

**Consumer Federation of America  
Fund Democracy, Inc.  
Certified Financial Planner Board of Standards  
Financial Planning Association  
National Association of Personal Financial Advisors**

November 21, 2014

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

Dear Chair White:

We recently read that the Division of Economic and Risk Analysis (DERA) has identified early next year as the likely completion date for its economic analysis regarding the regulatory standards that should apply when broker-dealers and investment advisers provide personalized investment advice to retail customers. We are encouraged that the Commission appears to be making progress on this important investor protection priority. For far too long Commission policy has allowed broker-dealers to market themselves to the public as trusted advisers without imposing the fiduciary standard appropriate to such a relationship of trust. A thorough, well-reasoned analysis by DERA has the potential to lay the groundwork for a strong, pro-investor policy. On the other hand, a faulty analysis could doom, or at the very least further delay, prospects for reform.

We are writing, therefore, to share with the Commission our views on the key elements an economic analysis must include if it is to provide an appropriate foundation for sound regulatory policy:

- It must accurately depict the differences between the suitability standard that applies to sales recommendations and the fiduciary duty that applies to investment advice.
- It must correctly identify the investor harm that regulation is intended to rectify.
- It must clearly describe the regulatory conditions that permit that harm to occur.
- Although the Commission cannot reasonably be expected to quantify the total costs to investors of that harm, it must comprehensively describe the form that harm takes and the means by which the harm occurs.
- It must clearly identify the regulatory alternatives available to address that investor harm.
- And finally, in analyzing regulatory alternatives, it must assess the likely effectiveness of the various possible approaches to reducing investor harm.

While the need to address these issues may seem self-evident, each of the above points represents an area where the Commission has gone astray in the past. As a result, the Commission has been either unwilling or unable over the past 25 years to develop a rational policy framework for the delivery of personalized investment advice to retail investors. We urge the Commission to rectify this problem now.

### **Accurately Describing the Existing Regulatory Standards**

When the Commission issued the Request for Information (RFI) to support this economic analysis, we were deeply troubled to discover that it described the fiduciary standard without once referring to the best interest obligation that is the cornerstone of the fiduciary standard. We have previously detailed our serious concerns with the approach outlined in the RFI and will not repeat the full range of those concerns here.<sup>1</sup> It is worth reiterating, however, that if the economic analysis does not clearly distinguish between a broker's obligation to make generally suitable recommendations and an investment adviser's fiduciary obligation to act in the customer's best interests, it will fail to take into account the primary means by which investors are harmed under the current regulatory approach. This failure could, in turn, be used to justify a watered down standard that would not meaningfully improve protections for investors who invest through broker-dealers and, if applied uniformly to brokers and advisers, could even weaken existing protections for those investors who are served by investment advisers.

### **Defining the Problem Regulation is Intended to Address**

In addition to correctly describing the existing standards, it is imperative that the economic analysis correctly define the problem that regulation is intended to correct. Investors who hire a financial professional to help them with their investment decisions face several significant and closely related challenges that demand a regulatory fix:

- Investors who expect to rely on advice from an objective, professional adviser may be misled into believing the sales recommendations offered by broker-dealers constitute such advice.
- When this occurs, investors' reasonable expectation that the recommendations they receive will be designed to serve their best interests will often not be met, although the investor will likely never realize that they have received suboptimum recommendations or that better options were available to them.
- The result is that investors who receive "suitable" sales recommendations from broker-dealers may nonetheless pay excessive costs, be exposed to unnecessary risks, or receive substandard performance. The result may be an inadequately funded retirement or other unmet financial goal.

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<sup>1</sup> Concerns regarding the RFI are detailed in a July 5, 2013 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Elizabeth M. Murphy, available [here](#), and in a July 5, 2013 letter from the Financial Planning Coalition to SEC Secretary Elizabeth M. Murphy, available [here](#).

It is certainly also true that investors are confused about the differences between broker-dealers and investment advisers. Contrary to what some have suggested, however, this is not the key problem that much-needed regulation is intended to solve. Rather, this confusion is relevant because it limits investors' ability to make an informed choice between brokers and advisers based on a clear understanding of the differences in the two business models and the legal standards that apply. As such, investor confusion and the ineffectiveness of disclosure in eliminating that confusion are among the key factors the Commission must take into account in weighing the likely effectiveness of various regulatory approaches. Regulatory approaches that depend on an investors' ability to make an informed choice must overcome the weight of evidence suggesting they are unlikely to be effective. Absent compelling evidence that disclosure is likely to be effective in overcoming investor confusion, the goal of regulation must be to ensure that investors' inability to make an informed choice does not result in investor harm.

