Discussion of the Commission's Proposed Regulation Best Interest and Proposed Restriction on the Use of Certain Names or Titles
Meeting of the Securities and Exchange Commission
Investor Advisory Committee
June 14, 2018

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Thank you for the invitation to speak to the Investor Advisory Committee (IAC) today. My name is Micah Hauptman and I am Financial Services Counsel at the Consumer Federation of America (CFA). CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

I want to focus my remarks on three points:

I. As currently drafted, the Commission proposal presents a host of problems. It fails to create a uniform fiduciary standard for investment advice offered by brokers and investment advisers. Instead, it relies on disclosures to enable investors to distinguish between the two standards, which past experience tells us they will not be able to do. In addition, the "best interest" standard is vague and undefined and, depending on how it is interpreted, could do little more than rebrand the existing FINRA suitability standard as a best interest standard. The standard also applies incomplete, episodic protections to ongoing relationships between brokers and their customers.
II. However, the proposal is not beyond repair. The Commission can still adopt a strong and clear standard for brokers' investment advice that is the same as and no less stringent than the Advisers' Act fiduciary standard. Such a standard could provide critical protections to investors who turn to brokers for investment advice and who reasonably expect that the advice they receive will be in their best interest. The IAC recommendation on Broker Dealer Fiduciary Duty set out two alternative approaches that would achieve this goal.[1] The Commission should use the IAC recommendation as a guide in revising its proposed standard.
III. Without significant changes, the proposed standard may not offer more than a veneer of providing the very protections investors reasonably expect and deserve. If the rule results in investors' expecting protections that the rule doesn't actually provide, that would perpetuate the very harm the Commission is seeking to curb.

Background

- In crafting the laws that govern broker-dealers and investment advisers, Congress drew a distinction between broker-dealers, who were regulated as salespeople under the Exchange Act, and investment advisers, who were regulated as advisers under the Investment Advisers Act. Brokers were excluded from regulation under the Advisers Act only to the extent that

[1] SEC IAC, Recommendation of the Investor Advisory Committee Broker-Dealer Fiduciary Duty, https://bit.ly/2jWB4rz.

they limited themselves to a strictly sales function and didn't receive special compensation for advice.

- Over time, brokers' role has blurred such that they effectively function as investment advisers, but are not held to the legal standard appropriate to their advisory role. For example, brokerage firms and their registered representatives routinely use titles such as "financial advisor," "financial consultant," or "wealth manager," giving the impression of specialized advisory expertise. They commonly describe their services as "investment advice," "advisory," and "investment planning." In holding themselves out as impartial experts, they seek to occupy positions of trust and confidence with their clients.[2]
- It's hardly surprising, given industry marketing practices, that investors don't distinguish between the advice they get from an investment adviser and a sales recommendation they receive from a broker. Regardless of who they are working with, investors reasonably expect to receive advice that's truly in their best interest.
- Unfortunately, all too often, investors don't receive advice that's in their best interest. And the harms that they suffer as a result can be immense. The harm can take a variety of forms, such as being steered into a higher-cost, lower-performing, riskier, or less liquid investment when better alternatives are available. Fundamentally, this is a matter of incentives. Typically, when an inferior product is recommended, that product also compensates the broker more. When brokers are paid to make certain recommendations, they are more likely to make them, and when brokers are discouraged from making certain recommendations, they are less likely to make them.
- This is a fixable problem, if the SEC has the will to fix it. Many of the most harmful incentives that exist in the current brokerage market are not inherent to the broker-dealer business model. Rather, firms artificially create many perverse incentives to encourage and reward advice that is most profitable to the firms, and which work against investors' best interest. These include sales contests and quotas, often for the sale of proprietary funds, trips, bonuses for meeting certain sales thresholds, and ratcheted payout grids, among others.
- The goal of the SEC regulatory proposal should be to ensure that investment advice – whether offered by a broker-dealer or investment adviser – is subject to the same high fiduciary standard and that conflicts of interest are reined in such that they aren't allowed to taint the broker's recommendations.

