning "in connection with and reasonably related to," the SEC has essentially erased the functional distinction Congress sought to create between brokers and advisers. Under this approach, brokers have faced few if any meaningful restrictions on their ability to offer advisory services without being regulated as advisers and without being held to the fiduciary standard appropriate to that role. For the SEC to fix this problem, it will have to be willing to correct past actions that helped to create it.

The fundamental challenge in correcting the problem lies in the broker-dealer business model and the fundamental conflicts of interest embedded within it. While every business model has its conflicts, the conflicts of interest associated with fee accounts offered by many advisers are

[12] Antoinette Schoar, *We Put Financial Advisers to the Test–and They Failed*, *WALL STREET JOURNAL*, Oct. 27, 2016, http://on.wsj.com/2k9LMMT.

[13] 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.

relatively straightforward, particularly when compared to the scope and magnitude of conflicts in the broker-dealer business model. This is not because commissions inherently impose greater conflicts than fees. Rather it is because of the complex web of financial incentives that have been incorporated in broker-dealer compensation practices. In 2015 testimony before the House Financial Services Committee, University of Mississippi School of Law Professor Mercer Bullard described a "wide variety of compensation structures" 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.[14] The testimony provides a sampling of common broker-dealer practices that create conflicts and describes the "mind-boggling" magnitude of the conflicts that can result.

In other words, the problem is not simply that brokers only get paid when they recommend a purchase or sale. Those conflicts are greatly exacerbated when the broker gets paid two, or five, or ten times as much to recommend one product over another, or when the broker is under pressure to sell in-house products, receives compensation based on a ratcheted payout grid, or otherwise has strong incentives to base his or her recommendation on factors other than the clients' best interests. This is particularly troubling since investment products that are opaque, illiquid, risky, or loaded up with unnecessary features often pay the highest compensation to the seller in order to overcome resistance to their sale. Similarly, regardless of whether they are paid through commission or fees, advisers may come under heavy pressure to sell in-house products, even when better alternatives are available, if the interests of the firm are allowed to outweigh the customers' best interests.

Disclosure Alone Will Not Solve the Problem

The Commission cannot simply look to improved disclosure to protect investors from the harmful effects of conflicts of interest. The reason for this is simple -- there is no evidence that a disclosure-based approach would be effective in protecting investors from the harmful effects of a conflicted business model. Indeed, there is a mountain of evidence that it would be ineffective.

We have already discussed the evidence from the SEC's own studies demonstrating that disclosures did not work to dispel investor confusion regarding the conduct standards that currently apply to different types of financial professionals. We would also refer the Commission

[14] 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://1.usa.gov/1V0ySje.

to the extensive literature demonstrating that even detailed disclosures of the terms of financial contracts should not be expected to be effective in protecting investors from disadvantageous contracts or conflicts of interest, and consumers can easily be led to disregard disclosure information by motivated salespersons.[15] The predictions of this literature were given a real-world test in the context of mortgage contracts, where both recent experience with predatory mortgages and academic experiments have shown that disclosures were inadequate protection against harmful mortgage contracts.[16] An extensive meta-analysis of hundreds of studies on financial literacy has found that even strong interventions to improve financial literacy have minimal independent effects on consumer or investor behavior.[17]

Perhaps most relevant is the extensive research literature demonstrating that disclosure of conflicts of interest have minimal effects on consumer behavior. Such disclosures may in fact by counterproductive by leading the consumer to be more trusting of the advisor, and may cause the advisor to feel more willing to act on conflicts. This evidence, and other evidence on the relationship between disclosures and investor behavior, was well summarized in a RAND Corporation research report conducted for the DOL.[18] The report concluded "research indicates that disclosure alone, even simplified disclosure, may not be effective at improving financial decision making."

None of this is to say that disclosure cannot be a useful supplement to other policy mechanisms that address conflicts of interest. But the evidence is overwhelming that disclosure alone cannot be effective. This is not surprising given that investors seek out financial advice precisely because they desire and believe they need expert advice, and wish to hire a trustworthy expert in order to delegate important aspects of their financial decision-making.

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[15] Stark, Debra Pogrund and Choplin, Jessica M., A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities (February 9, 2009). NYU Journal of Law & Business, Spring 2009. Available at SSRN: https://ssrn.com/abstract=1340166

[16] Stark, Debra Pogrund and Choplin, Jessica M., A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending (October 4, 2009). Psychology, Public Policy & Law Journal, Volume 16, Issue 1. Available at SSRN: https://ssrn.com/abstract=1482674; Stark, Debra Pogrund and Choplin, Jessica M. and LeBoeuf, Mark A., Ineffective in Any Form: How Confirmation Bias and Distractions Undermine Improved Home-Loan Disclosures (June 23, 2014). Yale Law Journal, Vol. 122, No. 2012-2013, 2013.