### **Identifying the Regulatory Actions that Produced Current Market Conditions**

In order to arrive at an appropriately targeted regulatory response, it is also essential that the Commission understand the regulatory conditions that created the problem new regulation is intended to address. This poses a particular challenge in that it is the Commission's past actions, and inaction, that have been primarily responsible for blurring the lines between broker-dealers and investment advisers. That is something the Commission has been reluctant to acknowledge in the past, choosing to blame the statutes and the natural evolution of the market, rather than the agency's interpretation of the statutes, for the blurring of the lines between broker-dealers and investment advisers. By not acknowledging the real cause of the problem, the Commission also overlooks the most appropriate regulatory solutions.

In fact, however, the federal securities laws created a clear functional distinction between broker-dealers and investment advisers. They provided a narrow broker-dealer exclusion from the Advisers Act solely for the transaction-specific recommendations inherent to the broker-dealer business model of that time. In the late 1980s and early 1990s, however, broker-dealers began to see financial benefits in offering advisory services and marketing themselves as advisers. While market forces provided the impetus for change, it was the Commission itself that erased the line between broker-dealers and investment advisers when it allowed brokers to call their sales representatives by titles such as financial consultant and financial advisor, to offer services such as financial planning and investment planning that were clearly advisory in nature, and to market themselves as if advice were the primary service they had to offer. They did all of this while still being permitted to rely on the "solely incidental to" exclusion in from the Advisers Act. The implications were clear: either broker-dealers had transformed themselves into advisers, in which case they should be regulated accordingly, or they were actively misrepresenting themselves to the investing public. In either case, the Commission had an obligation to act. Instead, it adopted policies specifically designed to further erode clear regulatory boundaries.

The most troubling and harmful of these policies is the Commission's definition of "solely incidental to," which forms the basis for brokers' exclusion from the Advisers Act. For years the Commission had failed to define the term, relying instead on method of compensation to distinguish between brokers and advisers. When it finally got around to defining the term, it defined it out of existence. Specifically, by defining "solely incidental to" to mean "in connection with and reasonably related to" the Commission effectively removed all reasonable limits on the advisory services brokers could offer without triggering regulation under the Advisers Act. The Commission justified this definition based on a highly selective and misleading picture of the legislative history behind the broker-

dealer exclusion.<sup>2</sup> This definition represents an even more egregious distortion of regulatory policy than that contained in the infamous “Merrill Rule,” which has since been over-turned in court.

This is significant because it makes clear that the current marketplace that investors find so confusing did not, contrary to the Commission’s assertions, grow up naturally within the constraints of the existing laws. It developed when the Commission chose to sweep away the constraints imposed by the laws in order to achieve its own regulatory goals. The Commission made these changes without the benefit of careful economic analysis designed to weigh their impact on investor protection, market integrity, or competition. Instead, the Commission put its thumb on the scale in favor of preserving the full-service broker-dealer business model, a mistake it can only correct now through regulation designed to ensure that all those who offer personalized investment advice to retail investors are subject to uniform and appropriate regulatory standards.

### **Describing the Resulting Harm to Investors**

Just as it has sought to deflect responsibility for blurring the lines between brokers and advisers, the Commission has in the past sought to gloss over the harm to investors that results from its *de facto* regulatory policy of allowing brokers to hold themselves out as advisers without regulating them accordingly. If it is to serve as an appropriate basis for regulatory policy, the economic analysis the Commission produces must not shy away from this topic. On the contrary, that analysis must include a description of the various forms that this investor harm takes. Only in this way can the analysis appropriately focus the Commission on regulatory approaches that are reasonably likely to significantly reduce that harm.

The harmful impact of Commission policy on investors starts with the well-documented fact that most investors are unable to make an informed choice among financial professionals. The point here is not that broker-dealer services are innately harmful or that choosing a broker would always be a bad or inappropriate choice. The point is that investors who seek personalized investment advice that goes beyond mere sales recommendations – advice that is designed to serve their best interests – are likely to find it difficult, if not impossible, to distinguish those services from the “investment planning” services offered by broker-dealer sales representatives who call themselves “financial advisors” but operate under the less protective suitability standard.<sup>3</sup> The fact that surveys have found that most investors are happy with their financial professional does not sufficiently mitigate this concern for the simple reason that, as surveys also show, most investors lack the financial sophistication to determine whether the recommendations they receive are appropriate, let alone the best available option for them.