I. IAC Recommendation

The IAC endorsed two alternative approaches to ensure that personalized investment advice is governed by a fiduciary standard.

A. The IAC favored an approach that involved rulemaking under the Investment Advisers Act to narrow the broker-dealer exclusion to restore the functional distinction between sales and advice that Congress created in the Exchange and Advisers Acts. Under this approach, any broker-dealer who holds out as providing investment advice or who engages in advisory services, would be regulated under the Advisers Act and subject to the Advisers Act fiduciary duty.

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[2] *See* Micah Hauptman and Barbara Roper, "Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways," Consumer Federation of America, January 18, 2017, https://bit.ly/2qKIhmO.

If a broker-dealer wanted to continue to be in the business of sales only, it would be free to do so as long as it limited itself to providing transaction-specific sales recommendations, clearly labeled those services as sales, and did not hold out as providing advice.

This approach would ensure that investors no longer receive a sales pitch that is disguised as advice. Any advice investors receive would be fiduciary advice.

B. Alternatively, the IAC supported adopting a uniform fiduciary standard for broker-dealers and investment advisers under section 913(g) of Dodd-Frank. This would also ensure that, regardless of who is providing the advice, that advice is fiduciary. Although the details of how the duty is applied would vary based on differences in the two business models, this approach would ensure that the investor protections are the same as and no weaker than the existing Advisers Act fiduciary standard.

For years, we've been told that the great benefit of SEC rulemaking would be that it would deliver a consistent standard across all securities accounts, regardless of whether the advice is provided in a retirement or taxable account, or by a broker or an adviser. We've also been told that having a uniform and consistent standard across all securities accounts would cure investor confusion about the different roles that different financial professionals play and the different standards of conduct to which they are held. In fact, these were among the leading arguments from industry groups about why the Commission should lead in this area rather than the Department of Labor (DOL).

- **Implications of the DOL Fiduciary Litigation**

While we certainly agree that the Commission has an important role to play here, and CFA has been actively urging the Commission to act for close to two decades, we also think retirement savers who invest in non-securities and retirement plan sponsors who rely on advice from financial professionals also are in need of protection. That is why we supported a strong DOL fiduciary rule and have opposed industry's efforts to water down or repeal that rule.

Unfortunately for retirement savers, the 5th Circuit Court of Appeals issued a decision vacating the DOL rule, making it even more important that the Commission act to adopt a strong standard. Following the decision by the 5th Circuit, the Commission is faced with a clear choice about which direction it should take with this rulemaking.

A. The Commission could subscribe to SIFMA and FSI's *legal* position — which the 5th Circuit panel endorsed — that brokers are mere salespeople, with no relationship of trust and confidence with their customers, no different from car dealers. Under this framework, it would naturally follow that the Commission should narrow the broker-dealer exclusion so that brokers could not hold out or function as advisers. Broker-dealers would be treated and would be required to act like the salespeople they claim legally to be. That is consistent with the IAC's preferred approach.

B. Alternatively, the Commission could subscribe to SIFMA and FSI's *public relations* position — and that of virtually every broker-dealer — that they are not merely salespeople, but a different kind of adviser, a "pay as you go" adviser who simply charge for their advice in the form of commissions. Under this framework, it would naturally follow that the Commission should follow the will of Congress by treating functionally equivalent activity the same and apply a uniform fiduciary standard to broker-dealers and investment advisers that is no less stringent than the Advisers Act fiduciary standard. That is consistent with the IAC's alternative approach.

It's completely unsupportable, however, to allow broker-dealers to continue to act and function as advisers when it helps them attract business, but to regulate them as salespeople. Unfortunately, the Commission has proposed an approach that has a strong likelihood of preserving this dichotomy.

- **The Commission Has Proposed a Regulatory Approach That Fails to Follow Either Recommended Alternative.**

The Commission's regulatory proposal would allow broker-dealers to continue to provide advice without regulating it as advice. While it wouldn't allow standalone brokers to use the specific title "advisor," it would allow them to describe their sales recommendations as advice and themselves as in positions of trust and confidence with their clients, without subjecting them to a fiduciary duty that's appropriate to their role.