[17] Fernandes, Daniel, John Lynch and Richard Netemeyer "Financial Literacy, Financial Education, and Downstream Financial Behaviors", *Management Science,* Volume 27, Issue 8, January 27, 2014 http://pubsonline.informs.org/doi/abs/10.1287/mnsc.2013.1849?journalCode=mnsc

[18] Hung, Angela, Min Gong and Jeremy Burke, *Effective Disclosures in Financial Decision Making: Final Report,* RAND Labor and Population, RR-1270 DOL, July 2015. https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/1210-AB32-2/effective-disclosures-in-financial-decision-making.pdf

More Extensive Regulatory Action Is Needed

Given the inadequacy of disclosure to address either investor confusion or investor harm, the SEC should act to raise the standard of conduct that applies to broker-dealers when providing advice and recommendations, to include a requirement to act in customers' best interests. However, the critical question here becomes whether this standard is backed by meaningful and enforceable requirements that address conflicted business models. To ensure that the best interest standard provides meaningful protections to investors, the standard would need to include restrictions on compensation and other practices that encourage recommendations based on factors other than the customers' best interests.

There are two broad paths that could be taken in implementing such a requirement:

- The first path would be to establish a best interest requirement that was binding on broker-dealers when they provided advice. This would render the issue of investor confusion far less significant, as investors would be protected when receiving advice regardless of the type of financial professional they were dealing with, as discussed further below.

- A second path would be to require broker-dealers to register under the Investment Advisers Act when holding themselves out as advisers. This would better align the designation of financial professionals with investor expectations.

Below, we provide discussions of the first approach. We focus on this approach both because many of the issues involved are also implicated in the second approach, and because we believe it is the superior approach. In our view, the challenges associated with adopting a strong, universal fiduciary standard for all advice are less daunting than those posed by the alternative of recreating the functional distinction between brokers and advisers that was erased decades ago.

However, we would note that if it were to adopt the second approach of making the Investment Advisors Act binding on all those who provide advice, the SEC would need to significantly strengthen rules under the Advisers Act to address the conflicts that arise when advice is combined with product sales. As noted above, Section 913 of the Dodd-Frank Act modifies the '34 Act specifically to grant the Commission the authority to restrict conflicts of interest, sales practices, or compensation schemes that are not compatible with investor protection, and does so for both investment advisors and brokers. The Department of Labor rule also offers an excellent model for the SEC to follow in addressing such conflicts. The key points made in the discussion below regarding a responsible framework for best interest advice in the broker-dealer framework would apply also to the case of moving broker-dealers into the Investment Advisors Act framework. It is particularly vital that disclosure-based solutions to unmanageable conflicts of interest are also rejected in the case of investment advisors, when such advisors are paid in a manner that necessarily distorts their incentives.

Taking the second route would also require that brokers who are not acting in their capacity as investment advisers regulated under the ’40 Act be firmly precluded from holding themselves out as advisers. Among other steps, their sales reps would need to be clearly labeled as precisely that, individuals making marketing or sales appeals rather than providing investment advice. Clear, up-front disclosures would need to be provided reinforcing the point that investment sales, not advice, is the service being offered.

Outlining a Best Interests Regulatory Framework for Broker-Dealer Advice

This approach is focused on minimizing investor harm by ensuring that all investment advice, including broker-dealer sales recommendations, is designed to serve the best interests of customers. Applying a fiduciary best interest standard is fairly easy when the conflicts of interest are minimal and straightforward (e.g., the incentive advisers who are paid AUM fees have to maximize their assets under management). It is far more challenging to develop an equally stringent standard for broker-dealers who operate with a more complex and extensive set of conflicts. As a result, the key questions the Commission faces in developing such an approach include: How do you develop a best interest standard that adequately addresses the myriad conflicts in the broker-dealer business model? How does a broker demonstrate that they’ve met their obligations under the best interest standard? How do you support informed decisions by investors seeking different types of investment services?