To analyze investor harm, however, the Commission must look beyond the difficulty investors have in shopping for investment advice. They must also examine the ways in which investors are

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<sup>2</sup> CFA detailed misleading aspects of the Commission’s presentation of the legislative history regarding the broker-dealer exclusion in a February 7, 2005 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan G. Katz. A copy of the letter is available [here](#).

<sup>3</sup> See IA Release No. 626 (May 4, 1978) (“[T]he Commission believes that the Advisers Act provides individuals with certain protections not available under the Exchange Act.”); see also SEC Staff, Study on Investment Advisers and BDs: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011) (“In practice, with broker-dealers, required disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship.”).

harmed when they rely on biased sales recommendations as if they were unbiased advice. This will require an examination of:

- the wide variation in products within particular investment categories that satisfy a suitability standard;
- how these differences, including differences in costs, risks, product features, and performance, offer very different level of benefits to investors;
- the financial incentives broker-dealers have to make recommendations that serve their own financial interests rather than the best interests of their customers; and
- evidence that these incentives, in a market in which products compete to be sold rather than bought, routinely result in recommendations of investment products that do not represent the best option for the investor.

It is unreasonable to expect that the analysis would be able to quantify the full extent to which investors are harmed by recommendations that fall short of the best interest standard they reasonably expect from a “financial advisor.” However, the analysis could and should offer representative examples. It could, for example, help to illustrate the long-term impact of investing in the lowest cost broker-sold mutual funds or variable annuities versus higher cost but still “suitable” alternatives. It could also examine the question of why broker-sold investment products often have higher underlying operational costs, even after the distribution costs are subtracted out, than direct marketed and adviser-sold alternatives.

Another question the Commission’s analysis should explore is what the market impact would be of requiring investment products to compete based on the best interests of the investor, rather than on the financial interests of the broker-dealer selling the product. In other words, if brokers had to have a reasonable basis for believing their recommendations were in the best interest of their clients, and if brokerage firms were responsible for offering a mix of products reasonably designed to enable their salespeople to fulfill their fiduciary obligations, how would that be likely to change the mix of investment products sold to retail investors? Again, we do not expect the Commission to be able to put a dollar amount on those potential benefits, but such a potentially significant change in market dynamics cannot be ignored.

There is a flip side to this. Some have argued that investors could be harmed if new regulations caused broker-dealers to stop offering advisory services to retail investors. This is the same claim that broker-dealers made when it was suggested that fee-based accounts be regulated as advisory accounts. It is worth remembering that, since the courts took that decision out of the Commission’s hands, the level of assets in fee-based accounts at broker-dealers has continued to grow. In light of that experience, the Commission must view similar predictions about the results of fiduciary rulemaking with a grain of salt. Moreover, it is essential to recognize that, in the unlikely event that the predictions proved true, what investors would be losing access to would not be investment advice, but product sales masquerading as advice. Ending misleading broker-dealer business practices should be viewed as a benefit of regulation, not as harm to investors. Finally, the Commission must recognize the evolving nature of the marketplace, which includes a number of new entrants that operate within the investment

adviser regulatory framework and market low-cost advisory services to middle- income clients. Thus, if some brokerage firms were to choose to stop serving this market rather than accept an obligation to act in the best interests of their customers, it does not automatically follow that investors would lose access to advice on affordable terms.

Some have similarly claimed that adopting a uniform fiduciary standard for personalized investment advice could harm investors by increasing their costs. In looking at the potential costs to investors of adopting a uniform fiduciary standard, the Commission must be willing to challenge certain common industry claims that lack a factual basis. It must ignore those, for example, that are based on the assumption that broker-dealers would not be permitted to charge commissions, since receiving commissions and other forms of transaction-based compensation is clearly permitted under both existing interpretations of the Advisers Act and under the legislative language in Section 913 of the Dodd-Frank Act. Similarly, we have recently read claims from the broker-dealer community that commission-based accounts virtually without exception offer a lower cost option for buy-and-hold investors. We question whether this is, in fact, reliably the case in common circumstances, such as where the investor holds a portfolio of mutual funds or where the investor is encouraged to purchase a variable annuity. The transaction costs in such circumstances could easily rival or significantly exceed the typical asset management fee, without covering the on-going account management provided by investment advisers but not by broker-dealers.<sup>4</sup> We expect the Commission to give careful scrutiny to such claims.