The Commission doesn't offer any coherent explanation for why it has abandoned the promise of uniformity. Troublingly, the Commission reinforces the pretense that brokers offer a different type of advice relationship, describing the brokerage model as a "pay as you go" advice model, in which brokers get paid for their advice through commissions rather than through an assets under management model. This characterization is inconsistent with the sales relationship that Congress contemplated in the Exchange Act.

And despite having reached the conclusion that brokers and advisers are just different advice providers who get paid in different ways, the Commission still chose to maintain separate standards. The Commission even seems to go out of its way to avoid referring to the Best Interest standard as a fiduciary duty, which is at odds with what Congress contemplated in Section 913(g) of Dodd-Frank.

II. What the Commission Has Proposed Presents a Host of Problems.

Proposed Regulation Best Interest putatively raises the standard on brokers from suitability to "best interest," which sounds appealing. But I'm concerned that there's less there than meets than eye.

A. The "Best Interest" Standard Perpetuates Inconsistency and Lacks Clarity

The proposal requires brokers to act in their customers' best interests, but it doesn't clearly define what that means. The rule text, which requires brokers to act in the best interests of their customers and prohibits them from placing their interests ahead of the customer's interests, doesn't offer any clarification. The problem here is that this same language that the Commission uses in its best interest standard has been used to describe broker's existing obligations under FINRA's suitability rules, investment advisers' fiduciary duties under the Advisers Act, and the requirements under the DOL fiduciary rule. All of these standards are different in significant ways and it's not clear how the proposed standard is similar to and different from each of these standards.

It's not enough to propose an undefined "best interest" standard because everyone claims to support a best interest standard. So the devil is in the details. Unfortunately, there are few details about this in the proposal.

Compounding the lack of clarity, the discussion is internally contradictory in spots. For example, first the release states that the standard requires broker-dealers to "put aside their financial incentives," which sounds a lot like the standard in 913(g) that the advice must be provided "without regard to" the broker-dealer's financial or other interest. Yet later it states that the broker's financial interest can't be the "predominant motivating factor" behind the recommendation. These are two very different standards. We would support the first formulation and strongly oppose the second, as it could continue to allow a broker's financial interest to influence recommendations to an undefined extent. And, "predominant motivating factor" seems to inject an element of *scienter*, despite the fact that the release suggests *scienter* is not required.

Moreover, in its discussion of the term "best interest," the release suggests that brokers would be required to analyze the reasonably available investment alternatives, which is a step in the right direction. But it doesn't clearly state that the broker would have to recommend, from among the available options, the one that the broker reasonably believes to be the best match for the investor, taking into account both the needs of the investor and the characteristics of the investment.

It's important to note that best match does *not* mean that the broker has to scour the world to find the single best investment, nor does it require 20/20 hindsight. What it does require is a prudent analysis of all the relevant considerations and recommending only the products that deliver the best value, and best meet the investor's needs, *irrespective of any compensation that the broker might receive.*

Given the vagueness in this discussion, however, the Commission is leaving open the possibility that brokers could analyze the available alternatives and then come up with a variety of reasons why they recommend a particular investment that just so happens to pay them more than available alternatives. And there is particularly concerning language in the release that could provide justification for brokers to recommend investments that are not the best match for the investor. For example, the release touts the benefits of encouraging a "diversity" of assets in investors' portfolios. Diversification is not an end in itself. After all, products with questionable value — such as many variable annuities, nontraded REITs, BDCs, and structured products — provide diversification. The question should be whether the diversification adds value to the investor's portfolio, does so at a reasonable cost, and does so better than other reasonably available alternatives. When one considers the excessive costs, significant underperformance, and years of illiquidity that come with many of these products, the answer will often be no, but that fact could be lost in an approach that seems to push diversity for diversity's sake.

B. There are Gaps in How the Standard Applies

Of course, Regulation Best Interest doesn't apply to recommendations of non-securities or exempt securities, as the Commission's authority extends only to securities markets.