Limiting Conflicts: The challenge in developing an effective best interest standard for broker-dealers has little to do with the fact that they receive transaction-based payments and thus only get paid when they complete a transaction. That is simply the flip side of the fact that advisers who receive asset-based fees can continue to collect those fees, even when they are providing only limited services to the customers. The types of conflicts involved with these transaction based fees can be addressed through a combination of up-front disclosure and oversight procedures to ensure they don’t adversely affect customers.

But other types of conflicts cannot effectively be addressed through disclosure and oversight alone. These conflicts include those associated with the use of differential compensation, ratcheted payout grids, sales quotas, etc.to incentivize brokers to sell products that are not in the client’s best interests, or indeed generally to create strong incentives to sell certain products without regard to whether these products are in the client’s interest. If we are to permit broker-dealers' sales reps to claim that they are providing advice that is truly in their customers' best interests, we must require firms to end policies, procedures, and payment methods that clearly conflict with that goal.

The Department of Labor's fiduciary rule offers an excellent model. And the good news here is that experience since the rule was finalized clearly demonstrates that it is possible to eliminate the most harmful conflicts while retaining the benefits of transaction-based sales recommendations. Contrary to early industry predictions that firms wouldn't offer commission accounts under the rule, most brokers have chosen to keep commission-based retirement accounts as an option under the rule. And products are being brought to market that ease implementation of the rule for commission-based advisers. The Commission itself has played an important role in bringing this about through its approval of "clean shares," which have the potential to revolutionize how brokers are compensated. Not only do clean shares have the potential to reduce conflicts, by creating a mechanism for eliminating differential compensation, but they also have the potential to bring market forces to bear on broker compensation in a way that simply isn't possible when funds, rather than investors, determine what brokers are paid for the services they provide when recommending funds. The development of more investor-friendly annuities – with shorter surrender periods and lower fees – also shows how product sponsors forced to compete based on the best interests of investors can innovate to meet that standard and benefit investors in the process.

Findings by the investor research firm Morningstar, incorporated into their recent letter to you, have highlighted how clean shares and other fiduciary-friendly innovations benefit investors and represent the leading edge of a new wave of innovative competition based on the fiduciary mandate to put investor interests first.[19] The main thing holding back this new wave of innovation is uncertainty over the ultimate fate of the fiduciary rule. If the Commission were to adopt a similar approach to the Department of Labor rule, it could help to spur further innovation that benefits both investors and those product sponsors ready and eager to compete based on cost and quality.

Demonstrating Compliance: Determining what is in the best interest of a particular investor is a subjective judgement that requires the financial professional to weigh a variety of factors related to both the needs, financial condition and objectives of the customer and the features of the various investments available. As the Department of Labor has shown, however, it is possible to develop an objective measure of whether the adviser has complied with his or her obligations under the best interest standard.

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[19] Morningstar Inc, "Standards of Conduct for Investment Advisors and Broker-Dealers", September 7, 2017. http://bit.ly/2xcWISS

- Compliance starts with a prudent process. Has the broker conducted the due diligence necessary to understand enough about both the customer and the available investment products to determine the best match?
- Is the recommendation based on reasonable assumptions?
- Are the fees reasonable?
- Has the broker refrained from making any misleading statements?
- Does the broker have in place, and follow, appropriate policies and procedures to minimize conflicts of interest and eliminate incentives to provide advice based on factors other than the customers' best interests?
- Has the broker documented the basis on which he or she reasonably concluded that the recommended investment was the best available option for the customer?

Many elements of this process are not so different from the process brokers must follow under "know your customer" and "suitability" rules. However, the process would require the broker to go a step further, once they've identified a pool of suitable investment options, and identify the available option that best meets the customer's needs. As with the DOL rule, the best option is not necessarily the lowest cost option, though cost is among the factors brokers must consider when evaluating available investments. Also consistent with the DOL rule, determining the best available option does not require the broker to consider all investment products available in the marketplace. Instead, the broker would need to recommend the best of the available investment options.

Any significant limitations on the product menu – such as selling from a limited menu of options, selling only proprietary investments, or selling only those investments that make revenue sharing payments – would need to be clearly disclosed through a pre-engagement disclosure document (see below). In addition, the Commission should make clear that some product menus are so limited that they inherently preclude compliance with a best interest standard, and should reject claims of compliance with the best interest standard in cases where the product menu was clearly skewed to prioritize dealer compensation over providing a range of options that genuinely serve the investor.