### **Assessing the Likely Effectiveness of Various Regulatory Approaches**

The Commission has a range of regulatory options for addressing this issue. The SEC's Investor Advisory Committee has recommended two possible approaches, for example. Others have suggested that disclosure alone would be sufficient to resolve concerns. Moreover, variations are possible within each of these approaches. Therefore, this analysis should not just be viewed simply as an analysis of the approach outlined in Section 913 of the Dodd-Frank Act. Rather, it should identify and analyze the broader range of possible approaches that have been suggested by various parties.

As the Commission assesses the economic impact of various possible regulatory approaches, it must look not just at the potential costs to industry but also to the potential of each approach to significantly reduce investor harm. This is true for regulatory approaches that stop short of imposing a uniform fiduciary standard, as well as for those that would apply a fiduciary standard to all personalized investment advice to retail customers. The relevant questions are: 1) would the proposed regulatory approach ensure that investors can make an informed choice when shopping for a financial professional or 2) if not, would it reduce the importance of that choice by ensuring that all those who provide personalized investment advice are subject to the same high fiduciary standard?

In keeping with this principle, any regulatory approach that relies primarily on improved disclosure must be assessed in light of past research that has shown that disclosure and investor education alone do not significantly improve the ability of investors to distinguish between the services offered by broker-dealers and those offered by investment advisers. This raises the question of whether

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<sup>4</sup> This argument is also counterintuitive because brokers working on commission only make money if a customer buys or sells something, which works at cross-purposes to a strategy focused on buying and holding the market. It would be naive to suggest brokers are not under pressure to generate revenue.

there are additional steps that would improve a disclosure-based approach's likely effectiveness. The most obvious example would be prohibiting brokers from calling their sales representatives financial advisors or using other titles designed to camouflage the true sales-based nature of the services they offer.

For regulatory approaches that seek to expand the fiduciary standard to cover personalized investment advice offered by brokers, the relevant question is whether the approach is reasonably likely to make a meaningful and beneficial change in the conduct of broker-dealers subject to the new standard. If the fiduciary standard is to be applied uniformly to broker-dealers and investment advisers, another essential question is whether the standard would maintain existing protections for investors who currently receive advice from investment advisers. This assessment should be applied not just to the question of whether a uniform fiduciary standard should be adopted, but also to the question of how that fiduciary standard should be applied. For example:

- Would a fiduciary duty that allows for sales from a limited menu of products truly produce best-interest recommendations? Or are there additional requirements that would need to apply at the firm level with regard to the menu of available investment options in order to achieve the desired result?
- How should principal trading be addressed?
- How would a fiduciary standard have to be designed to ensure that it did not allow for “hat switching?”
- What does the phrase “after the advice is rendered” mean in the context of an account where the investor reasonably expects to receive on-going account management?
- To the degree that issues such as these are addressed through disclosure, what evidence does the Commission have to support the conclusion that disclosures would be effective in reducing harm to investors from potential conflicts or limitations on the services they may receive?

Finally, we understand that the economic analysis is likely to look at a broader range of “harmonization” proposals related to personalized investment advice to retail investors. While our primary focus is on the standard of conduct issue, we would note that the Commission should follow a similar procedure with regard to the other proposals under consideration. It should clearly define the problem, in terms of investor harm, that the regulatory proposal is intended to address and weigh the likely effectiveness of various regulatory alternatives in addressing that harm.

## **Conclusion**

Appropriate economic analysis has the potential to promote more effective regulation. It will only achieve this goal, however, if it is based on a clear understanding of the problem regulation is intended to address, it accurately assesses the causes of that problem, and it fairly assesses the likely effectiveness of various possible regulatory approaches in addressing that problem. In the end, however, any assessment of the likely economic impact of rulemaking will be inherently subjective. In that case,

the Commission should look to basic principles to supplement what it learns from the economic analysis. Simply put:

- Professionals who are performing the same services should be subject to the same standards.
- Misleading practices should not be tolerated.
- Regulations that offer the pretense but not the reality of enhanced investor protection are worse than no regulation at all.

If, and only if, the Commission embraces these fundamental principles can it at long last develop a rational, pro-investor regulatory policy governing the provision of personalized investment advice to retail investors. We look forward to working with you to achieve that goal.

Respectfully submitted,

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