Regulation Best Interest also doesn't apply to:

- Recommendations about the type of account (brokerage vs. advisory). This is a strange omission, since the release specifically states that firms create incentives for financial professionals to recommend a certain type of account, and in many cases financial professionals do recommend, the account that pays the professional and the firm the most money. The proposal relies entirely on Form CRS to apprise the investor of what account would be most appropriate for them without any reasonable basis to believe those disclosures will be up to the task.
- Recommendations to small retirement plans, where some of the worst abuses occur. Say, for example, a small business owner who is financially unsophisticated tried to do right by her employees by setting up a 401(k). If that small business owner sought advice about how to structure that 401(k), including what investments to include, the advice about that plan lineup would not be covered because a 401(k) plan sponsor is not a retail customer under the rule. As a result of receiving highly conflicted advice, the small business owner could fill the 401(k) plan lineup with shoddy funds that cost orders of magnitude more than other available alternatives and suffer significant underperformance relative to available alternatives. The employees who invest in the 401(k) would end up paying the costs of those conflicts, which would erode their returns. So much for Mr. and Mrs. 401(k). And illogically, the broker-dealer who gave the conflicted advice that the small business owner relied on would be off the hook for that conflicted advice, while the small business owner potentially would be left holding the bag as a fiduciary.
- Recommendations to roll over from non-securities, such as taking a distribution from a pension fund. Workers who have pensions are often the target of recommendations to roll over their pensions to IRAs They're often told they would be better off if they take the lump sum and invest it, despite the fact that this is seldom the case. Because a recommendation to roll over a pension is a non-securities transaction, this would not be covered under the proposal.

These are huge gaps that leave large swaths of vulnerable and financially unsophisticated investors unprotected from this standard.

C. It is Unclear What the Conflict Mitigation Obligation Requires or the Activities it Restricts

Potentially the most powerful aspect of the proposal is the requirement for firms to mitigate conflicts of interest that arise from financial incentives. Potentially is the operative word because, here too, it's not clear what conflict mitigation practices are required and what compensation and other practices are restricted. It's not even clear what the distinction is between a material conflict and a material conflict arising from financial incentives. The proposal doesn't specify.

While we agree that the Commission should not try to impose a one-size-fits-all approach, there is far more it can and should do to clarify its intent with regard to conflict mitigation. For example, the proposal suggests that in formulating policies and procedures to mitigate financial incentives, firms should consider a non-exhaustive list of potential practices. Do firms have to do anything more than consider them? It's not even clear that firms would have to do anything more than consider the best practices that are discussed in FINRA's 2013 Conflict of Interest Report. Nor is it clear what standard the Commission and FINRA will use to judge whether firms' policies and procedures are effective. The Commission needs to make clear that the purpose of conflict mitigation is to ensure that conflicts are not allowed to taint the broker's recommendations.

In this regard, it is promising that the proposal states that there are certain conflicts of interest arising from financial incentives that may be more difficult to mitigate and therefore may be more appropriately avoided in their entirety, such as sales contests, trips, and prizes. But even this statement leaves open the possibility that there would be circumstances where such incentives would be allowed. Further, it leaves open the possibility that other practices, such sales quotas, including quotas for the sale of proprietary products, would be permitted. These are exactly the types of conflicts of interest that firms artificially create to encourage and reward advice that is most profitable to the firms, and which work against investors' best interest. Firms that are required to mitigate financial incentives should not be permitted to artificially create such incentives, which directly undermine compliance with the best interest standard.

The Commission provides no coherent justification for not restricting the use of these practices. Instead, the proposal paints a picture of financial incentives as if they can benefit investors by encouraging "greater effort" by the broker representative to provide quality advice. However, the proposal fails to distinguish between providing an incentive to expend "greater effort" to provide high quality advice and "greater effort" to close a sale. That is a critical difference and one that Commission can't just gloss over.