The fact that an investment did not perform well would not be considered proof that the broker had failed to meet the best interest standard. Instead, whether a broker has made a best interest recommendation would be determined based on the prudent expert standard. Would an independent expert, one whose judgement is not clouded by conflicts of interest, have concluded that the recommendation was reasonable (i.e., that it was consistent with the best interests of the customer) under like circumstances and based on a prudent process?

This approach allows for effective oversight and enforcement of the best interest standard despite the subjective nature inherent in determining which option is best. Because of the subjective nature of the best interest determination, however, restrictions on actual conflicts of interest are essential to its success. Otherwise, if brokers remain free to engage in practices that encourage and reward advice that is not in customers' best interest, recommendations of high-cost, complex, illiquid and otherwise inferior investments that pay the broker more are likely to continue to be common, with suggestions that they don't meet the best interest standard dismissed as a mere difference of opinion. That is why proposals, such as those from SIFMA, to adopt a "best interest" standard without restrictions on conflicts are so dangerous; they perpetuate the status quo while creating the illusion of reform.

Under this approach, disclosure plays a role, but that role is appropriately limited to helping support informed decisions within a regulatory structure where the consequences for a "wrong" decision are less extreme. Specifically, we believe the Commission should develop an abbreviated, plain English pre-engagement disclosure document for broker-dealers and investment advisers that answers key questions investors need to understand when choosing who to work with. Such a document would respond clearly to the following kinds of questions:

> What services do you offer and are these services covered by a fiduciary responsibility? (E.g., transactional sales information versus on-going advice and account management)? How will I pay for those services (e.g., commissions on product sales versus hourly, engagement, or AUM fees)? How are you compensated (e.g., on salary or through a percentage of the commission income I generate)? Are there limitations on your services or conflicts of interest that might reasonably be expected to influence your recommendations (e.g., selling exclusively from a limited menu of products that includes or consists entirely of in-house products)? Do you have a disciplinary record and, if so, where can I find information on that?

While the disclosure would cover some of the same ground as the ADV Form that investment advisers currently are required to provide to customers, the goal should be a two-page document, not the dense legal disclosures some ADV Forms have become.

This approach has the added benefit that it closely aligns with the reasonable expectations of investors when they turn to financial professionals for help with their investments. Research has consistently found that investors believe all investment advice should be subject to a best interest standard.[20] A recent survey commissioned by AARP found, for example, that nearly 9 in 10 retirement accountholders (88%) think it is important for professional financial advisers to give advice that is in the best interests of their clients.[21] A 2010 investor survey conducted by Infogroup/ORC found that the vast majority of investors (91%) believe that "a stockbroker and an investment adviser (who) provide the same kind of investment advisory services … should have to follow the same investor protection rules."[22] And nearly all (97%) believe that standard should require them to put the customers' interests ahead of their own and provide up-front disclosures of conflicts of interest. (Here again, the survey did not ask about restricting, as opposed to merely disclosing, conflicts.)

This expectation is entirely reasonable when you consider how broker-dealers market their services. As last year's CFA-AFR study demonstrated, major broker-dealer firms (and insurance companies) routinely refer to their financial professionals not as sales representatives or agents but as "financial advisors" and indicate that they have a level of expertise that can and should be relied upon by their less sophisticated clients. They typically describe their services as providing "advice" and retirement "planning," not simply product sales. And they market those services with messages whose clear intent is to convince retirement savers that they should trust that their advisor will be looking out for their best interests.[23] In other words, when investors expect broker-dealers to act in their best interests, they are simply responding to the messages brokers themselves are sending.

The approach outlined above would impose a standard on broker-dealer recommendations that matches the claims they make when marketing their services to customers. If the SEC is to promulgate a fiduciary standard for brokers, it must ensure that this standard is a genuine one. Any other approach risks perpetuating and increasing serious harm to investors.

Thank you for your attention to this letter. For more information please contact AFR's Policy Director, Marcus Stanley, at [redacted] or [redacted].

Sincerely,

Americans for Financial Reform

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[20] We use the term "best interest" standard as shorthand for a fiduciary standard because investors generally don't understand the term "fiduciary duty" or understand how it differs from a suitability standard. As we discuss below, however, must support that standard with restrictions no conflicts of interest.
[21] S. Kathi Brown, Fiduciary Duty and Investment Advice: Attitudes of 401(k) and 403(b) Participants, AARP (Sept. 2013), http://bit.ly/2phP3vs
[22] Infogroup/ORC, U.S. Investors & The Fiduciary Standard: A National Opinion Survey (September 15, 2010) http://bit.ly/1Npodra
[23] Hauptman and Roper, page 3.