D. The Proposal Inappropriately Allows Brokers to Escape Any Ongoing Duty to Their Customers

One of the most troubling aspects of the standard is that a broker would have no ongoing duty to the client, even in a long-term relationship in which he provides advice on an ongoing basis. The release acknowledges the fact that brokers can provide advice on an "episodic, periodic, or ongoing basis." Yet even when the broker provides ongoing advice, even when the broker receives ongoing compensation from that advice, for example through trailing 12b-1 fees, inexplicably there is still no duty to monitor the account or review the portfolio holistically when providing recommendations to make sure that the portfolio is constructed and performing optimally.

The effect of this aspect of the proposal is to endorse a system where the broker gets all the benefits of providing ongoing advice without any of the responsibility to their customers. It is also likely to result in mismatched expectations, whereby the investor reasonably believes that they are receiving benefits that they are not actually receiving. Here again, the proposal relies on disclosure to inform investors of this fundamental inconsistency, rather than requiring the broker's duty to the customer to follow the contours of the relationship, as an investment adviser's fiduciary duty would do. Form CRS is unlikely to cure this deficiency.

Even more concerning, Form CRS's disclosure could provide an unwarranted affirmative defense to brokers in FINRA arbitration. The most common claim in FINRA arbitration is breach of fiduciary duty, typically based on an investor's reasonable belief that they were in a long-term relationship with their broker and their broker was providing ongoing account management. The proposal and the Form CRS disclosure could provide the broker evidence they can point to in order to support their affirmative defense that there was in fact no ongoing relationship or duty. If this were to happen, it would weaken investors' ability to hold their brokers accountable – a perverse outcome for a proposal that is supposed to strengthen investor protections.

III. The Way Forward on Regulation Best Interest

While there are many problems and even more open questions with Regulation Best Interest, it is not beyond repair. Using this proposal as its starting point, the Commission can still adopt a strong and clear standard that is the same as and no less stringent than the Advisers Act fiduciary duty. Such a standard could provide critical protections to investors who turn to brokers for investment advice and who reasonably expect that that advice will truly be in their best interest and be untainted by conflicts of interest.

In order to adopt a true fiduciary best interest standard for brokers and advisers alike:

- The Commission should clarify that the best interest standard is the same as and "no less stringent" than the Advisers Act fiduciary standard. Chairman Clayton recently stated that he does not think that there is "any daylight" between the standards of conduct for investment advisers and broker-dealers and that "the core duty is the same." [3] These statements should be included in the release.
- The Commission should clarify that the best interest standard requires brokers and advisers alike to engage in a prudent process and, based on that analysis, to recommend the investment they reasonably believe is the best match providing the best value for the investor.
- The Commission should include the 913(g) standard of conduct language that the advice must be made "without regard to" the broker-dealer's financial or other interest and clarify that this means that firms can't allow conflicts to influence (taint) the recommendation. In addition, the Commission should remove any references suggesting that the broker's financial incentives can influence recommendations as long as they aren't the "predominant motivating factor" behind the recommendation.

In order to narrow significant gaps in coverage:

- The Commission should expand the applicability of the best interest standard to recommendations by dual registrants about the type of account, recommendations to small plans, and recommendations to rollover whenever there is a securities transaction involved (either coming or going).

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[3] David Armstrong, *SEC's Clayton: "No Daylight" Between Advisor, Broker/Dealer Duties in Proposed Rules*, WEALTH MANAGEMENT, May 23, 2018, https://bit.ly/2GOrpP2.

To ensure that conflicts of interest are not allowed to inappropriate influence recommendations, to the detriment of investors:

- The Commission should clarify that the appropriate standard for gauging whether a conflict must be mitigated is whether that conflict would be reasonably likely to influence (taint) the advice. The Commission should further clarify that certain conflicts present such a high likelihood that they would taint the advice, they must therefore be prohibited. These include sales contests, quotas and bonuses for meeting specific sales thresholds, trips, retroactive ratcheted payout grids, and other artificially created incentives that encourage and reward representatives for making recommendations that work against clients' best interest.
- In addition, to the extent firms don't levelize compensation between different product types with different compensation structures, firms should be required to undertake enhanced scrutiny on the sale of those products that pay the broker more in order to ensure that the additional potential compensation doesn't influence recommendations at representative level. The DOL rule included these same restrictions and requirements. Given firms' many statements that they were taking seriously those compliance obligations, firms should have no trouble complying with those requirements here.

To ensure that investors receive a level of protection and services that bear a reasonable nexus to the nature and scope of their relationship with their broker-dealer:

- The Commission should fundamentally change its approach regarding brokers' ongoing duty. Rather than allowing brokers to escape any ongoing duty to their customers, regardless of circumstances, the nature of the relationship between the broker and customer should guide whether there is an ongoing duty to monitor or periodically review the portfolio to make sure that it is constructed and performing optimally. Moreover, a broker's receipt of ongoing compensation should come with ongoing services and responsibilities. A broker should not be allowed to receive 12b-1 fees forever without doing anything in return. Otherwise, it's not clear what is being paid for and what value is being delivered.

Without these significant changes, the proposal may not offer more than a veneer of providing the very protections investors reasonably expect and deserve. If the rule results in investors' expecting protections that the rule doesn't actually provide, that would have the potential to perpetuate the very harm the Commission is seeking to curb.

IV. Form Client Relationship Summary (CRS)

The effectiveness of Regulation Best Interest depends on the effectiveness of Form CRS. After all, as the Commission itself has indicated, these proposals are designed to work in conjunction. The Commission assumes, with no evidence to support its assumption, that the proposed summary disclosure document will be adequate to apprise investors to important differences between brokerage accounts and advisory accounts. It is on this basis that the Commission justifies maintaining different standards for advice offered by broker-dealers and investment advisers.

But there are significant reasons to question that assumption.

- It's not clear investors will even read a document that, given the required timing, they probably won't receive until *after* they've already decided whom to work with and what type of account to open. Further, it's not clear whether investors will view the document as anything more than a form disclosure that isn't worth reading.
- If investors do read it, it's not clear they will understand critical differences between a brokerage account and an advisory account. Previous disclosure testing, conducted on behalf of the Commission, suggests they won't, particularly if brokers remain free to call themselves financial consultants or wealth managers and describe their services as advisory services, which the proposal would permit.
- Will investors understand how an investment adviser's fiduciary duty differs from a broker's best interest standard or why they should care? If securities lawyers can't figure out these differences, based on a thorough review of the rule proposal, what hope do average retail investors have based on a sentence or two in a disclosure document? After all, we and others have been using those terms interchangeably for years to draw a distinction between an adviser's fiduciary duty and a broker's suitability obligation. What harm to investors will result when the broker-dealer industry, with the Commission's endorsement, co-opts this messaging without living up to that fiduciary standard?
- Are the disclosures misleading and inaccurate? They imply that investors can get investment advice more cost effectively from brokers than from investment advisers. While that may be true in certain limited instances, it is false in many other instances. Making such a blanket assertion simply can't be supported.
- Will the disclosures of conflicts in a 4-page document be specific and clear enough to convey the magnitude and potential harmful impact of those conflicts? Given the complexity of many conflicts, it seems highly unlikely.

These are just a few of the many questions the Commission must answer when it tests its proposed disclosures. If the testing shows that the proposed disclosures will *not* enable investors, particularly financially unsophisticated investors, to make an informed choice among the different types of providers, accounts, and services available to them, then clearly the disclosures will need to be rethought. But in addition, the entire regulatory approach may need to be rethought as well.

For these reasons, it is critical that the Commission complete the testing and publish the test results before closing the comment period, so people can comment on whether the Commission's assumptions are valid. We and other organizations have called on the Commission to do so, and we hope the Commission honors this request.[4]

Thank you for inviting me to share my views on this critical investor protection issue.

[4] Letter from AARP, *et al*., to Chairman Jay Clayton, SEC, Calling on SEC to Delay Comment Deadline for "Best Interest" Regulatory Proposal, May 21, 2018, https://bit.ly/2Jkc7ay.